REVENUE ACT OF 1978

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 13511

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO REDUCE INCOME TAXES, AND FOR OTHER PURPOSES

AUGUST 17, 21, 22, 23, 24, 25, AND SEPTEMBER 6, 1978

PART 6 OF 6 PARTS

APPENDIXES AND COMMUNICATIONS

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APPENDIX A

Chart Referred to by Senator Long; Treasury Department Report on High Income Tax Returns, 1975 and 1976; Question Submitted by Senator Nelson in Writing and Answer by Department

Table G-1. TAX EXPENDITURE ESTIMATES BY FUNCTION[1]

(In millions of dollars)

Description	Corporations 1977	Corporations 1978	Corporations 1979	Individuals 1977	Individuals 1978	Individuals 1979
National defense:						
Exclusion of benefits and allowances to Armed Forces personnel	......	......	......	1,095	1,260	1,370
Exclusion of military disability pensions	......	......	......	105	115	120
International affairs:						
Exclusion of income earned abroad by U.S. citizens	......	......	......	545	360	385
Deferral of income of domestic international sales corporations (DISC)	945	1,135	1,335	......	......	......
Deferral of income of controlled foreign corporations	570	615	665	......	......	......
Special rate for Western Hemisphere trade corporations	35	25	15	......	......	......
General science, space, and technology:						
Expensing of research and development expenditures	1,395	1,450	1,520	30	30	30
Energy:						
Expensing of exploration and development costs	820	885	965	210	300	300
Excess of percentage over cost depletion	1,090	1,120	1,210	305	340	370
Capital gains treatment of royalties on coal	10	15	15	45	50	60
Natural resources and environment:						
Exclusion of interest on State and local government pollution control bonds	170	220	265	85	110	130
Exclusion of payments in aid of construction of water and sewage utilities	15	10	10	......	......	......
5-yr amortization on pollution control facilities	−80	−130	−45	......	......	......
Tax incentives for preservation of historic structures	......	......	5	......	......	5
Capital gains treatment of certain timber income	185	205	230	55	60	65
Capital gains treatment of iron ore	5	5	10	5	5	10
Agriculture:						
Expensing of certain capital outlays	80	70	75	375	445	460
Capital gains treatment of certain ordinary income	10	10	10	330	350	365
Deductibility of noncash patronage dividends and certain other items of cooperatives	455	490	525	−165	−175	−185
Commerce and housing credit:						
Dividend exclusion	......	......	......	450	475	505
Exclusion of interest on State and local industrial development bonds	195	235	270	95	115	135
Exemption of credit union income	70	80	90	......	......	......
Excess bad debt reserves of financial institutions	535	705	790	......	......	......
Deductibility of mortgage interest on owner-occupied homes	......	......	......	4,490	4,985	5,530
Deductibility of property tax on owner-occupied homes	......	......	......	4,205	4,665	5,180
Deductibility of interest on consumer credit	......	......	......	1,785	2,120	2,350
Expensing of construction period interest and taxes	475	500	525	150	140	90
Excess first-year depreciation	45	45	50	140	145	155
Depreciation on rental housing in excess of straightline	80	70	70	320	300	290

See footnote at end of table.

Table G-1. TAX EXPENDITURE ESTIMATES BY FUNCTION [1]—Continued

(In millions of dollars)

Description	Corporations			Individuals		
	1977	1978	1979	1977	1978	1979
Commerce and housing credit—Continued						
Depreciation on buildings (other than rental housing) in excess of straight line	160	140	130	140	125	115
Asset depreciation range	1,955	2,245	2,640	100	115	135
Capital gains (other than farming, timber, iron ore, and coal)	520	540	575	6,910	7,430	7,990
Deferral of capital gains on home sales	......	......	......	890	935	980
Capital gains at death	......	......	......	7,280	8,120	8,975
Corporate surtax exemption	3,875	3,885	3,540	......	......	......
Investment credit	8,880	10,735	12,320	2,075	2,390	2,725
Credit for purchase of new homes	......	......	......	100	......	......
Transportation:						
Deductibility of nonbusiness State gasoline taxes	......	......	......	685	760	840
5-yr amortization on railroad rolling stock	−35	−40	−40	......	......	......
Deferral of tax on shipping companies	130	105	85	......	......	......
Community and regional development: 5-yr amortization for housing rehabilitation	10	5	5	15	10	5
Education, training, employment, and social services:						
Exclusion of scholarship and fellowship income	......	......	......	245	295	330
Parental personal exemption for students age 19 or over	......	......	......	750	770	790
Exclusion of employee meals and lodging (other than military)	......	......	......	280	300	325
Exclusion of contributions to prepaid legal services plans	......	......	......	5	10	15
Investment credit for employee stock ownership plans (ESOPs)	245	255	305	......	......	......
Deductibility of charitable contributions (education)	235	255	285	525	585	645
Deductibility of charitable contributions to other than education and health	290	315	350	3,935	4,370	4,855
Maximum tax on personal service income	......	......	......	555	665	800
Credit for child and dependent care expenses	......	......	......	475	525	575
Credit for employment of AFDC recipients and public assistance recipients under work-incentive programs	15	15	20	......	......	......
Jobs credit	565	1,475	1,035	125	985	860
Health:						
Exclusion of employer contributions for medical insurance premiums and medical care	......	......	......	5,560	6,340	7,225
Deductibility of medical expenses	......	......	......	2,230	2,435	2,655
Expensing of removal of architectural and transportation barriers to the handicapped	5	10	10	......	......	......
Deductibility of charitable contributions (health)	145	160	175	790	875	970
Income security:						
Exclusion of social security benefits:						
Disability insurance benefits	......	......	......	470	550	605
OASI benefits for retired workers	......	......	......	3,790	4,210	4,700
Benefits for dependents and survivors	......	......	......	860	950	1,040
Exclusion of railroad retirement system benefits	......	......	......	250	265	280

See footnote at end of table.

Table G-1. TAX EXPENDITURE ESTIMATES BY FUNCTION [1]—Continued

(In millions of dollars)

Description	Corporations 1977	Corporations 1978	Corporations 1979	Individuals 1977	Individuals 1978	Individuals 1979
Income security—Continued						
Exclusion of workmen's compensation benefits	......	......	......	720	835	970
Exclusion of special benefits for disabled coal miners	......	......	......	50	50	50
Exclusion of unemployment insurance benefits	......	......	......	1,500	1,200	1,135
Exclusion of public assistance benefits	......	......	......	330	345	360
Exclusion of sick pay	......	......	......	110	75	60
Net exclusion of pension contributions and earnings:						
Employer plans	......	......	......	8,715	9,940	11,335
Plans for self-employed and others	......	......	......	1,390	1,650	1,920
Exclusion of other employee benefits:						
Premiums on group term life insurance	......	......	......	860	905	955
Premiums on accident and disability insurance	......	......	......	70	75	80
Income of trusts to finance supplementary unemployment benefits	......	......	......	10	10	10
Exclusion of interest on life insurance savings	......	......	......	1,850	2,075	2,225
Exclusion of capital gains on home sales for persons age 65 and over	......	......	......	40	70	70
Additional exemption for elderly	......	......	......	1,140	1,155	1,215
Additional exemption for the blind	......	......	......	20	20	20
Excess of percentage standard deduction over minimum standard deduction	......	......	......	530	......	......
Deductibility of casualty losses	......	......	......	320	360	395
Tax credit for the elderly	......	......	......	230	250	255
Earned income credit:						
Nonrefundable portion	......	......	......	365	285	265
Refundable portion	......	......	......	900	945	900
Veterans benefits and services:						
Exclusion of veterans disability compensation	......	......	......	745	840	830
Exclusion of veterans pensions	......	......	......	35	40	40
Exclusion of GI bill benefits	......	......	......	260	200	170
General government: Credits and deductions for political contributions	......	......	......	85	60	75
General purpose fiscal assistance:						
Exclusion of interest on general purpose State and local debt	3,105	3,470	3,865	1,725	1,925	2,150
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline)	......	......	......	7,660	8,505	9,440
Tax credit for corporations doing business in U.S. possessions	450	485	520	......	......	......
Interest: Deferral of interest on savings bonds	......	......	......	585	625	670
MEMORANDUM						
Combined effect of provisions disaggregated above:						
Capital gains	730	775	840	15,555	17,020	18,515
Exclusion of interest on State and local debt	3,470	3,925	4,400	1,905	2,150	2,415
Deductibility of State and local nonbusiness taxes	......	......	......	11,105	12,325	13,680
Deductibility of charitable contributions	670	730	810	5,250	5,830	6,470

[1] All estimates are based on the tax code as of Dec. 31, 1977.

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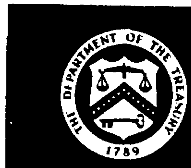

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August 17, 1978

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202/566-2356

TREASURY PUBLISHES 2ND ANNUAL REPORT
ON HIGH INCOME TAX RETURNS

The Treasury Department today made available the second annual report on high income taxpayers. The report, "High Income Tax Returns - 1975 and 1976," was prepared as required by Section 2123 of the Tax Reform Act of 1976.

The report contains the first data reflecting the changes made by the Tax Reform Act of 1976. For high income individuals, a major change was the strengthening of the minimum tax including an increase in the rate from 10 to 15 percent and the provision of new tax preference items for intangible drilling expenses and for itemized deductions (other than casualty losses and medical expenses) exceeding 60 percent of adjusted gross income (AGI).

The report highlights the fact that the Tax Reform Act of 1976 was "extraordinarily successful" in reducing the number of high-income nontaxable income tax returns. The number of nontaxable high-AGI returns fell from 260 in 1975 to 22 in 1976, a decline of 92 percent. In proportion, the nontaxables fell from 1 out of 130 high-income returns in 1975 to about 1 out of every 2,000 returns in 1976.

As measured by the more comprehensive expanded income, the decrease was similar although less dramatic. The number of nontaxable high expanded income returns fell by 75 percent, from 215 in 1975 to 53 in 1976. By either measure, there were far fewer high income nontaxable returns than in any year since data first became available in 1966.

In testimony today before the Senate Finance Committee, Secretary of the Treasury W. Michael Blumenthal urged passage of tax legislation that would "avoid a serious setback to important minimum tax reform efforts." He asked adoption of a "true alternative tax" approach that would provide a "much more reasonable minimum tax liability" for individuals with tax sheltered capital gains.

The report also highlights the fact that despite the sharp decline in the number of high income nontaxable returns there is still a significant number of high income taxpayers who, while paying some tax, fail to pay a fair share of the tax burden. For every nontaxable high-income return, there are about 10 or more nearly nontaxable returns where income has been reduced by more than 80 percent by use of preferences, deductions, and tax credits. The nontaxables, and these so-called nearly nontaxables, whose effective tax rates are lower than those of a typical middle or lower-middle income family, totaled nearly 500 in 1976. This is about twice the number of high-income nontaxables there were in the late 1960's, whose existence prompted the Treasury Department to focus on this problem and the Congress to enact the minimum tax.

The report finds that while the Tax Reform Act of 1976 reduced the number of nontaxables and nearly nontaxables and raised the average effective tax rate modestly for the remaining nearly nontaxables, it did not significantly change the average effective tax rate for other individuals with incomes of $200,000 or more. In fact, the tax rate on all high expanded income returns other than nontaxables and nearly nontaxables actually declined from 36 percent in 1975 to 35 percent in 1976.

Even the expanded income measure, which is broader than AGI, does not include income from some sources which are very valuable to high-income taxpayers. Thus, expanded income understates economic income because taxpayers are allowed deductions for real estate and agriculture expenses in excess of economic costs and because income such as interest on tax-exempt state and local bonds is omitted. This understatement of economic income results in some high-income individuals being omitted from the report. The actual number of individuals omitted, however, is not known. In addition, the understatement of income makes the effective tax rate for all high income returns appear higher than it actually is.

Presented in the report are data for all individuals with AGI of $200,000 or more, as well as similar data based on three other income measures specified in the 1976 Act. These include the broader-based "expanded income" (AGI plus preferences less investment interest), "AGI plus preferences," and "AGI less investment interest." In 1976, there were 53,587 high income taxpayers, as measured by expanded income. They paid an average tax of $144,942 or 35.0 percent of expanded income. Similarly, the 41,761 returns with AGI of $200,000 or more had an average tax of $167,656, or 44.5 percent of AGI.

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The 122 page report includes 57 statistical tables and 2 charts, which contain virtually all of the basic data about high income returns currently available for 1975 and 1976 tax returns.

Copies of the report are available from the Office of Tax Analysis, U. S. Department of the Treasury, Washington, D. C. 20020. Copies also are available from the Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402.

High Income Tax Returns

1975 and 1976

A Report
Emphasizing Nontaxable
and Nearly Nontaxable
Income Tax Returns

Office of Tax Analysis
U.S. Treasury Department
August, 1978

For sale by the Superintendent of Documents, U.S. Government Printing Office
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HIGH INCOME TAX RETURNS: 1975 and 1976

A Report on High-Income Taxpayers Emphasizing Nontaxable and Nearly Nontaxable Income Tax Returns

Chapter 1

Introduction

This is the second in an annual series of reports on high-income tax returns prepared by the Treasury Department in compliance with the Tax Reform Act of 1976. Section 2123 of the Act requires the annual publication of a report containing data on taxpayers with incomes of $200,000 or more (for income defined in four different ways), including the number of such taxpayers who do not pay any taxes and the importance of various tax provisions in making individuals nontaxable.

The Congressional mandate for a report on high-income taxpayers reflects interest on the part of the Congress in the perennial questions concerning the appropriate level of individual income taxes for individuals and the actual level of taxes that are paid. Thus, the Congressional mandate for information has been interpreted broadly. This report contains data on nontaxable income tax returns, but also it contains data for all high-income returns and for a group of taxpayers called "nearly nontaxables." The nearly nontaxables are those who have so-far escaped the public eye by paying a small amount of income tax, but the amount of tax that nearly nontaxables pay is so small that there can be no

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This report was prepared by Allen H. Lerman, Financial Economist, Office of Tax Analysis, under the general direction of Harvey Galper, Associate Director, Office of Tax Analysis.

doubt that they are not carrying a "fair share" of the tax burden. Similarly, while Congress specifically requested information on returns with incomes of at least $200,000, this report has historical data on other high-income classes.

This report contains data on individual income tax returns for 1975 and 1976. The data on which the report is based have been edited from a sample of tax returns as they were filed, and the sample has been weighted and tabulated so as to accurately represent all returns for the particular year. The data source is the Internal Revenue Service's Statistics of Income, Individual Income Tax data file. For the high-income returns that are the subject of this report, the sampling rate is very high (for some groups all returns filed are actually in the sample) so that the tabulations produced are very accurate.

This report contains the first data reflecting the impact of the Tax Reform Act of 1976. Some of the reforms in this Act were designed specifically to eliminate high-income nontaxables. The effect has been dramatic. Regardless of the income definition used, or the particular level of income considered, the number of nontaxable returns fell by well over 50 percent between 1975 and 1976. The tabulations in Tables 1 through 4 in Chapter 4 show that both the actual number of nontaxable returns and their share of all high income returns declined by one-half to three-fourths. The additional analysis in Chapter 6 undertaken to correct shortcomings in the data indicates an even larger decline. For returns with adjusted gross income (AGI) of $200,000 or more, there were only 22 nontaxables in 1976 as compared with 215 in 1975, a decline of 92 percent. For expanded income, the decrease was from 215 nontaxables to 53, a decline of 75 percent.

For individual taxpayers, the most important changes made by the Tax Reform Act of 1976, were the strengthening of the minimum tax on preference income and the new limitations on tax shelters. Four minimum tax changes were effective in 1976. First, the amount of preference income excluded from the minimum tax was reduced from $30,000 plus all of ordinary income tax liabilities to the larger of $10,000 or one-half of ordinary tax liabilities. 1/ Second, the minimum tax rate

1/ The $30,000 and $10,000 exclusions are halved for separate tax returns of married persons.

was increased from 10 percent of preferences in excess of the exclusion to 15 percent. Third, a new preference item specifically intended to eliminate high-income, nontaxable returns was created. Beginning in 1976, itemized deductions (other than casualty losses and medical expenses) are a preference item to the extent that they exceed 60 percent of AGI. Thus, any return on which itemized deductions (other than medical expenses and casualty losses) exceed 60 percent of AGI by at least $10,000 is subject to the minimum tax and, therefore, cannot be nontaxable. 2/ Fourth, intangible drilling costs on productive wells in excess of the amount deductible if the expense had been amortized became a preference item.

After summarizing the major conclusions that can be drawn from high-income tax return data for 1975 and 1976, this report explores the importance of the concept used to measure income and examines the overall significance of high-income returns. Data for all high-income returns are presented, together with separate data for nontaxable returns and for nearly nontaxable returns. The report examines whether nontaxable, high-income individuals are a unique phenomenon or whether they are merely extreme cases of high-income people who are avoiding their fair share of the tax burden. The report analyzes the methods by which high-income individuals may still severely minimize or completely eliminate Federal income taxes.

This report also provides a large selection of raw data from high-income tax returns for use by investigators outside government. At the end of this report, there are three statistical appendices. Two of the appendices contain statistical tables with data for 1976 and 1975 which together with tables in the body of the report contain virtually all of the data about high-income returns that are currently available for 1975 and 1976 returns. The third appendix contains data for 1974 high-income tax returns that have been reclassified to be consistent with 1975 and 1976 data. These appendices should be useful in the examination of many additional questions about high-income taxpayers. Except for some of the tables in Chapter 6, all of the data in the tables are from the tax returns as originally filed by taxpayers. Any changes which have been made or are likely to be made as a result of Internal Revenue Service audits are not reflected in the tables.

2/ $5,000 on separate tax returns of married persons.

Chapter 2

Highlights

1. The Tax Reform Act of 1976 was extraordinarily successful in reducing the number of high-income nontaxable income tax returns. For tax returns showing adjusted gross income (AGI) of $200,000 or more, the number of nontaxables fell to only 22 in 1976 from 260 in 1975, a decline of 92 percent. The proportion of nontaxables fell from 1 out of 130 high-income returns in 1975 to about 1 out of every 2,000 returns in 1976. As measured by the more comprehensive definition of expanded income, the decrease was similar, although not quite so dramatic. The number of nontaxable returns fell by 75 percent, from 215 in 1975 to 53 in 1976. This is far fewer than in any year since data became available in 1966.

2. The number of high-income nontaxable returns is not a good measure of the number of high-income individuals who avoid paying a fair share of the tax burden. For every nontaxable, high-income return there are a significant number of other returns -- called nearly nontaxables -- which do have some liability, but whose effective tax rates are lower than that of a typical middle- or lower-middle income family. As defined by either economic income or AGI, there were almost 500 nontaxable and nearly nontaxable high-income tax returns in 1976. This number is about twice as large as the number of high-income nontaxables in the late 1960's whose existence prompted the Congress to enact the minimum tax.

3. Even the expanded income measure, which is broader than AGI, does not include income from some sources which are very important for high-income individuals. Expanded income understates economic income because taxpayers are allowed deductions for real estate and agriculture expenses in excess of economic costs and because income such as interest on tax-exempt state and local bonds is omitted. The understatement of income causes some individuals with high economic incomes to be omitted from this report. The number of

such individuals, however, is not known. The understatement of income also makes the effective tax rate (taxes as a percentage of income) for all high-income returns appear higher than it actually is.

4. Despite the extraordinary publicity given to high-income, nontaxable returns, most taxpayers with income of $200,000 or over (however that income is defined) pay substantial Federal income taxes. As measured by expanded income, the income measure which most closely approximates economic income, the average effective tax rate was 30 percent in 1975 and 35 percent in 1976. Over two-thirds of high-income taxpayers paid Federal income taxes in excess of 30 percent of their expanded income, and over 85 percent paid 20 percent or more. In contrast, 2 to 3 percent of all high-income returns had an effective tax rate of less than 10 percent.

5. Despite important conceptual differences between the four income concepts (expanded income, adjusted gross income, adjusted gross income plus preferences, and adjusted gross income less investment interest), use of any of the concepts leads to essentially the same conclusions about high-income nontaxables and nearly nontaxables. This is so because one-half to two-thirds of the same individuals are in all of the high-income nontaxable groups.

6. Nontaxables and nearly nontaxables as measured by AGI do differ in one systematic way: nontaxable returns have very little tax preference income. This is the result of the minimum tax itself. If nontaxable returns had larger amounts of preference income, they would become subject to the minimum tax, and, therefore, could no longer be nontaxable.

7. By and large, returns are not made nontaxable by a single preference, deduction, or credit. However, nontaxability is often produced by one unusually large item in combination with a number of other substantial but not unusual items. Large foreign tax credits and large casualty losses produced most of the nontaxable high AGI returns in 1976. For the high expanded income returns, the most important causes of nontaxability were tax preference income excluded from the tax base (mainly the capital gains exclusion),

charitable contributions, casualty losses, miscellaneous deductions, investment interest expenses in excess of investment income, and the foreign tax credit. Even under present law, the foreign tax credit and the deductions for casualty loses and medical expenses are likely to produce a handful of nontaxables each year.

8. Available data are not sufficient to determine whether many high-income individuals are nontaxable for only a single year which is preceeded and followed by years when substantial amounts of taxes are paid, or whether some taxpayers pay little, if any, tax year after year.

9. The detailed analysis of high AGI nontaxables in 1976 indicates that when there is a large foreign tax credit, the credit is usually for a true income-type tax paid to a foreign government. Furthermore, in terms of income as measured in the United States, these individuals paid taxes to foreign governments at very high effective tax rates, typically in excess of 50 percent. Furthermore, in most of these instances, the taxpayers were in fact living abroad and deriving their incomes from abroad.

10. Although the Tax Reform Act of 1976 reduced the number of nontaxables and nearly nontaxables and raised the average effective tax rate modestly for the remaining nearly nontaxables, it did not significantly change the average effective tax rate for other individuals with incomes of $200,000 or more. In fact, the tax rate on all high expanded income returns other than nontaxables and nearly nontaxables actually declined from 36 percent in 1975 to 35 percent in 1976.

Chapter 3

The Measurement of Income

This chapter first discusses an ideal broad-based measure of income and then outlines the adjustments necessary to obtain a broad income measure solely from data available from tax returns.

Economic Income, the Ideal Measure

Since this report is concerned with the impact of the tax system on high-income individuals, the analysis requires the accurate measurement of income. Economists generally agree that for analyzing the impact of taxes the ideal measure of income over a particular period of time, say a year, is the amount that the individual or family has consumed over that period plus the change in its net worth. For example, if a family has spent $10,000 and has saved $2,000 during the year, economists would say that the family had had an income of $12,000. Similarly, if the family has spent $10,000 but owned an asset that has decreased in value by $1,000, economists would say that the family had had an income of only $9,000 during the year.

A brief examination of the differences between income as defined by economists, so-called economic income, and adjusted gross income (AGI), the concept currently used for income tax purposes, illustrates some of the problems of measuring income, especially for high-income individuals.

Adjusted Gross Income

Tax experts have long been aware that adjusted gross income is deficient as a measure of a taxpayer's economic income. AGI excludes some income such as interest from tax-exempt state and local bonds, social security benefits, the excluded portion of realized long-term capital gains (and all accrued but unrealized capital gains), and imputed rent on owner-occupied housing. Income from certain activities, while not "strictly" excluded from AGI, is deferred to a later year (or indefinitely) for income tax purposes. Depreciation deductions in excess of economic deductions

reduce AGI early in the life of an asset, but the resulting lower depreciation deductions in later years raises AGI. The net effect of accelerating depreciation deductions is to postpone taxes. 1/

Despite the fact that some types of income are excluded, AGI may overstate economic income because some expenses incurred in the production of income are not deductible in the computation of AGI; most of these are deductible from AGI in calculating taxable income, but only if the taxpayer itemizes his personal deductions. 2/ Two types of deductions which fall into this category are employee expenses and expenses attributable to a taxpayer's investments (as opposed to his active operation of a trade or business), including but not limited to investment interest. 3/ Although net

1/ The Internal Revenue Code defines AGI as all gross income that is not specifically excluded from gross income. Among these exclusions are (1) trade or business deductions (other than most such deductions by employees), (2) the deduction for one-half of net long-term capital gains, (3) limited deductions for losses from the sale or exchange of property, (4) deductions attributable to rents and royalties, (5) the moving expense adjustment, and (6) deductions for contributions to individual retirement accounts and H.R. 10 plans.

Gross income only includes income which has been "realized." Thus, for tax purposes, accrued increases or decreases in the value of assets generally are not recognized until a gain or loss is realized by a sale or exchange. Similarly, gross income does not include the value of the services received from the use of durable goods, such as imputed net rent of owner-occupied housing. Finally, interest on state and local government debt and social security benefits are not included in AGI.

2/ Taxes are related to but not calculated from AGI. Taxes are determined by taxable income which equals AGI minus itemized deductions (or, if the taxpayer so elects, the standard deduction) and the deduction for personal exemptions.

3/ For the years covered by this report, alimony payments were also treated as an itemized deduction even though alimony income was includable in the AGI of the recipient. Beginning in 1977, alimony is deducted from gross income in computing AGI.

realized capital losses reduce economic income, only the first $1,000 may be deducted in the computation of AGI; any excess must be carried forward to future years. 4/

Redefining Income

Ideally, the impact of all taxes should be measured relative to economic income. However, no accurate, detailed data on such a broadly defined income measure are available for a cross-section of American taxpayers. As a practical matter, any broad income measure must be determined from data already contained on Federal individual income tax returns. Thus, a more comprehensive income measure must start from AGI and make adjustments for omitted income and for expenses which ought to be deductible in calculating income.

Omitted Income

Tax returns contain information about only a portion of the income which is included in economic income but excluded from AGI. The omitted income which can be identified on tax returns consists of the dividend exclusion of up to $100 per taxpayer and the income from sources which were considered to be tax preferences for purposes of the minimum tax. It should be noted that unless such preferences exceeded $30,000 for a 1975 return or $10,000 for a 1976 return, 5/ the total amount of such preferences was not recorded, and the excluded half of net long-term capital gains is the only preference item available. The omission is not serious since preference items other than the excluded portion of net long-term capital gains represents less than 20 percent of all minimum tax preference income. 6/

4/ The $1,000 limit for the deduction of net capital losses applies to years before 1977. For 1977, the limit was $2,000, and beginning in 1978, the limit is $3,000. In all years, the limit for married persons filing separately is half of the amounts indicated.

5/ Half these amounts on returns of married persons filing separately.

6/ The 1976 minimum tax preference item of itemized deductions (other than medical expenses and casualty) in excess of 60 percent of AGI does not represent omitted income; hence, it has not been used to adjust AGI.

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Despite the inclusion of preference income which is not in AGI but which is identifiable on tax returns, several major sources of income for high-income taxpayers are still omitted: 7/

-- interest on tax-exempt state and local bonds;

-- certain agricultural expenses which are deducted when paid even though related income items are not includable in income for taxpayers until a later year; and

-- straight-line depreciation deductions on real estate to the extent that they exceed economic depreciation.

For real estate, the combination of a shorter life for tax purposes than the true economic life of the property and the straight-line depreciation method produce tax depreciation deductions which exceed economic depreciation in the early years of ownership. At some future time, income may be correspondingly higher, but in the meantime the taxpayer has had the interest-free use of the deferred taxes. Also, in the later year, the income may be converted into a long-term capital gain which is taxed at a lower rate.

Because sources of income that are not identifiable from tax return data are excluded, all income measures used in this report understate economic income. As a consequence, some individuals with high economic income will be omitted completely from the high-income group in this report. Moreover, even for the individuals included, income will be understated and taxes as a percentage of income (that is, the effective tax rate) will be overstated.

Investment Expenses

In determining economic income, it would be appropriate to deduct all expenses incurred in the production of income, including those related to any income-producing investments. Since economic income would include investment income

7/ Social security benefits and unemployment compensation are also excluded. In the aggregate, this is a major omission, but it is relatively unimportant for high-income taxpayers.

currently and completely, it would be proper to deduct all investment expenses without limit. Investment expenses in excess of income would then represent a net economic loss, roughly akin to a net operating loss from a trade or business. However, such a liberal deduction for investment-related expenses is not necessarily correct when a less comprehensive income definition is used. In such a case, a full deduction for investment expenses might well represent a mismatching of receipts and expenses with the result that net income would be understated. For example, if a taxpayer borrowed funds to purchase securities, his net income would be understated if he deducted all of the interest paid on the loan but he did not include as income any accrued gains on the securities. In this instance, it might be appropriate to postpone the deduction of the interest expense until the time when the capital gains were realized. A similar mismatching could occur if other investment expenses that should properly be capitalized are deducted when they are paid.

The fungibility of money creates additional problems. If a person with a loan has both income-producing assets, such as securities, and non-income producing assets, such as a vacation home or yacht, it is not possible to determine what portion, if any, of the interest expense is attributable to the income-producing assets and, therefore, ought to be deducted in measuring income.

As a result of these problems as well as the limited data which are available on Federal income tax returns, it has been necessary to define arbitrary limits for the amount of investment expenses which may be deducted in calculating a broader measure of income.

Investment expenses appear on a Federal income tax return in two places. Investment interest appears as part of the itemized deduction for interest; other investment expenses such as payments for investment advice are included in the miscellaneous category of itemized deductions. For this report, investment interest is defined as the entire interest deduction other than interest paid on a home mortgage. Since other investment expenses could not be separated from the remainder of miscellaneous deductions, this report defines non-mortgage interest as the only investment expense. This procedure tends to overstate income.

To the extent that interest expenses do not exceed investment income, they are considered to be a legitimate deduction in the computation of broadly measured income. One consequence of this definition is that investment expenses can never turn a profitable investment into a losing investment. It is logical to limit the investment expense deduction in this way. A person would not normally make an investment where the expenses are expected to approach or exceed investment income. Thus, allowing investment expenses to offset all of investment income is overly generous and tends to understate broadly measured income. On the other hand, there may be cases of genuine investment losses, akin to trade or business losses, which are not allowed, thereby causing overstatements of income.

The amount of investment income against which investment interest can be offset depends on the amount of investment income included in the income measure under consideration. Investment income consists of interest, dividends, and net capital gains (or losses). However, if only a portion of capital gains are included in the income concept, as is the case with AGI, then only that portion is considered to be investment income.

Expanded Income

The Congress has asked for high-income data to be tabulated on the basis of a measure closely approximating economic income but using only data available on tax returns. This measure is called "expanded income."

Expanded income is defined as adjusted gross income plus items of tax preference less investment expenses to the extent that they do not exceed investment income. 8/ Tax preferences that are included are the $100 per taxpayer exclusion for dividends of domestic corporations, the excluded half of net long-term capital gains, and, where the

8/ For the sake of brevity, "investment interest to the extent that it does not exceed investment" income is called "investment interest." "Investment interest in excess of investment income" is called "excess investment interest."

taxpayer has filed a minimum tax form with his tax return, all other preferences subject to the minimum tax except excess itemized deductions. For individuals, the only minimum tax items of significance other than excluded capital gains are the excess of accelerated depreciation over straight-line depreciation on real property and on personal property subject to a net lease, the excess of percentage depletion over the cost of the property, and deductions for intangible drilling costs in excess of the amount deductible if these costs had been amortized. Because expanded income is based on tax return data, it excludes items such as interest on tax-exempt state and local bonds, accrued but unrealized capital gains, and straight-line depreciation on real estate in excess of economic depreciation.

Four Income Measures

The Congress has mandated that high-income tax return data be selected and classified by four income measures. Expanded income and AGI have already been discussed. Each of the additional measures embodies only one of the two major conceptual differences between expanded income and AGI. "Adjusted gross income plus preferences" is calculated by increasing AGI by the amount of tax preference income. "Adjusted gross income less investment interest" is calculated by reducing AGI by the amount of investment interest to the extent that it does not exceed investment income.

When ranked according to size of income, AGI plus preferences is largest, AGI less investment interest is smallest, and AGI and expanded income fall in between. For any individual taxpayer, AGI can be larger or smaller than expanded income depending on whether preferences are larger or smaller than investment interest.

The four income concepts are related in the following manner 9/ :

Expanded Income

= Adjusted Gross Income + Preferences - Investment Interest

Adjusted Gross Income

= Expanded Income - Preferences + Investment Interest

Adjusted Gross Income plus Preferences

= Adjusted Gross Income + Preferences
or = Expanded Income + Investment Interest

Adjusted Gross Income minus Investment Interest

= Adjusted Gross Income - Investment Interest
or = Expanded Income - Preferences

Expanded income most closely approximates a measure of economic income. To the extent that the availablity of data permit, the analyses in this report are based on expanded income.

9/ Note that the investment income limitation for defining excess and non-excess investment interest is dependent upon the income concept. Hence, the amount of the investment interest adjustment differs depending on which definition is used.

Chapter 4

High-Income Tax Returns

Compared to the total number of Federal individual income tax returns filed each year, the number of high-income tax returns is rather small. There were only 41,761 income tax returns with adjusted gross income (AGI) of $200,000 or over in 1976; these returns represented only one-twentieth of one percent (0.05 percent) of the total of 84,700,000 income tax returns filed. Similarly, the number of tax returns with expanded income of $200,000 or over was 53,587, or 0.06 percent of all returns filed. In recent years due to both inflation and to rising levels of real income, the number of high-income tax returns has increased dramatically in both absolute numbers and as a percentage of all tax returns filed. For example, in 1970 there were 15,223 income tax returns with AGI of $200,000 or over, representing 0.02 percent of all tax returns filed in that year. In 1960, there were only 5,889 such returns, less than 0.01 percent of all returns. Thus, in 16 years, the number of high AGI returns increased seven-fold, and their share of all returns increased more than five-fold. 1/

Although high expanded income returns are only 0.06 percent of all returns filed, they contain 2.1 percent of all expanded income and pay 5.5 percent of all individual income tax liabilities. Similarly, although taxpayers with adjusted gross income of $200,000 or more represent only 0.05 percent of all returns, they have 1.5 percent of AGI and pay 4.9 percent of taxes.

Out of this relatively small percentage of all returns filed in a given year, the number of these returns that are nontaxable is far smaller. For each year between 1966 and 1976, Table 1 shows the number of nontaxable returns with adjusted gross income of $200,000 or more; it also shows the

1/ Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1960 and 1970.

Table 1

Number and Percentage of Nontaxable Income Tax Returns
With Income of $200,000 or Over Under Alternative Concepts

Year	Returns Selected By							
	Expanded Income		Adjusted Gross Income		Adjusted Gross Income plus Preferences		Adjusted Gross Income less Investment Interest	
	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class
1966			154	1.26 %				
1967			167	1.07				
1968			222	1.15				
1969			300	1.62				
1970			111	0.73				
1971			82	0.45				
1972			108	0.47				
1973 1/	91	0.26 %	164	0.64				
1974 2/	167	0.39	244	0.78	355	0.78 %	89	0.27 %
1975 3/	215	0.53	260	0.77	362	0.84	126	0.40
1976 4/	89	0.17	68	0.16	114	0.20	42	0.11
1976 retabulated 5/	53	0.10	22	0.05	41	0.07	21	0.05

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Source: Statistics of Income, except as noted.

1/ Expanded income number and percentage are from the 1973 Treasury tax model.

2/ For income concepts other than AGI, data are from the 1974 Internal Revenue Service tax model.

3/ Numbers of nontaxable returns for 1975 are from the 1975 Statistics of Income. Some numbers differ slightly from the 1975 data in the remainder of this report which are derived from the 1975 Internal Revenue Service tax model which is a subsample of the 1975 Statistics of Income data file.

4/ From the 1976 Statistics of Income. These data are derived from the final Statistics of Income data file and differ both from the information contained in the previously released 1976 preliminary Statistics of Income and from the retabulated numbers of nontaxable returns in Chapter 6.

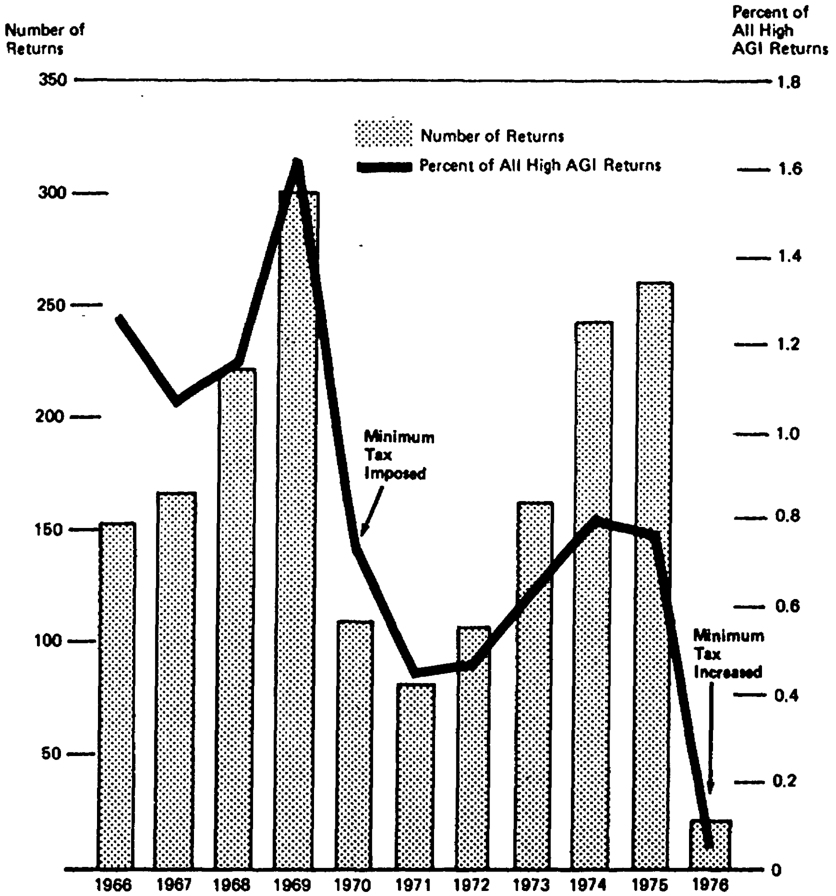
5/ See Chapter 6 for an explanation of reason for retabulation.

Chart 1

NUMBER AND PERCENTAGE OF NONTAXABLE HIGH ADJUSTED GROSS INCOME RETURNS

1966 - 1976

(Adjusted Gross Incomes of $200,000 and over)



number of nontaxable returns as a percentage of all returns in the income class. Similar data for years prior to 1966 are not available. For the years 1973 through 1976, Table 1 also presents the number of nontaxable returns as defined by expanded income, by adjusted gross income plus preferences, and by adjusted gross income less investment interest. Prior to 1973 these data were not available regularly and consistently. 2/

Chart 1 displays for each year between 1966 and 1976 the number of nontaxable high AGI returns and the percentage of all high AGI returns that are nontaxable. The percentage of high-income, nontaxable returns has increased over time except when the tax law has been tightened. The reason for this upward trend is not clear; however, it is possible that it represents a learning curve. That is, over time, taxpayers learn how to arrange their tax affairs so that within the constraints imposed by the Internal Revenue Code they minimize (or eliminate) their income taxes. Chart 1 also illustrates the sharp declines in nontaxables in 1970 as a result of the imposition of the minimum tax and again in 1976 as a result of the substantial strengthening of the minimum tax. 3/

Because of both inflation and rising real incomes, notions of what represents a truly high level of income have changed over the years. For this reason, as well as to give some idea of the differences which the income cutoff point makes, Tables 2, 3, and 4 show data similar to that contained

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2/ The data for 1974, 1975 and 1976 are from the Internal Revenue Service, either from the complete Statistics of Income individual file of income tax returns or from a subsample of that file called the Internal Revenue Service tax model. The data for 1973 were developed by the Office of Tax Analysis from the 1973 Treasury tax model.

3/ The data show a sharp decline in 1970 in nontaxables, both absolutely and as a fraction of all high AGI taxpayers and then a further decline in 1971. It is likely that the full decline actually took place in 1970 but because of poor compliance with the minimum tax in its first year, the decline was not fully reflected in data from unaudited tax returns.

Table 2

Number and Percentage of Nontaxable Income Tax Returns With Income of $100,000 or Over Under Alternative Concepts

Year	Returns Selected By: Expanded Income		Adjusted Gross Income		Adjusted Gross Income plus Preferences		Adjusted Gross Income less Investment Interest	
	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class
1964			355	0.97 %				
1965			285	0.62				
1966			367	0.69				
1967			399	0.60				
1968			538	0.65				
1969			745	0.91				
1970			400	0.51				
1971			300	0.33				
1972			425	0.37				
1973 1/	739	0.46 %	622	0.46				
1974 2/	1,143	0.59	966	0.58	1,867	0.90 %	480	0.29 %
1975 3/	901	0.44	994	0.53	1,785	0.82	533	0.30
1976 4/	622	0.24	560	0.25	814	0.30	477	0.22

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Source: Statistics of Income, except as noted.

1/ Expanded income number and percentage are from the 1973 Treasury tax model.
2/ For income concepts other than AGI, data are from the 1974 Internal Revenue Service tax model.
3/ Numbers of nontaxable returns for 1975 are from the 1975 Statistics of Income. Some numbers differ slightly from the 1975 data in the remainder of this report which are derived from the 1975 Internal Revenue Service tax model which is a subsample of the 1975 Statistics of Income data file.
4/ From the 1976 Statistics of Income. These data are derived from the final Statistics of Income data file and differ from the information contained in the previously released 1976 Statistics of Income.

Table 3

Number and Percentage of Nontaxable Income Tax Returns
With Income of $500,000 or Over Under Alternative Concepts

Year	Returns Selected By							
	Expanded Income		Adjusted Gross Income		Adjusted Gross Income plus Preferences		Adjusted Gross Income less Investment Interest	
	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class	Number of Returns	Percent of all Returns In Income Class
1964			35	2.25 %				
1965			35	1.71				
1966			51	2.30				
1967			63	2.15				
1968			82	2.18				
1969			112	3.01				
1970			21	0.88				
1971			15	0.49				
1972			20	0.54				
1973			22	0.62				
1974 1/	30	0.47 %	48	1.12	68	1.00 %	16	0.41 %
1975 2/	39	0.61	56	1.27	71	1.04	27	0.67
1976 3/	16	0.19	8	0.15	20	0.22	5	0.10
1976 retabulated 4/			3	0.06				

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Source: Statistics of Income, except as noted.

1/ For income concepts other than AGI, data are from the 1974 Internal Revenue Service tax model.
2/ Numbers of nontaxable returns for 1975 are from the 1975 Statistics of Income. Some numbers differ slightly from the 1975 data in the remainder of this report which are derived from the 1975 Internal Revenue Service tax model which is a subsample of the 1975 Statistics of Income data file.
3/ From the 1976 Statistics of Income. These data are derived from the final Statistics of Income data file and differ both from the information contained in the previously released 1976 preliminary Statistics of Income and from the retabulated numbers of nontaxable returns in Chapter 6.
4/ See Chapter 6 for an explanation of reason for retabulation.

Table 4

Number and Percentage of Nontaxable Income Tax Returns
With Income of $1,000,000 or Over Under Alternative Concepts

Year	Returns Selected By: Expanded Income: Number of Returns	Expanded Income: Percent of all Returns In Income Class	Adjusted Gross Income: Number of Returns	Adjusted Gross Income: Percent of all Returns In Income Class	Adjusted Gross Income plus Preferences: Number of Returns	Adjusted Gross Income plus Preferences: Percent of all Returns In Income Class	Adjusted Gross Income less Investment Interest: Number of Returns	Adjusted Gross Income less Investment Interest: Percent of all Returns In Income Class
1964			19	3.94 %				
1965			22	3.40				
1966			18	2.80				
1967			23	2.75				
1968			31	2.76				
1969			52	4.29				
1970			3	0.47				
1971			3	0.34				
1972			6	0.58				
1973			7	0.78				
1974 1/	3	0.17 %	12	1.09	13	0.70 %	2	0.20 %
1975 2/	8	0.44	12	1.07	17	0.88	3	0.29
1976 3/	2	0.08	2	0.15	4	0.15	1	0.08
1976 Retabulated 4/			1	0.07				

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Source: Statistics of Income, except as noted.

1/ For income concepts other than AGI, data are from the 1974 Internal Revenue Service tax model.
2/ Numbers of nontaxable returns for 1975 are from teh 1975 Statistics of Income. Some numbers differ slightly from the 1975 data in the remainder of this report which are derived from the 1975 Internal Revenue Service tax model which is a subsample of the 1975 Statistics of Income data file.
3/ From the 1976 Statistics of Income. These data are derived from the final Statistics of Income data file and differ both from the information contained in the previously released 1976 preliminary Statistics of Income and from the retabulated numbers of nontaxable returns in Chapter 6.
4/ See Chapter 6 for an explanation of reason for retabulation.

in Table 1 for tax returns with income of $100,000 or over, of $500,000 or over, and $1,000,000 or over, respectively. The columns showing nontaxable returns as a percentage of all returns in their income classes indicate that once the $100,000 level of income is reached, there is no trend, either increasing or decreasing, in this percentage. One might well expect to find a lower proportion of nontaxable returns with income of $500,000 to a $1,000,000 than in the $100,000 to $200,000 class, but no such pattern is discernible.

Distribution of Effective Tax Rates: Nearly Nontaxables

The preceeding section outlining how a small number of high-income taxpayers are able to entirely escape taxes may give the picture of two very different and clearly distinguishable types of high-income returns: taxables and nontaxables. Such a picture would be misleading. Examination of the distribution of high-income taxpayers by either effective tax rate or by the ratio of their taxable incomes to their total incomes shows a continuum from nontaxable returns to returns with high effective tax rates.

Tables 5 through 8 for 1975 and 1976 show the distributions of taxes paid by high-income taxpayers. Tables 5 and 6 show the distribution of tax returns by effective income tax rates, i.e., tax as a percentage of the relevant measure of income. Tables 7 and 8 show the distributions of actual tax liabilities. On all four tables, the distributions are given for all tax returns, for various income classes, and under all four definitions of income. The tables also show the distributions in terms of the actual numbers of tax returns as well as percentages of all returns in the income class. Examination of Tables 5 and 6 for returns with income of $200,000 or over indicates that regardless of the income concept used the majority of high-income taxpayers are concentrated in the 30 to 50 percent effective tax rate brackets. If one were to graph the percentage of taxpayers as a function of the effective tax rate, one would find a typical, bell-shaped curve familiar to statisticians and economists. This curve would peak in the 30 to 50 percent effective tax rate range and would fall off sharply with a small tail running down to zero percent for the nontaxables, and another small tail going out toward the maximum possible tax rate. The percentage of returns with low effective tax rates or very low actual

Table 5

Distribution of Tax Returns by Income Class and Effective Tax Rate -- 1976

Income Concept and Income Class	Total Number of Returns	Number and Percent with No Tax	Number and Percent of Returns by Size of Effective Tax Rate 1/									
			All Returns With Tax	Under 5%	5% to 10%	10% to 15%	15% to 20%	20% to 25%	25% to 30%	30% to 40%	40% to 50%	50% and over
All Returns												
Expanded Income												
$ 50,000 to $100,000	1,003,851	4,104	999,747	9,869	24,078	69,628	141,452	270,145	287,498	191,706	5,259	112
	(100.0%)	(0.4%)	(99.6%)	(1.0%)	(2.4%)	(6.9%)	(14.1%)	(26.9%)	(28.6%)	(19.1%)	(0.5%)	(*)
$ 100,000 to $200,000	204,278	533	203,745	923	3,899	7,118	12,313	17,892	31,384	99,282	29,708	1,226
	(100.0%)	(0.3%)	(99.7%)	(0.4%)	(1.9%)	(3.5%)	(6.0%)	(8.8%)	(15.4%)	(48.6%)	(14.5%)	(0.6%)
$ 200,000 and over	53,587	89	53,498	204	731	2,486	2,650	4,261	6,618	17,598	14,283	4,667
	(100.0%)	(0.2%)	(99.8%)	(0.4%)	(1.4%)	(4.6%)	(5.0%)	(8.0%)	(12.4%)	(32.8%)	(26.6%)	(8.7%)
Adjusted Gross Income												
$ 50,000 to $100,000	948,034	3,180	944,854	9,017	15,081	33,216	106,911	255,049	291,562	224,203	9,080	735
	(100.0%)	(0.3%)	(99.7%)	(1.0%)	(1.6%)	(3.5%)	(11.3%)	(26.9%)	(30.8%)	(23.6%)	(1.0%)	(0.1%)
$ 100,000 to $200,000	185,142	492	184,650	1,047	2,131	2,460	5,124	8,588	19,257	102,433	39,854	3,756
	(100.0%)	(0.3%)	(99.7%)	(0.6%)	(1.2%)	(1.3%)	(2.8%)	(4.6%)	(10.4%)	(55.3%)	(21.5%)	(2.0%)
$ 200,000 and over	41,761	68	41,693	186	365	627	878	1,330	1,909	10,081	16,056	10,261
	(100.0%)	(0.2%)	(99.8%)	(0.4%)	(0.9%)	(1.5%)	(2.1%)	(3.2%)	(4.6%)	(24.1%)	(38.4%)	(24.6%)
Adjusted Gross Income plus Preferences												
$ 50,000 to $100,000	1,021,791	4,480	1,017,311	11,722	27,762	77,700	152,908	283,691	279,117	179,180	5,121	110
	(100.0%)	(0.4%)	(99.6%)	(1.2%)	(2.7%)	(7.6%)	(15.0%)	(27.8%)	(27.3%)	(17.5%)	(0.5%)	(*)
$ 100,000 to $200,000	212,461	700	211,761	1,708	5,333	8,007	14,113	20,492	34,615	99,135	27,210	1,148
	(100.0%)	(0.3%)	(99.7%)	(0.8%)	(2.5%)	(3.8%)	(6.6%)	(9.7%)	(16.3%)	(46.7%)	(12.8%)	(0.5%)
$ 200,000 and over	56,512	114	56,398	313	1,345	3,082	3,059	4,890	7,182	18,279	13,928	4,320
	(100.0%	(0.2%)	(99.8%)	(0.6%)	(2.4%)	(5.4%)	(5.4%)	(8.7%)	(12.7%)	(32.4%)	(24.6%)	(7.6%)
Adjusted Gross Income less Investment Interest												
$ 50,000 to $100,000	925,833	2,721	923,112	7,400	12,126	26,410	91,419	237,400	295,971	241,376	10,096	914
	(100.0%)	(0.3%)	(99.7%)	(0.8%)	(1.3%)	(2.8%)	(9.9%)	(25.6%)	(32.0%)	(26.1%)	(1.1%)	(0.1%)
$ 100,000 to $200,000	176,934	435	176,499	667	1,452	1,827	3,878	6,618	15,627	9,811	44,127	4,192
	(100.0%)	(0.2%)	(99.8%)	(0.4%)	(0.8%)	(1.0%)	(2.2%)	(3.7%)	(8.8%)	(55.5%)	(24.9%)	(2.4%)
$ 200,000 and over	39,346	42	39,304	101	154	339	612	985	1,603	8,442	16,015	11,053
	(100.0%)	(0.1%)	(99.9%)	(0.3%)	(0.4%)	(0.9%)	(1.6%)	(2.5%)	(4.1%)	(21.5%)	(40.7%)	(28.1%)

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Source: 1976 Statistics of Income.

* Less than 0.05 percent.
1/ Income tax after credits including the minimum tax as a percentage of income.

Table 6

Distribution of Tax Returns by Income Class and Effective Tax Rate -- 1975

Income Concept and Income Class	Total Number of Returns	Number and Percent with No Tax	Number and Percent of Returns by Size of Effective Tax Rate 1/: All Returns With Tax	Under 5%	5% to 10%	10% to 15%	15% to 20%	20% to 25%	25% to 30%	30% to 40%	40% to 50%	50% and over
All Returns												
Expanded Income												
$ 50,000 to $100,000	807,399	4,654	802,745	12,268	27,282	40,382	101,777	208,141	239,117	168,492	5,286	0
	(100.0%)	(0.6%)	(99.4%)	(1.5%)	(3.4%)	(5.0%)	(12.6%)	(25.8%)	(29.6%)	(20.9%)	(0.6%)	(0)
$ 100,000 to $200,000	165,269	686	164,583	2,004	3,989	6,973	8,775	13,320	21,895	78,782	27,628	1,217
	(100.0%)	(0.4%)	(99.6%)	(1.2%)	(2.4%)	(4.2%)	(5.3%)	(8.1%)	(13.3%)	(47.7%)	(16.7%)	(0.7%)
$ 200,000 and over	40,884	215	40,669	585	1,462	1,500	2,294	3,443	4,282	10,687	11,908	4,508
	(100.0%)	(0.5%)	(99.5%)	(1.4%)	(3.6%)	(3.7%)	(5.6%)	(8.4%)	(10.5%)	(26.1%)	(29.1%)	(11.0%)
Adjusted Gross Income												
$ 50,000 to $100,000	780,470	4,749	775,721	7,704	12,720	25,741	85,700	207,298	244,755	185,441	6,315	47
	(100.0%)	(0.6%)	(99.4%)	(1.0%)	(1.6%)	(3,3%)	(11.0%)	(26.6%)	(31.4%)	(23.8%)	(0.8%)	(*)
$ 100,000 to $200,000	152,432	709	151,723	1,491	1,942	2,643	4,221	7,619	16,982	83,071	32,118	1,636
	(100.0%)	(0.5%)	(99.5%)	(1.0%)	(1.3%)	(1.7%)	(2.8%)	(5.0%)	(11.1%)	(54.5%)	(21.1%)	(1.1%)
$ 200,000 and over	33,606	260	33,346	504	456	523	759	1,083	1,596	7,654	13,307	7,464
	(100.0%)	(0.8%)	(99.2%)	(1.5%)	(1.4%)	(1.6%)	(2.3%)	(3.2%)	(4.8%)	(22.8%)	(39.6%)	(22.2%)
Adjusted Gross Income plus Preferences												
$ 50,000 to $100,000	821,253	6,607	814,646	14,402	29,500	44,977	111,547	218,528	233,888	156,956	4,848	0
	(100,0%)	(0.8%)	(99.2%)	(1.8%)	(3.6%)	(5.5%)	(13.6%)	(26.6%)	(28.5%)	(19.1%)	(0.6%)	(0)
$ 100,000 to $200,000	173,888	1,423	172,465	3,814	4,639	7,780	10,339	15,353	24,274	79,921	25,228	1,117
	(100.0%)	(0.8%)	(99.2%)	(2.2%)	(2.7%)	(4.5%)	(6.0%)	(8.8%)	(13.9%)	(46.0%)	(14.5%)	(0.6%)
$ 200,000 and over	43,344	362	42,982	1,245	1,701	1,738	2,600	3,824	4,725	11,330	11,636	4,183
	(100.0%)	(0.8%)	(99.2%)	(2.9%)	(3.9%)	(4.0%)	(6.0%)	(8.8%)	(10.9%)	(26.1%)	(26.9%)	(9.7%)
Adjusted Gross Income less Investment Interest												
$ 50,000 to $100,000	762,709	3,879	758,830	5,676	9,714	21,720	75,264	191,648	246,466	201,506	6,752	84
	(100.0%)	(0.5%)	(99.5%)	(0.7%)	(1.3%)	(2.8%)	(9.9%)	(25.1%)	(32.3%)	(26.4%)	(0.9%)	(*)
$ 100,000 to $200,000	145,330	407	144,923	908	1,266	1,835	3,240	5,868	13,958	80,303	35,670	1,875
	(100.0%)	(0.3%)	(99.7%)	(0.6%)	(0.9%)	(1.3%)	(2.2%)	(4.0%)	(9.6%)	(55.3%)	(24.5%)	(1.3%)
$ 200,000 and over	31,391	126	31,265	230	239	305	562	800	1,230	6,575	13,296	8,028
	(100.0%)	(0.4%)	(99.6%)	(0.7%)	(0.8%)	(1.0%)	(1.8%)	(2.6%)	(3.9%)	(21.0%)	(42.4%)	(25.6%)

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Source: 1975 Internal Revenue Service tax model

* Less than 0.05 percent.

1/ Income tax after credits including the minimum tax as a percentage of income.

Table 7

Distribution of Tax Returns by Income Class and Total Income Tax -- 1976

Income Concept and Income Class	Total Number of Returns	Number and Percent with No Tax	All Returns With Tax	Number and Percent of Returns by Size of Total Income Tax 1/							
				$1 under $1,000	$1,000 under $3,000	$3,000 under $4,000	$4,000 under $5,000	$ 5,000 under $10,000	$10,000 under $25,000	$25,000 under $50,000	$50,000 or more
All Returns	84,670,389	20,249,022	64,421,367	26,964,491	25,732,027	4,706,219	2,385,683	3,251,747	1,032,333	246,323	102,544
Expanded Income											
$ 50,000 to $100,000	1,003,851	4,104	999,747	2,087	6,555	7,245	6,402	124,343	735,558	117,446	111
	(100.0%)	(0.4%)	(99.6%)	(0.2%)	(0.7%)	(0.7%)	(0.6%)	(12.4%)	(73.3%)	(11.7%)	*
$100,000 to $200,000	204,278	533	203,745	147	164	168	139	2,054	22,538	125,020	53,515
	(100.0%)	(0.3%)	(99.7%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(1.0%)	(11.0%)	(61.2%)	(26.2%)
$200,000 and over	53,587	89	53,498	13	19	1	34	81	632	3,813	48,905
	(100.0%)	(0.2%)	(99.8%)	*	*	*	(0.1%)	(0.2%)	(1.2%)	(7.1%)	(91.3%)
Adjusted Gross Income											
$ 50,000 to $100,000	948,034	3,180	944,854	2,051	5,727	4,743	4,175	79,505	714,412	133,922	319
	(100.0%)	(0.3%)	(99.7%)	(0.2%)	(0.6%)	(0.5%)	(0.4%)	(8.4%)	(75.4%)	(14.1%)	*
$100,000 to $200,000	185,142	492	184,650	129	210	91	238	1,466	9,856	110,605	62,055
	(100.0%)	(0.3%)	(99.7%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.8%)	(5.3%)	(59.7%)	(33.5%)
$200,000 and over	41,761	68	41,693	12	15	1	16	58	331	1,278	39,982
	(100.0%)	(0.2%)	(99.8%)	*	*	*	*	(0.1%)	(0.8%)	(3.1%)	(95.7%)
Adjusted Gross Income plus Preferences											
$ 50,000 to $100,000	1,021,791	4,480	1,017,311	2,622	7,778	8,249	6,940	136,202	742,953	112,457	110
	(100.0%)	(0.4%)	(99.6%)	(0.3%)	(0.8%)	(0.8%)	(0.7%)	(13.3%)	(72.7%)	(11.0%)	*
$100,000 to $200,000	212,461	700	211,761	150	230	366	413	2,893	26,593	129,054	52,062
	(100.0%)	(0.3%)	(99.7%)	(0.1%)	(0.1%)	(0.2%)	(0.2%)	(1.4%)	(12.5%)	(60.7%)	(24.5%)
$200,000 and over	56,512	114	56,398	13	21	12	39	105	1,079	4,770	50,359
	(100.0%)	(0.2%)	(99.8%)	*	*	*	(0.1%)	(0.2%)	(1.9%)	(8.4%)	(89.1%)
Adjusted Gross Income less Investment Interest											
$ 50,000 to $100,000	925,833	2,721	923,112	1,722	4,913	4,124	3,254	66,251	701,494	140,970	384
	(100.0%)	(0.3%)	(99.7%)	(0.2%)	(0.5%)	(0.4%)	(0.4%)	(7.2%)	(75.8%)	(15.2%)	*
$100,000 to $200,000	176,934	435	176,499	109	135	47	143	966	7,505	103,953	63,641
	(100.0%)	(0.2%)	(99.8%)	(0.1%)	(0.1%)	*	(0.1%)	(0.6%)	(4.2%)	(58.8%)	(36.0%)
$200,000 and over	39,346	42	39,304	11	14	1	11	28	163	795	38,281
	(100.0%)	(0.1%)	(99.9%)	*	*	*	*	(0.1%)	(0.4%)	(2.0%)	(97.3%)

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Source: 1976 Statistics of Income.

* Less than 0.05 percent.

1/ Total income tax is income tax after credits including the minimum tax. It is impossible for tax after credits including the minimum tax to exceed income.

Table 8

Distribution of Tax Returns by Income Class and Total Income Tax -- 1975

Income Concept and Income Class	Total Number of Returns	Number and Percent with No Tax	Number and Percent of Returns by Size of Total Income Tax 1/								
			All Returns With Tax	$1 under $1,000	$1,000 under $3,000	$3,000 under $4,000	$4,000 under $5,000	$ 5,000 under $10,000	$10,000 under $25,000	$25,000 under $50,000	$50,000 or more
All Returns	82,229,182	20,822,251	261,406,931	6,357,938	25,353,480	4,026,297	1,982,979	2,597,263	803,402	204,794	80,778
Expanded Income											
$ 50,000 to $100,000	807,399	4,654	802,745	5,516	6,120	6,300	7,553	87,691	585,273	104,292	0
	(100.0%)	(0.6%)	(99.4%)	(0.7%)	(0.8%)	(0.8%)	(0.9%)	(10.9%)	(72.5%)	(12.9%)	0
$100,000 to $200,000	165,269	686	164,583	350	381	256	288	2,928	18,310	97,321	44,749
	(100.0%)	(0.4%)	(99.6%)	(0.2%)	(0.2%)	(0.2%)	(0.2%)	(1.8%)	(11.1%)	(58.9%)	(27.1%)
$200,000 and over	40,884	215	40,669	55	49	18	14	217	1,118	3,174	36,024
	(100.0%)	(0.5%)	(99.5%)	(0.1%)	(0.1%)	*	*	(0.5%)	(2.7%)	(7.8%)	(88.1%)
Adjusted Gross Income											
$ 50,000 to $100,000	780,470	4,749	775,721	2,812	4,519	3,370	4,227	61,347	586,923	112,502	21
	(100.0%)	(0.6%)	(99.4%)	(0.4%)	(0.6%)	(0.4%)	(0.5%)	(7.9%)	(75.2%)	(14.4%)	*
$100,000 to $200,000	152,432	709	151,723	250	349	265	266	1,472	8,808	91,033	49,280
	(100.0%)	(0.5%)	(99.5%)	(0.2%)	(0.2%)	(0.2%)	(0.2%)	(1.0%)	(5.8%)	(59.7%)	(32.3%)
$200,000 and over	33,606	260	33,346	55	77	28	18	149	475	1,131	31,413
	(100.0%)	(0.8%)	(99.2%)	(0.2%)	(0.2%)	(0.1%)	(0.0%)	(0.4%)	(1.4%)	(3.4%)	(93.5%)
Adjusted Gross Income plus Preferences											
$ 50,000 to $100,000	821,253	6,607	814,646	5,855	7,801	6,465	8,646	95,306	590,800	99,773	0
	(100.0%)	(0.8%)	(99.2%)	(0.7%)	(1.0%)	(0.8%)	(1.0%)	(11.6%)	(71.9%)	(12.2%)	0
$100,000 to $200,000	173,888	1,423	172,465	773	915	607	340	3,583	21,203	101,378	43,666
	(100.0%)	(0.8%)	(99.2%)	(0.4%)	(0.5%)	(0.4%)	(0.2%)	(2.1%)	(12.2%)	(58.3%)	(25.1%)
$200,000 and over	43,344	362	42,982	93	102	73	38	428	1,505	3,636	37,107
	(100.0%)	(0.8%)	(99.2%)	(0.2%)	(0.2%)	(0.2%)	(0.1%)	(1.0%)	(3.5%)	(8.4%)	(85.6%)
Adjusted Gross Income less Investment Interest											
$ 50,000 to $100,000	762,709	3,879	758,830	2,028	3,355	2,647	3,508	53,446	576,077	117,736	33
	(100.0%)	(0.5%)	(99.5%)	(0.3%)	(0.4%)	(0.4%)	(0.5%)	(7.0%)	(75.5%)	(15.4%)	*
$100,000 to $200,000	145,330	407	144,923	172	228	159	194	930	6,527	86,161	50,552
	(100.0%)	(0.3%)	(99.7%)	(0.1%)	(0.2%)	(0.1%)	(0.1%)	(0.6%)	(4.5%)	(59.3%)	(34.8%)
$200,000 and over	31,391	126	31,265	27	22	11	6	81	257	749	30,112
	(100.0%)	(0.4%)	(99.6%)	(0.1%)	(0.1%)	*	*	(0.3%)	(0.8%)	(2.4%)	(95.9%)

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Source: 1975 Internal Revenue Service tax model.

* Less than 0.05 percent.

1/ Total income tax is income tax after credits including the minimum tax. It is possible for tax after credits including the minimum tax to exceed income.

liabilities is very small. In 1976, as Table 7 shows, only 1.6 percent of all high expanded income taxpayers paid less than $25,000 of tax, and over 90 percent paid more than $50,000.

Tables 9 and 10 classify data by the ratio of taxable income to each of the four definitions of income for high-income returns. Table 9 is for 1976; Table 10 is for 1975. For various classes of ratios of taxable income to total income, the tables show the number of returns in the class; the percentage of the total number of returns which are in that class; and the cumulative percentage of the total in that class. For example, Table 9 shows that 0.90 percent of all returns with expanded income of $200,000 or over had a ratio of taxable income to expanded income of less than 20 percent.

Table 11 presents in one place the cumulative percentages for 1974, 1975, and 1976. Chart 2 displays the comparison between the cumulative percentages of high expanded income returns for 1975 and 1976 with ratios of taxable income to expanded income of less than a given percentage. Tables 5, 6, 9, 10, and 11 and Chart 2 show very clearly that there is a whole continuum of returns when returns are classified either by effective tax rate or by the ratio of taxable income to total income. It is an over-simplification to try to group returns into just the two categories of taxable or nontaxable.

The data just presented have been used to help define a class of taxpayers who pay some taxes -- and, hence, have not been brought to the public's eye because of their nontaxable status -- but who clearly are not paying their "fair share" of taxes. This group, which may be called the "nearly nontaxables," consists of the small tail of tax returns at the low end of the cumulative distribution of tax returns arrayed by the ratio of taxable income to total income. Chart 2 shows that based on 1976 data, there clearly is a break in the continuum of tax returns when the ratio of taxable income to total income rises above 20 percent. Thus, nearly nontaxable returns are defined as taxable returns having taxable income of less than 20 percent of the relevant income measure. All high-income tax returns fall into one of three categories: nontaxables; nearly nontaxables; or all other taxables.

A substantial portion of the analysis throughout the rest of this report will focus on the differences and similarities between nontaxables and nearly nontaxables. Are

Table 9

Number and Distribution of Tax Returns with Income of $200,000 or Over
Under Alternative Concepts, Classified by Taxpaying Status -- 1976

	Number of Returns	Percentage of Total	Cumulative Percentage of Total	Number of Returns	Percentage of Total	Cumulative Percentage of Total
	Expanded Income			Adjusted Gross Income		
All Returns	53,587	100 %		41,761	100 %	
Nontaxable Returns	89	0.17	0.17	68	0.16	0.16
Taxable Returns with Ratios of Taxable Income to Income: 1/						
Under 10%	85	0.16	0.32	87	0.21	0.37
10% to 15%	136	0.25	0.58	105	0.25	0.62
15% to 20%	172	0.32	0.90	219	0.52	1.15
20% to 25%	979	1.83	2.73	229	0.55	1.70
25% to 30%	1,523	2.84	5.57	358	0.86	2.55
30% to 40%	3,462	6.46	12.03	1,095	2.62	5.17
40% to 50%	5,914	11.04	23.07	1,760	4.21	9.39
50% and over	41,227	76.93	100	37,840	90.61	100
	Adjusted Gross Income plus Preference			Adjusted Gross Income less Investment Interest		
All Returns	56,512	100 %		39,346	100 %	
Nontaxable Returns	114	0.20	0.20	42	0.11	0.11
Taxable Returns with Ratios of Taxable Income to Income: 1/						
Under 10%	121	0.21	0.42	61	0.16	0.26
10% to 15%	255	0.45	0.87	41	0.10	0.37
15% to 20%	543	0.96	1.83	76	0.19	0.56
20% to 25%	1,299	2.30	4.13	130	0.33	0.89
25% to 30%	1,780	3.15	7.28	212	0.54	1.43
30% to 40%	4,029	7.13	14.41	738	1.88	3.30
40% to 50%	6,591	11.66	26.07	1,321	3.36	6.66
50% and over	41,780	73.93	100	36,723	93.34	100

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Source: 1976 Statistics of Income.

1/ Taxable income is defined as the amount of income which under the appropriate ordinary tax rate schedules would yield tax after credits plus the minimum tax.

Table 10

Number and Distribution of Tax Returns with Income of $200,000 or Over
Under Alternative Concepts, Classified by Taxpaying Status -- 1975

	Number of Returns	Percentage of Total	Cumulative Percentage of Total	Number of Returns	Percentage of Total	Cumulative Percentage of Total
	Expanded Income			Adjusted Gross Income		
All Returns	40,884	100 %		33,606	100 %	
Nontaxable Returns	215	0.53	0.53%	260	0.77	0.77%
Taxable Returns with Ratios of Taxable Income to Income: 1/						
Under 10%	286	0.70	1.23	332	0.99	1.76
10% to 15%	336	0.82	2.05	185	0.55	2.31
15% to 20%	787	1.92	3.97	215	0.64	2.95
20% to 25%	946	2.31	6.29	285	0.85	3.80
25% to 30%	876	2.14	8.43	352	1.05	4.85
30% to 40%	2,643	6.46	14.89	670	2.59	7.44
40% to 50%	5,026	12.29	27.19	1,347	4.01	11.44
50% and over	29,769	72.81	100	29,760	88.56	100
	Adjusted Gross Income plus Preferences			Adjusted Gross Income less Investment Interest		
All Returns	43,344	100 %		31,391	100 %	
Nontaxable Returns	362	0.84	0.84%	126	0.40	0.40%
Taxable Returns with Ratios of Taxable Income to Income: 1/						
Under 10%	615	1.42	2.25	150	0.48	0.88
10% to 15%	735	1.70	3.95	82	0.26	1.14
15% to 20%	907	2.09	6.04	113	0.36	1.50
20% to 25%	1,029	2.37	8.42	149	0.47	1.98
25% to 30%	1,072	2.47	10.89	201	0.64	2.62
30% to 40%	3,019	6.97	17.85	653	2.08	4.70
40% to 50%	5,356	12.36	30.21	1,041	3.32	8.01
50% and over	30,243	69.79	100	28,876	91.99	100

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Source: 1975 Internal Revenue Service tax model.

1/ Taxable income is defined as the amount of income which under the appropriate ordinary tax rate schedules would yield tax after credits plus the minimum tax.

Table 11

Comparison Between Cumulative Percentages of Tax Returns Classified by Tax-Paying Status With Income of $200,000 and Over Under Alternative Concepts -- 1974-1976

	1974	1975	1976	1974	1975	1976
	---------Expanded Income---------			-----Adjusted Gross Income-------		
Returns with ratios of Taxable Income to Income: 1/						
Zero (Nontaxable returns)	0.39 %	0.53 %	0.17 %	0.68 %	0.77 %	0.16 %
Less than 10%	1.16	1.23	0.32	1.95	1.76	0.37
Less than 15%	1.73	2.05	0.58	2.52	2.31	0.62
Less than 20%	3.38	3.97	0.90	3.17	2.95	1.15
Less than 25%	5.54	6.29	2.73	3.86	3.80	1.70
Less than 30%	7.75	8.43	5.57	4.85	4.85	2.55
Less than 40%	14.94	14.89	12.03	7.70	7.44	5.17
Less than 50%	27.79	27.19	23.07	11.78	11.44	9.39
All Returns	100	100	'00	100	100	100
	----Adjusted Gross Income plus--- Preference			----Adjusted Gross Income less--- Investment Interest		
Returns with ratios of Taxable Income to Income: 1/						
Zero (Nontaxable returns)	0.78	0.84	0.20	0.27	0.40	0.11
Less than 10%	2.55	2.25	0.42	0.80	0.88	0.26
Less than 15%	3.69	3.95	0.87	1.00	1.14	0.37
Less than 20%	5.78	6.04	1.83	1.37	1.50	0.56
Less than 25%	8.27	8.42	4.13	1.68	1.98	0.89
Less than 30%	10.40	10.89	7.28	2.21	2.62	1.43
Less than 40%	18.60	17.85	14.41	4.29	4.70	3.30
Less than 50%	31.53	30.21	26.07	7.52	8.01	6.66
All Returns	100	100	100	100	100	100

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Source: 1976 Statistics of Income, 1975 Internal Revenue Service tax model, and 1974 Internal Revenue Service tax model.

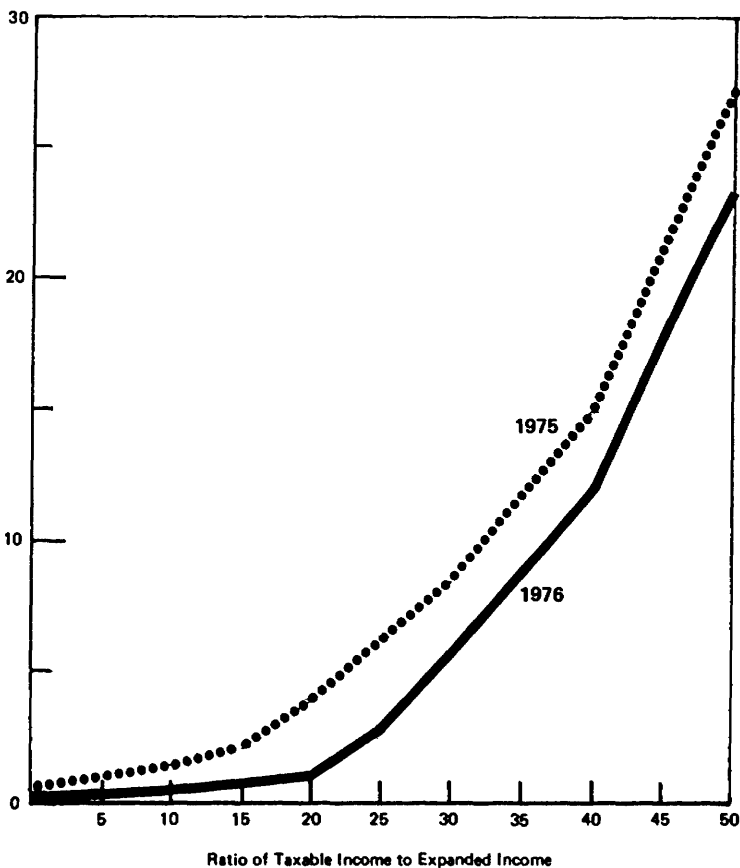
1/ Taxable income is defined as the amount of income which under the appropriate ordinary tax rate schedules would yield tax after credits plus the minimum tax.

Chart 2

PERCENTAGES OF TAX RETURNS BY RATIO OF TAXABLE INCOME TO EXPANDED INCOME

1975 and 1976

(Expanded Incomes of $200,000 and over)



nearly nontaxables similar to nontaxables, similar to all other taxables, or a breed unto themselves?

A Note on Taxable Income

It should be pointed out that in Tables 10 and 11 as well as in all other tables in this report in which the ratio of taxable income to total income is used, taxable income has been modified to take into account the value of tax credits, the minimum tax, and special tax computations such as income averaging, the alternative tax on long term capital gains, and the maximum tax on earned income. If taxable income as ordinarily defined had been used, a taxpayer who had a substantial taxable income but paid very little tax would not have been included among the nearly nontaxables. Thus, taxable income has been redefined as that amount of income which, taxed at ordinary rates, would yield the amount of tax actually shown for the particular return after credits and after imposition of the minimum tax.

An Overview of High Income Tax Returns

For each of the four income concepts (expanded income, AGI, AGI plus preferences, and AGI less investment interest), Tables 12 and 13 show the relative sizes of income as measured by the four income concepts on the basis of expanded income being 100 percent. Table 12 is for 1976; Table 13 is for 1975. A examination of these tables indicates some significant differences between nontaxable and other returns when measured by expanded income. Both investment interest and preferences are relatively more important on nontaxable and nearly nontaxable returns than on other taxable returns. Of course, these are two of the most important items in reducing taxable income under present law, thereby making the returns nontaxable or nearly nontaxable.

The first 8 tables in each of Appendices A, B, and C contain data on preferences, deductions, credits, and taxes. Appendix A is for 1976; Appendix B is for 1975; and Appendix C is for 1974. In each appendix, there are two tables for each income definition. One table contains aggregate data; the other shows each item as a percentage of the income concept used to select the returns shown in the table. Each table contains four separate columns of data: all returns; nontaxable returns; nearly nontaxable returns; and all other taxable returns. These 24 tables include much of the data on which this report is based. Appendices A and B each contain two additional tables that cross-classify the numbers of tax

Table 12

Relationships Between Four Income Concepts for Tax Returns with Income of $200,000 or Over Under Alternative Income Concepts -- 1976

	Returns Selected by			
	Expanded Income	Adjusted Gross Income	Adjusted Gross Income plus Preferences	Adjusted Gross Income less Investment Interest
	All Returns			
EXPANDED INCOME	100 %	100 %	100 %	100 %
Investment interest not in excess of investment income	2.3	2.8	2.9	2.1
Preferences	24.0	19.6	24.0	19.5
ADJUSTED GROSS INCOME	78.4	83.2	79.0	82.6
ADJUSTED GROSS INCOME PLUS PREFERENCES	102.3	102.8	102.9	102.1
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	76.0	80.4	76.1	80.6
	Nontaxable Returns			
EXPANDED INCOME	100	100	100	100
Investment interest not in excess of investment income	10.7	51.1	28.2	14.0
Preferences	53.6	12.3	52.4	6.0
ADJUSTED GROSS INCOME	67.2	141.1	85.3	109.1
ADJUSTED GROSS INCOME PLUS PREFERENCES	110.7	153.4	128.2	115.1
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	47.2	90.0	48.8	95.1
	Nearly Nontaxable Returns			
EXPANDED INCOME	100	100	100	100
Investment interest not in excess of investment income	7.5	43.0	31.0	6.8
Preferences	38.7	10.0	41.7	4.6
ADJUSTED GROSS INCOME	71.5	134.4	90.9	102.6
ADJUSTED GROSS INCOME PLUS PREFERENCES	107.5	144.3	131.0	107.2
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	61.4	91.4	59.3	95.8
	All Other Taxable Returns			
EXPANDED INCOME	100	100	100	100
Investment interest not in excess of investment income	2.2	2.4	2.3	2.0
Preferences	23.8	19.7	23.6	19.6
ADJUSTED GROSS INCOME	78.5	82.7	78.8	82.5
ADJUSTED GROSS INCOME PLUS PREFERENCES	102.2	102.4	102.3	102.1
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	76.2	80.3	76.4	80.5

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Source: 1976 Statistics of Income

Table 13

Relationships Between Four Income Concepts for Tax Returns with Income of $200,000 or Over Under Alternative Income Concepts -- 1975

	Returns Selected by			
	Expanded Income	Adjusted Gross Income	Adjusted Gross Income plus Preferences	Adjusted Gross Income less Investment Interest
	All Returns			
EXPANDED INCOME	100 %	100 %	100 %	100 %
Investment interest not in excess of investment income	2.8	3.6	3.7	2.4
Preferences	22.0	17.9	21.9	17.5
ADJUSTED GROSS INCOME	81.0	85.8	81.9	84.9
ADJUSTED GROSS INCOME PLUS PREFERENCES	102.8	103.7	103.7	102.4
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	78.1	82.2	78.2	82.5
	Nontaxable Returns			
EXPANDED INCOME	100	100	100	100
Investment interest not in excess of investment income	20.7	86.7	65.1	27.0
Preferences	46.0	10.9	43.8	8.5
ADJUSTED GROSS INCOME	83.5	177.9	128.7	119.3
ADJUSTED GROSS INCOME PLUS PREFERENCES	120.7	188.8	165.1	127.8
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	54.6	91.2	57.7	92.4
	Nearly Nontaxable Returns			
EXPANDED INCOME	100	100	100	100
Investment interest not in excess of investment income	15.1	43.6	23.3	18.6
Preferences	57.5	26.5	56.1	19.1
ADJUSTED GROSS INCOME	58.5	119.4	67.9	101.7
ADJUSTED GROSS INCOME PLUS PREFERENCES	115.1	146.0	123.3	120.7
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	43.2	75.8	44.7	83.0
	All Other Nontaxable Returns			
EXPANDED INCOME	100	100	100	100
Investment interest not in excess of investment income	2.0	2.3	2.1	2.0
Preferences	20.0	17.7	19.7	17.5
ADJUSTED GROSS INCOME	82.1	84.6	82.5	84.5
ADJUSTED GROSS INCOME PLUS PREFERENCES	102.0	102.4	102.1	102.1
ADJUSTED GROSS INCOME LESS INVESTMENT INTEREST	80.0	82.3	80.4	82.5

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Source: 1975 Internal Revenue Service tax model.

returns by income classes under each combination of the four income definitions. One table is for all returns; the other is for nontaxable returns. Using these tables, one can determine, for example, how many of the high expanded income nontaxables are also high AGI nontaxables.

Analysis of Tables 76-2, 76-4, 75-2, and 75-4 in the appendices shows the basic similarily between nontaxables and nearly nontaxables and their differences from all other taxables in 1975 and 1976. These similarities and differences will be discussed in detail in Chapter 5. In most cases where there is a substantial difference between nontaxables and all other taxables, the nontaxables show essentially the same characteristics as the nearly nontaxables. When defined by expanded income, nontaxables and nearly nontaxables have large shares of their income in the form of preferences, but when defined by AGI, they both have smaller shares. To some degree, this is expected since preferences are fully included in expanded income whereas they are excluded from AGI. Thus, it is more difficult to become a high AGI return on the basis of preference items alone.

It should be pointed out that if a return did have large amounts of preference income and no ordinary tax liability, it would be subject to the minimum tax and, therefore, would no longer be nontaxable. As already noted, in both 1975 and 1976, high expanded income nontaxables had a large share of their income in the form of tax preferences. With such large tax preferences, and no ordinary tax liability, how did these returns escape the minimum tax? It is probable that the minimum tax was avoided as a result of the "no tax benefit rule" which provides that if the preference income does not reduce ordinary taxes then it is not subject to the minimum tax. Table 76-2 in Appendix A and Table 75-2 in Appendix B show that, especially in 1976, these returns had more itemized deductions than they needed to reduce AGI to zero. Thus, in many cases including additional preference income in AGI would not have increased tax liabilities. Also, as explained in detail in Chapter 6, it is likely that in 1976 many of these returns were subject to the minimum tax but failed to report their liabilities on their tax returns.

Despite the publicity given to high-income, nontaxable returns, most taxpayers with income of $200,000 or more (however that income is measured) pay substantial Federal income taxes. It has already been mentioned that in 1976 over 90 percent of all high expanded income taxpayers had

liabilities of at least $50,000. Tables 14 and 15 summarize the tax status of high-income taxpayers in 1975 and 1976. For the four income measures, the tables show the average income, tax, and effective tax rate for all returns, nontaxables, nearly nontaxables, and all other taxables. In 1976, the average tax for all high expanded income returns was $145,000 or 35 percent of expanded income. This represented an increase over 1975 of $20,000 per return, or 5 percentage points in the effective tax rate. The average tax rate for the nearly nontaxables is only about one fifth of the rate for the all other taxables; their effective tax rate is much closer to that of the nontaxables than to that of the all other taxables.

Average income for the nontaxables was about 10 percent lower than for the group as a whole. Average income for the nearly nontaxables was about one and one-half times that of the whole group. There does not appear to be a simple explanation for the higher average income of the nearly nontaxable group.

Summary

Although there are some differences between nontaxables and nearly nontaxable, these differences are relatively small compared with the major difference between these two groups on the one hand and all other taxables on the other hand. The similarities between the two groups and their differences from other taxables can best be seen by examining the importance of several items shown in the appendix tables: tax preferences; investment interest; charitable contributions; miscellaneous deductions; casualty losses; and the foreign tax credit.

The similarity of nearly nontaxable high-income returns to nontaxable high-income returns indicates that the characteristics of nontaxable returns are not unique. They only represent extreme cases of returns with low ratios of taxable income (as adjusted) to expanded income. The importance of this observation is that tax policies which are designed to eliminate high-income nontaxable returns may address only part of the problem of high-income individuals not paying a fair share of taxes.

Table 14

Average Income, Average Income Tax, and Average Tax Rate for Tax Returns with Income of $200,000 and Over Under Alternative Concepts -- 1976

Taxpaying Class and Income Concept Used to Classify Returns	Number of Returns	Average Income (per Income Concept)	Average Expanded Income	Average Total Tax	Effective Tax Rate: per Income Concept	Effective Tax Rate: per Expanded Income
Expanded Income						
All Returns	53,587	$413,617	$413,617	$144,942	35.0%	35.0%
Nontaxable Returns	89	350,427	350,426	0	0	0
Nearly Nontaxable Returns	393	613,842	613,842	43,583	7.1	7.1
All Other Taxable Returns	53,105	412,241	412,241	145,936	35.4	35.4
Adjusted Gross Income						
All Returns	41,761	376,712	452,650	167,656	44.5	37.0
Nontaxable Returns	68	342,456	242,765	0	0	0
Nearly Nontaxable Returns	411	530,297	395,679	30,757	5.8	7.8
All Other Taxable Returns	41,282	375,239	453,573	169,296	45.1	37.3
Adjusted Gross Income plus Preferences						
All Returns	56,512	412,873	401,388	139,993	33.9	34.9
Nontaxable Returns	114	370,158	288,790	0	0	0
Nearly Nontaxable Returns	919	605,672	462,172	44,498	7.4	9.6
All Other Taxable Returns	55,479	409,767	400,613	141,863	34.6	35.4
Adjusted Gross Income less Investment Interest						
All Returns	39,346	375,988	466,644	174,066	46.3	37.3
Nontaxable Returns	42	321,595	338,190	0	0	0
Nearly Nontaxable Returns	178	483,478	504,798	21,916	4.5	4.3
All Other Taxable Returns	39,126	375,558	466,608	174,945	46.6	37.5

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Source: 1976 Statistics of Income.

Table 15

Average Income, Average Income Tax, and Average Tax Rate for Tax Returns with Income of $200,000 and Over Under Alternative Concepts -- 1975

Taxpaying Class and Income Concept Used to Classify Returns	Number of Returns	Average Income (per Income Concept)	Average Expanded Income	Average Total Tax	Effective Tax Rate per Income Concept	Effective Tax Rate per Expanded Income
Expanded Income						
All Returns	40,884	$412,202	$412,202	$124,412	30.2%	30.2%
Nontaxable Returns	215	377,260	377,260	0	0	0
Nearly Nontaxable Returns	1,409	585,061	585,061	38,505	6.6	6.6
All Other Taxable Returns	39,260	406,190	406,190	146,516	36.1	36.1
Adjusted Gross Income						
All Returns	33,606	377,395	439,787	160,356	42.5	36.5
Nontaxable Returns	260	450,385	253,112	0	0	0
Nearly Nontaxable Returns	732	522,967	437,803	15,251	2.9	3.5
All Other Taxable Returns	32,614	373,546	441,320	164,738	44.1	37.3
Adjusted Gross Income plus Preferences						
All Returns	43,344	413,254	398,425	136,322	33.0	34.2
Nontaxable Returns	362	436,122	264,174	0	0	0
Nearly Nontaxable Returns	2,257	551,326	447,293	30,793	5.6	6.9
All Other Taxable Returns	40,725	405,399	396,910	143,382	35.4	36.1
Adjusted Gross Income less Investment Interest						
All Returns	31,391	375,534	454,984	167,922	44.7	36.9
Nontaxable Returns	126	376,738	407,952	0	0	0
Nearly Nontaxable Returns	345	493,962	595,093	22,368	4.5	3.8
All Other Taxable Returns	30,900	374,450	453,906	170,340	45.5	37.5

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Source: 1975 Internal Revenue Service tax model.

Chapter 5

Avoiding Taxes: Exclusions, Deductions, Credits, and Other Devices

How did people with expanded income or AGI of $200,000 or more avoid paying any Federal individual income tax? Since the data indicate basic similarities between nontaxable and nearly nontaxable returns, an analysis of the reasons why nontaxable returns are nontaxable should also illuminate the methods used to reduce taxes on nearly nontaxable returns.

Basically, there are four means by which high-income persons may substantially reduce or eliminate their income taxes: (1) tax preference income which is omitted from the tax base; (2) deductions in calculating taxable income; (3) special tax computations; and (4) credits against tax. Since tax preference income is already omitted from AGI, traditional methods for analyzing reasons for nontaxability of high AGI returns have tended to understate the importance of tax preference income.

Attributing Nontaxability: Methodology

There are three approaches to analyzing the reasons for nontaxability (and near nontaxability). The first shows the largest single item of deduction or credit on each return. The second approach again treats each deduction or credit separately and gives its size relative to income. The third approach aggregates data for all returns in the group and shows the total value for each deduction or credit.

In many of the reviews of high-income nontaxable returns undertaken since the late 1960's, the largest single deduction or credit item on the return has been given as the reason for the return's nontaxability. However, it is not typical for any one deduction or credit to be large enough by itself to eliminate entirely a person's income tax. Ordinarily, nontaxability is produced by a combination of items, none of which taken alone may be extraordinarily large. Moreover, attributing nontaxability to the single largest item disregards the size of the largest item both in absolute terms and in relation to the total income on a return. If a return has many different deductions and credits, even the largest one may be relatively small. On

the other hand, if only a few provisions are used and the return is nontaxable, even the second or third largest item may be very significant. The largest item method would count the largest, but still small item on the first return but ignore the second largest, but still very large item on the second return. There are, therefore, deficiencies in this approach.

For comparability with earlier analyses, Tables 16 and 17 show the number of and percentages of the total number of returns on which particular a deduction or credit item was the largest item. Table 16 is for 1976; Table 17 is for 1975. These tables contain significantly more data than those available or prior years. In addition to showing the information for nontaxable returns, similar data is also shown for taxable returns. 1/ The comparable data for taxable returns permits the importance of various deductions to be put in perspective. Whether an item is more or less important on nontaxable than on taxable returns may be of more significance than its absolute importance. These two tables also contain data for the high income returns under all four definitions of income. This is the first time such information has been presented for other than high AGI returns.

Another means of determining the importance of various deductions or credits is to show the value of each deduction and credit as a percentage of income. If the percentages of income are made into a few categories, e.g., less than 10 percent of income, 10 percent to 20 percent of income, etc., the number and/or the share of deductions falling into these categories can be determined for a group of returns. This method has the advantage of providing two pieces of data for each deduction or credit used: whether or not the provision was used; and, if used, its importance relative to income. For nontaxable returns, this method shows the frequency with which a particular credit or deduction is large enough so that nontaxability can reasonably be attributed to it alone. However, this method only illuminates the importance of each deduction or credit separately; it does not provide information on how frequently particular combinations of deductions and/or credits appear on a single tax return.

1/ To avoid unnecessary complexity in the tables, only the percentage distribution and not the actual count is shown for taxable returns.

Table 16

Largest Deduction or Credit on Tax Returns with Income of $200,000 or Over, Under Alternative Income Concepts -- 1976

Largest Item 1/	Nontaxable Returns: Number	Nontaxable Returns: Percentage	Taxable Returns: Percentage	Nontaxable Returns: Number	Nontaxable Returns: Percentage	Taxable Returns: Percentage
	Expanded Income			Adjusted Gross Income		
Interest Paid Deduction 2/	18	20.2 %	4.2 %	31	45.6 %	14.6 %
Taxes Paid Deduction	2	2.2	55.2	1	1.5	50.4
Contributions Deduction	19	21.3	23.8	5	7.4	22.6
Medical Expense Deduction	--	--	1.0	--	--	0.8
Casualty Loss Deduction	22	24.7	0.3	6	8.8	0.3
Miscellaneous Deduction	14	15.7	6.5	11	16.2	5.1
Foreign Tax Credit	14	15.7	1.3	14	20.6	1.0
Investment Credit	--	--	6.4	--	--	4.6
All Other Preference Credits 3/	--	--	1.2	--	--	0.6
TOTAL	89	100 %	100 %	68	100 %	100 %
	AGI plus Preferences			AGI less Investment Interest		
Interest Paid Deduction 2/	45	39.5 %	16.4 %	7	16.7 %	3.9 %
Taxes Paid Deduction	1	0.9	47.9	1	2.4	57.0
Contributions Deduction	21	18.4	21.5	3	7.1	24.7
Medical Expense Deduction	--	--	0.9	--	--	0.9
Casualty Loss Deduction	22	19.3	0.3	6	14.3	0.4
Miscellaneous Deduction	11	9.6	5.3	11	26.2	6.1
Foreign Tax Credit	14	12.3	1.2	14	33.3	1.0
Investment Credit	--	--	5.5	--	--	5.4
All Other Preference Credits 3/	--	--	1.1	--	--	0.7
TOTAL	114	100 %	100 %	42	100 %	100 %

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Source: 1976 Statistics of Income.

1/ On returns with both large itemized deductions and large credits, the largest deduction or credit was determined by omitting the largest deduction, recomputing the tax, and comparing the resulting tax to the largest credit.

2/ Adjusted for any interest which may already have been deducted in the calculation of income.

3/ Includes credit for the elderly, child care credit, investment credit, work incentive (WIN) credit, foreign tax credit, credit for contributions to candidates for public office, new residence credit, and earned income credit.

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Table 17

Largest Deduction or Credit on Tax Returns with Income of $200,000 or Over
Under Alternative Income Concepts -- 1975

Largest Item 1/	Nontaxable Returns Number	Nontaxable Returns Percentage	Taxable Returns Percentage	Nontaxable Returns Number	Nontaxable Returns Percentage	Taxable Returns Percentage
	---Expanded Income---			---Adjusted Gross Income---		
Interest Paid Deduction 2/	80	37.2 %	3.9 %	163	62.7 %	15.3 %
Taxes Paid Deduction	28	13.0	54.7	17	6.5	48.7
Contributions Deduction	34	15.8	24.2	24	9.2	22.8
Medical Expense Deduction	--	--	1.1	--	--	0.7
Casualty Loss Deduction	13	6.1	0.3	8	3.1	0.3
Miscellaneous Deduction	43	20.0	6.7	35	13.5	5.1
Foreign Tax Credit	13	6.1	0.9	13	5.0	0.9
Investment Credit	4	1.9	6.8	--	--	5.5
All Other Preference Credits 3/	--	--	1.4	--	--	0.8
TOTAL	215	100 %	100 %	260	100 %	100 %
	---AGI plus Preferences---			---AGI less Investment Interest---		
Interest Paid Deduction 2/	232	64.1 %	17.1 %	41	32.5 %	3.7 %
Taxes Paid Deduction	22	6.1	47.0	14	11.1	55.6
Contributions Deduction	29	8.0	21.6	24	19.1	25.2
Medical Expense Deduction	--	--	0.9	--	--	0.8
Casualty Loss Deduction	15	4.1	0.3	6	4.8	0.3
Miscellaneous Deduction	47	13.0	5.2	28	22.2	6.3
Foreign Tax Credit	13	3.6	0.9	13	10.3	1.0
Investment Credit	4	1.1	5.7	--	--	6.3
All Other Preference Credits 3/	--	--	1.3	--	--	0.9
TOTAL	362	100 %	100 %	126	100 %	100 %

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Office of Tax Analysis

July 24, 1978

Source: 1975 Internal Revenue Servie Tax Model.

1/ On returns with both large itemized deductions and large credits, the largest deduction or credit was determined by omitting the largest deduction, recomputing the tax, and comparing the resulting tax to the largest credit.

2/ Adjusted for any interest which may already have been deducted in the calculation of income.

3/ Includes retirement income credit, investment credit, work incentive (WIN) credit, foreign tax credit, credit for contributions to candidates for public office, new residence credit, and earned income credit.

Tables 18 through 25 present itemized deductions as a whole and each itemized deduction and major tax credit separately as a percentage of income. Each line of these tables shows the total number of returns which used the particular deduction or credit at all and the relative importance of each deduction as a percentage of income. These tables also provide separate distributions for investment interest not in excess of investment income and for investment interest in excess of investment income. Tables 18 through 21 are for 1976; Tables 22 through 25 are for 1975. For each year, there is a separate table for high-income nontaxable returns selected by each of the four definitions of income.

A third method of examining how returns are made nearly or completely nontaxable is to calculate the average impact of a particular provision in reducing income or taxes for a group of taxpayers. This method is simple and straightforward. It can also be used to show the effect of particular provisions on average or aggregate tax liabilities. However, it does have the disadvantage of averaging data that may be widely disparate so that differences among returns are obscured. If 50 returns were to make extensive use of a provision and 50 others did not use that provision at all, average or aggregate data would indicate moderate use even though not a single return in the group used the provision moderately.

Aggregate income, preferences, deductions, credits, and taxes for 1976 returns with incomes of $200,000 or more are shown in the first eight tables in Appendix A. There are two tables for each of the four income definitions. The first table contains aggregate data; on the second table, all items are shown as percentages of income. Each table has data for all returns, nontaxable returns, nearly nontaxable returns, and all other taxable returns. The percentage tables facilitate comparisons among the nontaxable, nearly nontaxable, and all other taxable columns. Data for 1975 and for 1974 are contained in analogous tables in Appendices B and C, respectively.

How to Make a Return Nontaxable

All three of the approaches described in the preceeding section may be used together to analyze the reasons for nontaxability. However, because of serious data problems, only qualified conclusions can be drawn from analysis of the 1976 data. Apparently, at least half of the 1976 high-income

Table 18

Itemized Deductions and Credits as Percentages of Expanded Income for Nontaxable Returns with Expanded Income of $200,000 or Over -- 1976

Deduction or Credit	Total Number of Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of Expanded Income: Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	89									
Itemized deductions, total.....	79	14	3				3		22	37
Medical deduction	52	51			1					
Taxes paid deduction	71	60	6	2	2				1	
Contributions deduction	64	43			1	3			2	15
Interest deduction	17	9	1				1		4	2
Casualty loss deduction	23	1						1	18	3
Miscellaneous deduction	54	33	4	5	1		1		2	8
Deduction Equivalent of:										
Foreign tax credit	14							1	13	
Investment credit	3	2	1							
All other preference credits.	1	1								
Memo: Investment interest in excess of investment income 2/	10	4					1		3	2

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Source: 1976 Statistics of Income.

1/ Includes returns with total reported deductions equal to or exceeding expanded income.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 19

Itemized Deductions and Credits as Percentages of Adjusted Gross Income for Nontaxable Returns with Adjusted Gross Income of $200,000 or Over -- 1976

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of Adjusted Gross Income: Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	68									
Itemized deductions, total	68	11	2	1				1	11	42
Medical deduction	29	27			1	1				
Taxes paid deduction	60	48	8	3					1	
Contributions deduction	53	42	2	1	5		2		1	
Interest deduction	54	13	6	3	1		1		12	18
Casualty loss deduction	10	4						1	2	3
Miscellaneous deduction	56	33	9	3			1		2	8
Deduction Equivalent of:										
Foreign tax credit	15	1						1	13	
Investment credit	8	5	1	2						
All other preference credits.	2	2								
Memo: Investment Interest: 2/										
Not in excess of investment income	49	14	5	3	1	3	6	3	8	6
In excess of investment income	28	6	4	2	4	3	1		6	2

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Source: 1976 Statistics of Income.

1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 20

Itemized Deductions and Credits as Percentages of Adjusted Gross Income plus Preferences for Nontaxable Returns with Adjusted Gross Income plus Preferences of $200,000 or Over -- 1976

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of AGI Plus Preferences								
		Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	114									
Itemized deductions, total	104	13	2	1			1	6	26	55
Medical deduction	64	62			1	1				
Taxes paid deduction	96	81	11	3					1	
Contributions deduction	88	62	2	2	4	2			1	15
Interest deduction	75	31	6	6	1		2	1	12	16
Casualty loss deduction	26	4						1	18	3
Miscellaneous deduction	76	50	9	6			1		2	8
Deduction Equivalent of:										
Foreign tax credit	15	1						1	13	
Investment credit	8	5	1	2						
All other preference credits.	2	2								
Memo: Investment interest in excess of investment income 2/	26	6	4	2	3	3			6	2

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Source: 1976 Statistics of Income.

1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income plus preferences.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 21

Itemized Deductions and Credits as Percentages of Adjusted Gross Income less Investment Interest for Nontaxable Returns with Adjusted Gross Income less Investment Interest of $200,000 or Over -- 1976

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of AGI less Investment Interest: Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	42									
Itemized deductions, total	42	11	3						5	23
Medical deduction	17	16			1					
Taxes paid deduction	34	26	3	2	2				1	
Contributions deduction	28	22			1	2	1		2	
Interest deduction	16	8	1						4	3
Casualty loss deduction	7	1						1	2	3
Miscellaneous deduction	34	16	4	2	1		1		2	8
Deduction Equivalent of:										
Foreign tax credit	14							1	13	
Investment credit	3	2	1							
All other preference credits.	1	1								
Memo: Investment interest in excess of investment income 2/	10	4							3	3

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Source: 1976 Statistics of Income.

1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income less investment interest.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 22

Itemized Deductions and Credits as Percentages of Expanded Income for Nontaxable Returns with Expanded Income of $200,000 or Over -- 1975

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of Expanded Income								
		Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	215									
Itemized deductions, total	172	19	7	1	5	8	6	9	38	79
Medical deduction	74	68	5		1					
Taxes paid deduction	162	95	29	16	7	2	5	2	5	1
Contributions deduction	153	89	8	13	13	12	15	1	2	
Interest deduction	94	43	5	1	4	4	5	2	17	13
Casualty loss deduction	26	11	2						2	11
Miscellaneous deduction	143	63	20	10	8	16	8	4	8	6
Deduction Equivalent of:	51	20	11	7		1		1	11	
Foreign tax credit	25	6	3	3		1		1	11	
Investment credit	31	19	9	3						
All other preference credits.	2	2								
Memo: Investment interest in excess of investment income 2/	56	10	3		3	4	4	2	17	13

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Source: 1976 Statistics of Income.

1/ Includes returns with total reported deductions equal to or exceeding expanded income.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 23

Itemized Deductions and Credits as Percentages of Adjusted Gross Income for Nontaxable Returns with Adjusted Gross Income of $200,000 or Over -- 1975

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit								
		Deduction or Credit as Percentage of Adjusted Gross Income								
		Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	260									
Itemized deductions, total	256	3	4	1		1		4	70	173
Medical deduction	123	117	4	1	1					
Taxes paid deduction	253	184	34	13	9	2	2	2	6	1
Contributions deduction	242	146	22	19	29	13	13			
Interest deduction	246	41	17	9	12	13	8	19	74	53
Casualty loss deduction	29	20	1				1		2	5
Miscellaneous deduction	226	128	31	21	10	8	7	4	8	9
Deduction Equivalent of:	65	33	10	6	3		1	1	11	
Foreign tax credit	35	13	3	3	3		1	1	11	
Investment credit	39	30	6	3						
All other preference credits.	5	5								
Memo: Investment Interest: 2/										
Not in excess of investment income	238	52	30	21	18	15	14	21	60	7
In excess of investment income	119	21	11	10	18	14	11	6	18	10

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Source: 1975 Internal Revenue Service tax model.

1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 24

Itemized Deductions and Credits as Percentages of Adjusted Gross Income Plus Preferences for Nontaxable Returns with Adjusted Gross Income Plus Preferences of $200,000 or Over -- 1975

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of AGI plus Preferences: Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	362									
Itemized deductions, total	319	12	11	8	5	10	6	6	110	151
Medical deduction	143	137	5		1					
Taxes paid deduction	309	233	38	16	6	5	2	2	6	1
Contributions deduction	295	196	26	29	19	25				
Interest deduction	291	52	27	21	18	12	11	16	83	51
Casualty loss deduction	44	29					1		4	10
Miscellaneous deduction	265	156	33	22	11	17	8	3	8	7
Deduction Equivalent of:	80	45	14	8		1		2	10	
Foreign tax credit	35	14	3	5		1		2	10	
Investment credit	54	42	9	3						
All other preference credits.	5	5								
Memo: Investment Interest: 2/										
Not in excess of investment income	233	66	38	26	30	13	16	17	67	10
In excess of investment income	116	25	9	9	19	11	11	6	18	8

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Source: 1975 Internal Revenue Service tax model.

1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income plus preferences.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

Table 25

Itemized Deductions and Credits as Percentages of Adjusted Gross Income less Investment Interest for Nontaxable Returns with Adjusted Gross Income less Investment Interest of $200,000 or Over - 1976

Deduction or Credit	Total of Number Returns	Number of Returns with Deduction or Credit — Deduction or Credit as Percentage of AGI less Investment Interest: Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or more 1/
All Returns	126									
Itemized deductions, total	122	4	3	1		1		4	31	78
Medical deduction	59	53	5		1					
Taxes paid deduction	119	65	25	11	7	2	2	2	3	2
Contributions deduction	114	58	5	9	11	10	17	2	2	
Interest deduction	78	29	3	2	2	2	6	2	17	15
Casualty loss deduction	13	6	1						1	5
Miscellaneous deduction	108	43	15	11	8	6	7	5	6	7
Deduction Equivalent of:	39	11	8	4	3		1	1	11	
Foreign tax credit	24	5	2	1	3		1	1	11	
Investment credit	19	11	6	2						
All other preference credits	2	2								
Memo: Investment interest in excess of investment income 2/	55	10	2		2	2	5	3	16	15

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Source: 1976 Statistics of Income.

1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income less investment interest.

2/ For each return total interest was divided into two parts: an amount not in excess of investment income; and the remainder which represents investment interest in excess of investment income. Mortgage interest (which is ordinarily not a large portion of total interest for these returns) was subtracted from total interest to determine investment interest. Investment income consists of dividends, interest, and realized capital gains included in income.

returns which filed as nontaxables actually had large enough itemized deductions to be subject to the minimum tax and, therefore, were taxable. Usually, such returns would fall into the nearly nontaxable category. Because of these data problems, some of the analysis in this chapter is repeated in Chapter 6 for the truly nontaxables, but the corrected data is only available for high AGI returns. The data analyzed in this chapter are all that is available for the three other income measures. Despite these problems, analyzing the available data should shed some light on which tax provisions are used most commonly to make returns nontaxable or nearly nontaxable.

As in prior years, the interest paid deduction was the largest deduction item most frequently for high AGI returns (see Table 17). However, the importance of interest as the largest deduction or credit drops by more than half and falls to only the third most important item when high expanded income returns are used (Table 16). More importantly, on only 10 of the 89 high expanded income nontaxable returns was there <u>any</u> investment interest in excess of investment income (Table 18). Interest expense (including mortgage interest) was almost 17.6 percent of expanded income for nontaxables, 9.6 percent for nearly nontaxables, but only 2.9 percent for all other taxables. Excess investment was 6.5 percent for nontaxables, 1.6 percent for nearly nontaxables, and only 0.3 percent for all other taxables (see Table 76-2 in Appendix A). Clearly, investment interest, both non-excess and excess, was a less important item for the all other taxables than for the other groups. However, under the expanded income concept, non-excess investment interest is reognized as a legitimate investment expense, and in only six cases was excess investment interest large enough to play a major role in making a return nontaxable (Table 16).

The largest item method shows the casualty loss deduction to be the most frequent reason for making a high expanded income return nontaxable in 1976; it was among the least important items for taxable returns (Table 16). The importance of casualty losses is confirmed by both other methods, and it likely that it played a major role in the nontaxability of one quarter of all nontaxable high expanded income returns (Table 18). This item is vastly more important for nontaxables than for taxable returns. Although the absolute number of casualty loss deductions did not change appreciably between 1975 and 1976, the relative importance of the casualty losses grew dramatically because the casualty loss deduction became one of only two itemized

deductions not included among the excess itemized deductions subject to the minimum tax (Tables 18 and 22). The casualty deduction was the largest single item 14 times (out of 89) in 1976 (Table 16) and 13 times (out of 215) in 1975 (Table 17).

The deduction for charitable contributions was cited second most frequently as the largest item causing nontaxability. Contributions were the largest item on 21.3 percent of nontaxable expanded income returns, about as frequently (23.8 percent) as on taxable returns (Table 16). Also, on over two-thirds (43 out of 64) of the returns which had any contribution deduction, that deduction was less than 10 percent of expanded income (Table 18). On the the other hand, there are 17 returns on which this deduction exceeds 70 percent of expanded income, and 15 returns on which it exceeds 100 percent of expanded income (Table 18). This is approximately the same as the 19 cases in which it is the largest deduction (Table 16). In the aggregate, the deductions for charitable contributions on nontaxable high expanded income returns are extremely large (Table 76-2). In fact, it is one and one half times AGI, which far exceeds the statutory limit of deductibility. It is likely that the data are being distorted by a few extremely large deductions which have not been reduced to their legal limits because the returns would have been nontaxable anyway. In the aggregate, the contributions of the nearly nontaxables do not appear as impossibly large as for the nontaxables. Nevertheless, the charitable deduction is a three times larger share of expanded income for nearly nontaxables than for other taxables (Table 76-2). Thus, although the contributions deduction may have been a major factor in the nontaxability of more than one-fifth of the nontaxable returns, for most nontaxable returns, contributions are no more important than for taxable returns.

As measured by the largest single item method, the only two other items of significance are the miscellaneous deduction and the foreign tax credit (Table 16). Both are much more important for nontaxables than for taxables. For high-income returns, the miscellaneous deduction consists mainly of investment expenses other than interest, employee expenses, and alimony paid, all of which could arguably be "above-the-line" deductions which should be taken in computing income. 2/ As Table 76-2 shows, this deduction is far more important for nontaxables (22.8 percent of expanded

2/ Beginning in 1977, alimony payments have been converted from a miscellaneous deduction for itemizers to a deduction in the calculation of AGI.

income) than for nearly nontaxables (10.0 percent of expanded income) or for all other taxes (1.7 percent of expanded income). On 11 percent of the high expanded income returns, the miscellaneous exceeded 70 percent of expanded income, (Table 18).

When the foreign tax credit appears on a nontaxable return, it is usually large enough to account for nontaxability entirely by itself, even if other deductions and credits are relatively small. The nontaxability of about one out of six of the expanded income nontaxables can be attributed to the foreign tax credit (Table 18). As measured by aggregate data (Table 76-2), this credit is moderately important for both nontaxables (equivalent to a deduction of 9.5 percent of expanded income) and for nearly nontaxables (11.0 percent), but it is of almost no significance for all other taxables (0.2 percent). The foreign tax credit is the only credit of any importance for the nontaxables. In fact, only three nontaxables have any investment credit, and it is never large (Table 18). The investment credit is not the largest item on any nontaxable return even though it is the largest item for 6.4 percent of taxable high expanded income returns (Table 16). Its value relative to total expanded income of nontaxables is almost imperceptible (Table 76-2).

The deduction for state and local taxes is most noticeable for its lack of importance in causing nontaxability. In the aggregate, taxes as a percentage of expanded income are about the same level for all three categories of returns (Table 76-2). Taxes are the largest deduction category on only 2.2 percent of nontaxable returns but are the largest item on over half, (55.2 percent) of all taxable high expanded income taxable (Table 16). Though deductions for taxes appeared on most nontaxable expanded income returns, the deduction was less than 10 percent of expanded income two-thirds of the time, only exceeded 20 percent of expanded income 6 percent of the time, and only exceeded 70 percent of expanded income in one percent of the cases (Table 18).

For the nontaxables, preferences comprised 53.6 percent of expanded income, about 93 percent of which was due to the excluded portion of long-term capital gains. For the nearly nontaxables, preferences were substantially smaller (38.7 percent of expanded income) with about 79 percent of them from excluded capital gains. For all other taxable returns, preferences were 23.8 percent of expanded income, with about 74 percent of them for excluded capital gains (Table 76-2).

The tax savings from the alternative tax, from the maximum tax on earned income, and from income averaging are not significant for either nontaxables or nearly nontaxables. Taken together, they are much less important for these groups than for the remainder of taxable returns (Table 76-2).

Nontaxables are not affected by the minimum tax. For nearly nontaxables, the minimum tax is equivalent to losing a deduction of 10.0 percent of expanded income, but it does represent 79 percent of that group's tax bill. Thus, eliminating the minimum tax would reduce the tax liabilities to an insignificant level of 1.5 percent of expanded income. For all the other taxable returns, the minimum tax represents a loss of deductions of 3.7 percent of expanded income, but it represents less than 7 percent of the group's total tax bill (Table 76-2).

In terms of aggregates for the entire group of fully and nearly nontaxables, the significance of itemized deductions in reducing taxes appears to diminish. Of course, the aggregates do tend to show averages and thereby hide some of the differences that make individual returns unique. Nonetheless, this methodology indicates that the omission of tax preference income from the tax base is the most important means by which taxes are reduced or eliminated (Table 76-2).

Findings

This chapter has provided the data and the methods for analyzing the relative importance of various items in reducing taxes or in making a return nontaxable. Three different methods have been employed: the largest single deduction or credit; deductions and credits on a particular return as percentages of income shown on that return; and data showing the average shares of preferences, deductions, and credits for all returns in a particular class. The data indicate that nontaxability often is due to a combination of causes. Even in those cases where a very large single item does appear, no one particular item is of overwhelming importance. In terms of expanded income, several items play major rolls in nontaxability: preference income, predominantly capital gains; itemized deductions for interest, for miscellaneous expenses, for charitable contributions, and for casualty losses; and the foreign tax credit.

In order to verify the indications that many high-income individuals who reported that they had no tax liabilities were actually subject to the minimum tax, an individual inspection of the 68 supposedly nontaxable high AGI returns was undertaken. As a result of this case by case analysis, it was determined that there were only 22 high AGI nontaxables in 1976. An analysis of these 22 returns including the reasons for their nontaxability is contained in Chapter 6.

Chapter 6

22 High Adjusted Gross Income Nontaxable Returns in 1976

Fewer Nontaxable Returns

All of the data presented so far in this report have been derived from the Internal Revenue Service Statistics of Income (SOI) for individual income tax returns. For each year, the SOI consists of a weighted sample of all individual tax returns which have been filed. Except for certain corrections of obvious arithmetic errors, the SOI data are exactly as reported by taxpayers on their tax returns. Not only are the data before audit by the IRS, but also the data do not reflect errors in tax computations, etc. which are apparent from the income, deduction, and credit items shown by the taxpayers on their returns -- even if the tax shown is inconsistent with other items on the return.

For purposes of classifying tax returns for this report, the most important problem in using tax as reported on the return has been the failure of taxpayers to calculate properly the minimum tax on items of tax preference. In the first year or two after the introduction of the minimum tax in 1970, a substantial proportion of high income, supposedly nontaxable tax returns contained this error and were actually taxable. By 1973, the error rate had fallen to about 5 percent; and, in 1975, this error had virtually disappeared. However, this error has reoccurred on 1976 tax returns to such an extent that the 1976 SOI data vastly overstate the frequency of high-income, nontaxable returns. An examination of all 68 of the supposedly nontaxable high AGI returns showed that there are actually only 22 nontaxable returns with AGI of $200,000 or over.

After all of the 1976 tabulations shown elsewhere in this report were completed, it became apparent that there were internal inconsistencies in the tabulations that could only be a result of taxpayers' errors in the computation of the minimum tax on items of tax preference, particularly the new preference for excess itemized deductions. Under the Tax

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Reform Act of 197●, itemized deductions (other than casualty losses or medical expenses) to the extent that they exceed 60 percent of AGI were made a tax preference item for minimum tax purposes.1/ Beginning in 1976, the exclusion from the minimum tax is the larger of $10,000 ($5,000 on the return of a married person filing separately) or one-half of ordinary tax liabilities. For returns with no regular tax liability, a minimum tax would be due on any return where a particular itemized deduction or the sum of all itemized deductions (other than casualty and medical deductions) exceeded 60 percent of AGI by at least $10,000 (or $5,000 on the separate return of a married person). An examination of Table 19 shows that 54 and of the 68 supposedly nontaxable returns with AGI of $200,000 and over have total itemized deductions exceeding 60 percent of AGI and 53 have total deductions exceeding 70 percent of AGI. Even after excluding the returns with large casualty losses or large medical expenses, the table shows that 46 of the high-income returns as defined by AGI are likely to be subject to the minimum tax simply from their excess itemized deductions. 2/ Thus, instead of 68 high-income, nontaxable returns, Table 19 suggests that there are only about 22.

Examination of the 68 supposedly nontaxable high AGI returns for 1976 (which had already been asembled), verified the conclusions drawn from the data in Table 19. Based solely on the excess itemized deduction tax preference item, 45 of the returns were actually subject to the minimum tax. 3/

1/ Under the "no tax benefit rule," if itemized deductions exceed 100 percent of AGI, only the amount between 60 and 100 percent of AGI is a preference item. Otherwise, itemized deductions that did not reduce tax liabilities would produce an increase in the minimum tax.

2/ The exact number of returns subject to the minimum tax cannot be determined exactly from Table 19 because it cannot be determined which of the returns have the large casualty and medical deductions; hence, the table does not show the exact distribution of total itemized deductions excluding medical and casualty expenses.

3/ During this examination it was found that one return should not have been included in the high AGI group; it was included only because of the incorrect placement on the return of certain income and deduction items.

Thus, there are only 22 high AGI nontaxables for 1976. Only five one-hundredths of one percent of all high AGI tax returns filed in 1976 were nontaxable. These 22 nontaxable returns represent a reduction of over 90 percent in the number of nontaxable high income returns as compared to 1974 and 1975. With only 22 nontaxable returns, all of which were examined, it is possible to describe these returns, their characteristics, and the reasons for their nontaxability in more detail and with greater certainty than was possible for the far larger groups of nontaxable returns in prior years. The characteristics of these 22 returns are described in the second section of this chapter.

Since AGI plus preferences is always larger than AGI, any return with itemized deductions (other than medical expenses or casualty losses) in excess of 60 percent of AGI plus preferences will be subject to the minimum tax, and, therefore, will be taxable. Using this methodology for returns with at least $200,000 of AGI plus preferences, it appears as if at least 63 of the 114 returns, or 55 percent, which did not report any tax liabilities are actually taxable (See Table 20). This method of determining tax status is not quite as reliable for returns selected by expanded income or by AGI less investment interest. However, because of the substantial overlap of the same tax returns within all four groups, the results of a similar calculation for these two other groups cannot be too far off. Table 18 indicates that 36, or 40 percent, of the 89 returns with expanded income of $200,000 or over are taxable. Similarly, 21, or 50 percent, of the 42 returns with high AGI less investment interest are taxable (Table 21).

Unfortunately, it was not possible to verify fully these indications about the substantially reduced numbers of nontaxable returns as selected by expanded income, AGI plus preferences, and AGI less investment interest. The actual tax returns for the high income nontaxables under these three income definitions were not readily available. Since obtaining either the actual returns or additional tabulations from the 1976 SOI file would have delayed completion of this report inordinately, corrected tabulations and detailed analysis based on them will be included in the next high income report.

For purposes of this report, it will be assumed that the indications from Tables 18 through 22 are accurate and that in 1976 there are:

--53 high-income nontaxables as defined by expanded income;

--22 high-income nontaxables as defined by AGI;

--41 high-income nontaxables as defined by AGI plus preferences; and

--21 high-income nontaxables as defined by AGI less investment interest.

While the additional analyses of the 1976 high-AGI nontaxables do show a significant change from the SOI data, they do not eliminate the usefulness of SOI data, especially for the nearly nontaxable and all other taxable categories. Applying the minimum tax to these returns only shifts the returns from the nontaxables to the nearly nontaxables. Since these two groups generally exhibit similar characteristics, the shift of returns will not significantly affect the conclusions about these returns that can be drawn from the SOI data. The only significant change is a decrease in the number of nontaxables and an equivalent increase in the number of nearly nontaxables.

The 22 High-AGI Nontaxables in 1976

The examination of the 22 high-AGI nontaxable returns for 1976 indicated that all except two were nontaxable for one of two reasons: a foreign tax credit or a casualty loss deduction. Fourteen of the returns were clearly nontaxable because of foreign tax credits; six returns were nontaxable because of casualty loss deductions; nontaxability on the last two returns was due to a combination of factors.

As the upper portion of Table 26 indicates, on every one of the 14 returns which were nontaxable due to the foreign tax credit, the foreign tax credit was equivalent to a deduction of at least 70 percent of AGI. On four of these returns, either the standard deduction was used, or the taxpayers did not bother to take either the standard deduction or to itemize their deductions. On the ten returns

Table 26

Itemized Deductions and Credits as Percentages of Adjusted Gross Income for the 22 Nontaxable Returns with Adjusted Gross Income of $200,000 or Over in 1976

Itemized Deduction or Credit	Total Number of Returns	Number of Returns With Deduction or Credit — Deduction or Credit as Percentage of Adjusted Gross Income: Under 10%	10% under 20%	20% under 30%	30% under 40%	40% under 50%	50% under 60%	60% under 70%	70% under 100%	100% or More 1/
Returns Nontaxable due to the Foreign Tax Credit										
Number of Returns	14									
Itemized deductions, total..........	10	7	2	1						
Medical deduction	4	4								
Taxes paid deduction	9	9								
Interest deduction	6	5	1							
Contributions deduction	8	8								
Casualty loss deduction										
Miscellaneous deduction	7	6	1							
Deduction Equivalent of:										
Foreign tax credit	14								14	
Investment credit										
Returns Nontaxable due All Other Causes										
Number of Returns	8									
Itemized deductions, total	8							1	2	5
Medical deduction	3	2				1				
Taxes paid deduction	8	7	1							
Interest deduction	8	4	2	1			1			
Contributions deduction	8	6		1	1					
Casualty loss deduction	6							1	2	3
Miscellaneous deduction	6	3	2	1						
Deduction Equivalent of:										
Foreign tax credit	1	1								
Investment credit	1			1						

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1/ Includes returns with total reported deductions equal to or exceeding adjusted gross income.

that had itemized deductions, seven of the returns had deductions of less than 10 percent of AGI, and the remaining three had itemized deductions of between 10 and 30 percent of AGI. On no return were itemized deductions greater than 30 percent of AGI. Table 27 shows the relationship between the largest and the second largest items of deduction or credit on each of these returns. It indicates that on returns that were nontaxable because of the foreign tax credit there was no uniformly important second largest item of deduction or credit. On five of the returns, taxes were the next largest item; on three of the returns, the interest deduction was the next largest deduction; and on two returns various miscellaneous deductions were the next largest item. On four returns, there was no other credit or deduction item (except for the standard deduction). Moreover, in only two cases was the second largest deduction item greater than 10 percent of AGI.

Six of the eight remaining returns were nontaxable because of large casualty losses. These losses were about evenly divided between losses to income-producing property and casualty losses to non-income-producing property such as a personal residence. As indicated on the lower portion of Table 26, these casualty losses were very large. All six of them exceeded 60 percent of AGI; two of them were between 70 and 100 percent of AGI; and three exceeded the entire amount of AGI. The fraction of other itemized deductions on these returns was not nearly so uniform as on the returns that were nontaxable because of the foreign tax credit; however, itemized deductions were never very large. In no case did itemized deductions other than the reported casualty loss exceed 50 percent of AGI. As indicated on Table 27, there was no uniformly second most important deduction or credit item on these six returns. In one case it was interest; in another, taxes; in two cases, charitable contributions; and in two cases, the miscellaneous deduction. It is interesting to note that none of these six returns used the foreign tax credit or the investment credit.

The returns that had large casualty losses are likely to be nontaxable in two or more successive years because they have large carryover losses. However, because of peculiarities of the loss carryover computation and its placement on the tax return, these returns are not likely to appear as high-income nontaxable returns in the carryover years. The carryover of a casualty loss becomes part of a net operating loss. It reduces AGI; it is not a deduction from AGI, as is true for the year in which the casualty

Table 27

Largest and Second Largest Deduction or Credit on the 22 Nontaxable Returns with Adjusted Gross Income of $200,000 or Over in 1976

Largest Deduction or Credit	Total	Second Largest Deduction or Credit								
		Interest Paid Deduction	Taxes Paid Deduction	Contributions Deduction	Medical Expense Deduction	Casualty Loss Deduction	Miscellaneous Deduction	Foreign Tax Credit	Investment Credit	None
Interest Paid Deduction	1				1					
Taxes Paid Deduction										
Contributions Deduction	1								1	
Medical Expense Deduction										
Casualty Loss Deduction	6	1	1	2			2			
Miscellaneous Deduction										
Foreign Tax Credit	14	3	5				2			4
Investment Credit										

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actually occurred. Because the large casualty loss carryover losses reduce AGI, these returns are not likely to have AGI of $200,000 or over in the carryover years, and, therefore, they are not likely to be classified as high-income returns in those years.

The two remaining returns were nontaxable for combinations of reasons. One of the returns was nontaxable because of very large medical and interest deductions. This was the only return of the 22 in which the interest-paid deduction exceeded 30 percent of AGI. Even on this return, the interest deduction was only between 50 and 60 percent of AGI. On the last return, itemized deductions just slightly exceeded 60 percent of AGI; however, they did not exceed 60 percent by the $10,000 necessary to produce minimum tax liability. While itemized deductions reduced AGI by slightly more than 60 percent, the remainder was eliminated by a substantial investment credit and a rather insignificant foreign tax credit. It may be of some interest to note that of the 22 nontaxable returns, this is the only one which used the investment credit at all. 4/

Table 28 summarizes the sources of income, the deductions, and the credits for the 22 nontaxable returns. The data are presented separately for the 14 returns made nontaxable by the foreign tax credit, for those made not taxable for any other reason, and for all 22 returns together. These returns were noticeably different from nontaxables in the recent past. Aside from the one or two items which made them nontaxable, these returns did not appear unusual. Their income sources were typical of high-income taxpayers, they did not appear to be attempting to shelter income from taxes, and their itemized deductions were not unusually large.

Table 29 summarizes some characteristics of these 22 nontaxable returns. Again, the data are separated by the source of nontaxability: either the foreign tax credit or all other reasons. Only one of the 22 returns had AGI of over $1 million. None of the 8 returns whose nontaxability

4/ Some of the 14 returns which were made nontaxable by large foreign tax credits did have investment credits available. However, because the foreign tax credits completely wiped out tax liability, the investment credits were not used; they were carried forward to future tax years or back to prior years.

Table 28

Income, Deductions, and Credits for the 22 Nontaxable Returns with Adjusted Gross Income of $200,000 or Over in 1976

	Returns Nontaxable due to Foreign Tax Credit			Other Nontaxable Returns			All Nontaxable Returns		
	Number of Returns With Item	Amount	Amount as Percentage of AGI	Number of Returns With Item	Amount	Amount as Percentage of AGI	Number of Returns With Item	Amount	Amount as Percentage of AGI
Wages and salaries	11	$2,126,464	40.6 %	5	$ 779,066	34.6 %	16	$2,905,530	38.8 %
Sole Proprietorship Income	5	804,163	15.4	2	166,077	7.4	7	970,240	13.0
Dividends 1/	5	1,823,485	34.8	8	1,015,037	45.1	13	2,838,522	37.9
Interest	12	141,782	2.7	8	228,763	10.2	20	370,545	5.0
Capital gains 2/	5	2,426	0.1	4	152,888	6.8	9	155,314	2.1
Pensions	1	809	*				1	809	*
Rents and royalties	3	(15,890)	(0.3)	5	14,535	0.6	8	(1,355)	(*)
Partnership income 3/	5	450,573	8.6	6	(112,854)	(5.0)	11	337,719	4.5
Farm income	2	(86,062)	(1.6)	1	(5,418)	(0.2)	3	(91,480)	(1.2)
State income tax refunds	2	8,389	0.2	3	16,394	0.7	5	24,783	0.3
Other income	4	109	*	1	(123)	*	5	(14)	*
Total		5,260,368	100.5		2,254,345	100.2		7,514,713	100.4
Adjustments to income 4/	4	26,193	0.5	1	3,527	0.2	5	29,720	0.4
Adjusted Gross Income		5,234,177	100 %		2,250,818	100 %		7,484,995	100 %
Standard deduction	4	10,400	0.2				4	10,400	0.1
Medical expense deduction	5	739	*	3	110,903	4.9	8	111,642	1.5
Taxes paid deduction	10	62,786	1.2	8	131,565	5.8	18	194,351	2.6
Interest paid deduction	6	81,673	1.6	8	341,745	15.2	14	423,418	5.7
Contributions deduction	8	17,358	0.3	8	211,888	9.4	16	229,246	3.1
Casualty deduction				6	3,690,504	164.0	6	3,690,504	49.3
Miscellaneous deduction	7	54,700	1.1	6	169,949	7.6	13	224,649	3.0
Total deductions		217,256	4.2		4,656,556	206.9		4,873,812	65.1
Taxable Income		4,976,321	95.1		87,087	3.9		5,063,408	67.6
Foreign tax credit	14	2,962,593	56.6	1	262	*	15	2,962,855	39.6
Investment credit				1	18,785	0.8	1	18,785	0.3
Deduction equivalent of:									
Foreign tax credit	14	4,742,934	90.6	1	495	*	1	4,743,429	63.4
Investment credit				1	53,368	2.4	1	53,368	0.7
Number of Returns	14			8			22		

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Source: 1976 income tax returns

* Less than 0.05 percent.

1/ Net of $100 dividend exclusion.
2/ Net of the deduction of one-half of the excess of net long-term gains over short-term losses.
3/ Includes income from small business corporations and from estates and trusts.
4/ Predominantly, moving expenses.

Table 29

Characteristics of the 22 Nontaxable Returns with Adjusted Gross Income of $200,000 or Over in 1976

	Nontaxable Due to		All
	Foreign Tax Credit	All Other Reasons	Returns Nontaxable
Adjusted Gross Income			
$ 200,000 - $ 500,000	11	8	19
$ 500,000 - $1,000,000	2	0	2
$1,000,000 and over	1	0	1
ALL	14	8	22
Age			
Under 65	13	7	20
65 or over 1/	1	1	2
ALL	14	8	22
Tax Filing Status			
Single	1	0	1
Married, Filing Joint Return 2/	8	7	15
Married, Filing Separate Return	2	1	3
Unmarried, Head of Household	3	0	3
ALL	14	8	22

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1/ Indicates that on a joint return at least one of the taxpayers claims the extra exemption for age.

2/ Includes qualifying widow or widower with at least one dependent child.

was not attributable to the foreign tax credit had AGI in excess of $500,000. The distribution of the returns by filing status was somewhat unusual. Of the 22 returns only one filed as a single taxpayer, but 3 filed as heads of households, and 3 filed as married persons filing separately. Fourteen of the returns, or 64 percent, were joint returns of married couples. The age distribution on the returns was also noteworthy. On only 2 of the 22 returns were extra exemptions claimed because the tax filers were over 65 years of age.

Foreign Taxes and the Foreign Tax Credit

Because each of these returns was examined individually, it was possible to determine the nature of the foreign taxes for each return. Twelve of the fourteen taxpayers whose liabilities were eliminated by the foreign tax credit paid foreign taxes of more than 50 percent of their AGI. In the thirteenth case, the foreign tax was almost 40 percent of AGI. In the last case, the foreign tax paid during 1976 was just over 10 percent of AGI but because of a large foreign tax credit carryover the allowable foreign tax credit exceeded 40 percent of AGI. By comparison, in 1976, only 24.6 percent of all persons with AGI of $200,000 or over paid an effective tax rate of 50 percent or more (see Table 5).

One reason why the foreign tax crdit has been considered a tax preferences by many tax reformers is that foreign taxes, especially those associated with oil and gas exploration, may actually be royalty payments to foreign governments disguised as taxes. For the fourteen high-income nontaxables who were made nontaxable by use of the foreign tax credit, there is only one instance where the foreign taxes may have been disguised royalties to a foreign government. On the thirteen other returns, the foreign taxes represent legitimate tax payments to foreign governments based on income generated in foreign countries. In several of these cases, the tax filers were residents of foreign countries and either worked abroad, owned and operated businesses abroad, or had substantial income-producing properties abroad. To the extent that foreign accounting methods coincide with U.S. practices and do not "hide" income, these taxpayers, though not paying any U.S. tax, have actually paid very substantial income taxes on their worldwide income. It is not at all clear that these persons should be considered high-income nontaxables.

Conclusion

While one can deduce the reasons by which a high-income tax return can become nontaxable under present law, such theoretical analyses are not as nearly as persuasive to many people as is the evidence from actual tax returns. The actual evidence from 1976 returns indicates that the problems of high-AGI, completely nontaxable returns has been virtually eliminated. The 22 nontaxable returns represent only five one-hundredths of one percent of all high-income returns. Moreover almost two-thirds of these returns, the ones nontaxable in the United States because of large foreign tax credits, are not really nontaxable.

Thus, in 1976 there were only eight high-AGI individuals who paid no income tax. Six of these are nontaxable because of casualty losses. One return was nontaxable in large part because of extraordinarily large medical expenses. The final nontaxable return used a combination of provisions in the tax law each of which was provided for a seemingly good and equitable reason. None of the provisions were used extensively. It would be of particular interest to know whether this same taxpayer will be able to perform this feat frequently or perennially.

Chapter 7

Tax Policy Considerations

The most important conclusions reached in this year's high-income report are outlined in Chapter 2, Highlights. This chapter discusses some possible tax policy implications which may be drawn from the conclusions.

Nontaxables

Now that the number of high-income nontaxables has been reduced to a virtual handful, is it worth devoting further legislative attention to completely eliminating such tax returns? The answer to that question depends (1) on whether our data indicating virtual elimination are, indeed, correct and (2) upon the ease or difficulty in further reducing the number of high-income nontaxables.

As discussed in Chapter 3, even the broader expanded income measure used in this report is not as comprehensive as economic income because expanded income omits all sources of income which cannot be identified from tax returns. Tax returns simply do not provide information about several sources of income which are of importance to high-income taxpayers such as tax-exempt state and local bond interest and the income sheltered by straight-line depreciation of real estate in excess of economic depreciation. In order to get a better measure of tax rates of high-income individuals and the true number of high-income nontaxables, more data on the amounts of, and distributions of, these income sources are needed.

It would be relatively simple to reduce further the number of nontaxables as measured by expanded income. Complete elimination could be accomplished by including casualty losses and medical expenses in the excess itemized deduction preference subject to the minimum tax and by setting some limit on the share or amount of United States income taxes which could be offset by the credit for foreign tax payments. Both of these changes raise serious question of equity. Is it appropriate to disallow foreign taxes as a

credit against U.S. taxes? Should people whose extraordinary and unavoidable expenses have effectively reduced their taxable incomes to zero be made subject to tax?

Nearly Nontaxables

The minimum tax has been extremely important in substantially reducing the number of high-income nontaxables. However, its effect has been to create an equivalent number of nearly nontaxables. In this manner, the minimum tax obscures the numbers of, and the problems of, individuals with very large incomes who do not pay their "fair share" of tax liabilities. For those who worry about high-income individuals bearing an appropriate share of the tax burden, the focus of attention now must move from the nontaxables, who have almost disappeared, to the nearly nontaxables whose numbers are still substantial.

When the attention of the Treasury Department and the Congress first focused on high-income nontaxables late in the 1960's, there were fewer than 300 nontaxables with adjusted gross income of $200,000 or over. In 1976, even with the virtual elimination of high-income nontaxables, there are approximately 500 nontaxables and nearly nontaxables with income, however defined, of $200,000 or over. These 500 people did not carry a fair share of the tax burden. The effective tax rates paid in 1976 by the high-income nontaxables and nearly nontaxables together was 6.3 percent. For the similar high AGI group, the effective tax rate was only 5.2 percent. In the same year, 1976, Statistics of Income data show that the effective tax rate for taxpayers with AGI between $6,000 and $8,000 was 6.2 percent. Between $8,000 and $10,000 of AGI, the effective rate was 8.2 percent. In 1976, a four-person family only had to have had an AGI of $11,500 or more (which was below median family income) to have had an effective tax rate of 8.2 percent. Thus, the nearly nontaxables had lower effective tax rates than typical, middle-income and lower middle-income taxpayers. Again, this suggests that attention must be focused on the high-income nearly nontaxables, who have so far escaped serious scrutiny.

Foreign tax credits

Should individuals who are nontaxable because of the foreign tax credit and who actually paid substantial foreign taxes be considered nontaxable for purposes of these

analyses? If the U.S. tax return of a U.S. resident or citizen must include worldwide income of that individual, it seems only proper to give that person credit for his worldwide income tax payments, whether made to the U.S. or to a foreign government. Eliminating such returns from the analyses would considerably reduce the remaining number of high-income nontaxables. It would also focus attention more sharply on those remaining high-income nontaxables who do not pay any income tax.

Perennial Tax Avoiders

A final item of significance concerns the level of taxes for the nontaxables and nearly nontaxables over periods of several years. Are these people taxable or nearly nontaxable for a single year that is preceeded and followed by years in which they pay substantial taxes, or are the same people nontaxable and nearly nontaxable, year in and year out? The existence of perennial nontaxables or nearly nontaxables would be much more indicative of a fundamental problem in the tax system than would the existence of a few high-income individuals who pay little or no tax in one year because of unusual circumstances but who pay substantial taxes in most other years. This is a fruitful subject for future analysis. The Treasury Department will begin a project to examine the returns of high-income nontaxables and nearly nontaxables for a period of several years.

Appendix A

1976 Data

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Table 76-1

Income, Deductions, Credits, and Taxes for Tax Returns
with Expanded Income of $200,000 or Over -- 1976

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	$ 22,164,488	$ 31,188	$ 241,240	$ 21,892,060
EXPANDED INCOME	22,164,488	31,188	241,240	21,892,060
AGI PLUS PREFERENCES	22,674,237	34,529	259,279	22,380,429
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	16,844,148	14,720	148,199	16,681,229
Investment Interest < Investment Income 1/	509,749	3,341	18,039	488,368
Tax Preferences	5,330,679	16,712	93,411	5,220,557
Excluded Long-Term Capital Gains	3,930,427	15,546	73,519	3,841,361
Dividend Exclusion	7,721	10	47	7,664
Other Tax Preferences 2/	1,392,532	1,156	19,845	1,371,531
ADJUSTED GROSS INCOME	17,373,180	20,967	172,456	17,179,758
Deficits	- 29,623	-3,149	- 6,588	- 19,885
AGI of Returns with AGI > 0	17,343,557	17,817	165,868	17,159,872
Exemptions	142,169	217	1,076	140,876
Standard Deductions	3,182	2	16	3,164
Itemized Deductions	3,718,477	51,739	110,560	3,556,178
Charitable Contributions	1,317,871	30,478	37,656	1,249,737
Interest: Total	657,830	5,488	23,093	629,249
Home Mortgage	92,967	369	1,683	90,915
Invest. Interest < Invest. Income 3/	499,410	3,097	17,669	478,644
Invest. Interest > Invest. Income 4/	65,453	2,022	3,741	59,690
Medical	43,887	163	1,914	41,811
Casualty	29,368	7,040	2,856	19,472
Tax Expense	1,272,625	1,458	20,786	1,250,382
Miscellaneous Deductions	396,896	7,113	24,255	365,528
Excess of Exemptions & Deductions over AGI	56,175	35,987	3,256	16,932
Taxable Income	13,565,528	4,995	64,060	13,496,472
Tax at Normal Rates	8,086,288	3,158	38,231	8,044,899
Saving from Alternative Tax 5/	48,161	0	138	48,022
Saving from Maximum Tax 5/	472,160	176	2,006	469,978
Saving from Income Averaging	145,030	10	1,621	143,399
Tax Before Credits	7,431,261	2,973	34,465	7,393,823
Tax Credits	201,963	2,974	30,849	168,140
Foreign Tax Credit	74,646	2,954	28,378	43,314
Investment Credit	126,693	20	2,456	124,217
All Other Credits 6/	624	0	15	609
Tax After Credits	7,229,298	0	3,615	7,225,683
Minimum Tax	537,737	0	13,513	524,225
Total Income Tax	7,767,036	0	17,128	7,749,908
Deduction Equivalent of Tax Credits 7/	313,927	4,726	48,750	260,450
Taxable Income which would yield: 8/	12,600,806	4,726	58,099	12,537,981
Income Tax before Credits	12,286,879	0	9,349	12,277,531
Income Tax after Credits	13,133,143	0	33,524	13,099,619
Total Income Tax				
Number of Tax Returns Represented in the tabulation	53,587	89	393	53,105

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

Table 76-2

Income, Deductions, Credits, and Taxes for Tax Returns with Expanded Income of $200,000 or Over -- 1976

As Percentages of Expanded Income

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	100.0	100.0	100.0	100.0
AGI PLUS PREFERENCES	102.3	110.7	107.5	102.2
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	76.0	47.2	61.4	76.2
Investment Interest < Investment Income 1/	2.3	10.7	7.5	2.2
Tax Preferences	24.0	53.6	38.7	23.8
Excluded Long-Term Capital Gains	17.7	49.8	30.5	17.6
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	6.3	3.7	8.2	6.3
ADJUSTED GROSS INCOME	78.4	67.2	71.5	78.5
Deficits	- 0.1	-10.1	- 2.7	- 0.1
AGI of Returns with AGI > 0	72.3	57.1	68.8	78.4
Exemptions	0.6	0.7	0.4	0.6
Standard Deductions	*	*	*	*
Itemized Deductions	16.8	165.9	45.8	16.2
Charitable Contributions	6.0	97.7	15.6	5.7
Interest: Total	3.0	17.6	9.6	2.9
Home Mortgage	0.4	1.2	0.7	0.4
Invest. Interest < Invest. Income 3/	2.2	9.9	7.3	2.2
Invest. Interest > Invest. Income 4/	0.3	6.5	1.6	0.3
Medical	0.2	0.5	0.8	0.2
Casualty	0.1	22.6	1.2	0.1
Tax Expense	5.7	4.7	8.6	5.7
Miscellaneous Deductions	1.8	22.8	10.0	1.7
Excess of Exemptions & Deductions over AGI	0.2	115.4	1.4	0.1
Taxable Income	61.2	16.0	26.6	61.6
Tax at Normal Rates	36.5	10.1	15.8	36.8
Saving from Alternative Tax 5/	0.2	0	0.1	0.2
Saving from Maximum Tax 5/	2.1	0.6	0.8	2.2
Saving from Income Averaging	0.6	*	0.7	0.7
Tax Before Credits	33.5	9.5	14.3	33.8
Tax Credits	0.9	9.5	12.8	0.8
Foreign Tax Credit	0.3	9.5	11.8	0.2
Investment Credit	0.6	0.1	1.0	0.6
All Other Credits 6/	*	0	*	*
Tax After Credits	32.6	0	1.5	33.0
Minimum Tax	2.4	0	5.6	2.4
Total Income Tax	35.0	0	7.1	35.4
Deduction Equivalent of Tax Credits 7/	1.4	15.2	20.2	1.2
Taxable Income which would yield: 8/				
Income Tax before Credits	56.8	15.2	24.1	57.3
Income Tax after Credits	55.4	0	3.9	56.1
Total Income Tax	59.2	0	13.9	59.8
Number of Tax Returns Represented in the tabulation	53,587	89	393	53,105

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income

* Less than 0.05 percent.

Table 76-7

Income, Deductions, Credits, and Taxes for Tax Returns with Adjusted Gross Income of $200,000 or Over -- 1976

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	$ 15,731,871	$ 23,287	$ 217,952	$ 15,490,632
EXPANDED INCOME	18,903,111	16,508	162,213	18,724,390
AGI PLUS PREFERENCES	19,440,638	25,321	234,143	19,181,175
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	15,206,989	14,854	148,175	15,043,959
Investment Interest < Investment Income 1/	524,882	8,433	69,777	446,673
Tax Preferences	3,708,767	2,034	16,191	3,690,543
Excluded Long-Term Capital Gains	2,784,160	1,964	11,047	2,771,150
Dividend Exclusion	6,134	8	56	6,070
Other Tax Preferences 2/	918,473	63	5,088	913,323
ADJUSTED GROSS INCOME	15,731,871	23,287	217,952	15,490,632
Deficits	0	0	0	0
AGI of Returns with AGI > 0	15,731,871	23,287	217,952	15,490,632
Exemptions	111,354	179	1,115	110,060
Standard Deductions	1,410	0	3	1,407
Itemized Deductions	3,428,127	27,159	173,425	3,227,542
Charitable Contributions	1,205,943	1,689	44,584	1,159,670
Interest: Total	671,146	13,222	82,915	575,009
Home Mortgage	74,096	508	1,867	71,720
Invest. Interest < Invest. Income 3/	524,882	8,433	69,777	446,673
Invest. Interest > Invest. Income 4/	72,168	4,280	11,272	56,616
Medical	37,243	226	2,497	34,519
Casualty	22,489	3,695	1,103	17,692
Tax Expense	1,138,616	1,444	19,178	1,117,994
Miscellaneous Deductions	352,691	6,884	23,148	322,659
Excess of Exemptions & Deductions over AGI	22,501	9,202	6,865	6,434
Taxable Income	12,213,481	5,151	50,274	12,158,056
Tax at Normal Rates	7,414,525	3,217	29,499	7,381,809
Saving from Alternative Tax 5/	39,311	0	63	39,248
Saving from Maximum Tax 5/	467,235	176	1,975	465,085
Saving from Income Averaging	100,073	28	790	99,254
Tax Before Credits	6,816,240	3,015	26,677	6,786,549
Tax Credits	170,890	3,015	22,774	145,100
Foreign Tax Credit	66,856	2,954	21,301	42,601
Investment Credit	103,517	61	1,471	101,985
All Other Credits 6/	517	0	2	514
Tax After Credits	6,645,350	0	3,902	6,641,448
Minimum Tax	356,145	0	8,739	347,406
Total Income Tax	7,001,496	0	12,641	6,988,855
Deduction Equivalent of Tax Credits 7/	253,958	4,847	35,573	213,538
Taxable Income which would yield: 8/				
Income Tax before Credits	11,341,035	4,847	45,901	11,290,287
Income Tax after Credits	11,087,077	0	10,328	11,076,749
Total Income Tax	11,615,200	0	27,703	11,587,497
Number of Tax Returns Represented in the tabulation	41,761	68	411	41,282

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

Table 76-4

Income, Deductions, Credits, and Taxes for Tax Returns with Adjusted Gross Income of $200,000 or Over -- 1976

As Percentages of Adjusted Gross Income

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0%	100.0 %
EXPANDED INCOME	120.2	70.9	74.4	120.9
AGI PLUS PREFERENCES	123.6	108.7	107.4	123.8
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	96.7	63.8	68.0	97.1
Investment Interest < Investment Income 1/	3.3	36.2	32.0	2.9
Tax Preferences	23.6	8.7	7.4	23.8
Excluded Long-Term Capital Gains	17.7	8.4	5.1	17.9
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	5.8	0.3	2.3	5.9
ADJUSTED GROSS INCOME	100.0	100.0	100.0	100.0
Deficits	0	0	0	0
AGI of Returns with AGI > 0	100.0	100.0	100.0	100.0
Exemptions	0.7	0.8	0.5	0.7
Standard Deductions	*	0	*	*
Itemized Deductions	21.8	116.6	79.6	20.8
Charitable Contributions	7.7	7.2	20.5	7.5
Interest: Total	4.3	56.8	38.0	3.7
Home Mortgage	0.5	2.2	0.9	0.5
Invest. Interest < Invest. Income 3/	3.3	36.2	32.0	2.9
Invest. Interest > Invest. Income 4/	0.5	18.4	5.2	0.4
Medical	0.2	1.0	1.2	0.2
Casualty	0.1	15.9	0.5	0.1
Tax Expense	7.2	6.2	8.8	7.2
Miscellaneous Deductions	2.2	29.6	10.6	2.1
Excess of Exemptions & Deductions over AGI	0.1	39.5	3.2	*
Taxable Income	77.6	22.1	23.1	78.5
Tax at Normal Rates	47.1	13.8	13.5	47.6
Saving from Alternative Tax 5/	0.2	0	*	0.2
Saving from Maximum Tax 5/	3.0	0.8	0.9	3.0
Saving from Income Averaging	0.6	0.1	0.4	0.6
Tax Before Credits	43.3	13.0	12.2	43.8
Tax Credits	1.1	13.0	10.4	0.9
Foreign Tax Credit	0.4	12.7	9.8	0.3
Investment Credit	0.7	0.3	0.7	0.7
All Other Credits 6/	*	0	*	*
Tax After Credits	42.2	0	1.8	42.9
Minimum Tax	2.3	0	4.0	2.2
Total Income Tax	44.5	0	5.8	45.2
Deduction Equivalent of Tax Credits 7/	1.6	20.8	16.3	1.4
Taxable Income which would yield: 8/				
Income Tax before Credits	72.1	20.8	21.1	72.9
Income Tax after Credits	70.5	0	4.7	71.5
Total Income Tax	73.8	0	12.7	74.8
Number of Tax Returns Represented in the tabulation	41,761	68	411	41,282

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

* Less than 0.05 percent.

Table 76-5

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income plus Preferences of $200,000 or Over -- 1976

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	$ 23,332,268	$ 42,198	$ 556,613	$ 22,733,457
EXPANDED INCOME	22,683,261	32,922	424,736	22,225,603
AGI PLUS PREFERENCES	23,332,268	42,198	556,613	22,733,457
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	17,252,819	16,051	251,902	16,984,866
Investment Interest < Investment Income 1/	649,007	9,276	131,877	507,854
Tax Preferences	5,445,035	17,251	177,251	5,250,532
Excluded Long-Term Capital Gains	4,021,577	16,019	139,048	3,866,510
Dividend Exclusion	8,167	14	124	8,029
Other Tax Preferences 2/	1,415,291	1,218	38,080	1,275,993
ADJUSTED GROSS INCOME	17,916,857	28,097	385,950	17,502,810
Deficits	- 29,623	-3,149	- 6,588	- 19,885
AGI of Returns with AGI > 0	17,887,233	24,947	379,362	17,4[illegible],924
Exemptions	150,599	291	2,486	147,822
Standard Deductions	3,182	2	16	3,164
Itemized Deductions	3,968,676	61,323	310,792	3,596,561
Charitable Contributions	1,351,366	30,904	72,732	1,247,730
Interest: Total	814,716	13,699	149,383	651,635
Home Mortgage	100,504	522	4,512	95,470
Invest. Interest < Invest. Income 3/	634,415	8,896	127,460	498,059
Invest. Interest > Invest. Income 4/	79,798	4,280	17,411	58,106
Medical	46,255	289	3,225	42,741
Casualty	30,268	7,041	3,442	19,785
Tax Expense	1,311,517	1,911	40,353	1,269,253
Miscellaneous Deductions	414,554	7,479	41,657	365,418
Excess of Exemptions & Deductions over AGI	67,754	38,671	14,239	14,844
Taxable Income	13,862,153	5,151	86,895	13,770,107
Tax at Normal Rates	8,229,784	3,217	48,116	8,178,451
Saving from Alternative Tax 5/	49,859	0	175	49,684
Saving from Maximum Tax 5/	476,442	176	2,052	474,214
Saving from Income Averaging	148,258	28	3,452	144,778
Tax Before Credits	7,565,917	3,015	42,447	7,520,456
Tax Credits	206,853	3,015	34,437	169,402
Foreign Tax Credit	75,802	2,954	29,510	43,339
Investment Credit	130,371	61	4,907	125,403
All Other Credits 6/	680	0	20	660
Tax After Credits	7,359,064	0	8,011	7,351,054
Minimum Tax	552,240	0	32,883	519,357
Total Income Tax	7,911,305	0	40,894	7,870,411
Deduction Equivalent of Tax Credits 7/	323,376	4,847	56,669	261,860
Taxable Income which would yield: 8/				
Income Tax before Credits	12,882,439	6,847	77,456	12,800,136
Income Tax after Credits	12,559,063	0	20,787	12,538,276
Total Income Tax	13,437,036	0	81,874	13,355,162
Number of Tax Returns Represented in the tabulation	56,512	114	919	55,479

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

Table 76-6

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income plus Preferences of $200,000 or Over -- 1976

As Percentages of Adjusted Gross Income Plus Preferences

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	97.2	78.0	76.3	97.8
AGI PLUS PREFERENCES	100.0	100.0	100.0	100.0
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	73.9	38.0	45.3	74.7
Investment Interest < Investment Income 1/	2.8	22.0	23.7	2.2
Tax Preferences	23.3	40.9	31.8	23.1
Excluded Long-Term Capital Gains	17.2	38.0	25.0	17.0
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	6.1	2.9	6.8	6.0
ADJUSTED GROSS INCOME	76.8	66.6	69.3	77.0
Deficits	- 0.1	- 7.5	- 1.2	- 0.1
AGI of Returns with AGI > 0	76.7	59.1	68.2	76.9
Exemptions	0.6	0.7	0.4	0.6
Standard Deductions	*	*	*	*
Itemized Deductions	17.0	145.3	55.8	15.8
Charitable Contributions	5.8	73.2	13.1	5.5
Interest: Total	3.5	32.5	26.8	2.9
Home Mortgage	*	1.2	0.8	0.4
Invest. Interest < Invest. Income 3/	2.7	21.1	22.9	2.2
Invest. Interest > Invest. Income 4/	*	10.1	3.1	0.3
Medical	*	0.7	0.6	0.2
Casualty	*	16.7	0.6	0.1
Tax Expense	5.6	4.5	7.2	5.6
Miscellaneous Deductions	1.8	17.7	7.5	1.6
Excess of Exemptions & Deductions over AGI	0.3	91.6	2.6	0.1
Taxable Income	59.4	12.2	15.6	60.6
Tax at Normal Rates	35.3	7.6	8.6	36.0
Saving from Alternative Tax 5/	0.2	0	*	0.2
Saving from Maximum Tax 5/	2.0	0.4	0.4	2.1
Saving from Income Averaging	0.6	0.1	0.6	0.6
Tax Before Credits	32.4	7.1	7.6	33.1
Tax Credits	0.9	7.1	6.2	0.8
Foreign Tax Credit	0.3	7.0	5.3	0.2
Investment Credit	0.6	0.1	0.9	0.6
All Other Credits 6/	*	0	*	*
Tax After Credits	31.5	0	1.4	32.3
Minimum Tax	2.4	0	5.9	2.3
Total Income Tax	33.9	0	7.4	34.6
Deduction Equivalent of Tax Credits 7/	1.4	11.5	10.2	1.2
Taxable Income which would yield: 8/				
Income Tax before Credits	55.2	11.5	13.9	56.3
Income Tax after Credits	53.8	0	3.7	55.2
Total Income Tax	57.6	0	14.7	58.8
Number of Tax Returns Represented in the tabulation	56,512	114	919	55,479

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

* Less than 0.05 percent.

Table 76-7

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income minus Investment Interest of $200,000 or Over -- 1976

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	$ 14,793,632	$ 13,507	$ 86,059	$ 14,694,066
EXPANDED INCOME	18,360,566	14,204	89,854	18,256,508
AGI PLUS PREFERENCES	18,752,424	16,352	96,302	18,639,770
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	14,793,632	13,507	86,059	14,694,066
Investment Interest < Investment Income 1/	382,212	1,985	6,122	374,106
Tax Preferences	3,576,580	860	4,121	3,571,599
Excluded Long-Term Capital Gains	2,682,455	857	2,403	2,679,194
Dividend Exclusion	5,753	3	21	5,729
Other Tax Preferences 2/	888,372	0	1,697	886,676
ADJUSTED GROSS INCOME	15,175,844	15,492	92,181	15,068,171
Deficits	0	0	0	0
AGI of Returns with AGI > 0	15,175,844	15,492	92,181	15,068,171
Exemptions	104,624	98	475	104,051
Standard Deductions	1,410	0	3	1,407
Itemized Deductions	3,163,075	16,837	53,622	3,092,616
Charitable Contributions	1,167,757	1,261	18,868	1,147,628
Interest: Total	510,244	4,282	9,468	496,494
Home Mortgage	68,301	355	448	67,498
Invest. Interest < Invest. Income 3/	382,212	1,985	6,122	374,106
Invest. Interest > Invest. Income 4/	59,731	1,942	2,898	54,891
Medical	35,036	100	1,543	33,393
Casualty	20,144	3,693	1,016	15,436
Tax Expense	1,097,504	983	9,012	1,087,509
Miscellaneous Deductions	332,389	6,518	13,716	312,155
Excess of Exemptions & Deductions over AGI	12,210	6,438	829	4,943
Taxable Income	11,918,947	4,995	38,911	11,875,041
Tax at Normal Rates	7,264,768	3,158	24,305	7,237,304
Saving from Alternative Tax 5/	37,723	0	33	37,690
Saving from Maximum Tax 5/	461,810	176	1,900	459,733
Saving from Income Averaging	96,852	10	216	96,626
Tax Before Credits	6,676,197	2,973	22,156	6,651,067
Tax Credits	165,023	2,974	20,537	141,513
Foreign Tax Credit	65,009	2,954	19,938	42,118
Investment Credit	99,554	20	599	98,935
All Other Credits 6/	460	0	0	460
Tax After Credits	6,511,173	0	1,619	6,509,555
Minimum Tax	337,624	0	2,283	335,341
Total Income Tax	6,848,797	0	3,901	6,844,896
Deduction Equivalent of Tax Credits 7/	243,415	4,726	31,324	207,368
Taxable Income which would yield: 8/				
Income Tax before Credits	11,062,050	4,726	35,725	11,021,600
Income Tax after Credits	10,818,635	0	4,401	10,814,232
Total Income Tax	11,312,105	0	9,120	11,302,985
Number of Tax Returns Represented in the tabulation	39,346	42	178	39,126

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Office of Tax Analysis

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

Table 76-8

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income minus Investment Interest of $200,000 or Over -- 1976

As Percentages of Adjusted Gross Income minus Investment Interest

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	124.1	105.2	104.4	124.2
AGI PLUS PREFERENCES	126.8	121.1	111.9	126.8
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	100.0	100.0	100.0	100.0
Investment Interest < Investment Income 1/	2.6	14.7	7.1	2.6
Tax Preferences	24.2	6.4	4.8	24.3
Excluded Long-Term Capital Gains	18.1	6.3	2.8	18.2
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	6.0	0	2.0	6.0
ADJUSTED GROSS INCOME	102.6	114.7	107.1	102.6
Deficits	0	0	0	0
AGI of Returns with AGI > 0	102.6	114.7	107.1	102.6
Exemptions	0.7	0.7	0.6	0.7
Standard Deductions	*	0	*	*
Itemized Deductions	21.4	124.6	62.3	21.0
Charitable Contributions	7.9	9.3	21.9	7.8
Interest: Total	3.4	31.7	11.0	3.4
Home Mortgage	0.5	2.6	0.5	0.5
Invest. Interest < Invest. Income 3/	2.6	14.7	7.1	2.6
Invest. Interest > Invest. Income 4/	0.4	14.4	3.4	0.4
Medical	0.2	0.7	1.8	0.2
Casualty	0.1	27.3	1.2	0.1
Tax Expense	7.4	7.3	10.5	7.4
Miscellaneous Deductions	2.2	48.3	15.9	2.1
Excess of Exemptions & Deductions over AGI	0.1	47.7	1.0	*
Taxable Income	80.6	37.0	45.2	80.8
Tax at Normal Rates	49.1	23.4	28.2	49.2
Saving from Alternative Tax 5/	0.2	0	*	0.3
Saving from Maximum Tax 5/	3.1	1.3	2.2	3.1
Saving from Income Averaging	0.6	0.1	0.2	0.7
Tax Before Credits	45.1	22.0	25.8	45.3
Tax Credits	1.1	22.0	23.9	1.0
Foreign Tax Credit	0.4	21.9	23.2	0.3
Investment Credit	0.7	0.2	0.7	0.7
All Other Credits 6/	*	0	0	*
Tax After Credits	44.0	0	1.9	44.3
Minimum Tax	2.3	0	2.6	2.3
Total Income Tax	46.3	0	4.5	46.6
Deduction Equivalent of Tax Credits 7/	1.6	35.0	36.4	1.4
Taxable Income which would yield: 8/				
Income Tax before Credits	74.8	35.0	41.5	75.0
Income Tax after Credits	73.1	0	5.1	73.6
Total Income Tax	76.5	0	10.6	76.9
Number of Tax Returns Represented in the tabulation	39,346	42	178	39,126

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1976 Statistics of Income.

* Less than 0.05 percent.

Uniform Footnotes for Tables in Appendices A, B, and C

1. Investment interest not in excess of investment income. Investment interest is defined as total interest paid less mortgage interest. Investment income consists of dividends (before the $100 exclusion), interest, and realized capital gains (including the exceeded portion of long-term capital gains).

2. The amount of percentage depletion in excess of the adjusted basis of the property. The excess of accelerated over straight-line dpereciation on low income rental housing, on other real property, and on personal property subject to a net lease. Rapid amortization deductions in excess of otherwise allowable depreciation for certified pollution control facilities, railroad rolling stock, and on-the-job training and child care facilities.

3. Investment interest not in excess of investment income. Investment interest is defined as total interest paid less mortgage interest. Investment income consists of dividends (net of the $100 exclusion), interest, and realized capital gains after deducting the excluded portion of long-term capital gains. This definition differs from the definition in footnote 1 because the excluded portion of long-term capital gains and the dividend exclusion are omitted from AGI whereas they are included in expanded income.

4. Investment interest in excess of investment income. Investment interest (as defined in footnote 3) in excess of the the amount allowed as investment interest not in excess of investment income.

5. Savings from the alternative tax or the minimum tax on earned income are included on the appropriate line even if the taxpayer foregoes them in order to calculate his tax liability under the income averaging procedure.

6. All other credits include the child care credit, the credit for contributions to candidates for public offices, the retirement income credit or the credit for the elderly (depending on the year), the work incentive (WIN) credit, the credit for purchase of a new residence, and the earned income credit. The general tax credit not included.

7. The deduction equivalent of tax credits is caluclated in order to allow the relative importance of deductions and credits to be compared. The deduction equivalent is defined as the difference between the taxable income which would yield tax before credits and the taxable income which would yield tax after credits.

8. The amount of income which taxed under the appropriate ordinary tax rate schedule would yield tax after credits plus the minimum tax. For purposes of this computation, the general tax credits available in 1975 and 1976 have been ignored.

Office of the Secretary of the Treasury   August 25, 1978
Office of Tax Analysis

Table 76-9

Cross-Classification of Numbers of Tax Returns by Income Class by Alternative Income Concepts
--All Returns, 1976

	Total	Less Than $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 and over
Expanded Income	--------Adjusted Gross Income--------				
Total	84,670,389	83,495,452	948,034	185,142	41,761
Less than $ 50,000	83,408,673	83,389,317	19,149	193	14
$ 50,000 to $100,000	1,003,851	103,478	894,752	5,597	24
$100,000 to $200,000	204,278	2,058	33,287	167,745	1,188
$200,000 and over	53,587	599	846	11,607	40,535
Expanded Income	--------Adjusted Gross Income plus Preferences--------				
Total	84,670,389	83,379,625	1,021,791	212,461	56,512
Less than $ 50,000	83,408,673	83,379,625	28,822	195	31
$ 50,000 to $100,000	1,003,851		992,969	10,858	24
$100,000 to $200,000	204,278			201,408	2,870
$200,000 and over	53,587				53,587
Expanded Income	--------Adjusted Gross Income minus Investment Interest--------				
Total	84,670,389	83,528,276	925,833	176,934	39,346
Less than $ 50,000	83,408,673	83,408,673			
$ 50,000 to $100,000	1,003,851	116,367	887,484		
$100,000 to $200,000	204,278	2,529	37,337	164,412	
$200,000 and over	53,587	707	1,012	12,522	39,346
Adjusted Gross Income	--------Adjusted Gross Income plus Preferences--------				
Total	84,670,389	83,379,625	1,021,791	212,461	56,512
Less than $ 50,000	83,495,452		113,100	2,120	607
$ 50,000 to $100,000	948,034		908,691	38,338	1,005
$100,000 to $200,000	185,142			172,003	13,139
$200,000 and over	41,761				41,761
Adjusted Gross Income	--------Adjusted Gross Income minus Investment Interest--------				
Total	84,670,389	83,528,276	925,833	176,934	39,346
Less than $ 50,000	83,495,452	83,495,452			
$ 50,000 to $100,000	948,034	32,460	915,574		
$100,000 to $200,000	185,142	326	10,160	174,656	
$200,000 and over	41,761	38	99	2,278	39,346
Adjusted Gross Income plus Preferences	--------Adjusted Gross Income minus Investment Interest--------				
Total	84,670,389	83,528,276	925,833	176,934	39,346
Less than $ 50,000	83,379,625	83,379,625			
$ 50,000 to $100,000	1,021,791	144,262	877,529		
$100,000 to $200,000	212,461	3,560	46,828	162,073	
$200,000 and over	56,512	829	1,476	14,861	39,346

Office of the Secretary of the Treasury
Office of Tax Analysis

July 12, 1978

Source: 1976 Statistics of Income.

Table 76-10

Cross-Classification of Numbers of Tax Returns by Income Class by Alternative Income Concepts
-- Nontaxable Returns, 1976

	Total	Less Than $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 and over
Expanded Income	---Adjusted Gross Income---				
Total	20,249,022	20,245,282	3,180	492	68
Less than $ 50,000	20,244,296	20,243,890	393	3	10
$ 50,000 to $100,000	4,104	1,271	2,765	64	4
$100,000 to $200,000	533	109	7	406	11
$200,000 and over	89	12	15	19	43
Expanded Income	---Adjusted Gross Income plus Preferences---				
Total	20,249,022	20,243,728	4,480	700	114
Less than $ 50,000	20,244,296	20,243,728	554	4	10
$ 50,000 to $100,000	4,104		3,926	174	4
$100,000 to $200,000	533			522	11
$200,000 and over	89				89
Expanded Income	---Adjusted Gross Income minus Investment Interest---				
Total	20,249,022	20,245,824	2,721	435	42
Less than $ 50,000	20,244,296	20,244,296			
$ 50,000 to $100,000	4,104	1,405	2,699		
$100,000 to $200,000	533	110	7	416	
$200,000 and over	89	13	15	19	42
Adjusted Gross Income	---Adjusted Gross Income plus Preferences---				
Total	20,249,022	20,243,728	4,480	700	114
Less than $ 50,000	20,245,282	20,243,728	1,432	110	12
$ 50,000 to $100,000	3,180		3,048	117	15
$100,000 to $200,000	492			473	19
$200,000 and over	68				68
Adjusted Gross Income	---Adjusted Gross Income minus Investment Interest---				
Total	20,249,022	20,245,824	2,721	435	42
Less than $ 50,000	20,245,282	20,245,282			
$ 50,000 to $100,000	3,180	504	2,676		
$100,000 to $200,000	492	27	40	425	
$200,000 and over	68	11	5	10	42
Adjusted Gross Income plus Preferences	---Adjusted Gross Income minus Investment Interest---				
Total	20,249,022	20,245,824	2,721	435	42
Less than $ 50,000	20,243,728	20,243,728			
$ 50,000 to $100,000	4,480	1,825	2,655		
$100,000 to $200,000	700	248	46	406	
$200,000 and over	114	23	20	29	42

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Office of Tax Analysis

July 12, 1978

Source: 1976 Statistics of Income

Appendix B

1975 Data

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Table 75-1

Income, Deductions, Credits, and Taxes for Tax Returns with Expanded Income of $200,000 or Over -- 1975

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	16,852,472	81,111	824,351	15,947,009
EXPANDED INCOME	16,852,472	81,111	824,351	15,947,009
AGI PLUS PREFERENCES	17,318,131	97,916	948,605	16,271,609
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	13,161,611	44,316	356,026	12,761,269
Investment Interest < Investment Income 1/	465,659	16,805	124,254	324,601
Tax Preferences	3,700,821	37,348	473,920	3,189,555
Excluded Long-Term Capital Gains	3,097,209	34,850	389,018	2,673,342
Dividend Exclusion	5,913	26	207	5,681
Other Tax Preferences 2/	597,699	2,471	84,695	510,532
ADJUSTED GROSS INCOME	13,643,754	67,705	482,361	13,093,688
Deficits	- 26,442	-7,134	- 7,676	- 11,631
AGI of Returns with AGI > 0	13,617,309	60,569	474,685	13,082,057
Exemptions	107,622	602	3,887	103,133
Standard Deductions	2,580	7	54	2,520
Itemized Deductions	2,975,329	74,894	383,085	2,517,350
Charitable Contributions	1,016,809	11,127	96,624	909,058
Interest: Total	594,532	31,292	148,522	414,717
Home Mortgage	61,658	664	6,585	54,408
Invest. Interest < Invest. Income 3/	455,699	16,253	118,659	320,787
Invest. Interest > Invest. Income 4/	77,175	14,375	23,278	39,523
Medical	31,147	401	2,997	27,750
Casualty	24,052	7,772	3,530	12,750
Tax Expense	969,228	8,228	54,813	906,186
Miscellaneous Deductions	339,561	16,074	76,599	246,889
Excess of Exemptions & Deductions over AGI	31,897	15,102	14,266	2,530
Taxable Income	10,590,121	7,305	109,602	10,473,215
Tax at Normal Rates	6,340,213	4,317	57,188	6,278,708
Saving from Alternative Tax 5/	31,149	12	164	30,973
Saving from Maximum Tax 5/	334,153	180	1,050	332,923
Saving from Income Averaging	123,664	198	3,777	119,689
Tax Before Credits	5,853,658	3,926	52,194	5,797,538
Tax Credits	157,176	3,926	34,570	118,677
Foreign Tax Credit	56,069	3,681	24,894	27,494
Investment Credit	99,451	241	9,662	89,547
All Other Credits 6/	1,656	4	14	1,636
Tax After Credits	5,696,482	0	17,621	5,678,860
Minimum Tax	109,981	0	36,632	73,348
Total Income Tax	5,806,462	0	54,254	5,752,209
Deduction Equivalent of Tax Credits 7/	240,178	6,728	58,157	175,292
Taxable Income which would yield: 8/				
Income Tax before Credits	9,878,904	6,728	101,285	9,770,891
Income Tax after Credits	9,638,726	0	43,128	9,595,599
Total Income Tax	9,826,656	0	113,030	9,713,628
Number of Tax Returns Represented in the tabulation	40,884	215	1,409	39,260

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

Table 75-2

Income, Deductions, Credits, and Taxes for Tax Returns with Expanded Income of $200,000 or Over -- 1975

As Percentages of Expanded Income

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	100.0	100.0	100 0	100.0
AGI PLUS PREFERENCES	102.8	120.7	115.1	102.0
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	78.1	54.6	43.2	80.0
Investment Interest < Investment Income 1/	2.8	20.7	15.1	2.0
Tax Preferences	22.0	46.0	57.5	20.0
Excluded Long-Term Capital Gains	18.4	43.0	47.2	16.8
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	3.6	3.0	10.3	3.2
ADJUSTED GROSS INCOME	81.0	83.5	58.5	82.1
Deficits	- 0.2	- 8.8	- 0.9	- 0.1
AGI of Returns with AGI > 0	80.8	74.7	57.6	82.0
Exemptions	0.6	0.7	0.5	0.6
Standard Deductions	*	*	*	*
Itemized Deductions	17.7	92.3	46.5	15.8
Charitable Contributions	6.0	13.7	11.7	5.7
Interest: Total	3.5	38.6	18.0	2.6
Home Mortgage	0.4	0.8	0.8	0.3
Invest. Interest < Invest. Income 3/	2.7	20.0	14.4	2 0
Invest. Interest > Invest. Income 4/	0.5	17.7	2.8	0.2
Medical	0.2	0.5	0.4	0.2
Casualty	0.1	9.6	0.4	0.1
Tax Expense	5.8	10.1	6.6	5.7
Miscellaneous Deductions	2.0	19.8	9.3	1.6
Excess of Exemptions & Deductions over AGI	0.2	18.6	1.7	*
Taxable Income	62.8	9.0	13.3	65.7
Tax at Normal Rates	37.6	5.3	6.9	39.4
Saving from Alternative Tax 5/	0.2	*	*	0.2
Saving from Maximum Tax 5/	2.0	0.2	0.1	2.1
Saving from Income Averaging	0.7	0.2	0.5	0.8
Tax Before Credits	34.7	4.8	6.3	36.4
Tax Credits	0.9	4.8	4.2	0.7
Foreign Tax Credit	0.3	4.5	3.0	0.2
Investment Credit	0.6	0.3	1.2	0.6
All Other Credits 6/	*	*	*	*
Tax After Credits	33.8	0	2.1	35.6
Minimum Tax	0.6	0	4.4	0.5
Total Income Tax	34.4	0	6.6	36.1
Deduction Equivalent of Tax Credits 7/	1.4	8.3	7.0	1.1
Taxable Income which would yield: 8/				
Income Tax before Credits	58.6	8.3	12.3	61.3
Income Tax after Credits	57.2	0	5.2	60.2
Total Income Tax	58.3	0	13.7	60.9
Number of Tax Returns Represented in the tabulation	40,884	215	1,409	39,260

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 75-3

Income, Deductions. Credits and Taxes for Tax Returns with Adjusted Gross Income of $200,000 or over -- 1975

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	12,682,728	117,100	382,812	12,182,817
EXPANDED INCOME	14,779,494	65,809	330,472	14,393,214
AGI PLUS PREFERENCES	15,326,302	124,283	467,749	14,734,271
AGI MI INVESTMENT INTEREST < INVESTMENT INCOME	12,148,688	60,027	242,992	11,845,670
Investment Interest < Investment Income 1/	534,039	57,073	139,819	337,147
Tax Preferences	2,643,575	7,183	84,938	2,551,454
Excluded Long-Term Capital Gains	2,191,266	6,212	65,815	2,119,238
Dividend Exclusion	4,960	38	115	4,807
Other Tax Preferences 2/	447,349	932	19,007	427,409
ADJUSTED GROSS INCOME	12,682,728	117,100	382,812	12,182,817
Deficits	0	0	0	0
AGI of Returns with AGI > 0	12,682,728	117,100	382,812	12,182,817
Exemptions	89,711	701	2,004	87,007
Standard Deductions	1,484	7	13	1,465
Itemized Deductions	2,901,840	127,044	319,771	2,455,025
Charitable Contributions	968,519	13,661	64,160	890,698
Interest: Total	681,502	80,416	172,118	428,969
Home Mortgage	54,248	1,155	4,961	48,133
Invest. Interest < Invest. Income 3/	534,039	57,073	139,819	337,147
Invest. Interest > Invest. Income 4/	93,216	22,187	27,340	43,690
Medical	25,238	537	1,469	23,232
Casualty	18,848	3,967	2,709	12,172
Tax Expense	891,328	10,015	32,305	849,008
Miscellaneous Deductions	316,404	18,448	47,011	250,945
Excess of Exemptions & Deductions over AGI	31,026	18,228	8,011	4,787
Taxable Income	9,720,721	7,576	69,036	9,644,108
Tax at Normal Rates	5,903,344	4,404	37,816	5,861,123
Saving from Alternative Tax 5/	25,541	12	119	25,410
Saving from Maximum Tax 5/	333,701	180	1,010	332,512
Saving from Income Averaging	88,003	199	1,485	86,319
Tax Before Credits	5,457,908	4,012	35,202	5,418,694
Tax Credits	141,285	4,011	24,706	112,563
Foreign Tax Credit	54,100	3,763	22,049	28,286
Investment Credit	85,859	243	2,650	82,963
All Other Credits 6/	1,326	5	7	1,314
Tax After Credits	5,316,625	0	10,493	5,306,132
Minimum Tax	72,317	0	5,670	66,647
Total Income Tax	5,388,942	0	16,164	5,372,779
Deduction Equivalent of Tax Credits 7/	209,927	6,984	38,244	164,700
Taxable income which would yield: 8/				
Income Tax before Credits	9,074,719	6,984	64,758	9,002,978
Income Tax after Credits	8,864,792	0	26,514	8,838,278
Total Income Tax	8,975,907	0	38,126	8,937,781
Number of Tax Returns Represented in the tabulation	33,606	260	732	32,614

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

Table 75-4

Income, Deductions, Credits, and Taxes for Tax Returns with Adjusted Gross Income of $200,000 or over -- 1975

As Percentages of Adjusted Gross Income

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	116.5	56.2	83.7	118.1
AGI PLUS PREFERENCES	120.8	106.1	122.2	120.9
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	95.8	51.3	63.5	97.2
Investment Interest < Investment Income 1/	4.2	48.7	36.5	2.8
Tax Preferences	20.8	6.1	22.2	20.9
Excluded Long-Term Capital Gains	17.3	5.3	17.2	17.4
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	3.5	0.8	5.0	3.5
ADJUSTED GROSS INCOME	100.0	100.0	100.0	100.0
Deficits	0	0	0	0
AGI of Returns with AGI > 0	100.0	100.0	100.0	100.0
Exemptions	0.7	0.6	0.5	0.7
Standard Deductions	*	*	*	*
Itemized Deductions	22.9	108.5	83.5	20.2
Charitable Contributions	7.6	11.7	16.8	7.3
Interest: Total	5.4	68.7	45.0	3.5
Home Mortgage	0.4	1.0	1.3	0.4
Invest. Interest < Invest. Income 3/	4.2	48.7	36.5	2.8
Invest. Interest > Invest. Income 4/	0.7	19.0	7.1	0.4
Medical	0.2	0.5	0.4	0.2
Casualty	0.2	3.4	0.7	0.1
Tax Expense	7.0	8.6	8.4	7.0
Miscellaneous Deductions	2.5	15.8	12.3	2.1
Excess of Exemptions & Deductions over AGI	0.2	15.6	2.1	*
Taxable Income	76.6	6.5	18.0	79.2
Tax at Normal Rates	45.6	3.8	9.9	48.1
Saving from Alternative Tax 5/	0.2	*	*	0.2
Saving from Maximum Tax 5/	2.6	0.2	0.3	2.7
Saving from Income Averaging	0.7	0.2	0.4	0.7
Tax Before Credits	43.0	3.4	9.2	44.5
Tax Credits	1.1	3.4	6.4	0.9
Foreign Tax Credit	0.4	3.2	5.8	0.2
Investment Credit	0.7	0.2	0.7	0.7
All Other Credits 6/	*	*	*	*
Tax After Credits	41.9	0	2.7	43.6
Minimum Tax	0.6	0	1.5	0.6
Total Income Tax	42.5	0	4.2	44.1
Deduction Equivalent of Tax Credits 7/	1.7	6.0	10.0	1.4
Taxable Income which would yield: 8/				
Income Tax before Credits	71.6	6.0	16.9	73.9
Income Tax after Credits	69.9	0	6.9	72.6
Total Income Tax	70.8	0	10.0	73.4
Number of Tax Returns Represented in the tabulation	33,606	260	732	32,614

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 75-5

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income plus Preferences of $200,000 or Over -- 1975

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	17,912,101	157,876	1,244,343	16,509,882
EXPANDED INCOME	17,269,318	95,631	1,009,540	16,164,146
AGI PLUS PREFERENCES	17,912,101	157,876	1,244,343	16,509,882
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	13,495,332	55,208	451,660	12,988,464
Investment Interest < Investment Income 1/	642,783	62,244	234,803	345,735
Tax Preferences	3,788,730	41,891	566,594	3,180,245
Excluded Long-Term Capital Gains	3,171,700	38,764	463,354	2,669,580
Dividend Exclusion	6,289	50	327	5,913
Other Tax Preferences 2/	610,742	3,077	102,912	504,753
ADJUSTED GROSS INCOME	14,149,815	123,119	685,426	13,341,267
Deficits	- 26,442	- 7,134	- 7,676	- 11,631
AGI of Returns with AGI > 0	14,123,370	115,985	677,750	13,329,636
Exemptions	114,493	1,045	6,272	107,178
Standard Deductions	2,580	7	54	2,520
Itemized Deductions	3,262,745	138,332	558,265	2,566,148
Charitable Contributions	1,049,761	14,177	121,390	914,194
Interest: Total	793,069	84,462	268,185	440,422
Home Mortgage	67,649	1,341	9,932	56,376
Invest. Interest < Invest. Income 3/	628,038	60,777	226,089	341,173
Invest. Interest > Invest. Income 4/	97,383	22,344	32,164	42,875
Medical	33,087	556	3,869	28,662
Casualty	25,526	8,121	4,151	13,254
Tax Expense	1,002,517	11,228	70,508	920,781
Miscellaneous Deductions	358,785	19,788	90,162	248,836
Excess of Exemptions & Deductions over AGI	47,765	24,107	22,265	1,393
Taxable Income	10,817,759	7,844	143,100	10,666,815
Tax at Normal Rates	6,450,171	4,468	70,786	6,374,917
Saving from Alternative Tax 5/	32,163	12	219	31,932
Saving from Maximum Tax 5/	337,674	180	1,078	336,416
Saving from Income Averaging	125,692	199	4,746	120,748
Tax Before Credits	5,957,059	4,076	64,741	5,888,242
Tax Credits	160,997	4,075	37,601	119,319
Foreign Tax Credit	57,658	3,763	26,222	27,674
Investment Credit	101,621	307	11,361	89,951
All Other Credits 6/	1,718	5	18	1,694
Tax After Credits	5,796,062	0	27,140	5,768,923
Minimum Tax	112,677	0	42,360	70,318
Total Income Tax	5,908,739	0	69,500	5,839,240
Deduction Equivalent of Tax Credits 7/	248,051	7,241	64,469	176,342
Taxable Income which would yield: 8/				
Income Tax before Credits	10,095,744	7,241	132,697	9,955,807
Income Tax after Credits	9,847,693	0	68,228	9,779,465
Total Income Tax	10,043,925	0	152,685	9,891,241
Number of Tax Returns Represented in the tabulation	43,344	362	2,257	40,725

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

Table 75-6

Income, Deductions, Credits, and Taxes for Tax
with Adjusted Gross Income Plus Preferences of $200,000 or Over -- 1975

As Percentages of Adjusted Gross Income Plus Preferences

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	96.4	60.6	81.1	97.9
AGI PLUS PREFERENCES	100.0	100.0	100.0	100.0
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	75.3	35.0	36.3	78.7
Investment Interest < Investment Income 1/	3.6	39.4	18.9	2.1
Tax Preferences	21.2	26.5	45.5	19.3
Excluded Long-Term Capital Gains	17.7	24.6	37.2	16.2
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	3.4	2.0	8.3	3.1
ADJUSTED GROSS INCOME	79.0	78.0	55.1	80.8
Deficits	- 0.2	- 4.5	- 0.6	- 0.1
AGI of Returns with AGI > 0	78.8	73.5	54.5	80.7
Exemptions	0.6	0.7	0.5	0.6
Standard Deductions	*	*	*	*
Itemized Deductions	18.2	87.6	44.9	15.5
Charitable Contributions	5.9	9.0	9.8	5.5
Interest: Total	4.4	53.5	21.6	2.7
Home Mortgage	0.4	0.8	0.8	0.3
Invest. Interest < Invest. Income 3/	35	38.5	18.2	2.1
Invest. Interest > Invest. Income 4/	0.5	14.2	2.6	0.3
Medical	0.2	0.4	0.3	0.2
Casualty	0.1	5.1	0.3	0.1
Tax Expense	5.6	7.1	5.7	5.6
Miscellaneous Deductions	2.0	12.5	7.2	1.5
Excess of Exemptions & Deductions over AGI	0.3	15.3	1.8	*
Taxable Income	60.4	5.0	11.5	64.6
Tax at Normal Rates	36.0	2.8	5.7	38.6
Saving from Alternative Tax 5/	0.2	*	*	0.2
Saving from Maximum Tax 5/	1.9	0.1	0.1	2.0
Saving from Income Averaging	0.7	0.1	0.4	0.7
Tax Before Credits	33.3	2.6	5.2	35.7
Tax Credits	0.9	2.6	3.0	0.7
Foreign Tax Credit	0.3	2.4	2.1	0.2
Investment Credit	0.6	0.2	0.9	0.5
All Other Credits 6/	*	*	*	*
Tax After Credits	32.4	0	2.2	34.9
Minimum Tax	0.6	0	3.4	0.4
Total Income Tax	33.0	0	5.6	35.4
Deduction Equivalent of Tax Credits 7/	1.3	4.6	5.2	1.1
Taxable Income which would yield: 8/				
Income Tax before Credits	56.4	4.6	10.7	60.3
Income Tax after Credits	55.0	0	5.5	59.2
Total Income Tax	56.1	0	12.3	59.9
Number of Tax Returns Represented in the tabulaion	43,344	362	2,257	40,725

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See Uniform footnotes following Table 76-7 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 75-7

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income minus Investment Interest of $200,000 or Over -- 1975

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	11,788,400	47,469	170,417	11,570,514
EXPANDED INCOME	14,282,404	51,402	205,307	14,025,695
AGI PLUS PREFERENCES	14,629,433	65,669	247,897	14,315,866
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	11,788,400	47,469	170,417	11,570,514
Investment Interest < Investment Income 1/	338,213	13,853	38,294	286,066
Tax Preferences	2,502,820	4,349	39,184	2,459,287
Excluded Long-Term Capital Gains	2,073,083	3,803	29,256	2,040,023
Dividend Exclusion	4,602	16	52	4,533
Other Tax Preferences 2/	425,135	530	9,875	414,729
ADJUSTED GROSS INCOME	12,126,613	61,321	208,712	11,856,580
Deficits	0	0	0	0
AGI of Returns with AGI > 0	12,126,613	61,321	208,712	11,856,580
Exemptions	83,477	326	919	82,234
Standard Deductions	1,484	7	13	1,465
Itemized Deductions	2,582,521	63,325	162,271	2,356,925
Charitable Contributions	931,624	10,209	43,090	878,324
Interest: Total	461,584	28,631	61,393	371,560
Home Mortgage	49,360	602	3,644	45,113
Invest. Interest < Invest. Income 3/	338,213	13,853	38,294	286,066
Invest. Interest > Invest. Income 4/	74,011	14,176	19,453	40,382
Medical	23,644	387	813	22,444
Casualty	17,690	3,585	2,610	11,495
Tax Expense	854,672	6,762	20,523	827,388
Miscellaneous Deductions	293,306	13,750	33,844	245,711
Excess of Exemptions & Deductions over AGI	16,545	9,322	3,253	3,970
Taxable Income	9,475,676	6,986	48,765	9,419,927
Tax at Normal Rates	5,780,489	4,228	28,842	5,747,410
Saving from Alternative Tax 5/	24,373	12	88	24,274
Saving from Maximum Tax 5/	330,005	180	934	328,891
Saving from Income Averaging	84,827	198	734	83,895
Tax Before Credits	5,343,035	3,838	27,086	5,312,111
Tax Credits	137,006	3,837	22,300	110,869
Foreign Tax Credit	52,906	3,676	20,844	28,387
Investment Credit	82,816	157	1,454	81,205
All Other Credits 6/	1,284	4	2	1,277
Tax After Credits	5,206,027	0	4,787	5,201,241
Minimum Tax	65,210	0	2,930	62,279
Total Income Tax	5,271,237	0	7,717	5,263,520
Deduction Equivalent of Tax Credits 7/	201,786	6,415	33,696	161,675
Taxable Income which would yield: 8/				
Income Tax before Credits	8,842,379	6,415	46,010	8,789,954
Income Tax after Credits	8,640,593	0	12,314	8,628,279
Total Income Tax	8,737,761	0	18,121	8,719,640
Number of Tax Returns Represented in the tabulation	31,391	126	345	30,920

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

Table 75-8

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income minus Investment Interest of $200,000 or Over -- 1975

As Percentages of Adjusted Gross Income Minus Investment Interest

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	121.2	108.3	120.5	121.2
AGI PLUS PREFERENCES	124.1	138.3	145.5	123.7
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	100.0	100.0	100.0	100.0
Investment Interest < Investment Income 1/	2.9	29.2	22.5	2.5
Tax Preferences	21.2	9.2	23.0	21.2
Excluded Long-Term Capital Gains	17.6	8.0	17.2	17.6
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	3.6	1.1	5.8	3.6
ADJUSTED GROSS INCOME	102.9	129.2	122.5	102.5
Deficits	0	0	0	0
AGI of Returns with AGI > 0	102.9	129.2	122.5	102.5
Exemptions	0.7	0.7	0.5	0.7
Standard Deductions	*	*	*	*
Itemized Deductions	21.9	133.4	95.2	20.4
Charitable Contributions	7.9	21.5	25.3	7.6
Interest: Total	3.9	60.3	36.0	3.2
Home Mortgage	0.4	1.3	2.1	0.4
Invest. Interest < Invest. Income 3/	2.9	29.2	22.5	2.5
Invest. Interest > Invest. Income 4/	0.6	29.9	11.4	0.4
Medical	0.2	0.8	0.5	0.2
Casualty	0.2	7.6	1.5	0.1
Tax Expense	7.2	14.2	12.0	7.2
Miscellaneous Deductions	2.5	29.0	19.9	2.1
Excess of Exemptions & Deductions over AGI	0.1	19.6	1.9	*
Taxable Income	80.4	14.7	28.6	81.4
Tax at Normal Rates	49.0	8.9	16.9	49.7
Saving from Alternative Tax 5/	0.2	*	0.1	0.2
Saving from Maximum Tax 5/	2.8	0.4	0.6	2.8
Saving from Income Averaging	0.7	0.4	0.4	0.7
Tax Before Credits	45.3	8.1	15.9	45.9
Tax Credits	1.2	8.1	13.1	1.0
Foreign Tax Credit	0.4	7.7	12.2	0.2
Investment Credit	0.7	0.3	0.8	0.7
All Other Credits 6/	*	*	*	*
Tax After Credits	44.2	0	2.8	45.0
Minimum Tax	0.6	0	1.7	0.5
Total Income Tax	44.7	0	4.5	45.5
Deduction Equivalent of Tax Credits 7/	1.2	13.5	19.8	1.4
Taxable Income which would yield: 8/				
Income Tax before Credits	75.0	13.5	27.0	76.0
Income Tax after Credits	73.3	0	7.2	74.6
Total Income Tax	74.1	0	10.6	75.4
Number of Tax Returns Represented in the tabulation	31,391	126	345	30,920

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1975 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 75-9

Cross-Classification of Numbers of Tax Returns by Income Class by Alternative Income Concepts -- All Returns, 1975

	Total	Less Than $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 and over
Expanded Income	-----	-----Adjusted Gross Income-----			
Total	82,229,182	81,262,674	780,470	152,432	33,606
Less than $ 50,000	81,215,630	81,197,893	17,524	180	33
$ 50,000 to $100,000	807,399	63,103	738,376	5,825	95
$100,000 to $200,000	165,269	1,307	24,156	138,670	1,136
$200,000 and over	40,884	371	414	7,757	32,342
Expanded Income	-----	-----Adjusted Gross Income plus Preferences-----			
Total	82,229,182	81,190,697	821,253	173,888	43,344
Less than $ 50,000	81,215,630	81,190,697	24,477	418	38
$ 50,000 to $100,000	807,399		796,776	10,481	142
$100,000 to $200,000	165,269			162,989	2,280
$200,000 and over	40,884				40,884
Expanded Income	-----	-----Adjusted Gross Income minus Investment Interest-----			
Total	82,229,182	81,289,752	762,709	145,330	31,391
Less than $ 50,000	81,215,630	81,215,630			
$ 50,000 to $100,000	807,399	71,746	735,653		
$100,000 to $200,000	165,269	1,890	26,480	136,899	
$200,000 and over	40,884	486	576	8,431	31,391
Adjusted Gross Income	-----	-----Adjusted Gross Income plus Preferences-----			
Total	82,229,182	81,190,697	821,253	173,888	43,344
Less than $ 50,000	81,262,674	81,190,697	70,022	1,569	386
$ 50,000 to $100,000	780,470		751,231	28,747	492
$100,000 to $200,000	152,432			143,572	8,860
$200,000 and over	33,606				33,606
Adjusted Gross Income	-----	-----Adjusted Gross Income minus Investment Interest-----			
Total	82,229,182	81,289,752	762,709	145,330	31,391
Less than $ 50,000	81,262,674	81,262,674			
$ 50,000 to $100,000	780,470	26,582	753,898		
$100,000 to $200,000	152,432	410	8,678	143,344	
$200,000 and over	33,606	86	143	1,986	31,391
Adjusted Gross Income plus Preferences	-----	-----Adjusted Gross Income minus Investment Interest-----			
Total	82,229,182	81,289,752	762,709	145,330	31,391
Less than $ 50,000	81,190,697	81,190,697			
$ 50,000 to $100,000	821,253	94,959	726,294		
$100,000 to $200,000	173,888	3,412	35,442	135,034	
$200,000 and over	43,344	684	973	10,296	31,391

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Source: 1975 Internal Revenue Service Tax Model.

Table 75-10

Cross-Classification of Numbers of Tax Returns by Income Class by Alternative Income Concepts
-- Nontaxable Returns, 1975

	Total	Less Than $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 and over
Expanded Income	--Adjusted Gross Income--				
Total	20,822,251	20,816,533	4,749	709	260
Less than $ 50,000	20,816,696	20,815,601	958	115	22
$ 50,000 to $100,000	4,654	779	3,617	219	39
$100,000 to $200,000	686	107	152	366	61
$200,000 and over	215	46	22	9	138
Expanded Income	--Adjusted Gross Income plus Preferences--				
Total	20,822,251	20,813,859	6,607	1,423	362
Less than $ 50,000	20,816,696	20,813,859	2,467	343	27
$ 50,000 to $100,000	4,654		4,140	471	43
$100,000 to $200,000	686			609	77
$200,000 and over	215				215
Expanded Income	--Adjusted Gross Income minus Investment Interest--				
Total	20,822,251	20,817,839	3,879	407	126
Less than $ 50,000	20,816,696	20,816,696			
$ 50,000 to $100,000	4,654	876	3,778		
$100,000 to $200,000	686	212	87	387	
$200,000 and over	215	55	14	20	126
Adjusted Gross Income	--Adjusted Gross Income plus Preferences--				
Total	20,822,251	20,813,859	6,607	1,423	362
Less than $ 50,000	20,816,533	20,813,859	2,498	123	53
$ 50,000 to $100,000	4,749		4,109	618	22
$100,000 to $200,000	709			682	27
$200,000 and over	260				260
Adjusted Gross Income	--Adjusted Gross Income minus Investment Interest--				
Total	20,822,251	20,817,839	3,879	407	126
Less than $ 50,000	20,816,533	20,816,533			
$ 50,000 to $100,000	4,749	1,135	3,614		
$100,000 to $200,000	709	141	229	339	
$200,000 and over	260	30	36	68	126
Adjusted Gross Income plus Preferences	--Adjusted Gross Income minus Investment Interest--				
Total	20,822,251	20,817,839	3,879	407	126
Less than $ 50,000	20,813,859	20,813,859			
$ 50,000 to $100,000	6,607	3,279	3,328		
$100,000 to $200,000	1,423	596	501	326	
$200,000 and over	362	105	50	81	126

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Source: 1975 Internal Revenue Service Tax Model.

Appendix C

1974 Data

The eight tables in this appendix contain aggregate data and percentage distributions of the income, preference, deduction, credit, and tax items from 1974 returns. They are the counterparts to Tables 76-1 through 76-8 for 1976 and Tables 75-1 through 75-8 for 1975. They are similar to the Tables 15 through 22 in last year's high-income report, with two major exceptions. The first change is that the nearly nontaxable group has been redefined to be consistent with the definition for 1975 and 1976 used throughout this report. Nearly nontaxable returns are those returns which show some tax liability but which have a ratio of taxable income to income of less than 20 percent. 1/ The redefinition of nearly nontaxable returns also required a revision of the data for all other taxable returns. Again consistent with the data for 1975 and 1976, the second change is that in the percentage tables the income concept used as the classifier is considered to be 100 percent; in 1974-1975 report, expanded income was 100 percent on all tables, regardless of the classifier.

The data in this appendix, along with all other 1974 data in this report and all 1974 data in last year's high-income report, are derived from the 1974 Internal Revenue Service tax model. It has just been discovered that there is a systematic error in the 1974 IRS tax model and that all of the 1974 data in both last year's and this year's high-income report are subject to revision. The weights assigned to some of the specific tax returns in the model were incorrect. As a result, some of the population estimates from the 1974 IRS tax model are too large. The incorrectly weighted tax model indicates that there are 36,015 returns with adjusted gross income of $200,000 or more as compared to 31,132 in the correctly weighted 1974

1/ The denominator in the taxable income to income ratio is whichever income concept is used for selection and classification for that particular table.

Statistics of Income file from which the tax model itself was derived. This represents a 16 percent overstatement in the number of high-income returns. However, since the number of nontaxable returns appears to be correct, only the numbers of nearly nontaxables and of all other taxables are inflated. It is believed that the overestimates of the numbers of high-income returns for the three other income concepts are of the same order of magnitude.

While these errors are disturbing, we do not believe that they make the 1974 data published so far useless. The dollar aggregates of income, deductions, credits, and taxes attributable to these high-income returns are incorrect, but the distributions are correct. Thus, the shares representing the relative importance of each deduction, etc., which are shown on the even numbered tables are essentially correct.

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Table 74-1

Income, Deductions, Credits, And Taxes for Tax Returns
with Expanded Income of $200,000 or Over — 1974

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	17,087,358	58,190	697,474	16,331,694
EXPANDED INCOME	17,087,358	58,190	697,474	16,331,694
AGI PLUS PREFERENCES	17,603,969	78,076	824,151	16,701,742
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	13,439,765	33,673	285,814	13,120,278
Investment Interest < Investment Income 1/	516,610	19,887	126,677	370,046
Tax Preferences	3,657,128	24,754	416,207	3,216,167
Excluded Long-Term Capital Gains	3,381,524	24,732	338,785	3,018,007
Dividend Exclusion	6,022	21	179	5,822
Other Tax Preferences 2/	269,583	0	77,245	192,338
ADJUSTED GROSS INCOME	13,968,792	56,302	415,584	13,496,906
Deficits	- 21,950	-2,978	- 7,643	- 11,329
AGI of Returns with AGI > 0	13,946,840	53,323	407,941	13,485,576
Exemptions	113,375	724	3,569	109,082
Standard Deductions	2,255	11	41	2,203
Itemized Deductions	2,907,140	61,799	344,380	2,500,961
Charitable Contributions	970,901	8,333	81,222	881,346
Interest: Total	636,691	31,715	148,395	456,581
Home Mortgage	41,366	182	1,669	39,515
Invest. Interest < Invest. Income 3/	507,077	19,651	122,129	365,297
Invest. Interest > Invest. Income 4/	88,250	11,883	24,598	51,769
Medical	29,180	141	2,560	26,479
Casualty	18,180	2,721	3,601	11,858
Tax Expense	919,220	5,583	46,906	866,731
Miscellaneous Deductions	332,967	13,306	61,693	257,968
Excess of Exemptions & Deductions over AGI	25,639	10,259	11,170	4,210
Taxable Income	10,972,110	4,075	78,856	10,889,179
Tax at Normal Rates	6,567,115	2,248	39,816	6,525,051
Saving from Alternative Tax 5/	40,141	0	42	40,099
Saving from Maximum Tax 5/	290,766	66	978	289,722
Saving from Income Averaging	203,136	90	2,790	200,256
Tax Before Credits	6,033,169	2,094	36,007	5,995,068
Tax Credits	111,218	2,094	22,092	87,032
Foreign Tax Credit	47,933	1,916	16,400	29,617
Investment Credit	62,650	178	5,688	56,784
All Other Credits 6/	635	0	4	631
Tax After Credits	5,921,951	0	13,916	5,908,035
Minimum Tax	114,594	0	32,705	81,889
Total Income Tax	6,036,542	0	46,616	5,989,926
Deduction Equivalent of Tax Credits 7/	170,539	3,854	37,865	128,820
Taxable Income which would yield: 8/				
Income Tax before Credits	10,196,555	3,854	72,687	10,120,014
Income Tax after Credits	10,026,016	0	34,822	9,991,194
Total Income Tax	10,220,917	0	96,990	10,123,927
Number of Tax Returns Represented in the tabulation	42,687	167	1,275	41,245

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

Table 74-2

Income, Deductions, Credits, and Taxes for Tax Returns with Expanded Income of $200,000 or Over -- 1974

As Percentages of Expanded Income

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	100.0	100.0	100.0	100.0
AGI PLUS PREFERENCES	103.0	134.2	118.2	102.3
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	78.7	57.9	41.0	80.3
Investment Interest < Investment Income 1/	3.0	34.2	18.2	2.3
Tax Preferences	21.4	42.5	59.7	19.7
Excluded Long-Term Capital Gains	19.8	42.5	48.6	18.5
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	1.6	0	11.1	1.2
ADJUSTED GROSS INCOME	81.7	96.8	59.6	82.6
Deficits	- 0.1	- 5.1	- 1.1	- 0.1
AGI of Returns with AGI > 0	81.6	91.6	58.5	82.6
Exemptions	0.7	1.2	0.5	0.7
Standard Deductions	*	*	*	*
Itemized Deductions	17.0	106.2	49.4	15.3
Charitable Contributions	5.7	14.3	11.6	5.4
Interest: Total	3.7	54.5	21.3	2.8
Home Mortgage	0.2	0.3	0.2	0.2
Invest. Interest < Invest. Income 3/	3.0	33.8	17.5	2.2
Invest. Interest > Invest. Income 4/	0.5	20.4	3.5	0.3
Medical	0.2	0.2	0.4	0.2
Casualty	0.1	4.7	0.5	0.1
Tax Expense	5.4	9.6	6.7	5.3
Miscellaneous Deductions	1.9	22.9	8.8	1.6
Excess of Exemptions & Deductions over AGI	0.2	17.6	1.6	*
Taxable Income	64.2	7.0	11.3	66.7
Tax at Normal Rates	39.4	3.9	5.7	40.0
Saving from Alternative Tax 5/	0.2	0	*	0.2
Saving from Maximum Tax 5/	1.7	0.1	0.1	1.8
Saving from Income Averaging	1.2	0.2	0.4	1.2
Tax Before Credits	35.3	3.6	5.2	36.7
Tax Credits	0.7	3.6	3.2	0.5
Foreign Tax Credit	0.3	3.3	2.4	0.2
Investment Credit	0.4	0.3	0.8	0.4
All Other Credits 6/	*	0	*	*
Tax After Credits	34.7	0	2.0	36.2
Minimum Tax	0.7	0	4.7	0.5
Total Income Tax	35.4	0	6.7	36.7
Deduction Equivalent of Tax Credits 7/	1.0	6.6	5.4	0.8
Taxable Income which would yield: 8/				
Income Tax before Credits	59.7	6.6	10.4	62.0
Income Tax after Credits	58.7	0	5.0	61.2
Total Income Tax	59.8	0	13.9	62.0
Number of Tax Returns Represented in the tabulation	42,687	167	1,275	41,245

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 74-3

Income, Deductions, Credits, and Taxes for Tax Returns with Adjusted Gross Income of $200,000 or Over — 1974

Aggregate Data ($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	13,181,598	109,808	412,479	12,659,311
EXPANDED INCOME	15,097,684	45,979	313,614	14,738,091
AGI PLUS PREFERENCES	15,741,891	114,595	498,492	15,128,804
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	12,551,430	42,148	235,265	12,274,017
Investment Interest < Investment Income 1/	630,168	67,660	177,215	385,293
Tax Preferences	2,560,293	4,787	86,012	2,469,494
Excluded Long-Term Capital Gains	2,404,443	4,752	74,777	2,324,914
Dividend Exclusion	5,242	36	134	5,072
Other Tax Preferences 2/	150,609	0	11,103	139,506
ADJUSTED GROSS INCOME	13,181,598	109,808	412,479	12,659,311
Deficits	0	0	0	0
AGI of Returns with AGI > 0	13,181,598	109,808	412,479	12,659,311
Exemptions	96,396	972	2,538	92,886
Standard Deductions	1,286	4	0	1,282
Itemized Deductions	2,938,358	127,958	362,875	2,447,525
Charitable Contributions	934,795	11,254	64,331	859,210
Interest: Total	781,040	88,920	213,599	478,521
Home Mortgage	35,140	317	1,281	33,542
Invest. Interest < Invest. Income 3/	630,168	67,660	177,215	385,293
Invest. Interest > Invest. Income 4/	115,734	20,944	35,104	59,686
Medical	27,042	401	1,912	24,729
Casualty	17,743	2,785	3,391	11,567
Tax Expense	860,934	8,814	33,225	818,895
Miscellaneous Deductions	316,802	15,782	46,415	254,605
Excess of Exemptions & Deductions over AGI	36,330	23,013	11,975	1,342
Taxable Income	10,181,889	3,887	59,040	10,118,962
Tax at Normal Rates	6,170,348	2,208	30,271	6,137,869
Saving from Alternative Tax 5/	35,243	0	67	35,176
Saving from Maximum Tax 5/	291,366	66	986	290,314
Saving from Income Averaging	155,228	93	678	154,457
Tax Before Credits	5,688,566	2,051	28,539	5,657,976
Tax Credits	101,942	2,051	17,852	82,039
Foreign Tax Credit	45,837	1,965	15,815	28,057
Investment Credit	55,414	85	1,949	53,380
All Other Credits 6/	692	0	90	602
Tax After Credits	5,586,624	0	10,688	5,575,936
Minimum Tax	70,710	0	5,828	64,882
Total Income Tax	5,657,334	0	16,516	5,640,818
Deduction Equivalent of Tax Credits 7/	152,181	3,659	28,490	120,032
Taxable Income which would yield: 8/				
Income Tax before Credits	9,488,324	3,659	56,299	9,428,366
Income Tax after Credits	9,336,143	0	27,809	9,308,334
Total Income Tax	9,444,781	0	40,107	9,404,674
Number of Tax Returns Represented in the tabulation	36,015	244	896	34,875

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See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

Table 74-4

Income, Deductions, Credits, and Taxes for Tax Returns with Adjusted Gross Income of $200,000 or Over -- 1974

As Percentages of Adjusted Gross Income

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	114.5	41.9	76.0	116.4
AGI PLUS PREFERENCES	119.4	104.4	120.8	119.5
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	95.2	38.4	57.0	97.0
Investment Interest < Investment Income 1/	4.8	61.6	43.0	3.0
Tax Preferences	19.4	4.4	20.8	19.5
Excluded Long-Term Capital Gains	18.2	4.3	18.1	18.4
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	1.1	0	2.7	1.1
ADJUSTED GROSS INCOME	100.0	100.0	100.0	100.0
Deficits	0	0	0	0
AGI of Returns with AGI > 0	100.0	100.0	100.0	100.0
Exemptions	0.7	0.9	0.6	0.7
Standard Deductions	*	*	0	*
Itemized Deductions	22.3	116.5	88.0	19.3
Charitable Contributions	7.1	10.2	15.6	6.8
Interest: Total	5.9	81.0	51.8	3.8
Home Mortgage	0.3	0.3	0.3	0.3
Invest. Interest < Invest. Income 3/	4.8	61.6	43.0	3.0
Invest. Interest > Invest. Income 4/	0.9	19.1	8.5	0.5
Medical	0.2	0.4	0.5	0.2
Casualty	0.1	2.5	0.8	0.1
Tax Expense	6.5	8.0	8.0	6.5
Miscellaneous Deductions	2.4	14.4	11.2	2.0
Excess of Exemptions & Deductions over AGI	0.3	21.0	2.9	*
Taxable Income	77.2	3.5	14.3	79.9
Tax at Normal Rates	46.8	2.0	7.3	48.5
Saving from Alternative Tax 5/	0.3	0	*	0.3
Saving from Maximum Tax 5/	2.2	0.1	0.2	2.3
Saving from Income Averaging	1.2	0.1	0.2	1.2
Tax Before Credits	43.2	1.9	6.9	44.7
Tax Credits	0.8	1.9	4.3	0.6
Foreign Tax Credit	0.4	1.8	3.8	0.2
Investment Credit	0.4	0.1	0.5	0.4
All Other Credits 6/	*	0	*	*
Tax After Credits	42.4	0	2.6	44.0
Minimum Tax	0.5	0	1.4	0.5
Total Income Tax	42.9	0	4.0	44.6
Deduction Equivalent of Tax Credits 7/	1.2	3.3	6.9	1.0
Taxable Income which would yield: 8/				
Income Tax before Credits	72.0	3.5	13.6	74.5
Income Tax after Credits	70.8	0	6.7	73.5
Total Income Tax	71.6	0	9.7	74.3
Number of Tax Returns Represented in the tabulation	36,015	244	896	34,875

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 74-5

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income plus Preferences of $200,000 or Over -- 1974

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	18,335,322	148,012	1,168,928	17,018,382
EXPANDED INCOME	17,572,387	70,995	893,327	16,608,065
AGI PLUS PREFERENCES	18,335,322	148,012	1,168,928	17,018,382
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	13,839,140	43,463	386,851	13,408,826
Investment Interest < Investment Income 1/	762,934	77,018	275,599	410,317
Tax Preferences	3,753,496	29,377	519,373	3,204,748
Excluded Long-Term Capital Gains	3,469,828	29,329	429,079	3,011,420
Dividend Exclusion	6,494	49	329	6,116
Other Tax Preferences 2/	277,177	0	89,965	187,212
ADJUSTED GROSS INCOME	14,603,775	121,6.3	657,198	13,824,964
Deficits	- 21,950	- 2,978	- 7,643	- 11,329
AGI of Returns with AGI > 0	14,581,823	118,635	649,553	13,813,635
Exemptions	122,073	1,253	6,484	114,336
Standard Deductions	2,255	11	41	2,203
Itemized Deductions	3,294,290	144,638	563,150	2,586,502
Charitable Contributions	1,006,520	12,415	105,104	889,001
Interest: Total	918,086	101,574	309,592	506,920
Home Mortgage	45,561	450	3,137	41,974
Invest. Interest < Invest. Income 3/	742,682	75,172	262,703	404,807
Invest. Interest > Invest. Income 4/	129,842	25,951	43,752	60,139
Medical	30,960	422	3,395	27,143
Casualty	19,460	2,785	4,367	12,308
Tax Expense	963,294	10,126	65,463	887,705
Miscellaneous Deductions	355,971	17,315	75,232	263,424
Excess of Exemptions & Deductions over AGI	55,380	28,768	24,666	1,946
Taxable Income	11,240,983	4,528	112,274	11,124,181
Tax at Normal Rates	6,696,412	2,396	52,639	6,641,378
Saving from Alternative Tax 5/	41,184	0	74	41,110
Saving from Maximum Tax 5/	294,535	66	986	293,483
Saving from Income Averaging	206,673	93	3,769	202,811
Tax Before Credits	6,154,104	2,233	47,809	6,104,057
Tax Credits	114,757	2,238	24,154	88,365
Foreign Tax Credit	49,225	1,970	17,138	30,117
Investment Credit	64,804	268	6,925	57,611
All Other Credits 6/	729	0	92	637
Tax After Credits	6,039,347	0	23,653	6,015,694
Minimum Tax	117,372	0	39,404	77,968
Total Income Tax	6,156,719	0	63,057	6,093,662
Deduction Equivalent of Tax Credits 7/	177,590	4,300	42,425	130,865
Taxable Income which would yield: 8/				
Income Tax before Credits	10,452,087	4,300	104,213	10,343,574
Income Tax after Credits	10,274,497	0	61,788	10,212,709
Total Income Tax	10,477,920	0	140,452	10,337,467
Number of Tax Returns Represented in the tabulation	45,704	355	2,285	43,064

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A

Source: 1974 Internal Revenue Service tax model.

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Table 74-6

Income, Deductions, Credits, and Taxes for Tax Returns with Adjusted Gross Income plus Preferences of $200,000 or Over -- 1974

As Percentages of Adjusted Gross Income Plus Preferences

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	95.8	48.0	76.4	97.6
AGI PLUS PREFERENCES	100.0	100.0	100.0	100.0
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	75.5	29.4	33.1	78.8
Investment Interest < Investment Income 1/	4.2	52.0	23.6	2.4
Tax Preferences	20.5	19.8	44.4	18.8
Excluded Long-Term Capital Gains	18.9	19.8	36.7	17.7
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	1.5	0	7.7	1.1
ADJUSTED GROSS INCOME	79.6	82.2	56.2	81.2
Deficits	- 0.1	- 2.0	- 0.6	- 0.1
AGI of Returns with AGI > 0	79.5	80.2	55.6	81.2
Exemptions	0.7	0.8	0.6	0.7
Standard Deductions	*	*	*	*
Itemized Deductions	18.0	97.7	48.2	15.2
Charitable Contributions	5.5	8.4	9.0	5.2
Interest: Total	5.0	68.6	26.5	3.0
Home Mortgage	0.2	0.3	0.3	0.2
Invest. Interest < Invest. Income 3/	4.0	50.8	22.5	2.4
Invest. Interest > Invest. Income 4/	0.7	17.5	3.7	0.4
Medical	0.2	0.3	0.3	0.2
Casualty	0.1	1.9	0.4	0.1
Tax Expense	5.2	6.8	5.6	5.2
Miscellaneous Deductions	1.9	11.7	6.4	1.6
Excess of Exemptions & Deductions over AGI	0.3	19.4	2.1	*
Taxable Income	61.3	3.1	9.6	65.4
Tax at Normal Rates	36.5	1.6	4.5	39.0
Saving from Alternative Tax 5/	0.2	0	*	0.2
Saving from Maximum Tax 5/	1.6	*	0.1	1.7
Saving from Income Averaging	1.1	0.1	0.3	1.2
Tax Before Credits	33.6	1.5	4.1	35.9
Tax Credits	0.6	1.5	2.1	0.5
Foreign Tax Credit	0.3	1.3	1.5	0.2
Investment Credit	0.4	0.2	0.6	0.3
All Other Credits 6/	*	0	*	*
Tax After Credits	32.9	0	2.0	35.4
Minimum Tax	0.6	0	3.4	0.5
Total Income Tax	33.6	0	5.4	35.8
Deduction Equivalent of Tax Credits 7/	1.0	2.9	3.6	0.8
Taxable Income which would yield: 8/				
Income Tax before Credits	57.0	2.9	8.9	60.8
Income Tax after Credits	55.9	0	5.3	60.0
Total Income Tax	57.2	0	12.0	60.7
Number of Tax Returns Represented in the tabulation	45,704	355	2,285	43,064

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

* Less than 0.05 percent.

Table 74-7

Income, Deductions, Credits, and Taxes for Tax Return
with Adjusted Gross Income minus Investment Interest of $200,000 or Over -- 1974

Aggregate Data
($ in thousands)

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	12,097,231	32,719	146,957	11,917,555
EXPANDED INCOME	14,506,370	34,437	162,358	14,309,575
AGI PLUS PREFERENCES	14,889,783	50,985	202,360	14,636,438
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	12,097,231	32,719	146,957	11,917,555
Investment Interest < Investment Income 1/	375,242	16,323	37,735	321,184
Tax Preferences	2,417,307	1,943	17,664	2,397,700
Excluded Long-Term Capital Gains	2,271,746	1,932	12,479	2,257,335
Dividend Exclusion	4,789	11	51	4,727
Other Tax Preferences 2/	140,774	0	5,136	135,638
ADJUSTED GROSS INCOME	12,472,476	49,041	184,696	12,238,739
Deficits	0	0	0	0
AGI of Returns with AGI > 0	12,472,476	49,041	184,696	12,238,739
Exemptions	88,234	535	996	86,703
Standard Deductions	1,286	4	0	1,282
Itemized Deductions	2,531,637	54,807	157,163	2,319,667
Charitable Contributions	895,503	7,461	41,439	846,603
Interest: Total	492,795	28,303	59,447	405,045
Home Mortgage	31,687	110	517	31,060
Invest. Interest < Invest. Income 3/	375,242	16,323	37,735	321,184
Invest. Interest > Invest. Income 4/	85,867	11,871	21,195	52,801
Medical	25,306	115	1,176	24,015
Casualty	15,562	2,719	1,806	11,037
Tax Expense	812,789	4,370	19,743	788,676
Miscellaneous Deductions	289,682	11,839	33,552	244,291
Excess of Exemptions & Deductions over AGI	14,459	9,669	4,149	641
Taxable Income	9,865,778	3,365	30,684	9,831,729
Tax at Normal Rates	6,011,449	2,034	16,252	5,993,163
Saving from Alternative Tax 5/	33,611	0	36	33,575
Saving from Maximum Tax 5/	286,647	66	977	285,604
Saving from Income Averaging	150,694	90	259	150,345
Tax Before Credits	5,540,560	1,880	14,977	5,523,703
Tax Credits	97,705	1,880	10,415	85,410
Foreign Tax Credit	44,494	1,875	9,893	32,726
Investment Credit	52,611	6	516	52,089
All Other Credits 6/	598	0	3	595
Tax After Credits	5,442,855	0	4,560	5,438,295
Minimum Tax	64,152	0	964	63,188
Total Income Tax	5,507,007	0	5,524	5,501,483
Deduction Equivalent of Tax Credits 7/	144,306	3,144	16,766	124,396
Taxable Income which would yield: 8/				
Income Tax before Credits	9,188,943	3,144	28,761	9,157,038
Income Tax after Credits	9,044,637	0	11,995	9,032,642
Total Income Tax	9,139,904	0	14,467	9,125,437
Number of Tax Returns Represented in the tabulation	33,142	89	366	32,687

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

Table 74-8

Income, Deductions, Credits, and Taxes for Tax Returns
with Adjusted Gross Income minus Investment Interest of $200,000 or Over -- 1974

As Percentage of Adjusted Gross Income less Investment Interest

	All Returns	Nontaxable Returns	Nearly Nontaxable Returns	All Other Taxable Returns
INCOME, PER CONCEPT	100.0 %	100.0 %	100.0 %	100.0 %
EXPANDED INCOME	119.9	105.2	110.5	120.1
AGI PLUS PREFERENCES	123.1	155.8	137.7	122.8
AGI MINUS INVESTMENT INTEREST < INVESTMENT INCOME	100.0	100.0	100.0	100.0
Investment Interest < Investment Income 1/	3.1	49.9	25.7	2.7
Tax Preferences	20.0	5.9	12.0	20.1
Excluded Long-Term Capital Gains	18.8	5.9	8.5	18.9
Dividend Exclusion	*	*	*	*
Other Tax Preferences 2/	1.2	0	3.5	1.1
ADJUSTED GROSS INCOME	103.1	149.9	125.7	102.7
Deficits	0	0	0	0
AGI of Returns with AGI > 0	103.1	149.9	125.7	102.7
Exemptions	0.7	1.6	0.7	0.7
Standard Deductions	*	*	0	*
Itemized Deductions	20.9	167.5	106.9	19.5
Charitable Contributions	7.4	22.8	22.2	7.1
Interest: Total	4.1	86.5	40.4	3.4
Home Mortgage	0.3	0.3	0.4	0.3
Invest. Interest < Invest. Income 3/	3.1	49.9	25.7	2.7
Invest. Interest > Invest. Income 4/	0.7	36.3	14.4	0.4
Medical	0.2	0.4	0.8	0.2
Casualty	0.1	8.3	1.2	0.1
Tax Expense	6.7	13.4	13.4	6.6
Miscellaneous Deductions	2.4	36.2	22.8	2.0
Excess of Exemptions & Deductions over AGI	0.1	29.6	2.8	*
Taxable Income	81.6	10.3	20.9	82.5
Tax at Normal Rates	49.7	6.2	11.1	50.3
Saving from Alternative Tax 5/	0.3	0	*	0.3
Saving from Maximum Tax 5/	2.4	0.2	0.7	2.4
Saving from Income Averaging	1.2	0.3	0.2	1.3
Tax Before Credits	45.8	5.8	10.2	46.4
Tax Credits	0.8	5.8	7.1	0.7
Foreign Tax Credit	0.4	5.7	6.7	0.3
Investment Credit	0.4	*	0.4	0.4
All Other Credits 6/	*	0	*	*
Tax After Credits	45.0	0	3.1	45.6
Minimum Tax	0.5	0	0.7	0.5
Total Income Tax	45.5	0	3.8	46.2
Deduction Equivalent of Tax Credits 7/	1.2	9.6	11.4	1.0
Taxable Income which would yield: 8/				
Income Tax before Credits	76.0	9.6	19.6	76.8
Income Tax after Credits	74.8	0	8.2	75.8
Total Income Tax	75.6	0	9.8	76.6
Number of Tax Returns Represented in the tabulation	33,142	89	366	32,687

Office of the Secretary of the Treasury
Office of Tax Analysis
July 24, 1978

See Uniform footnotes following Table 76-8 in Appendix A.

Source: 1974 Internal Revenue Service tax model.

* Less than 0.05 percent.

Appendix D

Comparing Deductions, Credits, and Special Tax Computations

In order to be able to compare tax credits and special tax computations such as the minimum tax, the alternative tax, the maximum tax, and income averaging to deductions and exclusions, a deduction equivalent for each of these provisions must be calculated. The deduction equivalent of a credit or of a special tax computation is computed by determining the difference between the taxable income which, using normal tax rate schedules, would yield the actual tax before the provision and the actual tax after the provision. For example, "deduction equivalent of tax credits" is equal to the difference between "taxable income which would yield tax before credits" and "taxable income which would yield tax after credits." 1/

It should be noted that under this method of computing deductions and credits, the order in which the various deductions, credits, and special tax provisions are calculated affects the value of deduction equivalents. Because the tax rate schedule is progressive and successive increments to income are taxed at successively higher rates, the deduction of equivalent of the items which are last converted to a deduction equivalent will be larger (for the same amount of a credit) than the items converted first.

For purposes of computing the deduction equivalent of the credits for the tables in Appendices A, B, and C, credits were taken after deductions, so that the deduction equivalent of credits is biased upwards. In order to simplify computation, the general tax credits available to taxpayers in 1975 and 1976 were ignored. In 1975, the credit was $30

1/ An alternative would have been to compute the value of the tax saving provided by deductions and exclusions. That saving would be comparable to the value of a special tax computation and of a tax credit. Neither method is superior analytically.

for each exemption claimed, other than exemptions for age and blindness. In 1976, the general tax credit was the larger of $35 per exemption (other than those for age or blindness) or two percent of the first $9,000 of tax ($4,500 on a separate return of a married person). Omitting consideration of these credits is not significant for high-income returns. It also facilitates accurate comparisons between the deduction equivalents of nontaxable and taxable returns.

For Tables 16 and 17, credits and deductions were compared in a slightly different manner which tends to over-value credits as compared with the deduction equivalent method. Whether the largest credit or the largest deduction yielded a larger tax saving was determined by comparing the tax saving yielded by the largest deduction with the value of the largest credit.

GAYLORD NELSON, WIS., CHAIRMAN
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United States Senate
SELECT COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

August 24, 1978

The Honorable
Russell B. Long
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Senator Long:

The Senate Committee on Finance held a hearing on August 17, 1978 on the Tax Reform Act of 1978 during which Secretary of Treasury Blumenthal testified. While I was present at the hearing, I was not able to ask the attached question in the time frame allowed. I would therefore appreciate your submitting the question to Secretary Blumenthal's office and inserting the question and answer in the body of the record of the hearing.

Sincerely,

GAYLORD NELSON
Chairman

GN:jw

Enclosure

Less than a month ago, Secretary of Commerce Kreps announced the first federal program to address the serious economic problems facing thousands of small businesses that have had great difficulty in obtaining affordable product liability insurance. Many of these firms have had their product liability coverage escalate from 100 to as much as 1,000 percent or more, and face the prospects of closing their doors or going bare, thereby exposing themselves to great financial losses.

Consumers also face the danger that when injuries do occur, product manufacturers or distributors may not have the financial resources for compensating them sufficiently.

Additionally, as pointed out by Secretary Kreps, "The problem has also affected consumers because insurance costs have been passed on to them in terms of higher prices."

As part of its program, the Administration has endorsed a change in the tax code to afford a measure of immediate financial relief to small business hard-pressed by product liability costs. The need for such relief had also been highlighted in hearings by the Small Business Committee as well as an Interagency Task Force after an 18-month study of the problem.

In light of the Administration's acknowledgement that thousands of small businesses have great difficulty in obtaining this kind of insurance coverage and that the tax code offers an appropriate short-term remedy, do you think it useful to include such a provision in this tax bill?

September 15, 1978

Dear Mr. Chairman:

This is in reply to the question that Senator Nelson intended to pose to Secretary Blumenthal at the hearing on August 17, 1978, concerning product liability as set forth in his letter to you dated August 24, 1978. The Administration proposal to which Senator Nelson refers is to allow a special 10-year carryback for net operating losses attributable to product liability. We believe the proposal is the appropriate relief for the problem referred to by Senator Nelson.

The Administration would have no objection to the inclusion of its proposal in the tax bill presently before the Senate Finance Committee.

Please let me know if there is any further information I can furnish to you.

Sincerely,

/s/ Donald C. Lubick

Donald C. Lubick
Assistant Secretary
(Tax Policy)

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

cc: Senator Gaylord Nelson

APPENDIX B

Communications Received by the Committee Expressing an Interest in These Hearings

Statement of George S. Koch, Chairman of the Federal Finance Committee, Council of State Chambers of Commerce

The Federal Finance Committee of the Council of State Chambers of Commerce appreciates this opportunity to submit to the Committee on Finance its views on H.R. 13511, the House-approved tax reduction bill. Because of the relatively brief public hearings planned by the Committee, this statement is submitted in lieu of our usual presentation of oral testimony in order to save the time of the Committee.

In our presentations over the last ten years to the tax-writing committees of Congress we have repeatedly emphasized the need for increasing capital formation by reducing the bias against capital inherent in our income tax system. During the last few years there has been a growing recognition of this need both in the Congress and in the Executive Branch. But, until recently, there has been too much timidity in dealing with the problem. In passing H.R. 13511, the House has taken several significant forward steps; however, in their total impact they do not go far enough in light of the capitol investment needs now and in the period ahead. This appears to have been due in part, at least, to a decision to limit the first year's static revenue loss several billions under the level that the President and the Senate appear willing to accept. We do not subscribe to the position taken by the House in his regard.

To better meet urgent capital formation and investment needs, two amendments to the House bill are strongly recommended. One would reduce the top corporate income tax rate in 1979 to 45% instead of 46% as in H.R. 13511. The other would extend the investment credit to structures. These and other suggested changes in the bill are discussed in the paragraphs that follow.

BUSINESS TAXES

Corporate rate reduction

In our testimony before the House Committee on Ways and Means last March we supported the President's proposal to reduce the top rate of the corporate income tax from 48% to 45% in a first step, with a further reduction of 44% in 1980. The House bill, however, provides for a reduction of only two percentage points of 46% effective for taxable years beginning after December 31, 1978. We urge that the provision be amended to increase the reduction to three percentage points for a top rate of 45%.

We also supported the President's proposal to lower the corporate normal tax from 20% to 18% on the first $25,000 of income and from 22% to 20% on the second $25,000. The House bill would repeal the present normal tax and surtax and impose a new five-step structure of graduated rates on corporations. While we believe small business should be given significant tax relief, we do not support the method adopted by the House. That method seems to be based on the ability-to-pay concept of progressivity which is not applicable to corporations as a matter of equity. As Secretary Blumenthal pointed out in his presentation on August 17, a steeply graduated corporate rate schedule, such as in H.R. 13511, is actually regressive. In support he cited a Treasury study which showed that average incomes of all individual shareholders receiving corporate dividends is only half that of shareholders in closely-held corporations typical of those that would benefit from the graduation.

We recommend instead either adoption of the President's proposal or an increase in the surtax exemption to a level above $50,000 which would provide about the same overall tax reduction for small business as does the House provision.

Investment credit modifications

The President proposed several changes with respect to the investment credit which would materially improve present law. One would make the present 10 percent temporary rate permanent. Another would extend the credit to new industrial structures and rehabilitation of existing structures. A third would permit the credit to be claimed against 90 percent of tax liability instead of the present $25,000 plus 50 percent of tax liability. We supported these changes which would increase capital formation and encourage investment, and we urged their enactment.

The House bill makes the present 10 percent investment credit permanent but it modified the other two proposals significantly. Instead of providing for immediate use of the credit against 90 percent of tax liability, the bill would phase in the increase from 50 percent to 90 percent over four years by an additional ten percentage points per year. The House report on the bill recognizes that situations exist when inability to take the credit in full because of the present limitation becomes a disincentive to investment. We submit that the phase-in provision would only gradually alleviate this situation and, accordingly, we recommend the single-step increase to 90 percent as originally proposed by the President.

Extension of the investment credit to new structures, as originally proposed by the President, is not included in H.R. 13511. Instead, the bill only extends the credit to rehabilitation of existing buildings. This provision would do very little to solve the problem of inadequate facilities described by the Treasury in its January 30 supporting analysis for the President's 1978 tax program. Accordingly, we urge extension of the credit to all capital expenditures for structures, including rehabilitation expenditures.

Industrial development bonds

In recognition of the considerable reduction in the purchasing power of the dollar since 1968 when Congress approved tax-exempt status of interest on small issues of local industrial development bonds, the House increased the limitation from $5 million issues over a six-year period to $10 million. This is a desirable change and should be enacted.

Small business provisions

The House bill includes three special provisions designed to help small business. One would simplify and liberalize Subchapter S rules that treat certain small corporations as partnerships. A second would encourage investments in small corporations by doubling from $500,000 to $1,000,000 the amount of a small corporation's stock that can qualify under Sec. 1244 of the Code for special ordinary loss treatment and by simplifying the requirements for use of the provision. The third provision would increase from $2,000 to $5,000 the maximum deduction for additional first-year depreciation on depreciable property. The present additional first-year depreciation provision applies to any taxpayer but the House provision would limit it to taxpayers with less than $1 million of depreciable assets.

We support enactment of these small business provisions except for the $1 million assets limitation for use of additional first-year depreciation. This limitation would discriminate against many small businesses which are capital intensive and have depreciable assets considerably above $1 million. Asset depreciation provisions should be applicable in the same manner to all businesses regardless of size.

CAPITAL GAINS

The House has made a major reform in taxation of capital gains by removing such gains from the list of tax preferences under both the minimum and maximum taxes, thus reducing the maximum rate on capital gains to 35 percent from near 50 percent. Significantly offsetting this improvement for many taxpayers, however, is a provision repealing the present 25 percent alternative rate on the first $50,000 of long-term gains. Other capital gains provisions adopted by the House include:

An alternative minimum tax on capital gains which would be imposed at a rate of 10% on the excluded one-half of an individual's long-term gains less a $10,000 exemption. This alternative minimum tax would be imposed only to the extent that it exceeds the taxpayer's regular tax liability, and it would not include gain on sale of the taxpayer's principal residence.

An inflation adjustment would be applicable to the basis of assets sold after December 31, 1979 which would reflect inflation measured by the consumer price index for the holding period beginning after December 31, 1979. Assets eligible for the adjustment would include corporate stock, real estate, and tangible personal property.

Provision is made for exclusion from gross income of up to $100,000 of gain realized on sale of a taxpayer's principal residence which he has occupied for two years immediately preceding the sale. The exclusion could be elected by any individual regardless of age but only once in a taxpayer's lifetime, and only if present non-recognition treatment of rollovers is not elected.

The House decisions on capital gains reflect extended analysis and discussion of the adverse impact of present law on capital formation. Thus, we urge Senate approval of no less capital gains relief than that adopted by the House. One desirable modification would be retention of the present 25% alternative tax rate on the first $50,000 of long-term gains.

INDIVIDUAL INCOME TAXES

We commend the House for its statesmanship in dealing with individual income tax reductions. As stated in the House report on the bill, the intent was to direct a significant portion of the tax reduction to middle and upper-middle income taxpayers who have been hardest hit both by recent legislated social security tax increases and by automatic inflation-induced income tax increases. The report also noted that tax cuts in recent years have been directed primarily to lower-income taxpayers and that it is now appropriate to give relief predominantly to middle-income taxpayers.

The principal means adopted by the House for effecting the net tax reduction of $10 billion for individuals are an increase from $750 to $1,000 in the personal exemption, a widening of the individual tax brackets by 6%, and rate cuts in certain brackets. We fully support these decisions by the House.

FOREIGN SOURCE INCOME

As Secretary Blumenthal noted in his August 17 statement, neither of the President's proposals dealing with foreign source income are contained in H.R. 13511. These proposals would have phased out over three years the so-called tax deferral of unrepatriated income of foreign subsidiaries and the DISC provision. We commend the House for excluding these matters from the bill.

In his testimony before the Committee on Ways and Means, January 30, 1978, Secretary Blumenthal asserted that there is no sound reason to continue deferral of tax on retained earnings of foreign subsidiaries. But the fact is that there are very good reasons for continuing the present practice.

First, it is the practice followed by other industrial countries which compete with us in world markets. Elimination of deferral would make U.S. multinationals significantly less competitive with foreign companies in any host country where taxes are lower than the U.S. tax. It would also work to the disadvantage of U.S. companies in countries with tax rates equal to ours where the host country allows more rapid depreciation than U.S. law permits. In the early years of a project U.S. tax liability would be greater than tax liability in the host country and thus would adversely affect cash flow. The effects of terminating deferral would be to give up American production to foreign companies in countries with low taxes and thus reduce U.S. parent company jobs related to exports to foreign subsidiaries. Even in high tax host countries with advantageous depreciation provisions the effect could be to relinquish future investment to foreign competitors.

Second, the net result to the U.S. Treasury would be minimal. If the U.S. Treasury should tax retained earnings of foreign subsidiaries as deemed dividends, the host countries could, and very likely would impose their dividend withholding tax on such deemed dividends. The benefit to the Treasury would be nil with respect to subsidiary company earnings in countries with tax rates approaching the U.S. tax. The only revenue benefit would be to the host country.

In countries with low tax rates or other special tax inducements for investment, U.S. companies would have little recourse but to sell their investments to foreign competitors. Again the benefit would accrue to our foreign competitors, not to the United States. Some would argue that the proceeds would be invested at home but that would not necessarily follow. The likelihood is that they would be used for portfolio investments abroad that would be more profitable than project investments at home.

In view of the foregoing and for other reasons not stated here, we cannot see any valid tax or economic reasons for repeal of deferral.

With respect to the proposed phaseout of DISC it should not be overlooked that the major purpose of its enactment was to make U.S. exports more competitive with exports of other countries which provide special tax inducements, such as refund of value added taxes, to encourage exports. We know of no material change that has been made in the export policies of our competitors for overseas markets and, with the U.S. trade balance at its worst in history, we believe it would be a serious mistake to eliminate this export encouragement provision. Instead, it should be improved.

CONCLUSION

The House bill represents a good approach to alleviating the tax burdens on individuals and business. It moves in the direction of removing the tax bias against investment in present law. There are improvements that can be made in the bill, several of which we have suggested. We hope that the Senate accepts this conclusion.

Because of the time factor, it was impractical on this occasion to submit our committee's recommendations to the 33 member state organizations in the Council of State Chambers of Commerce for their endorsement. Had we been able to do so, we are confident that a great majority, if not all, would have endorsed this statement.

STATEMENT OF SENATOR THOMAS F. EAGLETON

Mr. Chairman, I appreciate the opportunity to present for the consideration of the Finance Committee a specific situation created by the Internal Revenue Service's efforts to clarify regulations on the refinancing of tax-exempt bond issues.

On September 24, 1976, Treasury news release WS 1097 was issued, outlining some new "Do's and Don'ts" for municipal bond refundings. My concern is not with the substance of these new rules, although I realize that some of my colleagues have questioned them, but with the efforts of the Internal Revenue Service to apply their new interpretation retroactively. In doing so, the IRS has changed the rules in the middle of the ball game for the seven jurisdictions which would be helped by a bill I have introduced, S. 3338. These jurisdictions all completed advance refundings prior to September 24, 1976, and planned to give the resulting "windfall profits" to charities.

In a municipal bond refunding, the issuers purchase United States government obligations which are deposited in escrow until the initial bond issue is refunded. Under arbitrage restrictions enacted in 1969, the government obligations must bear a limited yield rather than a market yield. Prior to the September 24, 1976 news release, issuers could purchase these obligations in either of two ways. One way was to buy them from a private party at a price greater than market price thereby generating a "windfall profit" which was held in escrow. The other way was to buy special low-yielding obligations issued by the U.S. Treasury, thereby generating a "windfall profit" for the federal government.

Jackson County, Mo., was one local government which had chosen to go the first route. In May of 1976, Jackson County refinanced $65 million worth of general obligation bonds, and in the process generated a windfall profit of about $4 million. The refunding was undertaken to lower property taxes by taking advantage of the more favorable interest rate available in 1976. In order to dispose of the profit generated by the refunding in accordance with IRS rules, the County devised a plan to distribute the money to over 200 local charitable and civic organizations.

It should be noted, Mr. Chairman, that there is no statute currently on the books which would prohibit charitable distribution of this type of profit, nor were there any regulations in effect to prohibit this at the time Jackson County

and the six other governments refunded their bonds. In 1973 Congress had an opportunity to enact legislation very similar to the current IRS policy, and Congress chose not to act on this issue. In May of 1974 the City of Carbondale, Ill., distributed a windfall profit to several charities, and this allocation of the profit has never been challenged by the IRS.

This was the situation when on September 24, 1976, the IRS threw a wrench into the works with its press release. The release indicated that under new rules "windfall profits" would no longer be generated. Furthermore, the IRS since has indicated that such profits accumulated prior to the September 24th release should be allowed to be distributed only to the U.S. Treasury, or to the investment bankers involved in the refundings. It appears that the IRS intends to regard the bonds issued as arbitrage bonds, which will lose their tax-exempt status if the windfall is distributed to charity.

I do not quarrel with the Internal Revenue Service's right and duty to interpret regulations. I do quarrel with the manner in which these regulations are being applied arbitrarily to seven jurisdictions which had completed their bond refundings, and had done so in good faith and in accordance with existing rules. I find it somewhat ironic that while the IRS will not allow the profit to be given to tax-exempt charities, they will allow the profit to go to the investment bankers who consulted on the refundings.

Mr. Chairman, I have summarized the situation in Jackson County, Mo., as that is the case with which I am most familiar. However, I would like to briefly outline the facts of the six other cases for inclusion with my statement.

The City of Wichita, Kans., refunded approximately $32.3 million in water revenue bonds in August of 1976. A windfall profit of around $1.25 million resulted, which is currently being held in escrow in the Fourth National Bank of Wichita pending a decision on the legality of distributing the profit to charities.

The Rhode Island Housing and Mortgage Finance Corporation refunded a total of $67 million of Mortgage Finance Bonds in July of 1976, and the profit is being held in escrow by the Industrial National Bank of Rhode Island. The escrow agreement includes an order of preference for the disposition of the profit to various tax-exempt charitable organizations, depending on the IRS' interpretation of the rules governing advance refundings.

The Sayre Borough Hospital Authority of Sayre, Pa. refunded around $23 million in bonds in August of 1976 with an approximate $480,000 resulting windfall profit, currently being held in escrow in the Girard Bank, Philadelphia. The Hospital Authority designated a list of 25 charities, in order of preference, to which they intended to distribute the proceeds after receiving a revenue ruling on the matter from the Internal Revenue Service.

In Mobile, Ala., the Board of Water and Sewer Commissioners refunded its January, 1975, bond issue of $11.5 million on September 2, 1976. Provisions were made for the windfall profit to be given voluntarily by the fiscal advisors to Mobile charities designated by an advisory group of three prominent Mobile citizens. The windfall profit has been taken into the income of one of the fiscal advisors and tax has been paid on the profit; the remainder will be distributed to charities designated in an October 18th letter from the fiscal advisor to the tax counsel of the Board if sufficient legal clarification can be obtained. Around $260,000 of the profit would be available for distribution to the Mobile charities.

The City of LaCrosse, Wis. refunded $19.8 million in general obligation bonds with a $21.4 million issue on September 1, 1976. A net windfall profit of around $1 million is being held in escrow at the Northern Trust Company of Chicago, Ill. Local chariites have been selected to receive the windfall profit under the escrow agreement if a favorable legal opinion or revenue ruling is obtained.

In Wierton, W. Va., the Wierton Municipal Hospital Building Commission refunded $23,375,000 of first mortgage gross revenue bonds on July 16, 1976. This generated a windfall profit of $419,659. Since an adverse revenue ruling was issued by the Internal Revenue Service on December 21. 1976, the profit has been turned over to the Treasury through special obligations issue by the Bureau of Public Debt rather than the designated charities.

I appreciate being able to bring this matter before the Finance Committee, as I consider this to be well worth the Senate's consideration. I feel strongly that legislation allowing these seven jurisdictions to proceed with the distribution of their windfall profits is necessary to correct this injustice.

TESTIMONY OF MIKE WHITE, COUNTY EXECUTIVE, JACKSON COUNTY, MO.

Mr. Chairman, I appreciate your inclusion of Jackson County's situation in the hearing record on this tax bill.

Almost two and a half years ago, the Jackson County government did something they thought was right. They did something they thought made sense. They did something in the best interest of their community.

In May, 1976, the county refinanced $65 million of its outstanding general obligation bonds. They borrowed new dollars to pay off the old bonds. They did that to take advantage of the lower interest rate available in the bond market and to save taxpayers about $4 million on their tax bills for debt service.

In that same transaction, the county earned about $3 and a half million net after expenses which is called the treasury profit or windfall profit. Many cities and counties have given the treasury or windfall profit to their bond advisors, but Jackson County had a better idea. They thought they would keep those dollars in the community and make the money work for the betterment of the community.

Upon deciding to give the windfall profit to charity, the bond and tax counsel for Jackson County structured the escrow of the proceeds so that this could be accomplished. A few other cities and counties in the United States are in the midst of trying to do the same.

Two years ago in September, the IRS published a statement saying there would be no more windfall profits and that distributing windfall profits from past refunding issues could mean revocation of the tax-free status of the county bonds. Furthermore, this new policy would be enforced retroactively.

I can understand the concern of the IRS that there be some control to prohibit local governments from excessive wheeling and dealing in their own securities and from using the tax-exempt privilege to pile up profits at the expense of the federal government, but I cannot understand the logic of the IRS when they say we can give this money to a bond advisor as personal profit but not to a charity to work for the public good.

I appreciate the Finance Committee's efforts in reviewing this situation, and I hope that the Congress will allow Jackson County and other units of government in the same situation to proceed with their plans to distribute this windfall to charity.

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., July 14, 1978.

Hon. W. MICHAEL BLUMENTHAL,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR SECRETARY BLUMENTHAL: It is our understanding that, for municipal bond issues closed prior to September 24, 1976, the Internal Revenue Service proposes to apply a Treasury news release (WS 1097, dated September 24, 1976) to interpret the "arbitrage" regulations (as in effect prior to September 24, 1976) in such a way as to effectively prohibit the distribution of profits, earned on the purchase and sale of government securities, to charitable and civic organizations. However, the IRS proposal would allow profits generated in precisely the same manner to be retained by investment bankers and others. We believe it is patently unfair to allow private investment bankers to receive these profits and, at the same time, prohibit public charitable and civic organizations from doing so.

In municipal bond refundings, municipal issuers purchase United States government obligations for deposit in escrow pending their application to discharge the bonds being refunded. As a result of the arbitrage restrictions enacted in 1969, the government obligations purchased are required to bear a limited yield rather than a market yield. In order to acquire government obligations with such a limited yield, municipal issuers were required either to purchase them from a private party at a price in excess of the market price, thus generating a "windfall" profit, or to purchase special low yielding obligations from the United States Treasury, thus, in effect, disposing of the "windfall" to the United States. Prior to September 24, 1976, it was clearly established that either method was acceptable. Indeed, in 1973 the Treasury Department proposed to Congress changes in the law which would have made disposition of the windfall to the

Treasury attractive, although not mandatory. However, the Congress did not act on this proposal (Proposals for Tax Change, April 30, 1973).

In certain refundings which took place in 1976 prior to the September 24 news release, arrangements were made under which the windfall profits would go to various charitable and civic organizations rather than to the underwriter or investment bankers involved in the transaction. In some cases, trusts acting on behalf of charities purchased the government obligations on the market and sold them to the issuer at a higher price, just as an investment banker would have done. In other cases, the investment banker himself purchased and sold the securities but agreed to give the profits to charities. In still others the profits were simply set aside in escrow for distribution to such organizations pending receipt of a ruling or opinion of counsel that such distribution would not cause the issuer's bonds to be classified as arbitrage bonds.

Favorable rulings were sought from the Internal Revenue Service that distribution of the windfall profit to the charities would not have adverse tax consequences to the issuers or the bondholders. However, the Service proposes to rule that the windfall profit can only be distributed to the Treasury or retained by the investment bankers. The Service's position appears to be that the bonds issued become arbitrage bonds and lose their tax exempt status if the windfall profit is distributed to charity. As indicated in Proposals for Tax Change, the only requirement was that the municipalities could not retain the arbitrage profits. Nothing in the Statute, or the Regulations in effect prior to September 24, 1976, mandated where the profits must be directed. Specifically, nothing in the Regulations forbade their distribution to 501(c) organizations.

The arbitrage regulations permit investment bankers to retain the profits generated from municipal bond refundings. We believe it would be sound public policy to also permit charitable institutions to receive the profits arising from municipal bond refunding transactions entered into before the date of the Treasury news release.

We would very much appreciate your personal attention to this matter.

Sincerely,

Gaylord Nelson, *U.S. Senator*; Thomas F. Eagleton, *U.S. Senator*; William Proxmire, *U.S. Senator*; Maryon Allen, *U.S. Senator*; Claiborne Pell, *U.S. Senator;* John Sparkman, *U.S. Senator;* John C. Danforth, *U.S. Senator;* H. John Heinz III, *U.S. Senator;* Robert Dole, *U.S. Senator.*

DEPARTMENT OF THE TREASURY,
Washington, D.C., August 16, 1978.

Hon. THOMAS F. EAGLETON,
U.S. Senate,
Washington, D.C.

DEAR SENATOR EAGLETON: This is in response to your letter of July 14, to Secretary Blumenthal, co-signed by eight of your colleagues.

Certain issuers have unsuccessfully sought rulings from the Internal Revenue Service that would permit them to transfer windfall arbitrage profits that arose prior to September 24, 1976, to various charities. You have expressed concern about possible discrimination against these charities and note that underwriters have been permitted to retain windfall profits already in their possession.

Requests for rulings are an administrative matter primarily within the jurisdiction of the Internal Revenue Service. In general, Treasury does not intercede in such proceedings unless policy questions of overriding importance are raised. For such reasons outlined below, we do not believe this is such an instance.

It is true that the Service has not initiated audit proceedings in cases where arbitrage profits have actually been received by third parties. There were a number of such recipients, including both underwriters and charities. Thus, *both* types of entity—charities and underwriters—have been allowed to retain windfall profits already in their possession. However, the Service has taken the position that because these amounts are windfall arbitrage profits, it is improper under the Internal Revenue Code for either underwriters or charities to receive additional amounts. For this reason, the Service has declined to issue favorable rulings regarding future receipts. This position applies to charities and underwriters alike.

Thus, the Service has not discriminated against charities. Both charities and underwriters have been permitted to *retain* windfall profits already in their possession; neither will be permitted to *receive* additional amounts.

Thank you for your interest in this matter.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary (tax policy).

STATEMENT OF ROBERT P. GRIFFIN, A U.S. SENATOR

I am very pleased to have an opportunity to put my views on record as the Senate Finance Committee considers the Revenue Act of 1978 (H.R. 13511).

I will be brief and to the point. I have come to urge the Committee—as I urged the Subcommittee on Taxation and Debt Management four months ago—to report to the Senate not just a tax-cut bill but a *real* tax reform bill.

And the only way *real* tax reform can be accomplished is by combining a tax *cut* with tax *indexation*. Because unless tax rates are adjusted automatically to reflect future increases in the cost of living, the effect of any tax cut granted this year will be quickly eroded and made meaningless.

Last year, during consideration of the Tax Reduction and Simplification Act, I offered a tax indexation amendment on the floor. Unfortunately, that amendment failed by a vote of 64 to 24. The very next day—April 29, 1977—I introduced the same language as a bill, S. 1431, to index personal income tax rate schedules, deductions, and exemptions to compensate for increases in the cost of living.

Since then, a number of similar bills have been introduced, including S. 2738, which I am pleased to cosponsor with Senators Dole and McClure.

I remain steadfastly convinced that enactment of tax indexation is the single most valuable and important step that this Congress could take to grant taxpayers genuine relief from the squeeze of raging inflation and ever-higher taxes that economists are now calling "taxflation."

And the *only* way to do that is through indexation. This is no longer an esoteric economic concept. The people all over the country understand it and want it. I know that first-hand from traveling around my State of Michigan, where at every stop, people are talking about indexation as the ultimate relief from taxflation.

But that's true not only in Michigan. A Roper poll released last month—which surveyed nationwide attitudes toward taxation—showed that *60 per cent* of American taxpayers would *prefer* having income tax rates adjusted for inflation to having periodic tax cuts!

Let me cite that figure again. *Six out of every ten* taxpaying Americans want *tax indexation*—not just a tax cut— as the means for real relief from the scourge of taxflation.

We all know the symptoms of taxflation. Unbridled inflation forces wages to rise so that taxpayers can keep up with the cost of living. As their wages rise, the taxpayers find that they are pushed up into higher tax brackets—and greater tax liability. So, although the taxpayers have realized no gain in terms of real income—their dollars have only been inflated—they must pay higher taxes. To compound the problem, our progressive tax system takes a steadily increasing percentage of a taxpayer's earnings as the taxpayer gets moved into higher tax brackets. As the well-known advertisement says: "There's no living with inflation"—and, I would add, there's no living with taxes!

Given this unhappy interplay between taxes and inflation, it's no wonder that workers today feel like the man trying to climb a ladder in a bog: for each rung the taxpayer climbs on the economic ladder, he settles the ladder that much deeper into the financial mire.

But, as in almost every arena of life, there's a winner and a loser. In this particular arena, the real winner—as you might have guessed—is the Federal government. Because the taxpayers' loss is the government's gain.

As Nobel prize-winning economist Milton Friedman computes it, when the cost of living goes up 10 per cent, the Federal treasury's take goes up—not 10 per cent—but 16 per cent. This works out to a windfall profit on inflation for the Federal government of about *$6 billion a year.*

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I must say that it's no surprise that some of the big spenders here in Washington take a very dim view indeed of a proposal that would eliminate this insidious but subtle revenue rake-off. Without even having to take a vote, taxes and tax revenues are increased—all Washington has to do to keep the tax dollars flowing in is continue to pursue inflationary policies.

But what does all this mean to the individual wage earner? Let me give you a few illustrations.

Consider the plight of the wage earner with a wife and two children who in 1977 made $15,000. If we are conservative (perhaps optimistic is a better term) and assume an inflation rate of 8 per cent for this year, our wage earners will have to earn $1,200 more—or $16,200—just to break even in 1978. But, while his income has increased by 8 percent his income taxes will go up by about 19 percent—because he's thrown into a higher tax bracket—which is a tax increase of $260. The government's hidden profit on this, by the way, is $150.

And, the situation worsens with each year if the tax rates are not adjusted. Next year—in 1979—if inflation stays at 8 percent and the family's wages manage to keep up, their taxes will increase by another 17 percent, and the government's windfall will be about $305—for a whopping two-year total of $455 taken by stealth from this one modest-income family.

The effects of taxflation become even harsher and more pronounced as workers climb the income ladder. A family with a $30,000 yearly income in 1977 will have to earn $32,400 in 1978 to keep pace with our projected inflation rate. However, at $32,400, the family's tax bill will rise about $857. The government's profit on that is $423.

But personal income is not the only area where taxpayers are hit by the impact of inflation. Let's take another typical situation.

A couple bought a home back in 1952 for $25,000. Twenty-five years later, their children have grown up and have gone off on their own, and the couple is able to sell their home for $60,000 and move into a small apartment. In that 25-year period, inflation has pushed the cost of living up 144 percent. The $25,000 that the couple paid in 1952 is actually equal to about $61,000 today. 25 years later. So, by selling the house for $60,000, the couple actually received less than they paid for it!

But, under our current tax system, the government says the couple has realized a $35,000 "gain" and must pay tax on it. For the average taxpayer, that's a tax bill of about $7,000.

I, for one, do not believe the government should impose a tax in such a case where the taxpayer has not realized a gain in actual purchasing power. And, I am very pleased to see that our colleagues in the House of Representatives have agreed. The House-passed version of the Revenue Act of 1978 would—for the first time—index most capital assets (such as homes) to reflect increases in the cost of living.

This is a very significant and important first step. But, we should not stop with capital assets. As I have shown, the harsh impact of taxflation is felt with equally devastating effects in a taxpayer's personal income. Congress should take the bull by the horns and—at the very least—adjust tax brackets, tax rates, the personal exemption and the standard deduction to reflect increases in the cost of living. Let's neutralize the tax impact of inflation.

I would like to make one final point. The Finance Committee—soon to be joined by the full Senate—is in the process of determining the size and shape of this year's tax cut. I want to emphasize that I wholeheartedly support efforts to cut taxes—but tax cuts are simply not the whole answer.

Too often—and this year is a perfect example—tax cuts are determined by prevailing political winds and do not entirely make taxpayers whole for past losses suffered through taxflation. Even if tax cuts help in the year they are enacted, the benefits are lost in the following years as the inflation spiral starts anew.

The traditional approach to trying to keep taxpayers even with the cost of living through sporadic and intermittent tax cuts is ineffective and dishonest. Because of inflation, these tax cuts aren't really tax cuts at all—they are merely a patchwork attempt to stem the tide of taxflation for one year.

I urge this Committee in the strongest terms to restore integrity to our tax system and give American taxpayers a reason to have confidence in it. In view of the citizen tax revolt that is sweeping the country today, this year provides us with an excellent opportunity to enact national tax limitation through tax indexation.

Let's have a tax cut this year that will put us back on an even keel—but let's also enact a tax indexation system to keep us on a steady course in the future without requiring constant adjustment and tampering.

If we move now to do this, the next tax cut Congress considers will be a *real* tax cut. But that will never happen without real reform. We can enact that reform now by enacting tax indexation.

Statement of Thomas H. Boggs, Jr., on Behalf of Ad Hoc Committee on Section 274(h)

This statement is submitted on behalf of the Ad Hoc Committee on Section 274(h), which consists of six major U.S. hotel chains (Hilton International, Hyatt International, Marriott Hotels, Sheraton Hotel Corp., Holiday Inns, Inc., and Western International Hotels) and the American Society of Association Executives. At issue are the limitations, enacted as part of the Tax Reform Act of 1976, on the deductibility of expenses incurred in attending foreign conventions. These appear as section 274(h) of the Internal Revenue Code.

The Ad Hoc Committee believes that section 274(h) as now drafted is hopelessly complex, burdensome, and unwise, and that it is preventing legitimate activity. The Committee therefore strongly recommends that the revisions described below be made an amendment to H.R. 13511. These revisions would prevent the abuses to which section 274(h) was directed, but would do so in a reasonable and workable manner.

To put these revisions into context, it first is necessary to summarize how section 274(h) now operates.

A "foreign convention" is defined as "any convention, seminar, or similar meeting held outside the United States, its possessions, and the Trust Territory of the Pacific." Transportation expenses to and from such convention are deductible only to the extent they do not exceed coach or economy fare, and only if more than half the days of the trip are spent in activities related to business. If less than half the days are so spent, only the allocable fraction of the transportation expense is deductible. Subsistence expenses while attending such a convention, for meals, lodging, local transportation and the like, cannot exceed the corresponding Government per diem rate; and whether this amount can be deducted in full, in part, or not at all depends on adherence to certain prescribed rules of attendance at meetings. Attendance must be verified not only by the individual, but also by an officer of the group sponsoring the convention. In addition, if an individual goes to more than two such conventions in a taxable year, only the expenses related to two of them may be deducted. All these limitations apply whether the person claiming the deduction is the traveler or another person, such as the traveler's employer.

The Treasury Department has yet to propose regulations under section 274(h), perhaps because it believes that the statute will be amended. Of course, the absence of such regulations makes the interpretation of the statute that much harder. Yet, even if regulations were issued, a series of basic problems inherent in the statute itself must inevitably frustrate its administration.

The first pair of problems with this structure relates to the definition of foreign convention. The legislative history of section 274(h) indicates that Congress had in mind vacation-like group gatherings which were short on business and long on sightseeing and recreation. However, the language of section 274(h) goes far beyond that concept. The phrase "convention, seminar, or similar meeting" could be interpreted to include all sorts of traditional, legitimate, nonrecreational business activities: one or a group of salesmen meeting with several employees of an actual or prospective customer; one or a group of lawyers conferring with the officials of a foreign client; one or a group of the executives of a company holding discussions with the officers of the company's foreign being brought together by the company for instruction on various items of subsidiary; or a group of the employees of a single multinational corporation common interest. These activities, which may be characterized by their nonpublic nature, obviously do not represent conduct which Congress found fault with and intended to discourage.

Furthermore, the definition of "foreign" should be confined to only those meetings held outside North America (including the Caribbean). The new provi-

sions are having a very significant impact—and in some instances a disastrous impact—on the economies of our close neighbors. This even has adverse effects on segments of some U.S. industries. For example, more than 70 percent of the GNP of the Bahamas comes from tourism, and most of the food products and transportation services connected with this industry are purchased from the United States. Canada is a net exporter of tourist dollars to the U.S., and the long-term impact of section 274(h) will be a severe dislocation in the Canadian travel industry. The situation in Mexico is comparable.

Moreover, it should be noted that the use of the North American area as the geographical demarcation was adopted by the Committee on Ways and Means during its early consideration of the reform legislation which ultimately become the Tax Reform Act of 1976. The North American area was likewise utilized in 1976 when the Senate passed its version of the foreign convention provision. It is understood that it was only by reason of an oversight on the part of the members of the House-Senate Conference Committee that the definition of "foreign" ultimately adopted was more inclusive.

A second problem involves the existing substantiation requirements. Under section 274(h)(7), the taxpayer attending the convention must secure from the sponsoring organization a written statement, signed by an officer of the organization. This statement must, among other things, describe the schedule of the business activities and state the number of hours during which the taxpayer attended these scheduled activities. Larger organizations may have dozens of sessions conducted concurrently. For example, the American Psychological Association held its annual meeting in Canada last year with approximately 11,400 persons in attendance. The schedule included 19 major and 12 minor sessions conducted simultaneously each morning and evening, along with 35 panel discussions. In this type of situation, organizations finds it extraordinarily difficult to keep track of the whereabouts of every participant at every point in time. It is very expensive for them to hire enough additional officers to attempt to monitor all participants; it cost the APA an addidtional $35,000 to satisfy the verification requirements for this one convention. Even then, it is not easy to prevent a dishonest participant from falsifying the records relating to attendance at any given session.

The third area of difficulty relates to the use of Government per diem rates as a reference guide for the deductibility of subsistence expenses. Government per diem rates frequently are fixed on the basis that, at the location in question, meals and/or lodging are available to Government employees either at reduced rates from private commercial establishments or for free at Government installations. It is thus irrational to make such rates the basis for limitations on the expenses of private individuals, to whom Government discounts or facilities are not available. The inappropriateness of this approach can easily be demonstrated by examining various per diem rates: the per diem in Israel and Ireland is $48; in Tokyo, $67; in Jidda, Saudi Arabia, $172; Trinidad is $98, compared to $46 in Montreal and $49 in London; Guadeloupe is $82 and Austria $81, but Rome is $54 and Southern Rhodesia only $18. Clearly, to the private traveler, these rates bear no relationship to reality—to the expenses he would actually incur in these cities. In fact, these rates are so far afield that they are not even imposed on a variety of Government employees in travel status.

The difficulties with section 274(h) have been widely recognized. Especially instructive are the comments of Representative Barber B. Conable, Jr., on March 17, 1978, during a Ways and Means Committee hearing on section 274(h) in connection with the 1978 tax cut legislation:

"I think Mr. Duncan and I probably started this more than anyone else and it has gotten out of control to some degree in terms of complexity and in terms of some of the substantive decisions that are made. Quite frankly, we realize that what we have now is not workable and not fair.

"Let me say that there has never been any intention of trying to—at least on the part of this member—of trying to suppress legitimate business activities overseas. If it has that effect, then clearly that is a subversion of the intent of the measure.

"I suspect the Chairman is right when he says we are not going to back off completely on it, but major amendments are needed, and the suggestions that have been made here today in part I think suggest the directions in which we ought to go.

"I don't like all this business of—personally, Mr. Chairman, I don't like all of this business of trying to decide that specific type of activity are going to

be prescribed first-class as opposed to coach travel. In don't like limitations on per diem. I think these are things that have to be considered by the IRS with respect to the purpose back of the deduction.

"It does seem to me that we can improve this. I hope we can generate some momentum for improvement, Mr. Chairman. I hope that we can do something in this bill on it and I appreciate the suggestions of the panel."

The Treasury Department, too, in the President's 1978 tax proposals, as much as conceded the inadequacy of section 274(h). While the Department's proposal for substitute legislation was, in our view and in the opinion of the Ways and Means Committee, no better, the proposal makes obvious that section 274(h) in its present form does not recommend itself even to the Treasury.

On the other hand, there have admittedly been abuses in the foreign convention area. As we analyze it, the real abuse situations have involved either or both of two factors: the failure to conduct meaningful business activities at the foreign conventions, and the incurring of costs at the foreign site which grossly exceeded what would have been incurred at a comparable U.S. site. A workable revision of section 274(h) must take these factors into account.

Accordingly, we recommend that section 274(h) be revised along the following lines.

First, the definition of convention should be amended to exclude private meetings relating to doing business directly or indirectly within a foreign country or with the government, a company, or a national of a foreign country. Private meetings of this nature, such as salesmen meeting customers or multinational corporations instructing employees, are clearly business-oriented, and the appropriateness of holding them outside the United States is obvious. Consequently, they present little potential for abuse. They should not be burdened with any limitations beyond the general requirements for business expenses. At the same time, the definition of foreign should be changed so as not to apply to countries in the North American area.

Second, the requirement in section 274(h)(7)(B)(ii), that the sponsoring organization precisely monitor the session-by-session attendance record of each individual attendee, should be deleted. The attestation of attendance in the written statement already required of the attendee by section 274(h)(7)(A) will be sufficient to permit the Service to enforce the requirements of section 274(h)(3) and (4) regarding the conduct of business-related activities at the foreign convention. Thus, without any significant cost to enforcement, sponsoring organizations will be relieved of an unconscionable burden.

Finally, the government per diem limitation on subsistence expenses in section 274(h)(5) should be abandoned. Instead, the rule should be that amounts cannot be deducted in excess of what would have been incurred had the convention been held within the United States. Such a rule is admittedly not precise. However, because sponsoring organizations hold conventions at regular intervals (typically once a year), and because the bulk of such conventions are held in the United States, it would not be particularly difficult for the Service to develop factual information sufficient to enforce such a rule. The gross situations would be easy to deal with and, furthermore, the in terrorem effect of such a rule would cause most organizations to be cautious about planning a convention at sites more expensive than their usual U.S. locations.

Statutory language which would give effect to these changes is set forth in the attached amendment to H.R. 13511. This amendment would convert section 274(h) from a virtually blanket prohibition on foreign conventions to an administerable restriction on abuse situations.

[H.R. 13511, 95th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. to H.R. 13511, an Act "To amend the Internal Revenue Code of 1954 to reduce income taxes, and for other purposes.", viz:

On page , line , insert the following:

SEC. . REVISION OF FOREIGN CONVENTION RULES.

(a) REFINEMENT OF DEFINITION OF FOREIGN CONVENTION.—Section 274(h)(6)(A) (relating to definition of foreign convention) is amended to read as follows:

"(A) FOREIGN CONVENTION DEFINED.—The term 'foreign convention' means any convention, seminar, or similar meeting not held within the United

States, its possessions, the Trust Territory of the Pacific, or the area lying west of the thirtieth meridian west of Greenwich, east of the international dateline, and north of the equator, but not including any country of South America. The term shall not include any private meeting which relates to doing business directly or indirectly within a foreign country or with the government, a company, or a national of a foreign country."

(b) IMPOSITION OF REASONABLE SUBSTANTIATION REQUIREMENTS.—Section 274 (h)(3) (relating to reporting requirements) is amended by amending (B)(ii) thereof to read "a statement that the individual attended such convention, and".

(c) IMPOSITION OF REASONABLE LIMIT ON SUBSISTENCE EXPENSES.—Section 274 (h)(5) (relating to deductible subsistence costs) is amended to read as follows:

"(5) LIMIT ON DEDUCTIBLE SUBSISTENCE COSTS.—In the case of any foreign convention, no deduction for subsistence expenses while at such convention or traveling to or from such convention shall be allowed in excess of the amount of subsistence expenses which would have been held within the United States."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to conventions held after the date of enactment.

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

The Air Transport Association of America represents virtually all of the scheduled airlines of the United States. These privately-owned airline companies make up the highly essential U.S. domestic and international air transportation system. The airline industry is a high growth industry playing a vital role in the American economy. It has a deep interest in tax policies designed to encourage economic expansion through increased private sector investment, employment and productivity.

The airline industry has very heavy capital investment needs. There is serious concern about its ability to meet those needs in the absence of special efforts to increase capital formation and to spur economic activity.

STATE OF THE AIRLINE INDUSTRY

Airline passenger traffic in 1977 increased 8 percent over the previous record year of 1976. Some 240 million passengers relied on the airlines for business and personal travel last year, accounting for more than 80 percent of public inter-city passenger miles and over 90 percent of travel abroad. Nine out of every ten inter-city first-class letters were transported by air, and the airlines produced a record 5.3 billion ton miles of air freight service. They employ over 300,000 workers and operate 2,300 aircraft which, together with supporting facilities and ground equipment, represent an investment of about $21 billion.

Total airline industry operating revenues in 1977 were approximately $20 billion. Industry reported earnings were $754 million, or $190 million higher than the previous record year of 1976. However, while airline financial performance has been impoving, low profit margins and huge investment needs present significant airline capital formation problems.

The recent record airline profit performance does not compare favorably with the rest of U.S. industry—namely, the other industries with which the airlines have to compete for capital. Although 1976 and 1977 were the highest profit years in absolute dollars in the industry's history, with 1978 earnings expected to exceed the 1977 level, airline financial performance has been substantially lower than the average for U.S. industry. The airline industry profit margin (net profit as percent of sales) was only 3.8 percent in 1977 and 2.6 percent in 1976 compared with 5.2 percent and 5.3 percent respectively for all U.S. industry.

In fact, in terms of profit margin, the "record earnings" of the airlines do not represent historical improvements. In 1966, the year of highest net income for the airlines prior to 1976, the airlines earned $428 million, representing a 7.4 percent profit margin. To attain a 7.4 percent profit margin today, airline earnings would have to amount to $1.7 billion. In appraising future earnings of the airline industry, investors and lenders will not ignore the poor earnings record which have characterized the industry for nearly a decade.

The airlines have made strenuous efforts to improve earnings by expanding the air transportation market, by reducing costs, and by increasing productivity.

For example, the average annual rate of growth of output per employee during the 1973–1977 period was 3.1 percent in the airline industry compared with only 1.0 percent for the rest of the business sector of the economy. This high level of airline industry productivity improvement has been attained in a large part because of aircraft technological developments, and future gains are dependent upon similar advancements.

Aircraft technology advances until now have occurred at a very rapid pace. Consumers have benefited from the almost constant introduction of new, more productive equipment enabling the airlines to keep fare increases lower than the price increases of other goods and services. These technological advances have also created and maintained many thousands of additional jobs in the aircraft manufacturing industry as well as the airlines themselves. But the cost of this technology to the airlines has been high, requiring an airline investment of $9 billion during the 1960's and $15 billion during the 1970's.

The large airline investments of the past two decades, however, pale in significance to those required during the 1980's. Because of continuing inflation, the large number of aircraft involved, and the anticipated increased public demand for air transportation, the airlines will require $60 billion in capital for new aircraft acquisitions during the ten year period 1980–1989. This is a conservative estimate since more than 75 percent of the current airline industry fleet will need to be replaced before 1990. Moreover, it assumes that the average aircraft life can be extended to 18 years, that airline traffic will grow at a modest rate of 5 percent per year, that the cost of aircraft will increase only 6 percent annually, and that annual airline load factors will average 60 percent even with the higher density seating configurations now being introduced. So, while the $60 billion figure may seem inordinately high, it was developed upon the basis of generally conservative assumptions.

Significantly improved airline earnings obviously will be necessary to compete with other industries for capital and to attract investors. Also needed are tax policies which will stimulate increased business activity, including the demand for air transportation, and encourage greater investment by the private sector to achieve higher levels of employment and productivity. This need is recognized in the tax reduction and investment tax credit improvement contained in the House passed tax bill H.R. 13511, as well as other proposals before the Committee.

CORPORATE TAX RATE REDUCTIONS

Corporate tax reductions represent a major part of the special effort necessary to spur the economy and, together with appropriate individual tax reductions to offset recent personal income losses, will help stimulate the increased business activity which is essential for economic recovery and growth. Because the demand for air transportation is closely related to business and consumer spending patterns, the airline industry urges favorable consideration of the corporate tax reductions contained in H.R. 13511, as well as individual tax reductions which are designed to restore and enhance general consumer purchasing power.

INVESTMENT TAX CREDIT IMPROVEMENT

The airline industry strongly supports improvements in the investment credit and believes improvement proposals contained in H.R. 13511 are a meaningful step in this direction.

The industry endorses the proposals contained in S. 2814 to increase the investment credit to 12 percent and to allow 100 percent offset and partial refundability. As a minimum, the airlines and railroads should be allowed to continue the present 90 percent utilization until all other taxpayers reach that level as provided for in H.R. 13511.

The purpose of the investment tax credit is to serve public policy by promoting productive investment by all companies, large and small, not just those with high levels of profitability. Unfortunately, the fact that the investment tax credit can only be offset against tax liability limits its use by marginally profitable companies. The partial investment tax credit refundability proposal contained in S. 2814 recognizes the problem faced by marginally profitable companies with large investment needs, with little opportunity for utilizing earned investment tax credits. Many companies, including airlines, have lost, and may in the future lose, expiring credits due to financial reverses or relatively low profits due, at least in part, to the heavy cost of new investments.

Increased investment by U.S. industry is necessary to increase productivity and offset the effects of inflation. By improving the investment credit program and thus accelerating the recovery of capital, the U.S. government will encourage the capital investment necessary for strong economic growth and increased employment.

The industry also suggests that consideration be given to another possible improvement of considerable importance to smaller companies involving the current $100,000 limitation on used equipment which qualifies for investment tax credits. Smaller airlines have bought, and will wish to continue buying, used aircraft from the larger airlines who in turn purchase new aircraft from the manufacturers. This makes good economic sense because used, but otherwise efficient and productive, aircraft can be acquired at lower cost and their purchase helps finance other new investments.

Used aircraft, however, have a value significantly higher than the current used equipment limitation. This limitation provides little investment tax credit benefit to the smaller airlines, and little incentive to participate in the aircraft investment cycle. The airlines suggest, therefore, that the used equipment limitation be eliminated or, as a first step, be increased to at least $250,000 in order to improve the investment tax credit program in a more meaningful and equitable way to smaller companies.

ASSET DEPRECIATION RANGE

The airline industry urges the Committee to adopt the proposal contained in S. 2814 to modify the ADR system for the purpose of stimulating business investment. This proposal would increase the range of allowable class life in the ADR system from 20 to 40 percent. This is necessary because the present 20 percent range requires substantially longer capital recovery periods than are appropriate or desirable with the current inadequate level of business investment. Moreover, present low levels of national productivity stem as much from capital recovery problems of this kind as from the availability of new capital. Broadening the depreciable life range would speed capital recovery significantly thereby effectively stimulating business investment.

FOREIGN CONVENTION TRAVEL

The airlines believe that the restrictions imposed on foreign convention deductibility in the 1976 Act should be repealed. The 1976 restrictions have proven to be extremely complex and burdensome. Taxpayer abuses should be dealt with through available administrative actions, instead of restricting foreign travel.

FIRST CLASS AIR TRAVEL

Some members of the Senate and the Administration have suggested the disallowance of the business expense deduction on the amount paid for first class air travel in excess of the "lowest priced, generally available fare". This suggestion is advanced by its proponents on the ground that first class travel is a "luxury" subsidized by other taxpayers, and on estimates that limiting the first class deduction will increase tax revenues substantially.

The U.S. airlines oppose this suggestion because it is discriminatory and prejudicial. Moreover estimates of the potential revenue impact are overstated. The Committee is urged to reject this suggestion.

The disallowance of first class air fares would be discriminatory because it would single out one particular "ordinary and necessary business expense" for special attention and legislative action. No suggestion is made that it is either necessary or desirable, for example, to limit deductions for ground transportation from the airport to "generally available" bus fares instead of taxi fares. Nor is any similar suggestion made about the class or price of other travel accommodations. No mention at all is made of competing forms of transportation including rail, limousine, car rental, and private automobile. To single out first class air travel would be to sanction discrimination in a way never before adopted as a matter of national tax policy—namely, influencing competitive buying decisions of individual taxpayers.

The disallowance of first class air fares would be prejudicial because it would be directed against a single industry, the airlines. The proponents acknlwledge that if such a suggestion were enacted it would result in a loss of revenue to the

airlines. The airline industry estimates that these losses would have totaled $300 million if this had been in effect last year. In addition to being prejudicial, such a disallowance would be highly inconsistent with initiatives to increase business activity and investments.

The business decision to use first class air travel is to different than any other "ordinary and necessary business expense" decision. No question has been raised about the need for differing tax treatment of other necessary business expenditures with differing cost, size, style, volume or quality of characteristics. The decision to use first class air travel is made on the same basis as decisions concerning, for example, office space and furniture, industrial supplies and services, or the range of other numerous purchases made by commercial enterprises in the conduct of their day-to-day business. The decision to use first class air travel is made because the person making the decision considers it a necessary expenditure for the conduct of business. The decision making should not be influenced by tax treatment to any greater extent than other business expenditure decisions.

CONCLUSION

There is general agreement on the need for tax policies designed to encourage increased private sector investment, employment and productivity. The recommendations of the airline industry addresses these concerns and we urge that they be given favorable consideration by the Committee.

AMERICAN ASSOCIATION OF EQUIPMENT LESSORS,
Hartford, Conn., September 1, 1978.

Attention: Michael Stern, staff director, Senate Finance Committee.

Re H.R. 13511: A bill to amend the Internal Revenue Code of 1954.

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

DEAR SENATOR LONG: This will express the concern of the American Association of Equipment Lessors (AAEL)[1] about the "at risk" provisions in sections 201–204 of H.R. 13511. These provisions affect some closely-held leasing corporations that are members of the AAEL.

H.R. 13511 proposes, in section 202, to extend the "at risk" provisions of the Tax Reform Act of 1976 to closely-held corporations (those in which five or fewer stockholders own 50% or more of the corporation's stock) to prevent close corporations from using "tax shelter deductions to avoid the accumulated earnings tax or to shelter income on which owner-employees would otherwise pay tax at the individual level." H.R.Rept. No. 85–1445, 95th Cong., 2d Sess. 68 (1978). The most basic purpose of this extension is to limit tax deductions by passive investors, who engage in highly unusual transactions without economic substance, for tax purposes rather than for ordinary commercial reasons. *See id.* at 70 [describing "tax shelter characteristics"].

We are advised that Congressman Al Ullman and the other members of the House Ways and Means Committee stressed in the House markup sessions that the extension of the "at risk" rules to close corporations *would not injure legitimate businessmen.* Yet the current language and coverage of H.R. 13511 would penalize legitimate closely-held corporations that actively engage in equipment leasing activities with definite economic substance on a regular basis.

The major problems with the current bill are: (1) Section 202 of H.R. 13511 extends the "at risk" rules indiscriminately to all closely-held corporations, without regard to whether the close corporation is a legitimate commercial enterprise, or merely an "incorporated pocketbook" created for tax purposes or an occasional passive investor. This overbroad coverage unfairly penalizes many legitimate closely-held leasing corporations engaged in *bona fide* leasing activities on a regular basis. Moreover, it places such legitimate close corporations at a competitive disadvantage with respect to widely-held corporations engaged in

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[1] The AAEL is the principal trade association for the leasing industry; it consists of over 500 companies engaged in all aspects of equipment leasing in the United States. Membership ranges from large and small banks or bank subsidiaries (over 200), independently owned lessors, insurance companies, major finance companies, and finance subsidiaries of manufacturing companies, to investment banks and lease brokers.

the same legitimate activities. (2) There is nothing in H.R. 13511 that permits closely-held corporations (those which are to be covered by the "at risk" provisions for the first time) to *aggregate* the amounts "at risk" in the original four activities (motion picture production, farming, leasing depreciable property, and oil and gas exploration) covered by the "at risk" rules in § 465(c)(1) of the Internal Revenue Code of 1954. This is a "gap" in the coverage of the aggregation rules in section 201 of H.R. 13511. (3) Through what appears to be an oversight, H.R. 13511 fails to include the Treasury Department's suggested provision that the new "at risk" rules will not apply to existing leasing transactions.

1. SECTION 202: COVERAGE OF THE NEW "AT RISK" RULES

Our basic submission is that closely-held leasing companies engaged in *bona fide* leasing activities on a regular basis should not be penalized by tax provisions aimed at eliminating the potential for "tax abuse" by totally different, passive investors. Our views are spelled out in detail in the attached comments which we earlier sent to the House Ways and Means Committee.

We suggest that the coverage provisions of the "at risk" rules (in section 202 of H.R. 13511) should be amended to totally exclude closely-held leasing corporations engaged in *bona fide* equipment leasing activities. The coverage provisions in section 202 can and should be amended to exclude those activities, involving the use of non-recourse financing, which a close corporation engages in as part of a legitimate commercial trade or business:

"(a) LIMITATIONS TO AMOUNT AT RISK.—

"(1) IN GENERAL.—In the case of—

"(A) an individual,

"(B) an electing small business corporation (as defined in section 1371(b)), and

"(C) a corporation with respect to which the stock ownership requirment of paragraph (2) of section 542(a) is met, *except where the corporation is regularly engaged in the activity as a trade or business,*

"engaged in an activity to which this section applies, * * *." [New language in italics].

This suggested amendment would make the "at risk" rules *inapplicable* to those activities, involving the use of non-recourse financing, which a closely-held corporation regularly engages in as a trade or business. It would also make the "at risk" rules *inapplicable* to those activities which a closely-held corporation had just embarked upon as a "new entrant" in beginning a regular course of business activity, and we recommend that the legislative history and the Treasury Department regulations should specifically so state. On the other hand, under the suggested amendment, the "at risk" rules *would apply* to any activities which were not part of a closely-held corporation's regular commercial trade or business.

This kind of amendment would make the coverage of the "at risk" rules in H.R. 13511 accord more closely with sound policy.[3] The current coverage provisions are overbroad and impose an unfair burden on small businesses engaged in *bona fide* trades or businesses. There is, therefore, a clear need to narrow the coverage provisions of section 202 as they apply to close corporations.

2. SECTION 201: AGGREGATION OF THE AMOUNTS "AT RISK" IN DIFFERENT ACTIVITIES WITHIN THE SAME TRADE OR BUSINESS

Whether the Committee decides to include all or (as we suggest) only some closely-held corporations within the "at risk" rules of H.R. 13511, there is another problem with the bill: The "at risk" aggregation rules in section 201 of H.R. 13511 do not cover all the activities they should with respect to close corporations.

The Tax Reform Act of 1976 contains aggregation rules allowing partnerships and subchapter "S" corporations to aggregate the amounts "at risk" in different activities within the same trade or business. [See § 465(c)(1), (2) of the Internal Revenue Code of 1954]. For example, in the case of a subchapter "S" corporation, it may treat all of its leases as a single "activity" for purposes

[3] Alternatively, the coverage provisions in section 202 could be amended to apply only to closely-held corporations that do not "actively participate in the management of the activity for which losses are sought to be deducted." Another alternative would be simply to amend the accumulated earnings tax provisions to restrict investments in tax shelter activities. What is clear, however, is that there is an imperative need to amend the current coverage provisions of the "at risk" rules in H.R. 13511.

of the "at risk" rules. H.R. 13511 extends the "at risk" rules to other activities, and to close corporations, and the aggregation rules in section 201(a) of H.R. 13511 state:

"(B) AGGREGATION OF ACTIVITIES WHERE TAXPAYER ACTIVITY PARTICIPATES IN MANAGEMENT OF TRADE OR BUSINESS.—Except as provided in subparagraph (C), for purposes of this section, *activities described in subparagraph (A)* [*i.e.*, all activities other than motion picture production, farming, leasing depreciable property, and oil and gas exploration] which constitute a trade or business shall be treated as 1 activity if—

"(i) the taxpayer actively participates in the management of such trade or business, or

"(ii) such trade or business is carried on by a partnership or electing small business corporation (as defined in section 1371(b)) and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business." [Emphasis added]

This language in H.R. 13511 does not clearly allow closely-held corporations that "actively participate in the management of the trade or business" to aggregate the amounts "at risk" in the activities of motion picture production, farming, leasing depreciable property, and oil and gas exploration.[3] The Tax Reform Act of 1976 says nothing about closely-held corporations. There is thus a "gap" in the aggregation rules of section 201 of H.R. 13511.

We suggest that the aggregation rules in § 465(c)(2) of the Internal Revenue Code of 1954 should be amended to add the following sentence:

"The activities of a corporation with respect to which the stock ownership requirement of paragraph (2) of section 542(c) is met, and with respect to which the corporation actively participates in management, shall be treated as a single activity to the extent that the activities are described in any subparagraph of this paragraph, and section 465(a) applies to such activities of the corporation."

This suggested language would mean, and the legislative history should confirm, that closely-held corporations could aggregate the amounts "at risk" in all of their activities within the same trade or business.

3. SECTION 204: "GRANDFATHERING" EXISTING EQUIPMENT LEASES

The Tax Reform Act of 1976 contained a "grandfather" clause generally exempting pre-existing leases (leases entered into before January 1, 1976) from the 1976 "at risk" rules. (Pub. L. 94-455, § 204(c)). The same sort of "grandfather" clause should be inserted in section 204 of H.R. 13511 to exempt existing leases by close corporations from the "at risk" rules in H.R. 13511. Section 204 of H.R. 13511 might be amended to add a new subsection (c):

"(c) SPECIAL TRANSITIONAL RULES FOR LEASING ACTIVITIES.—In the case of any activity described in section 465(c)(1)(C) of the Internal Revenue Code of 1954 which is engaged in by a corporation described in section 465(a)(1)(C) of the Internal Revenue Code of 1954, the amendments made by this subtitle shall not apply with respect to:

(i) leases entered into before January 1, 1979, and

(ii) leases where the property was ordered by the lessor or lessee before January 1, 1979.

"This subparagraph shall apply only to taxpayers who held their interests in the property on December 31, 1978."

This sort of "grandfather" provision only seems fair, since close corporations, which have not been subject to the "at risk" rules to date, have entered into existing leases in reliance on current tax law. Indeed, some of these leases are long term leases that were entered into before the enactment of the Tax Reform Act of 1976. Thus the Treasury Department's January 30, 1978 analysis of the President's 1978 Tax Program suggested that "[t]he proposed changes will apply to *transactions* entered into after December 31, 1978" (p. 113, emphasis added).

Thank you for considering our comments and giving us this opportunity to submit our views to the Senate Committee.

Sincerely yours,

BACON COLLAMORE, Jr.,
President, American Association of Equipment Lessors.

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[3] These four activities are enumerated in § 465(c)(1) of the Internal Revenue Code of 1954; they are *not* "activities described in subparagraph (A)"; and thus they are not explicitly covered by the above-quoted aggregation rules in section 201 of H.R. 13511.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., September 6, 1978.

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

DEAR MR. CHAIRMAN: The American Bankers Association would like to thank the committee for this opportunity to present the views of our members on the proposed tax cut bill. As a trade association whose membership includes more than 92% of the nation's full service banks, the ABA is vitally concerned with the economic impact of the proposed realignment of individual, corporate and capital gains taxes. On June 29, 1978, we testified on the subject of capital gains tax reform before the subcommittee on Taxation and Debt Management. Rather than repeating our comments, we request that our June 29th statement be made a part of the record of the hearings on H.R. 13511. This letter will address only those areas of the capital gains section of H.R. 13511 which will directly affect bank trust operations. Before turning to these specific remarks, we would like to offer some general observations on the overall impact of the bill.

The American Bankers Association supports H.R. 13511. Rapid inflation in conjunction with the progressive income tax structure has built automatic tax increases into the system. Rising nominal incomes push taxpayers into higher brackets, even though real incomes may not be rising. Projections based on current levels of inflation make it obvious that without some tax relief, the tax burden will become unbearable. The built-in increases in tax revenues also shift a rising percentage of total GNP to the government sector; this facilitates the expansion of government programs, and makes the reduction of government spending seemingly impossible.

Inflation has taken a heavy toll on corporate profits and business confidence, which are two of the major ingredients in capital investment. The apparent inability to come to grips with the double economic malady of unemployment and inflation has bred a dangerous "short-run" bias into business planning, and has inhibited the investment in plant and equipment which is the key to improving the standard of living in a capitalist economy. The short run business viewpoint has been reinforced by the temporary nature of several of the tax changes enacted over the past decade, which have been designed to have a short run countercyclical impact on the economy. The ABA feels that the change in emphasis toward the achievement of long-term economic objectives which underlies H.R. 13511 is perhaps more important than the actual dollar volume of the proposed tax cuts. Recognition by Congress that the increased productive capacity resulting from capital investment is beneficial to the economy at large will certainly have a positive impact on the willingness of businesses to commit themselves to long range investment plans.

While we are in general agreement with the size and direction of H.R. 13511, we believe that tax cuts should be accompanied by cuts in government spending. California's proposition 13, along with similar movements in other states, is a clear indication that American taxpayers will no longer tolerate continuously rising government expenditures which must be financed by ever higher taxes. The current trend in government expenditures clearly threatens to outpace our ability to pay. A tax policy designed to enhance the ability and willingness of the business sector to expand the potential GNP cannot by itself be expected to restore the basic health of the economy. The government must accompany the tax reduction with a meaningful reduction in expenditures.

In addition to these general observations, we would like to address certain specific areas of H.R. 13511 which impact directly on bank trust operations.

CASH OR DEFERRED PROFIT-SHARING PLANS

The American Bankers Association strongly supports Section 125 of the bill to the extent it provides that qualified cash or deferred profit-sharing plans shall be treated the same as they were prior to 1972. Under current law, employers have been foreclosed from providing their employees this type of plan. This loss of flexibility in providing retirement benefits has been just one more negative influence of ERISA on the expansion or improvement of pension plan coverage. Therefore, we urge adoption of the language of this section which will restore pre-1972 administration of these plans.

CAPITAL GAINS INDEXING AND CARRYOVER BASIS

The ABA seeks repeal of the carryover basis provisions of the Tax Reform Act of 1976 for a number of reasons including its extreme complexity. The current complexity would be magnified substantially by indexing. A substantial part of this additional complexity would be due to the apparent requirement that any basis adjustments under Section 1023 would be treated as a substantial improvement. Thus, it becomes more essential that carryover basis be repealed.

CAPITAL GAINS INDEXING AND COMMON TRUST FUNDS

The sections of the bill which provide indexing for capital gains and a one-time exclusion of gain from the sale of a taxpayer's principal residence raise problems for some trusts.

It is unclear whether a participation in a common trust fund is an "indexed asset". In fact, in view of the specific exclusion of other flow-through entities one is almost forced to conclude that common trust fund participations would not be included.

Such treatment of common trust funds would for all intents and purposes foreclose the use of common trust funds for investment in common stock. A trustee would probably find it difficult to justify as prudent the investment of trust assets in a common trust fund holding equity securities. This would severely handicap the beneficiaries of smaller trusts that need the availability of common trust funds to enhance diversification and reduce operation costs. The Congress has consistently recognized the value of collective trust funds for this purpose (see Sections 408(e) (6) and 584 of the Internal Revenue Code of 1954).

The elimination of common trust funds or a significant curtailment in their use for investment in common stocks could also have a substantial adverse impact on our nation's equity markets which have already been suffering for a number of years. What our country needs is more equity capital, not less. We believe that the indexing provision should be changed to avoid its deterrent effect on common trust funds.

In discussing the mutual fund exclusion, the House Report states that shareholders will receive the benefits of the inflation adjustment on the indexed assets sold by the entities when the gain is distributed to shareholders. In the case of common trust funds, this is accurate only with respect to current tax liability. However, the amount of appreciation in an asset which is indexed out in computing the current taxable gain remains in the value of the common trust fund participation. The basis adjustment which is allowed a participation on the payment of a capital gains tax is limited to the amount of the taxable gain. Thus, when a participating trust withdraws from a common trust fund, it recognizes a gain or loss which includes the value of the amounts which have been indexed out. Therefore, unless participations in common trust funds are included as indexed assets, Congress will have seriously hampered the use of common trust funds, particularly by the smaller trust department.

We recognize including common trust funds and other flow-through entities as indexed assets will cause complexite, but the complexities will be dealt with by financial professionals. We normally opt for simplicity but when simplicity means the virtual elimination of common trust funds we must endorse complexity.

Specifically, the ABA urges the adoption of an amendment which would define a common trust fund participation as an indexed asset to the same extent that the fund is invested in common stock or stock which possesses most of the attributes of common stock, provided that if at the end of each quarter of the taxable year the portion of the participation which is an indexed asset is at least 80 percent, then all of such participation shall be considered an indexed asset. The provision would provide more simplicity for those common trust funds that remain substantially invested in indexed assets. The same type of rule should also be adopted for regulated investment companies.

SECTION 267

Another problem of the proposed indexing language for trusts is that it would exacerbate the current impact of Section 267. Currently, Section 267 prevents the use of losses due to sales or exchanges between certain related persons including trusts and their beneficiaries. The section, however, does not apply to property

included in a decedent's probate estate. Such a distinction weighs unnecessarily against the use of a revocable trust as a method of making testamentary dispositions. The tax code should be neutral between testamentary instruments. The application of Section 267 to property otherwise entitled to indexing would make the distinction even more significant. The inequity of Section 267 in terms of revocable trust property could be cured by adding the following sentence to subsection 267(b):

"Nothwithstanding the preceding provisions of this subsection, the word 'trust' shall not, except as provided in paragraph (6), be deemed to refer to any trust to the extent that the same has been included in the gross estate of the grantor or of any other person pursuant to Chapter 11 of subtitle B or has been subjected to tax pursuant to Chapter 13 of said subtitle".

The reference to inclusion in the gross estate of any other person is intended to cover a marital deduction trust *after* the death of the surviving spouse.

The House Report states that the reason for not permitting the indexing basis adjustment in the case of transfers between related persons is "to prevent related persons from selling assets among themselves in order to increase basis while at the same time reducing tax on the sale because of the inflation adjustment". This reasoning is puzzling. Clearly game playing with losses should not be permitted, but Section 267 would accomplish this purpose without any reference being made in Section 1024 to Section 267. This reference has the effect of disallowing the indexing basis adjustment when gain is realized and a tax is payable. Why should a distinction be made in such a case depending upon whether the purchaser of stock is a family member or a non-family member. If the seller sold to a non-family member at a gain for the same price, the adjustment would be available. The quoted language from the House Report does not give a sound reason for the distinction that is made. Unless we are missing something, the refence in proposed Section 1024 to Section 256 should be stricken.

ONE-TIME EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE

The $100,000 lifetime residence exclusion provision should be amended to allow a marital trust or an estate to claim the exclusion. Under the bill, if a residence is devised outright to a surviving spouse, the spouse would be able to elect the exclusion. However, if the residence is held in a marital deduction trust it appears doubtful that the exclusion is available.

Normally in a marital deduction trust the spouse has the right to income, a trustee can distribute principal to the spouse for needs during lifetime, and the spouse has the power of disposition at death. It seems to us that these rights are sufficiently close to ownership for the election of the $100,000 exclusion to apply. The marital deduction trust is often used to provide professional financial aid investment assistance to a surviving spouse and the residence may be placed in the trust so that the trustee will make the mortgage payments and handle other details for the surviving spouse. Denying a spouse in such case the exclusion would surely be discriminating against the wrong person.

Policy considerations also suggest that the $100,000 residence exclusion should be carried over to an estate. In the case of a "death bed" sale, the exclusion as it is now written in the bill could be available. To avoid the confusion and undecorous scramble at the moment before death, we urge that the exclusion be made available to an estate. The purpose of the exclusion would in no way be changed by permitting this.

Therefore, we urge that the $100,000 lifetime residence exclusion be extended to a residence held in a marital deduction trust of an estate.

Sincerely,

GERALD M. LOWRIE,
Executive Director, Government Relations.

AMERICAN BAR ASSOCIATION,
SECTION OF TAXATION,
August 7, 1978.

Mr. MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As stated in the letter of August 4, 1978 from my predecessor, John S. Pennell, the Section of Taxation of the American Bar Association pro-

posed to express its views on the tax provisions of S. 2266, the Bankruptcy Reform Act of 1978. We have had the opportunity as of this time, however, to study the bill only very briefly and will limit this submission to three points; we will continue our study and plan to submit further comments to the Joint Committee Staff by way of supplement to Mr. Pennell's testimony of February 21, 1978 before the Ways and Means Committee of the House of Representatives on the substantive tax provisions of H.R. 9973.

TAX COURT JURISDICTION

Under present law, the Tax Court may retain jurisdiction over a case if a petition has been timely filed prior to an adjudication of bankruptcy. However, there is no opportunity to file a petition if the Internal Revenue Service makes an assessment under IRC § 6871 and files a claim in the bankruptcy court. This places an individual debtor at a severe disadvantage. His income tax liability is not dischargeable in bankruptcy and he may have assets subject to collection which are not within the jurisdiction of the bankruptcy court. If the Service's claims are not satisfied in the bankruptcy proceeding, it has one year to proceed against the debtor with respect to the unsatisfied portion of its claim. In many cases where there is a bona fide dispute as to liability, the debtor may be satisfied to join the Trustee in contesting liability in the bankruptcy court. However, the pre-assessment forum provided to solvent taxpayers in the Tax Court is denied him.

A proposed Joint Committee staff amendment to § 505 of S. 2266 would enable the taxpayer to either (1) petition the bankruptcy court for a determination of his personal liability or (2) proceed in the Tax Court. The Section of Taxation agrees with this approach. We see no reason why a distressed debtor, in addition to his other disabilities, should be deprived of remedies available to other taxpayers.

The bill makes one other significant change. Under present law, the trustee may intervene in a Tax Court litigation already in progress, but has no right to initiate a petition in the Tax Court (i.e., in a situation where a notice of deficiency has been mailed and the time to file a petition has not yet expired). A proposed Joint Committee staff amendment to § 346 of S. 2266 would enable the trustee to proceed in the Tax Court in this situation too. The Section supports this change. The Tax Court serves an important function in he administration of our income, estate and gift tax laws. Its expertise and body of precedents are a vital factor in the resolution of many tax disputes. There is nothing in bankruptcy policy which requires that the trustee be deprived of this expertise. It may be argued that the Tax Court's procedures are not as expeditious as those of the bankruptcy court, and it may take longer for a case to be reached for trial in the Tax Court. However, delay is a problem principally for the general creditors, and if the trustee, as their representative, opts for a Tax Court forum, this objection would seem to be obviated.

In those cases under current law where there is already concurrent jurisdiction, there may be some advantage to the debtor in remaining aloof from the bankruptcy court proceedings. There is some authority for the proposition that if he does, he may take advantage of a disallowance of a tax claim but be unaffected by its allowance. A proposed Joint Committee staff amendment to § 505 of S. 2266 would end this inconsistent treatment by providing that the Service may contest the debtor's petition in the Tax Court where it has lost in the bankruptcy court and the debtor has not intervened. The Section of Taxation supports this proposal.

DECLARATORY JUDGMENTS

S. 2266 originally contained a proposal in § 1146(d) that a bankruptcy judge could "declare" the tax effects of a plan of reorganization on motion of a proponent when the Service failed to respond to a request for an advance ruling within 279 days or issued an unfavorable ruling. H.R. 9973 contained a similar proposal, as did the Bankruptcy Commission's proposed bill. A proposed Joint Committee staff amendment would delete this provision.

Although our initial reactions to this proposal gave rise to some disagreement within the Section, at this time we favor § 1146(d) as originally proposed and we oppose its deletion. The uncertainty over tax consequences could have an adverse effect on the structuring of a plan of reorganization. Should the Service take an adverse position, its views would have undue finality since proponents

of a plan might not want to risk subsequent tax litigation even where they believe their position properly expresses the applicable law. In this situation, declaratory relief seems appropriate.

The choice between the Tax Court and the bankruptcy court as the appropriate forum is difficult. On the one hand, the bankruptcy court has the parties before it and is familiar with the facts, and the injection of the Tax Court could give rise to delay. On the other hand, the bankruptcy court may not be a completely disinterested party in developing a reorganization plan and is less likely than the Tax Court to reach results which would be uniform and consistent on a national basis. But this is no different than in other tax cases and is correctible by appeal. Accordingly, we favor Section 1146(d) with the declaratory judgment power in the bankruptcy court.

"QUICKIE" REFUNDS

Finally, we note an apparent omission from the Joint Committee staff's amendments. § 117 of H.R. 9973 would have enabled the Service to withhold a refund arising from an application for a tentative carryback adjustment from a taxpayer in a bankruptcy proceeding. We would have opposed this provision without some guarantee of a prompt audit. Proposed § 507 of S. 2266 does give special priority status to an erroneous refund from a tentative carryback adjustment actually paid to the taxpayer prior to the commencement of a bankruptcy case. We have no problem with this but wish to be sure that if the situation covered by § 117 of H.R. 9973 is re-inserted, we have the opportunity for review and comment, at least to insure a provision for prompt audit.

The Section is continuing to review the proposed legislation and may submit further comments on its other provisions. We appreciate the opportunity to comment, and we offer our assistance in further developing sound legislation in an area which is not widely understood and where clarification of the law is sorely needed.

Very truly yours,

LIPMAN REDMAN,
Chairman, Section of Taxation,
American Bar Association.

STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

H..R 13511—The Revenue Act of 1978—provides a highly constructive start toward removing the bias in the tax system that favors consumption but works against savings and productive investment. The tax bill that passed the House of Representatives on August 10 is pro-capital formation; and, atlhough it is on balance very good legislation as it stands, it can be improved eevn further. We urge the Committee and the Senate to make those improvements.

Although the American Council has focused primarily on the direct taxation of corporate profits and capital gains, it would be a mistake to assume that the shape of the $10.5 billion reduction in individual taxes is not related to capital formation. Individual taxpayers, particularly those in the middle and upper brackets, provide a substantial portion of the national saving that supports productive investment. Therefore, the reductions in the tax burden on those taxpayers promote capital formation. We urge the Committee to retain those reductions.

CORPORATE TAXES

Taken as a whole, the corporate tax reductions in H.R. 13511 would provide a long overdue boost to our lagging rate of capital formation. However, the favorable impact of these cuts could be increased significantly if the excessively high corporate rate were reduced below the 46 percent level proposed in the legislation. One approach would be that recommended by the Business Roundtable—a reduction to 45 percent on January 1, 1979, and 1-point reductions each year thereafter, to 42 percent by 1982. An alternative approach that would conserve revenue for the coming fiscal year would be to schedule additional 2-point reductions in 1980 and 1981, thereby reaching the 42 percent maximum a year earlier. The large positive feedback effect on Treasury revenues would minimize the impact of the reductions on the Federal deficit.

The American Council strongly endorses the House provisions relating to the investment tax credit. The provision for a permanent credit at 10 percent should at long last convince the business and financial community that the credit will not be varied for contracyclical purposes—a misuse which disrupts business planning and, by past experience, can be counterproductive. In addition, the liberalization of the ITC to provide for "90 percent utilization" is also constructive, although we favor an immediate increase rather than the four-year phase-in approved by the House. Moreover, a strong case can be made that the ITC should be fully refundable, thereby eliminating a discriminatory feature which also impairs the effectiveness of the credit.

We also support a reduction in the corporate capital gains rate by an amount equal to the cut in the top corporate.

The House recognizes the special problems that small businesses face by including a provision for a four-step corporate tax rate beginning with a 17 percent rate on the first $25.000 of taxable income and rising to the new 46 percent maximum rate for income above $100,000. We believe that both small business and the public interest would be better served by a simple two-step arrangement: 17 percent up to $75,000, with a maximum rate applicable above that level.

CAPITAL GAINS

Events of the past few months demonstrate that there is strong support both in Congress and among the public for a substantial cut in taxes on capital gains. The American Council has consistently voiced its strong support of such action, including testimony at the hearings before your Subcommittee on Debt Management on June 28. We shall not repeat the arguments then presented. The question now before this Committee is which of several approaches to cutting capital gains taxes will best meet the goal of simplicity, equity and broader and faster capital formation.

We submit that the evidence strongly favors the proposal advanced by the Chairman of this Committee, Senator Russell Long, in a speech before the National Press Club on July 26. In those remarks, the Chairman proposed an increase in the "excludable" portion of capital gains from the current 50 percent to 70 percent; elimination of the "poisoning" of the "MaxiTax" that results from 1976 amendments relating to "preference income"; and conversion of the "add-on" minimum income tax to an "alternative" approach designed to prevent recipients of large capital gains from paying little or no Federal income taxes.

Our comments on the proposal for an alternative tax will have to wait a description of how it will work. But the proposal for increasing the excludable portion of gains to 70 percent is clearly of great merit. Inasmuch as the 30 percent of gains would be taxed at ordinary rates, alternative calculations would be eliminated and preparation of returns would be simplified. Equity would be served because the reductions would apply to taxpayers in the low brackets as well as those in middle and upper brackets (for example, marginal rates on capital gains would range from a minimum of 4.2 percent in the lowest bracket to 21 percent at the top, assuming there is no reduction in the top bracket rate). And since the cuts would be deeper and more widely spread than would be the case with other proposals, capital formation would be more strongly stimulated. A new econometric study by Merrill Lynch Economics suggests that the Long proposal would have about three times the positive impact (e.g. real GNP growth, additional jobs, increase in investment, a reduction in the Federal budget deficit) of the House legislation, and 50 percent more than the so-called Steiger-Hansen bill. It would also stimulate Federal revenues significantly.

A sharp reversal in the decade-long upward trend in capital gains taxation is, quite clearly, an idea whose time has come. Chairman Long's proposal—especially if coupled with the House provisions to adjust capital gains for inflation after 1980, and to relieve sellers of residences through a once-in-a-lifetime exemption—will best serve the ends of simplicity, equity, and capital formation.

We urge its adoption.

OTHER PROPOSALS

The American Council for Capital Formation is pleased to add its endorsement of S. 3288 and its House counterpart. This legislation would allow a retirement savings deduction equal to the lesser of 10 percent of compensation or $1,000 for persons covered by certain pension plans. It is our belief that enactment of this legislation would be a positive step toward increasing the pension

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coverage in the private sector which is alarmingly low. This should have the added effect of increasing the aggregate level of savings in society. An increase in private saving will help finance the capital formation so necessary for the attainment of a higher level of economic growth and job creation. In addition to filling a real need for adequate pension coverage for private sector employees, particularly those employed by smaller firms, we believe this legislation will help reduce the pressure for social security increases.

Another proposal that deserves serious consideration would defer taxes on dividends reinvested in corporate stock. The temporary loss in Federal revenues would be small relative to the positive impact on capital formation.

CONCLUSION

The Committee is "marking up" major tax legislation at a highly propitious time. The public now supports the type of pro-capital formation tax legislation that has long been needed but, for a variety of reasons, could not be enacted. Efforts on the part of many people have helped convince the typical voter that reduction of the tax burden on savers, investors and business is not, in fact, tax relief for the rich. In the final analysis, it is the best and only lasting way to create the jobs and economic growth so essential to our national well-being.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

We appreciate this opportunity to present the views of the American Council of Life Insurance on H.R. 13511, the Revenue bill of 1978. The Council has a membership of 479 life insurance companies which, in the aggregate, have 93 percent of the life insurance in force in the United States and hold 99 percent of the reserves for insured pension plans.

INTRODUCTION AND SUMMARY

Our comments are directed primarily to issues which relate to insurance and pension matters. We are pleased that the bill does not include a number of Administration proposals that would have adversely affected millions of policyholders and their beneficiaries of the life insurance business. These undesirable proposals would revise the income tax treatment of holders of nonqualified deferred annuities, change the social security integration rules under the Internal Revenue Code for pension plans, require group life insurance and health insurance plans to meet non-discrimination rules, and repeal the $5,000 exclusion for death benefits paid under qualified pension plans. The rejection of these proposals by the House was wise since they would have impaired the essential financial protection and security that the insurance and annuity products concerned provide to many millions of individuals. We urge the Finance Committee similarly to reject these proposals and exclude them from the tax legislation that it approves.

We also urge deletion of the provision in H.R. 13511 which eliminates the present separate income tax deduction (outside the medical deduction floor) for one-half of the premiums paid by an individual for accident and health insurance. As indicated in detail below, this provision discriminates against individuals who purchase health insurance. It would have the practical effect of depriving large numbers of such individuals of deductions for their medical expenses under such insurance. This would discourage individuals from insuring against future medical bills at a time when it is particularly important to encourage such insurance in view of rapidly rising health costs.

In addition, we support the thrust of the provisions in the bill dealing with nonqualified deferred compensation arrangements of State and local governments and private employers and with qualified cash or deferred profit-sharing plans. We believe that these provisions represent a desirable solution which provides much needed certainty and equity in the tax treatment of these deferred compensation arrangements.

We support reduction in the tax on capital gains in order to increase productive capacity, create more jobs and fight inflation. Finally, we urge that a provision be added to the tax legislation to permit life insurance companies to fund state and local retirement systems and eligible state deferred compensation plans on the same basis as other financial intermediaries.

SPECIFIC COMMENTS

1. Deduction for accident and health insurance premiums

We join with the Health Insurance Association of America in opposing section 112 of H.R. 13511 which eliminates the present separate income tax deduction for premiums paid by an individual for accident and health insurance. Under present law, a taxpayer may deduct, outside of any floor, one-half of these premiums up to a maximum deduction of $150. The remainder may be aggregated with his other medical expenses and deducted to the extent the sum exceeds 3 percent of his adjusted gross income.

The present deduction (outside the medical deduction floor) for one-half of a taxpayer's health insurance premiums was added in 1965 in order to equalize to some degree the tax treatment of individuals who purchase health insurance and those who choose to self-insure. Without this deduction, it is likely that the taxpayer who purchases health insurance would never qualify for a medical expense deduction since, unlike the self-insurer, his medical expenses are essentially averaged out over a period of years and will usually fall below the medical expense deduction floor. It was believed by the Ways and Means Committee that a disparity in tax treatment between those that purchase health insurance and those who choose to self-insure "may have the effect of discouraging the provision of insurance protection against future medical bills". (See Ways and Means Committee Report on H.R. 6675, 89th Congress, page 137.) We believe this reason for continuing the separate deduction for premiums paid for accident and health insurance is equally valid today.

Moreover, national health insurance proposals are being actively debated and the need for upgrading and broadening health insurance coverage is universally recognized. To destroy the present incentives in the tax law for the purchase of health insurance while, at the same time, considering ways to improve health insurance coverage is contradictory.

Elimination of the separate deduction for health insurance premiums has been supported on the grounds that it would simplify the tax return. However, the net effect would not be simplification. Millions of taxpayers take the health insurance premium deduction without taking a deduction for their other medical and dental expenses. For many of these, repeal of the separate health insurance premium deduction will eliminate one line of the tax form (a minimal simplification at best), but at the possible price of higher taxes. For others, adding health insurance premiums to their other medical deductions will bring them over the "floor". Then, to claim the deduction, they will have to justify not only their health insurance premium payments but all their other varied medical and dental expenses which bring them up to the "floor". Thus, the tax return of some taxpayers would be minimally simplified at a price of higher taxes, but for others it would be made much more complicated.

These considerations clearly indicate that the proposed elimination of the separate income tax deduction for premiums paid for individual accident and health insurance would be highly inequitable and would complicate rather than simplify the individual income tax return. We therefore urge that this proposal not be adopted by the Finance Committee.

2. Deferred compensation plans

We support the thrust of Section 121 of the bill which provides that employees and indeepndent contractors who provide services for State and local governments that maintain "eligible deferred compensation plans" will be able to defer compensation as long as such deferral does not exceed prescribed annual limitations. In addition, this section provides a limited "catch-up" provision, integration with Section 403(b) arrangements, and rules as to when a deferred compensation arrangement may be entered into and when benefits may be made available to participants. It also permits participants to select among optional methods available for investing the deferred amounts but precludes them from having any ownership interest in the assets of the plan during the deferral period.

We also support Section 122 of the bill which provides that the taxable year for including compensation deferred under a nonqualified deferred compensation plan maintained by a taxable entity is to be governed by the principles set forth in rulings, regulations and judicial decisions in effect on February 1, 1978. This establishes clearly that a cash basis taxpayer is not in constructive receipt of income merely because he elects, before the compensation is earned, to defer the receipt of the compensation.

Finally, we support Section 125 of the bill which provides that employees covered by a qualified cash or deferred profit-sharing plan can defer tax on employer contributions to the plan, if the plan complies with the law as it was administered before January 1, 1972.

These provisions establish an equitable and practicable approach to the tax treatment of deferred compensation under State and local government plans, private nonqualified plans and qualified cash or deferred profit-sharing plans. The provisions clearly and correctly reverse the erroneous concept embodied in the proposed Internal Revenue Service regulations of February 3, 1978, dealing with nonqualified deferred compensation contracts and December 6, 1972, dealing with contributions to qualified plans, including cash or deferred profit-sharing plans, made pursuant to salary reduction agreements. We firmly believe that these regulations are contrary to the long-standing position of the courts and the Internal Revenue Service, itself, that a cash basis taxpayer is not in constructive receipt of income merely because he elects, before the compensation is earned, to defer the receipt of such compensation until a later time.

The tax treatment of deferred compensation arrangements provided by the bill will have the beneficial effect of encouraging more adequate provision for employees' retirement needs. The proposed regulations have created substantial uncertainty among taxpayers as to whether there is a proper deferral of income under deferred compensation arrangements. This uncertainty is severely curtailing the implementation by State and local governments and private employers of a wide variety of deferred compensation plans which would be beneficial to employees. The different tax rules that now apply to cash or deferred profit-sharing plans, depending on whether the plans were established before or after June 27, 1974, are also impeding the establishment of such plans. The provisions that we support eliminate these obstacles to the adoption of beneficial deferred compensation arrangements by establishing certain, uniform and equitable tax treatment for such arrangements.

However, we would like to call the Committee's attention to the fact that the bill does not deal with the status of deferred compensation arrangements of tax exempt organizations. We urge that the status of these plans be clarified in the pending legislation.

3. Capital gains

We support a reduction in the tax on capital gains. We take this action despite our usual policy of concentrating attention on issues particularly applicable to life insurance companies and their products and policyholders because we believe that the economic results of such tax reduction would be beneficial to the economy. Tax reduction for capital gains would encourage the flow of investment capital available to increase productive capacity through the creation of new plant and equipment and the modernization of existing facilities. It would also lead to an increased supply of goods and services as well as increased jobs. These are important elements if efforts to fight inflation are to succeed in the context of a growing economy with jobs for all our citizens. In this regard, we strongly believe that the fight against inflation should be the number one priority for this country.

Any adverse impact on government revenues of such a tax reduction on capital gains will be significantly offset by revenue increases resulting from the sale of assets which up to now have been "locked in" because of the steep capital gains taxes that would be payable.

4. Proposal to facilitate funding of public employee plans by life insurance companies

We urge that a provision be added to the tax legislation being considered by the Finance Committee to permit life insurance companies to fund State and local retirement systems and eligible state deferred compensation plans (new section 457 of the Code) on the same basis as other financial intermediaries. Currently, a limitation in the life insurance company tax provisions precludes State and local governments from accumulating funds invested with life insurance companies on an equivalent basis as funds invested with banks or mutual funds. In order to correct this inequity, we urge that section 805(d) and related provisions of the Code be amended to add a new category of pension plan reserves for contracts entered into with the retirement system of a State or local government or with an eligible state deferred compensation plan as described in proposed new Code section 457. Attached hereto is a memorandum which addresses this area in much greater detail.

We apreciate this opportunity to present our views on the pending tax legislation and would be glad to answer any questions the Committee may have.

Enclosure.

ATTACHMENT TO STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Proposal to Facilitate Funding of Public Employee Plans by Life Insurance Companies

Legislation is proposed to permit life insurance companies to fund state and local retirement systems and eligible state deferred compensation plans (new Code section 457) on the same basis as other financial intermediaries.

PUBLIC EMPLOYEE RETIREMENT SYSTEMS

Public Employee Retirement Systems (PERS) have come under close scrutiny in recent years by committees of the Congress and in the press. As required by ERISA, the House Pension Task Force published a comprehensive study of PERS during March of this year which catalogs and discusses the serious problems that those systems face.[1]

A major problem discussed in detail in the Pension Task Force report involves the funding of PERS. Historically, those systems have been poorly funded with many systems being funded on a pay-as-you-go basis. There has been a trend toward more adequate funding in recent years, which is attributable, at least in part, to more widespread recognition of the long-term costs of prior pension commitments. Despite this trend, the Pension Task Force report concludes that efforts still need to be made to discourage use of inappropriate financing methods and to encourage the accumulation of pension reserves through the use of actuarial funding methods.[2]

A closely related area of concern involves the investment policies and procedures of public employee plans. While investment performance is of no importance in a pay-as-you-go system, a small increase in investment yield can have a substantial impact on the funding of the plan. An increase on investment yield of 1 percentage point, for example, may reduce funding requirements by 15 to 20 percent.

Due to many statutory and historic limitations, PERS have not been managed in accordance with the best investment policies and procedures. In recognition of this fact, there has been a treind toward professional management of public employee funds. Because of the increasing attention being given to PERS generally, it is expected that trend toward professional investment management will be increasingly emphasized in the public sphere.

Another phenomenon documented by the Pension Task Force report is that the vast majority of PERS do not go through the process, which private plans almost always do, of obtaining letters from the Internal Revenue Service determining that their plans are qualified under section 401 of the Code. There are a number of reasons why this is so. In some cases, the retirement system may not meet federal standards. In other cases, the system may not wish to incur the expense and effort necessary to establish qualification or to comply with federally mandated reporting requirements. Also, state and local governments, unlike private employers, are not concerned with the deductibility of contributions. In other cases, state and local officials feel quite strongly that federal qualification of state and local plans is a fundamental infringement of state rights and is unconstitutional.

Recently the Internal Revenue Service tried to enforce the qualification requirements on state and local plans in a variety of ways. As a result of strong resistance by state and local units to these efforts, the Service has issued three releases (IR-1869 dated August 10, 1977, IR-1875 dated August 18, 1977, and IR-1923 dated December 28, 1977) which, pending a Treasury review of public plans, resolve the questions of discrimination and taxability of the income of such plans in favor of the taxpayer; eliminate the financial reporting questions required by ERISA Form 5500; and extend the due date for filing such forms to July 31, 1978.

[1] House Pension Task Force, 95th Cong., 2d sess., "Report on Public Employee Retirement Systems" (committee print 1978).

[2] "Pension Task Force Report," *supra* at 4.

Additionally, legislation has been introduced by a number of House and Senate Members which, if enacted, would make it clear that state and local pension plans are exempt from taxation and reporting requirements.

It is not at all clear what action, if any, will be taken by the Internal Revenue Service or Congress. Nor is it clear when such action might be taken. However, federal taxation and regulation of state and local plans does clearly involve difficult substantive issues and political questions, and it would not be surprising if a resolution of these issues were delayed indefinitely. In any event, no resolution of this problem currently under consideration deals with the problem of life insurance company taxation described below.

ELIGIBLE STATE DEFERRED COMPENSATION PLANS

As a means of providing limits on unfunded deferred compensation arrangements for state and local government employees, section 121 of the House-passed Revenue Act of 1978 would provide for establishment of eligible state deferred compensation plans.

To qualify, such plans must contain certain limitations and conditions which are similar to limitations and conditions imposed under other forms of retirement arrangements recognized in the Internal Revenue Code, such as section 403(b) annuities, individual retirement accounts and H.R. 10 plans. For example, the amount of compensation that may be deferred under such arrangements is limited to the lesser of $7,500 or 33⅓ percent of compensation. This limitation is to be reduced on a dollar-for-dollar basis to reflect amounts contributed under section 403(b) tax deferred annuities. Also, an eligible plan is not permitted to make benefits available to participants before the earlier of (1) retirement, (2) separation from service, (3) death, or (4) an occurrence of an unforeseeable emergency. Participants are precluded from having any ownership interest in the assets of the plan during the federal period, although they are permitted to select among any optional methods available for investing amounts deferred.

Similar to the rules for qualified retirement plans or qualified annuity arrangements, a participant in an eligible state deferred compensation plan would not be taxable on any amounts deferred, including any income earned on deferred amounts, until such amounts are paid or otherwise made available.

Life Insurance Companies Should Be Able To Fund Public Employee Plans on the Same Basis as Other Financial Intermediaries

Income earned by state and local governments is not subject to the Federal income tax. This means that under an eligible state deferred compensation plan, state and local governments may make direct investment, investments through bank trusts or investments in mutual funds and pay no tax. Similar tax-free accumulations may be made in connection with public employee retirement systems. A limitation in the life insurance company tax provisions precludes state and local governments from accumulating funds with life insurance companies on an equivalent basis. This limitation may be explained as follows:

The federal income tax structure for life insurance companies is designed, generally, so that amounts held for retirement plans will not be subject to federal income tax. The purpose of these provisions is to permit life insurance companies, like banks and other financial intermediaries, to accumulate investment income held for retirement purposes free of tax.

The Code provisions that prescribe this treatment in the case of life insurance companies are only applicable, however, if the life insurance company's contract is issued to a plan which is qualified under one of the various Code provisions enumerated in section 805(d).

The above-described limitation, in light of the reluctance of public plans to seek qualified status under the Code, explains why life insurance companies currently face great difficulties in soliciting or accepting funds from public retirement systems. In the case of private plans, life insurance companies cover approximately one-third of participants and fund approximately the same proportion of total private pension plan assets. While there are no complete statistics on the extent of professional management of public plans, the August 1978 issue of Institutional Investor reports that of the 53 largest state public employee funds, all or a portion of the assets of only 3 funds are held by life insurance companies. In contrast, 48 of the systems manage all or part of their funds internally. Similarly, a recent survey of seven major life insurance com-

panies, which hold $45 billion or 12 percent of the assets held for all plans, hold only $1.2 billion of 1 percent of the amounts held for public employee plans. Since state systems can invest funds directly or through a properly drafted bank trust on a tax-free basis, they would be ill advised to place those funds with life insurance companies, and, in effect, have investment results credited on an after-tax basis.

The full range of investment management alternatives should be available to public employee plans. While life insurance companies are not the only source for funding such plans, their relative prominence in the private sector suggests at least that their contracts and facilities should be available to the prudent administrator of a public plan on the same basis as other funding media.

The Code Should Be Amended To Clarify the Ability of Life Insurance Companies To Fund State and Local Retirement Systems

For the reasons stated above, the Internal Revenue Code should be amended to clarify the ability of life insurance companies to fund state and local retirement systems and eligible state deferred compensation plans on a tax-free basis.

Such an amendment would involve no revenue loss to the Federal Government. To the extent that the amendment permits state and local plans to obtain better investment performance, the cost of state and local retirement plans, and the burden they place on the taxpaying public, will be reduced. Of course, to the extent that investment results improve the funding of a public employee plan, it is easier also to make benefit improvements for participants in appropriate cases.

The proposed amendment would add a new category of pension plan reserves to section 805(d) of the Code for contracts entered into with the retirement systems, trusts or funds of a state, a political subdivision of a state or an agency of instrumentality of either or with eligible state deferred compensation plans as described in section 457. Additionally, a conforming cross-reference to this new paragraph would be added to section 801(g)(1)(B)(ii) and section 801(g)(7) of the Code, involving pension plan contracts based on separate accounts.

A copy of the proposed amendment is attached.

Proposed Amendments Relating to Public Employee Plans

SECTION 1. PENSION PLAN RESERVES.—Section 805(d) of the Internal Revenue Code of 1954 is amended by adding the following new paragraph:

> "(6) purchased under contracts entered into with plans which (as of the time the contracts were entered into) were (A) retirement systems, trusts, or funds of a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing which do not provide an option to defer compensation or (b) eligible state deferred compensation plans as described in section 457 of the Code and, in the case of taxable years beginning before January 1, 1982, plans described in sections 121(c)(2) of the Revenue Act of 1978."

SEC. 2. CONTRACTS WITH RESERVES BASED ON SEGREGATED ASSET ACCOUNTS.—

(a) DEFINITION OF CONTRACT WITH RESERVES BASED UPON SEGREGATED ASSET ACCOUNT.—Section 801(g)(1)(b)(ii) of the Internal Revenue Code of 1954 is amended as follows:

> "(ii) which is described in paragraph (1), (2), (3), (4), (5) and (6) of section 805(d) * * *."[1]

(b) BASIS OF ASSETS HELD FOR PENSION PLAN CONTRACTS.—Section 801(g)(7) of the Internal Revenue Code of 1954 is amended as follows:

> "(7) BASIS OF ASSETS HELD FOR QUALIFIED PENSION PLAN CONTRACTS.—In the case of contracts described in paragraph (1), (2), (3), (4), or (5) or (6) of section 805(d) the basic of each asset * * *."[1]

STATEMENT OF THE AMERICAN ELECTRONICS ASSOCIATION

On behalf of the American Electronics Association's high-technology exporters, we urge the Senate Finance Committee to oppose any effort to eliminate or modify the Domestic Internal Sales Corporation, or DISC.

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[1] The proposed amendments assume that current erroneous crossreferences to section 801(d) will be corrected by sec. 4(j)(4) of the Technical Corrections Act (H.R. 6715).

AEA (formerly WEMA) is a trade association representing more than 1,000 high-technology companies in 39 states. Over two-thirds of our member companies are small businesses employing fewer than 200 people. Exports and international trade are vital to our high-technology industries. In a recent AEA survey, the 325 responding companies reported generating over $16.4 billion in export and foreign operation revenues in 1976.

Mr. Chairman, our members are greatly disturbed by the Administration's proposals to modify or phase out DISC. We believe these suggestions are misguided and could prove damaging to the nation's economy. Right now our nation is struggling with high domestic unemployment, inflation and an enormous trade deficit. Increased exports could alleviate these problems. Our exporters are competing with foreign firms that are greatly assisted by their governments. Furthermore, it seems to us that U.S. negotiators in Geneva should be able to use DISC as an important bargaining chip in the export subsidy talks now underway.

This is just not the time for Congress to be considering eliminating or reducing the only export incentive the U.S. affords its exporters. Rather, Congress and the Administration should be focusing their energies on developing a national policy to put U.S. exports and the U.S. economy on much stronger footing. Export incentives should be expanded, regulatory obstacles to exports should be reduced, and a healthier domestic economic environment should be encouraged by reducing taxes, especially those on capital gains, and by stimulating industrial investment, research and development.

International competitiveness, especially in the technology-intensive industries, will continue to become ever more vital to the overall well being of the U.S. economy. As a trade, rather than a tax matter, the U.S. cannot afford to neglect the competitive strength of its exporters.

Since their creation in 1971 and despite their modification in 1976, the DISC provisions have done exactly what the Congress intended them to do. They have improved the competitiveness of U.S. firms in world markets by offsetting some of the advantages other countries give their exporters via direct and indirect tax subsidies. According to a study by the Special Committee for U.S. Exports, between 1973 and 1975 DISC increased exports by about $8.7 billion, GNP by $21.7 billion, export-related employment by 343,000 and overall employment by 1,070,300 (man-years), and federal revenues by $3.61 billion.

The DISC has greatly assisted the international competitiveness of AEA member companies and contributed considerably more to the U.S. economy than its "cost" in deferred tax revenues.

In 1975 one of our member companies, San Fernando Electric Manufacturing Company, told members of the House Ways and Means Committee how the DISC tax provisions gave it the incentive to enter and succeed in export markets. Mr. Alan Rubendall, San Fernando's executive vice president, pointed out that the greater cost of marketing abroad made it difficult, if not impossible, for a smaller company to comeptitively market its products abroad. In January of 1973, San Fernando Electric formed a DISC and began to export. By September 1975, they had sold nearly $4 million worth of products abroad. This additional volume created more than 96 U.S. jobs which otherwise would not have existed. The added sales export volume created by the DISC provided higher corporate income taxes for San Fernando Electric.

A 1975 AEA survey of its membership supported San Fernando Electric's experience. Two-thirds of the companies responding were small, with total sales of less than $15 million in 1974. They reported that from 1972 to 1974, DISC had helped them increase their total exports by $67 million a year and their U.S. employment by 6,388. The respondents estimated an aggregate loss of $44.5 million in sales in 1976 and an immediate net loss of 1,800 jobs if DISC were repealed. The AEA survey, like Mr. Rubendall's comments, clearly indicate that DISC has been particularly helpful to medium-to-small sized firms entering the export market or seeking to expand their sales of U.S. products abroad.

That was back in 1975. But given today's trade deficit, the ongoing trade negotiations, high unemployment and inflation, it is even clearer to us that there is a much greater need in 1978 for DISC and for a national trade policy explicitly recognizing the importance of exports to the U.S. economy.

We urge the Senate to follow the House of Representatives' lead and join with the National Governors' Conference and U.S. industry in opposing any changes to DISC this year. We applaud your efforts to reduce federal taxes,

especially those on capital gains. These kind of constructive reforms will prove extremely beneficial to the U.S. economy and its trading power. AEA's 1,000 member companies fully support this approach.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

The American Farm Bureau Federation is a voluntary, nongovernmental organization repersenting nearly 3 million member families whose major goal is to promote the interests of farmers and ranchers as well as the strength of the total economy.

Tax policy has a significant effct upon the economic well being of the agricultural community, and Farm Bureau has taken a stand on various tax issues affecting agriculture both directly and indirectly. We are pleased to submit this statement on the tax reduction and reform proposals contained in H.R. 13511.

In general Farm Bureau supports the provisions of the bill. At the 59th annual meeting of the American Farm Bureau Federation, the official voting delegates of the member State Farm Bureaus adopted a number of resolutions consistent with the tax policy embodied in this legislation.

I. Capital Gains Provisions

Farm Bureau policy maintains that "the tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property." The restructuring of capital gains taxes provided in H.R. 13511 advances this principle. Among other things, it allows farmers who desire to sell farmland an opportunity to do so without an onerous tax burden. Just as importantly, the reform and reduction of capital gains taxes can provide incentives to both individual and corporate investors and spark new economic growth by encouraging increased investment.

The proposal in H.R. 13511 to index capital gains also squares with "gains" which reflect, in part, a decline in the value of the dollar. A partial answer to this inequity is the indexing of such gains.

II. Business Tax Reductions and Extensions

A. CORPORATE RATE REDUCTIONS

Farm Bureau policy states that "tax policy should be designed to encourage private initiative, help stabilize the dollar, promote employment and economic growth, and distribute the tax burden equitably." The proposed reduction in the corporate tax rate is in accord with this policy. Small agricultural businesses, as well as many farms, will benefit from the enactment of this provision.

B. INVESTMENT TAX CREDIT

Farm Bureau supports the permanent extension of the 10-percent investment tax credit contained in H.R. 13511 and encourages this Committee to go further in revising the credit. Specifically, we urge the Committee to amend H.R. 13511 to include the provision of S. 3433, a bill introduced by Senator Herman Talmadge (D., Ga.) to clarify application of the credit to include structures designed and used solely for the production of poultry, eggs, beef, pork, or plants.

C. TAX ACCOUNTING

Farm Bureau is concerned that recent efforts by the Internal Revenue Service to institute a system of capitalizing inventories, including growing crops in the field, would have detrimental effects on many farmers. We support Section 342 of H.R. 13511, which permits a farmer, nurseryman or florist, who uses the accrual method of accounting and is not required by Section 447 of the Code to capitalize preproductive period expenses, to be exempt from the requirement of Rev. Rul. 76-242 that growing crops be inventoried.

Federal estate taxes

It is Farm Bureau policy to "initiate efforts to repeal or to make major modifications in the inequitable capital gains carryover basis provisions of the Tax Reform Act of 1976." These rules are an administrative and financial hardship on farmers, ranchers, and their families, and should be repealed.

Although H.R. 6715, which provides for a three-year moratorium on applications of the carryover basis rules, is on the Senate calendar and is supported by Farm Bureau, we urge that a complete repeal of the carryover basis provisions be included in the Committee's amendments to H.R. 13511.

Other considerations

In addition to Farm Bureau's general support of H.R. 13511 and specific endorsement of the items mentioned in this statement, we call to your attention these additional Farm Bureau policies:

"We believe that an amendment to the U.S. Constitution should be adopted to require that the Congress operate on a balanced budget each year, and that only in extreme emergencies could this requirement be waived with concurrence of the House of Representatives, the Senate, and the Executive Branch of the government.

"We support a Constitutional amendment to restrict the tax authority of the federal government to a realistic percentage of the gross national product.

"We recommend that any tax cut be accompanied by a comparable cut in government spending."

Adequate consideration of any revenue bill must take into consideration the concepts of a balanced budget and limitations on federal spending and taxation. These concerns are foremost in the minds of farmers and ranchers who daily contend with inflated costs of production caused to a great extent by the federal government's failure to live within its means.

We believe that the modest reductions proposed in this bill are justified by their potential contribution to economic growth; however, there remains an urgent need to bring Federal spending into balance with Federal revenues at tax rates the public can afford to pay.

We, therefore, urge the Senate Committee on Finance to explore various means of limiting both Federal spending and taxes at its earliest opportunity.

Statement of the American Hospital Association

The American Hospital Association, representing some 6,400 hospitals and other health care institutions, as well as over 27,000 personal members, appreciates this opportunity to present to the Committee our comments and recommendations regarding tax reform and the threat certain proposals pose to charitable nonprofit health care institutions. The majority of our members are nonprofit hospitals that to varying degrees depend on philanthropic contributions to help provide quality health care in their communities. Accordingly, the AHA and its members are deeply interested in any legislation affecting tax incentives for charitable giving.

Specifically, we are concerned about the Administration's proposals for decreasing or eliminating certain deductions which would increase the number of taxpayers who elect to use the standard deductions and could decrease charitable contributions to not-for-profit hospitals and other health care institutions.

THE NEED TO PRESERVE TAX INCENTIVES FOR PHILANTHROPY

During the early history of health and hospital care in this country, private contributions comprised a substantial proportion of funds for building and operating hospitals. While other sources, including the government, now provide a greater share of funds for these activities, not-for-profit health care institutions, which represent the greatest portion of our health care resources, continue to rely on charitable contributions for a variety of purposes. Some of these include helping to meet outstanding mortgage obligations and replace outdated facilities and equipment; helping to meet unavoidable operating deficits that result from payment limitations imposed by some third-party payers; support for health research and education programs; helping to maintain and improve community health care through, for example, subsidization of care for indigent patients; and helping to finance experimental and innovative approaches to the delivery of health care.

These worthy activities are clearly in the public interest and philanthropic support for them diminishes a burden on government. They also help reduce the cost

of services to all patients. Moreover, private philanthropy reflects and fosters a highly desirable participatory attitude by individuals toward the needs of their communities. Governmental and private philanthropic activities in the health care field, though often addressing different needs and problems, are complementary expressions of support for better health for the people of the nation, and we feel America can ill afford to forego this valuable source of venture capital.

THE TAX SYSTEM AND PHILANTHROPY

Our society is based on the belief that diversity, free choice, and competition are necessary elements of the public well-being. A pluralistic social structure confers many benefits on its citizenry. It fosters experimentation and standard setting. It supports endeavors which sometimes go beyond the expertise and obligation of government. Most importantly, it encourages citizen participation in identifying and attacking social problems.

Recognition of the many benefits of private giving for public purposes and the absence of any personal financial gain by donors led the Congress after enactment of the Federal income tax to establish tax incentives for charitable giving. This has for years encouraged the traditional volunteer spirit that has well served our society. However, charitable giving in America is in trouble and has not kept pace with economic growth. The Filer Commission's studies and report (1975) show that, when adjusted for inflation, the level of charitable giving is declining. A shift has also occurred in the source of charitable gifts. Whereas the bulk of such gifts once came from lower- and middle-income groups, today, as more and more taxpayers take the standard deduction, a smaller group of individuals with higher incomes contributes the largest proportion of charitable gifts. Tax proposals that would reduce the number of taxpayers who itemize their deductions would surely accelerate this trend.

We believe that participation by individuals in meeting health needs in their own communities should not be left solely to the affluent. When low and moderate income families have little incentive to give, their voice in community life is less, and they are less likely to become involved in community activities. Both the present tax system and proposed tax changes that would increase the use of the standard deduction would, unfortunately, abet this undesirable trend.

Further, reductions in the role of philanthropy would place additional burdens on government. The services that hospitals provide are essential functions that must be discharged, if not by the voluntary sector, then by the government. As we all know, governmental support for health care has greatly increased under Medicare and Medicaid and no one can doubt that additional tax revenues would be required should the government become the sole source of funds for hospital services. In such circumstances the government would in effect control and determine what health programs and what institutions would be funded.

The AHA favors encouraging broader citizen participation in voluntarism by allowing all taxpayers a deduction for charitable gifts. This is a proven, efficient and easily administered way to encourage private philanthropy. According to a study by Professor Martin Feldstein, for each dollar of government revenue lost by allowing the deduction of charitable contributions of persons whose incomes are $30,000 or less, charitable organizations will receive $2.40 in increased contributions. Clearly, the relationship between our tax laws and charitable giving is direct and highly significant.

In referring to this relationship and potential decreases in philanthropy for health activities in the United States, former Assistant Secretary for Health of the Department of HEW, Theodore Cooper, M.D., said:

"Such a loss might be calculated in dollars, but it would be reflected in research not carried out, service not provided, and innovations not exploited. In short, the loss of philanthropy would hit hard at the very places where our health care system is in most need of creativity and freedom, in the places where new ideas and new approaches to old problems can lead to needed change."

THE CHARITABLE DEDUCTION

The charitable deduction is not a tax loophole. Unlike other deductions, it is not an expenditure that is of personal benefit to the taxpayer. Individuals never gain financially from making charitable donations, since the tax savings are always less than the contribution. The Internal Revenue Code presently allows de-

duction of charitable contributions only by those taxpayers who itemize their deductions. There is no similar tax incentive to charitable giving for those who take the standard deduction. Changes in the tax laws that would increase the percentage of taxpayers who do not itemize deductions would inevitably bring a decline in both the number and size of philanthropic gifts to charitable institutions such as hospitals. The American Hospital Association strongly believes this Committee and the Congress should act to prevent such a result and should act, instead, to preserve tax incentives for charitable giving.

The AHA does not oppose tax simplification. Rather, we urge approval of legislation that would offset the adverse and, we trust, unintended effect of any changes in our tax laws that would reduce private giving for public purposes. Senators Moynihan and Packwood have offered such a legislative measure that would accomplish this goal. Their bill, S. 3111, would permit all taxpayers to deduct the amount of their charitable contributions in calculating taxable income, whether they itemize other deductions or use the standard deduction. We commend Senators Moynihan and Packwood for their leadership in introducing this legislation in the Senate and wholeheartedly support its enactment.

RECOMMENDATION

The American Hospital Association urges the Senate Finance Committee to approve the substance of S. 3111 as an amendment to H.R. 13511, the Revenue Act of 1978.

We appreciate the opportunity to present these views and recommendations.

AMERICAN INDUSTRIAL DEVELOPMENT COUNCIL, INC.,
Kansas City, Mo., August 28, 1978.

Hon. RUSSELL B. LONG,
U.S. Senator, Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: As I promised during my testimony to the Senate Finance Committee on August 24, I am sending, enclosed, a copy of a study done by our organization which proves conclusively that industrial development reveune bond issues do not cause a revenue lsos to the U.S. Treasury, but in fact, produce a gain for the Treasury.

At the hearings there was a lot of discussion about computer projections on future tax revenues. This booklet demonstrates that revenues *do* increase when economic activity is stimulated. The problem with most of the Treasury estimates is that they assume economic activity will remain static. In this way, they claim that tax revenue is lost through the exemption on the interest of the bond. We contend that the new jobs and new return on corporate investment results in new tax income from which most taxes accrue to the Treasury.

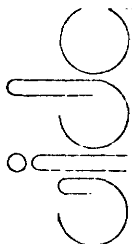
I am also sending one of these books along with a copy of this letter to Bernard M. Shapiro, Chief of Staff of the Joint Committee. I am sure that he will find this information to be of interest to other members of his staff.

Thank you again for the privilege of appearing before your Committee. We hope that the Committee will be able to give earnest consdieration to our position during the coming busy weeks when they will be charged with composing an adequate tax bill.

Best personal regards.

Yours truly,

THOMAS E. BUNDY,
Director of Industrial Development.



american industrial development council, incorporated

THE INTEREST TAX-EXEMPTION ON INDUSTRIAL DEVELOPMENT BONDS: THE COST TO THE UNITED STATES TREASURY

Dr. John A. Andrews

Dr. Dennis R. Murphy

Emory University

Prepared For

AMERICAN INDUSTRIAL DEVELOPMENT COUNCIL

SUMMARY REPORT

Debt issues with tax-exempt interest income have been criticized based on the argument that the cost to the Treasury is the foregone tax revenues associated with the tax-exempt income to the holder of the note. Preliminary research indicates that it would be difficult to agree with this premise for several reasons. Among them: 1) the attendant cash revenues to the Treasury as a result of activity generated from use of the proceeds of an issue. Included would be FICA payments by employee and employer, withholding of federal income taxes, and tax revenues generated by the increase in corporate income associated with issuance of a lower coupon issue. 2) A substantial amount of conventional corporate debt issues are purchased by institutions and individuals for tax-qualified portfolios. Ownership in this form reduces the immediate cash generation difference due to issuance of tax-exempt issues.

The use of qualified Industrial Revenue Bonds (IRB) permits the corporate user of the proceeds to acquire or improve depreciable assets at a lower cost due to the lower borrowing rate caused by the tax-exempt feature of the issue. In addition, the user is effectively able to tap a source of funds not previously available to him. All of this is done at no appreciable trade-off in tax-deductible expenses to the corporation, and effectively lowers the rate of discount used in evaluating projects, thus encouraging investment. Such investment adds jobs in the economy.

IRB's are an example of fiscal policy stimulation. The effect of the use on Treasury revenue requires the application of a cost/budget approach in order to assess the real cost of the issue. The treatment of measuring immediate foregone tax revenues as the net cost is perhaps applicable to municipal issues, but not to IRB's.

To compute the net benefit or cost to the federal government via use of the IRB vs. conventional debt, the analyst must first measure potential immediate loss of Treasury revenue via IRB's as opposed to conventional debt. Next, the additional or incremental tax revenues associated with the use of the IRB form of financing, through such well-known sources as federal withholding and FICA payments, must be deducted from the gross cost determined in the first step. Naturally most of the amount of any "off-set" against Treasury revenue losses depends on the net number of jobs created as a result of the IRB financing.

INTRODUCTION

Industrial development bonds, perhaps more appropriately called industrial revenue bonds (IRB's) by investors, are issued in compliance with Section 103(b) of the Internal Revenue Code of 1954, as amended. This section of the code and the regulations promulgated thereunder permit interest income from such qualified issues of IRB's to be exempt from Federal income taxation, as are all municipal issues.

The Federal tax exemption for the interest income makes this form of financing attractive to corporate users for a variety of reasons. Undoubtedly the most important reason for their use is the resulting direct decrease in the cost of funds to the issuer since tax-exempt issues naturally sell at a dollar premium. The user does not give up the ability to expense fully the payments made to service the issue. This effectively lowers the firm's cost of capital but does not affect the amount of tax expense claimed by the firm. In addition to the cost savings factor, the use of the IRB's permits the firm to tap a source of investment capital not available to it previously. Investors seeking a tax-exempt income in their investment portfolio are usually not the same as those seeking high-coupon current income. Also, the fact that most issues are sponsored by a development authority that actually issues the debt and services it, tends to give the issue a wider acceptance in the new issue market. That is, the name of the issuing authority is attached to the issue as well as the user of the property. It is assumed by many investors that the issuing authority has "invited" the user to the area and not only approves, but encourages the user to acquire or improve depreciable property in its area. It is interesting to notice that the default rate on these issues is second only to U.S. Government issues.

The issuer is not the only party that benefits from the issue of the securities. Since the primary use of the funds is to acquire or improve depreciable property, there will be an economic benefit to the related trades that support the depreciable property in the form of wages, salaries and so on. Beyond this initial stimulus, there is a long term benefit to the immediate area in the form of creation of jobs, resulting in wages, salaries and commissions that in turn create additional activity.

Over the course of the past several years there have been an increasing number of criticisms aimed at the tax-exempt status of interest paid on these issues. These criticisms have included charges of inequity and inefficiency, as well as claiming substantial revenue losses for the Treasury. It is our contention, however, that in light of the above discussion, IRB's are substantially different from other municipal issues, and must be analyzed as such. Far from being a cost to the Treasury, such issues may in fact provide net revenues.

This paper is intended to be suggestive rather than definitive, but it seeks to indicate the direction future research might follow. It uses very limited data to make a preliminary statement about the costs to the Treasury of IRB's. We do not attempt to discuss the other sizable benefits to industry of these bonds, nor their impact on the horizontal equity or progressivity of the tax system.

THE NATURE OF THE PROBLEM

In the course of the past several years the United States tax regulations have been altered with the objective of increasing the level of investment activity. The stimulation provided by these alterations have taken the form of investment tax credits, which are in effect a subsidy for purchasing new equipment; accelerated rates of depreciation on investment projects, which lower the present value of future tax liabilities; and various alterations of corporate and business tax rates. In addition to these policies, Industrial Development bonds as a source of long-term financing have been used in essentially their present form since 1968. Since the interest on such bonds is tax free, they have been subject to criticism on the grounds that the Treasury is being deprived of revenue that it would otherwise receive.

Industrial Development bonds have in general been analyzed in the same manner as any other Municipal bond issue, but it is our contention that they differ substantially, both in the use to which such funds are put and in their net impact on the Treasury. The usual style of analysis ignores completely the benefits to the Treasury, while concentrating on the costs.[1] We feel,

[1] For an example of the usual style of analysis, see U.S. Treasury Department, "Comparison of the Interest Cost Savings

however, that a cost-benefit study would be a much more valid approach in attempting to assess the real cost of this type of financing.

If the analysis is merely to compute foregone immediate Federal tax revenue on a taxable vs. tax-exempt issue, it can be clearly seen that there is a net cost in the use of this type of financing to the Federal government. In Figure 1 we present a simple supply and demand apparatus to aid in understanding the nature of the costs to the Treasury of tax-exempt interest payments. Let i_t denote the interest rate payable on a fully taxable instrument of similar risk and maturity as a representative tax-exempt instrument, while i_e is the tax-exempt rate. The supply curve of funds to the exempt market will be a function of the difference between these two rates, and the marginal tax rate paid by the prospective purchaser, and will be given by:

$$i_e = (i - t)\, i_t$$

where t is the highest marginal tax rate. As a purchaser moves into higher marginal tax brackets, he will be willing to accept lower i_e, which accounts for the positive slope of the supply curve.

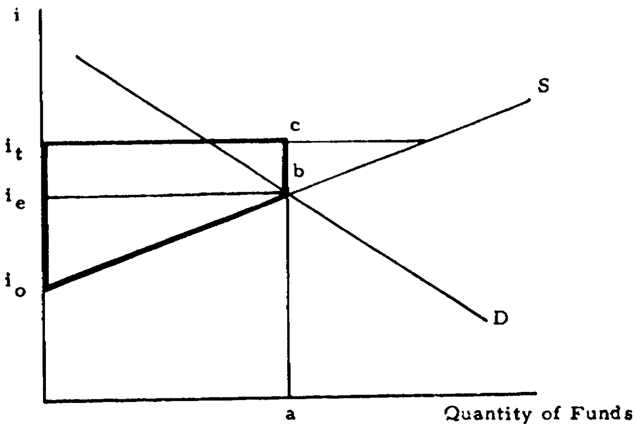


Figure 1

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and Revenue Loss on Tax-exempt Securities," State and Local Public Facility Needs and Financing, Vol. 2, U.S. Congress, Joint Economics Committee, 89th Congress, 2nd Session, 1966.

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A first approximation of the costs to the Treasury may be estimated from Figure 1. The rectangle $i_e i_t cb$ represents the interest subsidy to the firm using IRB's, while the area $i_o b i_e$ represents a subsidy to saving of the purchaser of these bonds. The total potential cost to the Treasury would then be the sum of these two areas, $i_o i_t cb$.

The preceding style of analysis is probably adequate to analyze an ordinary municipal bond issue, but not for industrial development bonds. One reason is immediately apparent. If the subsidy $i_e i_t cb$ represents actual reduced expenses to the firm, they will appear as gross profit, and be taxed at the corporate income tax rate. If we assume a corporate rate of 48%, almost one-half of this subsidy is immediately paid to the Treasury. This would reduce the cost to the Treasury to the outlined area of Figure 2, from the outlined area of Figure 1.

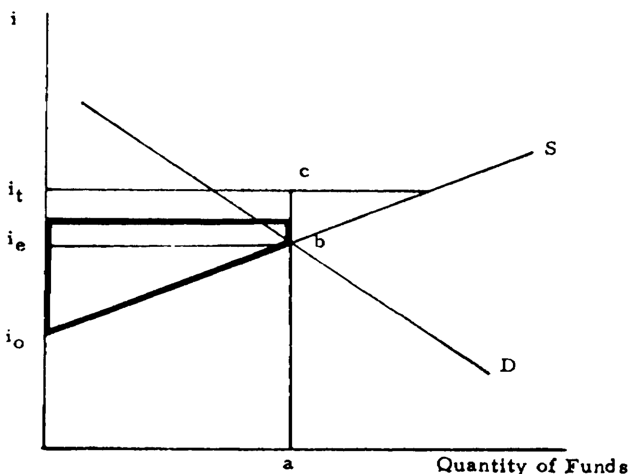

Figure 2

In addition to the above considerations, since it is generally assumed that new jobs are created as a result of the issue of an IRB, the wage-earner and his employer will both remit to the federal government a prescribed amount based on the payments to the employee for services performed. These remittances to the Treasury will offset some or all of the remaining cost, and could well represent a net benefit to the Treasury.

The remainder of this report will be concerned with a straightforward attempt to analyze the net cost or benefit to the federal government of the IRB form of industrial financing. The system of analysis used will be to compute:

1. Annual U.S. Treasury tax revenue loss via issuance of IRB's rather than straight corporate debt.

2. Determination of annual tax revenues remitted to the Treasury as a result of the economic activity created via the use of IRB's.

3. Determination of the net benefit or cost to the Treasury under alternative assumptions.

COMPUTATION OF TREASURY NET BENEFIT OR LOSS

In order to be able to complete the analysis, certain basic data and assumptions are necessary. State agencies have provided data on the dollar amounts of these issues, excluding pollution control issues, and the number of jobs created as a result of the IRB issue. Federal data were used to determine the average hourly payroll rates for the area affected by the issue of IRB's, as well as the average work week in the area, and the annual payroll tax rates for federal income tax and FICA contributions.

Table 1 provides a summary of the computations for the seven states for which data are available. Consider the data given for Arkansas. The State provided data for the period 1959-1977 (June), reporting the total value of IRB's issued over the period to be $703,564,850 and the number of jobs created as a result of these bonds to be 53,339. The potential cost to the Treasury owing to the fact that the interest payable on such bonds is tax-exempt, is computed assuming that the average rate of interest on taxable issues is 8.5% and that the applicable marginal tax rate is fifty percent. It is clear that if the interest rate were actually higher or lower for a particular period, the applicable rate should be used. We feel that 8.5% will represent a reasonable rate for taxable issues for the recent past.

In computing the potential loss, it is assumed that the principal amount will earn the 8.5% and all of this will be taxable at

the marginal rate of 50%. In fact, this rate is probably high owing to the fact that the high coupon corporate bond is a favorite holding for such tax-qualified investors as pension and profit-sharing plans. For example, in 1974 it was established by Soloman Brothers that approximately 40% of corporate debt issues were purchased by private and state and local pension plans, which would indicate that the appropriate marginal tax rate should be 30%. For the purposes of illustration in Table I, however, we use the 50% rate.

Offsetting the Treasury loss as computed above is the payment of Federal income tax and FICA contributions to the Treasury, which, using the current appropriate rates amount to $1,450 per worker per year. In addition, if the firm earns any accounting profits, the amount of the subsidy received due to lower interest costs will go to increase gross before tax profit, and will be subject to the 48% corporate income tax. This corporate income tax on the subsidy alone, will amount to $5,065,667. It is clear that a profitable firm will earn additional taxable income, and to the extent that the firm would not have come into existence without IRB financing, this would be an additional offset. We do not, however, include this tax.

The last column of Table I shows that the net annual benefit to the U.S. Treasury is $47,440,638. That is, if economic activity is undertaken which would not have been initiated in the absence of IRB financing, the Treasury not only would not suffer a loss in revenue, but would in fact gain 47.4 million dollars of additional tax revenue. Based on the data which we have examined, the average net tax revenue gained by the Treasury is $1,143.71 per job created per year.

It may be argued that the number of jobs reported as having been created in the short run due to IRB financing is excessive, since some of the investment spending which created the jobs would have taken place even in the absence of IRB's. In addition, some of the jobs reported would not be net increases since, for example, a firm relocating from one state to another may add few additional workers, and the gain reported for one state would be offset by the loss suffered in another. Table II shows the net benefit to the Treasury if we assume that the same dollar volume of IRB's were issued, but only one-half of the reported number of jobs are net additions. Table III makes the

ANNUAL BENEFIT OR LOSS TO THE TREASURY IF ALL JOBS REPORTED ARE NET ADDITIONS[1]

STATE	DOLLAR VALUE OF IRB'S ISSUED	POTENTIAL[2] TREASURY LOSS	SUBSIDY[3] TO FIRM	CORP. I.T. ON SUBSIDY	JOBS CREATED	TOTAL[4] TAXES PER WORKER	NET COST OR BENEFIT
Arkansas	703,564,850	29,901,506	10,553,472	5,065,667	53,339	1,450	47,440,638
Connecticut	100,037,984	4,251,615	1,500,569	720,273	5,152	2,343	7,821,606
Georgia	30,250,000	1,285,625	453,750	217,800	1,636	1,699	1,493,939
Illinois	32,140,000	1,365,950	482,100	231,408	2,236	2,774	4,836,652
New Hampshire	34,040,000	1,446,700	510,600	245,088	4,435	1,601	5,654,350
New York	206,251,000	8,765,667	3,093,765	1,485,007	13,164	2,325	21,838,107
Oklahoma	58,000,000	2,465,000	870,000	417,600	5,979	1,968	9,304,567

[1] The periods for which data are available differ from state to state. See Appendix.

[2] Assuming that the average interest rate on taxable issues is 8.5%, the marginal tax rate is 50%, and all bonds are term bonds.

[3] Assuming that the average interest rate of IRB's is 1.5% below the rate on taxable issues.

[4] Assuming a family comprised of the wage earner, spouse, and two children.

CORRECTED TABLE, PAGE 7

TABLE II

ANNUAL BENEFIT TO THE TREASURY IF ONE-HALF OF THE JOBS REPORTED ARE NET ADDITIONS

STATE	NET JOBS CREATED	TOTAL TAXES PER WORKER	NET COST OR BENEFIT
Arkansas	26,670	1,450	8,769,269
Connecticut	2,576	2,343	1,732,433
Georgia	818	1,699	104,157
Illinois	1,118	2,774	1,735,382
New Hampshire	2,218	1,601	2,103,517
New York	6,582	2,325	6,537,483
Oklahoma	2,990	1,968	3,418,336

TABLE III

NUMBER OF JOBS WHICH MUST BE CREATED FOR THE TREASURY TO BREAK EVEN

(1) STATE	(2) NET JOBS CREATED	COL. (2) AS A % OF JOBS REPORTED
Arkansas	20,622	39%
Connecticut	1,814	35%
Georgia	757	46%
Illinois	492	22%
New Hampshire	903	20%
New York	3,770	29%
Oklahoma	1,252	21%

same assumptions concerning the dollar value of bonds issued, but computes the number of jobs which must be created for there to be neither a gain nor a loss to the Treasury.

It is clear from a perusal of Table III that if the actual number of net jobs created ranges between 20% to a high of 46%, there will be no direct cost to the treasury as a result of IRB financing.

SUMMARY AND CONCLUSIONS

In analyzing the effect of federal revenues due to the use of the IRB as opposed to conventional corporate debt instruments to fund the acquisition of depreciable assets, the analyst must go beyond the shallow treatment that merely measures the loss of gross revenues to the Treasury by comparing estimated tax flows from the interest income on corporates against the tax-exempt status of the IRB interest income. Admittedly, there is a time difference to the Treasury relating to the taxability of both streams of interest income, although two points must be recognized even with this simple approach. One is that it is assumed that the corporate issues will be purchased and held by a current tax-paying entity. Such is obviously not the case. As tax-qualified institutions abound to fund private (fully fund under ERISA) and public pension plans, the revenue to be derived from immediate remittance of taxes are deferred for extended periods of time. Secondly, it is assumed that if the IRB is not available as a source of funds to the user, he will instead opt for the use of conventional corporate debt sources and proceed with the investment project. Such may not be the case for several reasons.

The use of IRB financing typically lowers the cost of capital for specific projects approximately 1.5% to 2.0%, and this factor then will in most cases cause the firm to raise its discount rate (present value factor) by the same amount. This will mean an increase of approximately 23% if a 6.5% tax-exempt IRB is compared to a fully taxable 8% issue.

In addition to the explicit cost factors mentioned, there is the fact that many small to medium-sized companies find it difficult to sell their bond offerings in the money market. Reasons for this include a lack of knowledge that the market has about such small firms, their lower capitalization, and the relatively small size of their issues which make secondary market sales difficult.

On the buying side of the market, it is at least implicitly assumed that all investors would buy the same volume of taxable bonds in the absence of tax-exempt issues. This would not be the case in the absence of very substantial increases in the coupon rate. Rather, it would be reasonable to assume that at

least some such investors would seek alternative i[illegible]stments which provide a tax shelter, and thus reduce the supply of funds to the capital market.

Going beyond the cursory look at gross revenue stream differentials to the Treasury, it is necessary to examine the effect of the use of the IRB on other revenue sources to the Treasury. Immediately two such sources are evident. The first relates to the cost savings associated with the use of the IRB to the using corporation. The 1.5% referred to earlier normally results in an increase in taxable income by the amount of the savings since there is no direct cost to the corporation for this amount of subsidy. This increase in taxable income will result in immediate remittance at the firm's federal marginal tax rate.

The second, and undoubtedly more important factor, is related to the number of jobs created by the use of IRB financing. Each net new position created by IRB's, including both the direct and indirect effects, results in federal withholding and employee/employer FICA contributions. Naturally the amount of contribution per job will depend upon wage levels, working time and tax status of the individual. Data are available to estimate the potential impact of such contributions, and we have shown in this study such estimates. The key to this part of the off-set to the Treasury of the cost of the use of IRB's is the number of jobs thus created. Since we lack suitable data on the short-run net job creation, we have presented evidence using several alternative assumptions.

It is clear from the foregoing analysis that previous studies have seriously overstated the net costs to the Treasury because of the tax-exempt interest payable on IRB's. It is very difficult to argue for the removal of the tax exemption on IRB's on the grounds of the costs to the Treasury in terms of foregone tax revenues.

PAYROLL TAX DATA

	CT	OK	NY	NH	GA	IL	AR
Annual Wage	$10,655.00	$9,832.00	$10,735.00	$8,590.00	$8,762.00	$12,025.00	$7,845.00
Federal Withholding Per Year	956.80	748.80	956.20	540.80	540.80	1,263.60	436.80
FICA Per Year Employee	623.40	574.92	627.60	502.54	512.52	703.44	459.12
FICA Per Year Employer	623.40	574.92	627.60	502.54	512.52	703.44	459.12

NOTES:

Annual Wage based on state's average gross earnings for production workers June, 1976.
Source: Employment and Earnings, June 1976, Vol. 22, No. 12, Bureau of Labor Statistics, U.S. Department of Labor.
Federal Withholding Taxes computed from applicable tables assuming four (4) dependents.
FICA computed based on current applicable rates.
FICA Per Year Employer same as Per Year Employee for annual salaries up to $16,000.00.

ARKANSAS

Statistics available for period 1959 - 1977 (June) with some issues eliminated because of incomplete data.

Total issues identified = $703,564,850.

Jobs created by issues = 53,339

Average interest rate = Not known

Assumed interest rate
if taxable bonds = 8.5%

Computed annual U.S. Treasury
Revenue loss = $703,564,850 x .085 x .5 = $29,901,506/Year.

Computed annual payroll
created by issues = 53,339 x 3.80/Hour x 39.7 Hours/Week x 52 Weeks/Year = $418,429,510/Year.

Computed annual payroll taxes:

Federal Income Tax	-	$23,298,475
FICA (Employee)	-	24,489,001
FICA (Employer)	-	24,489,001
TOTAL		$72,276,477/Year

CONNECTICUT

Statistics available for period July 1973 - June 1977

Total issues identified = $100,037,984.

Jobs created by issues = 5,152

Average interest rate = Not known

Assumed interest rate
if taxable bonds - 8.5%

Computed annual U.S. Treasury
Revenue loss = $100,037,984 x .085 x .5 = $4,251,615/Year.

Computed annual payroll
created by issues = 5,152 x $5.01/Hour x 40.9 Hours/Week x
52 Weeks/Year = $54,895,937/Year.

Computed annual payroll taxes:

Federal Income Tax	-	$4,929,434
FICA (Employee)	-	3,211,757
FICA (Employer)	-	3,211,757
TOTAL		$11,352,948/Year

GEORGIA

Statistics available cover year 1975

Total issues identified = $30,250,000.

Jobs created by issues = 1,636

Average interest rate = Not known

Assumed interest rate
if taxable bonds = 8.5%

Computed annual U.S. Treasury
Revenue loss = $30,250,000 x .085 x .5 = $1,285,625/Year.

Computed annual payroll
created by issues = 1,636 x $4.13/Hour x 40.8 Hours/Week x
52 Weeks/Year = $14,334,972/Year.

Computed annual payroll taxes:

Federal Income Tax	- $884,749
FICA (Employee)	- 838,482
FICA (Employer)	- 838,482
TOTAL	$2,561,713/Year

ILLINOIS

Statistics available for 1972 - 1977 (July)

Total issues identified = $32,140,000

Jobs created by issues = 2,236

Average interest rate = Not known

Assumed interest rate
if taxable bonds = 8.5%

Computed annual U.S. Treasury
Revenue loss = $32,140,000 x .085 x .5 = $1,365,950/Year.

Computed annual payroll
created by issues = 2,236 x $5.71/Hour x 40.5 Hours/Week x
52 Weeks/Year = $26,888,481/Year

Computed annual payroll taxes:

Federal Income Tax	- $2,825,410
FICA (Employee)	- 1,572,892
FICA (Employer)	- 1,572,892
TOTAL	$5,971,194/Year

NEW HAMPSHIRE

Statistics available for 1972 - 1977 (July)

Total issues identified = $34,040,000

Jobs created by issues = 4,435

Average interest rate = Not known

Assumed interest rate
 if taxable bonds = 8.5%

Computed annual U.S. Treasury
 Revenue loss = $34,040,000 x .085 x .5 = $1,446,700/Year.

Computed annual payroll
 created by issues = 4,435 x $4.13/Hour x 40.0 Hours/Week x 52 Weeks/Year = $38,098,424/Year

Computed annual payroll taxes:

Federal Income Tax	- $2,398,448
FICA (Employee)	- 2,228,757
FICA (Employer)	- 2,228,757
TOTAL	$6,855,962/Year

NEW YORK STATE

Statistics available cover period 1970 - 1976

Total issues identified = $206,251,000

Jobs created by issues = 13,164

Average interest rate = 7.09%

Assumed interest rate
if taxable bonds = 8.5%

Computed annual U.S. Treasury
Revenue loss = $206,251,000 x .085 x .5 = $8,765,667/Year.

Computed annual payroll
created by issues = 13,164 x $5.20/Hour x 39.7 Hours/Week x
52 Weeks/Year = $141,315,540/Year

Computed annual payroll taxes:

Federal Income Tax	-	$12,595,315
FICA (Employee)	-	8,261,726
FICA (Employer)	-	8,261,726
TOTAL		$29,118,767/Year

OKLAHOMA

Statistics available are based on sample of 27 projects

Total issues identified = $58,000,000

Jobs created by issues = 5,979

Average interest rate = Not known

Assumed interest rate
if taxable bonds = 8.5%

Computed annual U.S. Treasury
Revenue loss = $58,000,000 x .085 x .5 = $2,465,000/Year

Computed annual payroll
created by issues = 5,979 x $4.68/Hour x 40.4 Hours/Week x
52 Weeks/Year = $58,783,992/Year

Computed payroll taxes:

Federal Income Tax	- $4,477,075
FICA (Employee)	- 3,437,446
FICA (Employer)	- 3,437,446
TOTAL	$11,351,967/Year

STATEMENT OF THE FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Introductory Statement

The American Institute of Certified Public Accountants is the sole national organization of professional CPAs. It was established in 1887 and currently has over 140,000 members.

On April 7, 1978, the AICPA submitted comments to the House Ways and Means Committee on many of the President's 1978 tax proposals. Most of the recommendations we opposed are not included in H.R. 13511. Some amendments we favored are also omitted. With a few exceptions, we believe that H.R. 13511 is generally consistent with the positions we adopted and presented to the Ways and Means Committee. Our accompanying comments on H.R. 13511 are, therefore, limited to some general observations that we think are particularly pertinent, and a few specific provisions with respect to which we have previously expressed our disagreement. We have also previously commented to the Senate Finance Committee on a number of the provisions of H.R. 6715 and on various proposals to modify carryover basis (see attachment 1).

As intimate observers of the effects of our tax system on taxpayers in general and on the business community in particular, the AICPA is seriously concerned about what seems to be an accelerating pace of tax law changes. A list of all the major and miscellaneous additions to the amendments of the Internal Revenue Code enacted since June 30, 1969 (a period of nine years) is attached to this statement (attachment 2). That list runs almost seven pages. Most of the amending acts are minor, but a growing number are quite significant—and even the minor changes can be important to a significant group of taxpayers. As a result, CPAs are observing a serious phenomenon. Even our most sophisticated clients are beginning to despair understanding the system and how it affects them or their businesses. The constant changes, actual, proposed or suggested, make it very difficult to plan ahead and may very well be impeding business expansion and development. Cliche or not, it is true that business has difficulty with uncertainty. Constant changes in tax rules have become an important element of uncertainty. The Institute urges that the interim between major tax legislation be extended so that taxpayers can plan their affairs under a stable set of rules. The interim could then be used to study, discuss and refine proposed changes. Then, at the appropriate time, major revisions could be made with greater consensus and fewer imperfections. The AICPA would suggest that such a procedure would be, in and of itself, a major contribution to the professed goal of tax simplification.

TITLE I, SUBTITLE A—TAX REDUCTIONS AND EXTENSIONS

While the Institute supports a substantial reduction in personal income taxes because of the effects of inflation and increase in social security taxes, it does not have a position on the allocation of the reduction among income groups. These difficult decisions are appropriately made by Congress, as the people's representatives. Nevertheless, in making such decisions, the AICPA is sure that Congress will wish to consider the manner in which the burden of income taxes is presently borne.

It was pointed out recently, for example, that taxpayers with "expanded income" of $50,000 or more (using 1976 levels of income—see attachment 3) received 31.2 percent of the benefits of all "tax expenditures". It should also be noted, however, that this group, which made up 1.4 percent of taxpayers, received 10.7 percent of the total expanded income and was liable for 23 percent of the total individual income taxes. Thus, this small group of taxpayers owed more than twice their share of taxes as compared with their share of income. A more detailed comparison of the share of tax liabilities and tax expenditures at some levels of expanded income is even more enlightening. Taxpayers in the $30,000–$50,000 expanded income range owed 16.2 percent of the total taxes and received 16.7 percent of the tax expenditures. In the $50,000–$100,000 range, the shares are 12.2 percent and 13.6 percent respectively and from $100,000–$200,000 the equivalent shares are 6.0 percent and 7.8 percent. Only at the very highest brackets of taxpayers with expanded income of $200,000 or more do you get as high a disparity as 4.8 percent of tax

and 9.8 percent of tax expenditures. The AICPA would surmise that these figures will, if anything, skew further against higher income taxpayers in 1977.

The thrust of these statistics is to suggest that our often maligned income tax system, though far from perfect, works better than commonly perceived. The Insitute thinks, therefore, that the fairness and the effects of continually allocating a greater percentage of the burden to relatively higher income groups (who, incidentally, are often working men and women) should be seriously questioned. To the extent that H.R. 13511 distributes its reduction in regular income taxes in proportion to the present distribution of the tax burden among the various income groups, it is responsive to this concern.

Section 202—Extension of at risk provisions to closely held corporations

The AICPA does not agree with extending the "At Risk" rules to closely-held corporations (corporations that have five or fewer shareholders owning more than 50 percent of their stock). While non-recourse financing has been a problem at the individual level, there is no real evidence that corporations, other than Subchapter S corporations and personal holding companies, have used the *Crane* case rule other than in the ordinary course of their businesses. There is also no reason to distinguish between closely-held corporations and widely-held ones. Until such evidence is found, remedial legislation should continue to exclude corporations other than Subchapter S or personal holding companies.

Section 211—Penalty for failure to file partnership return

Section 211 provides a penalty of $50 per partner per month for up to five months for failure to timely file a complete partnership information return. This penalty is in addition to the criminal penalties imposed by Code section 7203 for willful failure to file a return, supply information, or pay a tax. There are also penalties applicable to the same income at the individual taxpayer level. The AICPA believes that the penalty provided by Section 211 should be consistent with the penalties that are currently assessed for failure to file other information documents, such as Forms 1086 and 1099.

TITLE III, SUBTITLE D, PART I—PROVISISONS RELATING TO SUBCHAPTER S

The AICPA generally agrees with the tax proposals that would liberalize the Subchapter S rules. However, the AICPA has submitted, under separate cover, a comprehensive *Proposal for Complete Revision of Subchapter S Provisions*, dated February, 1978. This AICPA proposal goes far beyond the House-passed provisions, and expresses the AICPA's definitive views on needed Subchapter S reform. Certain of the AICPA proposals—those related to areas covered in the House-passed bill—are included in the discussion that follows.

Section 331—Subchapter C corporations allowed 15 shareholders and section 332—permitted shareholders of subchapter S corporations

The AICPA agrees in principle with the expansion of ownership requirements to embrace more shareholders, i.e., the increase in allowable shareholders from 10 to 15, the addition of the grantor of a grantor trust as an allowable shareholder, and the treatment in all cases of a husband and wife as a single shareholder.

However, the expansion of eligible shareholders should not stop here. The AICPA advocates the complete elimination of any numeric limitation on the number of shareholders of an electing small business corporation, as long as all shareholders consent to Subchapter S treatment. Furthermore, the AICPA recommends that ineligible shareholders be restricted only to foreign persons and public corporations. For example, eligible shareholders should, at least, include Small Business Investment Companies (SBICs), Employee Stock Ownership Plans (ESOPs), and Tax Reduction Act ESOPs (TRASOPs).

The AICPA believes that further liberalization of Subchapter S ownership requirements will provide additional capital resources to small businesses and will reduce the incidence of double taxation.

Section 333—Extension of period for making subchapter S elections

The provision in the House-passed bill to expand the period of time to make the Subchapter S election to include the entire preceding taxable year of the corporation and the first 75 days of the taxable year for which the election is effective is a desirable improvement over the present law.

The AICPA, however, believes the election privilege should be further extended to allow the election and consents to be made up to the filing date of the corporate tax return. This procedure would be consistent with other corporate elections, such as the election to file consolidated returns and the adoption of the LIFO inventory method. This procedure would also be analogous to the provision which permits amendment of a partnership agreement any time prior to the unextended due date of the partnership return. An extended election period will also provide greater certainty of a proper election, particularly with respect to the first year of corporate existence where the exact date of the beginning of the taxable year is questionable.

As stated in the introduction to this section, the AICP has issued its comprehensive recommendations for revising the Subchapter S provisions. The AICPA asks Congress to give full consideration to these recommendations in connection with the specific comments on this legislation.

TITLE IV—CAPITAL GAINS

In general, the AICPA opposes any further increase in the Federal income tax burden on long-term capital gains. There is, we believe, general recognition of the importance of increasing the pool of investors in this country. The tax incentives for that purpose should, if anything, be increased rather than diminished. Our detailed views are set forth in the AICPA's Statement of Tax Policy Number 1, *Taxation of Capital Gains*, copies of which we would be pleased to make available.

Section 401—Repeal of alternative tax or capital gains of individuals

The AICPA opposes the repeal of the existing alternative tax on capital gains. Retention of the alternative tax on the first $50,000 of annual long-term capital gains serves a particularly useful purpose. It must be remembered that the alternative computation provides a "ceiling" on the tax. The actual liability may, of course, be lower—it can't be higher. In our judgment, this tax relief provides a meaningful incentive for taxpayers with some investable funds to make the decision to invest.

It should be noted that while the proposed legislation would generally decrease the tax on long-term capital gains, the repeal of the alternative tax would increase the tax on such gains for many investors. For example, a widow with $75,000 in net taxable income, realized from dividends and interest who realizes a long-term capital gains of $50,000, would pay over $3,000 more in taxes under the proposed bill than she would under existing law This is demonstrated by the following computations. (Note that the proposed reductions in the tax rates and the proposed changes in the minimum tax on capital gains do not offset the effect of the proposed change in the alternative tax.)

1978 tax

Tax on $75,000:	
Tax on $72,200	$32,790
Plus 66 percent times $2,800	1,848
	34,638
Alternative Tax on Capital Gains	12,500
	47,138
Minimum Tax:	
Total Tax Preferences	$25,000
Less one-half of income tax reduced by general tax credit (47,138 minus 180 divided by 2)	23,479
	1,521
	×.15
	228
	47,366

1979 tax under H.R. 13511 as passed by the House

Tax on $97,700	$48,813
Plus 69 percent times 2,300	1,587
	50,400
Proposed law	50,400
Existing law	47,366
Difference	3,034

We believe that a tax increase, as illustrated above, is an undesirable result, and is contrary to the goals intended to be achieved by the over-all reduction in long-term capital gains taxes contained in H.R. 13511.

ATTACHMENT 1.—COMMENTS ON VARIOUS PROPOSALS TO MODIFY CARRYOVER OF BASIS ON H.R. 6715

Introduction

In letters dated March 1, 1978, addressed to Senator Russell B. Long, Chairman, Senate Committee on Finance, and to Representative Al Ullman, Chairman, House Committee on Ways and Means, we stated that the Executive Committee of the Tax Division had determined that the AICPA should withdraw its opposition to carryover of basis.

The letters expressed the belief that the provisions of S. 2461, introduced by Senator Hathaway on January 31, 1978, if amended by certain other proposals which have been made by the Department of the Treasury, and others which the AICPA would proffer, would change our previously expressed conclusion that the current law is unworkable. Accordingly, we recommended that the effective date of carryover be deferred—as has been passed upon by the Senate Finance Committee—and that S. 2461, as appropriately amended, be enacted to become effective at the end of the deferral period. We also urged that further hearings be held in the near future so that the merits of further proposals to amend carryover could be weighed.

The AICPA has been pleased to see that sincere criticisms of the carryover basis rules have been met by responsible and constructive proposals, of expanding scope and perception, by the Department of the Treasury (in the form of a memorandum dated January 9, 1978, and addressed to the Joint Committee on Taxation) and those embodied in bills introduced by Senator William D. Hathaway (S. 2461), and Representative William A. Steiger (H.R. 10617). There are some differences among the proposals to change and improve the carryover basis rules, and there are matters as yet untouched by the proposals. In the comments which follow, the AICPA expresses its support for various proposals, its preferences where differences exist, and offers suggestions for further improvement in the rules.

In addition to the Hathaway and Steiger bills cited above, reference will be made to the bill introduced by Senators Harry F. Byrd, Jr. and Robert Dole (S. 2228).

PART I—PROPOSAL FOR MODIFICATION OF CARRYOVER BASIS WHICH ARE SUPPORTED THE AICPA

1. Exclusion from carryover

Under the Tax Reform Act of 1976, the carryover basis rules apply to estates containing $60,000 of carryover basis property. Consequently, although the executor may not be obliged to file a Federal estate tax return, he may nonetheless be obligated to perform the search of the decedent's records—for purchase dates and prices of assets—make the extensive computations, and maintain records and issue information called for under the carryover rules. The process is time-consuming, expensive, and unproductive of sufficient revenues to make the rigors of compliance justifiable in the case of estates of modest size.

The AICPA strongly urges adoption of the immediate outright exception from carryover provided for estates consisting of $175,000 or less of carryover basis property granted by both the Hathaway (S. 2461) and Steiger (H.R. 10617)

bills. The $175,000 figure corresponds to the exemption equivalent of the estate and gift tax unified credit when it is fully phased-in by 1981. This approach, as opposed to a phase-in of the exception would be particularly appropriate and would result in little revenue loss if the effective date of carryover is deferred until 1979, as contemplated by the Senate Finance Committee and as we have recommended.

2. Exemption from carryover for personal and household effects

Under current law, an executor can elect to exclude $10,000 in personal and household effects from carryover. This provision purports to solve the problems which would beset executors who must ascertain the bases for multitudes of assets which were in the possession of most decedents.

The AICPA supports the position in the forewords to the Hathaway and Steiger bills, that the exemption is inadequate to accomplish its purpose and should be increased to $25,000. It would be appropriate for the terms "personal and household effects" to be broadly defined so that the intended relief would apply to widely-held non-business tangible assets.

3. Minimum basis adjustment

Consistent with our recommendation for the exclusion of estates with less than $175,000 of carryover basis property from the carryover rules, the AICPA believes that the minimum basis adjustment should be increased from the figure of $60,000 under the Tax Reform Act of 1976 to $175,000 without phase-in, as proposed by the Hataway and Steiger bills.

4. Adjusted basis of personal residence

Determination of the decedent's basis for his personal residence is a particular problem for the Executor under current law. An accurate determination requires identification of every payment for improvements over what might be decades of residency. The Treasury proposals and the Hathaway and Steiger bills each offer resolutions of the problem, but vary in their details. The approach is an assumption of a dollar amount of improvements for each year the property was held. The Treasury's figure is $750 with a limitation of $30,000.

The AICPA recommends adoption of the Treasury's position. The figure must stand the test of time, and thus should take cognizance of future inflation. We believe that, in the long term, $750 will be reasonably proximate to the improvements made by the typical homeowner subject to carryover of basis.

5. Fresh start adjustment

(a) *Determining both gain and loss.*—The fresh start adjustment increases the bases of the decedent's assets to their values at December 31, 1976 only when gains are being recognized. The adjustment is not applicable for the purpose of determining a loss. Consequently, under present law, two sets of basis figures, each changing by reason of the death tax adjustment, etc. must be maintained.

The Hathaway and Steiger bills provide that fresh start would apply in computing both gain and loss. The AICPA recommends adoption of this solution to a particularly burdensome aspect of the current law.

(b) *Extension of the marketable security rule to other property.*—Securities which are listed on a stock exchange, in an over-the-counter market, and the like, are given valuations based upon their quoted prices. All other assets are valued in accordance with a formula which embodies the assumption that appreciation takes place evenly over the entire holding period. The assumption is patently false when the asset has an established price, or readily determinable value.

The AICPA supports the adoption of the provisions of the Hathaway and Steiger bills which would extend the method of valuing marketable securities at December 31, 1976 to non-convertible, fixed dividend preferred stock, and to other property subject to buy-sell, redemption or other agreements which establish relatively fixed values. (See "II-4", below re Section 306 stock.)

(c) *Estate tax value to calculate fresh start adjustment.*—The fresh start adjustment is calculated with reference to the excess of the date of death values over the decedent's adjusted basis for the property. The Treasury Department's Proposals contain the following recommendation. "The fresh start adjustment would be calculated on the basis of estate tax value rather than date of death value."

The AICPA agrees with the Treasury's recommendation. Where the estate tax return contains the election for alternate values for estate tax purposes, those values are finally determined as a result of the ensuing tax examination; the

date of death values for nonmarketable securities may receive little attention. We believe that the formula method could have reference to estate tax values, and the holding period factor could be modified accordingly.

(d) *Discount alternative to formula method for determining the value of property other than marketable securities.*—The formula method for valuing assets other than listed securities at December 31, 1976 employs the date of acquisition and cost of every item of property other than marketable securities. Determination of these facts from a decedent's records will often be time-consuming and expensive, if not wholly impossible. The Technical Corrections Bill (H.R. 6715) passed by the House of Representatives and reported out by the Senate Committee on Finance on April 19, 1978, recognized the difficulties of proving basis and holding period in the case of tangible personal property such as items of art, antiques, and collections of stamps and coins. The solution provided in H.R. 6715 is to permit the valuation of such property at December 31, 1976 to be established by discounting the date of death valuation at the annual rate of 8 percent.

The Hathaway and Steiger Bills provide the executor with an election to adopt the discount method of establishing a minimum basis for non-business tangible personal property (i.e. such property which was a capital asset in the hands of the decedent), and for certain personal, principal residences; furthermore, they reduce the discount rate to 6 percent. The bill differ to some extent: The Steiger version would not reduce the minimum basis below 50 percent of the date of death valuation; the Hathaway bill sets the floor at 25 percent.

The AICPA supports the Hathaway and Steiger concept of extending the opportunities to use the discount method of valuation; their adoption of a 6 percent discount rate; and establishment of minimums below which bases determined by the discount rate would not fall. We believe that a 6 percent assumed rate of appreciation of assets over a prolonged period is more reflective of economic realities than the 8 percent rate appearing in H.R. 6715. We also believe that the floor under the valuation determined by the discount method is appropriate recognition of the fact that market prices generally do not rise indefinitely without abatement. Accordingly, we support the 25 percent floor as a minimum basis provided by the Hathaway bill.

We note that the Treasury proposals afforded greater scope to the elective discount rate than the bills. According to the Proposals, "The elective discount rule of the Technical Corrections Act would be applied to determine a minimum 'fresh start' basis for *all property held on December 31, 1976 other than marketable bonds and securities.*" We believe that carryover basis raises so many valuation issues that it has the potential of clogging court calendars far into the future. We believe that executors will need a fair and reasonable alternative to specific proof of decedent's basis for all varieties of assets so that they can protest the estate's interest without engaging in litigation. Accordingly, we urge that serious consideration be given to broadening the coverage of the elective discount rule in line wih the Treasury's recommendation.

(e) *Basis information furnished by executors.*—Carryover presents a challenge to those who must compute and then alter the computations of the bases of assets. Because of the need in most cases to resort to imperfect records to establish the fresh start adjustment under the formula method; because of the likely impermanency of the initial determination of death taxes allocable to the appreciation of each asset (discussed in "I–6", below); in general, because of the potentially innumerable variations which would alter basis assigned to an estate's assets, an executor's responsibility—to report to both the Internal Revenue Service and beneficiaries under threat of severe and automatic penalties for inadvertant errors of omission—is a heavy responsibility indeed.

The AICPA supports the provision in the Hathaway and Steiger bills which require submission of information on basis only if the estate contaains more than $175,000 of carryover basis property, and then only to the beneficiary receiving such property. Furthermore, the penalty would be imposed only if the failure to furnish information is due to negligent or intentional disregard of rules and regulations. We believe that the present law constitutes an ill-advised barrier to service as executors by individuals. Those who are aware of the severity of the penalties for purely inadvertant, even trivial transgressions, especially in small estates where the assessment would outweigh commissions, are justified in declining appointment as executors. The tax law should not operate to deny the testator his choice of a representative.

6. Death tax adjustment

The Federal and state death and succession taxes attributable to the unrealized appreciation of each asset are added to basis. The adjustment is made asset-by-asset; and the tax rates employed in the computation are the average rates to which the estate is subject. The prescribed method requires recomputation of the bases of all assets whenever a tax examination or amended estate tax return revises the value of any single asset or the amount of any deduction. The Treasury proposals and the several bills take cognizance of the unusual burden imposed by this method of determining the death tax adjustment. In order to simplify the original computations and reduce the probability of an examination causing a multiplicity of re-computations, they propose that the adjusments be determined by reference to the highest Federal estate tax rates reached by the estate before being reduced by credits.

The AICPA recognizes the critical need to simplify the computations required under the present method of computing the death tax adjustment. In our testimony on carryover basis we protested against a formulation which in the normal course of an estate's administration obligates fiduciaries and beneficiaries to file, and the Internal Revenue Service to process innumerable amended income tax returns. The method proposed by the bills is a vast improvement over present law, and we support the proposed modification. It does not—as does present law—take account of state taxes which exceed the amount of the Federal credit granted for such taxes; and in some states the excess can be substantial. However, since the adjustment is based upon the highest rate of Federal estate tax to which the estate is subject, the impact of the resort to a single table of rates will be tempered.

7. Decedent's capital loss carryovers

The advocates of carryover embraced the concept of equality of tax treatment. A mainstay of their side of the long debate has been a comparison of the tax treatment accorded a taxpayer who sells appreciated property before his death, in contrast to one who holds such assets throughout his lifetime. However, at this juncture, inequality of tax treatment is a by-product of carryover since present law prescribes that a decedent's unused losses expire as conclusively as he does. This fact leads to a correlative illustration of inconstant tax treatment: the estate and heirs of a decedent who had capital loss carryovers, and who sold his appreciated assets before he died are greatly favored over the estate and heirs of a decedent who neglected to take advantage of his carryovers.

Every proposal referred to in this commentary—that of Treasury, and the various bills—recognizes that this anamoly should not exist. The Treasury phrased its proposal as follows: "The unused capital loss of a decedent will carryover to the decedent's estate *and to the distributees of the decedent's estate.*" (Underscoring added). The Hathaway and Steiger bills authorized the allowance of a carryover, "for the estate's first taxable year."

The Institute recommends adoption of a carryover of a decedent's unused capital losses, where the carryover of basis rules apply, to the estate and to its distributees.

8. Depreciation recapture on funding of pecuniary bequests

If appreciated property is transferred in satisfaction of a pecuniary bequest the estate must recognize gain to the extent of the appreciation occurring between the valuation date for estate tax purposes and the date of distribution. The Treasury proposed, the Hathaway and Steiger bills provide, and the AICPA supports a conforming provision: if the property has had basis adjustments subject to recapture, the ordinary income recognized will be limited to the post-death appreciation.

9. Installment obligations distributed by executor

If property is sold by an estate and the installment method of reporting gain is adopted, the transfer by the estate of the installment obligation to a legatee will cause the gain to be recognized. Carryover has made the problem especially acute, although it existed under prior law, since the gains on sales of carryover basis property may be substantial. Treasury proposed not to treat the transfer of an installment obligation to beneficiaries of the estate which sold the property as a disposition accelerating the gain. The Hathaway and Steiger bills adopt this position.

The AICPA believes that the current rule unduly impinges upon the executor's fulfillment of his duties. The installment method of reporting gain reflects the financial realities attending deferred payments. Yet, as executor should terminate his period of administration promptly. If distributions in termination accelerate the gain the tax law has created a quandry and snare for no perceptible reason. Accordingly, the Institute supports the provision which removes transfers of installment obligations to beneficiaries from dispositions accelerating gains.

10. Limitation on section 303 redemptions

In testimony before the House Ways and Means Committee on October 6, 1977, we addressed the problem of the estate of the owner of a closely-held family business. We pointed out that carryover piles income taxes upon estate taxes when the obligation to pay the latter necessitates the sale of assets and that the problem was especially acute in the case of such a business. It was in this context that we expressed concern that Section 303 fails to shelter from dividend income treatment the proceeds of a redemption to pay the income taxes, and, that the overall tax burden resulting from a shareholder's death can force the sale of family businesses.

The AICPA is pleased that the bills introduced by Senators Byrd and Dole, and by Representative Steiger would extend the limits upon a redemption qualifying under Section 303 to cover the amount of income taxes generated by the redemption. We enthusiastically endorse these proposals.

11. Conforming the qualification tests under the relief provisions

In order for an estate to avail itself of the installment payment privilege under Sections 6166 or 6166A, the decedent must have held an "interest in a closely-held business." The definition of such an interest is different for purposes of each section. Under Section 6166, the partners or stockholders may number as many as 15. Under Section 6166A, the figure is limited to 10. The AICPA urged that Section 6166A's definitional standard be conformed to that of Section 6166 in its *Recommendations for Technical Amendments to the Estate and Gift Tax Provisions of the Tax Reform Act of 1976*, submitted to the Ways and Means Committee on February 18, 1977. We are pleased that the Byrd-Dole, Hathaway and Steiger bills embrace the proposition, and we re-affirm our support of its adoption.

12. Capital gain treatment of inherited creative works

Adoption of carryover of basis had the effect of denying capital gain treatment to the estate and heirs of artists, composers and writers upon sale of the inherited creative work. The combination and sequence of estate taxes followed by income taxes at ordinary rates on sales of inherently low basis assets causes the tax burden to reach conficatory levels.

All of the proposals discussed herein—except for the Hathaway bill—would extend capital gain treatment to inherited created works. The AICPA enthusiastically supports the adoption of such a provision.

PART II—ADDITIONAL PROPOSALS BY THE AICPA FOR MODIFICATION OF CARRYOVER BASIS

1. Decedent's loss and deduction carryovers

We have endorsed the carryforward of a decedent's capital losses to his estate and distributees. As noted above (at "I-7") this relief provision appears in the Treasury proposals and the various bills. However, other items of loss and deduction which are allowed to be carried over during the decedent's lifetime expire upon his death. This expiration results in an unfair distinction between taxpayers, as we mentioned in the earlier section cited above.

The AICPA proposes that, during the period of deferral of the carryover of basis rules, the subject of loss and deduction carryovers be studied. The study should determine which items are suitable for allowance from decedent to his estate and its distributees in order to equitably counterbalance the impact of carryover of basis on income producing activities continued to be conducted after the taxpayer's death.

2. Removal of the taint on section 306 stock

Prior to the Tax Reform Act of 1976, the "taint" (in general, the application of ordinary income treatment in the event of sale of certain preferred stock) was removed upon the death of the stockholder. This rule was present in the Code

since the adoption of Section 306 in 1954. The carryover of basis rule had the technical consequence of leaving Section 306 stock with its taint after the death of its owner. As a result, the combination of estate taxes and ordinary income taxes on dividend income could reach confiscatory levels.

The Technical Corrections Bill (H.R. 6175), to a limited extent addresses the effects of carryover on Section 306 stock. It extends the fresh start adjustment to such stock; and permits redemptions to pay death taxes and funeral and administration expenses to qualify for capital gain treatment under Section 303. However, the AICPA in its testimony before the House Ways and Means Committee on September 8, 1977, and in earlier written comments, declared that the amendment applying the fresh start adjustment would fail in its avowed purpose. We pointed out the fresh start adjustment is computed under the special valuation method which presupposes that appreciation occurs at an even rate, day-by-day, over the entire holding period. As a result, when applied to assets having a fixed value such as Section 306 stock, the adjustment to basis would decrease for each day the owner lives past 1976. We believe that this particular problem should be resolved by the extension of the marketable security valuation rule to non-convertible, fixed dividend preferred stock, as provided in the Hathaway and Steiger bills. We expressed our support of this provision above (at "I-5-b").

Nevertheless, the taint remains after the death of the owner of Section 306 stock; and, unless redeemed under Section 303, post-1976 issues will be exposed to an unwarranted level of taxation. No proposal discussed herein offers a remedy for this problem.

The AICPA testified in favor of removal of the taint. We believe that in most instances the closely-held corporation is recapitalized and preferred stock is issued so that retired employees will have a source of income, and younger employees will be encouraged—by sharing to a larger extent in the equity of the business—to remain with a small company rather than seek positions in large public companies. The death of the preferred shareholder adequately rebuts the supposition of Section 306 that the issuance of such stock may well be the first step in a plan to bail-out the earnings of the corporation.

In light of these comments, the AICPA re-submits its appeal for reinstatement of the long-standing rule removing the taint from Section 306 stock upon the death of the shareholder. We believe that the Technical Corrections Bill and the Hathaway and Steiger proposals ameliorate but do not cure the problem facing closely-held corporations. Unless the taint is removed, Section 306 will constitute a barrier to recapitalizations designed to perpetuate the existence of many family-owned corporations.

Comments on the Technical Corrections Act of 1977, H.R. 6715, August 18, 1977

Summary of Contents

The AICPA is pleased to submit comments on H.R. 6715, the "Technical Corrections Act of 1977". The major portion of our comments deals with Section 3 of the bill which contains amendments to the estate and gift tax provisions of the Tax Reform Act of 1976. We also have several comments on items in Section 2 of the bill which contains amendments to income tax and administrative provisions of the Tax Reform Act of 1976.

Comments on Technical, Clerical, and Conforming Amendments to Estate and Gift Tax Provisions (Sec. 3 H.R. 6715)

The AICPA submitted a memorandum entitled *Recommendations for Technical Amendments to the Estate and Gift Tax Provisions of the Tax Reform Act of 1976* to the House Committee on Ways and Means on February 18, 1977. We appreciated the opportunity to make our views known, and we are pleased to note that Section 3 of the Technical Corrections Act of 1977 does contain a number of amendments proposed in the Institute's memorandum.

Part I of our comments contains a listing of the numerous provisions—27 of the 33 amendments—which the Institute unqualifiedly supports for passage by Congress. The numerical preponderence of endorsements signifies our view that, overall, Section 3 of the Bill constitutes a highly commendable effort to make the estate and gift tax provisions more workable and equitable.

Part II of these comments sets forth the AICPA's opinion that in a limited number of instances the amendments reflect policy decisions which deserve reconsideration. Our comments, for the most part, support the principles underlying the amendments, but express some reservations about their formulation. However, we take strong issue with the policy which would cause an estate of a decedent who owned Section 306 stock to be, literally and figuratively, beyond redemption. We believe that closely-held businesses will be adversely affected to a drastic extent.

Comments on Technical Amendments to Income Tax and Administrative Provisions (Sec. 2 of H.R. 6715)

On March 14, 1977, drafts of AICPA recommendations for Technical amendments to provisions of the Tax Reform Act of 1976 other than those of Title XX, estate and gift taxes, were sent to the Joint Committee on Taxation. We are pleased that many of our recommendations have been reflected in Section 2 of H.R. 6715. Our comments on Section 2 are brief since we are in basic agreement with the technical amendments it contains except as described in Parts III and IV of our comments.

Part III contains two items which we do not believe should be included in a technical amendments bill because, as written, they are substantive rather than technical in nature.

Part IV contains several items which we feel should be either rewritten or withdrawn because, as written, they have an incorrect result.

PART I—AMENDMENTS CONTAINED IN SECTION 3 OF H.R. 6715 WHICH ARE SUPPORTED BY THE AICPA

The AICPA unqualifiedly supports the adoption by Congress of 27 of the 33 amendments to the estate and gift tax provisions contained in the Bill. A tabulation of the favored amendments appears below. Our reasons for supporting a number of these amendments are contained in our *Recommendations* dated February 18, 1971 cited in the preceding summary of comments.

The numbers used in referring to the amendments are those appearing in Part B of the report on H.R. 6715, prepared by the staff of the Joint Committee.

Report No.	Description	Bill section	Code section
5	Treatment of indebtedness against carryover basis property	3(c)(2)	1023
6	Only 1 fresh start adjustment for carryover basis property	3(c)(3)	1023
7	Holding period for carryover basis property	3(c)(4)	1223
8	Adjustment to carryover basis property for State estate taxes	3(c)(5)	1023
9	Clarification of increase in basis for certain State succession taxes	3(c)(6)	1023(e)
10	Coordination of carryover basis adjustments	3(c)(7)	1023
11	Basis for certain term interests	3(c)(8)	1001
12	Clarification of the rules relating to special use valuation	3(d)(1)	2032A
13	Use of special use valuation property to satisfy pecuniary bequest	3(d)(2)	2032A
14	Gain recognized on use of special use valuation property to satisfy pecuniary bequest	3(d)(3)	1040
15	Treatment of community property under special use valuation provision	3(d)(4)	2032A
16	Bond to relieve qualified heir of personal liability for recapture of tax where special use valuation is utilized.	3(d)(5)	2032A
17	Security where extended payment provisions are elected	3(e)	6324A
18	(Missing)		
19	Transfer within 3 years of death	3(f)	2035
20	Coordination of gift tax exclusion and estate tax marital deduction	3(g)(1)	2056
21	Coordination of gift tax exclusion and estate tax marital deduction	3(g)(2)	2056
24	Estate tax exclusion for certain retirement benefits	3(j)(1)	2039(d)
25	Annual exclusion for spouse's interest in an individual retirement account	3(i)(2)	2503
26	Gift tax consequences from the creation of a joint tenancy in personal property	3(k)(1)	2515A
27	Fractional interest rule for certain joint tenancies	3(k)(2)	2040
28	Amendments relating to orphan's exclusion:		
	(a) Orphan's exclusion where there is a trust for minor children	3(l)(1)	2057(d)
	(b) Increasing to age 23 for terminable interest in the care of orphans' exclusion	3(l)(2)	2057(c)
29	Disclaimers	3(n)	2518
30	Termination of certain powers of independent trustees not subject to tax on generation-skipping transfers.	3(n)(1)	2613
31	Clarification of rules where a beneficiary has more than 1 power or interest in a generation-skipping trust.	3(n)(2)	2613
32	Alternate valuation date in the case of a generation-skipping trust	3(n)(3)	2602
33	Adjustment for trust accumulation distribution subject to transfer tax	3(o)	667
34	Clerical amendments	3(p)	(1016, 2051, 6324B, 6690).

PART II—AMENDMENTS CONTAINED IN SECTION 3 OF H.R. 6715 WHICH THE AICPA RECOMMENDS BE REVISED OR WITHDRAWN

1. Fresh start adjustment for certain preferred stock (sec. 3(a) (1) of the bill and sec. 306 of the code)

Present law.—Prior to the Tax Reform Act, property held by a decedent at his death generally acquired a basis equal to its fair market value at the date of death or alternate valuation date under Section 1014. For the taint of Section 306 to remain with stock after a transfer its basis must be determined by reference to the basis of Section 306 stock (Section 306(c)(1)(C)). Thus Section 306 stock lost its taint when, by reason of the death of its owner, its basis was determined under Section 1014.

Section 1023, added by the Tax Reform Act, provides for carryover of, or transferred basis for property acquired from a decedent dying after 1976. So, the Section 306 taint remains with stock passing to the owner's estate or heirs. As a result, a sale or redemption of the stock will result in dividend income treatment for the amount realized, to the extent of the stock's ratable portion of the corporation's earnings and profits.

The carryover of basis provisions are modified by the "fresh start" rule, designed to prevent pre-1977 appreciation in property held by a decedent on December 31, 1976 from being subject to income taxation. But, under present law the basis of Section 306 stock is not a factor in determining the attributable dividend income. Consequently, the impact of Section 1023 is to bring pre-1977 corporate earnings and profits within the measure of the taint attaching to Section 306 stock in the hands of the estate or heirs. The report of the Staff of the Joint Committee aptly observes: "the 'fresh start' provision for carryover basis purposes will provide little, if any, relief for Section 306 stock issued before 1977".

Proposed change.—The Bill would permit dividend income on the disposition of Section 306 stock, which was distributed before 1977, to be reduced by the basis of the stock on December 31, 1976, including any increase of basis under the "fresh start" rule contained in Section 1023(h). The report of the Staff sets forth the objection of the "fresh start" rule as it is embodied in the amendment: "to continue prior law for appreciation occurring before January 1, 1977 * * *."

AICPA comments.—The proposed change will not accomplish its objective. The AICPA urges adoption of one of its series of recommendations appearing at the end of these comments.

The "fresh start" for property, other than securities for which market quotations are readily available, is computed under a special valuation method. This method, which would apply to Section 306 stock, adopts the unconditional assumption that appreciation occurring between the dates of acquisition of the property and the decedent's death occurred at a perfectly even rate. However, if Section 306 stock has a clearly identifiable characteristic it is stability of value. Ordinarily, the terms and conditions of its issuance fixes its actual value at or about its par value. Any change comes about only as a function of its dividend rate to otherwise available investment yields. Also, Section 306 stock usually has a low adjusted basis since it derives from common stock in closely-held corporations having low capitalizations.

When low basis is combined with static valuation the application of the "fresh start" special valuation method formula will produce an appalling curiosity in the tax law: for each day the owner of Section 306 stock lives past 1976 his share of earnings and profits which are immune from dividend income treatment will fall. This penalization of longevity obviously contravenes the facts and the avowed purpose of the amendment.

The AICPA firmly believes that the position, set forth in its Recommendation dated February 18, 1977, and quoted below, should be adopted:

"The AICPA recommends that Section 306(c)(1)(C) should be amended to provide that the definition of Section 306 stock does not include stock which has its basis determined under Section 1023. Voluntary transfers by gift of Section 306 stock causes taint to pass through to the beneficiary. As an expression of policy, this serves the purpose of the section. But, death results in the involuntary and unavoidable transfer of the stock. Furthermore, death often necessitates the sale of property to pay taxes, debts and expenses or to best serve the sudden financial needs of the family. Carryover of basis will result in the recognition of gains, and the Section 306 stock taint would beset an estate with inordinate

taxes. If our recommendation is not adopted, the so-called 'classic recapitalization,' the transfer of control of a closely-held corporation from older to younger generations, would be adversely affected. When Section 305 previously was amended, and could have been interpreted as impeding such recapitalizations, that legislative intention was specifically disclaimed by Senator Long. We assume, therefore, that Congress did not foresee this ramification of carryover."

Since the date the foregoing was written, we have been told that the impact of carryover on Section 306 was recognized in advance of passage of the Tax Reform Act. If that is so, then the AICPA's plea is for reconsideration of the legislative judgment. In the long-run it will have unfortunate consequences. It will inevitably prompt closely-held businesses, the mainstays of the economies of a multitude of communities throughout the nation, to conclude that no opportunity—certainly not reallocation of stock amongst shareholders—remains open to perpetuate their existences.

We made the point above that the proposed amendment applying "fresh start" to Section 306 stock will not effectively accomplish the declared purpose of continuing prior law for appreciation occurring before 1977. So, as an alternative to its suggestion that prior law with respect to such stock be reinstated, the AICPA recommends that Section 306 stock which was *issued before 1977* be freed of the taint upon the death of its owner. This would achieve what the proposed amendment tries and fails to do. Practically speaking, there will be little if any post—1976 appreciation in such stock since its share of the shareholder's equity and rate of return usually will not vary after its issuance. This last point could be given statutory recognition (if Congress deems it necessary to apply strictures to post—1977 issues of Section 306 stock) : a material change of the terms of the stock subsequent to 1976 might result in denial of the exemption from Section 306 upon the death of the owner, i.e. the stock could be treated as if it had been issued after 1976. Under these conditions, if any appreciation does occur it will result from changes in general money market conditions; and such appreciation has long been subject to capital gains taxation.

Finally, we recommend the following as an alternative to disappearance of the taint at death (which we favor) for post-1976 issues of Section 306 stock:

(1) The adjusted basis of the stock (including the "fresh start" adjustment) should be available as an offset to dividend income reportable by the estate or heirs upon a sale or redemption.

(2) The period used in the computation under the special valuation method should run only to the date of issuance of the Section 306 stock. This recommendation is in recognition of the fact that the period after issuance of the stock essentially is one of static caluation. Therefore, we would establish a "fresh start" valuation at December 31, 1976 which would not erode over the lifetime of the owner. More importantly, this change in technical Amendment Number 1 would acknowledge the essential function of the "classic recapitalization" referred to with approval by Senator Long in his above-cited discussion of Section 305, and would remove the drastic inhibition upon its use now present in the law.

2. Redemptions of certain preferred stock to pay death taxes (sec. 3(a)(2) of the bill and sec. 303 of the code)

Prior law.—Before the Tax Reform Act, Section 306 stock received a stepped-up basis; lost its taint; and, if it constituted a sufficient proportion of the gross or taxable estate, it could be redeemed under the protection against dividend treatment afforded by Section 303. How the carryover privision served to cause the taint to remain, and what is being proposed to mitigate the consequences are discussed in our comments on Amendment Number 1, above. However, the Act was silent on whether or not Section 306 stock still might qualify for redemption under Section 303.

Proposed change.—Section 303, under the proposal, would be amended so that it would not apply to a distribution in redemption of Section 306 stock. Thus, dividend income would result from the redemption. The extent of the dividend income would depend upon the factors established in Amendment Number 1: whether or not the issue date precedes 1977; the longevity of the owner, etc. Post-1976 issues would bear the full brunt of estate taxes and dividend income treatment.

AICPA comments.—The AICPA recommends that the proposed amendment be withdrawn and a substitute be adopted which will declare the eligibility of Section 306 stock for Section 303 treatment.

Amendment Number 2 appears to be a determination that the mere ownership of stock to which the label "Section 306 stock" attached was a represensible act on the part of the deceased. Accordingly, when the misfortune of death occurs—and the estate thereby is forced to liquidate assets to pay taxes, debts and expenses—it is then that an arbitrary, severe and discriminatory rule will apply.

Section 306 was designed to prevent the bail-out of earnings. But, it should be recognized that Section 302 applicable to corporate stock generally, also was designed to prevent redemptions constituting bail-outs. So all stock carries with it the potential for bail-out. Furthermore, bail-outs do not take place unless and until stock is sold or redeemed; and sales and redemptions made necessary by death are hardly the appropriate target of tax provisions enacted to penalize the culpable.

Section 303 amounts to statutory recognition of this point; it added a note of compassion to the tax law: death is the time when assets accumulated over a lifetime become subject to a tax on capital: and, if the income tax law does not accommodate liquidation of assets to pay that tax, the cumulative taxes can reach confiscatory levels. Section 303 provides a realistic accommodation between the estate and income tax provisions. Why then adopt the discriminatory rule of the proposed amendment if both Section 306 stock and other corporate stock carry the potential for bail-out during the lifetime of their owners? Perhaps it is common stock which has the greater potential, since its share of undistributed earnings and profits grows while Section 306 stock ordinarily has a fixed dividend and and established share of the earnings and profits.

The AICPA would like to see the proposed amendment be reversed for the reasons stated above, but also because in its present form it inevitably will damage the prospects of many closely-held companies. Recapitalizations will be avoided which otherwise could have enabled small companies to compete with the large for management, and could have helped meet the differing financial needs of the stockholders (not by bailing-out earnings—that is proscribed by Section 306 but rather by providing different dividend rates, and participations in the growth of the business).

3. Deduction or adjustment to basis for estate tax on appreciation (sec. 3(b) of the bill and sec. 691 of the Code)

Present law.—When ordinary income or capital gain is realized by a decedent, but is recognized in whole or in part by his estate or heirs (as "income in respect of a decedent", exemplified by gains recognized over a period spanning the date of death) the death taxes attributable to the income or gain is allowable as a deduction under Section 691(c). The deduction may be utilized in full against long-term capital gains. A ch...n of cases supports this position (*Meissner*, 354 F. 2d, 409 (Ct. Cls., 1966), *Goodwin*, 458 F. 2d 108 (Ct. Cls., 1972), *Quick*, 503 F. 2d 100 (10th Cir., 1974), *Bridges, Jr.*, 64 TC 968 (1975), and *Sidles Est.*, 65 TC 873 (197).

Before the Tax Reform Act of 1976, the basis of assets other than income in respect of a decedent, was "stepped-up" to its date of death or alternate value. The carryover of basis provisions of the Act did away with this treatment. But, to avoid double taxation, they authorize an adjustment to basis not a deduction, for the Federal and State death taxes attributable to appreciation.

Proposed change.—It is the disparity of treatment between the deduction accorded death taxes on income in respect of a decedent and the adjustment to basis on appreciation of other assets which is to be remedied by the proposed amendment. Where income in respect of a decedent is long-term capital gain there will be no deduction for the attributable tax; instead, the basis of the property will be adjusted therefor.

AICPA comments.—The AICPA believes that amendments which purport to be technical and noncontroversial, and which will be voted upon by Congressmen in that light, should not contain provisions which overturn an established body of case law. This particular change is clearly substantive and should undergo the review and debate normally associated with such measures. Consequently, without expressing our opinion on the merits of the proposal, we urge its deletion from the Technical Corrections Bill of 1977.

4. Fresh start adjustment for certain carryover basis property (sec. 3(c)(1) of the bill and sec. 1023 of the code)

Present law.—The "fresh start" adjustment to basis (for property other than securities for which market quotations are readily available) is the product of

a formula using the date of acquisition and the cost of the property. These basic facts may be impossible to determine by the executor or the heirs. Particular difficulties would arise in the case of collections of tangible items accumulated over the years by the decedent.

Proposed change.—The amendment would establish a minimum basis. The value at date of death is the reference point; a discount at 8 percent a year is applied over the period measured back from the date of death to December 31, 1976.

AICPA comments.—The Institute is concerned that the presence in the Code of a minimum basis provision employing an exceptionally high assumed rate of appreciation will encourage examining agents to reject less than perfect evidence of dates of acquisition and the cost of items of tangible personal property. Accordingly, the AICPA recommends: (1) the adoption of a liberal standard of proof required of the executor or heirs; and (2) minimum basis be determined by assuming that post-1976 appreciation will accrue at a 6 percent, rather than the 8 percent rate appearing in the proposed amendment.

We believe that a survey of valuation trends over any extended period would confirm that the lesser figure is nearer the historic appreciation rates. Furthermore, there is no apparent reason to abandon the 6 percent factor found in the standard valuation tables currently used for tax purposes.

The AICPA also urges consideration of a widening of the scope of Amendment Number 4. It was designed specifically to deal with the absence of information where that condition would be commonplace: where collections of valuable items were assembled over a period of time. But, it is overly optimistic to assume that adequate records with respect to all other property will be maintained by every taxpayer and readily available to his executor and heirs. The courts will be resorted to in many cases to resolve basis issues. This prospect prompts the Institute to recommend a broad minimum basis provision which should relieve the pressures to litigate.

22. Split gifts made within 3 years of death (sec. 3(h) of the bill and sec. 2001 of the code)

Present law.—Section 2513 of the gift tax law provides that, where gifts are made by a husband or wife to a third party, the other spouse may consent to being treated as having made half the gift for gift tax purposes. The consenting spouse will apply her credit (assuming for our purpose a donor husband who predeceases) to offset the resultant tax, and the credit thereby will be exhausted in whole or in part. In addition, since the amount subject to the estate tax is comprised of both the taxable estate and the amount of taxable gifts made after 1976, the amount to which a spouse consents will be subject to estate tax at her death. Nevertheless, if the actual donor dies within three years of the date of a gift, it will be included in his estate under Section 2035, as amended by Act Section 2001(a). The result of these rules is that the property reflected in the consenting spouse's gift tax return and which causes exhaustion of the credit and an addition to her estate, will be subject to tax in the donor-spouse estate. The Tax Reform Act did not provide restoration of the gift tax credit to the surviving spouse; nor does it reduce the amount of her taxable gifts to be added to her taxable estate.

Proposed change.—Section 3(h) of the Bill partially corrects this problem by providing that for estate tax purposes a gift will be eliminated in determining "adjusted taxable gifts" in the computation of the tentative estate tax. But the Bill does no reverse the transaction's tax consequences for gift tax purposes. Therefore, the surviving consenting spouse must continue to use the split gift which was included in the decedent's estate in computing his or her taxable gifts for gift tax purposes. Further, if the consenting spouse had used any of his or her uniform credit against the tax due on the split gift it is not restored until death.

AICPA comments.—The Institute is pleased to see a correction made for this problem for estate tax purposes, but as indicated in our *Recommendations* dated February 18, 1977, we believe that the gifts reported by the consenting spouse under the circumstances described also should be adjusted for gift tax purposes. We feel that the attained level of gifts should be adjusted and any unified credit used should be restored as if the consent had not been given in the first instance.

We would recommend that the surviving spouse be given an opportunity to file a claim for refund for any overpayment of taxes which result from this adjust-

ment. If this procedure is not practical, then we would recommend that the above adjustment be made to the attained level of "adjusted taxable gifts" and that any unified credit used be restored but that any "excess taxes" paid be allowed as a credit against future gifts. Further, total taxes paid would be allowed as a credit against the tentative estate tax. We feel it is unfair to make a donor under these circumstances compute his or her gift taxes at an artificially higher rate during their lifetime than someone else who's made effectively the same dollar value of gifts. Further, we feel it is inequitable not to restore to a donor his or her uniform credit.

23. Inclusion in gross estate of stock transferred by the decedent where the decedent retained voting rights (sec. 3(i) of the bill and sec. 2036(b) of the code)

Present law.—The tax Reform Act added the following sentence to Section 2036(a): "* * * the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock". The provision requires inclusion in the donor's gross estate of the value of stock given as a gift even where the stock is that of a public company and control is absent.

Proposed change.—The proposed amendment changed the above-cited language to the following "* * * the direct or indirect retention of voting rights with respect to a *controlled corporation* shall be considered to be a retention of enjoyment of transferred property". (Emphasis added). A "controlled corporation" for this purpose is defined as one in which the decedent owned (including constructively), or had the right to vote, stock having 20 percent of the corporation's voting power.

AICPA comments.—The AICPA believes that the proposed amendment has needlessly broad reach, far beyond the problem addressed by the Tax Reform Act provision. The Institute's recommendations appear at the end of this discussion.

Our *Recommendations*, dated February 18, 1977, expressed the belief that a donor's estate should not include transferred stock in a public company where there is no vestige of control. The policy underlying the proposed amendment appears to adopt that premise. However, the amendment is not, as it should be, merely corrective in this regard.

The Tax Reform Act provision which is to be amended addressed itself to overturning the Supreme Court's decision in *Byrum*, 408 U.S. 125 (1972). The Court held that the transferred stock of a closely-held corporation, controlled by the donor, was not includible in his gross estate despite reservation of his power to vote the stock. Accordingly, Section 2036(a), quoted above, deals only with transferred stock where voting rights with respect to that stock was retained. The proposed amendment does not set such a logically limited standard. Rather if voting rights are held in 20 percent of the stock of the corporation—with constructive ownership rules specifically invoked—then it does not matter that years ago as much as 80 percent of the stock was given away, no strings attached. Under those circumstances, and, we emphasize, no matter how many years have passed since the transfer took place, the transferred stock would be drawn back into the donor's estate.

The AICPA believes that the problem has two facets. Accordingly, there should be two distinct selective processes: (1) of the corporations to which the anti-Byrum provision, should apply; and (2) of the specific stock of subject corporations which should be in the donor's gross estate.

The AICPA recommends that a corporation should not be considered for purposes of the anti-Byrum provision unless the decedent owned an establishhed percentage of the corporation. We do not take issue with use of the 20 percent figure employed in the amendment. This standard would cull out those corporations in which the decedent possibly could exercise control, and would eliminate from further consideration ownership of interests in most public companies. Secondly, the AICPA recommends that, where the first test is met, the only stock which would be includible in the donor's gross estate would be the specific stock over which he retained voting rights. Nevertheless, if Congress concludes that voting rights effectively might be retained where the decedent keeps a dominative portion of the voting stock, then we would recommend a second percentage test: the donor must have retained a much greater percentage—more than 50 percent—of all of the voting stock of the corporation in order for the transferred stock, over which he held no voting rights, to be includible in his gross estate.

PART III—AMENDMENTS CONTAINED IN SECTION II OF H.R. 6715 WHICH THE AICPA RECOMMENDS BE REVISED OR WITHDRAWN BECAUSE OF THEIR SUBSTANTIVE NATURE

The AICPA feels that the following two items should not be included in a technical amendments bill because, as written, they are substantive rather than technical in nature.

Bill section: 2(b).

Code section: 58(b).

Topic: Division of corporate $10,000 minimum tax exemption to members of a controlled group.

Recommendations.—Prior to the 1976 Act, generally a corporation's minimum tax exemption was $30,000 plus the amount of income taxes otherwise imposed (the regular tax deduction). In the case of a controlled group, the exemption was allocated among the members of the group equally or according to a plan adopted by the members of the group. The 1976 Act changed the exemption for corporations to the greater of $10,000 or their regular tax deduction, but did not change the manner in which the exemption could be apportioned in the case of a controlled group.

This bill would require the allocation of the $10,000 exemption in proportion to each member's regular tax deduction.

Since the technical amendments made by H.R. 6715 are intended to clarify and conform various provisions adopted by the 1976 Act, this proposed amendment to Section 58(b) should be deleted. All the 1976 Act did was reduce the $30,000 minimum tax exemption to $10,000, which change does not require a technical amendment.

The amendment as proposed is not logical, and would be unfair to controlled groups of corporations since it would allocate the $10,000 exemption to the member corporations with the highest regular tax deductions even if they did not have any preference items. Other members of the controlled group with smaller or no regular tax deductions would obtain little or no benefit from any allocation of the $10,000 exemption.

The proposed amendment also creates a technical problem in situations where there is no regular tax deduction. Apparently, there would be no allocation of the $10,000 exemption in these situations.

If there is a desire to eliminate the elective allocation, we suggest that Section 58(b) be amended to provide that the $10,000 exemption be allocated in proportion to each member's amount of tax preference items.

Bill section: 2(i).

Code section: 368(a)(2)(F).

Topic: Definition of "Securities" in certain transactions involving two or more investment companies.

Bill Section 2(i)(1)(C) amends Section 368(a)(2)(F) to provide a new definition for securities which is much broader than the present definition. This is more than a technical amendment; it is really a substantive change.

It is, therefore, recommended that this change be withdrawn or at least that the effective date be changed to no earlier than April 29, 1977, the date this bill was introduced to the Committee on Ways and Means. As currently included in H.R. 6715 this definition can retroactively change a previously qualifying tax-free reorganization into a taxable event.

PART IV.—AMENDMENTS CONTAINED IN SECTION 2 OF H.R. 6715 WHICH THE AICPA RECOMMENDS BE REVISED OR WITHDRAWN

For the reasons given in the following items, the AICPA feels that they should be rewritten or withdrawn.

Bill section: 2(i)(1)(A).

Code section: 368(a)(2)(F).

Topic: Certain transactions involving two or more investment companies.

Recommendations.—Bill section 2(i)(1)(A) amends Section 368(a)(2)(F) by adding the following sentence at the end thereof:

No loss shall be recognized to any party to the transaction (or to any shareholder or security holder of such a party) by reason of the preceding sentence."

This change makes mergers of certain types of investment companies a taxable transaction; however, loss is not recognized. This is clearly the intent of Con-

gress. However, there should be a specific statutory amendment as part of this Bill to provide for a carryover of basis for the loss on the shares disallowed. No present provision of the Code covers this situation.

Bill section: 2(i) (1) (C).

Code section: 368(a) (2) (F).

Topic: Certain transactions involving two or more investment companies.

Recommendations.—Bill Section 2(i) (1) (C) amends Clause (v) of Section 368(a) (2) (F). The effect of this amendment is to remove the exception that the reorganization of two investment companies, each of which is owned by the same persons in the same proportions, would continue to be a tax-free reorganization. The Committee Reports to the Bill do not indicate that any such change was intended.

It is, therefore, recommended that the present Clause (v) of Section 368(a) (2) (F) be renumbered 368(a) (2) (F) (vii). This would then continue to allow the tax-free reorganization between commonly controlled investment companies.

Bill section: 2(o).

Code section: 704(d).

Topic: Limitation on Allowance of Partnership Losses in Case of Nonrecourse Loans.

Recommendations.—The Tax Reform Act of 1976 provides that the Code Section 704(d) prohibition against including non-recourse debt in a partner's adjusted basis shall not apply to any partnership "the principal activity of which is investing in real property". Section 2(o) of H.R. 6715 deletes the above quoted material and limits this exception to partnerships in which "substantially all of the activities related to the holding of real property for sale or rental".

In order to clarify Section 2(o) of H.R. 6715 it is recommended that the last sentence of Section 704(d) (relating to limitation on allowance of partnership losses) be amended by striking out "the principal activity" and all that follows and inserting in lieu thereof "substantially all of the activities of which relates to the holding of real property (other than mineral property) for investment, sale or rental".

Bill section: 2(q) (13) and (14).

Code section: 6013(g).

Topic: Election to Treat Nonresident Alien Individual as Resident of the United States.

Recommendation.—The changes under section 2(q) (13) and (14) of the Bill affect two non-income tax areas with respect to nonresident aliens. First, they bring into play Section 1491 on transfers of appreciated property to a foreign trust, partnership, etc. for the entire taxable year. They also bring into play the requirements involved with Section 3401 which would require an employer to withhold income taxes for the entire year.

While the changes in the above paragraph would seem logical in that they coordinate the income tax reporting with the withholding tax and the excise tax handling, these changes present one basic problem. The way the revision reads, the change is effective for the entire taxable year of the person involved. Therefore, a nonresident alien electing at the time of filing his return in April could potentially subject his employer and himself to penalties for late filing and late payment of taxes for the entire previous calendar year. This would seem to be an unfair penalty to which to subject someone. While the excise tax liability is a personal one and therefore can be considered among the taxpayer's factors relating to the election, the penalties on the employer relate to matters beyond its control. It would seem that if these changes are to be made, there should be provisions made for relief from any penalty for both the taxpayer and his employer which might arise as a result of late payment of the taxes involved. If such a modification is not made, the AICPA recommends that this provision of H.R. 6715 be withdrawn.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., March 7, 1978.

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

DEAR CHAIRMAN LONG: On behalf of the American Institute of Certified Public Accountants and its approximately 135,000 members, I would like to convey our support for two amendments that were added to H.R. 6715 by the Senate Finance Committee.

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The first amendment was introduced by Senator Haskell and would eliminate IRS rulings from the term "rules and regulations" for the purposes of the tax return preparer penalty provisions which were enacted by the Tax Reform Act of 1976.

At hearings before the Senate Finance Committee on February 3, 1978, Acting Assistant Treasury Secretary Lubick stated that the Treasury Regulations under Section 6694 permit a preparer to take a position contrary to an IRS ruling where he does so in good faith and with reasonable support. Nevertheless, including IRS rulings with "rules and regulations" may unfairly inhibit return preparers from taking contrary positions on their clients' returns. Furthermore, under the present regulations, return preparers become responsible for an unreasonable volume of knowledge of IRS rulings, as well as for additional documentation to show "good faith and reasonable support" for positions contrary to any of the thousands of such rulings. These additional burdens would surely result in an increase in the cost to their clients. We also believe that this amendment is more consistent with the legislative history of Section 6694 than are the regulations.

The second amendment that we would like to express our support for is the exemption from the "14 day or ten percent test" for a taxpayer who uses his home as a principal residence for part of the year and rents it out during the remainder of the year. This situation arises for valid and bona fide reasons such as a permanent change of residence for business reasons during a taxable year. We do not believe that such cases were contemplated in the enactment of Section 280A.

We would appreciate your consideration and support of the above amendments as equitable additions to the statute.

Please feel free to call on me if you have any further questions, or if we can provide any additional information or background.

Sincerely,

ARTHUR J. DIXON,
Chairman,
Division of Federal Taxation.

ATTACHMENT 2

ACTS AMENDING THE INTERNAL REVENUE CODE FROM JUNE 30, 1969

AMENDING ACTS

The major and miscellaneous additions to and amendments of the Internal Revenue Code of 1954, enacted subsequent to its enactment on August 16, 1954, are made by Public Laws. Some of these bear special titles, such as "Revenue Act", "Reform Act", "Technical Changes Act", or "Technical Amendments Act" of a stated year. Others bear no title. The internal revenue code provisions and related acts provisions in all Public Laws enacted as of 6-30-69 appear under this tab card. Public Laws enacted before such date are in the Internal Revenue Cumulative Bulletins.

The sections of the Code appearing under the tab card "Internal Revenue Code of 1954" are kept up to date at all times to reflect the additions and amendments made by such Acts.

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Attachment 3

TAX RETURNS, EXPANDED INCOME, TAX AND TAX EXPENDITURES DISTRIBUTED BY EXPANDED INCOME CLASS

[1976 levels of income]

Expanded income class	Number of returns			Expanded income			Tax liability			Tax expenditures[1]		
		Percentage distribution			Percentage distribution			Percentage distribution			Percentage distribution	
	Number (thousands)	Cumulated from lowest incomes	Cumulated from highest incomes	Amount (millions)	Cumulated from lowest incomes	Cumulated from highest incomes	Amount (millions)	Cumulated from lowest incomes	Cumulated from highest incomes	Amount (millions)	Cumulated from lowest incomes	Cumulated from highest incomes
Less than $5,000	25, 474	28.9	100.0	$57, 557	5.3	100.0	$141	0.1	100.0	$3, 558	4.2	100.0
$5,000 to $10,000	20, 109	51.8	71.1	149, 590	19.0	94.7	8, 227	6.2	99.9	6, 469	11.9	95.8
$10,000 to $15,000	16, 106	70.1	48.2	201, 036	37.4	81.0	18, 071	19.5	93.8	7, 645	21.0	88.1
$15,000 to $20,000	11, 824	83.5	29.9	205, 086	56.2	62.6	23, 009	36.5	80.5	9, 765	32.6	79.0
$20,000 to $30,000	9, 907	94.8	16.5	237, 041	77.9	43.8	32, 778	60.8	63.5	16, 346	52.1	67.4
$30,000 to $50,000	3, 347	98.6	5.2	124, 836	89.3	22.1	22, 017	77.0	39.2	14, 015	68.8	47.9
$50,000 to $100,000	985	99.7	1.4	67, 484	95.5	10.7	16, 492	89.2	23.0	11, 497	82.4	31.2
$100,000 to $200,000	198	99.9	.3	27, 371	98.0	4.5	8, 084	95.2	10.8	6, 529	90.2	17.6
$200,000 or more	49	100.0	.1	21, 573	100.0	2.0	6, 476	100.0	4.8	8, 221	100.0	9.8
Total	87, 998			1, 091, 573			135, 293			84, 045		

[1] Tax expenditures directly affecting individuals in fiscal year 1977, summed without respect to interaction.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Feb. 14, 1978.

Statement of the American Lutheran Church Foundation

A. IDENTIFICATION

The American Lutheran Church Foundation is an office of The American Lutheran Church (ALC). It is responsible for encouraging charitable giving to congregations, national ALC programs, and the many ALC agencies, divisions, institutions, colleges and seminaries. The ALC has approximately 2,437,000 members in the United States.

The Lutheran Council in the USA has submitted a statement to this committee on behalf of the ALC, and the Foundation endorses and supports that statement. We, however, want to emphasize the need for the charitable deduction regardless of whether an individual itemizes his/her deductions.

B. NEED TO PERMIT ALL TAXPAYERS TO TAKE A DEDUCTION FOR CHARITABLE CONTRIBUTIONS

The report of the House Ways and Means Committee on the Revenue Bill of 1978 (H.R. 13511) describes the anticipated impact of the Revenue Bill. By increasing the zero bracket amount and the corresponding floor under itemized deductions for single and married persons, it is estimated that 2.5 million people will change to the standard deduction. Report No. 95-1445, I—Individual income tax reforms. In fact, the new tax bill is structured to discourage taxpayers from itemizing deductions. Itemizers may actually experience an increase in taxes. Report No. 95-1445(IV)(A)(3).

Studies conducted by Martin Feldstein of Harvard indicate that the increased use of the standard deduction adversely affects charitable giving. Professor Feldstein's study estimates that charities have lost approximately 5 billion dollars in the last seven years primarily as a result of the standard deduction. With the increasing pressure of inflation upon all budgets, the loss of such revenue can have disastrous consequences upon the social and other services of charitable organizations.

Contributions to charitable organizations have long been recognized as a socially desirable goal. Similarly, political contributions are encouraged to increase political participation. As a result, taxpayers are given tax incentives to make contributions to political parties by means of a credit. The taxpayer may avail him/herself of this credit regardless of whether he/she itemizes deductions. Just as the House Ways and Means Committee asserts that the credit simplifies and makes more equitable the tax incentive for political contributions, so, too, does an "above the line" deduction for charitable contributions. Report No. 95-1445 (II) (Base broadening and efficiency adjustments); (IV)(B)(3). All taxpayers, regardless of income level, would be able to benefit from the charitable deduction, which is already provided for political contributions. Record keeping for an above the line charitable deduction is no more or less complicated than for the political contribution credit. Above the line deductions, for such items as moving expenses and alimony, are already incorporated into the tax forms. We have seen no evidence of record keeping or audit problems caused by these deductions.

Many, if not most, of the persons who make contributions to The ALC and its congregations are in the middle income category at which the tax bill is aimed. As more individuals change to the standard deduction, the only foreseeable result is that contributions to The ALC, and all charitable organizations, will suffer.

C. RECOMMENDATION

We therefore recommend and urge the passage of the Moynihan-Packwood Bill (S. 3111) providing for an "above the line" deduction for charitable contributions.

Summary of the American Mining Congress Statement

The recognition of the need to lessen the corporate tax burden and thereby provide additional capital to the business sector is particularly appropriate in the case of the domestic mining industry which must make substantial capital expenditures in the years to come if it is to be able to provide the basic minerals

on which our economy depends. Accordingly, we support the corporate tax rate reduction and investment tax credit improvements contained in H.R. 13511. In addition we recommend that the investment credit be made refundable and be extended to all industrial buildings.

We support a reduction in the level of capital gains taxation as a positive step toward improving the climate for needed capital investment.

We support the allowance of the full 10-percent investment credit with respect to pollution control facilities subject to five-year amortization as an appropriate recognition of the economic burden of these nonproductive facilities. For that recognition to be meaningful, however, the restrictive definitional and certification requirements of present law should be eliminated. In addition, tax-exempt bond financing for pollution control facilities provides an important source of funds for these expenditures and should not be eliminated or curtailed, either directly as proposed by the Administration or indirectly through restriction of the availability of the full investment credit as provided in H.R. 13511.

In view of the present competitive disadvantage which the U.S. mining industry faces in operating abroad, the unrepatriated earnings of foreign subsidiaries should not be subjected to current taxation.

DISC benefits should be retained as a stimulus for exports, especially in view of our nations present very large and serious balance of payments deficits.

AMERICAN MINING CONGRESS,
Washington, D.C., Sept. 6, 1978.

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

DEAR MR. CHAIRMAN: In response to your press release announcing public hearings on H.R. 13511, the Revenue Act of 1978, the following comments are respectfully submitted on behalf of the American Mining Congress for the Committee's consideration.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

NEED FOR ADDITIONAL CAPITAL INVESTMENT

The need to lessen the Federal tax burden on business activity to provide additional needed capital to the private sector has been widely recognized. Additional capital must be provided to the private sector if our nation's productive capacity is to be expanded and modernized and needed jobs created. The expansion and modernization of our productive capacity also is vital if the United States is to remain competitive in the world economy. It is important to note in this regard, as shown by a 1975 Treasury Department study, that during the period 1960–1973 the rate of investment in the United States as a percentage of real national output was the lowest of the principal industrialized countries of the world. The recognition of the need for additional capital is particularly appropriate and important in the case of the domestic mining industry which has the task of providing the basic minerals that are the backbone of our industrial economy and our national defense.

For the domestic mining industry to meet the challenge of obtaining the minerals we will need in the years to come, the expenditure of tremendous amounts of capital will be required. Existing facilities must be expanded and modernized to more effectively exploit known mineral deposits. In addition, new deposits must be discovered and developed.

The discovery and development of minerals in the United States is becoming more and more costly. Most of the high-grade mineral beds have already been discovered. The ones left generally are deep, low-grade deposits. Today, the mining industry must expend great sums of money on exploration and development in the United States. This exploration requires sophisticated and expensive geological, geochemical, and geophysical equipment. Exploring underground is particularly costly. Moreover, in many cases, the deposits that are discovered are of such a low grade that the technology required to make it economically

feasible to mine and process them must first be developed. Also, to process low-grade ores at an economically attractive cost requires tremendous capital investment in facilities for large-scale operations.

In addition to these expenditures, the American mining industry is faced with large increases in required capital expenditures as a result of the great amount of environmental and health and safety legislation affecting the industry which has been enacted in recent years. These expenditures, which do not add to productive capacity or result in any significant economic return, further increase the mining industry's capital needs. The relative magnitude of these expenditures is enormous. For example, in recent years pollution control expenditures have not infrequently accounted for up to 40 percent of the capital expenditures of copper mining companies.

Moreover, the industry has been required to turn increasingly for capital funds to debt financing, thereby significantly increasing the industry's debt burden and its debt/equity ratio. According to a survey by Moody's Investors Service, the debt of ten major mining companies rose from 11 percent of capitalization in 1967 to 33 percent as of the end of 1976. The industry's ability to generate capital internally and to attract outside capital is dependent on its profitability for that determines its cash flow and return on investment. The lower the industry's profits are, the less funds there are generated internally to meet capital needs. Moreover, inadequate profitability seriously impairs the industry's ability to obtain external financing. Even if the industry is able to attract the needed funds in the first instance, inadequate profits impair its ability to service new debt burdens. The industries' ability to service its debt has significantly weakened in recent years. According to the Moody's survey, retained cash flow declined from 74 percent of long-term debt in 1967 to 21 percent in 1976.

The heavy inflation of recent years also has placed substantial additional burdens on the mining industry. As a result of inflation, the industry is encountering substantially higher operating and replacement costs. Moreover, it is faced with rapidly escalating costs on uncompleted mine development projects. The discovery of an ore body and the development of a mine is a long-term, 5 to 10 year project. The inflation induced escalation of costs of mining projects has imposed substantial new and uncontemplated capital expenditure burdens on the mining industry.

Rising energy costs, increased imports, and recent adverse economic circumstances in the case of a number of our major mineral sectors also have impaired the mining industry's ability to carry on the necessary expansion of our mineral productive capacity.

Our tax laws must provide an improved climate for capital investment and adequate incentives to allow the mining industry to obtain the capital it needs if we are to have the needed modernization and expansion of productive capacity.

CORPORATE TAX RATE REDUCTIONS AND INVESTMENT TAX CREDIT IMPROVEMENTS

H.R. 13511 moves in the proper direction by providing that the Federal income tax burden on business activity will be decreased through a reduction in the corporate tax rate to 46 percent and by improvements in the investment tax credit—namely, providing for a permanent 10-percent credit, extending the credit to certain expenditures of rehabilitating existing industrial buildings, and increasing to 90 percent of tax liability the limitation on the amount of the earned investment credit which a taxpayer may currently utilize.

We support the changes. We believe, however, that the strength of the investment credit as an incentive to encourage capital investment and as a source of funds for industry to use in meeting its capital needs should be further improved by making the credit refundable. At the very least, if the credit is not made refundable, the increase in the limitation on the amount of the credit which a taxpayer may currently utilize to 90 percent of tax liability should be made fully effective in 1979, rather than phased in over a four-year period. In addition, the credit should be made applicable to new and existing industrial buildings, including buildings used in connection with mining activity. The need for new industrial structures is just as great as the need for new equipment. Moreover, this change would structurally improve and simplify the tax law by eliminating the need to distinguish between equipment and building components.

In evaluating these needed reductions in the level of business taxation, it is important to recognize that to a significant extent the reductions will be offset

by the increased social security tax burden recently placed on business and by the pending energy taxes if enacted. Thus, the net effect will be a substantially smaller overall reduction in the level of business taxation and, accordingly, a substantially smaller degree of assistance to the private sector in carrying on the needed modernization and expansion of the nation's productive capacity.

CAPITAL GAINS TAXATION

H.R. 13511 recognizes that the present high level of capital gains taxation has contributed to the shortage of investment funds needed for capital formation. The American Mining Congress supports a reduction in the tax burden imposed on capital gains. We believe this will improve the climate for needed capital investment. It must be emphasized, however, that decreases in the capital gains tax burden should be in addition to, and not in place of, retention and improvement of other incentives for capital formation.

POLLUTION CONTROL EXPENDITURES

The mining industry has been faced with increasingly heavy capital expenditures to meet the many new environmental requirements being imposed on it. Moreover, in future years the mining industry will be required to spend staggering amounts of capital for pollution control facilities. The present treatment of pollution control facilities under the Code is so limited and restricted that it has not been effective in easing the industry's financial burden of meeting pollution control standards.

The provisions of H.R. 13511 which would allow the full 10-percent investment tax credit with respect to pollution control facilities subject to five-year amortization are a positive step which we support. This treatment, however, should not be made inapplicable, as it would be by H.R. 13511, to facilities which are financed in whole or in part with tax-exempt industrial development bonds. Such a limitation is contrary to the goal of providing a meaningful recognition in the tax laws of the economic burden of these nonproductive expenditures. Tax-exempt bond financing has provided an important source of funds to meet this burden. The viability of this type of financing should not be indirectly limited in this manner. This could result in diminished use of this important source of funds for pollution control expenditures and thereby require the industry to allocate to pollution control activities funds that otherwise would be used for the needed expansion of productive capacity. Moreover, this important type of financing should not be eliminated as has been proposed by the Administration.

In addition, to provide a meaningful recognition in the tax laws of the economic burden on industry of nonproductive pollution control and abatement facilities, further modifications are needed. The restrictive definitional and certification requirements of present law should be eliminated. Thus, the requirements of Federal and state certification, the limitations based on the useful life of a facility and receipts from the recovery of waste, and the exclusion of pollution control facilities used in connection with new plants should be eliminated. Instead, the test for whether a pollution control facility qualifies for five-year amortization should be whether the primary function of the facility is pollution abatement.

Under existing law a deduction for amortization of a pollution control facility that is part of a taxpayer's mining operations will reduce the taxpayer's taxable income from the mining property, and this reduction may result in a lower percentage depletion deduction for the mine—thus offsetting, in part, the effect of the amortization provision. We recommend that deductions for pollution control expenditures should not be offset by applying the deductions to reduce the 50 percent of taxable income limitation on percentage depletion deductions.

Under existing law the excess of deductions for amortization of pollution control facilities over ordinary depreciation deductions is included in the tax base for the 10-percent "minimum" tax as an item of tax preference, thus diminishing the effect of five-year amortization in many cases. We recommend that pollution control facilities be deleted from the base of the 10-percent minimum tax.

CURRENT TAXATION OF UNREPATRIATED FOREIGN EARNINGS

From time to time, the proposals have been made to subject the unrepatriated earnings of foreign subsidiaries of U.S. companies to current U.S. taxation. The American Mining Congress opposes such proposals.

In carrying on mining activities abroad—where mineral deposits are located—the U.S. mining industry must compete with mining companies from other capital exporting countries. U.S. mining companies operating abroad already are at a competitive disadvantage vis-a-vis mining companies from other countries. Eliminating deferral, and instead subjecting the retained earnings of foreign subsidiaries to current U.S. taxation, will aggravate that competitive disadvantage.

In view of the need of this country to import substantial amounts of the minerals we need, it is in our national interest that the U.S. mining industry be allowed to effectively participate in the development of these foreign minerals. If these foreign mineral sources are not developed by American mining companies, they will be developed by American mining companies of other major industrialized nations of the world. This would make the availability to us of needed foreign minerals even more deepndent on, and subject to variations in, the economic and political climates of other countries. It is also important to note that the availability of needed raw materials to American industry means that mineral processing and the fabrication of many products may be done in the United States by U.S. employees rather than abroad.

In addition to providing us with additional assurance that the minerals will be available to us, the development of foreign mineral deposits by the U.S. mining industry will also tend to mitigate the balance of payments effect of imports since the profits arising on the foreign operations of U.S. mining companies will be at least in part repatriated to the United States.

DISC

Although DISC benefits are not available with respect to exports of minerals, the American Mining Congress opposes further restrictions on DISC treatment. We believe that DISC benefits do have a stimulative effect on U.S. exports and that it is particularly inappropriate to remove this stimulus at the present time when the country is experiencing such an extraordinarily large and serious balance of payments deficit.

Respectfully submitted,

DENNIS P. BEDELL, *Chairman,*
American Mining Congress Tax Committee.

AMERICAN PAPER INSTITUTE, INC.,
New York, N.Y., September 18, 1978.

To: Members of Senate Finance Committee:

At the Senate Finance Committee hearings of August 21, our panel was asked to respond to proposed sunset laws for tax expenditures.

The enclosed comments summarize the position of the paper industry on what appears to be a one dimensional approach to the multifaceted problem of containing the role of government in our economy.

We applaud the efforts of this Committee to drive for a sensible and balanced tax program at this critical time in our economy. We agree that more action must be taken in the next session of Congress to prevent a drift of the economy into a dangerous no-growth, high inflation phase. We will work with you on this.

If you have any questions, do not hesitate to contact me, or our Washington office.

Sincerely yours,

NORMA PACE,
Senior Vice President.

Enclosure.

COMMENTS ON SUNSET LAWS FOR "TAX EXPENDITURES"

Simplification of government spending and taxing programs is a matter of greatest priority for Americans. The complexities inherent in managing a $500 billion federal budget have not only created a climate for abuse but have also built distrust among Americans. The low rating of the U.S. government in public opinion polls reflects this growing feeling that government may be getting out of hand. Proposition 13 in California was blessedly simple and therefore easily won. So any action that returns the U.S. to understandable concepts in government's role and fosters greater control over government is welcome.

Sunset laws which automatically extinguish government programs, unless they are proven beneficial and worthy of survival, are a step in the right direction. They increase the efficiency of government: they facilitate decisions that would not otherwise be made in a populist society. The simple automaticity of the procedure is appealing and repeated reevaluation of government programs provides assurance that they *do* keep up with the fast changing needs of a mobile and dynamic society.

Much of the legislative foundation for present social and economic policies was laid in the 1930's when an unusually severe depression rocked the U.S. economy and set the stage for massive spending programs. A mechanism that forces review and update of this legislation is certainly welcome.

But any proposal to apply sunset provisions to so-called "tax expenditures" is unwarranted and unnecessary, and could result in further inequities in the tax code and an adverse impact on capital formation.

"TAX EXPENDITURES" CONCEPT IS FAULTY

Using the term "tax expenditures" for all income flows that are exempt from federal taxes or receive favorable tax treatment is unfair. It is based upon the faulty premise that government has the first claim on all the income of U.S. citizens. It fails to recognize that taxes can have an uneven impact on incentives, on buying power and on risk-reward balances. Incentives and rewards are the life blood of our economic system and if they become distorted through tax policies, serious consequences to the economy result. Many "tax expenditures" provide the means for restoring balance to the imbalances created by government spending and taxing policies themselves. To single out these items without attention to the total matrix of government expenditures and taxes would have adverse effects on the economy.

BETTER REVENUE IMPACT ESTIMATES NEEDED

Moreover, the term "tax expenditures" implies a net cost to government but that is not necessarily true. Dynamic analysis of the impact of taxes shows much feedback effect. The investment tax credit, for example, increases tax revenues because it encourages more investment in plant and equipment, thereby creating income that yields much more revenue than the so-called "expenditure."

ADVERSE IMPACT ON CAPITAL FORMATION

Sunset provisions for these so-called "tax expenditures" would be discriminating and harmful to balanced growth.

1. They would prevent consistent planning of cash flow for both business and individuals and would thereby impair confidence and spending.

2. Tax planning would proceed around expiration dates of specific items of tax preference and would create distortions. (The stop and go history of the investment tax credit gives ample evidence of the distortion potential in such moves.)

3. They would adversely affect savings and investment. For example, interest payments on mortgages are deductible and provide an incentive for home ownership; they are considered a "tax expenditure." Suppose the sunset provision would let this die, then investment in housing would be adversely affected. At the same time, interest receipts are considered unearned income in the general tax revenue code and potentially subject to higher tax rates, which restricts savings flows to mortgage lending institutions and reduces the potential size of the mortgage market. If attention is not paid to this savings restriction in a timely way, the sunset provision on mortgage interest deductibility could have a double impact on future investment in housing.

Dividends are taxed at least three times: income is taxed before the after tax income is made available for investment in stocks; then dividends are taxed as corporate income and taxed again as individual income. An exclusion of $100 of dividends per investor is now available as a tax preference. A sunset provision may remove this benefit to investors but will Congress enact a timely alternative?

4. Another example is accelerated depreciation which in many cases merely changes the timing of tax payments and not the overall tax amount. Yet it is called a "tax expendtiure." Accelerated depreciation is a real investment incentive but its effectiveness would wither away if a time bomb were ticking away on it.

PRESENT TAX REVIEW PROCEDURES DO NOT NEGLECT "TAX EXPENDITURES"

Tax discussions since World War II have not ignored these special provisions in the tax system. As a matter of fact Congress periodically focuses on these issues in its tax policy deliberations. The investment tax credit has been removed once and the rate and coverage changed several times since its inception. Depreciation changes have been made; percentage depletion is being phased out. The new House tax bill will tax unemployment benefits of those receiving income from other sources above a specified amount.

The dialogue on these and other items is continuous and results in frequent tax changes.

As a matter of fact, tax policy which had been stable until the mid-1960's has become one of the more destabilizing items in our economy. It used to be a fairly predictable item and spending-investment decisions flowed more freely in that climate. Tax planning has become so complicated that it is becoming an end in itself.

NEED FOR REFORM AND RESTRAINT IS GREAT

The answer to our present fiscal problems does not lie in sunset provisions for tax policies which try to redress inequities caused by other government policies, tax or otherwise.

Government spending must stop rising more rapidly than private spending: the share of GNP accounted for by government spending must be held stable in the next two or three years and decline over time.

Tax policies can then proceed on a firm base of government spending forecasts and can result in a greatly simplified tax structure for both business and individuals. The existence of highly sophisticated computer programs that will tell us instantly who pays for what share of government services should encourage simplified tax policies that provide both greater equity and greater growth. This is possible.

If restraints on undue expansion in government are imposed, this alone will automatically correct the biggest inequity of federal taxes; namely, their growing share of national income.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE, MID-CONTINENT OIL AND GAS ASSOCIATION, ROCKY MOUNTAIN OIL AND GAS ASSOCIATION, WESTERN OIL AND GAS ASSOCIATION

SUMMARY

I. Tax Proposals Affecting Capital Formation

The United States economy is hampered by inadequate capital formation. The major underlying causes of the problem are inflation, a bias against capital formation in the tax system, and government policies which limit industry's ability to generate and invest new capital.

Impediments to capital formation are particularly significant to the petroleum industry. To minimize dependence on petroleum imports, it will be necessary to accelerate the rate at which domestic oil and gas reserves are discovered and developed; and the cost of finding and developing new reserves will require a doubling or tripling of historical capital expenditure levels.

It has been erroneously asserted that the petroleum industry can easily finance these sharply higher expenditure levels. However, the ability of the industry to do so will depend on market prices, the opportunity to make investments in the areas of greatest potential, and the stability of the economic, tax, and regulatory environment.

To aid in the achievement of vital national goals including higher employment levels and increased production of indigenous energy resources, the petroleum industry supports proposals which would (1) redress the bias in the Federal tax system against savings and capital investment, (2) recognize the impact of inflation on capital recovery provisions, and (3) reduce the capital costs to business of making non-productive expenditures.

As passed by the House, H.R. 13511 would reduce the corporate tax rate by two percentage points; but a more substantial reduction would increase corporate cash flow and make more investment projects economically viable.

The bill also provides a reduction in individual tax rates which is helpful to the individual business taxpayer in a manner that does not increase the present bias in the tax system against savings and investment.

The House adopted a five-step graduated corporate rate schedule, but a more direct and rational approach would be to increase the permanent surtax exemption to $100,000. A graduated rate schedule based on an "ability-to-pay" concept is inappropriate to the corporate tax system.

The bill provides improvements in the investment tax credit which should make the credit an even more effective incentive for capital investment and result in increased productivity. Consideration should be given to further improvements, such as (1) elimination of the time limit on the carryover, (2) extension to investments in new industrial buildings, and (3) extension of the maximum credit to all pollution control equipment regardless of means of financing. ESOP provisions relating to the investment tax credit should be expanded and made permanent.

On balance, the House Bill would ameliorate the taxation of capital gains. However, repeal of the 25 percent alternative tax on the first $50,000 of capital gains would increase tax rates on capital gains for some individuals. The treatment of capital gains would be further improved by adopting a proposal providing that 30 percent of long term capital gains would be subject to tax.

A new "alternative minimum tax" on capital gains would be assessed. This tax is less onerous than the current minimum tax. However, the application of any type of alternative or penalty tax on any of the so-called tax preferences will tend to erode the very tax incentives which have been legislated by Congress.

A provision should be included in the bill to eliminate intangible drilling and development costs from classification as a preference item subject to the minimum tax.

II. Proposals Affecting Audit and Taxation of Partnerships

As passed by the House, H.R. 13511 provides for extension of the Statute of Limitations relating to "partnership items" of "federally registered partnerships." The bill would also establish a civil penalty for the failure to file partnership returns. The penalty alone should be sufficient. Thus, consideration of a change in the period of limitation should be deferred until a conclusion can be made as to the effect of the new penalty provision in enforcing partnership filing requirements.

The new special period of limitation may be extended by the consent of any general partner, even though some partners may oppose such consent. The audit problems given as reason for such provisions do not justify such a serious impairment of the rights of individual taxpayers to determine their own tax liability. No one partner should be able to bind all partners.

Certain seriously ambiguous and misleading language in the bill must be dealt with.

The bill appears to grant to the Secretary the power to require by regulation the determination of items of income and expense at the partnership level rather than at the individual partner level. This implies that each partner may also be bound by this determination. Such a radical and fundamental change in the determination of partnership items is clearly unwarranted.

I. TAX PROPOSALS AFFECTING CAPITAL FORMATION

A. The need for capital formation

The United States economy is hampered by inadequate capital formation. There are three aspects to this problem: the ability to generate capital; the incentive to employ that capital in investments such as developing new oil and gas supplies; and the opportunity to make such investments.

The major underlying causes of the capital formation problem are:

Inflation, which results in shrinking real profit margins, higher effective tax rates, and under-recovery of costs of assets.

A bias against capital formation in the tax system which favors consumption over savings and investments.

Government fiscal, monetary, and regulatory policies which limit industry's ability to generate and invest new capital by ever increasing regulations, controls, and requirements for nonproductive capital expenditures.

These impediments to capital formation impact all segments of the economy and are particularly significant to the petroleum industry in view of its sharply increasing capital needs. It is widely recognized that U.S. demand for energy must continue to grow, even if at a slower rate than in the past; otherwise, economic growth cannot continue. Although much of this increase in energy demand will be met by alternate fuels, the U.S. will continue to rely on oil and gas for more than half of its energy over the next ten to fifteen years.

To minimize dependence on petroleum imports in the face of increasing demand, it will be necessary to accelerate the rate at which domestic oil and gas reserves are discovered and developed. Except for reserves added by the Prudhoe Bay discovery, total domestic oil and gas reserves peaked in the mid-1960's and have declined since that time. Oil and gas production peaked in the early 1970's and declined through 1976. Durnig 1977, oil production increased as production from Prudhoe Bay was initiated; and the rate of decline in gas production was reduced as a result of increasing drilling activity in response to rising prices.

The cost of finding and developing reserves will require a doubling or tripling of historical capital expenditure levels. This will result from: (1) higher real costs as industry increasingly directs its search to offshore and Arctic areas which are more expensive to develop and require longer lead times before production and income will be realized; (2) higher inflation rates which have been more rapid for petroleum equipment than for the general economy; (3) higher transportation investments associated with remote areas; and (4) higher expenditures for environmental protection equipment associated with both existing and new fields.

It has been erroneously asserted that the petroleum industry has ample cash flow and can easily finance these sharply higher expenditure levels from internally generated funds. However, an examination of readily available facts clearly refutes this assertion. For example:

The percentage of capital expenditures financed externally more than doubled from 13 percent to 29 percent between 1971 and 1976. New long term debt issues increased from $4.2 billion in 1971 to $9.3 billion in 1976, and new equity issues increased from $0.2 billion in 1971 to $0.8 billion in 1976.[1]

The petroleum industry ratio of long term debt to total capitalization increased from 17 percent in 1967 to 26 percent in 1976.[2] (See Appendix A.)

Capital expenditures exceeded cash flow after dividends by a total of $32 billion during the period 1967–76. This shortfall was financed by a net increase of $25 billion in new long term debt, $5 billion in new equity, and a $2 billion decrease in working capital.[3]

The dividend payout ratio declined from 50 percent of net income in 1967 to 38 percent in 1976.[4]

The ability of the petroleum industry to finance and achieve sharply higher future capital expenditures will depend on the incentive provided by market prices, the opportunity to make investments in the areas of greatest potential such as offshore, and the overall character and stability of the economic, tax, and regulatory environment.

B. Proposals for improvement in capital formation

It is essential that new capital formation be stimulated so as to aid in the achievement of vital national goals including higher employment levels and increased production of indigenous energy resources. It is important that the difficult problems impeding capital formation be addressed now. To this end, the petroleum industry supports proposals which would:

Redress the bias in the Federal tax system against savings and capital investment through measures such as: (1) a reduction in individual and corporate income tax rates; (2) establishment of a permanent investment tax credit at a minimum level of 10 percent; and (3) modifications to capital gains taxation such as an inflation adjustment to cost basis in order to eliminate the payment of taxes on illusory profits created solely by inflation.

Recognize the impact of inflation on the capital recovery provisions applicable to all U.S. industries including petroleum. Depreciation of capital assets on a

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[1] *Petroleum Companies Financial Position: Political Fiction Versus Financial Reality* by Dr. E. Anthony Copp—Salomon Brothers, New York, December 8, 1977.

[2] *Summary of Aggregate Financial Data and Composite Annual Comparisons of 40 Major Major Petroleum Companies*, Department of Energy, November 1, 1977.

[3] *Ibid.*

[4] *Ibid.*

historical cost basis has been inadequate to provide for replacements at inflated prices. This problem has been greatly magnified for industries experiencing increasing costs such as the petroleum industry. Capital cost recovery could be improved and under-depreciation avoided through measures such as: (1) more rapid depreciation methods; (2) adjustment of cost basis for depreciation to reflect inflation occurring subsequent to acquisition; (3) immediate expensing of geological and geophysical costs; and (4) accelerated depreciation for depletable assets in lieu of existing cost depletion provisions.

Reduce the capital costs to business of making governmentally mandated non-productive expenditures for pollution control facilities and for equipment installed to satisfy occupational safety and health requirements. The Internal Revenue Code allows the taxpayer to elect to amortize the cost of any governmentally certified pollution control facility over a five-year period. However, many business taxpayers have been unable to obtain the intended benefit of this provision because administrative agencies (Federal, State and local) are uncertain as to which facilities are certifiable and because lengthy delays occur in the certification process. Increasingly, Federal and State administrators operating under laws such as the Occupational Safety and Health Act require installation of new equipment to meet government safety and health standards, but the Internal Revenue Code has no provisions for accelerated amortization of this equipment. Moreover, many business taxpayers voluntarily install pollution control equipment and health and safety equipment even though such installation is not required specifically by law or regulation. There is no provision currently in the law permitting the rapid amortization of this equipment. In order to free capital for productive uses as rapidly as possible, the full costs of installing these types of equipment should be recovered through measures such as: (1) allowance of five-year amortization for the total costs of all such equipment; (2) establishment of guidelines by type and class for the identification of facilities and equipment eligible for this amortization so that certification would no longer be necessary; and (3) granting the maximum investment tax credit for all eligible facilities and equipment regardless of how financed.

C. Capital formation provisions of H.R. 13511

Rate reduction.—As passed by the House, H.R. 13511 provides that the corporate tax rate on income in excess of $100,000 would be reduced by two percentage points from 48 percent to 46 percent starting in 1979. As a positive step in aiding new capital formation, we strongly urge a more substantial reduction in the top corporate tax rate. Although a two percentage point reduction in the top corporate rate would surely help increase corporate cash flow and make more investment projects economically viable, a further reduction would encourage greater business spending and the creation of more new jobs. Each percentage point of reduction in the corporate tax rate provides about $2 billion of additional cash flow as a source of investment funds for industry—not including the "ripple" effects on economic growth and employment which would result from new investment. As a permanent tax reduction, it would facilitate longer-range investment planning and economic decision-making.

The bill also provides a reduction in individual tax rates which is helpful to the individual business taxpayer. The widening of individual income tax brackets by approxmately six percent and the increase in the personal exemption recognize the impact of inflation on individual taxpayers in a manner that does not increase the present bias in the tax system against savings and investment.

Corporate surtax exemption.—The surtax exemption was introduced in an attempt to assist the smallest corporations in capital formation. It could be particularly important to new and inovative individual businesses in the difficult beginning stages of their operations. Exemption from the surtax was fixed at $25,000 in 1950 and was later temporarily increased to $50,000. With inflation continuing, this level of exemption will no longer be adequate.

In H.R. 13511, the House eliminated the distinction between the normal tax and the surtax and adopted a five-step graduated corporate rate schedule of 17 percent on the first $25,000; 20 percent on the second $25,000; 30 percent on the third $25,000; 40 percent on the fourth $25,000; and 46 percent on corporate income exceeding $100,000. While this complex tax scale does provide a measure of relief, a more direct and rational approach would be to increase the permanent

surtax exemption to $100,000. This would maintain the simplicity of the current normal tax and surtax rate structure without instituting a concept of multiple graduated tax rates for the corporate tax system. A graduated tax rate schedule is based on an "ability-to-pay" concept which is clearly inappropriate to the corporate tax system.

Investment tax credit.—The bill provides certain improvements in the investment tax credit. These include making the 10 percent rate permanent, permitting investment credits to offset up to 90 percent of tax liability, extending the credit to rehabilitation of existing non-residential business structures, and granting the maximum credit for certified pollution control equipment for which five-year amortization has been elected.

The petroleum industry endorses these changes in the investment tax credit. These provisions are a step in the right direction and should make the investment tax credit an even more effective incentive for capital investment and result in increased productivity. Consideration should also be given to further improvements in the investment tax credit, such as:

(1) Elimination of the time limit on the carryover of the credit would permit full utilization of the credit on large projects in which profits lag timewise substantially behind investment. This should cause little revenue loss.

(2) The credit should be extended to include investments in new industrial buildings.

(3) ESOP provisions relating to the investment tax credit should be made permanent, and consideration should be given to expanding these provisions.

Secretary of the Treasury Blumenthal recommended in his testimony before this Committee that industrial development bond financing for pollution control facilities be eliminated. That suggestion works against the proposal to extend the investment tax credit to certified pollution control facilities. There is no basis to conclude that the proposed change in the investment tax credit would compensate business for the higher interest costs resulting from loss of the opportunity to borrow in the tax exempt market.

Capital gains.—On balance, the provisions of the House Bill would ameliorate the taxation of capital gains. The cost basis adjustment for inflation, the liberalized provisions for the sales of residences, and the revision of the minimum and maximum tax are positive steps in stimulating capital investment. However, repeal of the 25 percent alternative tax on the first $50,000 of capital gains is detrimental in that it will increase tax rates on capital gains for some individuals.

The adjustment to the cost basis of certain assets is one means of eliminating the taxation of phantom increases in the value of a capital asset which arise from inflation. This provision will provide a measure of equity in taxing real gains on the sale of capital assets held for differing periods of time and will encourage investment in long-life assets.

The bill authorizes a taxpayer to make a once-in-a-lifetime election to exclude from income up to $100,000 of any gain from the sale or exchange of a principal residence. It also provides that a taxpayer who relocates for employment purposes will not be subject to the limitation of current law under which the tax-free rollover of gain from the sale of a principal residence may be elected only once every 18 months. These favorable tax provisions should be retained.

The bill would eliminate capital gains as an item of so-called tax preference for purposes of determining minimum and maximum taxes. For individuals, a new "alternative minimum tax" on capital gains would be assessed. It would apply to the extent that 10 percent of the untaxed portion of capital gains (in excess of $10,000) exceeds normal taxes payable. This new alternative minimum tax is less onerous than the current minimum tax. However, the Administration has proposed to this Committee that the existing minimum tax be retained for corporation and that a new type of progressive minimum tax on capital gains be enacted for individuals. The proposal is so complex that its full implications and ramifications are in no way certain. However, it would surely be detrimental to capital formation, since it would increase the tax on successful investment in comparison with H.R. 13511. Accordingly, the incentive to save and invest would be diminished, with adverse consequences for economic growth. Furthermore, it must be recognized that the application of any type of alternative tax or penalty tax on any of the so-called tax preferences will tend to erode the very tax incentives which have been legislated by Congress.

A proposal before this distinguished Committee would improve the treatment of capital gains under present law by providing that 30 percent of long term capital gains would be subject to tax. This recommendation merits favorable consideration.

Minimum tax.—The problems created by the imposition of a minimum tax have become particularly acute in several areas in which continued investment incentives are critical to a growing economy. An important example of this problem is the application of the minimum tax to intangible drilling and development cost (IDC) deductions which, unlike permanent reductions in tax, are merely deferrals of tax. That is, IDC expenditures may be deducted currently instead of over the life of a well. Thus, the only preference involved is the interest value of the deferral of tax until some later period.

When Congress, as a part of the Tax Reform Act of 1976, added IDC as a "preference item", the full impact of that decision was not recognized. When investors became aware of the problems by the change, the effect was to discourage investment in energy resources at a time when encouragement of such investment should have had the highest priority. In some cases, the additional 15 percent after tax cost resulting from application of the minimum tax to IDC, would have encouraged an operator to abandon rather than produce a well which has only a marginal potential.

In the Tax Reduction and Simplification Act of 1977, Congress reacted to this very critical problem by enacting a temporary relief provision which subjected IDC to a minimum tax only to the extent that it exceeded a taxpayer's net income from oil and gas properties for the same tax year. This provision expired on December 31, 1977. In recognition of the urgent need to protect the IDC deduction, Congress has included specific provisions in both the House and Senate versions of the National Energy Act (H.R. 8444 and H.R. 5263) which would make permanent the temporary provisions of the Tax Reduction and Simplification Act of 1977. Although the permanent extension of these provisions would be a step in the right direction, a better approach would be to eliminate IDC from classification as a preference item. A provision to accomplish such relief should be included in the bill currently before this Committee.

II. PROPOSALS AFFECTING AUDIT AND TAXATION OF PARTNERSHIPS

As passed by the House, H.R. 13511 provides for the extension of the period of limitation for the assessment of deficiencies or the claiming of credits or refunds relating to "partnership items" of "federally registered partnerships," as those terms are defined therein. The bill would also establish a civil penalty for the failure to file partnership returns. A penalty of $50 per partner per month would be assessed "against the partnership, not to exceed a maximum of five months. Both of these changes are ostensibly designed to encourage compliance and to minimize audit problems of the Internal Revenue Service. However, the penalty alone should be sufficient incentive to attain that goal.

According to the Internal Revenue Service, audit problems relating to partnerships are primarily concentrated in large and diverse partnerships. Any abuse of filing requirements by such partnerships would be curtailed by imposition of the substantial penalties imposed by this bill. If such abuse is curtailed, the change in the period of limitation would be unnecessary. Thus, any consideration of a change in the period of limitation should be deferred until a conclusion can be made as to the effect of the new penalty provisions in enforcing partnership filing requirements. This is especially true when one considers that the proposed change in the period of limitation will affect not only those who may have abused current filing requirements, but also the vast majority of taxpayers who have fully complied with the law.

Besides being unnecessary and unfairly burdensome to those who comply, the provisions extending the period of limitation applicable to partnership items of "federally registered partnerships" are deficient in other respects. The period of limitation would, in no event, expire before four years after the date of filing a partnership return. (If the name or address of a taxpayer/partner is not on the partnership return as filed, the period of limitation applicable to that partner would be additionally extended until one year after such information is provided to the Secretary.) This new special period of limitation may be extended by the consent of any general partner, unless the Secretary is notified otherwise by the partnership. Any person authorized to do so by the partnership in writing may also provide such consent.

Given this procedure, a majority vote of the partners (or whatever voting margin is required under the agreement to constitute partnership action) can operate to consent to an extension of the period of limitation applicable to all individual partners, even though some partners may oppose such consent. The

audit problems given as reason for such provisions do not justify such a serious impairment of the rights of individual taxpayers to determine their own tax liability. No one partner should be able to bind all partners and thereby deprive any individual partner of any substantive or procedural rights, whether the forum be administrative or judicial.

In addition, certain provisions of the bill as drafted may not correctly reflect the legislative intent of the House as expressed in the Report of the Committee on Ways and Means. Section 212 of the bill establishes the new special period of limitation applicable to partnership items of a federally registered partnership "with respect to any *person*," and allows for extension of this new period "with respect to any *person*" by consent. (Emphasis supplied) The Committee Report states such provision is to apply with respect to "any *partner*." The language of the bill should be changed to avoid any ambiguity in this respect. Attempts to improve partnership audit procedures should not involve third parties.

The section of the bill which provides for extensions of the period of limitation "insofar as they relate to partnership items" should read "insofar as they relate to partnership items of federally registered partnerships." This change would make clear that the new extension provisions do not apply generally to all partnership items but only to those of a federally registered partnership.

The bill also defines "partnership item" as:

(A) any item required to be taken into account for the partnership taxable year under any provision of Subchapter K of Chapter 1 *to the extent that regulations prescribed by the Secretary provide that for purposes of this subtitle such item is more appropriately determined at the partnership level, than at the partner level, and*

(B) any other item to the extent affected by an item described in Subparagraph (A). [Emphasis supplied]

This language goes far beyond what is necessary to accomplish the purposes of the bill.

The definition of the term, "partnership item," is not only unnecessary but also ambiguous and misleading. There is no question under current law as to what "partnership items" must be reported on the annual returns. Subchapter K and regulations promulgated by the Secretary cover extensively the reporting requirements of all partnership items. Furthermore, partnerships are not taxable entities under current law; and all items of income and expense of the partnership flow through to the partners. As a result, current law requires that any audit of these items be made at the individual partner level with a separate assessment of any deficiency. However, the underlined language of section 212 of the bill appears to grant to the Secretary the power to require by regulation and determination of items of income and expense at the *partnership* level. This power implies that each partner may also be bound by this determination. Such a radical and fundamental change in the determination of partnership items is clearly unwarranted and was, in fact, rejected by the House Committee on Ways and Means. Comprehensive legislative language in the Administration's original proposals to Congress spelled out provisions which would have accomplished this result; but the Committee on Ways and Means chose to exclude these provisions from the bill as passed.

Even though the Administration's original proposals were rejected by the House, Secretary of the Treasury Blumenthal urged this Committee to adopt the Administration's proposals for sweeping and fundamental change in the treatment of partnerships for tax purposes. Excerpts from our testimony before the Committee on Ways and Means commenting on those proposals are attached in Appendix B.

In conclusion, both the provisions of H.R. 13511 and the original proposals of the Administration regarding the taxation and audit of partnerships include unnecessarily broad solutions to the difficulties perceived by the Internal Revenue Service in administering the partnership sections of the Internal Revenue Code. These perceived problems do not justify such radical and fundamental changes in the taxation and audit of partnerships. Moreover, joint audits would be unworkable and would severely impair the rights of individual taxpayers to determine their own tax liability. In no event should any one partner be able to bind all partners and thereby deprive any individual partner of any procedural or substantive rights. Any abuse of filing requirements by partnerships would be effectively curtailed by the imposition of a civil penalty on these partnerships which fail to file partnership returns.

TABLE 1.—SELECTED AGGREGATE CASH FLOW DATA FOR APPROXIMATELY 40 MAJOR PETROLEUM COMPANIES

[In billions]

	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967
Net income	$13.80	$11.56	$15.49	$11.80	$6.81	$7.20	$6.85	$6.83	$6.75	$6.17
Depreciation/depletion, etc	14.82	11.26	13.00	10.54	9.11	7.95	7.38	5.74	5.16	4.85
Cash flow	28.62	22.82	28.94	22.34	15.92	15.15	14.23	12.57	11.91	11.02
Dividends paid	5.28	4.74	4.48	4.00	3.78	3.79	3.75	3.65	3.33	3.06
Net internal funds available for investment or debt repayment	23.34	18.08	24.46	18.34	12.14	11.36	10.48	8.92	8.58	7.96
Total capital and exploratory expenditures [1]	28.83	26.93	25.75	16.33	14.32	14.15	13.27	12.87	12.40	10.85
Long-term debt	36.37	28.89	25.04	22.48	21.78	20.78	18.52	16.25	14.60	11.50

[1] Includes both capitalized and expensed expenditures. Includes TAPS debt of approximately $9,000,000,000 total during 1973-76.

Note: These data represent approximate rather than actual year-to-year comparisons because of changes in the makeup of the group of companies due to mergers and other corporate changes. The year-to-year distortions that result from this are considered minor.

Source: C. H. Pforzheimer & Co., New York. "Summary of Aggregate Financial Data and Composite Annual Comparisons of 40 Major Petroleum Companies," Department of Energy, Nov. 1, 1977.

TABLE 2.—NET INCOME ON TOTAL CAPITALIZATION AND AVERAGE NET WORTH FOR APPROXIMATELY 40 MAJOR PETROLEUM COMPANIES

	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967	10-year mean
Petroleum company composite—											
Net income as a percent of:											
Total average capitalization [1]	10.7	10.0	14.8	12.0	7.4	8.2	8.3	9.0	9.7	9.6	10.0
Average common equity	14.3	13.1	19.0	15.6	9.7	10.8	10.7	11.4	12.0	11.6	11.8
Manufacturing group net income as a percent of common equity [2]	15.0	12.2	13.9	14.7	12.5	10.7	9.8	12.6	13.4	12.6	12.7
Ratio of net income-to-common equity percentages: (Petroleum company composite versus manufacturing company composite)	95.3	107.4	136.7	106.1	77.6	100.9	109.2	90.5	90.0	92.1	92.8

[1] C.H. Pforzheimer & Co. data. Includes long-term debt, preferred and common stock, capital surplusand earned surplus.
[2] Citibank, N.A. aggregate data for approximately 2,000 nonpetroluem manufacturing companies.

Note: These data represent approximate rather than actual year-to-year comparisons because of changes in the makeup of the group of companies due to mergers and other corporate changes. The year-to-year distortions that result from this are considered minor.

Source: "Summary of Aggregate Financial Data and Composite Annual Comparisons of 40 Major Petroleum Companies," Department of Energy, Nov. 1, 1977.

TABLE 3.—NET INCOME AND DIVIDENDS FOR APPROXIMATELY 40 PETROLEUM COMPANIES

[Dollar amounts in billions]

	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967
Net income [1]	$13.80	$11.56	$15.94	$11.80	$6.81	$7.20	$6.85	$6.83	$6.75	$6.17
Dividends	$5.28	$4.74	$4.48	$4.00	$3.78	$3.79	$3.75	$3.65	$3.33	$3.06
Dividend payout ratio	38	41	28	34	56	53	55	53	49	50

[1] Before adjustment for extraordinary items.

Source: "Summary of Aggregate Financial Data and Composite Annual Comparisons of 40 Major Petroleum Companies," Department of Energy, Nov. 1, 1977.

TABLE 4.—TOTAL CAPITALIZATION DATA FOR APPROXIMATELY 40 MAJOR PETROLEUM COMPANIES

[Dollar amounts in billions]

	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967
Long-term debt	$36.37	$28.86	$25.04	$22.48	$21.78	$20.78	$18.52	$16.25	$14.60	$11.53
Preferred stock	.33	.39	.39	.38	.41	.43	1.34	.50	.53	.76
Common stock and retained earnings [1]	101.05	91.89	87.42	79.99	71.46	69.32	64.64	61.93	58.23	54.88
Total long-term capitalization	137.75	121.14	112.85	102.85	93.65	90.53	84.50	78.68	73.36	67.17
Long-term debt as a percent of total long-term capitalization	26.4	23.8	22.2	22.0	23.3	23.0	21.9	20.6	19.9	17.2
Common equity as a percent of total long-term capitalization	73.4	75.9	77.5	77.8	76.3	76.6	76.5	78.7	79.4	81.7

[1] Includes common stock, capital surplus and earned surplus accounts after adjustments.

Source: "Summary of Aggregate Financial Data and Composite Annual Comparisons of 40 Major Petroleum Companies," Department of Energy, Nov. 1, 1977.

TABLE 5.—CASH FLOW AFTER DIVIDENDS AS A PERCENT OF CAPITAL AND EXPLORATORY EXPENDITURES

[Dollar amounts in billions]

	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967
Cash flow	$28.62	$22.83	$28.94	$22.34	$15.92	$15.15	$14.23	$12.57	$11.91	$11.02
Cash flow after dividends	22.34	18.08	24.46	18.34	12.14	11.36	10.48	8.92	8.58	7.96
Capital and exploratory expenditures	28.83	26.93	25.75	16.33	14.32	14.15	13.27	12.87	12.40	10.85
Cash flow after dividends as a percent of C.&E.E	.810	671.	.950	1.123	.848	.803	.790	.693	.692	.732

Source: "Summary of Aggregate Financial Data and Composite Annual Comparisons of 40 Major Petroleum Companies," Department of Energy, Nov. 1, 1977.

APPENDIX B.—TAXATION AND AUDIT OF PARTNERSHIPS [1]

I. TAXATION OF LIMITED PARTNERSHIPS AS CORPORATIONS

The Administration's proposal would treat a partnership or any other unincorporated organization (except low-income housing partnerships) formed or expanded after the effective date as a corporation for tax purposes if the partnership or organization has more than fifteen limited partners. The use of certain syndicated partnerships as tax shelters is cited as the reason for the proposal. The conclusion is reached that, because substantive differences between syndicated partnerships and corporations are minimal, the same tax rules should apply in both instances. However, the proposal could result in many joint operations in the petroleum industry being taxed as corporations even though these organizations are not formed for tax shelter purposes.

The arbitrary classification of these joint operations as corporations would partially eliminate or defer deductions or credits incident to exploration and development, and would impose an additional tax at corporate rates on the total earnings from the operation. In the case of unsuccessful drilling operations, ordinary deductions might be converted into capital losses with the strong likelihood that these losses would be unavailable for use by corporate participants and only partially usable, if at all, by individual participants. Most importantly, if these are capital losses, they would not be usable against income from other oil and gas operations. On successful ventures and using the present tax rate structure, corporate participants woud be subjected to an effective tax rate increase of almost 52%, and non-corporate participants would be subjected to

[1] Excerpts from our statement submitted to the House Committee on Ways and Means, April 14, 1978.

effective rates as high as 84%. Such added tax burdens would completely disrupt conventional operating relationships and would frustrate efforts to increase domestic energy production.

The need for joint operations in the petroleum industry arises in a variety of ways. For example, the co-owners of undivided operating mineral or working interests in a single oil and gas property must join together, either voluntarily or by operation of law, to develop the property and produce the minerals. Such action has nothing to do with "tax shelters" and in no way resembles formation of a "syndicated partnership" as that term is generally understood.

Similarly, the owners of adjacent properties may need to join together to develop and produce an oil or gas reservoir underlying their properties. Each working interest owner in a particular deposit or reservoir theoretically possesses the right to drill a well. However, due to state regulations to promote conservation, only one well may be drilled to drain a particular portion of the reservoir. These spacing rules quite often result in several working interest owners being compelled to enter into a drilling unit under a joint or unit operating agreement. A common desire for efficient development and operation of a reservoir and for maximizing oil and gas recovery—clearly in the national interest—may also result in the several interest owners entering into a joint or unit operating agreement. For example, most secondary and tertiary recovery methods must be implemented on a reservoir-wide basis. Thus, each owner of an interest in the reservoir must agree to the implementation of the recovery program and the manner of operation and sharing of costs and production attributable to the program.

Under a typical joint or unit operating agreement, one of the interest owners is generally designated as operator. The operator agrees to conduct the operations and may look to each of the other working interest owners for his share of the drilling, development and operating costs. The operator, or course, has full liability to suppliers for all expenses arising out of his actions. However, the liability of non-operators to suppliers under these circumstances may be limited by local law. Several court decisions in cases brought by suppliers of a defaulting operator against the non-operators have established the limited liability of the non-operators * * * However, in other jurisdictions, the courts have either reached an opposite result or not faced the issue.

The difficulty of determining the extent of a non-operator's liability in all states should not be underestimated. Unless the limitation of liability has been clearly established by case law or by statute, considerable uncertainty may result from the potential classification of joint operations as limited partnerships taxable as corporations. Even if limited liability has been established, a slight change in the facts may result in a different classification. In view of existing differences in the law of various states, the proposal could result in comparable oil and gas operations in various states being treated differently for Federal income tax purposes.

The added tax burden on oil and gas joint and unit operations in states in which the non-operators have limited liability would make it much more difficult to obtain agreement to unitize all of the properties in a reservoir. As a result, many such projects would not go forward and the nation would lose potential domestic petroleum production. Moreover, the uncertainty created by the proposal would add enormous complexity to the planning and operation of jointly-owned mineral properties.

Without attempting to profess expertise regarding the impact of the proposal on other areas, it would appear that the proposal may also seriously affect other groups which have traditionally operated as joint ventures, cooperatives or partnerships (e.g., attorneys, accountants, physicians, investment firms, construction syndicates, etc.) * * *

II. PARTNERSHIP AUDITS

Under the Administration's proposal, the partnership would be treated as an entity for audit, administrative settlement, and judicial review purposes, even though the tax on partnership income is paid at the partner level. Such a separation of these functions from the imposition of the tax would be impractical and violative of a fundamental concept of partnerships.

Moreover, under the proposal, each general partner would be "presumed authorized to act for the partnership" at the audit level and would have the power to consent to a waiver of the statute of limitations for the partnership thereby keeping each partner's return open for changes attributable to the partnership. The proposal would require the Internal Revenue Service to notify all partners at the beginning of an audit and at the conclusion of the administrative proceeding in order that they be given an opportunity to participate in the determination. This opportunity to participate may be illusory, however, because any general partner would be "presumed authorized" to bind the partnership—even over the objection of the remaining partners.

As indicated in the discussion of the limited partnership proposal, the oil and gas industry presently utilizes several types of arrangements which fall within the partnership definition of Section 7701 of the Code. These arrangements include: (1) co-owners operating through joint operating agreements who have elected out of the partnership provisions of Subchapter K pursuant to Section 761(a) of the Code; (2) co-owners operating through joint operating agreements who have not elected out of Subchapter K; and (3) formal limited partnerships formed under state statutes comparable to the Uniform Limited Partnership Act. Presumably, this audit proposal would apply to all of these arrangements.

(1) *Co-owners electing out.*—In the first of these arrangements, co-owners of oil and gas properties can elect to be excluded from these partnership provisions of the Code if the operation is "* * * for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted" provided that "the income of the members of the organization may be adequately determined without the computation of partnership taxable income." Once co-owners have elected out of the partnership provisions, no annual partnership return is required. Each participant determines its own income and expenses relating to co-owned property and reports it directly on its own tax return. Since one of the prerequisites of electing out is the right of each co-owner to take its share of production in kind, there is no income at the partnership level and each co-owner may realize a different amount of income from its sale of its share of production. Under present law, each co-owner is responsible for reporting its own income and expenses from such co-owned property, and no partnership records exist which summarize total income and expenses of all co-owners of the property from which a partnership return could be prepared. For these reasons, the proposal regarding the audit of partnerships would be unworkable for co-owners electing out of the provisions of Subchapter K.

(2) *Co-owners not electing out.*—Some co-owners of oil and gas property may either choose not to elect out from the provisions of Subchapter K or may be ineligible to do so. Partnership tax returns are filed for these ventures, but the co-owners generally each take in kind and separately sell their share of the production from the joint operation so that the basic underlying records to support the income of the joint operation are in the books of the individual co-owners and not in the partnership books. Consequently, as in the case of co-owners electing out of Subchapter K, the audit function can best be performed at the individual co-owner level.

(3) *Formal limited partnerships.*—Oil and gas properties are sometimes developed by limited partnerships established under statutes comparable to the Uniform Limited Partnership Act. These limited partnerships have been able to attract needed equity capital for high risk activities because they offer investors limited liability for partnership debts and because deductions can be allocated to the limited partners who put up the necessary funds. However, even these formal limited partnerships are not taxable entities; accordingly, a partnership level audit is not appropriate.

Conclusion.—The perceived audit problems of the Internal Revenue Service do not provide sufficient basis for such a radical and fundamental change in the tax laws of the United States. An examination of the facts demonstrates that joint audits would be unworkable and would severely impair the rights of individual taxpayers to determine their own tax liability. This is true whether or not the joint operators have elected to be excluded from the provisions of Subchapter K. In no event should any one partner be able to bind all partners and thereby deprive any individual partner of any procedural or substantive rights whether the forum be administrative or judicial.

AMERICAN TEXTILE MANUFACTURES INSTITUTE, INC.,
Washington, D.C., September 1, 1978.

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

Re: Sunset bill.

DEAR MR. CHAIRMAN: During the course of the hearings on H.R. 13511 on August 21, you asked representatives from several industries, including textiles, whether they had taken a position on the question of including so-called "tax expenditures" in the Sunset bill (S. 2), which was recently reported favorably with an amendment by the Senate Committee on Rules and Administration. Report No. 95-981.

As you are aware, a tax expenditure proposal was included as Title IV of S. 2, as introduced, but was dropped from the bill, as reported by the Senate Governmental Affairs Committee on July 1, 1977 (Report No. 95-326). However, it appears probable that the substance of Title IV will be offered as a floor amendment when S. 2 is called up for debate.

ATMI is strongly opposed to the automatic termination of all so-called tax expenditures, every five years, as advocates of adding Title IV to the Sunset bill would provide.

We have no objection to the periodic review by the appropriate tax-writing committees of Congress of any and all provisions of the Internal Revenue Code, including the various sections of the Code that are frequently labeled as "tax" expenditures". However, we are vigorously opposed to automatic termination dates being provided for such important capital formation provisions as the investment credit, accelerated depreciation, rapid amortization for pollution control facilities, capital gains, etc.

To be effective, provisions included in the tax laws to encourage investment must have long-term continuity—thus a new textile mill or an expanded or modernized spinning or weaving operation may take years to go from the planning to the production stage. Estimates of after-tax return on investment which are the essential first step to almost all significant capital expenditure obviously will be less reliable—and less likely to form a basis for affirmative action—if important investment-stimulating provisions of the Tax Code will be available only if a majority of both Houses of Congress vote to continue them and the President doesn't veto the extension bill.

The textile industry has for many years supported a permanent investment credit and shorter capital cost recovery periods for machinery and equipment. The ADR depreciation rules (with a 20 percent shortening of lives) are presently a part of the Code without a termination date and H.R. 13511 would make the 10 percent investment credit a permanent part of the Code, rather than a provision having (as it now does) a 1980 termination date.

We cannot over-emphasize the importance to long-range investment plans of the American business community of the reasonable assurance of continuance or improvement of the tax rules applicable to capital cost recovery. The same can be said for investors who weigh the risks they are willing to take in connection with anticipated after-tax returns, which are obviously significantly affected by the tax rates imposed upon capital gains.

The reasonable expectation on the part of the business community of a stable or improving tax climate for investment will be seriously eroded if, on a recurring five-year cycle, investment-stimulating tax measures, even if approved on review by Congress, can nevertheless be eliminated from the Code by a Presidential veto. This would be the result if tax expenditures were subject to periodic sunset review under S. 2. As you so aptly stated at the hearings on August 21, an amendment to S. 2 subjecting tax expenditures to automatic termination would give the President and one-third of either House excessive power to determine such questions as whether the investment credit is to be retained or dropped or whether capital gains are to be taxed as ordinary income.

We strongly oppose such a sweeping change in the legislative process applicable to the Tax Code, and urge that the Finance Committee take whatever steps are necessary to assure that it and the House Ways and Means Committee retain full and exclusive jurisdiction over tax legislation.

Sincerely yours,

W. RAY SHOCKLEY,
Executive Vice President.

AMERICAN TRUCKING ASSOCIATIONS, INC.,
Washington, D.C., September 5, 1978.

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

DEAR MR. CHAIRMAN: This is in regard to H.R. 13511, the Revenue Act of 1978, which is now pending before your Committee, and is submitted on behalf of the American Trucking Associations, Inc. (ATA), a national federation, with affiliated associations in every state and the District of Columbia. In the aggregate the ATA represents every type of truck operation in the country, both for-hire and private.

The regulated trucking industry is composed of 16,472 firms, 13,000 of which have gross operating revenues of less than $500,000 annually. We directly employ over 600,000 persons. Truck transportation in total employs over 9 million, making it the single largest private employer in the United States. The regulated industry's total revenues for 1976 were $26 billion, with estimated revenues of over $30 billion for 1977. Based on the most current data, the industry utilizes approximately 840,000 pieces of rolling stock of which a significant portion is replaced annually. In short, the trucking industry plays a vital role in the nation's economy. Demands placed on our industry for modern plants and safe, fuel efficient and environmentally sound equipment make the reliance on the Investment Tax Credit apparent.

ATA suggests the Committee's consideration of the following recommended changes in the Federal tax policy:

(1) *Make the investment tax credit permanent.*—ATA supports provisions in H.R. 13511 which establish a permanent Investment Tax Credit, thereby lending stability to investment decisions. Permanency of the Investment Tax Credit, along with the expansion of Sec. 38 property as discussed in item (2), will further influence our investment decisions, principally long-term capital expansion programs (i.e., new terminal facilities).

(2) *Allow ITC for industrial buildings and rehabilitation expenditures for such structures.*—The Administration has proposed and the House has adopted language to extend the ITC allowances to rehabilitation expenditures for industrial buildings and structures. We encourage the Finance Committee to retain the House language in this area, except that we feel the provision which limits the commencement of qualified rehabilitation to buildings which have been in use for at least five years, should be removed. In addition, we feel that the definition of a "rehabilitation program" should be clarified to preclude inconsistent interpretations. We recommend the following language:

"For purposes of this provision, a rehabilitation plan will include continuous improvements or rehabilitation of eligible buildings, which are presently capitalized for tax purposes, regardless of the existence of a formal program or written plan."

Further, however, we urge the Committee to expand the definition of Section 38 property to include industrial buildings and commercial structures to permit application of the ITC in original construction, as previously proposed by the Administration.

Presently, the Investment Tax Credit is available for property, defined as depreciable tangible personal property having a useful life of three or more years, when such property is used as an integral part of manufacturing, production, or extraction, or *furnishing of transportation*, etc. The [1] statute specifically excludes buildings and their structural components.

Trucking companies use special purpose assets (currently excluded from the code) as an integral part of the productive process of furnishing transportation. For example, these assets include:

Terminal buildings—a facility used as a transportation control center for a specific economic center.

Loading docks—separate facilities, sometimes attached to terminals used for loading and unloading vehicles.

Inspection lanes—covered areas used to expedite safety inspection, fueling, and cleaning of equipment. (See exhibit No. 2.)

These assets are an integral part of the furnishing of a transportation service and meet the intent of the Investment Tax Credit. We urge their inclusion in the

[1] IRC Section 48 (a) (1).

definition of Section 38 property. We applaud the House's decision to extend the ITC to include rehabilitation expenditures for those assets in the definition of Section 38 property. Certainly those who choose to rehabilitate an existing structure should be equitably treated. Those who choose to initiate original construction of industrial and commercial facilities, however, should also have the benefit of the Investment Tax Credit. New capital expansion which increases company's productive capacity in the area of buildings and structures contribute to capital expansion and economic growth in much the same way as the purchase of a piece of new machinery or the rehabilitation of existing structures.

(3) *Remove ITC Limitation.*—Under H.R. 13511, the 50 percent limitation on the amountof investment credit that can be used to offset tax liability in excess of $25,000 would be increased to 90 percent, phased in at an additional 10 percent per year beginning in 1979. Although we strongly endorse enactment of legislation removing all investment tax credit limitations immediately, we are encouraged by this proposal which we feel is necessary for efficient and widespread application of the credit.

Even with the allowable carryback and carryforward provisions, our industry is generally unable to take full advantage of the ITC. Those who *can* take advantage of the carryforward provisions are unable to benefit from the ITC in the year the investment is made, thereby reducing the current purchasing incentive.

Given the heavy debt structure of the trucking industry [2], changes in hte ITC limitations will not only stimulate needed investments but will improve the cash flow position of motor carriers through the investment period, affording a more stable operating environment. This is especially applicable to investment in buildings and structures.

(4) *Increase the current ITC percentages for assets having a shorter useful life.*—ATA proposes a change related to the Investment Tax Credit for newly acquired equipment. Presently a ⅓ credit is allowable on assets with an estimated useful life of three or four years, a ⅔ credit is allowable on assets with an estimated life of five or six years, and a full credit is only allowable on assets with an estimated useful life of seven years or more.

The present restriction on ITC for shorter-lived equipment is discriminatory, unnecessarily complex and burdensome to the trucking industry, as a significant part of our operating assets have a useful life of less than seven years. Failure to include these assets we feel is contrary to the intended economic and job-stimulating purpose of the credit.

A 50 percent credit for qualified assets with an estimated useful life of three or four years, and 100 percent credit for qualified assets with a useful life of five or more would be reasonable and consistent with the depreciation practices of most motor carriers. Many motor carriers who utilize Asset Depreciation Range (ADR) estimations of useful lives for trucking assets are therefore unable to take advantage of the full ITC. (See exhibit No. 1 [3]).

Because of rapidly escalating equipment prices, caused in part by inflation and government mandated environmental and safety requirements, these recommended ITC modifications are more critical today than ever before. For example, a typical tractor/trailer combination costing $29,000 in 1973 required an approximate $43,000 investment in 1977. Engine and vehicle aerodynamic modifications, aimed at increased fuel efficiency also demand large capital investments. We understand that other witnesses have testified in favor of allowing the full ITC for assets having a useful life of three years or more. We would support such a proposal.

Further, the trucking industry's tax reform policy also recommends the elimination of the double taxation of corporate dividends, and the tax deductibility of estimated liabilities related to self-insurance plans. Although we have previously testified before the House [4] with respect to these matters, we respectfully request that your committee carefully consider this needed tax reform in current or future federal tax legislation.

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[2] The Sum of Money, 1972. authorized by Dr. Irwin Silberman (attached).
[3] The Exhibit was made a part of the committee file.
[4] Statement of American Trucking Associations, Inc., before the House Ways and Means Committee, March 13, 1978.

The American Trucking Associations, Inc., asks that the Senate Finance Committee favorably consider this statement and amend current Federal tax policy in the areas discussed. The adoption of these suggested reform measures would greatly reduce present tax inequities, not only as it applies to the nation's motor carrier industry, but to all industries as well. We also request that this letter be made part of the hearing record on H.R. 13511, the Revenue Act of 1978, which the Finance Committee is now reviewing.

Sincerely,

BENNETT C. WHITLOCK, Jr.,
President.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America is a national association representing more than 8,300 general construction firms. These firms perform approximately 60 percent of the annual contract construction volume in the United States and provide employment for some 2 million Americans. Furthermore, our member companies represent the full range of the industry, including the construction of highways, buildings, municipal and utilities facilities, water and wastewater treatment facilities, and heavy and industrial projects. We appreciate this opportunity to comment on some aspects of this country's tax policy.

INVESTMENT TAX CREDIT AND DEPRECIATION

Even though our nation's employment and anti-inflation goals cannot be met without the strengthening of private investment, capital spending in the United States has been seriously inadequate for many years. Therefore, AGC strongly endorses a permanent 10% Investment Tax Credit to offset up to 90% of a business' tax liability beginning in 1979. Furthermore, we believe that the credit should be extended to the construction and rehabilitation of industrial and utility structures. Also, in the interest of fairness and equity, we support a refundable investment tax credit so that small businesses, fledging companies, and indeed, all enterprises can enjoy equal benefits from the investment credit.

Without question, if a solid and permanent investment tax credit is enacted, it will significantly improve national productivity, reduce unemployment and increase the ability of American industry to compete in foreign markets. Moreover, certainly in this area of the law will greatly facilitate investment decision-making in all industries throughout the country.

AGC also strongly recommends that depreciation allowances be liberalized and suggests that the reduction in asset lives currently allowed under the Asset Depreciation Range System be increased to a 40 percent range. The justification for this proposal is simple: The purchase price of construction equipment is high but its useful life is of short duration. It is worked hard, out of doors, and under widely varying conditions. For any contractor, the useful life of his equipment varies with the type of work he does and the abilities of the men he employs. The same machine may be useless after six months on one type of job but have a life of several years on other types of work. This is one significant reason why the investment credit and depreciation allowances should be ample and flexible.

But perhaps the most important reason for increasing our nation's capital stock is to reduce unemployment throughout the country. In the construction industry alone, unemployment rose from an average of about 10 percent in 1974 to 18 percent in 1975. It continued in the 15 to 20 percent range throughout 1976 and averaged 12.7 percent in 1977. In fact, at year-end 1977, there were approximately 500,000 unemployed U.S. construction workers. These rates are nearly twice as high as historical averages and are totally unacceptable. To correct this situation, tax incentives such as a permanent investment tax credit and reasonable depreciation allowances are badly needed to stimulate investment and growth in America's capital stock.

CORPORATE RATE REDUCTIONS AND SMALL BUSINESS TAX LAWS

AGC completely supports reduced corporate tax rates and believes such rates will help stimulate meaningful long-term capital formation. However, any rate reduction should adequately compensate for inflation-raised taxable corporate income.

We also wholeheartedly endorse the provision in H.R. 13511 which allows up to $1 million of stock issued by small corporations to qualify for special loss treatment. Furthermore, the House's proposals to increase the number of shareholders permitted to own Subchapter S stock and to liberalize Subchapter S election rules are sound concepts and good tax policy.

CAPITAL GAINS

AGC believes that taxes on capital gains should be reduced to the pre-1969 twenty-five percent level. However, H.R. 13511's provision which allows a maximum gains tax rate of 35 percent is an excellent step in the right direction. This limitation will definitely encourage investment and stimulate growth in this nation's capital stock.

BUSINESS EXPENSES AND BUSINESS MEALS

AGC strongly supports the deduction of legitimate entertainment and meal expenses incurred in the course of doing business. Current law already adequately protects any abuse by prohibiting deductions for lavish or extravagant items. Thus, there is no need for further regulations or stricter laws. Besides, the government should not be permitted to decide how business sales and promotions should be carried on or where a business meeting should take place. The proper test as to whether a business deduction should be allowed is whether it is an ordinary and necessary business expense. If it is, employees should not have to pay for it out of their own pockets.

EARNINGS OF U.S. CONTROLLED FOREIGN CORPORATIONS AND DISC

Retained earnings of U.S. owned foreign corporations, especially when not returned to the U.S. in the form of dividends, should not be taxed. To do so would almost certainly hurt the competitive position of U.S. foreign operations in that such earnings are typically anticipated and utilized as operating capital in on-going work or bid into future work as such. Any immediate reduction in such earnings would therefore create both short and long term competitive problems for international contractors with an attendant reduction in U.S. employment. Also, the corporate tax deferral available to shareholders of domestic international sales corporations (DISC) on their qualified export income should be continued at a time when the U.S. trade deficit is at an all time high and alternative export promotion policy is nonexistent.

CONCLUSION

We hope the Senate Finance Committee will seriously consider the recommendations of the Associated General Contractors of America in its efforts to formulate a sound tax program for the country. If there is any further information or assistance we can provide, we will be happy to do so. Thank you for this opportunity to express our views.

ASSOCIATED JEWISH CHARITIES & WELFARE FUND,
Baltimore, Md., August 18, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: The Associated Jewish Charities & Welfare Fund of Baltimore, Maryland is pleased to offer testimony in support of the Moynihan-Packwood Bill (S. 3111). As a community service agency, we feel this amendment to the tax code is extremely important in helping maintain a strong voluntary sector.

The Associated Jewish Charities & Welfare Fund is a federation of 36 local, national, and overseas Jewish agencies which provide a comprehensive program of social welfare, health, educational, and recreational services to the Baltimore Jewish community. It is a voluntary body created, maintained, and funded by volunteers who determine its philosophy, objectives, and programs. As such, the Associated Jewish Charities is very closely attuned to the needs of the community

it serves and is able to deliver social services in a highly effective and personalized manner. Because its services are not mandated by law or encumbered by excessive regulations and because of its small size, the Associated Jewish Charities has the flexibility and capability to develop innovative, creative programs. The attached chart, describing the continuum of services for older adults sponsored by the Associated Jewish Charities, illustrates the capability of a voluntary agency to meet the needs of its community.

Voluntary agencies similar to the Associated Jewish Charities & Welfare Fund in Baltimore and in other communities supplement government involvement in social services by delivering needed services in an efficient, creative, and personalized manner. President Carter's Urban Policy Statement calls for the strengthening of this partnership between the voluntary sector and government; however, without adequate financial resources, the voluntary agencies cannot continue to serve their communities. Government might then have to assume services for which there are no private resources.

As greater public scrutiny is given to the expenditure of government funds for social services, it is increasingly important that the voluntary sector remain strong and viable. Unfortunately, the sharp increases in the standard deduction over the past eight years have inadvertently created disincentives to charitable giving, particularly among low and middle income taxpayers. In 1977, 77 percent of the taxpayers took the standard deduction.

If S. 3111 is enacted, it is estimated that the increases in direct charitable giving would be substantially greater than the revenue loss to the Treasury. Since these charitable donations would be used to provide community-based services in an efficient and cost-effective manner, without the administrative cost of the government bureaucracy, the impact of those dollars in meeting local needs would be maximized even further.

The Associated Jewish Charities thus urges that the Senate Finance Committee take favorable action on the Moynihan-Packwood Bill.

Sincerely,

JONAS M. L. COHEN,
Public Welfare Committee.

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Chart 3

CONTINUUM OF SERVICES OFFERED BY THE AJC&WF

HEALTHY AGED → ILL AGED

JCC Senior Adult Services	North-west Senior Center	APGB Voca-tional Guidance	Voca-tional Service Program	JCC Multi-Service Facility	Home-makers Home Health Service	Group Home JFCS	Foster Care	Hurwitz House	Concord House	Adult Day Treatment Center	Levindale Institutional Care

SERVICES TO OLDER ADULTS

Service	Brief description	Number served
(1) JCC senior adult services	Social, recreational, and cultural group activities, shopping assistance, information and referral, legal counseling.	2,000.
(2) Northwest Senior Center	Drop-in center for aged in Reisterstown Rd. Plaza area, information and referral, arts and crafts, social and cultural activities.	1,000.
(3) Advocacy & Community Relations	Shaping a Safer Community Committee, charged with investigating crime problem in Northwest corridor, preparing recommendations, advocacy in legislature, regarding issues of concern to aged.	Serve general community.
(4) APCB vocational services	Vocational guidance provided to aged and poor seeking employment.	About 50 in caseload at any one time; over 100 cases seen in 1-yr period.
(5) Vocational services program	Program to retrain aged, poor and handicapped to enter competitive employment or to obtain permanent employment in Levindale's Sheltered Workshop.	125.
(6) Multiservice facility	225 hot kosher lunches served daily; social and cultural programing; information and referral, health screening and health maintenance programs.	825 clients weekly.
(7) Financial services	Rent supplementation to individuals receiving inadequate DSS and SSI grants, transportation, rent, clothing and medical subsidies from the Department of Social Services or Social Security.	103 aged per month, 68 families per month, 152 Russians per month.
(8) Counseling services	Bereavement, marriage, death and loss counseling, and counseling for the mentally impaired, special services.	1,000 over 1-yr. period.
(9) Homemaker and home health aides.	Aides perform basic housekeeping and health services to enable the aged to remain independent members of the community.	About 80,000 hours of service.
(10) Group home—JFCS	Aged who require the aid of a homemaker and companionship to remain in the community, services includes 5-day-a-week homemaker, daily transportation to a recreation center and casework services.	25 people average of 7.
(11) Foster care	Aged who require protected living but not institutional care	Average of 50 in regular foster home and 12 in agency maintained apartments.
(12) Concord House Manhattan Har Sinai.	231-unit apartment house for aged who require protected living, communal dining room, JCC extension services, homemaker and 2 meals provided; enables aged to remain in the community.	700 units.
(13) Hurwitz House	Group home located in the community for aged who require protected living.	Average 23 bed occupancy.
(14) Adult day treatment center	Full day of activities for socially isolated, physically disabled aged; transportation and 2 meals provided; enables aged to remain in the community.	Average of 30 daily.
(15) Levindale Chronic Hospital	Short-term care and rehabilitation services provided for the ill aged.	43 beds.
(16) Levindale Geriatric Home and Hospital for the Aged.	All levels of care provided for those who need continuous care—intermediate care A and B and skilled nursing.	325 beds.
(17) Sinai Hospital	Provides comprehensive health services to community. Hospital facilities are heavily utilized by aged, particularly departments of rehabilitation, psychiatry, emergency room and primary care services.	

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING,
Washington, D.C., September 6, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

Re The Revenue Act of 1978 (H.R. 13511).

DEAR MR. STERN: On behalf of the Association for Advanced Life Underwriting (AALU) the following comments are submitted with respect to the provisions of the Revenue Act of 1978, H.R. 13511.

AALU is a national organization of approximately 1.000 members who specialize in one or more fields of advanced life underwriting. Collectively, the members are responsible for annual sales of life insurance in excess of $2

billion, mostly in circumstances involving complex factual situations and often dealing with qualified retirement plans, group term life insurance and other involved business planning. A great deal of the work performed by our members is with relatively small businesses and consequently AALU feels especially qualified to represent the opinion of small businesses before the Committee.

AALU is affiliated with the National Association of Life Underwriters (NALU), the largest life insurance industry field force organization in the United States. NALU has a membership of approximately 130,000 life insurance agents. NALU endorses and fully supports the remarks of AALU before this Committee.

AALU's comments are confined to two aspects of the pending legislation: (1) the provisions relating to deferred compensation and (2) the provisions relating to the treatment of cafeteria plans. AALU testified extensively on these and other provisions before other committees, such as the House Ways and Means Committee, and would be pleased to provide copies of this more extensive testimony if it would be useful to this Committee.

We are not here commenting on a number of the original proposals in the Treasury's program, which proposals were rightly rejected by the Ways and Means Committee and the full House and which have not been proposed for reinclusion in the bill before this Committee. We certainly do not choose to burden the Committee's time on extraneous matters. However, we would like to state here for the record our continued opposition to the Treasury's proposals with respect to the treatment of integrated pension and profit sharing plans and of certain welfare plans.

I. DEFERRED COMPENSATION

AALU strongly supports section 122 of H.R. 13511 affirming the long-standing treatment of private non-qualified deferred compensation arrangements This provision would remove the uncertainty created by proposed regulations issued on February 3, 1978[1] and would provide employers and employees with a clear set of rules under which they can operate in a fair and equitable manner. The rule that would have been established by the proposed regulations would probably be contrary to established law and would be counterproductive in their operation in the private sector. As a consequence, AALU strongly endorses the provisions of section 122 of H.R. 13511 and urges the Committee to accept this provision with only one minor change.

A technical error in section 122 of the bill, however, should be addressed and corrected. Section 122(b)(2)(D) states that the provisions of the bill do not apply to a transfer of property described in section 83 "(determined without regard to subsection (e) thereof)." Section 83(e) sets forth the situations in which section 83 does not apply. The parenthetical reference is confusing and literally indicates that the provisions of section 122 of H.R. 13511 may not apply to deferred compensation arrangements such as phantom stock plans. Further, the parenthetical reference appears to not serve any purpose. AALU therefore suggests that the confusion engendered by the provision be corrected by the Senate Finance Committee.

II. CAFETERIA PLANS

Section 124 of H.R. 13511 provides extensive rules regarding the tax treatment of cafeteria plans. The provisions in section 124 basically provide non-discrimination rules that must be adhered to by cafeteria plans in order to permit the desired tax treatment for such plans, i.e., taxation to employees in accordance with the benefit selected by the employee.

AALU believes that the non-discrimination requirement contained in section 124 is not necessary and should be deleted. In addition, if a non-discrimination proposal is contained in the legislation we would strongly urge that it be limited to non-discrimination in the availability of benefits and that it not apply to the operation of the plan. That is, a plan should not be disqualified merely because lower paid employees choose certain types of benefits, such as paid vacations or cash payments.

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[1] Prop. Treas. Reg. § 1.61-16.

A. Non-discrimination tests are not appropriate

Cafeteria plans offer employees a choice among various benefits such as health coverage, life insurance and extra paid vacation time. By offering this choice, cafeteria plans achieve greater cost efficiency for the employer while at the same time better matching the needs of the employee. An employee who has little need for life insurance can, for example, choose health insurance or vacation time. The importance of this saving in efficiency has been stressed by numerous commentators.[2]

The non-discrimination tests proposed in H.R. 13511 for cafeteria plans should be deleted because they add unnecessary complexity to the Internal Revenue Code and because they may be socially counterproductive. In carefully considering the potential impact of these new rules it should be remembered that the tests involved are both vague and complex. The definition "highly compensated" has never been clarified even though it has been used in the Internal Revenue Code for many years.[3] Even the term "officer" is not clear since many relatively low paid employees have titles and some supervisory functions.

Besides the difficulties in determining which employees are in the group that cannot be favored, numerous other complexities exist:

(1) The controlled group rules of section 414 of the Code are applied even though legitimate business reasons often justify diverse welfare plan benefits in different geographical regions;

(2) Welfare plans are more complex than retirement plans because of the nature of the benefit offered, so maintaining comparability where different insurers are used will be almost impossible;

(3) Employment records will have to be maintained to determine eligibility to participate;

(4) The plan cannot discriminate in operation, even though benefits are equally available to all, so constant monitoring is required to be sure discrimination in operation is not resulting;

(5) If health insurance is provided, it is necessary to apply an additional set of complex rules that includes a determination of which participants and their families are "similarly situated"—a highly subjective test.

In short, the proposed rules are exceedingly complex and will be an enormous burden to administer, especially for small employers.

Against this complexity must be considered the tax avoidance that is curtailed. Really there is no substantial gain derived from this added complexity. The nontaxable benefits generally can be individually provided to higher paid employees separately (e.g., health and life insurance) so that a company that is only interested in providing these benefits to higher paid employees can essentially do so without using the cafeteria plan provisions.

Further, imposing these restrictions will be counterproductive in that the social utility and efficiency gained from giving employees their choice of benefits will be lost to the extent employers abandon cafeteria plans in favor of individual plan benefits, e.g., health insurance provided separately.

As a consequence, AALU urges that section 124 of H.R. 13511 be revised to provide that employees will be taxed in accordance with the benefit form selected under a cafeteria plan regardless of the other benefit forms that would have been available.

B. Discrimination in operation is inappropriate

Even if the Commission concludes that it is necessary to have a non-discrimination test for cafeteria plans, the Committee should reconsider the application of a discrimination in operation test to cafeteria plans. While the statutory language of H.R. 13511 is not explicit on this point, the report of the House Ways and Means Committee makes it clear that the legislation includes that cafeteria plans be subject to a discrimination in operation test.[4] Even if a legitimate interest is served in requiring non-discrimination in the offering of cafeteria plan benefits to employees, any interest that the government has is adequately satisfied as long

[2] See, e.g., Prof. Henk Theery of the University of Amsterdam as quoted in Small Business Report at 8 (March 1978); Lawler, "New Approaches to Pay: Innovations That Work," *Personnel* at 11 (September–October 1976); Hettenhouse, et al, "Communicating the Compensation Package," *Personnel* at 19 (November–December 1975).

[3] See § 401(a) of the Internal Revenue Code.

[4] See Report No. 95–1445, Report of the Committee on Ways and Means of the U.S. House of Representatives on H.R. 13511 at 64, 95th Cong., 2d sess. (1978).

as employees have an equal choice among the benefits available under the cafeteria plan. If lower paid employees determine that they prefer a benefit that is currently taxable, such as a paid vacation option or cash option, that should be entirely within the employee's discretion. The government's interest in assuring non-discrimination in cafeteria plans is adequately satisfied as long as the employee could have selected non-taxable benefits such as health insurance and life insurance coverage. The principal purpose of cafeteria plans i.e., to allow employees to select the most suitable, is defeated to the extent the plan is required to be designed so that employees are limited in their ability to select benefit forms.

In short, a plan should be considered adequately non-discriminatory as long as it offers lower paid employees the same choices among benefits that are offered to higher paid employees. If higher paid employees, because of their current cash compensation, elect different forms of benefits, that does not justify upsetting the tax treatment of the plan. To force lower paid employees to make certain types of elections is unduly paternalistic. Lower paid employees would still have the choice. In addition, the plan is put in the position of either having to limit the availability of benefits to employees or to take a chance on the employees' selection of benefits. Since most employers would not find the later alternative desirable as stable and sound tax planning, it is probable that since the fundamental nature of cafeteria plans will be undermined because employers will insure that lower paid employees cannot select currently taxable benefits in any substantial percentage.

C. Other modifications

Four additional modifications in section 124 of H.R. 13511 should be made. First, in order to clarify the definition of cafeteria plans, section 124(d) should be modified to state that the plan must be written and that it must be expressly designated by the employer as a cafeteria plan. This will prevent disputes over whether a series of separate welfare benefits provided from an employer is really separate or part of a single cafeteria plan.

Second, any suggestion that the rule of constructive receipt *automatically* applies to arrangements not covered by section 124 should be expressly negated since it would be unfair to create any such presumption. The rule of constructive receipt rests on a factual determination and should remain so without any inferences from section 124.

Third, section 124(d)(2) should be modified to state that the term "cafeteria plan" does not include any plan that provides only a choice between a taxable benefit and deferred compensation. A plan should not be prevented from qualifying under section 124 merely because one of the benefit choices offered is deferred compensation. For example, section 124(d)(2) as currently written states that a nondiscriminatory plan that provides a choice among cash, deferred compensation and health insurance is not a cafeteria plan. Consequently, an employee electing health insurance might be taxable.

Fourth, the definition of nontaxable benefit in section 124(f) is circular because it defines the term as a benefit that is nontaxable, "with the application of subsection (a)." It should define the term as a benefit that would be nontaxable if offered separately.

We appreciate the opportunity to submit these comments and would be pleased to provide additional information or discuss these comments further if that would be helpful.

Very truly yours,

GERALD H. SHERMAN,
Counsel.
STUART M. LEWIS,
Associate Counsel.

ARTHUR ANDERSEN & Co.,
Washington, D.C., September 8, 1978.

Hon. ROBERT DOLE,
U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR DOLE: In your consideration of the Revenue Act of 1978 (H.R. 13511), as passed by the House of Representatives, we urge that you delete Section 202, which would extend the at-risk rules to closely held corporations. This provision would effectively deny to small business entities the right to make

certain types of investments that would continue to be available to large publicy held companies, and seems unjustified discrimination against smaller closely held companies.

There may be areas of possible abuse in leveraged transactions, involving large amounts of non-recourse debt, but these were generally eliminated by changes made in the 1976 Tax Reform Act. In our practice, we are not aware of situations of potential abuse involving corporations using these types of indebtedness, and we feel that the extension of the at-risk concept to closely held corporations is improper and not needed.

Furthermore, at a time of concern with shortages of capital, it does not seem prudent to eliminate closely held companies as sources of capital for these types of investments. However, that would be the likely result of this proposal if it is adopted.

Very truly yours,

WILLIAM C. PENICK,
Managing Director-Tax Policy.

Enclosure.

PREPARED STATEMENT OF ARTHUR ANDERSEN & CO., ON PRESIDENT'S TAX CUT BILL

INTRODUCTION

The two major issues affecting major Federal tax policy considerations this year are, in our view, (1) the impact of inflation on our tax system, and (2) how to meet our capital needs, both the creation of new capital and the preservation of the capital resources already available.

In analyzing the Revenue Act of 1978 (H.R. 13511), as passed by the House of Representatives, we have considered its major proposals from the viewpoint of their impact on the problems created by inflation and our capital needs. On balance, we think the overall thrust of the House bill does work toward solving some of the problems that need to be solved, and, within the fiscal constraints of the present and anticipated level of our Federal deficit, represents desirable steps to be taken at this time.

Before reviewing the provisions of HR 13511, we would refer the Committee to our earlier testimony on these subjects. In particular, reference is made to the following:

1. Finance Subcommittee on Taxation and Debt Management, "Inflation and Taxation," record of hearings on Indexation of Certain Provisions of the Tax Laws, page 134, April 24, 1978.
2. Finance Subcommittee on Taxation and Debt Management, "Capital Gains Taxation," June, 1978.
3. Senate Select Small Business Committee, "Capital Formation and Taxation of Small Business," May, 1978.
4. House Ways and Means Committee, "Inflation, Taxation, and Capital Formation," record of hearings on the President's 1978 Tax Reduction and Reform Proposals, part III, commencing at page 1683, April 1978.

In our comments on HR 13511, we will emphasize some points made in these earlier statements, but we urge your consideration of the complete statements in connection with your deliberations on this bill.

REVENUE ACT OF 1978 (H.R. 13511)

In reviewing the major proposals of HR 13511, we have tried to answer the question, "What does this bill do to meet the problems of inflation and capital formation?" The following comments about specific provisions are presented in that context.

1. Tax rate reductions

The bill provides meaningful reductions for both individuals and corporations, which should provide more after-tax dollars to save or to invest in new productive facilities or other business investments. We are particularly pleased with the method of reducing individual tax rates by widening the brackets by roughly 6% This appears a step toward indexing the individual tax rate structure, which we supported in our testimony to the Subcommittee on Taxation and Debt Management.

We also support the addition of two new brackets to the corporate tax rate schedules, in effect graduating the rate scale up to a maximum rate that would apply to taxable income over $100,000, rather than the present $50,000. Because of the particular problems and needs of small business entities, we are pleased to see this change in the corporate rate structure which should create a significant benefit to smaller companies.

2. Investment tax credit changes

The changes proposed in the investment tax credit rules are very desirable, and we urge their adoption. The permanent increase in the rate of 10%, and the change in the limitation on the amount creditable in any taxable year, gradually increasing to 90% of tax liability, should act as a stimulus to increased capital investment to modernize and expand productive facilities.

In connection with the decision to make a capital investment, whether it involves the purchase of a new lathe for a small metal working shop or the building of a new manufacturing plant by a major company, one of the most important factors is the analysis of the likely financial consequences of the investment. A major concern of the business manager faced with an investment decision is the projected rate of return on the investment.

Many factors bear on the determination of rate of return. Some are predictable and some are not. Some can be controlled and some cannot. In periods of uncertainty as to future economic conditions, such as the likely rate of inflation or the tax rules that may apply in the future, the business manager is likely to seek a higher rate of return from his investment, before he decides to make it, because of the adverse impact on his business operations if his forecasts prove wrong.

Because of uncertainties as to economic conditions, the impact of continuing inflation, and frequent changes in our tax laws, we have observed that businessmen strive for a higher rate of return on major investments today than was the case several years ago.

The provisions in H.R. 13511 relating to the investment tax credit, under which the credit limitation is expanded and the rate would be permanent, should provide greater certainty to business managers in evaluating business investments. Furthermore, a reduction in the tax rate itself will obviously enhance the rate of return and should in many cases be significant in the decision to proceed with the investment or not.

To illustrate the impact of changes in tax rates and the investment tax credit on the rate of return for a proposed business investment, we have analyzed the effects of a reduction of two percentage points in the corporate tax rate and an increase in the investment tax credit rate from 7% to 10%.

Our analysis assumed an investment of $3,000,000 in new productive facilities—$500,000 to be financed from available funds and $2,500,000 from a loan to be repaid over five years with a 9% interest rate. We further assumed that the new facility will have a ten year depreciable life and that maximum accelerated depreciation methods will be used. Net operating revenues were assumed to commence at $150,000 for the first year and increase by $100,000 per year until they reach $1,050,000 in the tenth year.

Assuming a 48% corporate tax rate and a 7% investment tax credit, the net rate of return projected on this investment is approximately 13.9%. Reducing the tax rate to 46% and increasing the investment tax credit to 10% increases the rate of return to nearly 15.7%, an increase of nearly 2 percentage points.

Combining the change in the investment tax credit and the corporate tax reduction, this increase in the rate of return is great enough to have a significant impact on many investment decisions. Accordingly, the provisions in the House bill that would reduce tax rates and increase the effectiveness of the investment tax credit are very desirable stimuli toward accomplishing the objective of encouraging capital investment in the private sector.

The extension of the investment credit to the rehabilitation of certain types of structures should also encourage the modernization of plant facilities. Such modernization should improve productivity, which could be one of the major factors in moderating or reducing our rate of inflation.

3. Capital gains changes

The needs for capital in the United States in the next few years have been well documented, adequately reported, and widely discussed. Studies of capital availability to meet these needs indicate a substantial capital gap for most of

the foreseeable future. Aside from the need to stimulate the development of new sources of capital, and in particular to encourage people who own capital to invest it for productive purposes, sound tax policy requires that we be concerned about preserving the pool of capital already available. The present U.S. system for taxing capital gains both erodes the existing pool of capital and acts as a strong deterrent to switches in capital from one form of investment to another more productive use.

Our present system for taxing an individual's capital gains may involve three levels of taxes. First, the gain itself is taxed at rates up to 35%. Second, one-half the gain may be taxed as preference income at a 15% rate. Finally, the preference element may be offset against personal service income, causing it to be taxed at rates up to 70% rather than 50%. As changed by the Tax Reform Act of 1976, a reduction in preference income is permitted for only one-half of the regular taxes paid. The combination of these three elements results in an effective Federal capital gains tax rate on individual taxpayers than can reach nearly 50%.

Furthermore, if a taxpayer lives in a high-tax location, such as New York City, additional state and city taxes on capital gains may reach nearly 14%. If the taxpayer is in the maximum Federal tax bracket of 70%, the deduction for state and city income taxes could reduce his Federal taxes by about 10% of the gains, leaving an added effective tax of roughly 4% on such gains.

These high levels of taxes have discouraged new capital investment, particularly in equity securities and high-risk ventures. Furthermore, no adjustment is presently permitted to recognize the inflation element in gains on sales of assets held for long periods of time, and this is not sound tax policy.

At a time when there are concerns about our capital requirements and a particular need to encourage investment in equity securities with the risks that are inherent in them, it seems highly appropriate to take steps to decrease taxes on capital gains that presently operate as disincentives to such investments. In particular, for assets that are vulnerable to inflationary pressures, prudent tax policy requires a decrease in capital gains taxes.

There are many different ways of changing our present system for taxing capital gains to make it less burdensome. The approach adopted by the House would reduce the impact of capital gains taxation to some extent and would help meet our capital needs. Other proposals, such as the Hansen-Steiger bills that would restore pre-1969 rules, and the suggestion made by your Chairman, providing a 70% capital gains deduction, would provide greater relief and should make investments in equities and venture capital entities even more attractive. The responsibility of your Committee is to decide how much capital gains reduction is appropriate at this time and then select a method to achieve it.

Economists have differed on their predictions of the effects of capital gains reductions on tax revenues and on the economy as a whole. The Treasury estimates of revenue losses from these proposals are generally based on traditional estimating procedures which assume little or no change in taxpayer behavior if the tax rules are changed. Economic forecasting and econometric analyses are not within our area of practice or competence, but common sense tells one that increased investment activity would tend to increase long-term tax revenues and stimulate the economy. It seems most unlikely that taxpayer behavior after a significant change such as this would be the same as before.

A potential investor is concerned with the likely rate of return in choosing among alternative investment opportunities. Investors in new equity securities and in venture capital situations expect higher rates of return to compensate for the risk factor. A very significant element in determining rate of return is the amount of taxes that will have to be paid both on current income from the investment and on the gain from its disposition when the taxpayer decides to dispose of it. Capital gains taxation is a major factor in this equation, and the reduction in the effective tax rate from proposals like these should make these types of investments more attractive.

Another important benefit from the capital gains change adopted by the House would be considerable simplification of the tax laws, particularly the preparation of tax returns, for the many thousands of taxpayers who have capital gains each year. The principal impact of the present preference tax system has simply been to increase the effective tax rate on capital gains. Since its enactment in 1969, more than 80% of all preference items subject to the tax have been represented by capital gains.

Furthermore, preference items are required to be offset against personal service income in determining the maximum tax to be applied to that income. The

combination of preference tax reporting and the calculation of the maximum tax on personal service income results in a highly complex reporting system for many taxpayers. Proposals that would remove capital gains as a preference item would greatly simplify tax reporting for the thousands of taxpayers who are affected.

4. Recognition of inflation in capital gains taxation

The provisions in the bill that would permit indexing the tax basis of assets sold, commencing January 1, 1980, would recognize an important policy issue in the taxation of gains on sales of assets held for long periods of time.

Inflation impacts many facets of our tax system, and it affects both individual and business taxpayers in many ways. It is particularly important in the taxation of gains on sales of assets held for long periods of time which are particularly vulnerable to the eroding effects of inflation.

If a person invests $10,000 in 1979, and by the end of 1984 the purchasing power of those dollars has declined due to inflation, the appropriate measurement of the economic gain, or loss, realized by the taxpayer should not be based on the $10,000 "nominal" dollars paid five years earlier. The House bill would recognize the impact of inflation in this example, and the basis of the asset for purposes of determining gain or loss would be increased. Assuming a 40% change in the Consumer Price Index during this five year period, if the taxpayer sold the asset for $18,000, his economic gain and taxable gain would be $4,000, rather than $8,000 under current law.

We think this provision in the House bill is highly desirable and, while it does not meet all of the problems created by inflation and its impact on our tax system, it is clearly a step in the right direction, and we are pleased to support it.

5. The inflationary element in business profits

We would also urge the Congress to study on a more comprehensive basis the impact of inflation on our tax system and make other changes in subsequent legislation to recognize the problems it creates. In particular, serious consideration should be given to eliminating the inflationary element in business profits.

A proposal made by our firm several years ago, and repeated in our testimony to the Finance Subcommittee on Taxation and Debt Management and the House Ways and Means Committee earlier this year, would permit a deduction for "capital maintenance" which would eliminate from taxable profits a portion of the erosion of capital invested in a business caused by inflation each year.

In an inflationary period, both financial and tax profits based on original cost concepts are overstated by the phantom profits caused by inflation. Various techniques for reducing or eliminating these phantom profits have been suggested. They range from adjusting the original cost of assets by changes in various indices to restating the cost of such assets based on current value or replacement costs.

Aside from recognizing changes in price levels or values of specific assets, another problem arises with respect to long-term debt which, when paid off in "cheaper dollars" than originally borrowed, may create an economic gain to the borrower. Whether or not recognition should be given to this so-called "gain" realized by the borrower is a controversial issue in itself.

In recent years, when our rate of inflation has become more significant, an inflation element has been recognized in the interest rate structure and in the negotiations between borrowers and lenders as to that rate. Some analysts estimate that, of the current long-term corporate bond rate (approximately 8½% for AAA-rated bonds), almost 5 percentage points represents an inflation premium. To the extent inflation is a factor in the determination of the interest rate, gain realized by a borrower on the repayment of long-term debt is in effect offset by the excess interest paid. Looking at both the borrower and the lender, the overall determination of income may be approximately correct.

In considering the impact of inflation on a business entity, it is helpful to view corporations in a long-term perspective. Corporations are generally considered as ongoing entities with an indefinite life. This is one cornerstone upon which many aspects of corporate law, financial accounting, business decision-making, and the taxation of corporations are based.

Financial accounting and tax laws are founded on a cost concept that, in periods of little or no inflation, results in profit determination that approximates economic earnings or profits. Under the ongoing entity assumption, as a corporation's assets are converted to cash, they will be replaced. If there has been no inflation, the cash recovered through operations should be adequate to purchase

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replacement assets. In an inflationary period, however, the replacement asset will cost more than the asset consumed. Furthermore, the deductions against taxable profits for the depreciation of plant and equipment and the cost of inventory consumed will not be adequate, resulting in the taxation of phantom profits. In this circumstance, the company may not have sufficient capital from its own resources to purchase the replacement asset and will either have to seek outside financing or find itself unable to continue in business.

Deduction for capital maintenance.—In an attempt to eliminate the inflationary element from business taxable income without a complex series of calculations involving both assets and liabilities, we suggest that consideration be given to allowing a tax deduction for capital maintenance. The theory behind this suggestion is that every business entity has a pool of capital invested in it, generally represented by its net worth or shareholders' equity. That pool of capital is at the risk of the business, including erosion in value caused by inflation. In periods of inflation, the decrease in the value of currency in which that equity is stated is a real economic cost. Accordingly, a reduction of the entity's profits should be allowed for the erosion of that capital caused by inflation during a particular year.

To use a simple example, assume that a company had a beginning equity of $2 million. pre-tax income of $1 million, Federal and state income taxes on that income of $300,000, and dividends paid of another $300,000. Ignoring the interdependent relationship of taxes and after-tax profits, the ending shareholders' equity would be about $2.4 million, or average equity for the entire year of $2.2 million. Assuming the rate of inflation for the year is 7%, a deduction for capital maintenance of $154,000 (7% of $2.2 million) would seem appropriate.

For unincorporated business entities, a similar calculation could be made, based on the excess of assets over liabilities relating to the business activity.

OTHER AREAS NOT COVERED BY H.R. 13511

1. Small business investments

Small businesses have for generations been the backbone of our American economic system. It is presently estimated that small business entities provide jobs for over 50% of our non-public workers. Although often characterized as labor-intensive in contrast with the capital-intensive nature of larger companies, small businesses must attract enough capital to provide employment opportunities. In most small business entities, a little capital may go a long way towards keeping our citizens off the unemployment rolls. Alarmingly, however, the Small Business Administration has reported a steadily decreasing percentage of total capital investments being directed to the small business sector.

With the combined impact of increasing capital gains taxes and the failure of our present system for taxing capital gains to adjust for or eliminate the inflationary element in such gains, it is little wonder that the small business sector has particular difficulty in attracting and retaining the capital needed to start new business entities and finance the expansion of mature ones.

Tax-deferred rollover of small business investments.—There is one specific legislative area requiring the immediate attention of the Congress. This involves the disposition of interests in small business entities. Senate Bill 2428, introduced in January of this year, proposes a unique change in the tax treatment of sales of small business investments where the proceeds of such sales are reinvested in other small business entities. This is sometimes referred to as a tax-deferred rollover.

In testimony before a Joint Meeting of the Senate Select Small Business Committee and the Senate Finance Committee on September 24, 1975, our firm discussed a hypothetical situation involving a small company that has reached the stage of its development where the founder and principal owner wishes to dispose of his investment, primarily for personal reasons. He has basically two options: first, a sale for cash or similar consideration that would generate a taxable capital gain; and second, a merger transaction with a large company structured on a tax-deferred basis. For various reasons, the owner would be attracted to a tax-deferred transaction to preserve the full value of his investment without erosion from current taxation.

In the typical situation where the principal shareholder of a small business concern wishes to dispose of his stock, employee groups or other "entrepreneurs" who might be interested in continuing to operate the business are not in a posi-

tion to offer readily marketable securities in exchange for such stock. Generally speaking, the only consideration they can offer is cash or promises to pay for the investment over a period of years. From the seller's viewpoint, the receipt of cash or debt instruments creates a taxable profit under present law, even though taxation generally may be deferred under the installment reporting method until cash has actually been received. This is usually not as attractive to the seller as an exchange of his assets or stock for securities of a listed company where tax can be deferred as long as those securities are held. Accordingly, the employee group or the small business entrepreneur who wishes to acquire the business is at a significant competitive disadvantage in negotiating the transaction. This seems bad tax policy since, as already noted, it creates a strong incentive for the merger of small companies into large ones and a greater concentration of economic wealth in larger entities.

While we agree with the concept of Senate bill 2428 that would extend non-recognition treatment to reinvestment in similar types of small business concerns, we question whether it should be limited to that extent. The objective of our original proposal was to provide non-recognition treatment on the sale of a small business interest to another entrepreneur in a transaction that would probably involve cash and notes, because this is usually the only form of consideration available to such a purchaser. Additionally, we do not believe that the small businessman, who is dependent on the proceeds of the sale of his business to provide for his retirement, should be required for tax reasons to reinvest such proceeds in another small company, as is proposed in S. 2428. Limiting non-recognition treatment to reinvestment in another small concern seems to represent an inappropriate merging of differing tax objectives.

As an alternative, we suggest that the reinvestment requirement permit using sales proceeds for investment in another business entity, including equity or debt securities of a publicy held company. This would provide the small business taxpayer greater security to meet his retirement objectives but would not create an open-ended investment opportunity. Furthermore, it would seem appropriate to limit this reinvestment opportunity to the initial investment of the proceeds of sale, so that the liquidation of the reinvested funds or conversion to another security would not enjoy tax deferred treatment.

These changes in the proposal would appear to be consistent with the basic objective of this concept, putting the seller of a small business entity in substantially the same position he would have been had the transaction been carried out on a tax deferred basis through a merger with a large company.

2. Administration proposal to tax currently undistributed earnings of foreign subsidiaries

The President's 1978 tax program, announced publicly in January of this year, included a recommendation that our long-standing rules for taxing the undistributed earnings of foreign subsidiaries be phased out over a three year period so that such earnings would be taxed currently. This has been referred to as the "elimination of deferral", but we think a more appropriate phrase would be the "anticipatory taxation of unrealized income". We were pleased to note that this recommendation was not included in H.R. 13511, and we urge that, in your consideration of the bill, your Committee decide to retain present law in this area.

In testimony before this Committee on April 20, 1976, on the "Tax Reform Act of 1975" (see record of hearings, part 3, commencing on page 1567), we analyzed the position of U.S. companies in international markets, emphasizing the competitive position of U.S. companies in relation to foreign companies. Some of these analyses have recently been updated, and a copy of this material is attached as Exhibit I. The overall analyses have recently been updated, and a copy of this material is attached as Exhibit I. The overall conclusions of the study are presented below.

Comparisons and analyses of available date with respect to the competitive position of the U.S. and foreign-based companies (both multinational and local) clearly indicate that:

1. The relative position of U.S.-based multinational companies in international markets has declined over the past ten years in relation to foreign-based multinational companies.

2. That decline has accelerated substantially since 1970 although it leveled off somewhat in 1975–76 (as a result of several factors not the least of which is the worldwide price of petroleum).

3. Local foreign-based companies have considerable strength and therefore intensify the competition in the marketplace where U.S. foreign business is principally located.

Our analysis shows further that, should the United States adopt a provision that would tax earnings of controlled foreign corporations without regard to repatriation of those earnings, the following will probably result:

1. U.S. corporations often will be required to pay a higher current tax, thereby creating a need to raise additional funds or divert funds from present productive uses. The adoption of a policy that brings this about is inconsistent with Administration and Congressional concern with capital formation.

2. Our competitors in the marketplace will be able to utilize important differentials in taxable income determination in other countries, which may no longer be available to U.S. international companies. Many of the tax incentive allowances presently granted by foreign countries will either be unused or become unavailable to U.S. companies, thus eliminating these incentives as an important source of financing for the companies. Since foreign competitors will not be restricted in their ability to use all local tax allowances and will not be required to pay any tax on the profits involved other than the local country tax, the competitive balance will be tipped in their favor.

3. The demand on U.S. companies for higher U.S. and foreign taxes will raise the costs and reduce the profitability of those companies in relation to their competitors, which are not subject to such taxation. Thus, U.S. companies will be weakened competitively in the world marketplace. This would result in reduced earnings and, thus, reduced market values of company stock, making it more difficult and expensive for U.S.-based companies to raise capital funds. Stock of foreign-based companies would not be similarly affected and would therefore be more attractive to investors. Capital markets for industrial giants are worldwide and many foreign companies and U.S. companies are listed on stock exchanges in several countries. Since such companies thus compete for available capital, a tax change of this type will adversely influence U.S. companies in the competition for capital.

4. Since foreign-based companies will be able to more effectively compete with U.S. companies due to their lower working capital needs and financing costs, they will become more successful in their markets as U.S. companies become less successful. Over a period of time, this could materially shift the balance of economic power among companies and nations. This may also result in the shift of our technological advantage to foreign competitors, ultimately resulting in U.S. dependence on foreign technology.

5. As U.S. companies lose competitive position abroad, they will become increasingly vulnerable to an equivalent loss of position to foreign competition in the U.S. market. The strength of international companies from such countries as Germany and Japan will enable them to continue to make important inroads into the U.S. market once they have control of international markets.

6. The management of many U.S. companies faced with the loss of international markets, a shift in technological advantage and possible major inroads into their U.S. markets could not, in fulfilling their fiduciary responsibilities to shareholders, remain inactive. Among the actions that could be considered would be (a) selling all of their overseas operations to foreigners, (b) selling control of their overseas operations to foreigners (an objective presently sought by governments of many countries) or (c) creating a separate domicile for their foreign operations such as has been done by Royal Dutch Shell or Unilever.

Because of the factors and conclusions stated above, we strongly urge that no additional tax burdens be placed upon U.S.-based multinational companies through provisions for immediate taxation of foreign subsidiary earnings. The position presented by the Administration on this issue is based on an incomplete understanding of the nature and problems of U.S. international business and instead assumes a largely illusory substantial "tax-avoidance" motive in foreign subsidiary utilization. Negotiation or renegotiation of income tax treaties cannot possibly undo the great potential damage that would be done by a change in taxation of earnings of foreign subsidiaries.

While the term "deferral" is commonly used to describe our present rules for taxing foreign subsidiaries, we do not agree that the taxation of earnings of a foreign corporation only when remitted is a deferral of U.S. tax. Instead, the change proposed by the President, in our opinion, would constitute anticipatory taxation of unrealized profits from the investment in the foreign corporation.

In supporting a change in the tax law, the Administration and other proponents present philosophical/political arguments involving concepts of "neutrality" and "equity".

We believe a philosophical/political question is involved in this situation, but it is not what the proponents argue. The real issue is not: "Is the current taxation of unremitted earnings of foreign subsidiaries necessary to achieve 'equity' among U.S. taxpayers?" Instead, the issue is: "Is the United States willing to risk driving many U.S.-based companies out of a number of foreign markets and, further, to risk subsequent major foreign inroads into U.S. markets in pursuit of a theoretical and unrealistic concept of equity in taxation?"

More recently, we were engaged by the National Association of Manufacturers and the Emergency Committee for American Trade to perform a study of a number of U.S. companies with overseas operations. The purpose of our study was to determine the likely impact of the elimination of the so-called "deferral" system as proposed by the President on U.S. tax revenues and company tax costs. In performing this study, we considered the likely changes in practices and behavior of these companies if such a change were enacted, particularly as they might affect divided distribution policies.

The thrust of our conclusions was that these companies would be forced to re-examine their dividend policies and their activities under the tax laws of other countries, so as to minimize the total tax burden on their operations, both U.S. and foreign. In our view, the net result of this change would be that, if this group of companies is representative, and it appears to be, American companies will increase their total tax burdens, but foreign governments will be the primary beneficiaries. It appears quite likely that there would be a loss of U.S. tax revenues but the overall cost to the companies involved would be substantially increased. This would further exacerbate the competitive position of these companies in world markets, at a time when we need to stimulate activities abroad that contribute toward improving our balance of payments situation and increasing employment in the United States.

The Arthur Anderson & Co. study has been discussed in testimony at these hearings by the National Association of Manufacturers and the Emergency Committee for American Trade. Copies have been provided separately to members of the Committee.

We urge that the Committee agree with the House position that no change in the present rules for taxing the earnings of foreign subsidiaries is desirable.

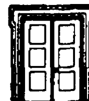
EXHIBIT I

Statement on

U.S. Companies in International Markets

President's Proposal for Current Taxation of Earnings of Foreign Subsidiaries

April 3, 1978



ARTHUR ANDERSEN & CO.

PREFACE

In its 1978 tax proposals, the Administration recommends the elimination of present tax rules that tax earnings of foreign subsidiaries only when remitted to U.S. parents. Thus, this would eliminate the long-standing provisions of our tax laws commonly referred to as "deferral."

When fully implemented, the Administration proposals would change completely our tax policy relating to earnings of foreign subsidiaries and would, in effect, tax such earnings to a U.S. parent on an anticipatory basis, even though those earnings would not have been realized by a U.S. entity. We strongly oppose this proposed change.

The statement that follows analyzes several important aspects of the operations of U.S.-controlled entities in international markets. First, we review the relative position of U.S.-based multinational companies in international markets and note the substantial decline of our position in relation to foreign-based multinationals. We then note the substantial and growing strength of our competitors in countries, in world markets and increasingly in the United States. Finally, we are concerned to note the continued declining share of worldwide gross national product represented by the United States.

Our statement then reviews the tax policies of six countries where U.S. businesses have invested significantly that are applicable to companies doing business in those countries. We also analyze the tax policies of seven major commercial countries regarding multinational companies headquartered in those countries.

We then identify potential consequences of adoption of the Administration proposal that may go far beyond the dollars of U.S. tax revenues involved. These include such things as the adverse impact on our position in competition with foreign companies in worldwide capital markets and the likelihood that these changes, if implemented, might force U.S. companies to either divest control of foreign subsidiaries or, at worst, withdraw completely from certain markets, leaving those markets to our major foreign competitors.

Finally, against the background of the tax principles that we think should be applied, we comment specifically about several basic arguments presented in support of the Administration's proposals.

We strongly urge that the Administration's proposals in this area not be adopted.

PART I—COMPETITIVE POSITION OF U.S. COMPANIES IN INTERNATIONAL MARKETS

International trade and investment today are highly competitive. Most major businesses are conducted on a global basis. It is apparent that only those companies that can achieve and maintain substantial competitive strength in the international marketplace can survive for a long period of time. Every major economy in the free world involves strong locally owned competitors and large international companies of other countries.

It is clear to us that, when business opportunities exist in countries throughout the world, business entities from some country will take advantage of those opportunities. Thus, if economic factors, government restrictions or other considerations make it difficult or impossible for U.S. companies to enter into business in a particular country, that opportunity will be taken advantage of by businesses of other countries.

Historically, it has been assumed that U.S. business dominates world markets. Statistics for recent years indicate that this dominance no longer exists. The relative position of U.S.-based multinational companies has declined significantly. During the past ten years, foreign-based companies, especially those from Europe and Japan, have become increasingly competitive with U.S. companies in international markets.

More important, since the mid-1960s, an important trend has developed: foreign-based companies have been rapidly overtaking and replacing U.S. companies in their relative position as the major commercial forces in the world.

We recognize that there are many factors which enter into this result, including the rapid economic recovery of Japan and European countries from World War II, the varying effects of changing economic factors, such as government fiscal policies, inflation, depression, currency adjustments, etc., as well as important political factors.

We do not pretend to quantify any of these factors, but wish merely to present a picture of what has happened to the relative position of U.S.-based international companies in relation to their foreign-based international and local competitors as that position appears today and as the trend to the current position has occurred over the past five to ten years.

All of the data used in arriving at our comparisons have been taken from statistics published by recognized sources: the Commerce Department; *Fortune;* the *London Times;* the *International Economic Report of the President;* the OECD; the World Bank and the *Financial Post* (Canada).

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Share of Worldwide Sales by U.S. Companies

The trend in competitive ability of U.S. companies vis-à-vis foreign companies can be clearly demonstrated by a review of annual sales of the 100 largest firms in the world. The table below shows that, in 1965, 68 U.S. corporations were among the 100 largest companies in the world, ranked by sales. By 1976 (the latest year for which these statistics are available), the number of U.S. companies in the top 100 had dropped to 48.

DISTRIBUTION OF THE WORLD'S 100 LARGEST INDUSTRIAL COMPANIES

(Ranked by Sales)

	Number of Companies			
	1965	1970	1973	1976
U.S.-based companies	68	63	49	48
Foreign-based companies	32	37	51	52
Total companies	100	100	100	100

Source: *Fortune*, various issues.

Note: Appendix A provides a summary of the number of companies by country.

If oil companies in the top 100 are excluded, the decrease is from 57 in 1965 to 33 in 1976. This represents a reduction of 22 percentage points (from 66% to 44% of the total number of companies).

DISTRIBUTION OF THE NONPETROLEUM COMPANIES AMONG THE WORLD'S 100 LARGEST INDUSTRIAL CORPORATIONS

(Ranked by Sales)

	Number of Nonpetroleum Companies Among 100 Largest			
	1965	1970	1973	1976
U.S.-based companies	57	49	36	33
Foreign-based companies	30	33	45	42
Total nonpetroleum companies	87	82	81	75

Source: *Fortune*, various issues.

Note: Appendix B provides a summary of the number of companies by country.

These tables demonstrate graphically that U.S. companies are being displaced by foreign companies as worldwide leaders in their industries.

Also during the period 1965-76, sales of the 50 largest foreign industrial companies increased 440% (from $68.4 billion in 1965 to $369.2 billion in 1976), whereas the corresponding increase for the 50 largest U.S. companies was only 230% (from $147.2 billion in 1965 to $487.0 billion in 1976). Put another way, in 1965 total sales of the foreign companies were 46% of the sales of their U.S. counterparts; by 1976 the foreign companies' sales had increased to 76% of the U.S. companies' sales.

Most of these large companies, which compete with U.S.-based companies in world markets, are based in Europe (primarily West Germany) and Japan. The only other major country that showed a decline in competitive position was the United Kingdom.

Share of Worldwide Assets of U.S. Companies

The relative growth and related competitive ability of U.S. companies also are indicated by the trends in the relative amounts of total assets of U.S. industrial (nonpetroleum) companies and their foreign competitors. The table below shows the growth in total assets of the ten largest U.S.- and foreign-based companies (ranked by 1976 sales). Since 1965, the combined total assets of the ten largest foreign companies grew by 388%, whereas the ten largest U.S.-based companies grew by only 152%. Put another way, in 1965 total assets of the foreign companies were 35% of the total assets of the U.S. companies; by 1976 the foreign companies' assets were 67% of the U.S. companies' assets.

COMPARISON OF COMBINED TOTAL ASSETS OF THE TEN LARGEST FOREIGN- AND U.S.-BASED NONPETROLEUM INDUSTRIAL COMPANIES

(Ranked by 1976 Sales)

	Combined Total Assets			
	1965	1970	1973	1976
		(In Billions)		
Ten largest foreign-based companies—				
Combined total assets	$15.6	$33.2	$54.0	$ 76.2
Percentage increase over 1965	—%	113%	246%	388%
Ten largest U.S.-based companies—				
Combined total assets	$45.1	$65.9	$89.4	$113.6
Percentage increase over 1965	—%	46%	98%	152%

Source: *Fortune*, various issues.

Note: Appendix C provides a breakdown of the names and countries of incorporation of the companies included above.

A similar trend is apparent with respect to commercial banks. The following table shows that the number of U.S.-based commercial banks included in the top 50 banks in the world in 1970 was 15; by 1976, that number was reduced to 10, dropping the U.S. position in the top 50 banks by 10 percentage points. Those 10 percentage points were picked up largely by banks in Europe (See Appendix D).

DISTRIBUTION OF THE 50 LARGEST COMMERCIAL BANKS IN THE WORLD
(Ranked by Assets)

	Number of Banks			Change in Percent of Total
	1970	1973	1976	1970-76
U.S.-based banks	15	12	10	(10%)
Foreign-based banks	35	38	40	10
Total banks	50	50	50	

Source: *Fortune*, various issues.

Note: Appendix D provides a summary of the number of banks by country.

Relative Net Income of U.S. Companies

The relative competitive ability of U.S. companies is also indicated by the trend in their net income as compared with that of their foreign competitors. The following table compares the totals of the net income of the 50 largest U.S. and foreign companies for 1965 and for 1970, 1973 and 1976. Net income of the 50 largest foreign companies by 1976 had increased by 254% over the net income in 1965. The corresponding increase for U.S. companies was only 126%. In summary, the table indicates a substantial increase in the relative net income earned by foreign companies vis-à-vis U.S. companies in the last few years from 24% of the profits of the U.S. companies in 1965 to 37% in 1976.

COMPARISON OF NET INCOME OF 50 LARGEST U.S. AND 50 LARGEST FOREIGN INDUSTRIAL COMPANIES
(Ranked by Sales)

	Net Income	
	Foreign Companies	U.S. Companies
	(In Millions)	
1965	$2,651	$11,112
1970	3,974	11,082
1973	8,587	20,523
1976	9,390	25,188
Percentage increase from 1965 to 1976	254%	126%

Source: *Fortune*, various issues. (Details on methods of consolidation of affiliates can be found in specific issues of *Fortune*.)

Share of Gross National Product

The following tabulations indicate that the U.S. share of world production of goods and services has also declined in recent years. Some decline of the U.S. and other developed countries is to be expected in view of the commercial development of the many underdeveloped countries in the world, and such a trend should be considered desirable. However, beginning in the early 1970s, the decline in the U.S. share of world gross national product (GNP) accelerated substantially.

U.S. Share of GNP

The accompanying table shows the percentage of the world GNP for major segments of the world for selected years during the period 1960 to 1975. The U.S. share of the world GNP in 1960 was approximately 34%; by 1975 it had declined to only 25%.

Percentage Share of World GNP

	1960	1965	1970	1975
	100%	100%	100%	100%
UNITED STATES	33.7	31.2	30.7	25.0
EEC (excluding U.K.)	12.8	14.2	15.8	17.6
UNITED KINGDOM	4.7	4.5	3.8	3.6
JAPAN	2.6	3.9	6.2	8.3
ALL OTHER	46.2	46.2	43.5	45.5
TRILLION U.S. $	$1.5	$2.2	$3.2	$6.0

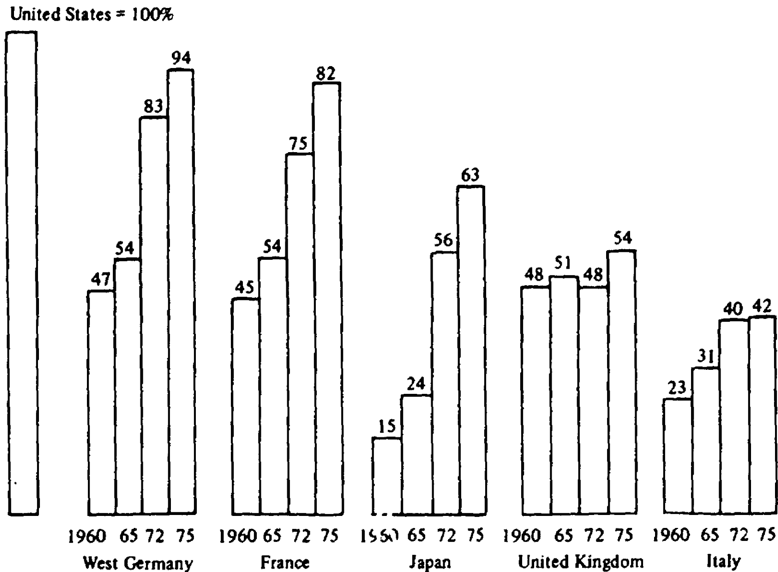
Source: *International Economic Report of the President*. 1976 (based on Commerce Department statistics); *1977 World Population Data Sheet*, OECD, Jan. 1978.

From the foregoing table (and Appendix G which further analyzes relative GNP changes), it is apparent that the nine percentage point decline in the U.S. share has been taken over by the countries in which our major commercial competitors are domiciled, European Community countries other than the United Kingdom (an increase of nearly five percentage points) and Japan (an increase of over five percentage points). Among the major countries, the only country other than the United States showing a significant decline was the United Kingdom.

U.S. Per Capita Share of GNP

The following table shows the GNP per capita for each of several years during the 1960-75 period. The countries included are West Germany, France, Japan, the United Kingdom and Italy. The statistics show that per capita GNP in West Germany was less than half that of the United States in 1960 but is only slightly below that of the United States as of 1975. Japan's per capita GNP relative to the United States has grown from 15% to 63%; France's per capita GNP has grown from 45% to 82% of the United States. If these trends continue, GNP per capita in West Germany, France and Japan will eventually exceed that in the United States.

GNP Per Capita as a Percentage of U.S.



Source: *International Economic Report of the President,* 1973 and 1976 (based on Commerce Department statistics), *1977 World Population Data Sheet,* OECD.

The increased shares of GNP of our competitors have apparently been converted to real gains for the residents of their countries. Historically, the GNP per capita of the United States has been substantially greater than that of other countries in the world including developed nations.

Summary of Present Competitive Position

We believe the preceding data, all of which have been extracted from accepted and reliable published sources, show that the relative position of U.S. companies in international markets has declined during the past five to ten years. Since 1970, that decline has been substantial. The data shows that competition faced by U.S. companies in overseas markets is of substantial economic strength; it shows further that the larger companies outside the United States are growing faster than their U.S. counterparts.

Very importantly, it is quite apparent that significant markets exist outside the United States. If U.S. companies are to avoid relative growth stagnation, they must participate in those foreign markets.

Presence of Locally Based Competition

While the above data clearly illustrate the change in position of U.S. international companies in relation to foreign-owned international companies, they do not tell the full competitive story. In every major national economy in the free world, competition is provided by local companies (large and small) as well as international companies. Many of the local competitors are substantial in size and economic strength while not reaching the size or scope of operation of *Fortune's* 100 foreign companies. Such companies as R.W.E. Rheinisch of Germany and the Imperial Group of the United Kingdom, although not in the top 100 world companies, are strong competitors for U.S.-owned companies.

This point can be demonstrated rather simply by examining the local companies and their economic strength in major countries in which U.S. business has historically placed most of its foreign investment. Appendix E shows the breakdown of U.S. industrial investment patterns (excluding petroleum) in other countries.

The first six countries in Appendix E, excluding Switzerland, are the situs of over 55% of U.S. foreign direct investment. Switzerland should not be looked upon as a significant situs of investment because much direct investment made in Swiss companies represents businesses owned in other countries through Swiss companies rather than the ownership of an operating business in Switzerland. It is interesting to note that three of the six (United Kingdom, Germany and France) are also the home base for 27 of the top 100 industrial companies of the world as shown in Appendix A. Thus when

U.S. international business invests in those countries it is meeting many of its largest competitors on their home grounds.

From various sources, we have accumulated publicly available data regarding locally based companies with annual sales exceeding $500 million operating in each of these six countries. The results are extremely interesting (see Appendix F for details). In Europe over 250 of these sized companies compete with U.S. business at the heart of U.S.-owned investment there (France, Germany and the United Kingdom). In Canada, where many people believe U.S. business monopolizes the economy, there are 30 locally based competitors of that size. Even in Brazil, a country in a much earlier stage of development, there are four large locally based competitors. It is likely the actual number of such sized companies in Brazil is greater but others cannot be identified because of the unavailability of complete financial information on many companies. In four of the countries, all except Australia and Brazil, the largest local company below *Fortune's* 100 has sales of about $4 billion or more. Companies of such size must provide strong competition. Obviously, severe competition is also provided by companies smaller than those we have summarized, but tabulating data regarding companies with sales below $500 million would seem to be overkill.

PART II—TAXATION OF COMPETITORS OF UNITED STATES INTERNATIONAL BUSINESS

In Part I of this statement, we have analyzed the competition faced by U.S. international business and compared economic trends in that competitive situation. In this part we shall discuss the tax treatment the competitor companies face and compare it with that U.S. international business would face if deferral were to be eliminated.

In fully understanding the impact of changing the tax law regarding the taxation of unremitted earnings of foreign subsidiaries of U.S. business, we believe you should be informed regarding:

1. The principal unusual income and deduction items applicable in determining taxable income in countries where U.S. companies principally invest.
2. How the world's other major commercial nations tax the foreign subsidiaries of companies incorporated in their country.

Both of these factors are of great consequence in evaluating the impact of eliminating deferral since both are involved in determining how U.S. foreign subsidiaries stack up against foreign competitors.

Principles of Taxable Income Determination in Other Countries

Earlier in this statement we discussed the strength of the competition faced by U.S. international business with reference to six countries where over 50% of total U.S. direct investment has taken place. Those six countries have many unusual features in their tax laws regarding taxation of income or allowance of deductions.

In establishing tax rules and practices, the government of a country must take into consideration many factors peculiar to that country, including such things as the strength of its currency, local inflationary trends, local business custom, the local business system, local accounting practices, the condition of local industry and legal requirements or restrictions. Invariably, such considerations will mean that that country's income tax system arrives at a taxable amount for a particular business that is significantly different from the taxable income on the same business as would be determined under U.S. rules.

Table 1, which appears on pages 12 and 13, summarizes the principal unusual items of taxable income determination in the six primary nations in which U.S. business operates. In Appendix H, we have described those factors for each country in greater detail.

A close review will disclose that there are many types of adjustments to local country taxable income that could be of great importance. While some of the adjustments can be looked on as "tax incentives" designed to attract greater investment, most of them are not of that type. All are simply reflective of business and economic conditions in the country.

Such deductions as the general write-down of inventory for inflation (inventory stock relief) and the nondepreciable nature of office buildings in the United Kingdom, specific inventory write-downs (base stock allowances and the reserve for price variations) in France, the allowance of highly accelerated depreciation on machinery (two-year write-off) in Canada and the monetary restatement of assets in Brazil often have a significant effect on taxable income in those countries.

Even the special depreciation allowances for machinery in several countries such as the United Kingdom should not be looked upon merely as incentives influencing U.S. business to put new investment there. Clearly with almost 120 local companies with sales in excess of $500 million in the United Kingdom, such allowances are not established by the government primarily to influence U.S. investment. Such allowances apply to all businesses (U.S., local and those from other countries) to encourage replacement of existing assets as well as the acquisition of new assets as a company's share of the market grows. They thus significantly affect the local company (the competition for U.S. business) in its ability to retain and strengthen its position in that marketplace.

TABLE 1

SUMMARY OF MAJOR DIFFERENCES IN TAXATION OF BUSINESS INCOME AND DEDUCTIONS IN SIX COUNTRIES THAT ARE IMPORTANT RECIPIENTS OF U.S. INVESTMENT

Brief Description of Tax Accounting Item	Australia	Brazil	Canada	France	Germany	United Kingdom
Corporate tax rate	46%	30%	42% or 48% (1)	50%	44%-61% (2)	52%
Arbitrary write-down of inventory allowed:						
General write-down allowed	D		D			D
Write-down allowed under specific circumstances				D	D	
Depreciation allowances are significantly different from U.S. tax depreciation:						
Special depreciation allowed on machinery and equipment	D	D	D			D
Depreciation of buildings partially not allowed	I					I
Goodwill amortization allowed			D			
Investment tax credit allowed			D			
Tax-free reinvestment of gains from sale of fixed assets allowed	D		D		D	
Special reserves allowed to cover estimated losses or estimated expenses				D	D	

Brief Description of Tax Accounting Item	Australia	Brazil	Canada	France	Germany	United Kingdom
Other items:						
Interest and royalty income taxable (and deductible) only when paid						E
Capital gains taxed on limited basis or not at all	D		D	D		
Foreign and/or export income specially treated	D	D		D		
Foreign exchange gains/losses partially taxable/deductible						E
Capital maintenance allowance allowed to correct for inflation		D				

Explanation of effect on local country taxable income:

D—Normally decreases it

I—Normally increases it

E—Could either increase or decrease it

Notes:

(1) Canadian Dominion tax rate is 40% on manufacturing business and 46% on other businesses; provincial tax rates generally average 2%.

(2) German corporate tax rate (ignoring withholding tax) ranges from about 44% when all earnings are paid out as a dividend to about 61% when no dividends are paid.

The taxation of all earnings of foreign subsidiaries of U.S. companies would require the adjustment of local country taxable income to U.S. standards. Adjustments for items of the type described in Table 1 would often substantially change taxable income of the local subsidiary. The impact of such changes would clearly affect significantly (in a few cases positively) the competitive posture of U.S.-owned subsidiaries in that country.

In all cases the requirement to adjust local income to U.S. taxable income standards will result in tremendous administrative problems for both the taxpayers and the Internal Revenue Service. Neither we, nor anyone we are aware of, can accurately quantify the impact of such changes on particular companies or the potentially endless complexities in making them for all companies. Present determinations of earnings of subsidiaries reported in U.S. corporate tax returns virtually never involve the refinements that a determination of U.S. taxable income would call for. Because of the complexities of revising foreign subsidiary income to a U.S. tax base and for many other reasons not discussed here, we strongly disagree with the assertion by the Administration in its report that the elimination of deferral will "permit the simplification of U.S. rules relating to the taxation of foreign income." The Internal Revenue Code might be simpler as a result but the administration of the Code by the Internal Revenue Service and the taxpayers will be exceedingly more complex. We would emphasize, however, that we strongly endorse overall simplification of the Code as a general principle.

When competing with all businesses in any country, U.S. international business must be able to operate under the economic, business, legal and political conditions in that arena. A vital part of those conditions is the tax rules prescribed by the law of the country. Taxing the profits of a controlled foreign subsidiary based on U.S. taxable income rules would completely vitiate the impact of the taxable income rules established by the local country. Far more importantly, however, it would put U.S.-owned subsidiaries in a substantially worse competitive position than that available to every other company operating there.

Taxation of Foreign Business by Other Countries

As illustrated above in the section regarding competition, the large foreign international companies are generally headquartered in a handful of countries which are the major commercial bases from which their operations historically originated. Generally, such companies have originated in Belgium, France, Germany, Italy, Japan, The Netherlands or the United Kingdom. As U.S. international business operates around the world, it often competes with subsidiaries and branches of companies of those nations. In 1975, we submitted to your Committee a study of how those countries tax their international business. We have now updated that study. The specifics of each country's approach to such taxation as described in Appendix I and are summarized in Table 2.

TABLE 2

TAXATION OF INTERNATIONAL BUSINESS

Home Country	Does Country Tax Profit of Foreign Subsidiary: When Unremitted	When Paid as Dividends	Earnings of Foreign Branch	Is Foreign Tax Credit Given	Are Foreign Earnings Taxed as a Practical Matter
Belgium	No	No	No	Not Needed	No
France	No	No	No	Not Needed	No
Germany	No(1)	Yes	Yes	Yes	No
Italy(2)	No	Yes	No	Partially	Partially
Japan	No(1)	Yes	Yes	Yes	No
The Netherlands	No	No	Yes	Yes	No
United Kingdom	No	Yes	Yes	Yes	No

Notes:

(1) Germany has limited Subpart F-type provisions. Japan will enact limited Subpart F-type provisions effective April 1, 1978.

(2) Italy only taxes foreign branches that do not have separate management and accounting. It allows foreign tax credits for taxes paid on branch income and for withholding taxes, but not indirect credits, on dividends.

Foreign Subsidiaries

Four countries (Germany, Italy, Japan and the United Kingdom) tax dividends from foreign subsidiaries of their companies but do not tax the unremitted earnings of such subsidiaries. For exchange control reasons, the Bank of England requires U.K. companies to remit annually to the U.K. two-thirds of the combined profits of overseas subsidiaries. The parent company, however, can select the subsidiaries from which the dividends are to be paid, thus allowing it to minimize taxation of the dividends. Two countries (Belgium and France) tax the dividends of the foreign subsidiaries, but only on a very limited basis; they also do not tax unremitted earnings of such subsidiaries. The Netherlands does not tax either foreign subsidiary dividends or unremitted earnings of those subsidiaries. In addition, Japan, Italy, Germany, France and The Netherlands, in various ways, allow tax deductions for part or all of the losses of foreign subsidiaries or branches of their national companies or capital investments in foreign subsidiaries. Germany taxes income of a Subpart F nature in a manner similar to the United States. Japan is proposing to adopt a similar, but more limited, approach, effective April 1, 1978.

Three of the countries that do tax such dividends (Germany, Japan and the United Kingdom) allow a foreign tax credit equivalent to our deemed tax credit under Section 902 of the Internal Revenue Code. Italy does not have a deemed tax credit but only subjects such dividends to partial taxation and grants a credit for withholding taxes subject to some special limitations.

There are variations in the mechanics of each country's provisions relating to the determination of indirect foreign tax credits. The U.K. provisions are more liberal than those of the United States. The provisions of Japan and Germany are somewhat less liberal.

The combination of existing legislation and general government attitude in many countries encourages the utilization of tax-haven-type holding companies as a way to minimize or eliminate taxation of dividends from the foreign subsidiaries in some of the countries. The large Japanese trading companies regularly have utilized such vehicles in their operations but will be restricted in such activities in the future because of the anticipated new Subpart F-type rules in Japan.

The attitude of the Italian government is so favorable to this approach that government-owned industrial enterprises, such as Istituto Ricostruzione Industriale, Ente Nazionale Idrocarburi and Istituto Mobiliare Italiano, utilize such tax-haven holding company organizations in their corporate group. In the United Kingdom, it is possible to establish a corporation that operates and is managed totally outside the United Kingdom and which is, therefore, a nonresident. Such a corporation, although a legal entity of the United Kingdom, is not subject to U.K. tax on its foreign income. Also, U.K. companies are able to utilize holding companies in tax-haven countries to own foreign subsidiaries.

Foreign Branches

While this statement does not place emphasis on the question of taxation of direct operations in another country by a U.S. corporation, the approach to such taxation by the seven countries in our study is relevant in the consideration of the competitive effect of U.S. tax laws, since a tax on unremitted foreign subsidiary earnings would create the same result as the present U.S. tax on foreign branch earnings.

Overall, the seven major countries are less restrictive than the United States in taxing foreign branches of locally incorporated companies. Japan, The Netherlands and the United Kingdom tax such branch operations in a manner similar to the United States. In each case, a foreign tax credit is given for taxes incurred in the country of operations. The Dutch credit is determined to be at the rate of the Dutch corporate income tax regardless of the rate of tax actually paid. Thus, effectively, no tax is applied by the Dutch government on the branch income.

As a general matter, by tax treaty, Belgium and Germany do not tax branches of their corporations in other treaty countries. It is our understanding that eventually most of the European Common Market (EEC) countries will establish such treaty provisions with the other EEC countries. The necessary treaty changes will probably take several years. When this occurs, it will mean that, as a general matter, only the country of operation will tax the branch. France, as a matter of tax policy, does not tax foreign branch income.

Italy does not tax branch income for purposes of the local income tax if the branch has separate management and accounting; Italy does tax branch income for purposes of the national corporate tax with a foreign tax credit allowed subject to certain special limitations. Branch losses are deductible for purposes of the national tax. Thus, effectively four of the seven countries do not tax the income of foreign branches.

Both France and Germany have provisions in their laws that allow the home office to deduct start-up losses that are incurred in the otherwise nontaxable branch. In each case, there is a provision for recapturing the amount of the loss as profits are earned in later years by the branch.

PART III—COMMENTS REGARDING ADMINISTRATION PROPOSAL

Because of our firm belief that any significant change in the taxation of the earnings of foreign subsidiaries would be highly detrimental, we do not believe it appropriate to offer comments regarding the specific features of the Administration proposal. We do have some strong disagreements with several basic arguments supporting the proposal, however. Our comments below refer to the page in *The President's 1978 Tax Program*, dated January 30, 1978, on which the argument appears.

Use of Foreign Subsidiary Based on Business Considerations

The "concept of deferral" is not founded on the artificial factor that arbitrarily treats the use of a foreign legal entity differently from the use of a domestic one (pages 282-3). It is founded on the basis that the legal jurisdiction of U.S. taxation extends to U.S. citizens (corporate or individual), U.S. residents (corporate or individual) and income earned in the United States. Thus, U.S. law taxes U.S. citizens or residents on all of their income and income earned in the United States by whomever earns it, citizen or foreigner. Under those sound jurisdictional rules, income earned by foreign corporations from business carried on in other countries should not be subject to U.S. tax when earned. The Subpart F provisions are an exception that was established to deal with abusive situations.

Even if the basic proposition was sound, the Administration's arguments supporting the proposal are unsound when it contends (pages 286-7) that U.S. companies establish foreign subsidiaries principally for tax reasons such as to utilize tax inducements in other countries or to manipulate profits through improper pricing of goods and services. It further contends that the interposing of a foreign corporate entity between the overseas operation and the U.S. Treasury generally is a major objective in the establishment of a foreign corporation by U.S. international business (page 283).

Our experience is almost wholly contrary to such a contention. While occasionally such an objective is key in the establishment of a foreign subsidiary, as a general matter, U.S. taxes are of little significance in the decision.

It has been our experience that decisions to enter into substantial business activities in other countries are not primarily tax-oriented decisions. Taxes are certainly a factor in such decisions as they are in similar decisions within the United States. However, the strong preference among U.S. businesses is to make investment at home and only invest in other countries when available business can only be served through such an investment. It is much easier to serve a market from the United States than it is to get involved deeply with foreign currencies, different legal and tax systems, different labor rules and practices, new sets of government regulations and restrictions and the many other differences that exist in the economic, social, political and cultural conditions in other countries. Even the service industries (architects, engineers, bankers, construction companies, etc.), which can only carry on important parts of their work at the work site, are normally organized to do as much basic work as possible at home where their pool of experienced talent is located. That basic work is then supplemented and implemented at the site of the project. Many factors are involved in the preference to operate from the United States, a key one being the need to allocate and utilize three very scarce commodities—capital, technical skills and management talent.

The selection of the type of legal entity to be used when a new foreign operation is found to be necessary is invariably a natural consequence of the business activity involved. Such business considerations as having a local country identification in the marketplace, the need to deal with the local government perhaps as a customer, the ability to qualify for potential local government grants and loans, in some countries the legal necessity of obtaining government approval to operate, the need to have local investors, and many others often are decisive in the decision to utilize a foreign corporate subsidiary. We have often seen situations where there are distinct U.S. tax benefits in utilizing a U.S. subsidiary but where the other business considerations are paramount and a foreign subsidiary is used.

Real Competition of Concern Is from Other Countries

In discussing the general subject of competition, the report entirely misses a key point. It focuses on competition in the United States for investment capital and funds (pages 283 and 284). The real competition to be concerned about is from other countries and is faced in other countries. If, through the elimination of deferral, U.S. international business is forced to withdraw, partially or totally, from overseas markets, as we discussed above, the competitors will be strengthened and eventually their economic strength will be faced in the United States. How meaningful might be the consequences of such a change?

This answer to this question can be provided through a simple illustration. Any knowledgeable person will agree the U.S. petroleum industry is the strongest in the world and the strength of that industry has been substantially increased by its international business. Regardless of how critical a person's

views might be of that industry, even the harshest critics could not in good conscience believe it would be better for the U.S. if that strength were held today by companies of other nations. If, in the 1950s and 1960s, U.S. tax rules had forced the U.S. petroleum industry out of exploration and development in the Middle East, Indonesia, etc., and left that development to companies of other countries, clearly the U.S. energy problem today would be much more critical than it is.

Tax Treaties Will Not Repair the Damage

The Administration proposal advocates the use of tax treaties to (1) negotiate on an individual country basis the continuation of deferral (pages 290 and 295) and (2) protect U.S.-owned foreign subsidiaries against retaliation by the local country should deferral be eliminated (pages 289-90). Anyone familiar with the present U.S. tax treaty picture would seriously question proposition (1) above. In order to evaluate it, an understanding of the treaty picture is important.

Presently, the United States has 22 tax treaties in effect even though there are over 120 nations in the world; by way of comparison, France has 39 treaties and the United Kingdom has 72. Presently, the United States has eight treaties which have been signed but not ratified. Five of those were signed in 1975 or 1976; two were signed prior to 1968. Announcements have been made through the years by the U.S. Treasury regarding negotiations for 21 other new treaties and revisions of seven existing treaties. Thirteen of those announcements were made prior to 1971 and nothing has been completed on them to date. Only four of these announcements have been made since 1975.

A number of existing U.S. tax treaties contain specific provisions that would apparently be breached by the enactment of the President's proposal. To illustrate, the treaty with Germany (Article II(1)) reads as follows:

> "Industrial or commercial profits of an enterprise of one of the contracting States shall be exempt from tax by the other State unless the enterprise is engaged in trade or business in such other State through a permanent establishment situated therein. . . ."

Rephrased, this sentence says that the United States will not tax the business profits of a German company unless the German company carries on business through a branch in the United States. Since the President's proposal, if enacted, would clearly tax the profits of a German subsidiary, that enactment would appear to violate the treaty. Under the circumstances, the German government would be justified in contending the treaty was no longer applicable. Thus the Treasury could find itself having to renegotiate several treaties because of their being violated. Further it would appear the renegotiation position of the United States would be one of weakness because of its unilateral violation.

The history of existing treaties certainly cannot give one great confidence that new treaties or treaty revisions could be negotiated in any reasonable

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time frame which would provide the necessary relief to the competitive damage that the elimination of deferral would cause. Further, the act of taxing earnings of their subsidiaries through an extraterritorial application of U.S. tax law may so exacerbate our relations with some countries as to make normal treaty negotiations impossible. Such a result would be a certainty for many of the countries whose treaties would be violated by the President's proposal.

The lack of treaties in effect and the slowness in the treaty negotiation process would clearly limit the Treasury's ability to protect against retaliation through the treaty vehicle. Without an existing tax treaty, the U.S. government would have much less ability to influence the other government's actions in the area. Recent experiences in many areas of international negotiations (international monetary management, import reductions, arms sales, nuclear facility proliferation, etc.) certainly offer reasons to question the U.S. government's ability to accomplish a significant change in the posture of many governments on an expeditious basis, particularly where the U.S. government has so many potential areas of intercountry agreement.

When the Administration fears retaliation by other countries if deferral is eliminated, it fails to recognize the real economic facts of international business. Action by the local subsidiary, not the foreign government, is more likely to cause a loss of the local tax benefits. For example, where tax deductions allowed by a country represent an acceleration of a future deduction, such as the United Kingdom's 100% depreciation allowance for new machinery, the U.S. subsidiary in that country probably could not afford to take advantage of that deduction. Since the United States would be taxing the other country's (U.K.) income after allowing a deduction for normal U.S. tax depreciation, the foreign subsidiary may best be able to protect its economic position by not taking advantage of the special (U.K.) accelerated depreciation in order to not have to pay double tax on the income.

Unanticipated By-product of Proposed Change

Finally, the Administration's proposal contains an important by-product that could be a disaster for many U.S. international companies. Conceptually, the U.S. parent would be required to report as taxable income the "gross income" of its foreign subsidiaries. The finalized regulations under Section 1.861-8, which were issued in 1977, significantly limit the foreign tax credits of many U.S. companies. Those regulations use "foreign-source gross income" of the U.S. company as a key factor in limiting the credit. The "foreign-source gross income" of virtually every U.S. international company would be substantially increased by the proposed elimination of deferral. The net result would be a much greater overall loss of foreign tax credits under these regulations than previously. Thus the competitive posture of U.S. international business would be further weakened indirectly by these mechanics in addition to the direct weakening from the elimination of deferral itself.

APPENDIX A

DISTRIBUTION OF THE WORLD'S 100 LARGEST INDUSTRIAL COMPANIES

(Ranked by Sales)

Country	Number of Companies			
	1965	1970	1973	1976
United States	68	63	49	48
West Germany	12	10	12	12
Japan	2	8	11	11
France	3	3	9	8
United Kingdom	9	7	6	7
Italy	2	3	3	3
The Netherlands	1	2	3	2
Other	3	4	7	9
Total Companies	100	100	100	100

Source: *Fortune*, various issues.

APPENDIX B

DISTRIBUTION OF THE NONPETROLEUM COMPANIES THAT ARE AMONG THE WORLD'S 100 LARGEST INDUSTRIAL CORPORATIONS

(Ranked by Sales)

Country	Number of Companies			
	1965	1970	1973	1976
United States	57	49	36	33
West Germany	12	10	12	12
Japan	2	8	11	10
France	3	2	7	6
United Kingdom	8	6	5	6
Italy	2	2	2	2
The Netherlands	1	2	3	2
Other	2	3	5	4
Total Companies	87	82	81	75

Source: *Fortune*, various issues.

COMPARISON OF COMBINED TOTAL ASSETS OF THE 10 LARGEST FOREIGN- AND U.S.-BASED NONPETROLEUM INDUSTRIAL COMPANIES

(Ranked by Sales in 1976)

Foreign-Based Companies	Country	Total Assets 1965	1970	1973	1976
Unilever	United Kingdom	$ 3,105	$ 3,952	$ 5,676	$ 7,794
Philips'	The Netherlands	2,728	5,273	8,557	12,245
Renault	France	524	1,362	1,818	2,733
Hoechst	West Germany	1,157	3,585	5,879	8,754
Basf	West Germany	1,051	3,279	4,841	6,579
Daimler-Benz	West Germany	556	1,227	2,161	3,566
Volkswagenwerk	West Germany	1,137	2,445	4,793	6,144
Bayer	West Germany	1,165	3,252	5,020	8,517
Nippon Steel	Japan	2,778	5,772	9,082	11,625
Siemens	West Germany	1,401	3,099	6,184	8,230
Total assets of the 10 largest foreign corporations		$ 15,602	$ 33,246	$ 54,011	$ 76,187
U.S.-Based Companies					
General Motors		$ 12,586	$ 14,174	$ 20,297	$ 24,442
Ford Motor		7,597	9,904	12,954	15,768
International Business Machines		3,745	8,539	12,289	17,723
General Electric		4,300	6,310	8,324	12,050
Chrysler		2,934	4,816	6,105	7,074
International Telephone & Telegraph		2,022	6,697	10,133	11,070
U.S. Steel		5,452	6,311	6,919	9,168
E. I. du Pont de Nemours		2,848	3,567	4,832	7,027
Western Electric		2,303	3,744	4,828	5,178
Procter and Gamble		1,337	1,855	2,687	4,103
Total assets of the 10 largest U.S. corporations		$ 45,124	$ 65,917	$ 89,368	$113,603

Source: *Fortune*, various issues. (Details on methods of consolidation of affiliates are available in specific issues of *Fortune*.)

APPENDIX D

DISTRIBUTION OF THE 50 LARGEST COMMERCIAL BANKS IN THE WORLD

(Ranked by Assets)

Country	Number of Banks		
	1970	1973	1976
United States	15	12	10
West Germany	4	7	7
Japan	11	14	12
France	3	4	5
United Kingdom	5	4	4
Italy	4	5	2
The Netherlands	—	—	3
Switzerland	3	—	2
Canada	4	3	4
Brazil	1	1	1
Total Banks	50	50	50

Source: *Fortune*, various issues.

APPENDIX E

DIRECT FOREIGN INVESTMENT OF THE U.S. BY COUNTRY—END OF 1975

(Excluding Petroleum)

Country	Amount ($ Millions)	Percent of Total
Canada	24,946	25.4%
United Kingdom	10,092	10.3
Germany	6,589	6.7
Switzerland	5,109	5.2
France	4,821	4.9
Brazil	4,271	4.3
Australia	4,202	4.3
Mexico	3,156	3.2
Belgium-Luxembourg	2,926	3.0
The Netherlands	2,224	2.3
Other countries	30,026	30.4
Total	98,362	100%

Source: U.S. Department of Commerce Survey of Current Business.

LOCALLY SITUATED COMPETITORS IN PRINCIPAL COUNTRIES WHERE UNITED STATES BUSINESS HAS INVESTED (EXCLUDING PETROLEUM)

Country	Percent of Total U.S. Investment Located in Country	Country's Annual GNP (1975) (Billions)	Companies With Sales Exceeding $500 Million (1976)		
			Total No. of Companies	Largest Company Below Fortune 100	
				Name	Annual Sales (Millions)
Canada	25.4%	$152	30	Canadian Pacific, Ltd.	$3,965
United Kingdom	10.3	215	118	Imperial Group	5,190
Germany	6.7	409	81*	R.W.E. Rheinisch-Westfalisches	5,247
France	4.9	304	56	CIE. Generale d'Electricite	6,755
Brazil	4.3	107	4*	Vale do Rio Doce	864
Australia	4.3	76	11	Woolworths	1,445
	55.9%				

*Excluded from both Germany and Brazil is a government-owned resource company which is not a competitor.

Sources: *The Times Books of London Times*
Financial Post (Canada)
Fortune
World Bank and OECD (GNP Data)

WORLD GROSS NATIONAL PRODUCT

(In Billions of U.S. Dollars and Percent of Total)

	1960		1965		1970		1975	
	$	%	$	%	$	%	$	%
Total	$1,500	100%	$2,200	100%	$3,200	100%	$6,018	100%
United States	506	34	688	31	982	31	1,507	25
Canada	36	2	48	2	80	2	152	2
Japan	39	3	85	4	197	6	498	8
European Community (excluding U.K.)	192	13	312	14	505	16	1,057	18
United Kingdom	71	5	99	5	121	4	215	4
All other	656	43	968	44	1,315	41	2,589	43

Sources: *International Economic Report of the President,* March, 1976 (based on Commerce Department Statistics), World Bank and *1977 World Data Sheet,* OECD.

APPENDIX H

PRINCIPAL DIFFERENCES BETWEEN U.S. AND AUSTRALIAN TAX TREATMENT OF CORPORATIONS

Inventories—Inventory valuations at the beginning of the year are adjusted to reflect inflationary effects. One-half of the percentage increase in the goods component of the consumer price index for one year is applied to inventory to revalue it. The difference between the revalued amount and the original amount is allowed as a tax deduction.

Depreciation—Machinery and equipment is normally depreciable on the straight-line or 150% declining-balance method. Most new depreciable plant and equipment is subject to a 40% first-year investment allowance for assets acquired by June 30, 1978, and 20% for assets acquired thereafter until June 30, 1983. The allowance does not reduce the asset's cost for purposes of normal depreciation.

Manufacturing buildings are depreciable on a very limited basis. Other buildings are not depreciable.

Gain on the sale of a depreciable asset can be applied to reduce the costs of other depreciable assets free of tax.

Capital Gains—When property held more than 12 months is sold at a gain, the gain is not generally included in income if the property was not sold in the ordinary course of business.

Foreign Income—Generally, foreign income, except dividends, which is subject to a direct or indirect income tax in the country where it is earned, is exempt from Australian tax.

PRINCIPAL DIFFERENCES BETWEEN U.S. AND BRAZILIAN TAX TREATMENT OF CORPORATIONS

Monetary Correction of Financial Statements—Brazilian companies must restate the value of permanent assets to account for inflationary impact. Permanent assets include fixed assets, investments in stock and deferred assets (principally consisting of deferred start-up costs, financing costs and other costs related to important industrial projects). For each year, both cost and depreciation (or amortization) are monetarily corrected. Monetary correction of depreciation is allowed as a tax deduction.

At the same date the monetary restatement of permanent assets is recorded, a monetary correction of net worth (the stockholder's equity) accounts is also required.

The monetary correction results of permanent assets and net worth will, respectively, be credited and debited to a profit and loss account. The net result will be considered either a deductible loss or taxable gain, with an option allowed to the taxpayer to defer the taxation in the case of a gain.

APPENDIX H

Manufacturing Projects—Upon Brazilian government approval, specific manufacturing projects may benefit from accelerated depreciation on machinery and equipment for tax purposes (up to three times the normal depreciation rates). Approved projects qualifying for this accelerated depreciation are available to encourage investment in particular industries including chemicals, petrochemicals, pulp and paper, agricultural equipment, road construction equipment, mining and high technology industries.

Export Incentives—Income derived from the exportation of products manufactured in Brazil is exempt from income tax.

PRINCIPAL DIFFERENCES BETWEEN U.S. AND CANADIAN TAX TREATMENT OF CORPORATIONS

Inventory—Taxpayers may claim a deduction equal to 3% of the opening inventory.

Depreciation—Assets are placed into asset classes in a manner similar to ADR, each having its own rate of depreciation with lives generally shorter than acceptable U.S. lives. For example, machinery and equipment for manufacturing or processing of goods can be written off completely within two years. The amount of depreciation that can be claimed in any year is flexible, ranging from zero up to the amount normally allowable. All asset sales are subject to depreciation recapture but, before any recapture is recognized, the sales proceeds are first credited against the total cost of the asset class until there is no cost remaining.

Investment Tax Credit—Canada allows an investment tax credit of 5% on new property including buildings. The depreciation base must be reduced by the amount of the credit.

Goodwill—50% of goodwill purchased may be deducted for tax purposes using a 10% declining-balance rate.

Reinvestment of Gain on Sale of Building—Proceeds from the voluntary disposition of business real estate (both buildings and land) may be reinvested into new real estate without the recognition of gain or recapture of depreciation.

Capital Gains—Since Canada adopted a capital gains tax in 1971, all capital assets (securities, land, buildings, etc.) have a new fair market value for gains purposes as of December 31, 1971. Normally lower gains are the result.

PRINCIPAL DIFFERENCES BETWEEN U.S. AND FRENCH TAX TREATMENT OF CORPORATIONS

Inventory Reserves—1. Base stock allowances—Companies are allowed to reduce taxable income through an inventory reserve to the extent that price increases of particular classes of goods exceed 10% over a two-year period. Any deduction taken must be added back to taxable income at the end of the

sixth year following the deduction or, for slow turnover inventory, after twice the inventory turnover period, whichever is longer.

2. A reserve for price variations may also be deducted for tax purposes when increases in the price of base inventory are determined by world market price fluctuations. The amounts deducted must be restored to taxable income in case of a reduction in the world market price.

Profit-Sharing and Investment Reserves—All French enterprises having more than 100 employees must establish a profit-sharing reserve for the benefit of employees. The amount of the yearly provision to the reserve is determined by a formula. The provision is deductible in the following year. At the time of the provision, an amount is allocated to each qualified employee who receives that amount five years later.

In addition to the deduction for the profit-sharing reserve, companies are permitted to deduct amounts credited to a reserve for investments in fixed assets. The amount that may be deducted as the provision to this reserve is limited to 50% of that year's profit-sharing reserve provision. Amounts in this reserve may be transferred to earned surplus after five years from the date of allocation. The cost of fixed assets acquired with reserved funds may be depreciated.

Foreign Operations—French companies basically are not taxed on profits (losses) made through foreign branches or made by foreign subsidiaries and received as dividends. Despite the nontaxability of the foreign branch activity, special deductions are allowed for certain start-up costs and funds invested in underdeveloped countries. Appendix I describes the foreign income exemptions and allowable deductions in detail.

Depreciation—Most fixed assets, other than real estate, are subject to declining-balance depreciation. The acceptable straight-line depreciation rates for machinery, equipment and tools range from 10%-20%. The coefficient applicable to the declining-balance method for assets with a life in excess of six years is 2.5.

The acceptable depreciation rate for industrial buildings such as factories and warehouses is 5%. For commercial buildings, the acceptable rate ranges between 2% and 5%.

Capital Gains—Capital gains and losses are subject to a series of complex rules that reduce the tax impact through a lower rate or statutory installment taxation of the gain. Net short-term losses are deductible. Net long-term gains are only taxed at 15% provided the gain is credited to a special reserve. Additional tax (35%) is payable when the gain is distributed as a dividend.

PRINCIPAL DIFFERENCES BETWEEN U.S. AND GERMAN TAX TREATMENT OF CORPORATIONS

Inventories—A provision for a reserve for price variations is deductible for inventories whose cost has increased 10% or more since the previous balance

APPENDIX H

sheet date. The reserve, which need not be booked for financial purposes, must be restored to taxable income within the succeeding six years.

To encourage the stockpiling of specified basic raw materials that are scarce in Germany, 20% of the cost of such materials, if imported, may be written off for tax purposes. These write-offs must be booked in the financial accounts.

Depreciation—60% of the cost of depreciable assets acquired for purposes of controlling water, air and noise pollution can be deducted in the year of acquisition. The cost of fixed assets acquired for research purposes may be written off rapidly with an allowance in the first year of 50% for personal property and 30% for buildings.

Gains on the sale of fixed assets may be reinvested free of tax in replacement assets or certain other assets during the year of sale or two subsequent years.

Other Reserves—A tax deduction is permitted for provisions to several reserves that are recorded on the books to meet losses or liabilities that are likely to occur. The reasonableness of the provisions must be proved to the tax authorities. Specific reserves for which such provisions are deductible include (1) future pension payments, (2) losses on pending lawsuits and (3) guarantees.

The reserve for pension payments can include full past-service cost as a deduction in one year including costs arising from an expansion of benefits. If the costs from such benefit increase exceed 25% of the prior accrual balance, the business is allowed to deduct the costs involved over three years.

Foreign Operations—Reserves can be established for investments in foreign subsidiaries with the provision to the reserve allowed as a deduction and recaptured several years later. See Appendix I for complete detail of the reserves allowable.

PRINCIPAL DIFFERENCES BETWEEN U.S. AND UNITED KINGDOM TAX TREATMENT OF CORPORATIONS

Inventories—A reduction of taxable profits is allowed equal to the value of the increase in inventory for an accounting period reduced by 15% of taxable trading income. This allows corporations to defer taxation on a substantial portion of the annual increase in inventory, thus mitigating the effects of inflation. At present the tax deferral continues until inventory declines.

Depreciation—In the United Kingdom, depreciation used for financial purposes is ignored for tax purposes and, instead, capital allowances are substituted. The rates allowed vary greatly depending upon the type of property. For machinery and equipment, up to 100% of the cost may be

depreciated in the year of acquisition, at the option of the taxpayer. Industrial buildings or structures must be depreciated 50% in the year of construction, with a straight-line write-off of the remaining basis at 4% per year, beginning with the year of acquisition. Cash grants are available from the government for acquiring fixed assets for use in large areas of the country. The grants do not reduce the depreciable cost.

Generally, commercial buildings such as offices, hotels, etc., are not depreciable for tax purposes.

Interest and Royalties—Generally these items are taxed as income (or deductible as expense) when cash is received (paid) rather than on the accrual basis.

Exchange Losses—Generally, exchange losses are deductible only when related to a transaction that flows through the profit and loss statement, such as a gain or loss on trade payables. When exchange losses are of a capital nature, i.e., relate to balance sheet items, such as long-term debt, the exchange losses are not allowed as a deduction. The converse rule applies to exchange gains.

APPENDIX I

TAXATION OF FOREIGN BUSINESS OPERATIONS BY BELGIUM

Foreign Branch Operations

In principle, a company resident in Belgium that conducts business through a branch in another country is subject to current Belgian tax on a portion of the foreign branch profits. Conversely, losses sustained by the branch are currently deductible against the income of the Belgian company.

The income of a branch located in a country with which Belgium has an income tax treaty is exempt from Belgian tax. If losses from a branch in a treaty country have been deducted in Belgium and subsequent profits of the branch are not taxed in the branch country because of loss carry-overs there, those profits are fully taxed in Belgium. If the branch is located in a country that has no treaty with Belgium, the Belgian income tax applicable to this income is reduced by three-fourths. Foreign income taxes paid are deductible. The branch income may qualify for this reduction only if the branch is actually a permanent foreign establishment that maintains separate accounting records.

Foreign Subsidiary Operations

If the Belgian company operates in another country through a subsidiary rather than a branch, profits are not currently taxable and losses are not currently deductible. Tax at the normal corporate rate is imposed when the subsidiary distributes dividends. However, 95% of foreign dividends received, net of foreign taxes, are excluded from taxable income provided the shares in the foreign corporation have been held for a full taxable year. The remaining 5% of foreign dividends received is considered to represent financial and administrative expenses included in the recipient corporation's deductions attributable to this dividend income.

A foreign tax credit of 5% can be applied against the recipient corporation's tax liability; any excess of the credit over the liability will be refunded. Dividends subject to the 95% exclusion must be grossed up for the amount of the 5% foreign tax credit.

The overall effect is that foreign dividends flow through the Belgian corporation to its shareholders without any further corporate tax.

If the shares of the foreign corporation have not been held for a full taxable year, the net dividend received is taxable. A credit of 15% of that amount is granted.

Foreign Tax Credit

Normally, a direct foreign tax credit is not allowed when profits from a branch operation are currently taxable in Belgium. Double taxation of such foreign income is avoided by the exclusion (or exemption) of the income

from taxable income by tax treaty or through a tax rate reduction of 75% in the absence of a treaty. As already described, a limited foreign tax credit applies when foreign dividends are received.

A fixed foreign tax credit also applies on foreign interest and royalty payments if such income was taxed in a foreign country. Such interest and royalties generally are subject to the Belgian corporate tax. Applicable foreign income taxes are deductible in determining the corporate taxable income. In addition, a 15% foreign tax credit applies to such interest or royalty income. The credit is applied against the current income tax liability of the Belgian corporation. Any excess credit is unusable. No expenses need be allocated against the foreign-source interest or royalty income.

TAXATION OF FOREIGN BUSINESS OPERATIONS BY FRANCE

Foreign Branch Operations

In France, the principle of territoriality applies in that only income generated from activities in France is taxable. A company resident in France that operates through a branch in another country generally is not subject on a current basis to French tax on the foreign branch profits. Likewise, losses sustained by the branch are not currently deductible against the other income of the French company.

Expenses of starting foreign operations represent an exception to the general rule relating to the nontaxability of foreign profits. A deductible reserve for these expenses is permitted; however, this reserve must be added back to taxable income in equal installments during the sixth to tenth years following the year of deduction. Start-up costs related to sales and information or study offices located in foreign countries generally qualify for this treatment. The total allowable reserve varies according to the foreign country involved. For European Economic Community countries, the total allowable annual reserve is equal to the losses incurred during each of the first five years, but the amount generally is limited to the capital invested during that period. For all other foreign countries, except those considered to be tax havens, the reserve is equal to the capital invested during the first five years, irrespective of the losses incurred.

A similar tax deduction is available in France for industrial operations in prescribed underdeveloped countries if prior approval is obtained from the Ministry of Economy and Finance. The amount of the deductible reserve must be negotiated with the tax authorities but cannot exceed one-half of the funds invested in the first five years.

The French law also provides that a taxpayer may enter into an agreement with the Minister of Finance to permit the current inclusion of the results of foreign branch operations in taxable income. The Minister's consent is difficult to obtain, and this privilege, called "benefice mondial," has been

APPENDIX I

granted to only about 20 entities in France. For these few companies, the tax paid to the foreign country is creditable against the French income tax but only to the extent of 50% of the income.

Foreign Subsidiary Operations

Generally, if the French company operates in another country through a foreign subsidiary, profits are not currently taxable and losses are not currently deductible. Dividends received from a 10%-or-more-owned subsidiary are not taxable in France. However, expenses equal to 5% of any dividend received are deemed to be attributable to the tax-exempt income and are included in taxable income. If the parent incurs and can prove expenses of less than 5% of the distribution, then the inclusion in taxable income is limited to this lesser amount. Dividend withholding taxes paid to the other country are not deductible.

An exception to the noninclusion of subsidiary profits in current taxable income permits the consolidation of all foreign subsidiaries and branches in a single tax return. To be included, any subsidiary must be at least 50% owned. The use of this procedure requires permission of the Minister of Finance. In practice, this permission is almost never given. A credit is allowed for foreign income taxes paid up to 50% of the foreign income.

The deduction for losses and subsequent return to taxable income (as described in the section dealing with branches) is also applicable if the foreign subsidiary is at least 50% owned. Under those circumstances, current subsidiary losses can be offset against other taxable French income. French companies operating outside of France that grant medium-term loans (such as the sale of merchandise on extended terms) are allowed to establish a reserve, which is deductible for tax purposes, amounting to 10% of the amount receivable from the loans.

Royalties or the proceeds from the sale of patent rights received by a French company are taxable to French entities at a reduced rate of 15%. This rate applies to royalties resulting from agreements between affiliated entities when the licensee is a foreign company.

Foreign Tax Credit

The law in France does not provide specifically for a direct or deemed foreign tax credit since most of the foreign income involved is not taxable. As previously discussed, there are provisions that allow for the consolidation of all foreign subsidiaries and branches or the inclusion of all branches in one tax return. In such circumstances, a credit is allowed against the French tax but may not exceed 50% of the foreign income included in the return. The limitation is computed on a per-country basis. For unused credits, there is a five-year carry-over period; if the taxes are not claimed as a credit during that period, they become automatically deductible.

A foreign tax credit is allowed for certain withholding taxes applicable to taxable income if the credit is provided for in a treaty. As an investment incentive, some treaties provide for a credit higher than the tax withheld. There is no provision for a carry-over or carry-back of an unused credit. If it cannot be utilized, it becomes immediately deductible.

French law does not require allocating indirect expenses against foreign-source income for purposes of a foreign tax credit limitation although direct expenses are allocable against such income.

TAXATION OF FOREIGN BUSINESS OPERATIONS BY GERMANY

Foreign Branch Operations

A company resident in Germany that conducts business operations through a branch in another country is subject to German corporate income tax on the foreign branch profits on a current basis. Conversely, for corporate income tax purposes, losses sustained by the branch are currently deductible against its other income.

Generally, where Germany has entered into double taxation treaties with other countries, the right to tax profits attributable to a permanent establishment rests with the country where such permanent establishment is located. Therefore, profits from a branch that qualifies as a permanent establishment are exempt from German tax. Conversely, losses incurred by a foreign branch located in a treaty country are not deductible for German income tax purposes.

Normally, the transfer of assets from a domestic business enterprise to a branch or subsidiary in a foreign country requires the disclosure and taxation of unrealized gain relating to such assets. Under the Foreign Investment Tax Law, an amount not in excess of such a gain may be transferred to a tax-free reserve for five years. At the end of this period, the reserve must be credited to taxable income in annual installments of at least one-fifth of the reserve.

The Foreign Investment Tax Law also allows a German resident company to apply for permission to currently deduct losses generated by a permanent establishment located in a country that has a double taxation treaty with Germany. Permission is granted if the losses are computed according to German tax and accounting standards. The loss deduction is available only for corporation income tax purposes and not for the municipal trade tax on income. To the extent losses have been claimed, subsequent years' profits from the branch (which would normally be exempt from tax by treaty) are subject to German tax to the extent the foreign branch is able to utilize the prior-year losses through a tax loss carry-forward in the local country. Similarly, any branch loss claimed must be included in German income in subsequent years if the foreign branch is incorporated, unless the branch loss carry-forward in the local country is lost through the incorporation.

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Foreign Subsidiary Operations

If the German company operates in another country through a subsidiary, the profits are not currently taxable and losses are not deductible. Tax is normally imposed only when dividends are paid. If the operations of a foreign subsidiary are located in a "developing" country, as defined in the Developing Countries Tax Act, effectively no tax is levied on the dividends since the amount of foreign tax creditable against the income is assumed to be equal to the amount of tax attributable to the dividends.

One exception exists to the basic rule of taxing only remitted earnings. The income of foreign base companies controlled directly or indirectly (more than 50% control) by shareholders resident in Germany, and under certain circumstances by nonresident German citizens, is taxed currently to the shareholders without payment of dividends. A deemed foreign tax credit is allowed. Foreign base company income is taxed if:

1. The income is subject to an effective tax rate of less than 30% in the country of operation.
2. The passive income of the foreign company together with foreign base company sales and services income exceeds 10% of its total gross income. Foreign base company income below 10% of the foreign company's total gross income is taxed if the aggregate amount, otherwise exempt, that is allocable to a German shareholder exceeds DM 120.00.

These provisions, which are similar to the U.S. Subpart F provisions, were modeled after the U.S. provisions.

Under the German Foreign Investment Tax Law, a domestic corporation that directly owns at least 50% of the share capital of a foreign corporation (25% if the foreign corporation is located in a "developing" country) may establish a tax deductible reserve for that portion of the foreign subsidiary's losses applicable to investments made after December 31, 1968. However, the investments made after December 31, 1968, must have (1) increased the parent's ownership to 50% or more or (2) when added to previous investments, increased the ownership to at least 50% and (3) must be at least 5% of the subsidiary's capital. Unincorporated resident taxpayers may qualify for the same benefit.

There are certain other prerequisites for establishing the tax deductible reserve. The foreign subsidiary must have income from industrial or commercial activities (leasing or licensing income is nonqualifying). The subsidiary's loss must be computed under German tax accounting rules, and any foreign tax incentives claimed must be disregarded. Certain documentation must also be provided to the German tax authorities to prove the loss, and the foreign subsidiary must authorize the local tax administration to provide information to the German tax authorities upon request.

The tax-free reserve must be recaptured as taxable income to the extent subsequent profits are generated by the subsidiary. It must also be recaptured

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to the extent a write-down of the investment is claimed by the parent corporation or to the extent the reserve is allocable to shares sold by the domestic corporation. The parent may claim a write-down after a consistent pattern of serious losses occurs. The reserve must be recaptured in full at the end of five years after the year in which such reserve was established.

In addition to the above reserves resulting from current losses of a foreign subsidiary, other reserves may be established for qualifying investments made in developing countries (that are covered under the Developing Countries Tax Act) after December 31, 1973, and before January 1, 1979. An extension of this date is generally expected. A transfer of 40% to 100% of the cost of an investment to the tax-free developing country reserve is permitted for six years. At the end of six years, the reserve must be credited to taxable profits in annual installments of at least one-sixth of the reserve. For investments in labor-intensive enterprises, the annual installments must equal at least one-twelfth of the reserve. This reserve may not generate or increase a tax loss of a resident. It appears that under certain circumstances a deduction may be allowed relating to the same investment under both the Foreign Investment Tax Law and the Developing Countries Tax Act.

Foreign Tax Credit

German law provides for an extensive system of granting relief from double taxation through a foreign tax credit where income is subject to tax both in Germany and another country. The requirements for claiming the credit are similar to the U.S. rules in that the claimant must be a German resident taxpayer and the foreign-source income must also be subject to German tax. The foreign income taxes claimed as a credit qualify only if they are national taxes as opposed to state or local taxes. All double taxation agreements concluded by Germany specify which foreign income taxes qualify for the foreign tax credit and when foreign-source income may be taxed by the source country as well as Germany.

Those taxes not qualifying for the foreign tax credit may be claimed as a deduction if allocable to income taxable in Germany.

A limitation on the allowable foreign tax credit must be computed on a per-country basis similar to the U.S. method. The credit may not exceed the German tax allocable to the item of foreign-source income. Also, qualifying foreign income taxes are creditable only to the extent they apply to taxable foreign-source income from the same tax year.

The foreign-source income includable in the German company's taxable income is determined after deduction of those expenses incurred directly in earning that income. Indirect administrative expenses normally need not be allocated against that income.

Upon application, a foreign tax credit is allowed for the taxes deemed to have been paid by a foreign corporation. The credit is allowed only if the resident corporate shareholders own 25% or more of the foreign corporation's capital shares and the profits received from the foreign corporation

have been earned through the active conduct of a trade or business. For dividends received from a qualifying subsidiary with management and legal situs in a developing country, a hypothetical tax at the German rate is granted as a tax credit, irrespective of actual taxes paid by the foreign subsidiary.

If a first-tier subsidiary, which is at least 25% owned by a German corporation, in turn owns at least 25% of the voting stock of a second-tier foreign corporation, which also pays dividends, upon application, the dividend is treated as if received directly from the second-tier subsidiary. This can occur only if the German corporation's indirect ownership in the second-tier subsidiary through the first-tier subsidiary is at least 25%. The profits received from the second-tier subsidiary must be earned through the active conduct of a trade or business. The mechanics of computing the deemed credit for first- and second-tier subsidiaries are generally similar to the U.S. method. The German tax law requires the taxpayer to adjust the foreign subsidiary's profits to the German accounting standards. The adjustments are similar to those required by U.S. law.

The treatment of dividends received from a first-tier subsidiary, of course, depends on the treaty provisions applicable to its country of incorporation. If the second-tier subsidiary is domiciled in a treaty country, either the dividend to the first-tier subsidiary is not taxable or, if no such exemption is provided for in the treaty, the tax credit system described above applies. In addition, German tax treaties with developing countries mostly have tax-sparing clauses for dividends, interest and/or royalty payments to Germany. If the developing country grants a tax holiday or reduces withholding taxes, the foreign tax credit allowed to the German corporate recipient will be based upon a higher tax rate than the one actually paid.

TAXATION OF FOREIGN BUSINESS OPERATIONS BY ITALY

Foreign Branch Operations

Business income in Italy is generally subject to two income taxes: a corporate tax at a rate of 25% and a local income tax at a rate of 15%. As the local tax is a deductible item for the corporate tax, the effective overall income tax rate is 36.25%. A company resident in Italy that conducts business operations through a branch in another country is subject to the corporate income tax on foreign branch profits on a current basis. The local income tax does not apply if the branch has separate management and accounting. Conversely, losses sustained by the branch are currently deductible against the other income of the company for corporate tax purposes. A foreign tax credit can be claimed against the corporate tax for income taxes paid abroad by the branch.

Foreign Subsidiary Operations

If the Italian company operates in another country through a subsidiary, undistributed profits are not currently taxable. Distributed profits are subject only to corporate income tax, and then only 40% of such distributions are taxable. Losses sustained by the foreign subsidiary are, in effect, allowed as deductions for purposes of both the corporate and local income taxes. This results from a provision in the law that allows a company to reduce the carrying value of investment not quoted on an exchange by the proportionate reduction in net book value of the subsidiary as reflected by its latest approved financial statements. If the subsidiary's stock is quoted on an exchange, a deduction is allowed to the Italian company to the extent necessary to reduce the investment to market price, based on the average price during the last quarter of the year.

Foreign Tax Credit

The foreign tax credit is a new feature of the Italian tax law that became effective January 1, 1974. Italian corporations that are subject to the Italian corporate tax on foreign-source income, i.e., dividends, branch profits, royalties, etc., may claim a credit against Italian corporate tax for foreign income taxes actually paid abroad.

The credit is allowed only to the extent that the foreign country imposing the tax reciprocally allows a foreign tax credit. It is limited to the lower of (1) the actual taxes paid, (2) two-thirds of the corporate tax when the foreign country also allows a credit on income of the same nature or (3) 25% of the corporate tax when the foreign country does not allow a reciprocal credit. For foreign branch operations, the credit can be claimed for foreign income taxes imposed on branch profits. For a foreign subsidiary operation, the credit can be claimed for withholding taxes on dividends paid but not for the underlying foreign tax paid by the subsidiary itself.

TAXATION OF FOREIGN BUSINESS OPERATIONS BY JAPAN

Foreign Branch Operations

A Japanese company that conducts business operations through a branch in another country is subject to Japanese tax on the foreign branch profits on a current basis. A foreign tax credit for taxes paid in the other country is allowed; the mechanics will be described below. Conversely, losses sustained by the branch are currently deductible against the other income of the Japanese company.

Foreign Subsidiary Operations

If the Japanese company operates in another country through a subsidiary rather than a branch, profits are not currently taxable at the present time and losses are not currently deductible. Tax at the normal corporate rate is

imposed when dividends are distributed from the subsidiary with a deemed foreign tax credit generally being available.

As of April 1, 1978, Japan will tax currently income of certain subsidiaries whether distributed as a dividend or not (a modified form of Subpart F income). Proposals (not yet in legislative form) indicate the following rules may be involved:

1. Current earnings (after March 31, 1978) of an overseas subsidiary in tax-haven countries will be taxed currently with the parent company's taxable income.
2. A subsidiary in a tax-haven country is defined as a company owned over 50% directly or indirectly by the Japanese parent company or its related parties.
3. An overseas subsidiary not carrying on substantial business activity in the tax-haven country would be taxed unless Japan has a tax treaty with the country.
4. Tax-haven countries would be countries (including treaty countries) that have the following conditions:
   a. No corporation taxation,
   b. An effective tax rate of 25% or less on corporate income or
   c. No taxation on offshore source income.

Subsidiary losses create tax benefits recognized only upon liquidation or bankruptcy of the subsidiary or when there has been a "significant deterioration" of the value of the subsidiary. A "significant deterioration" occurs when the value of the original investment has decreased by 50% and there is little prospect of recovery in the future. If these events occur, the parent company may, for tax purposes, write down the value of its original investment to the current value.

The parent company has the option of deducting a reserve for foreign investments. A reserve of 30% may be claimed in the initial year for investments in underdeveloped countries. A reserve of 40% to 100% is available in any country for companies organized to develop natural resources. After five years, the reserve is restored to income in five annual installments.

Foreign Tax Credit

The Japanese law provides for an extensive system of granting relief through a foreign tax credit where income is subject to taxation in Japan and another country. The requirements for claiming the credit are similar to the U.S. rules in that (1) the claimant must be a Japanese resident taxpayer and (2) the foreign-source income must also be subject to Japanese and foreign tax. In addition, a Japanese resident company that owns at least 25% of the voting stock of a foreign subsidiary may claim a credit for taxes deemed to have been paid by the foreign subsidiary when a dividend is received from that subsidiary. This credit is similar to the U.S. deemed credit under Section 902.

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A limitation on the allowable foreign tax credits must be computed on an overall basis. Originally, Japanese tax law provided for a per-country limitation; then the concept of the overall limitation was introduced and the taxpayer was permitted to elect either method. In 1963, the per-country limitation was deleted from the law and only the overall limitation remains.

For purposes of computing the overall limitation, any loss incurred by a foreign branch need not reduce other foreign-source income. This provision is referred to as the "modified" overall limitation.

In practice, the Japanese authorities do not normally allocate indirect expenses to foreign income.

The deemed foreign tax credit is allowed for taxes paid by a foreign subsidiary if the Japanese parent owns at least 25% of the issued and outstanding stock for an uninterrupted period of at least six months before the dividend is received. This credit is available upon receipt of a dividend from a "qualified" foreign subsidiary. To qualify, a foreign subsidiary must carry on an active business and may not be a tax-haven-type corporation organized for the purpose of reducing income tax in Japan.

The mechanics for computing the deemed foreign tax credit are similar to those of the U.S. credit. The ratio of the dividend received to the foreign income (net of foreign taxes) is multiplied by the foreign tax to determine the tax deemed paid. The amount of foreign tax deemed paid is included in the Japanese parent's income and is included in foreign-source income when computing the overall limitation. The deemed credit is allowed only for taxes paid by directly owned subsidiaries; taxes paid by second- or third-tier subsidiaries do not qualify.

The Japanese tax law does not require the taxpayer to substantially adjust a foreign subsidiary's earnings and profits to the Japanese standards when computing the deemed credit. The profits to be used for computing the foreign tax credit are either the profits as shown by the foreign financial statements or taxable income as reflected on the tax return, whichever is greater. There are certain minor adjustments that should be made regardless of whether financial statement income or taxable income is utilized. For example, if there is any income that is not subject to foreign income tax, it must be included in foreign-source income for purposes of the deemed credit calculation.

Unused foreign tax credits may be carried forward to the five taxable years following the year in which the foreign income taxes are paid or accrued. Also, the current-year credit may be increased to the extent the foreign income limitation exceeded available credits during the five previous years. Thus, either the excess foreign tax credit or the unused limitation can be carried forward five years. Refunds of prior years' income taxes paid are not granted; instead, the procedure is simply to increase the foreign tax credit in the current year by recomputing the Japanese taxes paid on foreign-source income including that of prior years.

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TAXATION OF FOREIGN BUSINESS OPERATIONS BY THE NETHERLANDS

Foreign Branch Operations

A company resident in The Netherlands that conducts business operations through a branch in another country is subject to The Netherlands tax on the foreign branch profits on a current basis. However, a foreign tax credit for taxes paid in the other country is allowed; the credit can effectively make the branch profits tax exempt (the mechanics are described below). Conversely, losses sustained by the branch are currently deductible against the other income of the company. However, to the extent branch losses reduce current taxable income from Dutch sources, the losses will be recaptured against future branch profits of the next six years that might otherwise not be taxed because of the credit. If foreign branch income exceeds total net income of a Netherlands corporation, the excess may be carried forward as excludable foreign income in the six following years.

Foreign Subsidiary Operations

If The Netherlands company operates in another country through a subsidiary, the profits or losses of the subsidiary are normally not taxable or deductible. Any dividends received by the parent corporation are exempt from tax, provided the parent operates as an integrated business (and not a pure holding company), owns at least 5% of the share capital of the foreign subsidiary and the subsidiary is subject to some kind of foreign income tax. If the subsidiary's income is not subject to foreign tax, dividends it pays are not exempt from tax.

Foreign Tax Credit

The Netherlands has entered into numerous income tax treaties in order to avoid double taxation of income. Normally, foreign tax credits are granted in The Netherlands in accordance with the provisions of these treaties. If no treaty exists, The Netherlands law includes unilateral provisions for the avoidance of double taxation.

In theory, a Netherlands corporation is subject to Dutch corporate taxation on its worldwide income. However, if, in accordance with a tax treaty, an item of income is excluded from Dutch taxation, a tax credit is granted in order to comply with the provisions of that treaty. Generally speaking, the Dutch tax credits are limited to the Dutch tax due on the foreign income. Under most Dutch treaties, the foreign tax credit is determined by multiplying the total Dutch tax due on worldwide income by a fraction, the numerator of which is the foreign-source income and the denominator of which is worldwide income.

In cases where no tax treaty has been negotiated with a particular country, a Netherlands corporation may claim a foreign tax credit only on certain specific types of foreign income, including profits from a foreign branch or

partnership, income from real estate located outside The Netherlands and income from loans secured by mortgages on real estate located outside The Netherlands. The foreign tax credit would be computed as described above. In determining the allowable foreign tax credit, an overall limitation is utilized permitting a taxpayer to group all foreign-source income, including losses.

In addition, a foreign tax credit is granted (whether a treaty exists or not) to a resident corporation against tax due on dividends, interest and royalties received from a debtor in a "development country," if the dividends, interest and/or royalties are subject to income tax in the development country. This tax credit is limited to the lower of the tax levied in the development country (for dividends limited to 25%) or The Netherlands corporate income tax due on the income. There are presently about 100 qualifying development countries.

Foreign taxes paid on any other type of foreign income are not allowed as foreign tax credits in the absence of treaties. Where foreign income is included in taxable income and no tax credit is allowed, any foreign taxes paid on the income can be claimed as a deduction.

All direct and indirect expenses of earning foreign-source income must be allocated against that income in computing the applicable foreign tax credit limitation unless an applicable tax treaty holds otherwise. There are no specific statutory guidelines on the mechanics of allocating indirect expenses.

The Netherlands law does not provide for the deemed foreign tax credit similar to the Section 902 credit in the United States since the dividends involved are not taxed.

TAXATION OF FOREIGN BUSINESS OPERATIONS BY THE UNITED KINGDOM

Foreign Branch Operations

A company resident in the United Kingdom that conducts business operations through a branch in another country is subject to U.K. tax on the foreign branch profits on a current basis. A foreign tax credit for taxes paid in the other country is allowed; the mechanics are described below. Conversely, losses sustained by the branch are currently deductible against the other income of the U.K. company.

Foreign Subsidiary Operations

Assuming the U.K. company operates in another country through a subsidiary, which is a nonresident U.K. company rather than a branch, profits are not currently taxable and losses are not currently deductible. Tax at the normal corporate rate is imposed when dividends are distributed from the subsidiary. Generally, a foreign tax credit is available (see details below).

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The exchange control rules of the Bank of England require annual repatriation of two-thirds of the combined profits of overseas subsidiaries. The U.K. parent company may select foreign subsidiaries with high foreign tax credits from which to pay dividends, if it wishes.

Foreign Tax Credit

The U.K. law provides for an extensive system of granting "double taxation relief" through a foreign tax credit where income is subject to taxation in the United Kingdom and another country. The requirements for claiming the credit are: (1) the claimant must be a U.K. resident taxpayer and (2) the foreign income must also be subject to U.K. tax.

In addition, a U.K. resident company directly or indirectly controlling not less than 10% of the voting power of a foreign subsidiary may also claim credit for the "underlying" corporate income tax paid by the foreign subsidiary when a dividend is paid to the parent. This credit is broadly similar to the United States deemed credit under Section 902.

If a foreign tax credit is not allowable or not claimed, a deduction for those taxes (withheld or underlying) may be claimed. The limitation on the allowable foreign tax credit claimed must be computed on each separate "source" of foreign income and the credit is limited to the greater of the foreign tax or the U.K. tax payable on that particular source of income. The income from each separate subsidiary or branch is considered a separate source of income. Because of this rule, there is no overall limitation in the U.K. law. Furthermore, unused foreign taxes may not be carried back or forward to another year. However, U.K. companies with varied overseas interests commonly incorporate an overseas holding company, which receives all foreign dividends from the subsidiaries and thereafter pays a single dividend to the U.K. parent company. Thus, there is only one source of income for U.K. tax purposes and, effectively, the averaging of foreign taxes (as the U.S. overall limitation allows) is possible in the United Kingdom.

The foreign-source income includable in a U.K. company's taxable income is determined after the deduction of those expenses incurred directly in earning that income. The allocation of indirect expenses against that income is not normally required in the United Kingdom.

As mentioned above, a foreign tax credit is allowed for the "underlying tax" incurred by a foreign subsidiary, provided the U.K. parent company owns not less than 10% of the voting power of the subsidiary. There is no restriction on the number of tiers of subsidiaries for which the "underlying" tax credits may be obtained, provided the 10% ownership exists at each level of the chain of ownership. Unlike the United States, the ownership requirement is examined directly at each tier level and the law is not concerned with the effective percentage of ownership. For example, if U.K. resident company A owns 10% of foreign company B which in turn owns 10% of foreign company C, company A can receive a credit for its proportionate share of the

underlying taxes paid by companies B and C, provided dividends are paid through the chain of ownership.

The mechanics for computing the underlying tax credit are generally similar to the U.S. method of computing the deemed credit for a developed country corporation. The taxes in the "underlying tax" credit are normally computed on an accrual basis adjusted to the amount actually paid. The U.K. tax law does not require the taxpayer to adjust the foreign subsidiary's earnings and profits to the U.K. standards. Instead, the profits to be used for computing the foreign tax credit are distributable profits as determined from the foreign company's financial statements.

Foreign tax credit benefits may be restricted by payments of Advance Corporation Tax (ACT). ACT is collected as a percentage of dividends paid. It is creditable in arriving at the annual corporation tax liability subject to certain limits. Foreign tax credits must be taken into account before crediting ACT. The impact of the rules involved varies according to the rates of overseas taxes, the ratio of overseas to U.K.-source income and the level of dividends paid. Where the U.K. business has significant foreign-source income subject to high foreign taxation, part or all of the foreign tax credits will be lost.

BAKER & MCKENZIE,
ATTORNEYS AT LAW,
Washington, D.C., August 28, 1978.

Re H.R. 13511—Pre-1977 Nonrecourse Debt of Partnerships—Effective Date.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This letter relates to an apparently unintended change in the effective date of the partnership at risk rules governing nonrecourse debt incurred prior to January 1, 1977 which may be brought about if H.R. 13511, the Revenue Bill of 1978, is enacted in its present form.

The Tax Reform Act of 1976 expressly provided in section 213(f) (2)—by reason of a special correction in H. Con. Res. 751—that in the case of partnerships the new at risk limitations introduced by the 1976 Act as section 704(d), would apply only with respect to nonrecourse liabilities "incurred after December 31, 1976." Before this special correction the statute provided that the new at risk rules were to "apply in the case of partnership taxable years beginning after December 31, 1976." The correction, of course, constitutes a clear-cut Congressional determination to remove from the impact of the at risk limitations all partnership nonrecourse liabilities incurred prior to January 1, 1977.

If the partnership at risk rules of section 704(d) are repealed as proposed in section 210(b) of H.R. 13511, and the general at risk rules are extended, as proposed in section 201(a) of that Bill, a serious question arises as to whether the pre-1977 nonrecourse liabilities of partnerships will have been made subject to the at risk rules, despite their prior statutory exclusion therefrom. Certainly the language or proposed section 465(c) of the Code, and the following statement from the report of the Ways and Means Committee regarding its effective date, would make it difficult to argue that the effective date provisions of section 704 (d), as in effect prior to the enactment of H.R. 13511, retain their original vitality:

"The amendments made to the at risk rule generally apply to taxable years beginning after December 31, 1978. Thus, activities and transactions entered into prior to such taxable years may be subject to the expanded at risk rule even though they were not subject to section 465 as in effect prior to taxable years beginning after December 31, 1978." [H. Rep. No. 95-1445. 95th Cong., 2d Sess., p. 73.]

I respectfully submit that it would represent highly undesirable legislative policy to revoke in this manner a statutory grandfather benefit with respect to preexisting nonrecourse liabilities. Obviously Congress considered those grandfather rights to be meritorious when it granted them. The considerations warranting the grant of those rights have not lessened in merit. Indeed, the passage of time has strengthened the reasons for removing pre-1977 nonrecourse debts from the effect of the at risk provisions. Many important decisions have been made and significant transactions consummated in reliance upon the rules announced in section 213(f) (2) of the 1976 Act. If those rules were now to be reversed it would work a harsh and unfair result upon taxpayers who, we submit, had a reasonable right to rely on a statutory provision so recently enacted.

In view of the foregoing the Finance Committee is earnestly requested to modify H.R. 13511 to make it perfectly clear that pre-1977 nonrecourse debts of partnerships will continue, as provided in section 213(f) (2) of the Tax Reform Act of 1976, to be unaffected by the at risk provisions of the Internal Revenue Code.

Sincerely,

MICHAEL WARIS, Jr.

PREPARED STATEMENT OF ROBERT BELFER, PRESIDENT OF BELCO PETROLEUM CORP.

SUMMARY

Witness will testify in support of S. 3463, sponsored by Senator Wallop, a bill to extend until December 31, 1979 to independent producers the legislative grace period validating foreign tax credits under certain production sharing agreements as provided by Section 1035(c) of the Tax Reform Act of 1976.

Belco Petroleum Corporation is an independent petroleum company which is seeking to extend until December 31, 1979, the legislative protection provided by Section 1035(c) of the Tax Reform Act of 1976 for the crediting of foreign taxes paid on the income earned from Production Sharing Agreements ("PSA's").

Belco is headquartered in New York City and has production in Wyoming, Utah, Colorado, Texas, New Mexico and Louisiana. Its major foreign production operations are conducted in Peru and in addition, has limited production in Canada.

When the Internal Revenue Service publishes an unfavorable ruling regarding taxes paid under PSA's in effect in Indonesia in May, 1976, questions were raised as to the creditability of foreign taxes paid under all PSA's. Recognizing the problems the ruling would cause to companies operating under existing agreements, the Senate Finance Committee on June 10, 1976 reported out Section 1035(f) as part of the Tax Reform Act of 1976 (subsequently redesignated Section 1035(c) in the bill as finally enacted), providing that amounts designated as taxes under production sharing agreements in existence on April 8, 1976 shall be deemed to be creditable for taxable years ending on or before December 31, 1981. The report of the Senate Finance Committee on this provision states that:

"While the Committee takes no position on the correctness of the IRS Ruling, the Committee feels that *oil companies operating under existing production sharing contracts should have a reasonable time to renegotiate their contracts with the foreign government.* Thus, assuming the ruling is sustained, if challenged, generally the companies should be allowed the foreign tax credit for another *five years.*" [Emphasis added.]

The December 31, 1981 date was subsequently cut back to December 31, 1977 in the bill as enacted. Subsequent events have shown that the reduced time frame given companies to rearrange their agreements was not sufficient. In Peru, as in other countries having PSA's, changing the form of agreement involve changes in the basic laws of the country. Foreign governments cannot be expected to readily understand subtle distinctions that U.S. tax policy draws between a creditable tax and a royalty, nor can they be asked to accept without question changes which they perceive as arising from interference by the I.R.S. in matters of national sovereignty. Accordingly, Belco needed clear guidance as to the requirements of the I.R.S. before embarking on the process of renegotiating its existing contracts with Peru, if such renegotiation were in fact to be necessary. Unfortunately, the criteria issued by the I.R.S. in July, 1976 were too vague and ambiguous to be of much assistance. It was generally expected that these guidelines would be amplified by the I.R.S. when they responded to a request for ruling on a modified Indonesian arrangement. This ruling, which required 18 months of delicate negotiation involving the governments of both Indonesia and the U.S., was issued on May 8, 1978, did in fact expand and clarify the former guidelines.

While the modified Indonesian arrangement is not readily adaptable in Peru. Belco now has a clear U.S. legal framework within which to embark on its own course of negotiation with the I.R.S. and Peru to reach a solution that is acceptable to all concerned. Accordingly, Belco is asking for an extension of the grace period while this renegotiation process goes forward.

Immediately upon the issuance of the May 8, 1978 ruling, Belco commenced discussions with the Government of Peru with a view to revising existing agreements in order to have them comply with I.R.S. guidelines. The Peruvian government strongly favors expanded investments by U.S. companies. However, such investments cannot be made under the existing contractual framework. Accordingly, Peru has retained Washington counsel to advise them in this matter and has been diligently working with Belco to develop a form of agreement satisfactory to itself, Belco and the I.R.S. and which would attract other U.S. based companies. Nevertheless, this process may take many months.

The fact that eighteen months of renegotiation were required before the I.R.S. could issue a favorable ruling is testimony to the complexity of the renegotiation process. As demonstrated by the Indonesian experience, time and patience are required to achieve a result that is satisfactory to all parties, and that gives recognition to the sovereignty and independence of the host government.

The original Senate Finance Committee version of 1035(c) provided legislative protection until the end of 1981. The protection period was subsequently cut back to the end of 1977. What is asked for here—an extension to the end of 1979—is *less* than what the Senate Finance Committee originally approved in 1976. The possibility that a further extension of time might be needed for companies to renegotiate their PSAs was recognized by the Ways and Means Committee's Task Force on Foreign Source Income in a report issued in March 1977, which stated:

"The recommendations of the task force with respect to the foreign tax credit are, in substantial part, reflected in the Tax Reform Act of 1976. However, the one-year delay in the disallowance of foreign tax credits for amounts paid as

taxes under production-sharing contracts provided in the Act *may need to be extended for an additional year in order to insure that the companies are able to renegotiate their contracts.*" [Emphasis added.]

The delays with Indonesia have proven the wisdom of the Finance Committee and the Task Force's recommendation.

Belco seeks its extension as an independent producer, qualifying for such status under the provision of Section 613A(c) of the Internal Revenue Code of 1954 relating to domestic oil and natural gas production. An extension of Section 1035(c) only for independent producers would guarantee that competition in international petroleum production is not inadvertently lessened in the course of the Internal Revenue Service's overall effort to rationalize the foreign tax credit treatment of U.S. companies.

The final irony could be presented if Belco did not receive the requested extension, and were forced to divest its holdings in Peru. These holdings could very well be acquired by one of the major U.S. petroleum companies that had sufficient excess foreign tax credits that it could afford to ignore the issue of the applicability of Section 1035(c).

It has been suggested that Section 1035(c) applies only to taxes paid to the Government of Indonesia and not to any other country having a production sharing form of agreement. There is no reason to believe that either the 1976 ruling on Indonesia or the language of this statute itself were intended to have such a narrow and restrictive interpretation. The 1976 Indonesian ruling was preceded by an IRS press release (IR 1591) which stated:

"The IRS today announced that it has considered the application of the foreign tax credit provisions of the Internal Revenue Code to the production sharing agreements made by petroleum corporations with certain foreign *governments.*" [Emphasis added.]

Clearly, the language of the Indonesian ruling was intended to apply to more than one government, and there is nothing in the statute to indicate that it is of narrower scope. The original sponsor of Section 1035(c) in the Senate has indicated that the statute was not intended to have such a narrow scope and the Conference Committee report on Section 1035(c) states:

"The Senate amendment provides that Rev. Rul. 76-215 is not to be applicable for taxable years ending in 1977 to amounts paid to foreign *governments* and designated as taxes under production-sharing contracts entered into before April 8, 1976 for taxable years beginning on or after June 30, 1976." [Emphasis added.]

It is clear, therefore, that the members of the Conference Committee believed they were enacting a provision which applied to all countries having production-sharing agreements, and not merely Indonesia. The requested extension will insure that companies such as Belco operating in non-Indonesian countries will obtain the relief that was always intended.

The revenue effect from the extension is estimated to approximate $4 million for 1978. This amount may be reduced by subsequent events. While the impact for 1979 is indeterminate at this time, it is expected to be about the same magnitude if no new form of agreement is concluded.

PREPARED STATEMENT OF ROREBT J. CASEY, ESQ.

AMENDMENT OF SECTION 1348 TO DEFINE PERSONAL SERVICE INCOME

Under present law, Section 1348 in establishing a maximum tax rate for "personal service income" defines that term by reference to Section 911(b).

Where both capital and personal services are material income producing factors in a business, both Section 911 and Regs. Sec. 1.1348-3(a)(3) limit earned income to 30% of the taxpayer's share of net profit from that business. The limitation operates despite the fact that only a small percentage of income may be produced by the capital assets.

The inequity is magnified in an investment banking partnership where the unlimited liablity of the partners is a source of security and a guarantee of careful attention to investor-clients. In this situation, the operation of present law will likely force such partnerships into incorporating so that reasonable salaries to the managers will qualify as earned income subject to the maximum tax, and without regard to the arbitrary 30% rule of Sec. 911(b). Only the clients would lose from such a development.

The present rule changes the character of income from "earned" to "passive" by fiat without regard to the facts. For example, if an investment banking firm

derived $10 million of revenue from the personal services of its partners and $1 million from interest and dividends from the firm's portfolio, assuming $2 million of expenses, the earned income of the individual partners for maximum tax purposes would be restricted to $2.7 million, and $6.3 million would be taxed at rates higher than 50% as passive income even though only $1 million was, in fact, derived from dividends and interest on the portfolio.

It is proposed to amend Section 1348(b)(1)(A) to strike the reference to Section 911(b) and to define personal service income as "any income derived on account of the personal services performed by the taxpayer."

PREPARED STATEMENT OF THOMAS J. DONOHUE, EXECUTIVE VICE PRESIDENT, CITIZEN'S CHOICE, AND GUY ALFORD, COMMODITY PURCHASING MANAGER, BLACK & DECKER ADVISORY BOARD MEMBER, CITIZEN'S CHOICE

Mr. Chairman, I am Thomas J. Donohue, Executive Vice President of Citizen's Choice. Accompanying me is Guy Alford, a Citizen's Choice member who serves on our Advisory Board. Guy Alford is a commodity purchasing manager with Black and Decker. Mr. Alford would like to present you with this testimony on behalf of Citizen's Choice. We thank you and the Committee for this opportunity to share our views and recommendations on the tax cut bill being considered by the Senate Finance Committee.

Mr. Chairman, Citizen's Choice is a national grass roots taxpayer's lobby affiliated with the Chamber of Commerce of the United States. We come representing over 25,000 taxpaying Citizens's Choice members. Citizen's Choice members strive to protect our personal and economic freedoms and to maintain the health and vigor of our free enterprise system that has made this the greatest country in the world.

The Revenue Act of 1978 is widely being referred to as the "tax cut bill." It is our contention that this bill will not reduce real taxes at all, but will only result in a limitation of tax increases.

Citizen's Choice members are very concerned with the problems of spiraling inflation and taxation, as are all Americans. Inflation and taxation work hand in hand. Inflation is chopping away at the purchasing power of every wage earner, while at the same time it is pushing them into higher and higher tax brackets.

This has become a convenient way for government to increase its share of the GNP every year without having to institute new revenue creating measures, which are politically unpopular. This has been going on for years, and not on a small scale. This year, if we are able to hold inflation under 7 percent, the government will automatically take in over 30 billion dollars as a result of this inflation process. That amounts to more than a 600 dollar a year increase for the average American family! So who are we trying to kid with all this talk about a "tax cut" for taxpayers this year? If the government stands to increase tax receipts by at least 30 billion dollars and then only reduces that by 16 billion, the result is still a 14 billion dollar increase over last year.

Furthermore, if we are not able to temper inflation for the remainder of this year, double-digit inflation could once again raise its ugly head. An eleven percent inflation rate would automatically increase government tax receipts by about 14 percent, or over 65 billion dollars, the equivalent of over one thousand one hundred ($1.100.00) for the average American family.

Additional proof of this trend is found in an August 23rd Commerce Department study which reported that federal receipts—mostly taxes—in the second quarter were growing at an annual rate of more than 27.5 percent. This is a much faster increase than recorded for national income. The double-digit inflation of the year's first half accounts for this spurt in federal receipts.

Americans won't take this anymore, and you need only look to California, Michigan and other states who *are* responding to taxpayers.

For example, a concerned Citizen's Choice member in Whiting, New Jersey writes, "Does the government think we can't see that inflation is boosting federal taxes by tremendous amounts every year? This can't continue."

This committee has a fantastic opportunity to demonstrate that it is listening to what the American people are saying. Each of you represent thousands of citizens back in your home states. And by increasing the amount of the tax cut to 30 billion dollars would be telling your constitutents that you do understand their concerns about taxes and are doing something for them about it.

The problem is that for each six percent increase in inflation, taxes go up eight and a half percent as wage earners are pushed into higher income tax brackets. The House Bill (H.R. 13511) to some extent, recognizes this fact. It includes higher personal exemptions, a six percent widening of the tax brackets, an automatic adjustment for inflation in taxing capital gains, and a one hundred thousand dollar ($100,000) exclusion of gain on the sale of a residence. Citizen's Choice applauds these provisions as steps in the right direction. However, when coupled with the 16.3 billion dollar "tax reduction" voted by the House, it still does not constitute an actual tax cut. Taxes are still rising by an even greater rate, so that almost all taxpayers will still end up paying higher taxes next year.

Clearly, if the Senate wants to respond to citizen demand for bonafide tax relief, the size of the "tax cut" must be increased substantially. Citizen's Choice would recommend a tax cut of 30 billion dollars.

But this is only half the story. A tax cut is not a tax cut if it is accompanied by a rise in federal spending that exceeds the rate of inflation. If the government spends more than it raises in receipts, who will pay the difference? Taxpayers will of course, through deficit spending that will stimulate inflation and contribute to taxes in future years.

The federal government must learn to spend only as much as they take in. As a homeowner I could not stay financially solvent if I used the same spending practices as the federal government.

A Citizen's Choice member in Anchorage, Alaska understands this well as she writes, "Inflation is caused by basically one thing: government spending more than it is taking in. When the government prints a new dollar out of nowhere, the one in my pocket suddenly becomes worthless."

Citizen's Choice believes that the only way to change this deficit spending trend in government is to limit federal spending. Future federal spending increases must be held to no more than the rate of inflation.

Citizen's Choice would also recommend that the Senate pass a measure which would provide for phased-in reductions of the tax rates. Because of this nation's steep progressive tax schedule, inflation-induced wage increases are sending wage earners into tax brackets that were originally meant only for wealthy individuals. Today that taxpayer takes home dollars that have a significantly reduced purchasing power. So the average taxpayer is taxed at a rich man's rate while having the purchasing power of a poor man. The House-passed six percent individual tax bracket expansion is a step towards correcting this problem, but it isn't enough because it is only a one shot measure. Congress must recognize the damaging effects of inflation through the tax brackets. Congress must take strong measures to ease this strain on the taxpayer. One way to accomplish this would be through phased-in reduction of the tax rate extended over several years. In this way citizens would know exactly what rate they would be taxed at without any surprises in future years.

The American citizens have made their views clear on the issue of taxation. Instead of dumping tea overboard as they did 200 years ago, they are passing measures such as Proposition 13 in California. By increasing the size of the tax relief to 30 billion, each Senator would be demonstrating to their constituency that they *are* listening and representing the people's interest. By phased-in reductions of the tax rate, you could prevent future "back door" tax increases from occurring. Citizen's Choice urges the Senate Finance Committee to include these measures into the "tax cut" bill.

Child Welfare League of America, Inc.,
Center for Governmental Affairs,
Washington, D.C., Sptember 5, 1978.

Senator Russell Long,
Chairman, Committee on Finance, U.S. Senate,
Dirksen Senate Office Building, Washington, D.C.

Dear Chairman Long: The Child Welfare League of America, Inc. urges the Finance Committee to approve the Moynihan-Packwood bill (S. 3111) as an amendment to the Revenue Act of 1978 (H.R. 13511). The Child Welfare League, a private nonprofit organization devoting its efforts to the improvement of care and services for children, supports S. 3111 to allow all taxpayers a deduction for their charitable contributions whether they itemize or not. There are nearly 400 child welfare agencies directly affiliated with the League, including representatives from all religious groups as well as nonsectarian public and nonprofit

agencies. Charitable giving to these and other social welfare programs is an important source of funds and must be encouraged by providing the tax reduction proposed in S. 3111.

When voluntary agencies were first organized in the United States, they were funded through citizen contributions and bequests. As the population and social programs of the United States increased, voluntary charitable organizations grew in number and began to experience competition for limited charitable contributions from their communities. For example, ten years ago most of the nearly 400 affiliates child welfare agencies of the League, were receiving from fifty to seventy five per cent of their operating income from federated fund raising campaigns. Currently, most of these agencies receive less than ten percent of their income from these donations.

The experience of child welfare agencies is consistent with the findings of the Commission on Private Philanthropy and Public Needs which contends that charities have lost $5 billion in contributions since 1970 as standard deductions in the tax code have increased. The Commission and the United Way of America have estimated that if S. 3111 is adopted, charitable giving will rise nearly $5 billion during 1978 by retaining a tax incentive for lower and middle income taxpayers to continue to contribute to local charitable organizations and United Way campaigns. In addition, it has been estimated that voluntary organizations take in $1.30 in charitable contributions for every dollar of diminished Federal revenue, representing an efficient use of funds.

Failure to maintain a tax incentive for charitable donations of money undermines the preservation of the nonprofit, nongovernmental sector which is so integral to our pluralistic society. Not only a loss of funds, but also a lack of volunteer time and commitment may be experienced by voluntary agencies which as a result of decreasing contributions must rely more heavily on governmental grants and contracts. Likewise, as state and local tax reforms continue to be implemented, public funds for social welfare activities are decreased placing a larger burden on the private sector to assist in activities formerly supported and administered by the governmental sector.

The Moynihan-Packwood bill, S. 3111, is sound public policy in its provision of a much needed tax reduction for American taxpayers and the consequent enhancement of the charitable organizations and voluntary social welfare programs in their communities. We urge the Finance Committee to approve S. 3111 as an amendment to H.R. 13511, which will result in an efficient source of community funds for services to children and their families.

Sincerely,

WILLIAM L. PIERCE,
Assistant Executive Director.

PREPARED STATEMENT OF BAYARD EWING, CHAIRMAN, COALITION OF NATIONAL VOLUNTARY ORGANIZATIONS

Mr. Chairman, Members of the Committee. I am Bayard Ewing, Chairman of the Coalition of National Voluntary Organizations. We thank you for the chance to offer our testimony on a matter of extreme importance to the voluntary sector, namely, the impact of the President's 1978 Tax Reduction and Reform Proposals on charitable giving.

The Coalition, often referred to by its acronym, CONVO, is a new cooperative effort of the leading national voluntary organizations in the United States. CONVO is the first attempt in this country to bring together representation from every discrete branch of the voluntary world—religion, education, health, welfare, the arts, environmental concerns, and other fields of philanthropy. The complete listing of members is attached to this written testimony.[1]

CONVO serves its members in two major ways: it acts as a clearinghouse for information covering those issues, legislative and other, which impact the viability of the entire voluntary sector, and secondly, it works through its members in a long overdue attempt to interpret the voluntary sector to the public so that the contribution of voluntarism to the quality of life in the nation may be better understood and appreciated.

In appearing at this hearing, along with several of its member organizations who are also offering testimony, CONVO is fulfilling its role as an advocate for that climate within which the nonprofit, voluntary sector of our society may best

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[1] It should be noted, however, that each of our 45 member organizations has not specifically endorsed the language of this testimony.

prosper and continue its important contribution to America. That climate *is* changing. Public charities are finding it increasingly more difficult to finance the growing demand for services of all sorts to the American people. The fact that increases in inflation have greatly exceeded increases in charity in recent years makes it imperative that new sources of charitable gifts be found.

The underlying philosophy upon which this nation was founded strongly emphasized individual initiative in the achievement of public goals. For generations it has been a matter of public policy to encourage such personal initiatives and to provide encouragement and incentives to our citizens to transfer voluntarily a part of their incomes to public purposes. The encouragement of such charitable activity has always been a matter of high government priority, and it remains a policy to which our elected representatives assert their allegiance.

The results of this policy are evident at every hand. In every community there is physical and human evidence of the enormous contributions to the quality of American life which have been made by voluntary organizations since Colonial times. The buildings devoted to religion, health, culture, education, and all sorts of other human services are everywhere. These organizations have become efficient and practical tools for the delivery of a vast array of needed services to the people of America.

One of the manifestations of public policy in this area is the provision in our tax law which allows the deduction of charitable contributions in the calculation of income subject to income tax. This deduction proved to be an incentive to charitable giving that was both efficient and equitable. In the sixty-one years since the Congress built it into the structure of the individual income tax it has been repeatedly expanded in size and liberalized in scope. Clearly the Congress has recognized the deduction as an efficient inducement to charitable giving and has wished to increase and broaden this tax incentive for voluntary action.

In recent years, however, there have been an increasing number of changes in the tax treatment of personal deductions designed to promote goals deemed desirable by the Congress but which have inadvertently had negative effects on charitable giving. In this process, the charitable contribution has unfortunately become confused with other things. Charitable giving is very different from any of the other expenditures for which deductions are permitted, and this difference should be recognized by according the charitable deduction distinctive treatment. Charitable giving is after all a voluntary transfer by a taxpayer of a part of his income to a public purpose and there is no direct financial benefit to the taxpayer as a result of his generosity. By contrast, all other transactions for which a deduction is permitted are expenditures which either result in a direct financial benefit to the taxpayer or relieve him of some of the burdens of disaster. All of these effects are deemed desirable by the Congress. To group together, within the Code, an individual's altruistic motivation for giving voluntarily with expenditures for which there is some *quid pro quo* is to denigrate his generosity. An income transfer which is a matter of self denial for the benefit of others deserves to be treated as a transaction made in the public interest. Charitable giving is not a tax loophole. Yet it is often referred to as such when the unique character of the act of giving is overlooked.

The distinction between charitable giving and other personal deductions is frequently acknowledged, yet often forgotten, by those who would reform our tax policy. They announce support of charity while at the same time they advocate legislation that inadvertently decreases the ability of the voluntary sector to meet the growing needs of the American public. The present tax package recommended by President Carter provides an example: it contains proposals to eliminate or limit certain deductions, such as gasoline taxes, sales taxes, and medical and casualty expenses, and these proposals, if adopted will decrease the tax incentives for charitable giving. It does so by increasing the proportion of taxpayers using the standard deduction from about 75% to 84%.

The facts clearly support our contention that increases in the use of the standard deduction are harmful to charity. The standard deduction represents a block of income that is actually sheltered from taxation. It is the equivalent of tax-free income, and it is therefore the most valuable income that the individual earns in the course of the year. This means that it is also the most expensive income with which to make a charitable gift. The net cost of philanthropic giving to those who use the standard deduction is one hundred cents on every dollar given. It is no surprise, therefore, to find that the studies done by economist Martin S. Feldstein of Harvard University indicate clearly that standard deductors are less generous to charity than are those who itemize. We estimate that the liberalization of the standard deduction since 1969 has

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resulted in a cumulative loss to the voluntary sector of nearly six billion dollars. The loss in 1977 alone is estimated at over $1.3 billion. The additional changes currently proposed which may add another six million taxpayers as non-itemizers. will greatly add to this declining revenue.

I should like to state emphatically that CONVO has not opposed, nor does it now oppose, the desirability of extending the standard deduction to additional taxpayers, either by a direct liberalization of the amounts or through the indirect means involved in the Administration's current proposals. By simplifying the income tax structure and by providing some tax relief, the encouragement to the use of the standard deduction has been of great assistance and benefit to those in the lower income brackets. But such action should not be permitted to cause inadvertent damage to the long-held policy of encouraging the voluntary financial support of the charitable community.

A simple and desirable solution to this problem has been put forward by Representatives Barber Conable and Joseph Fisher, distinguished members of this Committee. These two gentlemen have introduced a bill, H.R. 11183, which would permit all taxpayers, whether they itemize their personal deductions or not, to subtract their charitable giving from their gross incomes in determining their adjusted gross incomes. We endorse this legislation as meeting the objectives we have outlined.

Our endorsement also reflects another concern. As the percentage of taxpayers utilizing the standard deduction increases, the charitable deduction is made to appear more and more as a benefit accorded only to the very rich. Since altruism is truly in the public interest. it should be encouraged broadly to all citizens regardless of income and wealth. To do otherwise would be grossly inequitable to the generous individuals in the lower tax brackets who continue to give to their favorite charities. It would seem more in keeping with the public policy favoring action for the public good to democratize the incentives for charitable giving by extending the right to all taxpayers to itemize such gifts, and not to reserve that right to a small fraction of the taxpaying public at the upper end of the income scale.

The present tendency to group together self-benefiting deductions with altruistic charitable contributions, combined with the disincentives to giving that the extension of the standard deduction entails, point clearly to the need for permitting charitable gifts to be deducted directly from gross income as provided in H.R. 11183 rather than from adjusted gross income as is presently the case. This change would offer incentives for all taxpayers to increase their support of voluntary activities in the public interest. It would recognize the essential difference between charitable giving and other deductions now permitted. And it would democratize the charitable deduction. To adopt this change seems to me to be both sensible and fair.

Such a change is not without precedent. The Congress has already seen fit to permit the deduction of child support, alimony payments, and certain other expenditures above the line as adjustments to gross income. It should be pointed out that the expenditures are all tinged with some degree of self-interest. Such expenditures are not altruistic transfers of personal income as is the charitable gift. If they deserve distinctive treatment, it would seem to be inescapable that charitable giving should be treated at least as well.

The expense to the Treasury of such a change in the law is not a valid objection. This is a year in which we are talking of tax reductions that range upwards of twenty-five billions of dollars. It is estimated that the extension of the charitable deduction to all taxpayers would cost the Treasury something on the order of two billion dollars. The gain in total charitable giving will exceed that figure by a significant margin, because the charitable deduction has proven to be an efficient incentive to giving. Furthermore, these additional constributions would be used to meet public needs in ways that will relieve the Treasury of much larger outlays in the future. The immediate loss of tax revenues would not be lost to public purposes; rather, those dollars and more will be injected directly into the economy to provide services to people in ways that are very much in the public interest.

Given that there will be a general tax reduction, the Congress need only take into account the cost of extending the charitable deduction to all taxpayers in arriving at the overall reduction in taxes it believes to be desirable as economic stimulus. It would be the greatest gesture of support of voluntarism that the Congress could possibly offer. It was a strong recommendation of the Commission on Private Philanthropy and Public Needs, otherwise known as The Filer

Commission, and is a prime objective of all the charitable organizations that CONVO represents.

The public philosophy and public policies that have historically encouraged voluntarism in the United States, the growing needs of the voluntary sector, the recent erosion for the majority of taxpayers of tax incentives for private giving, would suggest that the change is one whose time has come. We would respectfully urge that the Committee incorporate the Conable-Fisher bill, H.R. 11183, in the markup of the current tax package.

On behalf of the member organizations of the Coalition of National Voluntary Organizations, I thank you for this opportunity to give testimony on this most important matter.

CONVO MEMBER ORGANIZATIONS—JANUARY 1, 1978

Alliance for Volunteerism.
American Arts Alliance.
American Association of Fund Raising Counsel, Inc.
American Cancer Society.
American Council for the Arts.
American Council on Education.
American Federation of Labor/Congress of Industrial Organizations.[1]
American Foundation for the Blind.[1]
American Heart Association.
American Hospital Association.
American National Red Cross.
American Theater Association.
Arrow, Inc.[1]
Association of Governing Boards of Universities and Colleges.
Big Brothers/Big Sisters of America.[1]
Christian Church Foundation.[1]
Conference of Major Superiors of Men's Institutes of the U.S.
Council for Financial Aid to Education.
Council of Jewish Federations and Welfare Funds.
Council on Foundations.
Direct Mail Fundraisers Association.
Epilepsy Foundation of America.[1]
Joint Action in Community Service.
Leukemia Society of America.
Lutheran Council in the U.S.A.-Office of Governmental Affairs.
Lutheran Resources Commission-Washington.
Mental Health Association.
National Assembly of National Voluntary Health & Social Welfare Organzations, Inc.
National Association for Hospital Development.
National Audubon Society.
National Center for Voluntary Action.
National Conference of Catholic Charities.
National Council on the Aging.
National Council of the Churches of Christ-Commission on Stewardship.
National Council on Philanthropy.
National Council of Women of the U.S.A., Inc.
National Council of YMCA's in the U.S.
National Foundation-March of Dimes.
National Health Council, Inc.
National Society for Autistic Children.[1]
National Society of Fund Raisers.
National Urban Coalition.
National Urban League.
Salvation Army-Headquarters Division.
United Methodist Church-Division of Finance & Administration.
United Presbyterian Foundation.[1]
United States Catholic Conference.
United States Olympic Committee.
United Way of America.
Volunteers of America.
Zero Population Growth.

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[1] Member by Intent—Decision pending.

STATEMENT OF ROGER J. SULLIVAN, DIRECTOR OF DEVELOPMENT AND PUBLIC AFFAIRS, CHILD & FAMILY SERVICES, INC.

Senate bill number 3111, sponsored by Senators Packwood, Moynihan, et al. touches upon one of the most unique qualities of our American civilization. Its passage is critical to the revitalization of our faltering vountary sector.

Few aspects of American society are more characteristically, more famously American than our nation's array of voluntary organizations and the support in both time and money that is given to them by its citizens.

America is indeed a grand tapestry, woven of many cultures, and colored by the people and events of our history. Its very creation has been novel, but its true magnificence stems from that mysterious human synergy which made our national character so uniquely generous.

Throughout our history, lawmakers and tax proposers have recognized that, in America, giving ranks near to voting as a vital form of democratic expression; as a stimulus to our treasured pluralism.

When the Commission on Private Philanthropy and Public Needs, chaired by John H. Filer of Aetna Life and Casualty, issued in 1975 its report "Giving in America", it warned of the erosion of private giving. The Commission cited discriminatory federal tax regulations as a principal cause and prescribed several important remedies, one of which is embodied before you in S. 3111.

Indeed, while the total of dollars given by all Americans to all charitable and religious causes has doubled between 1967 and 1978, it has shrunk as a proportion of gross national product from 2.21 percent to 1.74 percent. It seems that while we weren't looking, one of our greatest legacies began to slip away from us. The Commission did look, saw trouble and prescribed a plan of action.

You are now debating measures which lie at the very heart of the matter. On the one hand, a U.S. Treasury proposal to expand the standardized deduction, and on the other a measure which would place the charitable gift deduction within reach of all Americans, whether they itemize their tax returns or not. The first is diametrically opposed to the Filer Commission's pleas, the second precisely in concert with them.

The inclusion of charitable gifts in the expanded standardized deduction says, in effect, to those taxpayers who fit its general parameters:

"You are typical of a group (with 2.1 kids, 1.3 cars, etc.) which spends X dollars on medical services and insurance, has a mortgage of Y dollars * * * and who contributes approximately Z dollars to various charities. We've gotten your numbers from the computer and now you no longer have to worry about how much charity is enough, since we've given you an automatic deduction. (Incidentally, everybody else 'like you' gets the same deduction, whether they donated or not)."

That is what lumping charitable giving into the standardized deduction says about our commitment to good citizenship. It says that for the sake of IRS expediency, we will measure, define and circumscribe generosity.

The second measure, introduced a S. 311 by Senators Moynihan and Packwood, and now co-sponsored by numerous others, not only would avoid such an undemocratic statement but would once and for all say that charitable gifts are vital to the nature of our society. It would ensure the pluralism which has so long added to our American life style, and help to prevent the need for further costly takeover of services by public agencies.

There are several key points to be considered in support of this bill:

1. Charitable giving never belonged in the standardized deduction, because its voluntary nature is negated by a formula deduction; *this is a corrective measure.*

2. Authoritative studies show that charities have lost some $5 billion in contributions in this decade because of the adverse effects of the current standard deduction system for charitable giving; *charities have suffered unjustly.*

3. The estimated loss in tax revenue is only one half the amount which charities would gain through reinstatement of the charitable deduction for all taxpayers; *benefits far outweigh cost.*

4. Since even the I.R.S. concedes that bona fide charitable gifts are deducible, any tax revenue lost through such a corrective measure is revenue the government was never entitled to in the first place; *no true tax loss.*

We are fostering an insidious process which will one day soon destroy the uniqueness of our nation. Unwillingly, we are saying not to bother with charity—there is no percentage in it. Worse still, we infer to those who standardize, and therefore have no direct exposure to the charitable deduction, that such giving matters only for "the rich" who itemize. Charity is *not* a sport of the rich! Studies have shown that families earning $5,000 or $50,000 per year annually donate to bona fide charities roughly the same percentage of their income. Moreover, people will still give no matter what our tax code says.

Since no one seems to know who is responsible for our American tradition of giving, it's difficult to say who must take action to preserve it. We all enjoy its legacies however, and unless we rise in defense, we all surely will miss its presence in our future.

Please support S. 3111, and all measures which will endorse our traditional spirit of voluntary action. We can't afford, financially or spiritually, the notion in this country that government should do everything.

COVINGTON & BURLING,
Washington, D.C., September 6, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I enclose herewith the written statement for the record of the Senate Committee on Finance with respect to its hearings on H.R. 13511. The statement relates to sections 202 and 204(a) of the bill, which would extend to closely held corporations the "at risk" provisions of Code section 465. The statement urges a technical correction to section 204(a) of the bill to insure that the exception in present law with respect to leases entered into prior to 1976 will be applicable to closely held corporations when the "at risk" provisions are extended to them by section 202 of the pending bill.

Respectfully yours,

EDWIN S. COHEN.

Enclosure.

WRITTEN STATEMENT FOR THE RECORD OF THE SENATE COMMITTEE ON FINANCE REGARDING SECTIONS 202 AND 204(a) OF H.R. 13511

Section 202 of H.R. 13511 would extend the "at risk" provisions of section 465 of the Internal Revenue Code to closely held corporations. Section 204(a) of the bill provides that the amendment will apply to taxable years beginning after December 31, 1978.

The "at risk" provisions of section 465 were inserted in the Internal Revenue Code by section 204 of the Tax Reform Act of 1976 (P.L. 94–455). Section 204(c)(3) of the Tax Reform Act of 1976 (as it would be corrected by section 2(k) of H.R. 6715, the Technical Corrections Act of 1978) specifically provides that, while Internal Revenue Code section 465 is generally applicable with respect to taxable years beginning after January 1, 1975, it will not be applicable in the case of leases entered into prior to January 1, 1976. Because this effective date provision in the 1976 Act was not inserted as a part of section 465 of the Internal Revenue Code, it is possible that as a technical matter the exclusion of pre-1976 leases would not apply to closely held corporations under the new provisions of H.R. 13511 when the "at risk" provisions are extended to them, even though it would continue to be applicable in the case of individuals.

It seems apparent from the title of section 202 of H.R. 13511 and the accompanying Committee Report that it is intended merely to "extend" the provisions of existing section 465 to closely held corporations, and not to make the provisions applicable to corporations in cases in which they would not be applicable to individuals. To make this clear, it is suggested that the effective date provision in section 204(a) of H.R. 13511 be expanded to include the provisions of section 204(c)(3) of the Tax Reform Act of 1976 (together with the correction in section 2(k) of H.R. 6715) and thus make clear that when section 465 becomes effective with respect to corporations after 1978 it will not apply with respect to leases entered into prior to January 1, 1976.

COUNCIL OF VIETNAM VETERANS, INC.,
Washington, D.C., September 13, 1978.

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

DEAR MR. CHAIRMAN: During our testimony on the targeted jobs tax credit provisions of H.R. 13511, you asked whether this targeting should be limited to just "war theatre" veterans, service connected disabled veterans, or kept broad enough to encompass all who served in the military.

As an organization that is composed mainly of combat veterans, we are very sensitive to this type of distinction and are often at the forefront in advocating focused veterans' benefits. However, when the benefit is based on need, as with the jobs tax credit, then we feel the distinction should not be drawn. We are talking about benefiting veterans who fully ten years after the Tet Offensive, at an average age of 33, are still in dire poverty. The job tax-credit program can solve the problems of many veterans.

While we appreciate the extraordinary difficulties the combat soldier endured, we are not insensitive to the general problems that any military service entailed during our most recent war. All veterans returned to an inadequate GI Bill and faced the difficulties of unaided readjustment to civilian employment. All faced the broken promises of badly developed jobs programs. While most crossed these hurdles, many could not.

It is these general problems that the tax credit provision addresses. The credit must be drawn broadly enough to meet them.

Similarly, although the difficulties of service-connected disabled veterans cannot be minimized, there already exists an extensive series of special compensation and training programs to assist them. For example, of the President's three January 1977 initiatives for veterans, the only one to be continued is the Disabled Veterans' Outreach Program. The priority at this time must be a program to meet the needs of economically disadvantaged veterans, disabled or not.

Thank you again for your consideration of the veterans in this most hectic and demanding legislative period.

Sincerely,

ROBERT O. MULLER,
Executive Director.

STATEMENT OF GEORGE W. CREGG

My name is George W. Cregg. I live at 932 Onondaga Road, Camillus, New York, 13031. I am a lawyer and I am a partner in the firm of Melvin and Melvin located at 700 Merchants Bank Building, Syracuse, New York, 13202. I appear here today as an individual. However, I have clients who are interested and who may benefit from the legislation proposed. I am Counsel for the New York State Association of Industrial Development Agencies, Inc. I am the author of the New York State Association of Industrial Development Agencies Act, and I personally represent several local industrial development agencies that have been formed in New York State pursuant to the terms of that Act. I also represent the Auburn Industrial Development Authority. I not only represent industrial development agencies, but also, from time to time, represent institutional purchasers of the bonds which are issued by industrial development agencies, represent corporations that desire to do industrial revenue bond financing, and represent trustees of the trust indentures which are issued in connection with industrial revenue bond financings. We have also issued opinions with reference to revenue bond financings.

Based on my personal experiences in dealing with a large number of companies in transactions relating to capital improvements, I have come to know some of the good management practices that are followed in making decisions regarding capital investments. The divisions and subsidiaries of large companies are constantly examining their operations, formulating plans and making requests for modifications or expansions of their operations. Smaller companies follow similar decision making processes in formulating proposals for plant expansions or modifications, or the construction of new facilities.

When a small company puts together all of the information needed for a capital improvement to an existing plant or for the construction of a new facility, all of the costs are put together in order to determine the extent of the proposed investment, and then such investment is evaluated in relation to the annual return that is anticipated on such an investment. Frequently the decision not to go ahead with a project is based on the high interest rate that is necessary to obtain the capital for such a project. *It is a common occurrence that the difference of one or two percent in the interest rate will tip the scales in favor of or against a capital project. Tax exempt interest can often make projects viable which could not otherwise be undertaken.*

In larger companies the same decision making process is followed except that instead of one small company management team making the final decision the various teams of the many divisions and subsidiaries of a large company are constantly competing with one another. In a large company the "best probability of return" is used as a criteria, and often individual projects are denied to local management two or three times before a suggestion is made to use tax exempt financing. *Tax exempt financing when factored into an otherwise marginal deal frequently tips the scales in making a project viable and in providing hundreds of new jobs.*

Therefore, it can be seen that tax exempt financing does not too often represent "where" a project will be constructed, but whether such a project will "come into being or not."

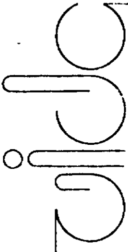
Tax exempt financing for industrial construction is available in one form or another in practically every section of the United States. The whole nation is competing equally for expansion of older facilities and for the construction of new facilities. There is very little "shifting around" of industry because of the availability of tax exempt financing. Tax exempt financing is not causing investment in one area as against another area of the United States. Tax exempt financing is, however, encouraging the "very being" of industrial expansion and new construction.

We propose at this time (a) to increase the $1 million small issue exemption to $3 million and (b) to increase the limit subject to the capital expenditure rule, if such rule be retained, from $5 million to $15 million. We would of course also like to eliminate the inequitable and self-defeating 6 year capital expenditure rule, and simply raise the $1 million exemption to $15 million. Either approach will substantially stimulate the economy and bring into being capital projects which would not otherwise be constructed. Either approach will create thousands of immediate new jobs throughout the United States.

I am a member of the American Industrial Development Council. Robert E. Lee Garner, of Atlanta, Georgia, and I prepared a memorandum entitled "Industrial Development Bonds and Their Role in Alleviating Unemployment" which has been published by the American Industrial Development Council along with a statistical abstract of long-term municipal bond dollar volume, prepared by James G. Belch, of Gainesville, Florida. Copies of this memorandum have been submitted to your Committee to be included in the record of this hearing. Such memorandum speaks for itself and outlines in Appendix A thereof the industrial building cost increase between 1967 and 1976 indicating that a $5 million project in 1967 cost over $10 million in 1976, and would far exceed that cost today. Such memorandum also describes the limiting effects of the capital expenditure rule.

I have also submitted to your Committee copies of a memorandum entitled "The Interest Tax-Exemption on Industrial Development Bonds: The Cost to the United States Treasury" by Dr. John A. Andrews and Dr. Dennis R. Murphy of Emory University in order to show the net benefit to the U.S. Treasury of Industrial Revenue Bond Projects.

american industrial development council, incorporated



INDUSTRIAL DEVELOPMENT BONDS and THEIR ROLE IN ALLEVIATING UNEMPLOYMENT

with

A STATISTICAL ABSTRACT of LONG-TERM MUNICIPAL BOND DOLLAR VOLUME: 1970-1976

GEORGE W. CREGG
ROBERT E. LEE GARNER
JAMES G. BELCH

FOREWORD

Practitioners of industrial development have, since Colonial times, been concerned with capital formation. Adequate financing for land, building and equipment in the plant location process continues to be a major factor just as it has been throughout our nation's history.

The widespread use of bonds for industrial development purposes, which began with Mississippi's "Balance Agriculture With Industry" program in 1936, is still a very important means of plant location financing.

The current restrictions and limitations on this form of financing have acted as an inhibitor in the creation of new employment during a period when high unemployment has been a critical national problem.

This paper was written by George W. Cregg of Melvin and Melvin of Syracuse, New York, and Robert E. Lee Garner of Gambrell, Russell, Killorin & Forbes of Atlanta, Georgia specifically for the American Industrial Development Council. Its purpose is to provide sound, reliable and valid arguments for using IDRB's to finance industrial development projects which will lead to the new jobs so vital to the continued strength of our economy.

The Statistical Abstract portion of this publication was compiled by AIDC Director James G. Belch of Gainesville, Florida. Information in the Abstract clearly shows, as presented in the position paper, that IDRB's "compete for sale principally with corporate bonds, and not with the traditional general obligation bonds of municipalities." In fact, Mr. Belch's figures show that IDRB's are a very, very small part of the overall bond picture. Their importance lies in their use as "small issue" tools which can be used most effectively in "alleviating the problem of unemployment and stimulating the economy without triggering further dangerous inflation."

Both the position paper and statistical abstract were presented, by their authors, at the AIDC-sponsored conference on "The Future of Industrial Revenue Bonds" which was held in Chicago on December 15, 1976. Requests for copies of both presentations were so great that it was decided to make them available in this form.

AIDC will argue strongly, through this method and through its Legislative Committees, for improved methods of capital formation for industrial development purposes during 1977 and in the future. It is hoped that this publication will be of value to those who feel that this form of financing has been especially useful and should be continued in an expanded form.

This publication is a joint effort of the American Industrial Development Council and the Southern Industrial Development Council. This represents a major joint effort by these organizations and it is hoped that it will lead to additional project cooperation on the issues which concern the practice of industrial development.

Larry D. Cohick, C.I.D., FM/AIDC
Executive Vice President
American Industrial Development Council

INDUSTRIAL DEVELOPMENT BONDS

AND

THEIR ROLE

IN

ALLEVIATING UNEMPLOYMENT

Prepared by:

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Atlanta, Georgia

For The American Industrial
Development Council Inc.'s
"Conference on the Future of
Industrial Development Revenue
Bond Financing"

December 15, 1976, Chicago, Illinois

INTRODUCTION

During the past several weeks, we have been seeing statements in the business news media that the nation's economy is stagnating and that unemployment which has been such a severe problem for the past several years is creeping upwards again. President-elect Carter, his economic advisors and his transition staff tell us on a daily basis that the first priority of the new administration must be stimulation of the economy with particular emphasis on the creation of new jobs to alleviate the stubborn unemployment problem. They say that unemployment in the United States is a crisis of the first order that must be dealt with immediately. This, of course, is something that those of us who work in the field of industrial development have known for some time. President-elect Carter and his staff warn us of the difficulties and dangers, particularly that of inflation, in trying to stimulate the economy too rapidly. They are struggling with the problem of finding some economic tool that will increase employment opportunities without creating an unacceptable rate of inflation.

We submit that a tool or vehicle exists which, with proper amendatory legislation, can be effectively used to help alleviate the problem of unemployment and stimulate the economy without triggering further dangerous inflation. This tool is the "small issue" industrial development bond.

It is a widely recognized fact that one of the primary contributors to continuing unemployment is business's reluc-

tance over the past several years to build new industrial plants or to purchase new industrial equipment. Therefore, it is critically important that industrial construction and expansion be encouraged so that new jobs will be created. An immediate result of new industrial plant construction would be direct relief to the construction industry where unemployment continues at a double-digit rate.

The two reasons most often given by businessmen for cancellation of plans for industrial expansion are high interest rates and rapidly increasing construction costs. Therefore, in order to stimulate industrial construction and expansion, funds for capital investment must be made available to industry at a cost which makes construction and expansion economically feasible.

Insofar as interest rates are concerned, exempting interest paid to lenders for borrowed funds from income taxation obviously provides lower interest rates to the borrowers. Consequently, to the extent that industry can borrow money through a vehicle that will allow its lenders to receive interest tax-free and thus borrow at a lower cost, it follows that industry will be encouraged to increase industrial construction and expand industrial capacity.

The Internal Revenue Code of 1954, as amended (hereinafter the "Code") does provide such a vehicle for tax-free borrowing. It is the "small issue" industrial development bond whose use is outlined in §103(c)(6) of the Code. This section

provides that businesses may borrow, indirectly, through municipalities' issuance of industrial development bonds up to $1,000,000 (and in some instances $5,000,000) on a tax-exempt basis. Obviously, the primary purpose of this provision of the Code was to encourage industrial expansion. However, the provisions of the Code enacted in 1968 relating to the "small issue" industrial development bond no longer serve that intended purpose because the statutory limitations on the use of the "small issue" bonds have become unrealistic in light of continued increases in construction costs since 1967.

E. H. Boeckh & Associates, the Engineering News-Record and Turner Construction Company building cost indices for factory buildings more than doubled from 1967 to July 1976. A summary of such rate increases is attached hereto as Appendix "A". Clearly, inflation in the construction industry has reduced the "building power" of "small issue" industrial development bonds to less than half of what it was in 1968 when the exemptions were enacted. Moreover, the three years forward and three years back "capital expenditure" prohibition relating to the $5,000,000 "small issue" industrial development bond has proved to be inequitable and self-defeating as will be more fully explained below.

It is for this and other reasons that §103(c)(6) of the Code relating to taxation of interest paid on industrial development bonds must be amended, to increase the dollar limit on "small issue" industrial development bonds and to

remove or at least modify the limitation with respect to "capital expenditures" made at facilities financed with such bonds.

DISCUSSION

Under present law, industrial development bonds do not perform efficiently in the expansion of existing industrial facilities and the construction of new industrial facilities. Provision is made in the Code for industrial development bonds, the interest on which is exempt from Federal income tax under §103(c) of the Code, to be used to finance several specified categories of development including the construction of low cost housing, sports facilities, convention or trade show facilities, certain transportation facilities, public utilities, industrial parks and air or water pollution control facilities. Additionally, there is a "small issue" exemption in the Code which allows tax-exempt industrial development bonds to be issued in the principal amount of $1,000,000 or, in some cases, $5,000,000, for the construction, improvement or acquisition of land or property of a character subject to the allowance for depreciation under §167 of the Code (i.e., among other things manufacturing facilities).

Under §103(c)(6) of the Code, interest on industrial development bonds is tax-exempt if the bonds are part of an issue which is limited to $1,000,000 or, at the election of the issuer of the bonds, to $5,000,000. (These monetary

limitations are structured so that a business using a facility financed by the proceeds may not use multiple bond issues in the same municipality or county to construct larger facilities.) If the $5,000,000 election is exercised, however, the total of (i) the "capital expenditures" incurred by the user of the facility financed by such bonds which are related to that facility or any other facility of the user in the same county or municipality (including both those expenditures financed by the issuance of the bonds and those expenditures made with funds raised from any other sources) and (ii) the bond proceeds may not exceed $5,000,000 during the six-year period beginning three years prior to the date of the bonds' issuance and ending three years after their issuance. Violation of this limit makes interest on the bonds taxable, retroactively.

In today's economy (where construction costs since 1968 -- when these dollar limitations were imposed -- have more than doubled)[1/] the interest savings achieved by a company through using $1,000,000 in tax-exempt bonds usually is not sufficient to provide a substantial incentive for incurring the costs of capital expansion. The incentive provided by the $5,000,000 exemption is also not adequate due to inflation since 1968 and the six-year "capital expenditure" rule. No business can rationally use the entire $5,000,000 made available under the exemption because it must maintain a "cushion" for "capital expenditures" which will probably have to be

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1/ See Appendix "A" attached hereto.

incurred within the three-year period after the bonds are issued (not to mention applicable "capital expenditures" that may have been incurred during the three-year period prior to the bonds' issuance). Furthermore, many corporations are afraid to use the $5,000,000 exemption for fear that technological or other changes will require that the $5,000,000 "capital expenditure" limit be exceeded during the three years following the bonds' issuance, thus, by law, triggering taxability of the interest paid on the industrial development bonds previously issued. Such taxability in turn usually requires the redemption of such bonds at a substantial premium pursuant to the leases and trust indentures between the user of the facilities being financed and the purchasers of the bonds.

Part of the legislation imposing the $1,000,000 limit on industrial development bonds was passed in June of 1968 after the promulgation of proposed Treasury Department regulations in March of 1968 which would have eliminated, entirely, the tax-exempt status for all industrial development bonds. The Treasury's proposed regulations were intended to correct what Department officials deemed to be abuses in the use of industrial development bonds. The Congress, however, recognized that, while abuses existed, industrial development bond financing serves a valuable purpose by providing communities an opportunity to improve their economic base through industrial development. Accordingly, the Congress passed Section 103(c)(6) of the Code to preserve the tax-exempt status of industrial

development bonds, but with a $1,000,000 limitation on the size of the bond issues. Upon further study during 1968, the Congress determined that the $1,000,000 limitation would not enable communities to use this method of financing as effectively as had been intended. Consequently, in October 1968, the Congress amended Section 103(c)(6) to provide the alternative $5,000,000 limitation.[2/]

The need to provide employment opportunities in all areas, and, in particular, in areas which were hardest hit by the recent recession and which show no signs of recovery, is much greater than it was in 1968. Unemployment in America has been, and continues to be, on the increase. The return of Viet Nam veterans to the work force, the increasing numbers of women seeking employment and the general increase in the work force due to growth in our population, have accentuated the need for expanded employment opportunities. All of these factors have

2/ Tied to the alternative $5,000,000 "small issue" exemption is the "capital expenditure" rule described previously. No rationale, or reasoning, has ever been given to community developers for this limitation. The limitation has been negative and self-defeating. It is important to note that "capital expenditures" are not limited to the amounts raised from bond issues, but also must include the money which users borrow themselves, and expenditures from their own cash reserves. Companies who find themselves suddenly in a fast growth situation are prevented from spending their own money to grow and to further stimulate the public benefits which the industrial development bond financing was supposed to bring about in the first place. Not the least of these, is the payment of increased Federal income taxes. Community economic developers have never questioned the concept of limiting the amount of tax-exempt bonds to be issued for a single tenant in a given municipality or county, but seriously question the wisdom of freezing projects by the "capital expenditure" rule, so that they cannot expand through other sources.

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been compounded by the cutback in industry's plans for capital expansion which result in great part from increased interest rates and rapidly increasing construction costs.

For these reasons, the tax-exempt industrial development bond concept is more valid and necessary than ever before. If §103(c)(6) were amended to liberalize its monetary limitations and the "capital expenditure" restriction, it would re-establish a unique incentive that would enable communities to improve their economic base by providing businesses with an effective vehicle to finance their growth or expansion with capital supplied at lower interest costs than otherwise available from conventional sources.

The Impact of Inflation.

Inflation has been particularly troublesome in the construction industry. As shown in Appendix "A", construction costs more than doubled between 1967 and July 1976. Additionally, the value of farm land, which greatly affects the price of land required for industrial expansion, increased 225% from 1968 to 1976.

Increase in Average U.S. Farm Real Estate Values Since Adoption of Section 103(c)(6)

Date	Value per Acre ($)	% of 1968 Value
1968	179[a]	100
1976	403 or more[b]	225 plus

[a] Economic Research Service, United States Department of Agriculture, Farm Real Estate Historical Series Data: 1850-1970 (1973) 2.

[b] Economic Research Service, United States Department of Agriculture, Farm Real Estate Market Developments (Feb. 1, 1976).

The foregoing information shows that farm land costing $1,000,000 in 1968 costs $2,250,000 today. Construction which cost $1,000,000 in 1967 costs between $2,030,000 and $2,240,000 today, and construction which cost $5,000,000 in 1968 costs between $10,150,000 and $11,200,000 today (see Appendix "A").

The impact of this inflationary trend has been sharply felt by the businessman seeking to build a new plant or expand his present facilities. The opportunity seemingly afforded him by §103(c)(6) of the Code may well be unavailable because fewer projects can fit within the dollar limits now contained in the Code. The consequence is that contemplated projects may either be reduced in scope or abandoned -- to the detriment of economic development in numerous localities.

The "Capital Expenditure" Rule.

The 1968 amendment providing for the issuance of up to $5,000,000 of industrial development bonds includes requirements which have greatly reduced the expected utility of this alternative to the $1,000,000 exemption. The most significant of these is the "capital expenditure" limitation. Under §103(c)(6) of the Code, "capital expenditures" made by or on behalf of the primary user of the facilities being financed by indusrial development bonds, if such expenditures are for plants located in the same municipality or county as the bond financed facility (even if they are not made in conjunction with that facility) are credited against the

$5,000,000 ceiling and thereby correspondingly reduce the amount of tax-exempt bonds that may be issued. These expenditures include any "capital expenditures" made during the six-year period beginning three years immediately preceding the date of the bond issue and ending three years after such date.

For purposes of §103(c)(6) of the Code, the term "capital expenditures" includes any expenditures properly chargeable to the capital account of the company on whose behalf the bonds are issued, even if such expenditures otherwise could be expensed. This would include such items as research and development, the purchase of equipment and machinery, the addition of new facilities and other expenditures necessary for the growth of a business.

The most significant effect of the "capital expenditure" rule is that, as a practical matter, the limit on tax-exempt industrial development bond financing is closer to $4,000,000 than $5,000,000. This is due in large part to considerations of marketing the bonds. Investors in tax-exempt bonds are not willing to take the risk of buying a bond that is part of an issue the dollar amount of which is too close to the upper limits of the exemption because violation of the $5,000,000 ceiling renders interest on the bonds taxable.

Further, the capital expenditure limit is burdensome, in the context of the $5,000,000 ceiling, in the case of plants that are in the initial stages of development. A plant initially financed by industrial development bonds under the

$5,000,000 alternative could be prevented from expanding, reaching new markets and increasing its employment levels because additional expenditures for research, equipment or plant expansion could not be made without the loss of the tax-exempt status of outstanding bonds which financed the plant.

For example, if a facility costing $3,900,000 is financed through the use of industrial development bonds and immediately thereafter the business engaged in research costing $500,000 and purchased trucks, machinery and other equipment costing $600,000, no further "capital expenditures" could be made by the enterprise during the three years immediately following the date of the bond issue even if sound business practice would dictate such expenditures.

Discussion of Arguments Raised in Opposition to Industrial Development Bonds

Opponents of industrial development bonds have argued that they are undesirable because:

A. industrial development bonds constitute a Federal subsidy to private corporations;

B. industrial development bonds compete in the financial markets with traditional general obligation bonds of municipalities, thus the very existence of such bonds increases the cost of borrowing for municipalities; and

C. industrial development bonds are an inefficient subsidy in any event, because the cost they represent to the Federal government, in terms of lost tax revenues, is far greater than any economic benefit received by

companies utilizing such bonds as a tool for financing capital expansion and improvement.

An accurate analysis of industrial development bond financing shows these arguments to be specious and based on half-truths. A more thorough examination indicates that such financing does encourage new and expanded industrial development thereby creating new jobs which are so desperately needed in today's job market and, most importantly, does it more effectively than direct federal subsidies.

In the interest of clarity, the following analysis of industrial development bond financing is subdivided in the same order as the purported arguments against such financing listed above.

A. As a matter of economic reality, it is unquestionably true that industrial development bond financing generates an economic benefit to private corporations whose capital expansions are financed by such bonds. However, this is not, in itself, an argument against industrial development bonds. The proper question is whether the need for such a form of financing, and the benefits it yields to economically depressed areas, outweighsthe "private benefit" it affords to corporations at the expense of lost tax revenues. The answer to that question, manifestly, is "yes".

Industrial development bonds provide, through lower interest rates, an incentive for businesses to expand their productive capacity. With today's high unemployment rates follow-

ing several years of inflation, it is recognized that one of our country's most pressing needs is the expansion of productive capacity. Such an expansion will serve two purposes: (i) alleviation of excess demand which feeds the inflationary spiral; and (ii) provision of additional jobs which are so desperately needed today.

The benefits that redound to economically deprived areas from the introduction of a new facility are too numerous to list exhaustively. The most important is the creation of industrial jobs. Furthermore, the local tax base may be substantially increased. In most states provision is made for ad valorem taxation of the facilities financed by industrial development bonds or for alternate methods of collecting "in lieu of tax" payments. Moreover, the increase in local salary levels provides for greater taxes from other local sources -- such as sales and income taxes. This results in better schools, better roads, etc. which, in turn, makes it easier to attract more job-producing businesses. It should also be noted that the U.S. Department of Commerce estimates that the creation of 100 industrial jobs creates 65 additional service jobs.

B. It has been argued that industrial development bonds are economically detrimental to the very municipalities and counties they are supposed to help, because such bonds compete in the same markets with traditional general obligation bonds

and, consequently, increase demand for funds which in turn increases the cost of ordinary borrowing for municipalities and counties. It is highly questionable whether industrial development bonds compete in the same market as traditional municipal obligations because purchasers of industrial development bonds look principally to the credit of the company whose facilities are being financed by the bonds, rather than to that of the issuing municipality, county or authority, in deciding whether to buy these bonds. The issuing municipality or agency traditionally has no liability or obligation to pay the industrial development bonds if the business, for whose benefit the bonds have been issued, is unable to meet its obligations with respect to those bonds. Consequently, industrial development bonds compete for sale principally with corporate bonds, and not with the traditional general obligation bonds of municipalities.

This conclusion is buttressed by the results of a "Statistical Abstract of Long-Term Municipal Bond Dollar Volume Jan. 1970 - Sept. 1976" prepared for the American Industrial Development Council, Inc. by James G. Belch, and a statement of John Peterson of the Municipal Finance Officers Association which was introduced into the hearings of the Senate Subcommittee on Small Business on July 1976. These results indicate that, taking as an example a 1975 twenty-year $1,000,000 issue with an assumed debt service cost of $64,000, there would have been a reduction of only $748.06 on that debt service had there been

no industrial issues (including the proliferation of large pollution control issues) during 1975. Thus, we can see that the impact of industrial financing on the debt service cost of all municipal obligations is minimal, and, if we assume that some limits will be forthcoming on pollution control issues, the impact of the "small issue" industrial development bond on the debt service cost of all municipal issues would be almost nonexistent. The impact of industrial development bond issues will be further reduced as a result of the revisions in the Tax Reform Act of 1976 which will permit mutual funds to pass through to their investors the tax-exempt status of obligations in which the funds invest. This provision will widely broaden the market for all types of municipal obligations and thus reduce any demand pressure which has tended to drive up the interest rate of tax free municipal obligations.

C. The frequently raised argument that the industrial development bond is an inefficient means to encourage capital expansion and development must be examined closely. It is founded principally on two premises:

(i) that the forces of supply and demand in the capital money markets are the most efficient means of determining which capital expansions are efficient and which are not, and, therefore, such forces should be left free to operate (without the influence of government sponsored incentives) because they automatically will result in the allocation of capital resources to the most qualified capital projects; and

(ii) that most corporations commit to undertake capital expansions based on considerations other than the expected interest cost experienced on funds borrowed to finance the expansion, and, therefore, it is unnecessary to offer the incentive of the lower interest rates available on tax-exempt industrial development bonds in order to induce corporations to make capital expansions.

Examination reveals, however, that both these premises fail to consider certain critical facts. First among these is that in today's "tight" capital money markets funds for capital expansion are simply unavailable from conventional financing institutions for most small companies and many medium-sized companies[3/] (particularly those which are not publicly-held) regardless of the interest rate these companies are willing to pay. Consequently, such companies have no alternative but to seek funds from the investing public for any capital expansions the costs of which exceed that portion of their internally generated funds available for capital projects.

In the public money market, however, such small and medium-sized companies can no longer effectively compete with the bond offerings of corporate giants, who can provide greater security to their bondholders, unless the smaller companies can offer some special incentive to potential purchasers of

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3/ Many of these companies have operations throughout the United States, but because of their size relative to the corporate giants continue to experience considerable difficulty in trying to raise funds for capital expansion from conventional financing institutions.

their bonds. The tax-exempt status of the industrial development bond could be utilized to offer just such a special incentive. Without this incentive, the smaller companies' ability to compete for capital funds in the public market will be more and more seriously jeopardized. (As already pointed out, the present limitations on "small issue" tax-exempt industrial development bonds, coupled with the ravaging effects of inflation in the construction industry since 1968, have drastically emasculated the ability of small to medium-sized companies to effectively utilize the tax-exemption incentive for capital expansions.)

The second critical fact which these premises ignore is that while corporations consider many criteria in determining whether to undertake a capital project, one of the most important factors in making such a determination is the "cost" (i.e., the interest rate) of funds needed for such project. There is no doubt that every year many capital projects are abandoned or postponed because at that particular time the costs involved in obtaining funds for such projects are considered excessive or render the project economically unsound. Similarly, there is no doubt that for many projects the difference in the cost of capital represented by the lower tax-exempt interest rate on an industrial development bond versus the taxable interest rate on taxable corporate bonds or other comparable financing vehicles may be the deciding factor in determining whether a capital project should be undertaken at

any given time. (Furthermore, the larger the project, the larger -- and therefore the more important -- this "cost of capital" factor becomes). Consequently, the incentive to capital expansion offered by the industrial development bond is definitely an inducement toward capital expansion and, in some cases, may well be the deciding factor. It is not enough to say, as the opponents to industrial development bond financing have, that if capital expansions would not be undertaken without the "subsidy" of tax-exempt bonds, such expansions are not the projects that should be built. The crux of the problem is that the rate of capital expansion in the United States is declining and incentives such as the tax-exempt industrial development bond are required to reverse this trend and, in turn, alleviate the worsening problem of unemployment.

Finally, we have heard officials of the Treasury Department argue over and over that the industrial development bond is an inefficient subsidy because the tax dollars "withheld" from Treasury's coffers far exceed the direct cost saving to industry resulting from industrial development bond financing. The argument continues, that it would be much more efficient for the Federal government to give direct subsidy payments to businesses for industrial expansion that created new jobs. There are several things wrong with this analysis. Firstly, the Treasury Department's figures have always seemed totally unrealistic and have varied from time to time. Mr. Belch's study, using assumptions that in

every instance are most favorable to the Treasury Department's position indicates that corporations using industrial development bond financing can achieve an extra $1.04 of profit for each $4.04 of taxes withheld from Treasury's coffers. His analysis makes no attempt, as he clearly states, to take into account all of the indirect benefits that result from the new jobs created by this additional corporate profit. These include things that do not lend themselves to a direct cost-benefit analysis, but which cannot be ignored such as additional personal income taxes that will be paid from the new jobs directly created as well as ancillary jobs that result therefrom, and increased tax collections by state and local government, including not only personal income taxes but property taxes as well. Furthermore, we must also consider the reduction in drains on Treasury funds such as welfare and relief payments. We submit that it is quite possible that if all the factors that must be taken into account could be subjected to a cost-benefit analysis, the result might well indicate that the industrial development bond gives the Treasury a net profit rather than a net loss.

Most importantly, as documented by Mr. Belch's statistical abstract, the net public indirect cost of each job created by an industrial development bond in 1975 was only $3,727 of which 56.9% was borne by the general citizenry in the form of added interest costs on all municipal bonds (which costs will be reduced in the future as a result of

probable limitations on pollution control financing and the expanded supply of capital resulting from revisions in the Tax Reform Act of 1976) and 43.1% was the amount "withheld" from the Treasury. In comparison, recent media reports indicate that the Government is considering expenditure of $5,000,000,000 to create 130,000 jobs during the next five years. If this statement is correct, direct federally subsidized job programs have a gross cost per job of $38,461.54, or a net cost after return of federal personal income tax of $37,854. Thus, the Government cost per job creation, is twenty-three times greater than the amount "withheld" from the Treasury to create a job with industrial development bonds.

Furthermore, a new federal job subsidy program will result in yet another federal bureaucracy which will have a tendency to grow and feed on itself and will probably be just as inefficient as most other bureaucracies. On the other hand, there is already an established, actively functioning monitoring agency for the industrial development bond program -- that is the Treasury Department.

CONCLUSION

For the reasons set forth herein legislation which would provide more liberal rules relating to "small issue" industrial development bonds should be enacted. In particular, such legislation should at least double the monetary limita-

tions on "small issue" industrial development bonds to approach making up the inflation that has accrued in the construction industry since 1967. Additionally, serious thought should be given to eliminating or modifying the "capital expenditure" rule which has proved to defeat the purpose "small issue" industrial development bonds were intended to serve.

In the past, industrial development bonds have played a vital role in strengthening the American economy. They have made feasible many worthwhile enterprises which could not have been undertaken at conventional financing costs. But even more importantly, they have brought increased prosperity, new jobs and economic development to many communities. It is more important today than ever before that this financing tool be revitalized so that it can be used to help provide the jobs that are so desperately needed.

INDUSTRIAL BUILDING COST INCREASE

1967 - 1976

SOURCE	1967	1968	1969	1970	1971	1972	1973	1974	1975	JULY 1976	PERCENT INCREASE	1 MILLION 1967 PROJECT WOULD COST IN 1976	5 MILLION 1967 PROJECT WOULD COST IN 1976
E. H. Boeckh & Assoc. (1) Bldg. Cost Index for Commercial & Factory Buildings	100.0	106.8	114.5	123.1	133.9	144.8	154.4	171.0	189.0	207.0 (4)	107	$2,070,000	$10,350,000
Engineering News Record (2)													
Bldg. Constr.	100.0	107.4	117.7	124.4	140.5	155.2	168.6	178.3	193.0	209.0 (4)	109	2,090,000	10,450,000
Gen. Constr.	100.0	107.9	118.7	128.9	146.8	162.9	176.6	188.3	206.0	224.0 (4)	124	2,240,000	11,200,000
Turner Construction Co. (3)													
Bldg. Constr.	100.0	107.0	116.0	129.0	143.0	154.0	162.0	190.0	198.0	203.0 (5)	103	2,030,000	10,150,000
Average	100.0	107.27	116.73	126.35	141.05	154.23	165.4	181.9	196.5	210.8	110.8	2,108,000	10,540,000

(1) Average of 20 cities. Weights based on surveys of building costs. Wage rates used for both common and skilled labor. Reflects payment of sales taxes and social security payroll taxes. Unweighted averages from Boeckh series prepared by Bureau of Census. U.S. Statistical Abstract.

(2) Building construction index computed on basis of hypothetical unit of construction requiring 6 b.b.l. of Portland Cement, 1,088 M bd. ft. of 2" x 4" lumber, 2500 lb. of structural steel, and 68.38 hours of skilled labor. General construction index based on same material components combined with 200 hours of common labor. U.S. Statistical Abstract.

(3) Eastern cities. Based on firm's cost experience with respect to labor rates, material prices, competitive conditions, efficiency of plant and management and productivity. Reflects payment of sales taxes and employee benefit costs. U.S. Statistical Abstract.

(4) 1976 averages from building cost and price index roundup. Engineering News-Record. Data as of July 1976.

(5) Turner Construction Company.

APPENDIX "A

STATES

A STATISTICAL ABSTRACT
of Long-Term
MUNICIPAL BOND DOLLAR VOLUME
JAN. 1970 - SEPT. 1976

Prepared Exclusively for
American Industrial Development Council, Inc.

by
James G. Belch

34-369 O - 78 - 22

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME
(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE ALABAMA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	Change From Prior Year*	Total $ All N & E Industry (IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	Change From Prior Year*	Total $ All P.C. (IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	Change From Prior Year*
1970	263,664	—	3,505 \ 7	1.33	—	3,505 \ 7	1.33	100.0	—	0 \ 0	0	0	—
1971	257,137	-2.5	40,205 \ 21	15.6	+1047.1	31,705 \ 20	12.3	78.9	+804.6	8,500 \ 1	3.3	21.1	+ T
1972	275,222	+7.0	45,740 \ 10	16.6	+13.8	13,240 \ 7	4.8	28.9	-58.2	32,500 \ 3	11.8	71.1	+282.4
1973	289,068	+5.0	121,410 \ 26	42.0	+165.4	27,710 \ 19	9.6	22.8	+109.3	93,700 \ 7	32.4	77.2	+188.3
1974	396,664	+37.2	152,445 \ 41	38.4	+25.6	42,995 \ 30	10.8	28.2	+55.2	109,450 \ 11	27.6	71.8	+16.8
1975	425,429	+7.3	194,590 \ 48	45.7	+27.6	48,665 \ 31	11.4	25.0	+13.2	145,925 \ 17	34.3	75.0	+33.3
1976 9 mos.	289,354	-32.0	87,894 \ 37	30.4	-54.8	33,659 \ 28	11.6	38.3	-30.8	54,235 \ 9	18.7	61.7	-62.8
Total Study Period	2,196,538		645,789 \ 190	29.4		201,479 \ 142	9.2	31.2		444,310 \ 48	20.2	68.8	

*Plus or minus. "T" represents a change of entirety (or total) from the prior year. *Caution is advised in using % changes, especially negative figures. Although mathematically correct as shown, 100 minus the negative figure is the % that the present year is of the prior year, i.e. a -70% change in 1974 means that the 1974 figure is 30% of the 1973 figure. Magnitudes can only be shown by absolute figures—not % changes.*

NOTE: Purposes for all Long-Term Municipal Bonds include
- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE ALABAMA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE ALASKA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	Change From Prior Year*
1970	132,981	—			—				—				—
1971	106,745	-19.7											
1972	150,265	+40.8											
1973	229,700	+52.9											
1974	175,670	-23.5											
1975	331,814	+88.8											
1976 (9 mos.)	215,849	-34.9											
Total Study Period	1,343,024		NONE			NONE				NONE			

*Plus or minus "%" represents a change of entirety (or total) from the prior year. Caution is advised in using % changes, especially negative figures. Although mathematically correct as shown, 100 minus the negative figure is the % that the present year is of the prior year, i.e., a -70% change in 1974 means that the 1974 figure is 30% of the 1973 figure. Magnitudes can only be shown by *absolute* figures—not % changes.

NOTE: Purposes for all Long Term Municipal Bonds include:
- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE ALASKA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE ARIZONA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	131,311	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	188,361	+43.4	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1972	252,930	+71.4	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	521,449	+106.2	98,000 / 2	18.8	+ T	0 / 0	0	0	0	98,000 / 2	18.8	100.0	+ T
1974	506,154	-2.9	112,700 / 3	22.3	+15.0	0 / 0	0	0	0	112,700 / 3	22.3	100.0	+15.0
1975	563,435	+11.3	18,725 / 4	3.3	-83.4	3,025 / 3	0.54	16.2	+ T	15,700 / 1	2.8	83.8	+86.1
1976 9 mos.	606,120	+7.6	0 / 0	0	- T	0 / 0	0	0	- T	0 / 0	0	0	- T
Total Study Period	2,769,760		229,425 / 9	8.3		3,025 / 3	0.1	1.3		226,400 / 6	4.6	98.7	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

School	Pollution Control
Water & Sewer	Local Housing Authority
Highway, Bridge and Tunnel	Hospital
Gas and Electric	Other
Industrial A.S	

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE ARIZONA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE ARKANSAS

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)														
							FOR NEW & EXPANDED INDUSTRY					FOR POLLUTION CONTROL					
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses	# Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's	# Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's	# Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	25,518	—	0	0	0	—	0	0	0	0	—	0	0	0	0	—
1971	43,879	+71.9	2,475	3	5.6	+T	2,475	3	5.6	100.0	+T	0	0	0	0	0
1972	32,659	-25.6	2,500	1	7.7	+1.0	2500	1	7.7	100.0	+1.0	0	0	0	0	0
1973	61,371	+87.9	24,285	7	39.6	+871.4	19,915	6	32.5	82.0	+696.6	4,370	1	7.1	18.0	+T
1974	36,256	-40.9	7,500	2	20.7	-69.1	7,500	2	20.0	100.0	-62.3	0	0	0	0	-T
1975	59,923	+65.3	8,650	3	14.4	+15.3	2,600	1	4.3	30.1	-65.3	6,050	2	10.1	69.1	+T
1976 (9 mos.)	44,418	-25.9	19,624	3	44.2	+126.9	524	1	1.2	2.7	-79.8	19,100	2	43.0	97.3	+215.7
Total Study Period	301,024		65,034	19	21.6		35,514	14	11.8	54.6		29,520	5	9.8	45.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School
Water & Sewer
Highway, Bridge and Tunnel
Gas and Electric
Industrial Aid
Pollution Control
Local Housing Authority
Hospital
Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE ARKANSAS

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME
(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE CALIFORNIA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)														
							FOR NEW & EXPANDED INDUSTRY					FOR POLLUTION CONTROL					
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses	# Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's	# Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's	# Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	Change From Prior Year*
1970	1508,679	—	0	0	0	—	0	0	0	0	—	0	0	0	0	—
1971	1,786,101	+18.4	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1972	1,713,862	-4.0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1973	1,165,056	-32.0	1,269	1	0.1	+T	1269	1	0.1	100.0	+T	0	0	0	0	0
1974	1,530,712	+31.4	52,990	7	3.5	+407.6	0	0	0	0	-T	52,990	7	3.5	100.0	+T
1975	1820,643	+18.9	94,357	6	5.2	+78.1	87,993	4	4.8	93.3	+T	6,364	2	0.4	6.7	-88.0
1976 (9 mos.)	1,265,884	-30.5	46,450	8	3.7	-50.8	29000	4	2.3	62.4	-67.0	17,450	4	1.4	37.6	+174.2
Total Sends Period	9,790,937		195,066	22	2.0		118,262	9	1.2	60.6		76,804	13	0.8	39.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include
- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE CALIFORNIA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE COLORADO

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	90,926	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	135,538	+49.1	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1972	249,819	+84.3	18900 (1)	7.7	+T	0 (0)	0	0	0	18900 (1)	7.7	100.0	+T
1973	181,189	-27.5	6000 (1)	3.3	-68.3	0 (0)	0	0	0	6000 (1)	3.3	100.0	-68.3
1974	255,496	+4.1	74000 (2)	29.0	+113.3	0 (0)	0	0	0	74000 (2)	29.0	100.0	+113.3
1975	389,767	+52.6	9,650 (3)	2.5	-87.0	9,650 (3)	2.5	100.0	+T	0 (0)	0	0	-T
1976 (9 mos.)	250,803	-35.7	1,450 (1)	0.58	-85.0	1,450 (1)	0.58	100.0	-84.9	0 (0)	0	0.	0
Total Study Period	1,533,538		110,000 (8)	7.1		11,100 (4)	0.7	10.1		98,900 (4)	6.4	89.9	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School; Water & Sewer; Highway, Bridge and Tunnel; Gas and Electric; Industrial Aid; Pollution Control; Local Housing Authority; Hospital; Other

SOURCE RESEARCH DEPT. THE DAILY BOND BUYER

STATE COLORADO

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE CONNECTICUT

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	337,604	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	680 838	+101.7	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1972	838,618	+23.2	5000 / 1	0.60	+T	0 / 0	0	0	0	5000 / 1	0.6	100.0	+T
1973	370,817	-55.8	18,300 / 4	4.9	+266.0	5800 / 2	1.6	31.7	+T	12,500 / 2	3.3	68.3	+150.0
1974	515,248	+38.9	14,000 / 3	2.7	-23.5	4,500 / 1	0.87	32.1	-22.4	9,500 / 2	1.8	67.9	-24.0
1975	542,525	+5.3	25,845 / 2	4.8	+84.6	25,845 / 2	4.8	100.0	+474.3	0 / 0	0	0	-T
1976 (9 mos.)	367,118	-32.3	2,015 / 2	0.55	-92.2	2015 / 2	0.55	100.0	-92.2	0 / 0	0	0	0
Total Study Period	3,652,768		65,160 / 12	1.8		38,160 / 7	1.0	58.6		27,000 / 5	0.7	41.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE CONNECTICUT

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE DELAWARE

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	96,911	—	750 / 1	0.77	—	750 / 1	0.77	100.0	—	0 / 0	0	0	—
1971	67,297	-30.6	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	0
1972	87,752	+30.4	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	149,518	+70.4	18,600 / 3	12.4	+T	1,400 / 1	0.9	7.5	+T	17,200 / 2	11.5	92.5	+T
1974	38,068	-74.5	5,643 / 3	14.8	-69.7	5,643 / 3	14.8	100.0	+303.1	0 / 0	0	0	-T
1975	167,310	+339.5	3,700 / 2	2.2	-34.4	1,000 / 1	0.6	27.0	-82.3	2,700 / 1	1.6	73.0	+T
1976 (9 mos.)	105,284	-37.0	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0.	-T
Total Study Period	712,140		28,693 / 9	4.0		8,793 / 6	1.2	30.6		19,900 / 3	2.3	69.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE DELAWARE

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE FLORIDA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	503,561	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	673,332	+33.7	6000 / 2	0.89	+T	1,500 / 1	0.22	25.0	+T	4,500 / 1	0.67	75.0	+T
1972	649,504	-3.5	43,040 / 2	6.6	+617.3	0 / •	0	0	-T	43,040 / 2	6.6	100.0	+856.4
1973	890,350	+37.1	122,785 / 8	13.8	+185.3	4,135 / 2	0.46	3.4	+T	118,650 / 6	13.3	96.6	+175.7
1974	740,801	-16.8	82,375 / 5	11.1	-32.9	3,300 / 1	0.45	4.0	-20.2	79,075 / 4	10.7	96.0	-33.4
1975	850,655	+14.8	71,480 / 9	8.4	-13.2	2,000 / 2	0.24	2.8	-39.4	69,480 / 7	8.2	97.2	-12.1
1976 (9 mos.)	751,213	-11.7	55,260 / 4	7.4	-22.7	0 / •	0	0	-T	55,260 / 4	7.4	100.0	-20.5
Total Study Period	5,059,416		380,940 / 30	7.5		10,935 / 6	0.2	2.9		370,005 / 24	7.3	97.1	

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- Hospital
- Other

SOURCE RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE FLORIDA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE GEORGIA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	293,125	—	575 [1]	0.20	—	575 [1]	0.20	100.0	—	0 [0]	0	0	—
1971	322,083	+9.9	22,895 [9]	7.1	+3881.7	11,895 [8]	3.7	52.0	+196.9	11,000 [1]	3.4	48.0	+T
1972	361,644	+12.3	40,100 [5]	11.1	+75.1	8,350 [2]	2.3	20.8	−29.8	31,750 [3]	8.8	79.2	+188.6
1973	387,080	+7.0	83,285 [4]	21.5	+107.7	7,285 [2]	1.9	8.7	−12.8	76,000 [2]	19.6	91.3	+139.4
1974	216,054	−44.2	0 [0]	0	−T	0 [0]	0	0	−T	0 [0]	0	0	−T
1975	375,525	+73.8	74,865 [15]	19.9	+T	13,165 [6]	3.5	17.6	+T	61,700 [9]	16.4	82.4	+T
1976 (9 mos.)	172,995	−53.9	20,000 [4]	11.6	−73.3	8,500 [3]	4.9	42.5	−35.4	11,500 [1]	6.6	57.5	−81.4
Total Study Period	2,128,506		241,720 [38]	11.4		49,770 [22]	2.3	20.6		191,950 [16]	9.0	79.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
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- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE GEORGIA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE HAWAII

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	142,700	—			—				—				—
1971	228,945	+60.4											
1972	194,281	-15.1											
1973	178,500	-8.1											
1974	105,000	-41.2											
1975	220,000	+109.5											
1976 (9 mos.)	226,910	+3.1											
Total Study Period	1,296,336		NONE			NONE				NONE			

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NOTE: Purposes for all Long-Term Municipal Bonds include:
- School
- Water & Sewer
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- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE HAWAII

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE IDAHO

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	7,755	—			—				—				—
1971	14,629	+88.6											
1972	8,295	-43.3											
1973	16,067	+93.7											
1974	50,977	+217.3											
1975	39,752	-22.0											
1976 (9 mos.)	12,224	-69.0											
Total Study Period	149,699		NONE			NONE				NONE			

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
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- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE IDAHO

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE ILLINOIS

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
'70	721,798	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	985,787	+36.6	4750 (1)	0.48	+T	4750 (1)	0.48	100.0	+T	0 (0)	0	0	0
1972	631,943	-35.9	0 (0)	0	-T	0 (0)	0	0	-T	0 (0)	0	0	0
1973	768,528	+21.6	14,140 (3)	1.8	+T	850 (1)	0.11	6.0	+T	13,290 (2)	1.7	94.0	+T
1974	1,294,261	+68.4	101,180 (12)	7.8	-28.3	8275 (5)	0.64	7.8	+873.5	92,905 (7)	7.2	92.2	+599.0
1975	1,700,954	+31.4	92,270 (7)	5.4	-8.8	5,870 (3)	0.35	6.3	-29.1	86,400 (4)	5.1	93.7	-7.0
1976 (9 mos.)	1,509,120	-11.3	63,700 (6)	4.2	-31.0	4200 (2)	2.8	6.9	-28.4	59,500 (4)	3.9	93.4	-31.1
Total Study Period	7,612,391		276,040 (29)	3.6		23,945 (12)	0.3	8.7		252,095 (17)	3.3	91.3	

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- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE ILLINOIS

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE INDIANA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	261,226	—	0 (0)	0	—	0 (•)	0	0	—	0 (•)	0	0	—
1971	261,654	+0.16	6000 (2)	2.3	+T	6000 (2)	2.3	100.0	+T	0 (•)	0	0	0
1972	216,778	-17.2	15,500 (2)	7.2	+158.3	2000 (1)	0.92	12.9	-66.7	13,500 (1)	6.2	87.1	+T
1973	393,440	+81.5	96,940 (7)	24.6	+525.4	3900 (1)	1.0	4.0	+95.0	93,040 (6)	23.6	96.0	+227.3
1974	303,280	-22.9	31,900 (6)	10.5	-67.1	7150 (4)	2.4	22.4	+83.3	24,750 (2)	8.1	77.6	-73.4
1975	335,430	+10.6	105,725 (11)	31.5	+231.4	15,125 (7)	4.5	14.3	+111.5	90,600 (4)	27.0	85.7	+266.1
1976 (9 mos.)	235,200	-29.9	75,150 (6)	32.0	-28.9	8150 (3)	3.5	10.8	-46.1	67,000 (3)	28.5	89.2	-26.0
Total Study Period	2,007,008		331,215 (34)	16.5		42,325 (18)	2.1	12.8		288,890 (16)	14.4	87.2	

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SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE INDIANA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE IOWA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	91,739	—	4,000 (1)	4.36	—	4000 (1)	4.36	100.0	—	0 (0)	0	0	—
1971	70,172	-23.5	4,100 (1)	5.8	+2.5	4100 (1)	5.8	100.0	+2.5	0 (0)	0	0	0
1972	112,165	+59.9	8,500 (1)	7.6	+107.3	0 (0)	0	0	-T	8,500 (1)	7.6	100.0	+T
1973	173,982	+55.1	71,800 (8)	41.5	+744.7	0 (0)	0	0	0	71,800 (8)	41.3	100.0	+744.5
1974	133,614	-23.2	12,400 (3)	9.3	-114.7	12,400 (3)	9.3	100.0	+T	0 (0)	0	0	-T
1975	104,097	-22.1	9,980 (6)	9.6	-19.5	9,230 (5)	8.9	92.5	-25.6	750 (1)	0.7	7.5	+T
1976 (9 mos.)	177,890	+70.9	20,500 (2)	11.5	+105.4	0 (0)	0	0	-T	20,500 (2)	11.5	100.0	+263.3
Total Study Period	863,659		131,280 (22)	15.2		29,730 (10)	3.4	22.6		101,550 (12)	11.8	77.4	

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- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE IOWA

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A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE KANSAS

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)				FOR NEW & EXPANDED INDUSTRY					FOR POLLUTION CONTROL				
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses	# Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's	# Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's	# Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	98,643	—	1,500	1	1.52	—	1,500	1	1.52	100.0	—	0	0	0	0	—
1971	119,821	+21.5	3,250	4	2.7	+116.7	3,250	4	2.7	100.0	+116.7	0	0	0	0	0
1972	148,272	+23.7	2,250	2	1.5	-30.8	2,250	2	1.5	100.0	-30.8	0	0	0	0	0
1973	154,271	+4.0	42,000	7	27.2	+176.7	11,600	5	7.5	27.6	+415.6	30,400	2	19.7	72.4	+T
1974	129,004	-16.4	4,535	3	3.5	-89.2	4,535	3	3.5	100.0	-60.9	0	0	0	0	-T
1975	232,562	+80.3	43,200	4	18.6	+852.6	4,200	3	1.8	9.7	-7.4	39,000	1	16.8	90.3	+T
1976 (9 mos.)	284,519	+22.3	8,700	4	3.1	-79.9	3,200	3	1.1	36.8	-23.8	5,500	1	1.9	63.2	-85.9
Total Study Period	1,167,092		105,435	25	9.0		30,535	21	2.6	29.0		74,900	4	6.4	71.0	

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SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE KANSAS

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE KENTUCKY

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	233,022	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	661,953	+184.1	6900 / 2	1.0	+T	4500 / 1	0.68	65.2	+T	2400 / 1	0.36	37.5	+T
1972	297,626	-55.0	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	-T
1973	416,967	+40.1	27900 / 5	6.7	+T	8650 / 3	2.1	31.0	+T	19250 / 2	4.6	69.0	+T
1974	310,996	-25.4	26,350 / 2	8.5	-5.6	3350 / 1	1.1	12.7	-61.3	23,000 / 1	7.4	87.3	+19.5
1975	229,877	-26.1	81,850 / 11	35.6	+210.6	7,450 / 3	3.2	9.1	+112.4	74,400 / 8	32.4	90.9	+223.5
1976 (9 mos.)	267,895	+16.5	43,510 / 4	16.2	-46.8	4,300 / 1	1.6	9.9	-42.3	39,210 / 3	14.6	90.1	-47.3
Total Study Period	2,418,236		186,510 / 24	7.7		28,250 / 9	1.2	15.1		158,260 / 15	6.5	84.9	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

School	Pollution Control
Water & Sewer	Local Housing Authority
Highway, Bridge and Tunnel	Hospital
Gas and Electric	Other
Industrial Aid	

SOURCE. RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE KENTUCKY

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE LOUISIANA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	216,821	—	636 / 1	0.29	—	636 / 1	0.29	100.0	—	0 / 0	0	0	—
1971	576,009	+165.7	1,435 / 1	0.25	+125.6	1,435 / 1	0.25	100.0	+125.6	0 / 0	0	0	0
1972	297,578	-48.3	17,650 / 3	5.9	+1130.0	17,650 / 3	5.9	100.0	+1130.0	0 / 0	0	0	0
1973	307,424	+3.3	58,940 / 11	19.2	+233.9	3,390 / 4	1.1	5.8	-80.8	55,550 / 7	18.1	94.2	+T
1974	403,241	+31.2	168,130 / 9	41.7	+185.3	2,450 / 3	0.61	1.5	-27.7	165,680 / 6	41.1	98.5	+198.3
1975	509,421	+26.3	198,615 / 21	39.0	+18.1	12,300 / 8	2.4	6.2	+402.0	186,315 / 13	36.6	93.8	+12.5
1976 (9 mos.)	330,227	-35.2	56,570 / 12	17.1	-71.5	5,910 / 6	1.8	10.4	-52.0	50,660 / 6	15.3	89.6	-72.8
Total Study Period	2,640,721		501,976 / 58	19.0		43,771 / 26	1.7	8.7		458,205 / 32	17.4	91.3	

*Plus or minus "T" represents a change of activity (or total) from the prior year. Caution is advised in using % changes, especially negative figures. Although mathematically correct as shown, 100 minus the negative figure is the % that the present year is of the prior year i.e., a -70% change in 1974 means that the 1974 figure is 30% of the 1973 figure. Magnitudes can only be shown by *absolute* figures—not % changes.

NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE LOUISIANA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME
(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MAINE

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	92,232	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	48,266	-47.6	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1972	126,055	+161.2	8,600 (2)	6.8	+T	0 (0)	0	0	0	8600 (2)	6.8	100.0	+T
1973	62,304	-50.6	9,100 (2)	14.6	+5.8	0 (0)	0	0	0	9,100 (2)	14.6	100.0	+5.8
1974	114,010	+83.0	0 (0)	0	-T	0 (0)	0	0	0	0 (0)	0	0	-T
1975	188,520	+65.4	69,450 (9)	36.8	+T	7,600 (3)	4.0	10.9	+T	61,850 (6)	32.8	89.1	+T
1976 (9 mos.)	77,840	-58.7	23,300 (2)	29.9	-66.5	0 (0)	0	0	-T	23,300 (2)	39.9	100.0	-62.3
Total Study Period	709,227		110,450 (15)	15.6		7,600 (3)	1.1	6.9		102,850 (12)	14.5	93.1	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School, Water & Sewer, Highway, Bridge and Tunnel, Gas and Electric, Industrial Aid, Pollution Control, Local Housing Authority, Hospital, Other

SOURCE. RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE MAINE

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MARYLAND

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	433,070	—	0 / 0	0	—				—	0 / 0	0	0	—
1971	564,840	+30.4	0 / 0	0	0					0 / 0	0	0	0
1972	474,390	-16.0	0 / 0	0	0					0 / 0	0	0	0
1973	679,045	+43.1	144,900 / 5	21.3	+T					144,900 / 5	21.3	100.0	+T
1974	561,555	-17.3	14,300 / 2	2.5	-90.1					14,300 / 2	2.5	100.0	-90.1
1975	832,120	+48.2	41,500 / 4	5.0	+190.2					41,500 / 4	5.0	100.0	+190.2
1976 (9 mos.)	680,425	-18.2	4,700 / 1	0.69	-88.7					4,700 / 1	0.69	100.0	-88.7
Total Study Period	4,225,445		205,400 / 12	4.9		NONE				205,400 / 12	4.9	100.0	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
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- Industrial Aid
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- Local Housing Authority
- Hospital
- Other

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STATE MARYLAND

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MASSACHUSETTS

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	647,888	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	945,674	+46.0	3,500 / 1	0.37	+T	3,500 / 1	0.37	100.0	+T	0 / 0	0	0	0
1972	771,671	-18.4	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	0
1973	791,524	+2.6	11,650 / 1	1.5	+T	0 / 0	0	0	0	11,650 / 1	1.5	100.0	+T
1974	750,665	-5.2	5,385 / 2	0.71	-53.8	5,385 / 2	0.71	100.0	+T	0 / 0	0	0	-T
1975	1,152,764	+53.6	900 / 1	0.08	-83.3	900 / 1	0.08	100.0	-83.3	0 / 0	0	0	0
1976 (9 mos.)	1,352,838	+17.4	6,200 / 3	0.46	+588.9	1,000 / 1	0.07	16.1	+11.1	5,200 / 2	0.38	83.9	+T
Total Study Period	6,413,024		27,635 / 8	0.4		10,785 / 5	0.2	39.0		16,850 / 3	0.3	61.0	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
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- Local Housing Authority
- Hospital
- Other

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STATE MASSACHUSETTS

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MICHIGAN

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	1,006,620	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	911,466	-9.5	16,450 (3)	1.8	+T	4800 (2)	0.53	29.0	+T	11,650 (1)	1.3	71.0	+T
1972	571,694	-37.3	25,000 (1)	4.4	+52.0	0 (0)	0	0	-T	25,000 (1)	4.4	100.0	+114.6
1973	760,887	+33.1	113,665 (7)	14.9	+354.7	3,600 (1)	0.47	3.2	+T	110,065 (6)	14.5	96.8	+340.3
1974	732,873	-3.7	100,050 (6)	13.7	-12.0	1,800 (1)	0.25	1.8	-50.0	98,250 (5)	13.4	98.2	-10.7
1975	1,142,295	+55.9	112,305 (10)	9.8	+12.2	12,900 (4)	0.90	13.6	+616.7	99,405 (6)	8.7	88.5	+1.2
1976 (9 mos.)	702,308	-38.5	72,905 (7)	10.4	-35.1	1205 (1)	0.17	16.5	-90.7	71700 (6)	10.2	83.5	-27.9
Total Study Period	5,828,143		440,375 (34)	7.6		24,305 (9)	0.4	5.5		416,070 (25)	7.1	94.5	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School
Water & Sewer
Highway, Bridge and Tunnel
Gas and Electric
Industrial Aid
Pollution Control
Local Housing Authority
Hospital
Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE MICHIGAN

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MINNESOTA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	598,355		1550 / 1	0.26	—	1,550 / 1	0.26	100.0	—	0 / 0	0	0	—
1971	415,989	-30.5	1560 / 1	3.8	+0.65	1560 / 1	3.8	100.0	+0.65	0 / 0	0	0	0
1972	458,855	+10.3	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	0
1973	549,895	+19.8	53550 / 5	9.7	+T	0 / 0	0	0	0	53550 / 5	9.7	100.0	+T
1974	618,987	+12.6	84578 / 12	13.7	+57.9	16,587 / 9	2.7	19.6	+T	68,000 / 3	11.0	80.4	+27.0
1975	668,744	+8.0	44,000 / 5	6.6	-48.0	6,000 / 3	0.9	13.6	-63.8	38,000 / 2	5.7	68.4	-44.1
1976 (9 mos.)	639,317	-4.4	8,800 / 1	1.4	-80.0	0 / 0	0	0	-T	8,800 / 1	1.4	100.0	-76.8
Total Study Period	3,950,142		194,038 / 25	4.9		25,697 / 14	0.7	13.2		168,350 / 11	4.3	86.8	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE. RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE MINNESOTA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MISSISSIPPI

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	Change From Prior Year*
	120,781	—	6,662 / 15	5.25	—	6,662 / 15	5.25	100.0	—	0 / 0	0	0	—
1971	105,020	-13.0	6,304 / 12	6.0	-5.4	6,304 / 12	6.0	100.0	-5.4	0 / 0	0	0	0
1972	178,597	+70.1	9,685 / 8	5.4	+53.6	9,685 / 8	5.4	100.0	+53.6	0 / 0	0	0	0
1973	122,749	-31.3	29,826 / 11	24.3	+208.0	12,567 / 10	10.2	42.2	+29.8	17,250 / 1	14.1	57.8	+T
1974	114,915	-6.4	81,900 / 13	71.2	+174.6	10,775 / 8	9.4	13.2	-14.3	71,125 / 5	61.9	86.8	+312.3
1975	213,524	+85.6	410 / 1	0.2	-99.5	410 / 1	0.2	100.0	-96.2	0 / 0	0	0	-T
1976 (9 mos.)	104,720	-50.9	1,516 / 3	1.4	+269.8	1,516 / 3	1.4	100.0	+269.8	0 / 0	0	0	0
Total Study Period	960,106		136,303 / 63	14.2		47,919 / 57	5.0	35.2		88,375 / 6	9.2	64.8	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School
Water & Sewer
Highway, Bridge and Tunnel
Gas and Electric
Industrial Aid
Pollution Control
Local Housing Authority
Hospital
Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE MISSISSIPPI

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MISSOURI

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	156,894	—	1,700 / 3	1.08	—	1,700 / 3	1.08	100.0	—	0 / 0	0	0	—
1971	257,756	+64.3	2,495 / 2	1.0	+46.8	2,495 / 2	0.97	100.0	+46.8	0 / 0	0	0	0
1972	156,634	-39.2	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	0
1973	180,034	+14.9	14,725 / 6	8.2	+T	7,725 / 5	4.3	52.5	+T	7,000 / 1	3.9	47.5	+T
1974	219,531	+21.9	25,150 / 4	11.5	+70.8	8650 / 3	3.9	34.4	+12.0	16,500 / 1	7.6	65.6	+135.7
1975	276,595	+26.0	34,650 / 3	12.5	+37.8	300 / 1	0.1	0.9	-96.5	34,350 / 2	12.4	99.1	+108.2
1976 (9 mos.)	209,517	-24.3	15,700 / 4	7.5	-54.7	5,200 / 3	2.5	33.1	+1633.3	10,500 / 1	5.0	66.9	-69.4
Total Study Period	1,456,961		94,420 / 22	6.5		26,070 / 17	1.8	27.6		68,350 / 5	4.7	72.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School
Water & Sewer
Highway, Bridge and Tunnel
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Local Housing Authority
Hospital
Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE MISSOURI

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE MONTANA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	22,495	—	0 [0]	0	—	0 [0]	0	0	—	0 [0]	0	0	—
1971	26,889	+19.5	15,000 [1]	55.8	+T	0 [0]	0	0	0	15,000 [1]	55.8	100.0	+T
	41,085	+52.8	17,000 [1]	4.1	+13.3	0 [0]	0	0	0	17,000 [1]	4.1	100.0	+13.3
1973	92,953	+126.2	47,450 [4]	51.0	+179.1	0 [0]	0	0	0	47,450 [4]	51.0	100.0	+179.1
1974	27,880	-70.0	0 [0]	0	-T	0 [0]	0	0	0	0 [0]	0	0	-T
1975	26,956	-3.3	6,550 [2]	24.2	+T	2,550 [1]	9.5	38.9	+T	4,000 [1]	14.8	61.1	+T
1976 (9 mos.)	23,822	-11.6	4000 [1]	16.8	-38.9	4,000 [1]	16.8	100.0	+56.9	0 [0]	0	0.	-T
Total Study Period	262,080		90,000 [9]	34.3		6,550 [2]	2.5	7.3		83,450 [7]	31.8	92.7	

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- School
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- Local Housing Authority
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- Other

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STATE MONTANA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NEBRASKA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	241,891	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	18,595	-92.4	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
'72	548,015	+287.9	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	152,001	-72.3	2,902 / 4	1.9	+T	2,152 / 3	1.4	74.2	+T	750 / 1	0.5	25.8	+T
1974	131,281	-13.6	7,150 / 3	5.4	+146.4	7,150 / 3	5.4	100.0	+232.2	0 / 0	0	0	-T
1975	308,800	+135.2	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	0
1976 (9 mos.)	564,888	+82.9	1,000 / 1	0.18	+T	1,000 / 1	0.18	100.0	+T	0 / 0	0	0.	0
Total Study Period	1,965,271		11,052 / 8	0.6		10,302 / 7	0.5	93.2		750 / 1	0.04	6.8	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE NEBRASKA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NEVADA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	45,200	—	0 / 0	0	—				—	0 / 0	0	0	—
1971	86,115	+90.5	0 / 0	0	0					0 / 0	0	0	0
[illegible]	59,402	-31.0	0 / 0	0	0					0 / 0	0	0	0
1973	55,585	-6.4	5,000 / 1	9.0	+ T					5,000 / 1	9.0	100.0	+ T
1974	98,053	+76.4	20,000 / 1	20.4	+300.0					20,000 / 1	20.4	100.0	+300.0
1975	74,417	-24.1	0 / 0	0	- T					0 / 0	0	0	- T
1976 (9 mos.)	68,335	-8.2	11,000 / 2	16.1	+ T					11,000 / 2	16.1	100.0	+ T
Total Study Period	487,107		36,000 / 4	7.4		NONE				36,000 / 4	7.4	100.0	

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STATE NEVADA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NEW HAMPSHIRE

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)												
							FOR NEW & EXPANDED INDUSTRY					FOR POLLUTION CONTROL				
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses	And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's	And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's	And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	59,878	—	0	0	0	—	0	0	0	0	—	0	0	0	0	—
1971	93,726	+56.5	0	0	0	0	0	0	0	0	0	0	0	0	0	0
'72	45,414	-51.5	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1973	83,949	+84.9	10,000	1	11.9	+T	0	0	0	0	0	10,000	1	11.9	100.0	+T
1974	85,278	+1.6	30,150	4	35.4	+201.5	4850	2	5.7	16.1	+T	25,300	2	29.7	83.9	+153.0
1975	71,352	-16.3	5,270	2	7.4	-82.5	5,270	2	7.4	100.0	+8.7	0	0	0	0	-T
1976 (9 mos.)	117,288	+64.4	0	0	0	-T	0	0	0	0	-T	0	0	0	0	0
Total Study Period	556,885		45,420	7	8.2		10,120	4	1.8	22.2		35,300	3	6.3	77.7	

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STATE NEW HAMPSHIRE

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NEW JERSEY

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	696,116	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	1,297,558	+86.4	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
[illegible]	1,295,685	-0.14	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	811,971	-37.3	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1974	987,230	+21.6	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1975	752,091	-23.8	131,385 / 16	17.5	+T	25,445 / 8	3.4	19.4	+T	105,940 / 8	14.1	80.6	+T
1976 (9 mos.)	808,169	+11.4	83,128 / 10	10.3	-36.7	30,633 / 5	3.8	36.9	+20.4	52,495 / 5	6.5	63.1	-50.4
Total Study Period	6,648,820		214,513 / 26	3.2		56,078 / 13	0.8	26.1		158,435 / 13	2.4	73.9	

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STATE NEW JERSEY

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME
(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NEW MEXICO

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	51,383	—	1,000 \ 1	1.95	—	1,000 \ 1	1.95	100.0	—	0 \ 0	0	0	—
1971	73,800	+43.6	0 \ 0	0	-T	0 \ 0	0	0	-T	0 \ 0	0	0	0
1972	65,763	-10.9	0 \ 0	0	0	0 \ 0	0	0	0	0 \ 0	0	0	0
1973	124,877	+89.9	57,200 \ 2	45.8	+T	2,200 \ 1	1.8	3.8	+T	55,000 \ 1	44.0	96.2	+T
1974	158,462	+26.9	55,000 \ 1	34.7	-3.8	0 \ 0	0	0	-T	55,000 \ 1	34.7	100.0	0
1975	235,910	+48.9	70,000 \ 1	29.7	+27.3	0 \ 0	0	0	0	70,000 \ 1	29.7	100.0	+27.3
1976 (9 mos.)	205,519	-12.9	46,275 \ 3	22.5	-33.9	1,275 \ 1	0.62	2.8	+T	45,000 \ 2	21.9	97.2	-35.7
Total Study Period	915,714		229,475 \ 8	25.1		4,475 \ 3	0.5	2.0		225,000 \ 5	24.6	98.0	

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STATE NEW MEXICO

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NEW YORK

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	2,766,879	—	4,500 \ 1	0.16	—	4,500 \ 1	0.16	100.0	—	0 \ 0	0	0	—
1971	4,803,055	+73.6	4,375 \ 3	0.09	-2.8	4,375 \ 3	0.09	100.0	-2.8	0 \ 0	0	0	0
1972	4,535,322	-5.6	9,000 \ 3	0.2	+105.7	2900 \ 1	0.06	32.2	-33.7	6100 \ 2	0.13	67.8	+T
1973	4,168,917	-8.1	34,385 \ 7	0.8	+282.1	11,050 \ 3	0.27	32.1	+281.0	23,335 \ 4	0.56	67.9	+282.5
1974	3,629,979	-12.9	93525 \ 9	2.6	+172.0	16,200 \ 4	0.45	17.3	+46.6	77,325 \ 5	2.2	82.7	+231.4
1975	5,779,347	+59.2	31,600 \ 9	0.5	-66.2	3,000 \ 3	0.05	9.5	-81.5	28,600 \ 6	0.5	90.5	-63.0
1976 (9 mos.)	2,980,889	-48.4	13,140 \ 5	0.44	-58.4	1,000 \ 1	0.30	7.6	-66.7	12,140 \ 4	0.41	92.4	-57.6
Total Study Period	28,664,388		190,525 \ 37	0.7		43,025 \ 16	0.2	22.6		147,500 \ 21	0.5	77.4	

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- Other

SOURCE. RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE NEW YORK

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NORTH CAROLINA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	146,975	—			—				—				—
1971	333,952	+127.2											
1972	166,400	-50.2											
1973	164,311	-1.3											
1974	250,570	+52.5											
1975	205,175	-18.1											
1976 (9 mos.)	294,317	+43.4											
Total Study Period	1,561,700		NONE			NONE				NONE			

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School
Water & Sewer
Highway, Bridge and Tunnel
Gas and Electric
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Hospital
Other

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STATE NORTH CAROLINA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE NORTH DAKOTA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)													
							FOR NEW & EXPANDED INDUSTRY					FOR POLLUTION CONTROL				
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses	# Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's	# Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's	# Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	8,240	—	0	0	0	—	0	0	0	0	—	0	0	0	0	—
1971	51,659	+526.9	315	1	0.61	+T	315	1	0.61	100.0	+T	0	0	0	0	0
1972	36,008	-30.3	0	0	0	-T	0	0	0	0	-T	0	0	0	0	0
1973	28,223	-21.6	0	0	0	0	0	0	0	0	0	0	0	0	0	0
1974	28,594	+1.3	4,800	1	16.8	+T	0	0	0	0	0	4800	1	16.8	100.0	+T
1975	47,067	+64.6	20,100	4	42.7	+318.8	2,900	2	6.2	14.4	+T	17,200	2	36.5	85.6	+258.3
1976 (9 mos.)	53,843	+14.4	26,400	3	49.0	+31.3	6,400	2	11.9	24.2	+120.7	20,000	1	37.1	75.8	+16.3
Total Study Period	253,634		51,615	9	20.4		9,615	5	3.8	18.6		42,000	4	16.6	81.4	

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STATE NORTH DAKOTA

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(Long-Term Financing)

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STATE OHIO

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	659,591	—	9,200 / 4	1.39	—	9,200 / 4	1.39	100.0	—	0 / 0	0	0	—
1971	1,061,624	+61.0	15,850 / 6	1.5	+72.3	15,850 / 6	1.5	100.0	+72.3	0 / •	0	0	0
1972	808,648	-23.8	15,400 / 2	1.9	-2.8	15,400 / 2	1.9	100.0	-2.8	0 / 0	0	0	0
1973	606,283	-25.0	68,990 / 10	11.4	+348.0	18,000 / 4	3.0	26.1	+16.9	50,990 / 6	8.0	73.9	+T
1974	764,715	+26.1	99,215 / 56	13.0	+43.8	82,855 / 50	10.8	83.5	+360.3	16,360 / 6	2.2	16.5	-67.9
1975	846,239	+10.7	226,086 / 76	26.7	+127.9	80,291 / 59	9.5	35.5	-3.1	145,795 / 17	17.2	64.5	+791.2
1976 (9 mos.)	966,246	+14.2	53,000 / 7	0.55	-76.6	5,150 / 2	0.53	9.7	-93.6	47,850 / 5	5.0	90.3	-67.2
Total Study Period	5,713,346		487,741 / 161	8.5		226,746 / 127	4.0	46.5		260,995 / 34	4.6	53.5	

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STATE OHIO

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

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STATE OKLAHOMA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	155,263	—	1,705 [7]	1.10	—	1,705 [7]	1.10	100.0	—	0 [0]	0	0	—
1971	312,578	+101.3	3,901 [5]	1.2	+128.8	3,901 [5]	1.2	100.0	+128.8	0 [0]	0	0	0
1972	149,622	-55.0	0 [0]	0	-T	0 [0]	0	0	-T	0 [0]	0	0	0
1973	248,072	+76.4	25,925 [9]	10.5	+T	7,400 [7]	3.0	28.5	+T	18,525 [2]	7.5	71.5	+T
1974	191,630	-22.8	17,095 [11]	8.9	-34.1	17,095 [11]	8.9	100.0	+131.0	0 [0]	0	0	-T
1975	155,318	-18.9	11,495 [6]	7.4	-32.8	5,570 [4]	3.6	48.5	-67.4	5,925 [2]	3.8	51.5	+T
1976 (9 mos.)	148,867	-4.2	43,120 [5]	29.0	+275.1	6,620 [3]	4.4	15.4	+18.9	36,500 [2]	24.5	84.6	+516.0
Total Sample Period	1,352,350		103,241 [43]	7.6		42,291 [37]	3.1	41.0		60,950 [6]	4.5	59.0	

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STATE OKLAHOMA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

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STATE OREGON

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	128,156	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	410,888	+220.6	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1972	204,990	-50.1	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1973	390,253	+90.4	38600 (2)	9.9	+T	0 (0)	0	0	0	38600 (2)	9.9	100.0	+T
1974	394,182	+1.0	0 (0)	0	-T	0 (0)	0	0	0	0 (0)	0	0	-T
1975	742,267	+88.3	74450 (9)	10.0	+T	19,500 (3)	2.6	26.2	+T	54950 (6)	7.4	73.8	+T
1976 (9 mos.)	383,177	-48.4	25735 (4)	6.7	-65.4	3,600 (2)	0.94	14.0	-81.5	22,135 (2)	5.8	86.0	-59.7
Total Study Period	2,653,913		138,785 (15)	5.2		23,100 (5)	0.9	16.6		115,685 (10)	4.4	83.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE OREGON

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE PENNSYLVANIA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	1,315,995	—	1,000 / 1	.08	—	1,000 / 1	.08	100.0	—	0 / 0	0	0	—
1971	1,494,306	+13.5	30,000 / 2	2.0	+2900.0	0 / 0	0	0	-T	30,000 / 2	2.0	100.0	+T
1972	1,678,103	+12.3	138,500 / 6	8.3	+361.7	4,500 / 1	0.27	3.2	+T	134,000 / 5	8.0	96.8	+346.7
1973	1,399,665	-16.6	159,280 / 14	11.4	+15.0	4,780 / 3	0.34	3.0	+6.2	154,500 / 11	8.4	97.0	+15.3
1974	1,192,755	-14.8	67,550 / 11	5.7	-57.6	5,700 / 4	0.48	8.4	+19.2	61,850 / 7	5.2	91.6	-60.0
1975	1,563,637	+31.1	214,507 / 16	13.7	+217.6	40,782 / 5	2.6	19.0	+615.5	173,725 / 11	11.1	81.0	+180.9
1976 (9 mos.)	1,844,534	+18.0	194,169 / 18	10.5	-9.5	42,669 / 8	2.3	22.0	+4.6	151,500 / 10	8.2	78.0	-12.8
Total Study Period	10,488,995		805,006 / 68	7.7		99,431 / 22	0.9	12.4		705,575 / 46	6.7	87.6	

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- Hospital
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SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE PENNSYLVANIA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE RHODE ISLAND

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	113,133	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	89,563	-20.8	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1972	71,465	-20.2	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	48,305	-32.4	5,500 / 2	11.4	+T	5,500 / 2	11.4	100.0	+T	0 / 0	0	0	0
1974	151,675	+214.0	19,650 / 4	13.0	+257.3	8150 / 3	5.4	41.5	+48.2	11,500 / 1	7.6	58.5	+T
1975	55,870	-63.1	0 / 0	0	-T	0 / 0	0	0	-T	0 / 0	0	0	-T
1976 (9 mos.)	113,740	+103.6	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
Total Study Period	643,751		25,150 / 6	3.9		13,650 / 5	2.1	54.2		11,500 / 1	1.8	45.7	

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- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE RHODE ISLAND

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE SOUTH CAROLINA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	160,434	—	4,300 / 1	2.68	—	4,300 / 1	2.68	100.0	—	0	0	0	—
1971	291,910	+82.0	1,000 / 1	0.34	-76.7	1,000 / 1	0.34	100.0	-76.7	0	0	0	0
1972	176,655	-39.5	4,200 / 3	2.4	+320.0	4,200 / 3	2.4	100.0	+320.0	0	0	0	0
1973	351,180	+98.8	46,900 / 8	13.4	+101.7	3,300 / 2	0.94	7.0	-21.4	43,600 / 6	12.4	93.0	+ T
1974	250,105	-28.8	35,100 / 5	14.0	-25.2	5,600 / 3	2.2	16.0	+69.7	29,500 / 2	11.8	84.0	-32.3
1975	158,550	-36.6	18,625 / 7	11.7	-46.9	14,975 / 6	9.4	80.4	+167.4	3,650 / 1	2.3	19.6	-87.6
1976 (9 mos.)	326,259	+105.8	23,460 / 4	7.2	+ 26.0	5,460 / 3	1.7	23.3	-63.5	18,000 / 1	5.5	76.7	+393.2
Total Study Period	1,715,093		133,585 / 29	7.8		38,835 / 19	2.3	29.1		94,750 / 10	5.5	70.9	

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- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE SOUTH CAROLINA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE SOUTH DAKOTA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	37,416	—	0 / 0	0	—				—	0 / 0	0	0	—
1971	7,331	-80.4	0 / 0	0	0					0 / 0	0	0	0
1972	9,795	+33.6	0 / 0	0	0					0 / 0	0	0	0
1973	9,795	0	0 / 0	0	0					0 / 0	0	0	0
1974	69,293	+607.4	28,000 / 3	40.4	+T					28,000 / 3	40.4	100.0	+T
1975	53,036	-23.5	0 / 0	0	-T					0 / 0	0	0	-T
1976 (9 mos.)	63,618	+20.0	0 / 0	0	0					0 / 0	0	0	0
Total Study Period	240,489		28,000 / 3	11.6		NONE				28,000 / 3	11.6	100.0	

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- Local Housing Authority
- Hospital
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SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE SOUTH DAKOTA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE TENNESSEE

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	345,290	—	1,510 (2)	0.44	—	1,510 (3)	0.44	100.0	—	0 (0)	0	0	—
1971	350,972	+1.65	10,250 (4)	2.9	+578.8	10,250 (4)	2.9	100.0	+578.8	0 (0)	0	0	0
1972	443,386	+26.3	2,000 (2)	0.45	-80.5	2,000 (2)	0.45	100.0	-80.5	0 (0)	0	0	0
1973	293,880	-33.7	34,250 (22)	11.7	+1612.5	28,250 (20)	9.6	82.5	+131.3	6,000 (2)	2.1	17.5	+T
1974	276,683	-5.9	15,600 (8)	5.6	-54.5	8,600 (7)	3.1	55.1	+69.7	7,000 (1)	2.5	44.9	+16.7
1975	527,398	+90.6	72,715 (13)	13.8	+366.1	14,250 (7)	2.7	19.6	+65.7	58,465 (6)	11.1	80.4	+735.2
1976 (9 mos.)	631,892	+19.8	24,968 (13)	4.0	-65.7	17,948 (11)	2.8	71.9	+26.0	7,020 (2)	1.1	28.1	-88.0
Total Study Period	2,869,501		161,293 (65)	5.6		82,808 (54)	2.9	51.3		78,485 (11)	2.7	48.7	

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- Industrial Aid
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- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE TENNESSEE

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE TEXAS

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	921,716	—	0 / 0	0	—				—	0 / 0	0	0	—
1971	1,355,894	+47.1	10,500 / 1	0.77	+T					10,500 / 1	0.77	100.0	+T
1972	1,451,625	+7.1	0 / 0	0	-T					0 / 0	0	0	-T
1973	1,366,541	-5.9	29,560 / 2	2.2	+T					29,560 / 2	2.2	100.0	+T
1974	1,411,262	+3.3	152,140 / 9	10.8	+414.7					152,140 / 9	10.8	100.0	+414.7
1975	1,336,507	-5.3	173,960 / 15	13.0	+14.3					173,960 / 15	13.0	100.0	+14.3
1976 (9 mos.)	1,478,774	+10.6	223,400 / 10	15.1	+28.4					223,400 / 10	15.1	100.0	+28.4
Total Study Period	9,322,319		589,560 / 37	6.3		NONE				589,560 / 37	6.3	100.0	

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School
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STATE TEXAS

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE UTAH

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
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Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	15,520	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	28,023	+80.6	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1972	29,365	+4.8	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1973	51,151	+74.2	2,100 (1)	4.1	+T	0 (0)	0	0	0	2,100 (1)	4.1	100.0	+T
1974	89,985	+75.9	25,000 (2)	27.8	+1090.5	0 (0)	0	0	0	25,000 (2)	27.8	100.0	+1090.5
1975	127,714	+41.9	7,500 (2)	5.9	-70.0	7,500 (2)	5.9	100.0	+T	0 (0)	0	0	-T
1976 (9 mos.)	89,060	-30.3	0 (0)	0	-T	0 (0)	0	0	-T	0 (0)	0	0	0
Total Study Period	430,818		34,600 (5)	8.0		7,500 (2)	1.7	21.7		27,100 (3)	6.3	78.3	

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STATE UTAH

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

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STATE VERMONT

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	80,000	—	0 (0)	0	—	0 (0)	0	0	—				—
1971	82,577	+3.2	0 (0)	0	0	0 (0)	0	0	0				
1972	77,569	-6.1	0 (0)	0	0	0 (0)	0	0	0				
1973	70,875	-8.6	2075 (2)	2.9	+T	2075 (2)	2.9	100.0	+T				
1974	15,438	-78.2	0 (0)	0	-T	0 (0)	0	0	-T				
1975	47,520	+207.8	0 (0)	0	0	0 (0)	0	0	0				
1976 (9 mos.)	57,685	+21.4	2800 (1)	4.9	+T	2800 (1)	4.9	100.0	+T				
Total Study Period	431,664		4,875 (3)	1.1		4,875 (3)	1.1	100.0		NONE			

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STATE VERMONT

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

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STATE VIRGINIA

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
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Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	406,385	—	3,500 (1)	0.86	—	3,500 (1)	0.86	100.0	—	0 (0)	0	0	—
1971	330,785	-18.6	0 (0)	0	-T	0 (0)	0	0	-T	0 (0)	0	0	0
1972	296910	-10.2	4,600 (1)	1.5	+T	4,600 (1)	1.5	100.0	+T	0 (0)	0	0	0
1973	614,210	+106.9	35,650 (6)	5.8	+675.0	1,950 (2)	0.32	5.5	-57.6	33,700 (4)	5.5	94.5	+T
1974	315,335	-48.7	69,025 (9)	21.9	+93.6	9,475 (5)	3.0	13.7	+385.9	59,550 (4)	18.9	86.3	+76.7
1975	522,195	+65.6	91,050 (10)	17.4	+24.2	2,000 (2)	0.38	2.3	-78.9	89,050 (8)	17.1	97.7	+49.5
1976 (9 mos.)	361,595	-30.8	40,400 (7)	11.2	-55.6	10,100 (3)	2.8	25.0	+405.0	30,300 (4)	8.4	75.0	-66.0
Total Study Period	2,847,415		244,225 (34)	8.6		31,625 (14)	1.1	12.9		212,600 (20)	7.5	87.0	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

School	Pollution Control
Water & Sewer	Local Housing Authority
Highway, Bridge and Tunnel	Hospital
Gas and Electric	Other
Industrial Aid	

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE VIRGINIA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE WASHINGTON

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)			FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry (IDB's) And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. (IDB's) And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	418,746	—	0 \ 0	0	—				—	0 \ 0	0	0	—
1971	413,039	-1.4	0 \ 0	0	0					0 \ 0	0	0	0
1972	451,352	+9.3	0 \ 0	0	0					0 \ 0	0	0	0
1973	899,341	+99.3	61,100 \ 5	6.8	+ T					61100 \ 5	6.8	100.0	+ T
1974	674,326	-25.0	40,600 \ 3	6.0	-33.6					40,600 \ 3	6.0	100.0	-33.6
1975	851,536	+26.3	0 \ 0	0	- T					0 \ 0	0	0	- T
1976 (9 mos.)	979,959	+15.1	0 \ 0	0	0					0 \ 0	0	0.	0
Total Study Period	4,688,301		101,700 \ 8	2.2		NONE				101,700 \ 8	2.2	100.0	

*Plus or minus "T" represents a change of entirety (or total) from the prior year. Caution is advised in using % changes, especially negative figures. Although mathematically correct as shown, 100 minus the negative figure is the % that the present year is of the prior year, i.e., a -70% change in 1974 means that the 1974 figure is 30% of the 1973 figure. Magnitudes can only be shown by *absolute* figures—not % changes.

NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE WASHINGTON

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A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME
(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE WEST VIRGINIA

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	8,499	—	0 (0)	0	—	0 (0)	0	0	—	0 (0)	0	0	—
1971	143,279	+1585.8	0 (0)	0	0	0 (0)	0	0	0	0 (0)	0	0	0
1972	150,904	+5.3	18780 (4)	12.4	+T	7,000 (2)	4.6	37.2	+T	11780 (2)	7.8	62.8	+T
1973	193,023	+27.9	63,750 (5)	33.0	+239.5	0 (0)	0	0	−T	63,750 (5)	33.0	100.0	+441.2
1974	184,571	−4.4	22,990 (5)	12.5	−63.9	2750 (3)	1.5	12.0	+T	20,240 (2)	11.0	88.0	−68.3
1975	321,525	+74.2	38,050 (7)	11.8	+65.5	2000 (2)	0.6	5.3	−27.2	36,050 (5)	11.2	94.7	+78.1
1976 (9 mos.)	226,655	−29.5	93,600 (5)	41.3	+146.0	0 (0)	0	0	−T	93,600 (5)	41.3	100.0	+159.6
Total Study Period	1,228,456		237,170 (26)	19.3		11,750 (7)	1.0	5.0		225,420 (19)	18.3	95.0	

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NOTE: Purposes for all Long-Term Municipal Bonds include:
School; Water & Sewer; Highway, Bridge and Tunnel; Gas and Electric; Industrial Aid; Pollution Control; Local Housing Authority; Hospital; Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE WEST VIRGINIA

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE WISCONSIN

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	401,823	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	322,571	-19.7	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1972	350,639	+8.7	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	280,845	-19.9	18,500 / 2	6.6	+T	0 / 0	0	0	0	18,500 / 2	6.6	100.0	+T
1974	262,709	-6.5	5,400 / 3	2.1	-70.8	2400 / 2	0.9	44.4	+T	3000 / 1	1.2	55.6	-83.8
1975	620,589	+136.2	71,460 / 14	11.5	+122.3	13,250 / 6	2.1	18.5	+452.1	58,210 / 8	9.4	81.5	+1840.3
1976 (9 mos.)	686,018	+10.5	33720 / 8	4.9	-52.8	7,100 / 4	1.0	21.1	-46.4	26,620 / 4	3.9	78.9	-54.2
Total Study Period	2,925,194		129,080 / 27	4.4		22,750 / 12	0.8	17.6		106,330 / 15	3.6	82.4	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE WISCONSIN

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

STATE WYOMING

ALL MUNICIPAL BONDS ($,000 omitted)			MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	3,794	—	0 / 0	0	—	0 / 0	0	0	—	0 / 0	0	0	—
1971	14,110	+271.9	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1972	9,202	-34.8	0 / 0	0	0	0 / 0	0	0	0	0 / 0	0	0	0
1973	86,738	+842.6	52000 / 2	60.0	+T	0 / 0	0	0	0	52,000 / 2	60.0	100.0	+T
1974	75,030	-13.5	24,600 / 3	32.8	-52.7	1000 / 1	1.3	4.1	+T	23,600 / 2	31.5	95.9	-54.6
1975	72,939	-2.8	49,125 / 6	67.4	+99.7	1 000 / 1	1.4	2.0	0	48,125 / 5	66.0	98.0	+103.9
1976 (9 mos.)	71,150	-2.5	30000 / 1	42.2	-38.9	0 / 0	0	0	-T	30,000 / 1	3.9	78.9	-37.7
Total Study Period	332,963		155,725 / 12	46.8		2,000 / 2	0.6	1.3		153,725 / 10	46.2	98.7	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

STATE WYOMING

A STATISTICAL ABSTRACT OF MUNICIPAL BOND DOLLAR VOLUME

(Long-Term Financing)

A Special Analysis Prepared Exclusively for the American Industrial Development Council, Inc.

U. S. SUMMARY

Including D.C., Guam, Puerto Rico & Virgin Islands

	ALL MUNICIPAL BONDS ($,000 omitted)		MUNICIPAL BONDS FOR ALL INDUSTRIAL USES ($,000 omitted)										
						FOR NEW & EXPANDED INDUSTRY				FOR POLLUTION CONTROL			
Year	Total $ All Municipal Bonds	% Change From Prior Year*	Total $ All Industrial Uses And # Of Issues	As % Of All Municipal Bonds	% Change From Prior Year*	Total $ All N & E Industry IDRB's And # Of Issues	As % Of All Municipal Bonds	As % of All Industrial Use Bonds	% Change From Prior Year*	Total $ All P.C. IDRB's And # Of Issues	As % Of All Municipal Bonds	As % Of All Industrial Use Bonds	% Change From Prior Year*
1970	17,761,645	—	47,593 / 50	0.27	—	47,593 / 50	0.27	100.0	—	0 / 0	0	0	0
1971	24,369,536	+ 37.2	219,510 / 89	0.90	+ 361.2	125,960 / 80	0.52	+ 57.4	+ 164.7	93,550 / 9	0.38	42.6	+ T
1972	22,940,843	- 5.9	451,945 / 61	2.0	+ 105.9	96,275 / 36	0.42	21.3	- 23.6	355,670 / 25	1.6	78.7	+ 280.2
1973	22,952,646	+ 0.05	1,984,187 / 245	8.6	+ 339.0	206,462 / 112	0.90	10.4	+ 114.5	1,777,725 / 133	7.7	89.6	+ 399.8
1974	22,823,968	- 0.56	1,990,110 / 291	8.7	+ 0.3	317,120 / 177	1.40	15.9	+ 53.6	1,672,990 / 114	7.3	84.1	- 5.9
1975	29,326,229	+ 28.5	2,650,645 / 400	9.0	+ 33.2	516,511 / 208	1.76	19.5	+ 62.9	2,134,134 / 192	7.3	80.5	+ 27.6
1976 (9 mos.)	24,629,444	- 16.0	1,607,358 / 222	6.5	- 39.4	255,583 / 110	1.0	15.9	- 50.5	1,351,775 / 112	5.5	84.1	- 36.7
Total Study Period	164,804,311		8,951,348 / 1358	5.43		1,565,504 / 773	0.95	17.5		*7,385,844 / 585	4.48	82.5	

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NOTE: Purposes for all Long-Term Municipal Bonds include:

- School
- Water & Sewer
- Highway, Bridge and Tunnel
- Gas and Electric
- Industrial Aid
- Pollution Control
- Local Housing Authority
- Hospital
- Other

SOURCE: RESEARCH DEPT., *THE DAILY BOND BUYER*

U. S. SUMMARY

Including D.C., Guam, Puerto Rico & Virgin Islands

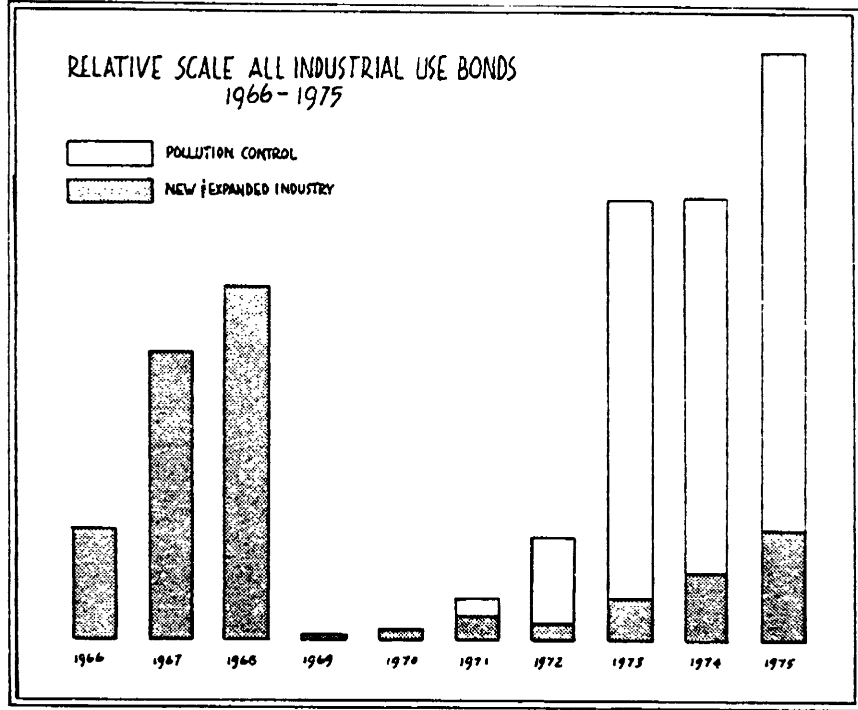
SUMMARY OF MUNICIPAL BOND ISSUES

(LONG-TERM FINANCING)

ALL ISSUES			ALL ISSUES FOR INDUSTRIAL PURPOSES					
					N&E INDUSTRY		POLLUTION CONTROL	
YEAR	# ALL ISSUES	% OF ISSUES NEGOTIATED	TOTAL ALL INDUSTRIAL USE ISSUES	AS % OF ALL ISSUES	# OF ALL N&E ISSUES	AS % OF ALL ISSUES	# OF ALL P.C. ISSUES	AS % OF ALL ISSUES
1970	4,701	N.A.	50	1.06	50	1.06	0	0
1971	5,461	N.A.	89	1.63	80	1.46	9	0.16
1972	5,103	N.A.	61	1.20	36	0.71	25	0.49
1973	4,741	26.0	245	5.17	112	2.36	133	2.81
1974	4,287	27.0	291	6.78	177	4.13	114	2.66
1975	4,724	40.0	400	8.47	208	4.40	192	4.06
1976 (9 mos.)	3,490	41.0	222	6.36	110	3.15	112	3.21
SUMMARY STUDY PERIOD	32,507		1,358	4.18	773	2.38	585	1.80

NOTE: # OF ISSUES REPRESENTS THE ACTUAL NUMBER OF PRIMARY FINANCINGS THAT ENTER THE MARKET FOR SALE.
DO NOT TRANSLATE TO DOLLARS

U.S. SUMMARY


RELATIVE SCALE ALL INDUSTRIAL USE BONDS
1966 - 1975
POLLUTION CONTROL
NEW & EXPANDED INDUSTRY
1966
1967
1968
1969
1970
1971
1972
1973
1974
1975

ANALYSIS OF THE JULY 1976 PETERSEN STATEMENT

A statement from a study by John Petersen (MFOA) was introduced into the hearings of the Senate Subcommittee on Small Business in July, 1976. Although the statement addressed itself to the new law which authorized the S.B.A. a limited guarantee on certain tax-exempt pollution control bond issues, it appears applicable regardless of the ultimate use of the bond proceeds. The statement is, in fact, one of the few which attempts to place a dollar value (when translated) on the added cost of debt service as new bonds enter the market.

An excerpt from the statement reads:

"...(It is estimated) that as the volume of pollution bonds grows, their added volume and higher yields drive up rates on all tax-exempt bonds anywhere from five to 20 basis points (at a 20 year maturity) per billion of annual pollution bond financing, depending on market conditions."

INCREASE* IN BASIS POINTS	ADDED ANNUAL DEBT SERVICE PER $ MILLION AS $1 BILLION OF NEW BONDS ENTER THE MARKET ANNUALLY					
	1971	1972	1973	1974	1975	1976 (9 MOS.)
5.0	$ 32.79	$ 124.67	$ 623.13	$ 586.42	$ 748.06	$ 473.82
12.5	81.98	311.68	1,557.84	1,466.06	1,870.16	1,184.57
20.0	131.17	498.68	2,492.53	2,345.68	2,992.25	1,895.31
25.0	163.96	623.51	3,115.66	2,932.10	3,740.30	2,369.13
50.0	327.91	1,246.71	6,231.34	5,864.21	7,480.65	4,738.28

NOTE: TABLE OF ADDED COSTS IS COMPUTED ON A 20 YEAR BOND SELLING AT PAR WITH A 5.50 YIELD.

* A BASIS POINT IS 1/100 % OF ANNUAL YIELD TO MATURITY. IT IS NOT NORMALLY ASSOCIATED WITH DEBT SERVICE COST OR INTEREST RATES. FIVE BASIS POINTS IS THE SMALLEST INCREMENT USED IN BOND QUOTATIONS.

INSIGHT

ANALYSIS OF REVENUE FROM CORPORATE TAX-EXEMPT AND TAXABLE BORROWING OF $100

	TAX-EXEMPT BONDS (IDRB)		TAXABLE BONDS	
	CORPORATION PROFIT	FEDERAL TAX REVENUES	CORPORATION PROFIT	FEDERAL TAX REVENUES
GROSS EARNINGS (R.O.I.)	$ 15.00	---	$ 15.00	---
LESS INTEREST COST	8.00	0	10.00	$ 5.00
NET BEFORE TAXES	7.00	---	5.00	---
LESS CORPORATE INCOME TAX AT 48%	3.36	$ 3.36	2.40	2.40
TOTAL	$ 3.64	$ 3.36	$ 2.60	$ 7.40

CORPORATION USING I.D.R.B FINANCING

PROFIT AFTER TAX (WITH I.D.R.B'S)	$ 3.64
LESS PROFIT AFTER TAX (TAXABLE BONDS)	2.60
	$ 1.04

FEDERAL REVENUE WITHHELD BY I.D.R.B FINANCING

FEDERAL TAX REVENUES (WITHOUT I.D.R.B'S)	$ 7.40
LESS FEDERAL TAX REVENUES (WITH I.D.R.B'S)	3.36
	$ 4.04

NOTE: THE FOLLOWING ASSUMPTIONS ARE USED IN THE EXAMPLE:
(1) 15% RETURN ON INVESTMENT
(2) INTEREST AT 8% FOR I.D.R.B. AND 10% FOR TAXABLE
(3) PURCHASER OF BOND IN 50% INCOME TAX BRACKET

WHAT 20 NEWLY CREATED MANUFACTURING JOBS MEANS TO U.S. TREASURY

— IN ADDED PERSONAL INCOME TAX ONLY —

NEW JOB OPENINGS FILLED FROM:		NUMBER	ANNUAL WAGE/EMPLOYEE	NEW PAYROLL
	1. NEW ENTRANTS	2	$ 6,300	$ 12,600
	2. EXPERIENCED UNEMPLOYED	4	$ 9,000	$ 36,000
	3. UNDEREMPLOYED	4	$ 9,000	$ 36,000
	4. PRESENTLY EMPLOYED	10	$ 9,500	$ 95,000
			TOTAL NEW PAYROLL	$ 179,000

PERSONAL FEDERAL TAX AT 2/3 ANNUAL WAGE FROM:		NUMBER	TAXABLE INCOME/EMPLOYEE	FEDERAL PERSONAL INCOME TAX
	1. NEW ENTRANTS	2	$ 4,200	$ 1,316
	2. EXPERIENCED UNEMPLOYED	4	$ 6,000	$ 4,000
	3. UNDEREMPLOYED	4	$ 6,000	$ 4,000
	4. PRESENTLY EMPLOYED	10	$ 6,300	$ 10,570
			TOTAL FED. PERS. INCOME TAX	$ 19,886

REFILLED OLD JOBS VACATED FOR NEW EMPLOYMENT FROM:		NUMBER	ANNUAL WAGE/EMPLOYEE	FED. PERS. INCOME TAX	
	1. NEW ENTRANTS	0	$ 0	$ 0	NEW TAX $19,886
	2. EXPERIENCED UNEMPLOYED	0	$ 0	$ 0	LESS OLD TAX
	3. UNDEREMPLOYED	2	$ 8000	$ 1,746	$ 11,746
	4. PRESENTLY EMPLOYED	10	$ 9,000	$ 10,000	
			NET NEW FED PERS. INCOME TAX	$ 8,140	

NOTE: FIGURES DO NOT INCLUDE ADDITIONAL PERSONAL TAXES DERIVED FROM ANCILLARY JOBS CREATED

EROSION OF DOLLAR PURCHASING POWER

U.S. DEPARTMENT OF COMMERCE CONSUMER PRICE INDEX - ALL ITEMS

YEAR	AMOUNT REQUIRED TO OBTAIN $1 OF VALUE IN 1967	VALUE EROSION OVER PRIOR YEAR
1967	$ 1.00	$ 0
1968	1.042	0.042
1969	1.098	0.056
1970	1.163	0.065
1971	1.213	0.050
1972	1.253	0.040
1973	1.331	0.078
1974	1.492	0.161
1975	1.612	0.120
1976 est	1.708	0.096

NOTE: EROSION FIGURES ARE "ADD-ON" ONLY. COMPOUNDED RATES WOULD INCREASE THE EROSION.

EROSION FRAME	AVERAGE ANNUAL $ EROSION	AVERAGE ANNUAL $ EROSION
A. 1968-1976	$ 0.0787	$ 0.0066
B. 1974-1976	$ 0.1257	$ 0.0147
C. U.S ACCEPTABLE LEVEL OF ANNUAL EROSION (5%)	$ 0.0500	$ 0.0042

TIME WHEN $10 MILLION PURCHASES $5 MILLION OF 1967 VALUE (FROM AUGUST 1976)

A. 44 MONTHS — APRIL 1980

B. 28 MONTHS — DECEMBER 1979

C. 70 MONTHS — JUNE 1982

CONTINUED

CONTINUED

EROSION OF DOLLAR PURCHASING POWER

MANUFACTURING BUILDING CONSTRUCTION COST INDEX-VARIOUS

	BOECKH INDEX		E·N·R· INDEX		TURNER INDEX	
YEAR	AMOUNT REQUIRED TO OBTAIN $1 OF VALUE IN 1967	VALUE EROSION OVER PRIOR YEAR	AMOUNT REQUIRED TO OBTAIN $1 OF VALUE IN 1967	VALUE EROSION OVER PRIOR YEAR	AMOUNT REQUIRED TO OBTAIN $1 OF VALUE IN 1967	VALUE EROSION OVER PRIOR YEAR
1967	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
1968	1.068	0.068	1.074	0.074	1.070	0.070
1969	1.145	0.077	1.177	0.103	1.160	0.090
1970	1.231	0.086	1.244	0.067	1.290	0.130
1971	1.339	0.108	1.405	0.161	1.430	0.140
1972	1.448	0.109	1.552	0.147	1.540	0.110
1973	1.544	0.096	1.686	0.134	1.620	0.080
1974	1.710	0.166	1.783	0.097	1.900	0.280

COMBINED AVERAGES OF DOLLAR EROSION:

	ANNUAL	MONTHLY
A. 1968-1974	$ 0.1137	$ 0.0095
B. 1972-1974	$ 0.1355	$ 0.0113
C. GOV'T LEVEL (5%)	$ 0.0500	$ 0.0042

TIME WHEN $10 MILLION PURCHASES $5 MILLION OF 1967 VALUE (FROM DEC. 1974):

A. 22 MONTHS — OCTOBER 1976
B. 18 MONTHS — JUNE 1975
C. 49 MONTHS — JANUARY 1979

NOTE: EROSION FIGURES ARE "ADD-ON" ONLY. COMPOUNDED RATES WOULD INCREASE THE EROSION.

CRICKET PUBLISHING CO.,
PRINTERS OF ACCOUNTING AND TAX SCHEDULES,
Battle Creek, Mich., August 16, 1978.

COMMITTEE ON FINANCE,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SIRS: I have a deep concern, as the enclosed material will indicate, that you have not realized what this Zero Bracket (Standard Deduction) along with what the Discriminatory Tax Schedules are doing.

"I would prefer to see our tax structure reformed so that one's marital status does not affect one's taxes. The decision to marry or not is a personal one. Tax consequences do not belong in that process." Honorable S. I. Hayakawa.

Drop the Zero Base * * * not raise it as the Jones-Ullman compromise asked * * * Allow All Itemized Deductions that can be proven * * * raise the Individual credit for each dependent and make the Rate Schedules so they do not favor "Living in Sin".

Transfer the Man hours Wasted in the Energy Department and you will collect many more 'Billions'.

I have received over a hundred letters from United States Senators and Congressmen and they all agree—so why don't we act?

Sincerely yours,

STANLEY E. CANFIELD,
President.

Enclosure.

DROP THE ZERO BASE
ALLOW ALL PROVEN DEDUCTIONS -
WHY GIVE AWAY
$200 BILLION ANNUAL
WAGES WITHOUT ACCOUNTABILITY?
MAKES THEM COME
OUT SMELLING LIKE
A ROSE !!

TAX GUIDE
WEEKLY ALERT

July 13, 1978

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Tax Report

HOUSE MATES: A separated couple can be apart under the same roof, a court finds.

Support payments during marital separation usually are deductible. But the Tax Court a while ago denied Richard S. a support deduction because he continued to live in the same house with his wife Lugene. He argued that they had separate rooms, ate meals apart and seldom saw each other. But the court said the deduction was available only if a separated couple lived apart.

The Tax Court declared that it shouldn't be required "to delve into intimate questions of whether husband and wife are in fact living apart while residing in the same house." But that prim assertion was rejected recently by an appeals court. A deduction for support isn't automatically barred if a separated couple live under the same roof, the higher court asserted.

Delving into Richard and Lugene's living arrangements, the appeals court determined that in fact they were living apart in the same house. Thus Richard could deduct some $1,200 for support.

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I call this ' MAKING OUT ' in more ways than one.

HOUSE MATES . . .
Deduction for alimony . . .
Singles living together Doubled since 1970
and now giving $2300.00 each or $4600.00
for singles ' HOUSE MATES '

$3400.00 for Married??!

1 — Ways and Means to take up "Jones-Ullman compromise" tax plan

The House Ways and Means Committee plans to resume mark-up of what is now being referred to as the Jones-Ullman compromise bill. Here are the highlights of the proposals contained in the bill.

Individual tax rates. Individual tax brackets would be widened by 6% of taxable income in excess of the zero bracket amount. The zero bracket amount would be increased from $2,200 to $2,300 for single persons and from $3,200 to $3,400 for married couples.

Itemized deductions. The deductions for state and local nonbusiness gas taxes as well as for political contributions would be repealed. The alternative political contribution credit would be retained.

The medical expense deduction would be modified to eliminate the separate deduction for insurance premiums, the separate 1% limitation on medicines and drugs, and would allow only insulin and *prescription* medicine and drugs to be included as medical expenses subject to the 3% limitation.

Tax shelters. The at risk rules which currently apply to unincorporated entities engaged in farming, oil and gas, motion pictures, and equipment leasing, would be extended to closely held (5 or fewer shareholders owning more than 50% of the stock) corporations and to all activities except real estate. The partnership at risk restriction would be repealed.

Partnership audits. Where the tax liabilities of 100 or more partners could be affected, the statute of limitations with respect to partnership passthrough items on the partners' returns

Time Essay

Threat to an American Tradition

John W. Gardner, the founding chairman of Common Cause and formerly Secretary of Health, Education and Welfare, sees danger in certain proposals that have come forth lately from various tax reformers to eliminate or reduce the charitable contributions that Americans can deduct from taxable income. He stated his case recently at a United Way conference in a speech on which this essay is based.

"These Americans are a peculiar people. If, in a local community, a citizen becomes aware of a human need which is not being met, he thereupon discusses the situation with his neighbors. Suddenly a committee comes into existence. The committee thereupon begins to operate on behalf of the need and a new community function is established. It is like watching a miracle, because these citizens perform this act without a single reference to any bureaucracy, or any official agency."

Just so, 150 years ago, Tocqueville described a unique feature of the American system. It is the spontaneous working of a creative public spirit. Out of this fundamental national trait have come such vitally important institutions as libraries, museums, civic organizations, great universities, the United Way, the Little Leagues, the Salvation Army, symphony orchestras, garden clubs, historical societies, adoption services, hospitals, religious organizations, Alcoholics Anonymous, the 4-H clubs. Indeed, this American spirit reaches into almost every field of human interest. Tied to another powerful American tradition—that of private giving for public purposes—the volunteer spirit has released incredible human energy and commitment in behalf of community all over the country.

Yet in the next two or three years the Federal Government may destroy this feature of the American system. The destruction could be accomplished silently and invisibly—in the name of tax reform. The threat lies in proposals that would reduce, directly and indirectly, the charitable contributions Americans itemize as deductions from taxable income. And there are even those who, with the intent of simplifying the tax code, would eliminate such deductions entirely. With due respect to the reformers, the alarm should be shouted: Our tradition of private giving for public purposes is endangered by some of their good intentions.

Up till now, Government tax policy has deliberately fostered that tradition. The deductibility of charitable gifts is based on the idea that it is good for a great many people, independently, privately, to contribute to charitable, religious, scientific and educational activities of their choice. Such giving supports the American pluralism that allows all kinds of people to take the initiative in all kinds of activities. In reality, the tradition that has produced the innumerable institutions that are sometimes called the nonprofit sector lies at the very heart of our intellectual and spiritual strivings. The deductibility of charitable donations has been only an expression of that larger philosophy.

Now there is a new school of thought with a very different view. It holds that a deductible dollar donated, say, to a school for blind children, would have found its way into the federal treasury—if it had not been deductible. That dollar is therefore to be regarded as Government money—and labeled a "tax expenditure." This new doctrine began innocently enough with a concern about the multiplicity of existing tax loopholes. It made sense to calculate the amount of benefits granted by the Government through allowable deductions—as, say, certain industrial tax credit. So the term "tax expenditure" was invented as a convenient way to describe such an amount. Some tax-simplification theorists just have not given much thought to the implications of applying that term to voluntary charitable donations. But there is another type of theorist we have to cope with: the Government-knows-best type who positively resents the freedom of the tax-deductible gift. His argument is to eliminate the deductibility of that dollar given to the school for the blind, take the money into the treasury and, if the school needs money, let Congress and the federal agencies appropriate it.

Such a doctrine makes the head ache. The American people have been remarkably resourceful in launching activities to serve their communities. They freely give $30 billion a year and contribute God knows how many billion more in nonmonetary services. Now Americans are told that Congress and the Government bureaucracies could do a better job.

Somehow the available evidence on Government efficiency (speaking with the respect of one who served two tours of duty in Government) does not drive one toward that conclusion. But apart from the question of efficiency, if Government pre-empted charitable functions, what outlet would be left for personal caring and concern? Can anyone believe that a manual of regulations from Washington would unlock the miraculous energy which has been so impressive since the days of Tocqueville?

The truth is that the present charitable deduction is not adequate to bring out the best of which Americans are capable. Even recent increases in the standard deduction—five in the last eight years—decreased the number of taxpayers itemizing deductions from almost 50% in 1970 to less than 25% today. The result damaged the voluntary sector. Contributions to public charities decreased, with losses recently estimated at $5 billion. In 1977 alone, greater use of the standard deduction could cost voluntary American institutions some $1.3 billion. It is estimated that only 16% of taxpayers will itemize deductions (and thus have an added incentive to make charitable donations) if the Carter Administration's tax reform proposals are enacted.

What would result if the new antideduction doctrine ever were in force is not pleasant to contemplate. As it is, the trend is already running against voluntarism. The only way to reverse this trend is to amend the tax code to allow all taxpayers to deduct charitable gifts whether they itemize or not. This change alone would eliminate a twofold danger: first, that denying most Americans any encouragement to give will bring more Government into their lives; second, that charitable giving will become the province of only the wealthy.

The Government will best contribute to the health of the society if it actively furthers the vitality of the private, voluntary sector. We must wake up to the fact that the government of a gigantic, tumultuous society cannot be administered entirely by a conventional, centralized, top-down governmental hierarchy. Local levels of government and local private institutions are going to have to figure out how they can collaborate to make things work in the community. The old American trait of voluntary activity and giving is indispensable to that end.

Finally, it is not easy to make a blanket defense of private giving; after all, it consists of so many unrelated, unofficial, unclassifiable activities. Yet that diversity is one of the qualities that make it beautiful. It is an area in which freedom survives and flourishes. Let's keep it that way.

STATEMENT OF HARRY C. GREEN, JR., M.D., PRESIDENT, DEACONESS HOSPITAL FOUNDATION, SPOKANE, WASH.

The Board of Directors of Deaconess Hospital Foundation support the Moynihan-Packwood Bill S3111.

This bill would provide tax benefits for the average American and would benefit the nation by providing additional support for charitable institutions which serve the general public.

LAW OFFICES OF DELANEY & PATRICK,
Washington, D.C., September 5, 1978.

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

DEAR MR. CHAIRMAN: This is in reference to the Press Release of the Committee on Finance, United States Senate (sometimes hereinafter referred to as the "Committee"), of August 2, 1978, regarding the Committee's public hearings on the President's tax cut bill and related matters.

We wish to thank the Committee for its continuing efforts to provide representatives of the private sector an opportunity to express views on international tax and trade matters. In this regard, we are particularly concerned about the implications of the Carter Administration's proposals concerning United States taxation of foreign source income and related matters, and we request that the enclosed memorandum, submitted on behalf of Cargill Incorporated, be made a part of the record of the Committee's hearings. This memorandum updates previous materials concerning the subject issues provided to the Committee, and its Subcommittee on International Trade, during 1975, 1976 and 1977.

Based on recent developments and proceedings, including the tax proposals of the Carter Administration and the deliberations of the House Ways and Means Committee on the subject issues, it now appears that the Carter Administration has ignored, or is unconcerned with, significant considerations relating to the linkage of tax and trade issues and the need for utilizing approaches involving legislative and international trade negotiating techniques. More particularly, we wish to point out that important United States national and international interests are served by preserving the competitive position of United States owned firms engaged in international trading activities. Accordingly, we urge the Committee to undertake such steps as are necessary to assure that United States owned firms engaged in international trading activities will be able to compete on a substantially equivalent tax footing with foreign owned firms beyond United States tax jurisdiction and control.

Again, we wish to express our appreciation to the Committee and we trust that our comments will be useful to the Committee during its present deliberations and in the future.

Respectfully submitted,

PAUL H. DELANEY, Jr.

Enclosure.

COMMENTS AND RECOMMENDATIONS REGARDING UNITED STATES TAXATION OF FOREIGN SOURCE INCOME AND RELATED MATTERS WITH PARTICULAR REFERENCE TO THE LINKAGE OF TAX AND TRADE ISSUES AND THE IMPORTANCE OF UTILIZING BOTH LEGISLATIVE AND INTERNATIONAL TRADE NEGOTIATING APPROACHES AND TECHNIQUES TO PRESERVE THE COMPETITIVE POSITION OF UNITED STATES FIRMS ENGAGED IN INTERNATIONAL TRADING ACTIVITIES

Introduction

The purpose of this memorandum is to provide comments and recommendations regarding United States taxation of foreign source income and related matters, with particular reference to the linkage of tax and trade issues and the importance of utilizing both legislative and international trade negotiating approaches and techniques to preserve the competitive position of United States firms engaged in international trading activities.

As related below, in accordance with recent international and unilateral tax and trade developments, including changes in United States domestic tax law and international trade proceedings and negotiations, with particular reference to the

November 1976 Panel Decisions under the auspices of the General Agreement on Tariffs and Trade ("GATT") on certain tax practices of the United States, France, Belgium and the Netherlands, it is urged that the United States Congress, and particularly the Members of the House Ways and Means Committee and the Senate Finance Committee, reaffirm the need for legislative and negotiating efforts directed towards placing United States owned firms engaged in international trading activities on a substantially equivalent tax footing with their foreign owned competitors.

Notwithstanding these considerations, the Carter Administration has recently recommended the repeal of DISC and deferral of United States taxation of undistributed earnings and profits of foreign corporations controlled by, or associated with, United States shareholders, apparently, the Carter Administration has based its decisions on a lack of understanding or concern for important United States national and international interests which are served by United States participation in international trading activities through United States owned firms which are subject to United States tax jurisdiction and control. It is particularly unfortunate that the Carter Administration has come forward with these proposals at a time when the United States is in the midst of major international trade negotiations, both with respect to the multilateral trade negotiations in Geneva, Switzerland and the GATT panel decisions involving the tax practices of the United States, France, Belgium and the Netherlands. Furthermore, the Carter Administration has undertaken these legislative initiatives at a time when the United States is experiencing its largest trade deficit in history.

It is also to be expected that the tax proposals of the Carter Administration to eliminate deferral by expanding the Subpart F approach (current taxation of the undistributed earnings and profits of controlled foreign corporations) to cover a broader range of foreign source income (extend beyond present coverage of so-called tax haven income) would necessarily involve additional complexities and problems in the administration of United States tax law.

Discussion

GENERAL CONSIDERATIONS REGARDING UNITED STATES TAXATION OF FOREIGN SOURCE INCOME

Tax jurisdiction and taxation of foreign source income

A particular nation may tax the worldwide income of its nationals, restrict the scope of its tax jurisdiction to a territorial basis (tax only domestic source income), or provide for other means of limiting the taxation of foreign source income.

In response to a United States Congressional inquiry in March 1973, a study was prepared under the auspices of the Council on International Economic Policy ("CIEP") regarding tax treatment by other nations of their own multinational firms (taxation of foreign source income).[1]

This study summarized the basic rules of the following countries with respect to taxation of foreign source income: Belgium, Brazil, Canada, Denmark, France, Federal Republic of Germany, Ireland, Italy, Japan, the Netherlands, Norway, Switzerland, and the United Kingdom.

The analysis included:

1. Taxation of income of foreign branches of domestic corporations;
2. Taxation of foreign subsidiaries of domestic corporations;
3. Taxation of interest, dividends and patent royalties received from abroad; and
4. Treatment of foreign taxes paid by domestic corporations and their subsidiaries (in certain instances, intercompany pricing practices were considered).

Although it is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income, it should be noted that despite varied approaches to taxation (worldwide, territorial, and varied forms of exemptions and credits), not one of the nations considered in the CIEP study taxed currently the undistributed profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that the United States taxes undistributed profits of United States controlled foreign corporations on a current

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[1] See information submitted for the record by the Council on International Economic Policy to the Subcommittee on International Trade, Senate Finance Committee, Hearings on Multinational Enterprises, February 26 through March 6, 1973.

basis, this places United States based companies engaged in international operations at a competitive disadvantage and constitutes a departure from the general scheme of international taxation practiced by other nations.

U.S. constitutional considerations

In accordance with the principal taxation provisions of the Constitution of the United States (sometimes hereinafter referred to as the "Constitution"), the United States Congress (sometimes hereinafter referred to as the "Congress"), possesses the power to lay and collect, taxes, duties, imposts, and exercises to pay the debts and provide for common defense and general welfare of the United States.[2]

Under the Constitution, as initially ratified, the Congress could only impose direct taxes in proportion to the census (apportionment on the basis of population).[3] However, pursuant to Constitutional Amendment, the Congress is now empowered to lay and collect taxes on income from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.[4] Although the Congress has exercised its Constitutional tax authority in enacting the provisions of the United States Internal Revenue Code,[5] administration of United States federal income tax laws has generally been delegated to the United States Treasury Department and the Internal Revenue Service.[6]

United States federal tax jurisdiction is based on two general principles.[7]

1. Nationality, under which the United States taxes worldwide income of "United States persons";[8] and
2. Source of income, under which the United States taxes "United States source income" of United States persons and "foreign persons", including "nonresident aliens" and "foreign corporations" (in limited circumstances, the United States taxes "foreign source income" of foreign persons "effectively connected with a United States trade or business").

Accordingly, under relevant provisions of the Internal Revenue Code, nonresident aliens and foreign corporations are subject to United States federal income tax on:[9]

1. Income derived from United States sources; and
2. Income effectively connected with a United States trade or business.

The term "United States person" includes United States domestic corporations.[10]

U.S. taxation of U.S. corporations and foreign corporations

As noted above, United States tax jurisdiction is based on both nationality and source of income. The United States taxes United States persons (citizens, residents, corporations, partnerships, trusts, etc.) on income from all sources.

The modern United States corporate income tax dates from 1909. At that time, dometsic corporations were taxed on income from all sources and foreign corporations on income from business transacted and capital invested with the United States. This jurisdictional pattern remained substantially unchanged until 1962.

The impact of tax on the foreign source income of United States persons was softened somewhat in 1918 with the adoption of a foreign tax credit. Previously, foreign taxes had merely been deductible, like state and local taxes. The credit can apply to both the earnings and profits of foreign subsidiary corporations and foreign branches. Only payments treated as income taxes, or "in lieu of income taxes," qualify for the credit.[11]

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[2] See U.S. Const. Art. I. Sec. 8.
[3] See U.S. Const Art I, Sec 9.
[4] See U.S. Const. Amend. XVI.
[5] See Internal Revenue Code of 1954, as amended. Title 26 U.S.C. § 1 *et seq.* (sometimes hereinafter referred to as the "I.R.C.").
[6] The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, is charged with the responsibility for prescribing and publishing rules and regulations for the enforcement of United States income taxes. See I.R.C. § 62.
[7] I.R.C. §§ 1 and 11(a) set forth very broad jurisdictional rules, imposing tax on the taxable income of "every individual" and "every corporation", respectively.
[8] The term "United States person" and other relevant terms pertaining to United States tax jurisdiction are defined and discussed subsequently in this memorandum.
[9] See I.R.C. §§ 871, 872, 881 and 882 which limit United States tax jurisdiction with respect to taxation of nonresident aliens and foreign corporations to income from sources within the United States and income effectively connected with the conduct of a United States trade or business.
[10] I.R.C. § 7701(a)(30) defines "United States person" to include citizens, residents domestic partnerships, domestic corporations, and domestic estates and trusts.
[11] See I.R.C. §§ 901–906.

The income of foreign corporations, if derived from business conducted outside the United States, is generally not subject to current United States income taxation.

In broad terms, a corporation is treated as a United States domestic corporation if it is incorporated in any of the states of the United States or the District of Columbia and is treated as a foreign corporation if it derives its charter from a foreign government.

Foreign source income earned by a foreign corporation controlled by United States persons is generally exempt from United States taxation until distributed to shareholders who are United States persons.[12] The effect of these provisions of the Internal Revenue Code is that a United States person (United States shareholder) is allowed to defer paying United States income tax on undistributed earnings and profits of a controlled foreign subsidiary corporation until such earnings and profits are repatriated to the United States (this development is often referred to as "deferral" of tax with respect to foreign investment).

A corporation receiving a dividend from a controlled United States domestic corporation is generally entitled to exclude most of that dividend from its taxable income on the theory that it has already been subject to tax.[13] Dividends from a foreign corporation are not entitled to this exclusion. Likewise, dividends from a foreign corporation are not entitled to the $100 exclusion of dividends received by individuals.[14] Therefore, United States shareholders of foreign corporations are generally taxed fully on dividends received from foreign corporations.

A United States corporation which in any taxable year owns at least 10 percent of the voting stock of a foreign corporation from which it received dividends is entitled to a foreign tax credit for income taxes paid by that foreign corporation.[15]

Current taxation of undistributed earnings and profits of foreign corporations

Although United States shareholders (United States persons) of foreign corporations are generally not subject to United States tax on the income of such foreign corporations unless, and until, such income is repatriated to the United States in the form of dividends (or remittances in the nature of a dividend), United States shareholders of two categories of foreign corporations are effectively subject to current United States taxation on certain types of undistributed income:

1. "Foreign personal holding companies"; and
2. "Controlled foreign corporations."

U.S. TAXATION OF FOREIGN PERSONAL HOLDING COMPANIES

A foreign corporation is treated as a foreign personal holding company:

1. If at least 60 percent of the corporation's gross income for the taxable year is foreign personal holding company income (passive income such as dividends, interest, rents and royalties); and
2. If at any time during the taxable year, more than 50 percent in value of the corporation's outstanding stock is held directly or indirectly by not more than five individuals who are citizens or residents of the United States.[16]

The rationale for the foreign personal holding company provisions is to prevent a small group of United States taxpayers from incorporating their investments overseas in order to escape taxation of investment income at the individual level. The shareholders of a foreign personal holding company are subject to current United States taxation on their pro-rata share of the corporation's personal holding company income.

U.S. TAXATION OF CONTROLLED FOREIGN CORPORATIONS UNDER SUBPART F

In accordance with the provisions of the Revenue Act of 1962,[17] the United States Congress added Subpart F to the Internal Revenue Code in an effort to deal with the problem of tax haven operations.[18] Under this approach, United States shareholders of controlled foreign corporations ("CFCs") are subject to

[12] See I.R.C. §§ 1, 11, 861–864, 881–883, and 1201.
[13] See I.R.C. § 243.
[14] See I.R.C. § 116.
[15] See I.R.C. § 902.
[16] See I.R.C. §§ 551–558.
[17] See Revenue Act of 1962, P.L. 87–834, H.R. 10650, 87th Cong. 2d Sess., 76 Stat. 960. October 16, 1962.
[18] See I.R.C. § 951(a)(1).

current United States income taxation on certain forms of undistributed tainted income (tax haven or Subpart F income):

1. Subpart F income, including foreign base company income and income derived from insurance of United States risks;
2. Previously untaxed Subpart F income withdrawn from investment in less developed countries; and
3. Any increase in investment in United States property to the extent it would be taxable as a dividend if distributed to United States shareholders.

It should be understood that Subpart F taxes United States shareholders not on their own income, but on the income of CFCs in which they own an interest. This development relates to the consideration that there may be no jurisdictional basis for taxing a foreign corporation unless it earns income from sources within the country asserting jurisdiction to tax (or has income effectively connected with business operations in such country). Therefore, Subpart F jurisdiction is predicated on United States citizenship or residence, rather than source of income.

Controlled foreign corporations

A CFC is defined as a foreign corporation whose total combined voting power of all classes of stock entitled to vote is more than 50 percent owned, on any day during the taxable year, by United States shareholders.[19]

A "United States shareholder" is defined as a United States person owning, actually or constructively, 10 percent or more of the total combined voting power of a CFC.[20]

Foreign base company income

Foreign base company income (as noted before, foreign base company income is included in the definition of Subpart F income) is computed on the basis of three components:[21]

1. Foreign personal holding company income;
2. Foreign base company sales income; and
3. Foreign base company services income.

For operational purposes, a primary issue often pertains to tax treatment of foreign base company sales income. Essentially, a CFC engaged in buying and selling personal property to, from, or on behalf of, a related person is treated as generating foreign base company sales income, unless the property has been manufactured, produced, grown, or extracted in the CFC's country of incorporation or is intended to be used, consumed, or disposed of in that country, or both.[22] These rules are designed to subject to current taxation the income of CFCs primarily engaged in selling, as opposed to manufacturing or similar actiivties.

In applying the foreign base company sales income rules, the income of a branch operation outside the CFC's country of incorporation is treated as foreign base company sales income of the CFC when use of the branch has substantially the same tax effect as if the branch were a wholly-owned subsidiary.[23] The Treasury Income Tax Regulations set forth detailed rules for making this determination with respect to both sales and manufacturing branches. The effect of this procedure is to prevent avoidance of tax by United States shareholders on income which in substance is identical to foreign base company sales income where the existence of such income would not otherwise be recognized because of formal unity of a CFC and its branch as a single corporate entity.[24]

Legislative chronology of subpart F

In accordance with the legislative history of Subpart F under the Revenue Act of 1962, it is clear that the United States Congress adopted the percentage of voting power test contained in Section 957 (pertaining to the definition of a controlled foreign corporation) and specifically rejecting percentage of value and effective control tests, recognizing that United States shareholders should only be taxed currently on undistributed foreign corporate profits where such shareholders possess sufficient power to cause payment of dividends.

An analysis of the specific legislative chronology on this matter reveals the following:

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[19] See I.R.C. § 957.
[20] See I.R.C. § 951(b).
[21] See I.R.C. § 954(a).
[22] See I.R.C. § 95(d)(1).
[23] See I.R.C. § 954(d)(2).
[24] See Treas. Reg. § 1.954-3(b).

1. The Treasury Department's original proposal to tax United States shareholders currently on undistributed earnings of foreign corporations was rejected by the Congress as overreaching;

2. In a second and narrower proposal, the Treasury Department pressed Congress to adopt a definition for CFCs which would be based on either a value test or a voting power test (it should be noted that the Congress, on its own initiative, did not consider a test beyond a voting power test);

3. Despite the suggestions and arguments of the Treasury Department, the Congress selected the voting power test to determine CFC status.

4. The Congress concluded that United States shareholders should not be taxed on undistributed earnings of a foreign corporation unless such shareholders had the requisite voting power to cause the declaration and payment of dividends.

5. The Congress was aware of other types of tests for determining CFC status, such as percentage of value, practical control, effective control, etc. (the Congress had often used such various control tests either individually or in combination to remedy specific problems) and therefore, it is particularly significant that the Congress did not select any test other than that of voting power for the CFC definition.

House Ways and Means Committee hearings

It is important to recognize that early in the process of the legislative history of Subpart F, various members of the House Ways and Means Committee expressed concern about the apparent approach of the Treasury Department regarding standards for the definition of a CFC. Apparently, the Treasury had hoped to give the newly-proposed taxing mechanism the broadest possible scope as demonstrated by its proposal that with respect to a corporation created after enactment of the legislation, any United States shareholder owning ten percent or more of the stock of a foreign corporation would be taxed on its share of the foreign corporation's earnings even though no other United States shareholder owned stock in the subsidiary, i.e. a 10 percent ownership test rather than a 50 percent ownership test would be applied to new foreign subsidiaries.

This approach attracted substantial opposition within the House Ways and Means Committee, and the Treasury Department withdrew the proposal and advanced another. The second Treasury initiative provided that a ten percent or greater United States shareholder would be taxed currently on its pro rata share of the foreign corporation's income only if five or fewer United States shareholders owned either (1) more than 50 percent of the voting power, or (2) more than 50 percent of the value, of the foreign corporation's stock.[25] Under this method, the Treasury's test of control was a two-pronged alternative test, i.e. ownership of either more than 50 percent in value or voting power would cause a foreign corporation to be classified as a CFC.

Again, key members of the House Ways and Means Committee expressed reservations about this type of control test. Senior Committee member Hale Boggs and ranking Republican member John Byrnes (recognized within the Committee as active and knowledgeable members in the foreign income area) doubted that the United States had the power to pierce the veil of foreign corporate entities in the manner proposed by the Treasury, despite Secretary of the Treasury Dillon's opinion that the manner in which United States shareholders of foreign personal holding companies were taxed established that the Treasury approach was legally proper. Accordingly, Congressman Boggs (who was not satisfied with Secretary Dillon's statement) asked that the staff of the Joint Committee on Internal Revenue Taxation prepare and submit a memorandum to the House Ways and Means Committee on this issue, such memorandum to be made an official part of the record of the hearings.[26] As noted below, this Joint Committee staff memorandum provides better evidence of Congressional intent on this issue than the pronouncements of the Treasury.

The following colloquies involving members of the House Ways and Means Committee and representatives of the Treasury Department are particularly instructive on this matter:[27]

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[25] See U.S. Treas. Dept. Press Release D-186 (July 28, 1961).

[26] See Hearings on President's 1961 Tax Recommendations Before the House Ways and Means Committee, Vol. 1, p. 310, 87th Cong., 1st Sess., May 4, 1961.

[27] See Hearings on President's 1961 Tax Recommendations Before the House Ways and Means Committee, Vol. 1, pp. 340–343, 87th Cong., 1st Sess., May 4, 1961.

"Mr. BYRNES. [speaking to Secretary Dillon] You talked about American firms abroad and U.S. companies abroad throughout your statement. That is the context in which you put it. But what is a foreign subsidiary? Is is not, in the first place, a corporation set up under a foreign flag? Let us say France. It is a French corporation basically, is it not?

Secretary DILLON. That is correct. What we are talking about here as we specifically define them is American-controlled subsidiaries, so we are talking about ones where the control, a majority of the stock, is held by no more than 10 American stockholders, individuals or corporations. That is the definition.

Mr. BYRNES. But it is a foreign corporation in which Americans have the principal investment as far as the stockownership?

Secretary DILLON. That is right. They manage and control it.

Mr. BYRNES. Your definition now is 51 percent?

Secretary DILLON. Over 50 percent.

Mr. BYRNES. Over 50 percent?

Secretary DILLON. Yes, so it could be 50½ percent, anything that gives a majority control.

Mr. BYRNES. By less than 10?

Secretary DILLON. By not more than 10, American corporations or individuals.

Mr. BYRNES. In other words, if there are 11 investors then and they own 50½ percent, it no longer is a foreign subsidiary?

Secretary DILLON. Our proposal draws a distinction between existing and newly created foreign subsidiaries. The more than 50 percent test would apply to subsidiaries that are presently in existence. For new companies that are not now in existence there is a different and broader definition.

Mr. BYRNES. What is that?

Secretary DILLON. For corporations created after the enactment of our proposal, deferral would be eliminated for any American stockholder with a 10 percent or greater stock interest.

Mr. BYRNES. So from now on, it is going to mean that it is not an American-controlled corporation that we are talking about as far as the future?

Secretary DILLON. That is correct.

Mr. BYRNES. It is as little as 10 percent?

Secretary DILLON. That is correct.

Mr. BYRNES. If there are two American investors in a company and they each have 5 percent, would that be then a foreign subsidiary of an American company?

Secretary DILLON. That is a question we would have to consider. If they were related, I think it would.

Mr. BYRNES You mean by blood, or marriage, or what?

Secretary DILLON. I mean a business relationship.

Mr. BYRNES. As far as those that are there maybe you are not saying, 'Yankee, come home,' but you are saying for the future, 'Yankee, you better stay home, because you just should not even get a 10 percent investment in a foreign company.'

However, that company in which you own only 10 percent of the stock is a French corporation is it not?

Secretary DILLON. That is correct.

Mr. BYRNES. Governed by the laws of France?

Secretary DILLON. That is right.

Mr. BYRNES. *Insofar as what that company does by way of distribution of profits or income, investments it makes, where it makes them, and so forth, the American does not have any control, does it?*

Secretary DILLON. *Normally, not in the case you mentioned where there is less than a majority control of the subsidiary.*

Mr. BYRNES. *We are talking about the minimum that this can go down to, the 10 percent stock ownership.*

Secretary DILLON. That is correct.

Mr. BYRNES. So that certainly as far as these are concerned, we cannot in any way refer to them as American firms or American businesses, can we, that we are going to tax?

Secretary DILLON. *In the future, we feel that this 10 percent limit which we picked is an arbitrary one. If we wanted to set a limit at some other place, that would avoid evasion by just reducing from 50 percent to 45 or 40 percent and still maintain effective control, maybe we would come out at some different place.*

We thought 10 percent was reasonable considering the form which new foreign investments have been taking. By putting this into the future, I do not think any American company or individual would make an investment that large in a foreign company or in, for that matter, a domestic company unless he had a voice in the management and had some say in what was going to happen. And I would think that with that voice he could make the necessary arrangements to be sure that an adequate amount of dividends would be returned to him at home or else he would not make the investment on that basis.

Mr. BYRNES. *That is an interesting theory concerning how you control this corporation, but fundamentally what we are talking about here, are we not, as far as the corporate veil, the entity, is concerned, as Mr. Boggs mentioned, is either a French corporation, or a Dutch corporation, et cetera.*

Secretary DILLON. That is correct.

Mr. BYRNES. And yet, we are going to tax some of the earnings of this foreign corporation, are we not, by this action?

Secretary DILLON. The earnings accumulated for the American stockholders, yes.

Mr. BYRNES. We are not talking here at all about distributed earnings, are we? They are taxed today, are they not? Other than in the 'gross up' section?

Secretary DILLON. That is right.

Mr. BYRNES. So that what we are talking about now are undistributed earnings of a foreign corporation in which American corporations have some interest?

Secretary DILLON. That is correct.

Mr. BYRNES. *I, too, share the concern of Mr. Boggs as to how you can constitutionally move in on this foreign corporation and on undistributed earnings and say we have to have the tax that our country would have if they were distributed. You suggest that you have a precedent in the foreign personal holding company. I was also under the impression that this decision revolved around the concept that this personal holding company was really an incorporated pocketbook and that, therefore, it was a tax evasion device and for that reason the court was willing to discard this concept of the corporate entity to pierce the corporate veil.*

Secretary DILLON. I do not think as far as foreign law is concerned there is that sort of thing.

Mr. BYRNES. I am talking about U.S. law. That is what you are trying to apply here, U.S. law to a French corporation. You say we can do it because we do it to a foreign personal holding company. A foreign personal holding company is a foreign personal holding company, organized under the laws of France.

Secretary DILLON. I think it is perfectly clear that there is no U.S. law that says we cannot do what we propose.

Mr. BYRNES. I thought even in the co-op case one of the things the court said was we cannot put the tax on somebody until he gets something of value. You could not tax a dividend if the person never received the dividend, did not have any right to its enjoyment, and might never have the right of enjoyment, and therefore, constitutionally, we could not tax it.

Secretary DILLON. We will be glad to submit a legal brief of our own which, together with the legal brief which the joint staff, should help clarify this situation.

Mr. BOGGS. Mr. Chairman, Mr. Stam has completed his brief. We got permission to put it in the record. I would suggest that Mr. Stam also make his brief available to counsel for the Treasury Department to see whether or not they can answer it.

The CHAIRMAN. All right. The brief that will be prepared under your direction, will be inserted at the same point.

(The above mentioned briefs are on pp. 311 and 313, respectively.)

Secretary DILLON. Thank you very much, Mr. Chairman.

Mr. BYRNES. Mr. Secretary, do you know any foreign country that taxes American corporations or any other foreign corporations on the basis that you are suggesting here that we tax funds in a foreign corporation?

Secretary DILLON. The German law, as I said earlier, operates under the basis of management and control, which is related to what we are talking about. Their definition of a Germany company, that is, a taxable entity, is not based on the place of incorporation alone. They will look through the factor of foreign incorporation and tax the company on its entire income if management and control is in Germany.

Mr. BYRNES. We are also talking about a 10-percent possibility here of ownership. Do you mean to tell me that with regard to an American corporation that may have a 10-percent German ownership—that ownership may have come about because of patents or something else—that Germany comes in and taxes the undistributed profits to the tune of, let us say, 10 percent of the profits on the theory this belongs to a German and therefore applies the German tax against it when it is undistributed?

Secretary DILLON. This comes back to the question of what is management and control. I said that the 10-percent figure was arbitrary, as setting what we thought in the future would be a clear limit below which there would be no management or no control.

Now, maybe that figure could be set higher than this. That would be something that we would be perfectly glad to consider with the committee. The thing we are trying to do here is to set it low enough so as to prevent the avoidance of the general principle if the principle should be adopted."

Treasury Department legal memorandum

In a legal memorandum from General Counsel of the Treasury Department Robert H. Knight to Secretary of the Treasury Dillon, it was the opinion of the Treasury Department that the subject Treasury proposal, including both the 50 percent threshold test for existing foreign corporations and the 10 percent threshold test for future foreign corporations, would be held valid under the United States Constitution both with respect to the taxing power and the power to regulate foreign commerce.[28]

Joint committee staff legal memorandum

The Joint Committee staff memorandum confirmed the basic concern and thinking of members of the House Ways and Means Committee, particularly on the question of the appropriateness under the United States Constitution of subjecting United States taxpayers to current tax treatment with respect to undistributed corporate income on the basis of constructive receipt:[29]

"*The administration's proposal is that the income earned by foreign corporations be taxed to the American shareholders without any distribution or dividend declaration. This raises certain basic questions as to whether or not the shareholder has income within the meaning of the 16th amendment when he has received nothing and does not have the right and power to demand any payment.*" [Emphasis supplied.]

The staff memorandum emphasized the separateness of corporate entities, even in the case of a United States subsidiary wholly-owned by a foreign government, and distinguished the Subpart F proposal from the foreign personal holding company provisions which were described as a special case which must be viewed as depending on the power of Congress to prevent an obvious tax-evasion device. Finding no basis to justify current dividend-like taxation of undistributed foreign corporate earnings, the staff memorandum further concluded that the constructive receipt had no application because the United States shareholder had no power to declare a dividend and therefore lacked the power to demand the payment which makes the constructive receipt doctrine operative. Accordingly, the Joint Committee staff memorandum rejected the Treasury Department's contentions and adopted the view that only when a United States shareholder possessed the power to declare a dividend would the constructive receipt theory provide an appropriate basis for current taxation.

1973 and 1974 tax proceedings

In January 1973, the Chairman of the House Ways and Means Committee announced that extensive public hearings would be held on tax reform, specifically noting taxation of foreign income.

In November 1974, pursuant to tentative decisions on tax reform proposals, the House Ways and Means Committee agreed to modify the definition of foreign base company sales income to exclude income arising from the sale of goods manufactured abroad. This change was reflected in a bill entitled, the "Energy Tax and

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[28] See memorandum prepared by the United States Treasury Department entitled, "Opinion re Proposal to Include in Gross Income of United States Shareholders Undistributed Earnings and Profits of a Controlled Foreign Corporation", June 12, 1961.

[29] See memorandum prepared by the staff of the Joint Committee on Internal Revenue Taxation entitled, "Constitutional Power to Tax Shareholders on Undistributed Income of a Corporation, p. 311.

Individual Relief Act of 1974", introduced by Congressman Mills and referred to the Committee on Ways and Means.[30]

The Report of the House Ways and Means Committee accompanying the "Energy Tax and Individual Relief Act of 1974" provided an explanation of the Committee's reasons for this contemplated change in the definition of foreign base company sales income: [31]

"Your committee's bill changes the definition of foreign base company sales income (i.e., what sales income constitutes tax haven income) to exclude sales income from goods manufactured, produced, grown, or extracted outside of the United States."

Tax Reduction Act of 1975

In March 1975, the President of the United States signed the Tax Reduction Act of 1975 (sometimes hereinafter referred to as the "TRA"), thus providing for several significant modifications concerning United States taxation of foreign source income: [32]

1. The so-called "30-70" "safe haven" or "shielding" rules which had applied to CFCs where foreign based company income constitutes less than 30 percent of gross income were amended to reduce the relevant threshold test to less than 10 percent;
2. The minimum distribution exception to current taxation of Subpart F income was terminated;
3. The exclusion for certain foreign personal holding company income reinvested in less developed countries was eliminated; and,
4. The exception for foreign base company shipping income was limited to income reinvested in shipping operations.

The relevant House bill had contained no provisions amending United States rules for CFCs and their United States shareholders.[33] Nor did the Senate Finance Committee recommend changes in this area of United States tax law.[34] Nevertheless, pursuant to amendments voted on the floor of the Senate, it was provided that United States persons holding a one percent or greater interest in a foreign corporation would be taxed currently on their proportionate share of the income from such a corporation in cases where more than 50 percent of the stock of the corporation was controlled by United States persons.

The House and Senate conferees adopted a compromise approach which did not eliminate deferral across-the-board, but rather expanded on the Subpart F approach to tax specific categories of income on a current basis: [35]

"The conference substitute provides for a number of specific measures which substantially expand the extent to which foreign subsidiaries of U.S. corporations are subject to current U.S. taxation on tax haven types of income under the so-called subpart F rules of the Code.

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"The conference substitute repeals the minimum distribution exception to the subpart F rules which, under present law, permits a deferral of U.S. taxation on tax haven types of income in cases where the foreign corporation (or various combinations of foreign-related corporations) distributed certain minimum dividends to their U.S. shareholders. The effect of repealing this exception is to tax currently all income of foreign subsidiaries of U.S. corporations which is deemed to be tax haven income under the existing so-called subpart F rules of the Code. An exception to this provision was made for agricultural commodities not produced in commercially marketable quantities in the United States. Under the exception, these commodities grown (or raised) abroad are to be excluded from foreign base company sales income."

It was noted at the time of conference, that unless an agricultural commodities exception was adopted, the competitive position of United States owned firms

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[30] See § 332, Energy Tax and Individual Relief Act of 1974, H.R. 17488, 93rd Cong. 2d Sess., November 21, 1974.

[31] See Report of House Ways and Means Committee accompanying H.R. 17488, pp. 313 and 132. H Rep. No. 93-1502, 83rd Cong. 2d Sess., November 26, 1974.

[32] See § 602, Tax Reduction Act of 1975, P.L. 94-12, H.R. 2166, 94th Cong. 1st Sess., 89 Stat. 58, March 29, 1975.

[33] See Tax Reduction Act of 1975, H.R. 2166, 94th Cong. 1st Sess., March 17, 1975.

[34] See Report of the Senate Finance Committee accompanying H.R. 2166, Sen. Rep. No. 94-36, 94th Cong. 1st Sess., March 17, 1975.

[35] See Conference Report accompanying H.R. 2166, p. 70, Rep. No. 94-120, 94th Cong. 1st Sess., March 26, 1975.

participating in international agricultural commodities trade would be undermined with the result that this important business would be transferred to foreign owned firms beyond United States tax jurisdiction and control and that this would be contrary to important United States national and international interests.

It was recognized that under United States tax law, United States owned firms had for many years competed on an equal tax footing with foreign owned firms in world agricultural trade. As a result United States owned firms were involved in a significant portion of this trade. However, if United States owned firms were required to pay taxes on a current basis they could not compete in this market, as they possess no special advantages such as technology or established brand names that would enable them to absorb such a significant tax disadvantage. United States firms buy and sell the same commodities as their foreign owned competitors. No other country in the world taxes earnings on this trade on a current basis.

Following enactment of the Tax Reduction Act of 1975, it was recognized that certain ambiguity was inherent in language chosen to create the new agricultural commodities exception.

Tax Reform Act of 1975

The issue of the agricultural exception was raised again during proceedings of the House Ways and Means Committee in late 1975.[36] The consensus was that a technical amendment was probably incorporated in the 1975 House Bill to accomplish this purpose, provided:[37]

"(a) IN GENERAL.—The last sentence of paragraph (1) of section 954(d) (relating to definition of foreign based company sales income) is amended to read as follows:

> 'For purposes of this subsection, personal property does not include agricultural commodities which are significantly different in grade or type from and are determined by Secretary of the Treasury after consultation with the Secretary of Agriculture not to be readily substitutable for (taking into account consumer preferences) agricultural products grown in the United States in commercially marketable quantities.'"

The House Ways and Means Committee advanced the following arguments in support of revising the language of the Tax Reduction Act of 1975:[38]

"* * * One of the categories of tax haven income subject to current taxation under the subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to your committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. Your committee believes that sales of foreign-grown agricultural products which are not readily substitutable for U.S.-grown agricultural products should not be included within the definition of foreign base company sales income in the case of sales made to third countries. *Your committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies would have difficulty competing with foreign-controlled companies. Accordingly, your committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States.*" [Emphasis supplied.]

Nowithstanding the clear concern of the House Ways and Means Committee that the United States owned companies be given a continuing opportunity to compete for this important business, it was recognized that substantial complexity might be involved in interpreting this language as a consequence of inherently difficult constructions.

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[36] See Committee Print prepared for the use of the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation concerning U.S. Taxation of Foreign Soucre Income, p. 8, September 27, 1975.

[37] See Section 1025 of the Tax Reform Act of 1975 (concerning limitation on definition of foreign base company sales income in the case of certain agricultural products), H.R. 10612, p. 211 and 212, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

[38] See Report of the House Ways and Means Committee accompanying H.R. 10612, p. 221, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

Tax Reform Act of 1976

In early December 1975, the full House passed the Tax Reform Act of 1975, H.R. 10612, and referred the bill to the Senate. Because of time constraints and other considerations, the Senate Finance Committee directed its immediate attention to the tax reduction provisions of the 1975 House bill and did not undertake consideration of the tax reform provisions of the bill.

During the month of December 1975, the House and Senate debated and acted on this legislation and then forwarded a bill to the President to extend tax reductions until June 30, 1976. The tax reform provisions of the 1975 House bill, including the provisions modifying the agricultural exception to Subpart F, were not considered by the Senate Finance Committee in 1975.

In February 1976, the Chairman of the Senate Finance Committee announced that the Committee would begin hearings in March 1976 on major tax revision proposals and extension of expiring tax cut provisions. Following these hearings, the Senate Finance Committee proceeded with mark-up of the subject tax legislation and reported out a bill for consideration of the full Senate in June 1976.[39]

Based on considerations noted above, the Senate Finance Committee initially adopted an agricultural commodities exception based on the third market country approach:[40]

"SEC. 1025. LIMITATION ON DEFINITION OF FOREIGN BASE COMPANY SALES INCOME IN THE CASE OF CERTAIN AGRICULTURAL PRODUCTS.

(a) IN GENERAL.—The last sentence of paragraph (1) of section 954(d) (relating to definition of foreign base company sales income) is amended to read as follows: 'For purposes of this subsection, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States.'

This approach provided a clear and easily administered standard which would enable United States owned firms to compete for this important third country trade without significant doubts about the tax consequences under United States laws.

The following reasons for adopting this approach were noted in the Senate Finance Committee report.[41]

"Certain agricultural products

Reasons for change

As indicated above, one of the categories of tax haven income subject to current taxation under the subpart F provisions of the Code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to the committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. The committee believes that sales of foreign-grown agricultural products for use, consumption, or disposition outside the United States should not be included within the definition of foreign base company sales income. *The committee is aware that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies could have difficulty competing with foreign-controlled companies. Accordingly, the committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States.* [Emphasis supplied.]

Explanation of provisions

The committee's amendment provides that for purposes of the tax haven foreign base company sales rules of subpart F, personal property does not include agriculture commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States. The committee believes that this rule will be easier for the Internal Revenue Service to administer than either the rule contained in present law or the rule contained in the House bill."

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[39] See Report of the Committee on Finance. United States Senate, accompanying H.R. 10612, Rep. No. 94-938, 94th Cong. 2d Sess., June 10, 1976.

[40] See H.R. 10612, Rep No. 94-938, 94th Cong., 2d Sess., p. 471, June 10, 1976.

[41] See Report of the Committee on Finance. United States Senate, accompanying H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., pp. 232-233, June 10, 1976.

As noted above; in accordance with its consideration of the House-passed Tax Reform Act of 1975, the Senate Finance Committee initially adopted an agricultural commodities exception based on the third market country approach. This language was subsequently dropped from the Senate-passed Tax Reform Act of 1976.[42]

Although the House-Senate Conference Committee on the Tax Reform Act of 1976 chose not to adopt the agricultural exception to Subpart F under Section 1025 of the House-passed Tax Reform Act of 1975, it is significant that both the House Ways and Means Committee and the Senate Finance Committee had determined that important United States national and international interests would be served by preserving an ongoing opportunity for United States owned firms to participate in international agricultural trade, the final provisions of the Tax Reform Act of 1976 left unchanged the language of the Tax Reduction Act of 1975 on this matter.[43]

ECONOMIC AND TRANSACTIONAL DISTINCTIONS INVOLVING INTERNATIONAL TRADING OPERATIONS

The decisions of the House Ways and Means Committee and the Senate Finance Committee to create a new Subpart F exception for income derived from sales of agricultural products produced abroad reflected awareness that in certain instances, United States interests are not served by taxing the operations of United States owned foreign corporations on a current basis. More specifically, the Congress recognized inherent economic distinctions between manufacturing and mining activities on the one hand and agricultural marketing and international trading operations on the other. These industries involve fundamentally different international economic and marketing considerations. A manufacturing company may utilize a trading affiliate in a low-tax jurisdiction to handle exports of its products manufactured within or without the United States. Owing to the nature of manufacturing processes, such arrangements could potentially displace United States exports of domestically manufactured goods as a consequence of the ability to shift manufacturing processes to various countries.

Conversely, trading of commodities in international commerce is not similarly susceptible to this form of shifting and United States export displacement. For example, grains, oilseeds, and other agricultural commodities are produced by individual farmers in particular countries. The nature and quantity of agricultural commodities depends on matters such as climate, available land, etc. Although most production is consumed in the producing country, residual supplies are sold in world trade channels by exporters and intermediate resellers unrelated to the farmer-producers. Consequently, international agricultural trading activities have traditionally involved a structure that includes intermediate resellers (organized in low-tax jurisdictions) which are controlled by both United States owned companies and foreign owned companies.

As noted above, the Congress has recognized that the effect of taxing on a current basis the income of United States owned international trading companies would be to shift important commercial advantages to foreign based international trading companies.

International commodities trading

United States controlled foreign based trading companies compete in a complex business requiring skilled management and extensive resources. The basic role of international commodity traders is to anticipate demand for commodities throughout the world and to position themselves in relation to each of the basic elements of commodities trade—for example, the commodity itself, freight, foreign exchange and, in some cases, import levies—so that they can compete for sales as demand emerges. Back-to-back purchases and sales are rarely possible. Instead, positions must be taken before the emergence of new demand or new supply is fully reflected in price adjustments. Risk is unavoidable because values of each of the elements of a commodity trade are subject to continuous change. Effective management of risk in this environment is critical to success. Both the volume and value of the commodities involved in international transactions are enormous. Therefore, substantial working capital is required. Trading firms traditionally operate facilities required to handle and transport commodities.

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[42] See H.R. 10612, 94th Cong., 2d Sess., August 6, 1976.
[43] See Tax Reform Act of 1976, P.L. 94–455, H.R. 10612, 94th Cong., 2d Sess., 90 Stat 1520, October 4, 1976.

The need for related companies in international trading operations

Although theoretically, United States trading companies could avoid Subpart F problems by dealing with unrelated companies, as a matter of practical necessity, this is not possible. As noted below, related companies have been required not for tax reasons, but rather for business and marketing purposes. Furthermore, as noted elsewhere, it is essentially impossible to shift earnings and profits among related companies as a consequence of other provisions of United States tax law.

A number of considerations are involved in deciding whether a domestic affiliated company is necessary to be competitive in buying commodities from or selling commodities to a particular country. For example, the limited amount of business available may not justify the costs of organizing a separate company (Greece, Norway, Sweden, Kenya and Tanzania). Limitations imposed by the local government often are decisive (Eastern Europe and in the People's Republic of China). The dominant role of a government marketing agency may limit competitive opportunities for domestic affiliates (South Africa).

On the other hand, in other countries it is often necessary to use a local subsidiary engaged in domestic marketing, exporting and importing grain. To the extent that a significant free market operates within an exporting country, it is seldom possible to compete as an f.o.b. buyer with other international trading firms which can originate grain through offices and elevators controlled by a domestic affiliate. Sellers in these countries sometimes require and usually prefer to deal with a domestic subsidiary whose representatives are available to provide within the jurisdiction of the host country. The same considerations often apply to selling grain in countries of ultimate destination. Moreover, both in selling and buying countries, market intelligence gained through involvement in domestic market operations improves opportunities for concluding trades. This can be true even in countries in which government marketing boards play an important role (for example, Canada and Australia). Thus, the decision tò organize and deal through a domestic affiliate both in buying and selling agricultural commodities turns mainly on business considerations as distinguished from tax considerations.

Although related companies are often used in these transactions, as a practical matter, there is limited need for concern regarding prospects for shifting earnings and profits among a group of related companies for tax purposes. Policing of intercompany pricing among related firms dealing in agricultural commodities is more simple and effective than policing of transactions in manufactured goods. Prices are easily established based on transactions publicly noted by commodity futures exchanges. Furthermore, comparisons are possible between transactions involving identical commodities with related and unrelated firms. Therefore, in this context, the United States Internal Revenue Service can effectively audit these transactions under Section 482 of the Internal Revenue Code (pertaining to arms-length standards for related companies). in a continuous basis, which provides further support for the proposition that the decision to establish domestic marketing subsidiaries in supplying and consuming countries (and transactions among these related companies) are predicated on business and marketing considerations rather than on considerations.

Typical transactions

The following transactions will illustrate the operations of related companies in international agricultural trade; the limited scope of proposed exceptions; and competition at each stage among United States controlled and foreign controlled foreign based firms. In each case, transactions can involve the related company organized in the country of origin to assemble commodities from producers and local resellers; a related company operating in a country of ultimate use to receive the shipment, break it down. and resell it to local users; and, between these different elements, a separate risk taking profit center capable of assessing world market conditions, anticipating demand, identifying supplies available from diverse sources, assembling other elements of an international transaction and putting them all together in a saleable package that meets the needs of sellers in originating countries and buyers in countries of ultimate use.

Production and use abroad (third market countries)

ABC Grain Company, Ltd., a Canadian corporation, may buy wheat from the Canadian Wheat Board and resell it f.o.b. Canadian port to ABC Interna-

tional, a United States affiliated international trading company. ABC International, in turn, will resell it c.i.f., or c and f, to an Italian buyer for redistribution to flour millers within Italy (Italian buyer may be a related company). In such a transaction, the ABC group of companies would compete at each stage with foreign controlled international commodities trading firms.

Production in United States and use abroad (U.S. exports)

Sales of United States grains and other agricultural commodities to foreign destinations typically involve a number of different channels, usually beginning in a company organized in the United States. Sales of wheat to India, for example, almost always involved direct sales from a United States company to the Indian Buying Mission, which maintains offices in the United States. A sale of United States corn to Western Europe could involve a United States company as the f.o.b. seller to an affiliated international trading corporation which avails itself of United States tax incentives designed to stimulate United States exports f.o.b. an American port. The affiliated international trading corporation, in turn, could resell c.i.f. to an unrelated third party for resale in Western Europe. A sale of United States wheat to the Soviet Union also might involve a sale by a United States company to an affiliated international trading corporation f.o.b. delivered on board at an American or St. Lawrence port and a resale by the affiliated international trading corporation to the Soviet grain buying agency.

Production abroad and use in United States

Sales of agricultural commodities produced abroad and imported into the United States also involve somewhat different patterns, usually culminating with a purchase by a United States company. For example, a United States controlled affiliated company in the Philippines, purchases coconut oil and coconut meal from local firms and resells it to buyers in the United States (including its United States parent) and in Western Europe (possibly to an affiliated company for resale in the country of ultimate consumption).

Effects of current taxation on competition between U.S. owned foreign sales companies and their foreign owned competitors

Without an appropriate exception, United States controlled international trading companies would be subject to United States current taxation on undistributed earnings of most sales of agricultural commodities produced and consumed outside the United States. Such transactions would not have been subject to current taxation in the past. Foreign controlled foreign based international trading companies, able to utilize arrangements which do not subject them to current taxation on income derived from these transactions, will possess a decisive competitive advantage.

The effect of differential tax treatment can be illustrated by an example:

A French based company and a United States based company may engage in similar transactions involving international trade of agricultural commodities. Such commodities can originate from any of a number of major exporting nations, such as the United States, Canada, Brazil, Argentina, South Africa, Australia or the European Community, and move to a number of major importing areas, such as Western Europe, the Indian subcontinent, the Middle East, Central America or elsewhere. A French based company and a United States based company may operate through foreign subsidiaries established in Panama in order to participate on a competitive basis in such international agricultural trade. Each of these companies may purchase soybeans grown in Brazil and ship the commodity to a European nation, realizing a profit of $100 on this type of transaction.

If a Panamanian subsidiary of a United States based company is forced to pay accelerated United States income tax (current taxation of $48 by means of eliminating deferral)), the United States based company would have substantially less capital available for competitive purposes ($52 as a result of the $48 United States tax on $100 profit). In contrast, a Panamanian subsidiary of a French based company would pay no immediate tax, as neither Panama nor France would impose a current tax on this type of transaction, thus, all $100 of pre-tax profits would be available for future competitive purposes.

Thus, under these circumstances, the United States controlled foreign based company would not be able to compete with foreign controlled counterparts in the third market countries trade in agricultural commodities:

Limited capacity to absorb tax disadvantages

Unlike United States controlled firms manufacturing products abroad and distributing them in world markets through a foreign based sales company, United States traders in basic agricultural commodities in world markets possess no unique advantages like established brand franchises or product superiority to offset fundamental tax disadvantages. The products they offer—agricultural surpluses of other countries—are the same products offered by foreign based competitors, acquired from the same sources, and distributed to the same markets.

Financing international trade

An essential requirement for successful competition in this trade is access to adequate amounts of capital. Major sources are retained earnings and borrowings. Impact of differential tax treatment on retained earnings is clear. However, the impact of differential tax treatment on the ability to borrow capital to finance trade is less clear, but equally important.

Capital requirements for international trading operations have increased significantly as commodity prices have risen above levels in the 1960s. Moreover, because prices now fluctuate through a broader range than before, the risks to lenders financing international agricultural trade has increased. Thus, risks associated with lending funds to international traders have increased simultaneously with their capital needs.

There is substantial competition for capital in this area. and foreign based firms (operating with the same prudence and skill as United States based firms) would have a substantial competitive edge over United States based firms if United States based firms are penalized by changes in United States tax law which would provide a comparative advantage to their foreign based competitors.

Human resources

As noted above, risk is unavoidable in international trading of agricultural commodities because the values of all elements of a commodity trade are subject to continuous change. Back-to-back transactions involving these elements are rarely possible and therefore success is heavily dependent upon human judgments of future events. Skilled merchants and traders, capable of managing risk in this environment, are an essential resource in international trading operations. United States owned firms cannot attract and hold skilled merchants and traders also sought by foreign based firms if, because of substantial tax advantages, earnings from operations reflecting the same level of skill and insight are no more than half the earnings of their foreign competitors.

Collateral effects on U.S. exports

An ability to compete effectively on an international basis in global commodities transactions would severely limit the capacity of United States based international trading companies to locate and expand markets for surplus agricultural commodities produced in this country.

The needs of buyers of agricultural commodities in international markets often can be met by supplies from a number of possible origins. Indeed, sellers are often given the option of supplying agricultural commodities produced in different countries. United States based international trading firms typically have substantially greater investments in facilities for originating, handling, transporting, storing and delivering agricultural commodities produced in the United States, and therefore have a greater incentive to encourage the purchase of commodities produced in this country wherever possible. Their inability to compete in all international transactions involving agricultural commodities would deprive the United States of opportunities that would otherwise exist for substituting exportable surpluses of agricultural commodities produced in the United States.

It is important for another reason that United States based firms participate in transactions involving commodities produced abroad even where the possibility of substituting United States commodities does not exist. Market intelligence gained in these transactions increases the effectiveness of U.S. based international trading firms in selling United States produced commodities abroad. Market intelligence enables a trader to anticipate events and to take positions before prices adjust to reflect the influence of new supply and demand. By trading in all international markets, United States based international trading companies are better positioned to sell agricultural products produced in the United States.

CONGRESSIONAL CONCERN ABOUT THE COMPETITIVE POSITION OF THE UNITED STATES IN INTERNATIONAL TRADE NEGOTIATIONS

Trade Act of 1974

In his opening statement of March 4, 1974, commencing the Senate Finance Committee hearings on the Trade Reform Act of 1973, H.R. 10710 (later to be voted into law as the Trade Act of 1974), Chairman Russell B. Long stated: [44]

"I was very much in favor of the Trade Expansion Act of 1962. I still desire an 'open nondiscriminatory, and fair world economic system,' but I am tired of the United States being the 'least favored nation' in a world which is full of discrimination. We can no longer expose our markets, while the rest of the world hides behind variable levies, export subsidies, import equalization fees, quotas, and a host of other practices which effectively bar our products." [Emphasis supplied.]

GATT reform

In the context of reform of the General Agreement on Tariffs and Trade ("GATT"), the Congress has specifically instructed United States trade negotiators to seek revision of those GATT articles which discriminate against the United States, and it is clear from the statutory language that the Congress was particularly concerned about this matter with respect to the DISC: [45]

"The President shall, as soon as practicable, take such action as may be necessary to bring trade agreements heretofore entered into, and the application thereof, into conformity with principles promoting the development of an open, nondiscriminatory, and fair world economic system. The action and principles referred to in the preceding sentence include, but are not limited to, the following—

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"The revision of GATT articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs . . ."

Congressional oversight involving international trade negotiations

The Senate Finance Committee has stated that the Congress will be actively involved in securing full reciprocity and equal competitive opportunities for United States interests: [46]

"The Trade Reform Act, as reported by the Committee, is intended to be more than a delegation of authority for negotiated reduction in the rates of duty. While a significant authority to reduce tariffs would be provided to insure the flexibility the trade negotiations will require, our foreign trading partners and our negotiators are on notice that the authority must be exercised to obtain full reciprocity and equal competitive opportunities for U.S. commerce."

House Ways and Means Committee task force on U.S. taxation on foreign source income

During the course of consideration of the Tax Reform Act of 1975, the House Ways and Means Committee established a special task force to study United States taxation of foreign source income (sometimes hereinafter referred to as the "Foreign Source Income Task Force"). This task force was instructed to report its findings and recommendations to the full Committee.[47]

On March 8, 1977, the Foreign Source Income Task Force issued its report (sometimes hereinafter referred to as the "Foreign Source Income Task Force Report").[48]

Based on its deliberations, the Foreign Source Income Task Force recommended no changes with respect to the tax treatment of deferred earnings of foreign corporations controlled by United States shareholders.[49]

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[44] See Hearings before the Senate Finance Committee concerning The Trade Reform Act of 1973, H.R. 10710, Part 1, p. 2, 93rd Cong., 2d Sess., March 4 and 5, 1974.

[45] See § 121 of the Trade Act of 1974, P.L. 93-618, H.R. 10710, 93rd Cong., 2d Sess., 88 Stat. 1978, January 3, 1975.

[46] See Report of the Senate Finance Committee accompanying H.R. 10710, p. 18, S. Rep. No. 93-1298, 93rd Cong., 2d Sess., November 26, 1974.

[47] See Press Release No. 12, House Ways and Means Committee, January 5, 1976.

[48] See House Ways and Means Committee report entitled "Recommendations of the Task Force on Foreign Source Income", 95th Cong., 1st Sess., March 8, 1977.

[49] *Id.* at p. 59.

The final statement of the Foreign Source Income Task Force on this matter not only reconfirms strong support for international and multilateral approaches to certain international tax policy issues (as distinguished from unilateral action under the Internal Revenue Code), but the language chosen for this purpose is even broader in scope than the language contained in earlier draft reports:[50]

"*In its consideration of the several questions referred to it, the task force found that fundamental change by the United States in the taxation of foreign source income in many areas requires the agreement and cooperation of foreign governments. Certain changes which might otherwise have been appropriate were found not to be acceptable if unilaterally adopted by the United States because they would subject U.S. businesses operating abroad to tax while their foreign competitors would not be similarly taxed, thus placing the U.S. businesses at a competitive disadvantage. Others were found to be unacceptable because they would subject foreign businesses to U.S. tax under circumstances involving a substantial possibility of retaliatory taxes by foreign governments against U.S. businesses operating abroad. Therefore, in addition to its specific recommendations directed toward the particular issues considered by the task force, the task force strongly recommends that steps be taken to initiate multilateral discussions between the United States and our major trading partners to consider a broad range of tax and investment questions, in particular those areas where unilateral action by any single nation is not feasible.*" [Emphasis supplied.]

GATT PANEL DECISIONS ON CERTAIN TAX PRACTICES OF THE UNITED STATES, FRANCE, BELGIUM, AND THE NETHERLANDS

GATT DISC panel decisions

In accordance with procedures under the provisions of the General Agreement on Tariffs and Trade "GATT"), a panel was established in July 1973 to examine a complaint submitted by the European Communities ("EC"), pursuant to paragraph 2 of Article XXIII of the GATT, relating to United States tax legislation on the Domestic International Sales Corporation ("DISC"), and to make such findings as would assist the Contracting Parties of GATT to make recommendations or rulings provided for in paragraph 2 of Article XXIII of GATT (this panel is sometimes hereinafter referred to as the "GATT DISC Panel").

The EC requested the GATT DISC Panel to find that the DISC system was incompatible with the relevant clauses of GATT regarding export subsidies.

In the course of its proceedings, the GATT DISC Panel held consultations with the EC and the United States, and background arguments and information were submitted by both parties.

Based on its findings, in November 1976, the GATT DISC Panel concluded that the DISC legislation, in some cases, had effects which were not in accordance with United States' obligations under Article XVI(4) of GATT and that as it had found the DISC legislation to constitute an export subsidy which had led to an increase in exports it was also covered by the notification obligation contained in Article XVI(1) of GATT and that accordingly there was a prime facie case of nullification or impairment of benefits under GATT.

GATT European tax practices panel decisions

Partially in response to the aforementioned EC complaint, the United States initiated counter claims and proceedings against certain tax practices of France, Belgium and the Netherlands alleging that such tax practices constituted export subsidies in violation of GATT. In accordance with GATT procedures, separate GATT panels were established in July 1973 to examine the United States complaints with respect to each of the subject countries, pursuant to paragraph 2 of Article XXIII of the GATT, and to make recommendations or rulings provided for in paragraph 2 of Article XXIII of the GATT (these panels are sometimes hereinafter collectively referred to as the "GATT European Tax Practices Panels").

The United States requested the GATT European Tax Practices Panels to find that certain tax practices of France, Belgium, and the Netherlands violated Article XVI(4) of GATT and that there was therefore a prima facie case that these practices were nullifying or impairing benefits accruing to the United States under GATT.

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[50] *Id.* at p. 2.

The United States also suggested that the four complaints involving the DISC and certain tax practices of France, Belgium and the Netherlands should be considered together because they raised the same principles concerning application of GATT.

In the course of its proceedings the GATT European Tax Practices Panels held consultations with the United States, France, Belgium and the Netherlands, and background arguments and relevant information were submitted by each of these parties.

Based on their findings, in November 1976, the GATT European Tax Practices Panels concluded that the tax practices of France, Belgium and the Netherlands, in some cases, had effects which were not in accordance with the respective obligations of these countries under Article XVI(4) of GATT and that as these practices had been found to constitute export subsidies which had led to increases in exports they were also covered by the notification obligations contained in Article XVI(1) of GATT and that accordingly there were prima facie cases of nullification or impairment of benefits under GATT with respect to the subject practices of each of these countries.

Representative GATT panel findings and determinations on income tax practices of France

The GATT panel on French tax practices related the following factual aspects regarding the tax practices in question.[51]

"The French income tax system for corporation is based on the territoriality principle which, in general, taxes income earned in France but not income arising outside France. It is a principle deriving from the history of the French system dating back to the beginning of the century. French companies are liable to corporation tax solely in respect of profits made by enterprises operating in France and of profits taxable by France under an international double taxation agreement (Article 209:1 of Code Generale des Impots).

"Under the territoriality rule as applied by France profits generated by undertakings operated abroad are exempt from French taxation. On the other hand, a French company is not entitled to any foreign tax credit and cannot deduct losses suffered abroad, apart from exceptions specified below.

"Ninety-five per cent of dividends from the French or foreign subsidiaries of a French company is excluded from the profits of the parent corporation. Participation by the parent in the subsidiary must exceed 10 per cent (Article 145 and 216 of CGI)."

On the effects of the territoriality principle as applied by France for taxation of foreign profits, the panel noted:[52]

"The representatives of the United States pointed out that France followed the territoriality principle of taxation, and that as a result, did not tax the export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms. Taxes on such income were the most part permanently forgiven rather than merely deferred. He stated that the exclusion apparently extended to foreign source income from activities carried out by a French selling corporation through its own agents or employees abroad even without a foreign permanent establishment, as income from transactions which were separate from the corporation's French operations and which constituted complete commercial cycles outside France were excludable. The representative of the United States argued that these provisions, and relaxed intercompany pricing rules and other practices in relation to export transactions, created a distortion in conditions of international competition in that they afforded remission or exemption of direct taxes in respect of exports in violation of France's commitment as a contracting party under Article XVI:4. The permanent exemption could be freely used by the domestic manufacturing firm. The relative tax burden on the sales of products for export as against domestic sales was lower as a result of the remission.

"The representatives of the United States argued that, by organizing a foreign branch or subsidiary in a low-tax country, a French manufacturing firm could enjoy the low-tax rate on that portion of the total export sales income which was allocated to the foreign branch or foreign sales subsidiary, that the amount of export sales income allocated to foreign sources was generally substantial, that under the French system the right to tax foreign income was given up. He con-

[51] See Report of GATT Panel on Income Taxes Maintained by France, p. 2, November 2, 1976.
[52] *Id.* at p. 4.

cluded that at a minimum the sales element of export earnings was exempt from taxation and therefore subsidized in violation of Article XVI : 4."

The panel stated the following concerning the effects of the territoriality principle as applied by France for taxation of foreign dividends :[53]

"The representatives of the United States stated that under the territorial principle, profits of a foreign subsidiary were not consolidated with the profits of its French parent, and so not taxed in France. He went on to make the point that even if the subsidiaries' profits were repatriated in the form of a dividend, 95 per cent of it was deducted from the taxable income of the company, whether or not the foreign subsidiary was subject to taxes in its country of residence, and whether or not the rate of tax applied by that country was less than the French rate. In fact, the dividend was not expected to be taxed at all, as the remaining 5 per cent was considered to be deducted as ordinary expenses against the taxes of the recipient corporation. He argued that this amounted to a permanent exemption from taxation."

In its conclusion and recommendations, the panel determined the following:[54]

"The Panel noted that the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.

"The Panel found that however much the practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context.

"The Panel also noted that the tax treatment of dividends from abroad ensured that the benefits referred to above were fully preserved."

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"The Panel therefore concluded that the French tax practices in some cases had effects which were not in accordance with French obligations under Article XVI : 4."

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"The Panel considered that the fact that these arrangements might have existed before the General Agreement was not a justification for them and noted that France had made no reservation with respect to the standstill agreement or to the 1960 Declaration (BISD, 9 Suppl. p. 32).

"The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in French exports in some sectors and, although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI : 1.

"In the light of the above, and bearing in mind the precedent set by the Uruguayan cases (BISD, 11 Suppl. p. 100), the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement."

The relevant GATT panels charged with responsibility for reviewing the income tax practices of Belgium and the Netherlands made findings and determinations similar to those for France in concluding that the tax practices of Belgium and the Netherlands were also in violation of GATT obligations.

Congressional involvement in GATT panel proceedings

During the course of GATT consideration of DISC and certain tax practices of France, Belgium and the Netherlands, Members of the House Ways and Means Committee and the Senate Finance Committee participated in the GATT sessions in Geneva, Switzerland. Based on these international proceedings, and other arguments and submissions, Members of the House Ways and Means Committee and the Senate Finance Committee have recently indicated that the United States should take a hardline position on these issues in international

[53] *Id.* at p. 7.
[54] *Id.* at pp. 11–13.

trade negotiations (as distinguished from United States unilateral action on DISC), and that such an approach comports with United States international tax and trade policy objectives and United States international negotiating opportunities.

Although representatives of the European Communities and the United States raised the GATT Panel Decisions at the GATT Council meeting in Genéva, Switzerland on March 2, 1977, it is understood that this matter has, on several occasions, been postponed for further consideration. In this regard, it is important for the representatives of the United States to be well prepared on substantive and procedural issues and negotiating techniques in order to maximize opportunities for obtaining beneficial results for the United States in these proceedings. Such efforts should emphasize consultations and technical analysis involving Members and staff of the House Ways and Means Committee and the Senate Finance Committee, staff of the Joint Committee on Taxation, and officials of STR and Treasury in an effort tō obtain a United States domestic consensus on these issues before undertaking specific initiatives in an international context.

In the past, representatives of the United States federal government have experienced ongoing difficulties in attempting to secure open and nondiscriminatory treatment for United States exports through elimination or reduction of trade distorting practices of other nations.

Nevertheless, new opportunities are now available concerning the relationship of United States domestic tax legislation and international trade proceedings and negotiations, particularly in the matter of the GATT Panel Decisions. Accordingly, at this time, it would seem particularly unwise for the United States to unilaterally eliminate or reduce DISC benefits, thereby handicapping United States trade negotiators.

Again, it should be urged that the United States regain DISC, and other tax benefits, including deferral, under United States domestic tax law until such time as requisite concessions have been obtained from our trading partners. Such an international trade negotiations approach (as ditsinguished from unilateral legislative action) comports with United States international tax and trade policy objectives and strengthens the United States bargaining position by providing needed leverage and negotiating tools for dealing with the trade distorting and discriminatory practices of other nations.

Conclusion and Recommendations

Although it is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income, it should be noted that despite varied approaches to taxation (worldwide territorial, and certain forms of exemptions and credits), not one of the major free market trading nations of the world, other than the United States, taxes currently the undistributed earnings and profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that the United States taxes undistributed earnings and profits of United States owned international trading firms on a current basis, this places United States based companies engaged in international trading operations at a competitive disadvantage and constitutes a departure from the general scheme of international taxation practiced by other nations.

During the course of considertion of the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the more recent deliberations and recommendations of the House Ways and Means Committee Task Force on Taxation of Foreign Source Income, the United States Congress has indicated an increasing awareness that, in certain instances, United States interests are not served by taxing currently the undistributed earnings and profits of United States owned foreign corporations.

More specifically, the Congress has recognized inherent economic distinctions between manufacturing and production operations on the one hand, and international marketing and trading activities on the other. These industries involve fundamentally different transactional considerations. A manufacturing company may utilize a trading affiliate in a low-tax jurisdiction to handle exports of its products manufactured within or without the United States. Owing to the nature of manufacturing processes, such arrangements could potentially displace United States exports of domestically manufactured goods (and United States jobs) as a consequence of the ability to shift manufacturing processes to foreign countries.

Conversely, trading operations in international commerce are not similarly susceptible to this form of shifting which could result in displacement of United States exports and jobs.

In the absence of continuing deferral on the undistributed earnings and profits of United States owned firms derived from international trading activities, the competitive position of such United States firms will be undermined and ultimately this business will be transferred to foreign owned firms beyond United States tax jurisdiction and control.

Under United States tax law, United States owned international trading firms have for many years competed on a substantially equivalent tax footing with foreign owned firms in world trade. As a result United States firms now handle a significant portion of this trade. However, if United States firms are required to pay taxes on a current basis they will not be able to compete in this market. United States firms possess no special advantages which would enable them to absorb significant additional tax burdens. United States firms buy and sell the same commodities as their foreign owned competitors.

As stated in the reports of the House Ways and Means Committee and the Senate Finance Committee noted above, it was determined that it was necessary to provide an exception for sales of agricultural commodities in international trade in order for United States owned firms to continue to participate in this highly competitive business.

In assessing the Carter Administration's tax proposal to eliminate deferral, it is important to give due consideration to the deliberations and decisions of the House Ways and Means Committee Task Force on Taxation of Foreign Source Income which directed considerable attention to the very issues now raised by the Carter Administration. In this regard, the record establishes that the Committee's Task Force on Taxation of Foreign Source Income specifically determined that it would be inappropriate to adopt the changes now recommended by the Carter Administraiton. Furthermore, the recommendations of the Committee's task force noted that problems associated with international tax issues do not always lend themselves to unilateral solutions, but rather require international approaches and negotiations. Accordingly, the statements of the task force clearly support the proposition that the unilateral action now recommended by Carter Administration to eliminate deferral across-board would be contrary to important United States national and international interest. For example, a comparative analysis of tax burdens imposed on foreign owned firms by other countries relative to the tax burden imposed on United States owned firms by the United States clearly demonstrates that the competitive position of United States owned firms engaged in international trading activities would be undermined by the unilateral tax changes recommended by the Carter Administration (unless commensurate tax changes were adopted simultaneously by other countries).

The Carter Administration's tax proposals would also change the threshold rules concerning the definition of a controlled foreign corporation. The legislative history on this matter under the Revenue Act of 1962 indicates that the House Ways and Means Committee rejected similar recommendations of the Kennedy Administration on this subject. In this regard, the Kennedy Administration had also proposed the adoption of a value test, as distinguished from a voting control test, for determining whether a foreign corporation should be treated as a controlled foreign corporation for purposes of Subpart F of the United States Internal Revenue Code.

The points and concerns expresesd by the Congress when this issue was last examined pursuant to the Revenue Act of 1962 are still present today. The primary reason for Congressional rejection of the Kennedy Administration's proposal to, in effect, utilize a value test rather than a voting control test related to considerations of fairness and equity which suggested that United States shareholders should not be taxed on the undistributed earnings and profits of a foreign corporation where such shareholders could not cause a divided distribution to the United States, i.e. the United States shareholders would be unable, as a matter of law, to require the foreign corporation to distribute dividends to the United States shareholders. Accordingly, it is important to recognize that if the Carter Administration's proposed value test were adopted, notwithstanding the prior legislative history on this issue noted above, this could result in United States taxpayers being forced to pay current United States taxes on income which the United States taxpayer had not received and over which the United States tax-

payer had no means of requiring a dividend distribution to the United States. The Carter Administration's proposal to change the threshold definition for a controlled foreign corporation by substituting, in effect, a value test for the voting control test under present law, would be contrary to considerations of equity and fairness which were of major concern to the House Ways and Means Committee and the Senate Finance Committee when the United States Congress last considered this issue.

During the consideration of the legislation which was enacted into law as the Trade Act of 1974, various representatives of the United States Congress expressed concern about the United States position in world trade while specifically noting the need for an open, nondiscriminatory and fair world trading system. It was recognized that the United States could no longer expose its markets while other nations utilize all manner of government-instituted practices to effectively bar United States products and distort international trade.

As part of Congressional oversight of international trade negotiations, the Congress has indicated that it will be actively involved in securing full reciprocity and equal competitive opportunities for United States interests and has noted that the Trade Act of 1974 was intended to be more than a delegation of authority for negotiating duty rate reductions and that United States trading partners and United States negotiators should be on notice that this authority must be exercised to accomplish these objectives.

In accordance with the relevant GATT Panel Decisions noted above, it is significant that the GATT panel on French tax practices (which was representative of the other GATT panels on the tax practices of Belgium and the Netherlands) determined that as a result of the territoriality principle of taxation France did not tax the export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms and that taxes on such income were for the most part permanently forgiven rather than merely deferred.

Although representatives of the United States federal government have experienced ongoing difficulties in attempting to secure open and nondiscriminatory treatment for United States exports through elimination or reduction of trade distorting practices of other nations, substantial opportunities are now available concerning the relationship of United States domestic tax legislation and international trade proceedings and negotiations, particularly in reference to the subject GATT Panel Decisions.

Furthermore, as related above, the House Ways and Means Committee Task Force of Foreign Source Income has reconfirmed its strong support for utilizing international and multilateral approaches with respect to certain international tax policy issues so as to preserve important United States national and international interests. In this regard, unilateral changes to the United States Internal Revenue Code, which would further increase the effective tax burden on United States firms which now participate in international trading activities, would only serve to undermine the competitive position of such United States firms and would result in a transfer of this business (and any income generated by this business) to foreign owned firms beyond United States tax jurisdiction and control.

Based on the points, authorities, developments and considerations set forth above, it is urged that Members of the Senate Finance Committee continue their efforts to assure that United States owned firms engaged in international trading activities will be placed on a substantially equivalent tax footing with their foreign owned competitors.

STATEMENT BY DAYTON-HUDSON CORP.; FEDERATED DEPARTMENT STORES; J. C. PENNEY CO., INC.; K MART CORP.; SEARS, ROEBUCK & CO.; AND THE MAY CO.

I. INTRODUCTION

A. Proposed amendment to the law

The 10 percent investment tax credit should be extended to qualified investment in *new* and rehabilitated retail structures. Although it has been confined to machinery and equipment, the investment tax credit was originally designed and proposed to apply to business structures as well—retail, other commercial, office, industrial and agricultural. The House bill, H.R. 13511, would allow the credit for the cost of rehabilitating an existing building of the type mentioned.

That is a step forward, but greater efficiency and productivity gains would be achieved by allowing the credit for the cost of new buildings as well. At a minimum, the credit should be allowed for the cost of replacing an existing structure with a modern, efficient structure on the same site or in the same market or service area. It is often more economical to replace an outmoded structure than to rehabilitate it.

B. Special case for retail structures

The case for extending the credit to new and rehabilitated retail structures is especially compelling.

The capital needs of the distribution sector are great and growing; the percentage of the fixed capital investment devoted to structures by retailing is more than twice that of manufacturing where nearly 80 percent is spent on machinery and equipment already eligible for the credit. The manufacturing sector and the distribution sector are the two engines of the economy—one to produce goods and the other to distribute them. Both add value. Greater efficiency from increased capital investment in the distribution sector holds down final prices and exerts a strong pull-through effect on manufacturing. Yet, while retailing contributes nearly as much to the GNP as manufacturing, the distribution sector receives only nine percent of the investment tax credit—45 percent of which goes to manufacturers. That disparity is in a significant part due to the fact that retail structures are excluded from the credit—even though structures are the basic productive tool of the retail sector and play a major role in increased efficiency and, hence, productivity. In part for the same reason, retailing pays a high effective rate of tax compared to other sectors of the economy. Measured in constant dollars, investment in commercial structures has actually declined by 28 percent since 1973.

Nevertheless, a dollar of capital investment in retailing is associated with more than three times as many jobs as a dollar of capital investment in manufacturing. In 1977, 22 percent of the nonagricultural work force was in retail and wholesale trade—17 percent in retail alone. One out of every five new jobs created in the 1970's has been in the retail sector. Retailing is nationwide, in every village, town and city, where it contributes to all local economies. In part because of that accessibility of jobs, and because of the high ratio of part-time jobs in retailing, retailing plays a major role in alleviating "structural unemployment." Many women, youths and older persons wish to work, but cannot work full time and would otherwise be unemployed. For example, about half of the 400,000 employees of Sears, Roebuck and Co. work part time.

II. DEFINITION AND FUNCTION OF RETAILING

A. General

Retailing is an extension and necessary element of all consumer products industries—manufacturing and agricultural. The largest single segment of retail trade is GAF which includes general merchandise as well as the apparel, appliance and furniture categories.[1] The other principal elements of retail trade are food stores, stores selling building materials, hardware and farm equipment, and automotive sales.

The functions of the distribution sector, the manufacturing and the agricultural sectors are interdependent. The function of retailing is to provide the capital and skill to assemble the physical output of the economy, to bring those products to the marketplace in the right quantities and locations, and to provide them to consumers at the least possible cost. The output of the retail sector is thus a service—and the value of that output by the retail sector was about $200 billion or ten percent of the Gross National Product in 1977. In effect, the distribution sector provides a market, and assumes the risk, with its own capital, of being able to resell the output of the other sectors of the economy.

B. Efficiency of distribution function exerts a strong pull-through effect on economy

Both manufacturing and distribution add value to the final product and enter into its cost. An efficient distribution system creates a market and exerts a strong "pull-through" effect on manufacturing. Without mass distribution there could be no mass production or mass consumption. Conversely, an inefficient distribution system will have dampening effect, by increasing costs and impeding flows, that may offset incentives in the manufacturing sector and throughout the economy.

[1] U.S. Bureau of the Census, U.S. Census of Retail Trade; 1972, Series RC-72-S-2.

Retailers' costs consist of the amount they pay for their inventory plus the costs they incur in distributing and selling those products. Retailing is highly competitive and to the extent that through efficiencies the costs of distribution are less, the products of manufacturers will be available to the consumer at lower prices, which stimulates demand and production.

C. Efficiency of retailing has resulted in lower consumer prices

Over the past 25 years the Consumer Price Index rose 128.3 percent while the Department Store Inventory Price Index rose only 81.9 percent.

While the costs of inventory and construction, and operating expenses of payroll, rent, taxes, utilities, and the like were rising at a much more rapid race, mark-ups by department stores have increased by only a small margin—from 37.94 percent of gross sales in 1967 to 41.12 percent in 1976.[2]

These results are in part attributable to efficiencies achieved by the retail industry through new, and improved methods, and the introduction of new technologies in the purchasing, handling and location of inventories both as between stores and within the store, space design and utilization, store location and size, merchandise display and location, point of sale inventory control and accounting, personnel use, and the like. Retail structures play a vital role in achieving those efficiencies.

D. Critical role of retail structures in retail efficiency

A retail structure is the basic productive tool of the industry; and such structures have increasingly become specifically, scientifically designed facilities. The emphasis in retailing is increasingly focused on making space more productive.

A modern, efficient retail structure must be both the optimum size and at the proper location to serve the market most efficiently. New design and construction techniques are used to hold down energy and other operating and maintenance costs associated with the building itself. Moreover, the overall configuration of the building, and the design of its interior space, is in a large part the ultimate constraint on the retailer's ability to employ new, efficient techniques of personnel use, goods storage, access, handling, display, sale and delivery which are critical. Thus, many older retail structures simply are too old-fashioned to efficiently serve their market and must either be substantially modernized where possible or replaced.

III. MAGNITUDE AND CHARACTERISTICS OF RETAIL SECTOR

A. General

Consumer spending represents over 64 percent of the Gross National Product, and more than 54 percent of expenditures for personal consumption is in retailing.[3] In 1977, total retail sales were $708 billion;[4] so that in that year 37 percent of the total value of the output of goods[5] flowed through the approximately 1.9 million retail establishments[6] located throughout the country.

The fixed assets of retail trade establishments, when last surveyed in 1972, were over $61 billion.[7] The figure for 1978 would be much higher, not only because of inflation but because of continuing capital expenditures.[8] In 1972, retailers purchased $327 billion worth of merchandise and their average inventories represented an investment of $55 billion at cost.[9] Purchases in 1976 had risen to $466 billion and average inventories increased to $76 billion.[10]

B. Employment and payroll

1. *Employment intensive.*—Retailing has a payroll of about $80 billion[11] and currently employs more than 14 million people. In 1976, "general merchandise" retailers alone employed 3.8 million people.[12] *One out of every six jobs is in retailing.*

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[2] Financial and Operating Results of Department Stores and Specialty Stores; 1976. National Retail Merchants Association.

[3] Based on U.S. Bureau of Economic Analysis, 1976 Personal Consumption Expenditurese by Type of Products, in 1972 constant dollars.

[4] Economic Report of the President, January 1978, p. 310.

[5] Based on U.S. Bureau of Economic Analysis, 1977 GNP was $1,890 billion.

[6] U.S. Bureau of the Census, *1972 Census of Retail Trade*.

[7] *Statistical Abstract of the United States 1977*, p. 836.

[8] Idem.

[9] U.S. Bureau of the Census, *Current Business Reports, 1972 Retail Trade*, pp. 11–13.

[10] *Ibid., 1976 Retail Trade.*

[11] U.S. Bureau of Labor Statistics. 1976 average weekly earnings for retail trade was $113.96 Total payroll is derived by multiplying $113.96 by 52 weeks and further multiplying by the number of employees on retail trade payroll.

[12] 1977 Statistical Abstract, p. 404.

2. *New job creation.*—The growth in employment in retailing has been accelerating. One out of every five jobs created in the 1970's has been in the retail sector.

Since the end of World War II, employment in retailing has increased by more than 150 percent; in the past 10 years alone, it has increased more than 40 percent.

In contrast, employment in manufacturing has increased by less than 30 percent since the War and not at all in the past decade.[13]

3. *Large number of jobs associated with capital investment in retail sector.*—A Study prepared at Northwestern University, using input/output analysis, concludes that a dollar invested in retail is associated with three times as many permanent jobs compared to a dollar invested in the manufacturing section.[14] This study shows that the *direct* employment effect is the same—those jobs to construct the plant and equipment—but that the *indirect* employment effect—permanent jobs associated with operating the facility—is three times greater where the investment is made in the retail sector.

The following Table I confirms that the number of jobs per dollar of capital investment is at least more than twice as high in retailing compared to manufacturing.

TABLE I.—EMPLOYMENT, ASSETS, AND ASSETS PER WORKER IN MANUFACTURING AND RETAIL TRADE, 1976

	Manufacturing	Wholesale and retail trade
Employment (millions)	19.6	18.3
Assets (billions)	$883.9	$343.0
Assets per worker	$45,097	$18,743

4. *Alleviates structural unemployment—part-time jobs, women, youths, elderly.*—Retailing is especially important in alleviating structural unemployment. A growing portion of the persons unemployed are relatively untrained and unskilled, or do not seek full-time jobs. A higher level of general economic activity will not necessarily absorb them into the work force. Their talents do not match the jobs that will be created with higher levels of economic activity.

Many retailing employees are, of course, highly skilled and experienced. But a large percentage of retailing jobs can be filled by less skilled, less experienced workers. There are, for example, large numbers of stock persons, materials handlers, maintenance personnel and clerks with relatively routine duties.

Equally important, retailing provides a very large number of part-time jobs, thus giving employment to older persons, students and mothers with children who need and want jobs but cannot work full time. Sears, Roebuck and Co., for example, employs a total of 400,000 persons, of whom about half are part-time employees.

Furthermore, retailing jobs tend to be geographically more accessible than those in other sectors of the economy. By the nature of their business, stores are located where people already live, and are distributed throughout populated areas. Stores are not generally located in remote, unsettled areas nor are retailers interested in building there, because that is not where their customers are.

C. Capital requirements; structures are a large part

1. *General.*—The capital requirements of retailers are great and growing. It is projected that the five largest retailers alone will in 1978 have spent about $1.4 billion on fixed capital investment. In the aggregate, it is estimated that in 1977 the retail industry spent about $7.3 billion on fixed capital investments.

2. *Structures are a large part.*—Modern, efficient structures are especially important to greater efficiency in the retail sector. Yet, much of the retail footage in the U.S. is obsolete and more is becoming obsolete each year.

Retail space becomes obsolete for a number of reasons: (1) a retail establishment may be located in a geographical area where the market is declining; (2) changing consumer preferences, shopping patterns, and competition may result

[13] *Census of Retail Trade, 1972*, U.S. Bureau of the Census, RC-72-A-1. *Employment and Earnings December 1977*, U.S. Bureau of Labor Statistics, p. 63.

[14] "The Application of the Investment Tax Credit to Commercial Structures," Haskey Benishay, Philip Ginsburg, Eugene M. Lerner, Northwestern University Graduate School of Management, 1977.

in retail establishments being either too large or too small to serve the marketplace where they exist; (3) existing physical layouts may be "old-fashioned" in design and construction, may be energy inefficient, and may entail inefficient and costly use of labor or uneconomic storage, access and inventory management; and (4) many retail establishments are too old to efficiently serve the markets where they exist and return a reasonable profit to the operator of the business.

For these reasons, and because a retail store must be renovated, remodeled and modernized many times during its lifetime, retailers are required to make large capital investments merely to maintain their existing levels of sales. At the same time, additional stores and support facilities are necessary to provide a distribution system of sufficient size and efficiency adequately to serve the economy in the face of growing population, shifting population patterns, changing shopping habits and new consumer preferences.

3. *New construction lagging despite large Investments.*—The percentage of their capital investment devoted to structures by retailers is more than twice that of the manufacturing sector, where most fixed capital investments are for machinery and equipment already eligible for the investment credit.

Yet, in an absolute sense, investments are lagging despite the need for new capital expenditures. Between 1973 and 1977 investment in commercial structures (other than office buildings) has actually declined by 28 percent, when measured in constant dollars. In contrast, measured in constant dollars, business investment in machinery for manufacturing has recovered from the recession in 1974 and is steadily increasing.

The dramatically escalating costs of structures have made needed expansion, replacement and renovation programs increasingly difficult for retailers. From 1960 to 1976, the cost of commercial and factory buildings increased by 154 percent—much faster than the GNP deflator which increased only 95 percent.[15] In addition, retailing pays the highest effective tax rate of any sector of the economy—40 percent or more. In part, that is because an unusually large portion of a retailer's capital expenditures are for investment in structures which are presently excluded from the investment tax credit. It should also be noted that ever since 1962 the maximum rate of depreciation on structures has steadily been reduced by a series of amendments to the tax law, thus providing a further disincentive to investment in retail structures.

D. Retailing is nationwide

1. *No regional bias in allowing the credit for new and rehabilitated retail structures.*—There are about two million retail establishments located nationwide in every town and village, in the city and in the suburbs. Thus, unlike many industries which are concentrated in a few areas, retailing is dispersed nationwide and contributes importantly to the economies of *all* communities in *all* areas of the country—as will the increased capital investment and employment resulting from extending the investment tax credit to new and rehabilitated retail structures.

Thus, extension of the investment tax credit to retail structures will tend to lessen the regional bias in the present investment tax credit for machinery and equipment, the benefits of which are more concentrated in the manufacturing states.

2. *Importance of retailing to towns and cities: Urban redevelopment.*—By definition, retail and other commercial buildings form the economic framework of a town or city. As industrial plants tend less and less to be located in cities because of environmental concerns and other factors, the particular suitability of retail businesses will become increasingly important. This was recognized by a recent study by the Congressional Budget Office.

Because of population shifts and other changes in local economies, parts of many medium-to-large cities around the country have begun to decay. Where this has occurred, urban redevelopment often starts with a new, large and modern retail store which serves as the catalyst and anchor for revitalizing the whole area. The additional employment and consumer traffic generated by such a new retail establishment quickly attracts other businesses to the area, and the process of redevelopment goes on.

Retailers are leaders in improving the center cities. In Brooklyn, Chicago, Philadelphia, Boston, Detroit, Oakland, Houston, and Portland, major retail

[15] Economic Report of the President, January 1978, p. 260 and E. H. Boeck Building Cost Index, 1971 Statistical Abstract, p. 773.

developments are augmenting and refurbishing the older business areas as places to shop and work. But these are only major examples. The same thing is happening all around the country almost daily.

The function of the "downtowns" is changing. Incomes of city-dwellers are rising and in some major cities there is a movement toward increased center-city living, especially by singles and young couples as well as older couples without children, many of whom find the density and proximity to office and commercial employment and urban amenities preferable. Downtown shopping malls are increasingly attractive to consumers.

3. *Retail growth is balanced; no flight from central cities.*—Concerns have been expressed by some that extension of the investment tax credit to new industrial structures would hasten some perceived flight of industrial plants away from the older central cities and toward new, less crowded areas of the country. It is not thought that such would be the case even with industrial plants. Certainly, it could not be the case with retail establishments.

Retail stores must be located in population centers—where their market is. As the population grows in new areas, additional retail stores will be added to serve those larger retail markets. But it would not be the case that existing retail stores in existing population centers would move to the new area. A retail store would relocate a major distance away only if there were a major *shift*, as opposed to *growth* in population, and that could, of course, occur only over a long period of time.

When a retail store relocates, it is normally to a nearby location—sometimes only a few blocks away and sometimes even a number of miles away, but generally in the same market or service area.

Even in areas where there has been a growth in suburban areas surrounding central cities, and consequently a growth in suburban retail stores to serve that expanding market, it is a mistake to assume that this growth represents a shift out of the downtown or central city retail location.

A recent survey[16] of retail development projects in metropolitan areas all around the country indicates a reasonable balance between new *urban* and new *suburban* retail facilities.

Of 69 reported examples of retail development projects, in operation or proposed, 38 were urban and 31 were suburban. The urban developments total about 11 million square feet, employing (or expecting to employ) about 56,000 people with an estimated payroll of about $350 million, and paying an estimated $100 million in local taxes. The suburban developments involve upwards of 23 million square feet of leasable area, employing an estimated 55,000 people with annual payrolls estimated at $425 million, and paying upwards of $40 million in local taxes.

In most of the cities cited, retail development is both urban *and* suburban, not urban *or* suburban. That is, retailing is expanding in response to the changing demands both in the cities as major shopping areas and, at the same time, in response to the demands of suburban populations.

In most cases, retail development in important metropolitan areas was taking place (more or less simultaneously) in urban *and* suburban sections. In Hartford, in Atlanta, in New Orleans, in Portland, in Salt Lake City, in Seattle, urban *and* suburban developments have proceeded in parallel. In Chicago, six major urban projects have been undertaken or are proposed, along with eight in the suburbs and neighboring communities. In Boston two urban projects, including the redevelopment of the historic Faneuil Hall area are matched by two outlying developments in Chestnut Hill and Manchester, New Hampshire. In Detroit, one very large urban center is in prospect along with the already opened and well-known Renaissance Center, and two large projects are already in operation in outlying communities. In downtown Philadelphia the Gallery and Market Street East project links two department stores, while several regional shopping malls have opened in the suburbs in the past four years. In Houston large-scale projects have been developed in the city and in the suburbs.

IV. FEDERAL TAX TREATMENT OF RETAILING

Retailing receives a relatively small share of the investment tax credit. Also, depreciation allowable on the industry's large capital investment in structures has been steadily reduced, and retailing pays tax at the highest effective rate of any sector of the economy.

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[16] Conducted by Management Horizons, Inc., Columbus, Ohio.

A. Investment tax credit

Relative to the manufacturing sector, retailing has received substantially less benefit from the investment tax credit. There are two reasons for that result.

The allowance of the credit only for tangible personal property and the exclusion of buildings and structural components; and

The allowance of the credit for "other tangible property" if used as an integral part of manufacturing,[17] but not if used as an integral part of retail trade. See section 48(a)(1)(B).

As already mentioned, the cost of buildings and structural components constitutes a high percentage of fixed capital investment by retailers, but such costs are a relatively small portion of fixed capital investment in the manufacturing sector where the cost of equipment—which is eligible for the credit—is predominant. Moreover, in the case of manufacturing large portions of capital investment for assets which might otherwise appear to be part of a building or to be a land improvement, qualify for the credit as "other tangible property." The most glaring discrepancy between manufacturing and retailing in that respect is illustrated by two major investments in "other tangible property" common to both sectors—central air conditioning and parking lots. Manufacturers generally are allowed the credit for parking lots associated with an industrial facility and for air conditioning systems to maintain temperature and humidity control.

Table II shows that the distribution sector (wholesale and retail trade) receives a comparatively small portion of the investment tax credit, despite the fact that it accounts for nearly three-fourths as much of the Gross National Product as the manufacturing sector.

TABLE II

	Percentage contribution to GNP in 1972	Percentage of investment tax credit received in 1972
Retail and wholesale trade	17.2	8.7
Manufacturing	24.6	45.6

B. Depreciation

When the investment tax credit was enacted in 1962, retail and other structures were thought to enjoy favorable depreciation rules. At that time, retail structures could be depreciated under the 200 percent declining balance method in section 167(b) and depreciation on structures was not subject to recapture. Also, the depreciable lives then permitted for structures were perceived by many to be liberal. Since 1962, allowable depreciation on retail structures steadily has been reduced. At the same time, allowable depreciation on machinery and equipment has steadily been increased which has benefitted retailers relatively less than manufacturers.

In 1964, section 1250 was enacted to recapture upon disposition of a structure the excess of accelerated depreciation over straight line depreciation. Section 1250 was made more stringent by further amendment in 1969. Also in 1969, section 167(j) was added, which limited depreciation on retail structures to the 150 percent declining balance mode. Retail structures have been excluded from the shortening of depreciable lives for machinery and equipment which occurred in 1962 with the introduction of guideline depreciation in Revenue Procedure 62-21 and which occurred again in 1971 with the enactment of the asset depreciation range system in section 167(m).

In the meantime, the prescribed depreciable lives for retail structures, which might have been thought liberal in 1962, have become increasingly inadequate to replace retail structures increasingly made obsolete or inefficient by new techniques of space utilization, design, shifting population patterns and the like. The effect of inflation has been particularly great in the case of structures, the cost of which has inflated half again as fast as prices generally.

C. Effective Federal income tax rates

Retailers as a group pay federal income tax at a high effective rate—about 40 percent or more.[18]

[17] Or as an integral part of production or extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services. See also section 48(a)(1)(B)(ii) and (iii).

[18] Department stores reporting to the National Retail Merchants Association in 1976 paid an effective income tax rate of 43 percent.

One study of effective tax rates concludes that retailing pays the highest effective rate of tax of any sector of the economy and has consistently done so over a period of years. *Study of the Effective 1976 Income Tax Rates of Selected Large U.S. Corporations, Table IV.*[19] While the industry believes that this study understates the effective rates of tax, it does illustrate the relatively high burden of tax borne by the retail sector.

D. Payroll taxes

Retail trade pays a dispropotionately large share of payroll taxes. Retail trade is labor-intensive, but it also employs a large number of part-time workers. The entire compensation of such part-time workers tends to be covered by the taxable wage base, whereas the wage cutoff tends to hold down the effective rate of payroll tax on wages paid full-time employees. This doubling-up effect in the case of part-time employees increases the tax paid by retailers as a percentage of total payroll.

V. COMMENTS AND RECOMMENDATIONS WITH RESPECT TO THE HOUSE BILL—H.R. 13511

A. Credit for rehabilitation cost of existing structures is a positive step forward which should be retained

The credit allowed by section 314 of the House bill for rehabilitation expenditures is a positive step forward in bringing about a greater degree of neutrality in the application of the investment tax credit and should be retained.

B. Expansion of the credit to include new structures as well

The credit in section 314 of the House bill should be expanded to allow the credit for the cost of a new structure as well as for expenditures for rehabilitating an existing structure. The apparent reason in the House bill for limiting the credit to rehabilitation of existing structures was the concern that allowance of a credit for new structures might accelerate relocation of businesses—particularly industrial plants—away from the older urban areas.

Such concern is generally unfounded. The limitation to rehabilitation is an unnecessary restriction which sacrifices far too much of the benefits to be derived—by the cities, all areas of the country and the economy generally—from extending the credit to new structures as well.

The Congressional Budget Office study—which is the principal source of concern about an adverse effect on inner cities—expressly recognized that any such effect would tend to be counter-balanced by allowing the credit for new retail and commercial structures which would benefit the inner cities.

Contrary to the concerns of the Congressional Budget Office study, it is doubtful that even a credit limited to new and rehabilitated industrial structures would cause any significant relocations of existing industrial plants. The relocation of an existing industrial plant is an enormously expensive proposition, that also involves many complex factors other than the cost of fixed capital investment.

As long as the credit were allowed for both the rehabilitation of an existing industrial plant as well as for the construction of a new plant, the credit for the cost of the structure should tend to be a neutral factor. A dollar spent for a structure at either the old location or a new location now costs a dollar since no credit is allowed. If the 10 percent credit were allowed, the cost would be 90 cents at either location—no relative change.

It should also be remembered that only a relatively small part of the cost of relocating an industrial plant would be attributable to the structure. The greater cost is the machinery and equipment for the new plant—most of which could not economically be moved from the old plant. Machinery and equipment at the new location is already eligible for the 10 percent investment tax credit.

There is in fact very little *relocation* of industrial plants, as distinguished from the addition of new industrial plants which reflects new economic growth in newer, less urban areas.

C. Expansion of credit to include replacement structures and expenditures to enlarge existing structures

Even if the credit were to be confined to existing structures, the credit in section 314 of the House bill should be expanded to include the cost of a structure which *replaces* an older outmoded structure at or near the same location. For

[19] Cong. Rec., January 26, 1978, p. E168.

example, it is often more economical and productive to replace an older outmoded structure, by rebuilding it on the same or a nearby site, than to rehabilitate it. In the case of a retail store, the credit could be allowed if the new store was in the same market area as the store it replaced. The credit could be allowed for a new industrial structure if it was not more than 25 miles away from the outmoded structure it replaced.

In addition, section 314 of the House bill unnecessarily denies the credit for an expansion of an existing structure even when that expansion occurs in connection with the rehabilitation of the structure.

Also, if the credit is to be confined to existing structures, at least one glaring disparity in the treatment of the retail sector and other sectors of the economy under the present credit should be corrected. Section 48(a)(1)(B) of the Code should be amended to permit the credit for "other tangible property" used as an integral part of the conduct of retail and wholesale trade. Presently, only such property used as an integral part of manufacturing, production, or extraction, etc. [but not retail or wholesale trade] is eligible for the credit.

CALIFORNIA-NEVADA ANNUAL CONFERENCE
OF THE UNITED METHODIST CHURCH,
Berkeley, Calif., August 18, 1978.

Re Moynihan-Packwood bill, S. 3111.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

TO MEMBERS OF THE SENATE FINANCE COMMITTEE: I ask you to support the above bill for one basic reason. That is, I believe it will provide an additional incentive to charitable giving. My basis for wanting to see charitable giving increased in this country is because it has traditionally, is currently, and can be in the future, the avenue which releases not only millions of dollars into causes that are of great benefit to this country's people and thus to the nation, but it also releases millions of hours of voluntary service that will not be triggered in any other way. Each of us has but to examine the heritage we've received to realize the vast benefits that have come from the strong current of charitable organizations in our country. I believe a vote for this bill and for any other measure that tends to increase charitable giving cannot but help the people and the country in a way that far exceeds any matching benefits from the tax dollars that are lost.

A proper balance, of course, between tax dollars and charitable dollars must be maintained, but we have begun in this country to allow and encourage and receive the number of charitable dollars that could be used to maximum benefit to all concerned. Persons like myself working in this field to encourage others to see the value in charitable contributions, not only in their own lives, but in that of others, will be greatly encouraged by reflections of this same spirit in the Senate, the House and the whole Congress.

Thank you for your consideration.

Sincerely,

JOHN C. ESPIE,
Development Officer.

COMMENTS OF ERNST & ERNST ON THE PROPOSED REVENUE ACT OF 1978—H.R. 13511

Ernst & Ernst is an international firm of Certified Public Accountants with 118 offices in the United States and 160 offices in 59 other countries. We provide accounting, auditing, tax and management consulting services to clients engaged in various forms of commercial, governmental and other activities.

General Comments

Our comments on this proposed legislation are designed to further the following primary objectives:

Simplification of our tax system;

Increased equity or fairness in its application; and

Incentives for greater productivity, capital investment and employment.

We have included comments in this statement on selected subjects that we believe will be of particular interest to the Senate Finance Committee. None of our comments are made on behalf of clients of our firm.

Specific Comments

CORPORATE TAX RATES

Proposed change (H.R. 13511).—The Ways and Means Committee has proposed that the present corporate tax rate structure would be repealed and replaced with a five-step structure beginning in 1979. The following chart provides a comparison of rates under present law and under H.R. 13511.

[In percent]

	Tax rate under present law	Tax rate under H.R. 13511
Corporate taxable income:		
0 to $25,000	20	17
$25,000 to $50,000	22	20
$50,000 to $75,000	48	30
$75,000 to $100,000	48	40
Over $100,000	48	46

Ernst & Ernst comments.—Tax relief can be achieved by reducing rates directly, increasing surtax exemptions and restructuring rates to provide desired graduation. Increased surtax exemptions or graduated rate schedules can direct more rate relief to smaller corporate taxpayers. We support rate reductions effected in such a way as to give smaller businesses greater relief. However, we do not support changes in rate schedules that produce higher tax rates at any income level than presently exist. We believe that corporate rate reduction is needed today and that all corporate taxpayers should benefit from that rate reduction.

INVESTMENT TAX CREDIT

In general, taxpayers are currently granted a credit against tax equal to 10% of their "qualified" investments in certain specified properties having estimated useful lives of three years or more. Most buildings and their structural components do not qualify for this credit, nor do expenditures incurred to rehabilitate existing buildings. The investment tax credit may annually offset the first $25,000 of tax liability and 50% of tax in excess of that amount. Unused investment tax credits may be carried back three years and forward seven years.

Proposed change (H.R. 13511).—The House Bill would extend the availability of the investment credit and make it permanent. The specific changes are as follows:

The 10% investment credit and the $100,000 limit on the amount of used property eligible for the credit would be made permanent.

The 50% limitation would gradually be raised to 90% at the rate of 10 percentage points per year beginning with taxable years that end in 1979.

The investment credit would be extended to rehabilitation expenditures incurred in connection with existing buildings used in all types of business except buildings which are used for residential purposes. Eligible buildings would include factories, warehouses, office buildings, hotels, motels and retail or wholesale stores which have been in use for more than five years.

The limitation on the amount of investment credit available for pollution control facilities would be relaxed where the taxpayer has elected rapid amortization.

Ernst & Ernst Comments.—We continue to support the basic concept of the investment tax credit. This credit reflects the Federal government's willingness to share the risk of investing in qualified business properties; it helps provide a greater return on business venture capital (which in today's economic seems desperately needed); and it tends to reward efficiency and the use of modern technology.

Extending the availability of the investment credit to rehabilitation expenditures incurred in connection with certain existing buildings should provide a

necessary stimulus to encourage businesses to obtain maximum utilization from their plants. Long-range certainty regarding the investment tax credit should also help foster greater investment confidence and more positive attitudes in the business community.

Although we prefer the proposed 90% limitation to the present $25,000 plus 50% limitation, greater encouragement may be needed to stimulate new investments by capital-intensive industries which have been depressed in recent years, by businesses with long-term contracts and by new businesses. This encouragement could take the form of rate increases and/or extension of the carryover period. We would also support a refundable feature for the investment tax credit.

CAPITAL GAINS

Alternative capital gains tax

Proposed change (H.R. 13511).—The election for individuals to have the first $50,000 of net capital gains taxed at an alternative rate of 25% would be repealed, effective for tax years beginning after 1978. Thus, all such gains would be subject to tax at one-half the marginal tax rate on ordinary income. The 30% alternative tax on capital gains recognized by corporate taxpayers would not be affected by the Bill.

Ernst & Ernst comments.—While the proposed repeal of the alternative tax on capital gains recognized by individuals would provide some simplification, we believe that the overall effect of such a measure probably would counteract efforts to encourage capital formation. Thus, while the elimination of the alternative tax can be rationalized on the basis of simplification, we suggest that its elimination can be better accomplished through an overall reduction in the rates of taxation on capital gains. Such a reduction could be accomplished simply and effectively by adopting the proposals advanced during President Kennedy's administration, which would have increased the excluded portion of capital gains from 50 percent to 70 percent, thus providing a maximum effective tax rate on capital gains of 21 percent. A greater capital gains exclusion would be shared equally by taxpayers in all income tax brackets, whereas a reduction in the capital gains tax rate (to pre-1970 levels) would only benefit those taxpayers whose marginal rate of tax exceeds the rate of tax on capital gains.

Minimum and maximum tax

Proposed change (H.R. 13511).—Capital gains would be removed from the list of tax preferences for individuals, corporations, estates and trusts, effective for tax years beginning after 1978. This change would reduce the present maximum effective rate of tax on capital gains for individuals to 35 percent by eliminating the 15 percent minimum tax and the requirement that personal service income be reduced by one-half of net capital gains in applying the maximum tax rules.

An alternative minimum tax would be provided at the rate of 10 percent on the excluded one-half of an individual's net capital gains, reduced by a $10,000 exemption. The alternative minimum tax would be imposed only to the extent this tax exceeds the individual's regular tax liability. (The alternative minimum tax base would exclude any capital gain realized on the sale or exchange of an individual's principal residence.)

Ernst & Ernst comments.—We support the proposal to eliminate capital gains from the list of tax preferences for both minimum and maximum tax purposes. Imposition of the minimum tax has adversely affected capital formation and no longer appropriately serves the purpose for which it was enacted, *i.e.*, to insure that high-income individuals, who obtain the bulk of their income from such sources as capital gains, pay at least some income tax. We believe that the alternative minimum tax, which would be payable only to the extent it exceeds an individual's regular tax liability, is a more appropriate way to accomplish the intended purpose. It should not impede capital formation and it should respond effectively to the objectives set forth by President Carter for meaningful tax reform. The appropriate rate for this alternative minimum tax (proposed at 10 percent) should be based on considerations which include equity for affected taxpayers as well as overall revenue needs.

We also believe that the present requirement that personal service income be reduced by tax preferences should be repealed. This offset encourages complex tax planning and forces individuals to consider the effect on personal service income of transactions giving rise to preference items. It seems to us that this is

exactly the kind of complexity that the Administration and Congress should seek to avoid. Furthermore, with the elimination of capital gains as a preference item, the revenue effect of this complex provision would be of very little significance.

Ernst & Ernst believes that the policy of reducing the incentive for tax sheltering investments is sufficiently served by the minimum tax without requiring the additional penalty of reducing the benefits of the maximum tax. Furthermore, the clear effect of the minimum tax as an "additional tax" has been effectively demonstrated. For these reasons, we find it inconsistent and inequitable to create a greater "regular tax" based on the same tax preferences that give rise to the minimum tax.

Gain on sale of a principal residence

Proposed change (H.R. 13511).—An individual, regardless of age, could elect to exclude from gross income $100,000 of any gain realized on the sale or exchange of his or her principal residence. The exclusion would apply only once in a taxpayer's lifetime, and would be available only if the present nonrecognition treatment for rollovers is not elected. It would apply with respect to gain realized on the sale or exchange of a principal residence which the taxpayer has owned and occupied as a principal residence for the two-year period which immediately precedes the sale. The exclusion would apply to sales or exchanges which are closed after July 26, 1978.

In addition, the Bill provides that an individual could elect not to recognize gain on the sale of more than one principal residence within an 18-month period if a replacement principal residence is purchased and occupied within that period, and if each sale and purchase is attributed to the individual's relocation for the convenience of his or her employer. Gain not recognized would reduce the individual's tax basis for each new residence.

Ernst & Ernst comments.—We support the proposal to exclude the first $100,000 of any capital gain recognized on the sale of a principal residence. This change is appropriate since the realization of capital gain on the sale of a personal residence would probably be attributable in large part to the effects of inflation during the period the property was held.

In addition, we support the provisions in H.R. 13511 which provides for nonrecognition of gain on residential sales which result from an individual's relocation for the convenience of his or her employer. This change would help to eliminate artificial restrictions on the mobility of our work force which result from hardships imposed by our tax laws.

INFLATION ADJUSTMENT (INDEXING)

Proposed Change (H.R. 13511).—Beginning in 1980 taxpayers would be allowed to adjust the basis of certain capital assets upward by the rate of inflation. For eligible assets sold after December 31, 1979, the basis adjustment would reflect the rate of inflation indicated by the consumer price index for the holding period of the asset. However, the adjustment would be made only with respect to increases in the consumer price index occurring after December 31, 1979. In general, assets eligible for the basis adjustment would be common stock, real property (including land, structures and mineral interests in real property) and tangible personal property as defined for purposes of the investment credit.

Ernst & Ernst comments.—We support the provisions in the House proposal which would recognize the effects of inflation and provide a limited system of indexing to compensate for excessive gains caused by inflation.

An alternative to indexing tax rates for individuals is to periodically enact tax cuts when inflation causes de facto tax increases and accompanying economic hardship. This is the route Congress has chosen to follow since 1964 by enacting six tax reduction acts in the past fourteen years.

While tax rate reductions for individuals can provide a temporary substitute for indexing, they do not provide an appropriate long-term solution to the capital formation problems of corporate and individual taxpayers.

Somewhat akin to the problems of indexing the income tax base are the problems of accounting for inflation, and in that regard we testified on April 24, 1978 before your Subcommittee on Taxation and Debt Management on the

proposed Tax Indexation Act of 1978 (S. 2738). At that time, we presented to the Subcommittee a practical new approach for computing depreciation for tax and financial accounting purposes that we think will achieve many of the objectives to aid capital formation that are encompassed in S. 2738 and H.R. 13511.

Under our proposal, businesses would base their annual depreciation allowances for both tax and financial reporting purposes on the current cost (based on an objective index) of replacing the underlying assets. In times of inflation, the increased costs of the assets would be measured by the increase in the implicit deflator for capital goods as reported in the National Income and Products Accounts (or such other convenient measure as Congress might consider appropriate).

The Ernst & Ernst proposal, called Current Cost Depreciation (CCD) has the advantages of more clearly reflecting income by a better matching of revenues and related costs, preventing misleading distortions in financial statements caused by high rates of inflation, and avoiding computational complexities that might be introduced by attempting to determine fair market values of capital assets based on subjective estimates and appraisals.

In order to determine the economic impact of the introduction of this change in tax and financial accounting procedure, Ernst & Ernst engaged Chase Econometric Associates, Inc. (CEAI) to study the macroeconomic impact of CCD. The CEAI study shows that if CCD had been adopted effective January 1, 1977 applicable only to new investments after that date:

The initial impact of the change in 1977 would have been modest, primarily as a result of the lagged effect of changes in the tax laws on investment.

1978 purchases of producers' equipment would be $1.1 billion higher in terms of 1972 prices, or $1.6 billion higher in terms of current prices, while nonresidential construction would increase an additional $1.3 and $2.2 billion in constant and current dollars, respectively. Accordingly, fixed business investment would be 1.8% higher than would otherwise be the case.

Unemployment would be 0.15% lower for 1978.

Real Gross National Product (GNP) for 1978 would rise $4.6 billion, or 0.3%.

The primary revenue loss to the Federal government from higher depreciation allowances in 1978 would be $5.2 billion, higher interest payments would cost an additional $0.5 billion and higher cost of Federal government purchases would be $0.1 billion. Transfer payments would be $0.3 billion lower because of the increased level of economic activity. Additional tax revenues induced by higher growth in 1978 would be $2.2 billion, leaving a total increase in the Federal budget deficit of $3.3 billion.

In addition, the CEAI study shows that the application of CCD on new equipment would have a significant positive effect on the economy. It would create 400,000 new jobs by 1980 without increasing the rate of inflation, since the higher level of demand would be offset by an improved level of productivity. The increase in the Federal budget deficit would be minimal; as a result, capital markets would not be upset, and interest would not be materially affected. Investment in producers' durable equipment would rise by an additional 2% by 1980, while nonresidential construction would be 5½% greater. On balance, CCD would strengthen capital formation, growth and employment without the negative side effect of higher inflation which usually accompanies fiscal stimulus.

Since the Finance Committee's announcement of these hearings indicated that all previous testimony on the subject of indexing the tax system would automatically become part of the record of these hearings, we have not included copies of our proposal, "Current Cost Depreciation," or the accompanying report, "The Macroeconomic Impact of Current Cost Depreciation," prepared by Chase Econometric Associates, Inc. Copies of these reports were included with our statement on the proposed Tax Indexation Act of 1978 (S. 2738); however, we would be pleased to provide additional copies.

We are aware of the Carter administration's objection to the adoption of an indexing proposal. We regard the indexing proposal in H.R. 13511 as a good start. Since it would not become effective until 1980, Congress would be provided with an additional year to further develop a system of indexation. We therefore support retention of this provision.

Subchapter "S" corporations

Proposed change (H.R. 13511).—In order to simplify the Subchapter S rules and facilitate use of this election, the proposed legislation would increase the number of initial shareholders permitted an electing corporation from ten to fifteen. A husband and wife would be counted as one shareholder regardless of whether or not they live in a community property state or the manner in which the stock is owned by them, *e.g.*, joint tenants, tenants in common, etc.

The Bill also extends the period of time for making Subchapter S elections. If enacted, the period of time for making a Subchapter S election would include the entire preceding taxable year of the corporation as well as the first 75 days of the taxable year for which the election is to be effective. Shareholders who acquire stock after the date an election is filed will not have to file a consent to the election.

Ernst & Ernst comments.—We know from experience that many small businesses have not elected taxation under Subchapter S because of the technical restrictions and complexity of the law and regulations. We believe that the changes proposed in H.R. 13511 will help to alleviate some of these unnecessary restrictions, including the increase in the permissible number of shareholders. We support these proposed changes.

We note that two provisions generally proposed as part of President Carter's tax program have been omitted from the House Bill. Those provisions would have: (1) Permitted certain testamentary trusts and revocable living trusts to qualify as shareholders following the death of the grantor, and (2) permitted the later absorption of losses in excess of a shareholder's stock investment and debt of the corporation for a loss year, if in a subsequent year the shareholder increases his investment in the corporation's stock or debt (*i.e.*, a carryover of excess losses). The former proposal would permit a taxpayer to plan the administration of his estate more flexibly and economically without the threat of an unnecessary tax trap triggered by the taxpayer's death; and the latter proposal would provide greater parity of treatment with the present partnership rules and thereby further the concept of horizontal equity for similar small business taxpayers. We therefore recommend that consideration be given to including them in the final legislation. If there are special implementation problems with respect to the latter proposal, we suggest that these be handled through a broad delegation of regulation authority.

Small business "section 1244" corporation stock

Proposed change (H.R. 13511).—Presently, ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation (Section 1244) stock that is disposed of at a loss. This special treatment which is accorded only to individuals owning issued stock is liberalized under the Bill as follows:

The amount of Section 1244 stock that a qualified small business corporation may issue would be increased from $500,000 to $1,000,000.

The equity capital limitation on corporations wishing to qualify as small business corporations for purposes of Section 1244 would be repealed. Therefore, a qualifying corporation could continue to issue additional common stock under Section 1244 without regard to the amount of its equity capital to the extent that the amount received for common stock issued does not exceed $1,000,000.

The maximum amount of ordinary loss from the disposition of Section 1244 stock that may be claimed in any one taxable year would be increased from $25,000 to $50,000. For married taxpayers filing joint returns, this limitation would be increased from $50,000 to $100,000.

The present requirement that a written plan to issue Section 1244 stock must be adopted by the issuing corporation would be dropped. Only the first $1,000,000 worth of common stock issued could qualify as Section 1244 stock.

Ernst & Ernst comments.—We support the House proposals to liberalize the rules relating to small business stock. They should assist in raising needed capital by decreasing the risks of such investments. We also believe that these changes provide some simplification and therefore should contribute to greater effective use of this section of the law by small businesses.

DEFERRED COMPENSATION PLANS

Proposed change (H.R. 13511).—On February 3, 1978, the Internal Revenue Service issued proposed regulations which provide that if a taxpayer can choose to have some portion of his current compensation deferred, such amounts would be treated as received by the taxpayer in the earlier taxable year.

For private sector plans (plans maintained by taxable entities) the Bill would negate the intent of these proposed regulations by providing that compensation deferred under unfunded deferred compensation plans would be subject to the principles of law in effect on February 1, 1978, *i.e.*, without regard to the proposed regulations.

For State and local government plans, the Bill would negate the objectives of the proposed regulations and enact a new Code provision. Under the new provision, employees and independent contractors performing services for a State or local government or tax-exempt rural electric cooperatives (and their affiliates) would be able to defer annually an amount equal to the lesser of $7,500 or 33⅓% of their current includible compensation.

Ernst & Ernst comments.—We agree with the House proposals which would continue present law in determining the taxable year for the inclusion of compensation deferred under unfunded deferred compensation plans maintained by a taxable entity. In addition, we agree with the intent of the new Code provision which would permit deferral of compensation by an employee or an independent contractor of a State or local government.

Ernst & Ernst testified on May 4, 1978 at the Internal Revenue Service hearings on the proposed amendments to the regulations under Section 61 of the Internal Revenue Code. We opposed the proposed regulations because we believed they fail to adequately define the types of plans and arrangements within their scope and, with respect to plans which will be affected, they create additional uncertainties and inconsistencies in the application of the revenue laws. In addition, the proposed changes are contrary to existing case law and are mandated by no change in the statute; thus, the changes are an improper subject for a rule-making proceeding. At that time we urged that the proposed regulations be withdrawn. We would be happy to provide copies of the comments we submitted to the IRS on this subject for your further consideration.

ARBITRAGE BONDS

Proposed change (S. 3370).—While not part of the House proposals, your Committee did devote time during the tax revision hearings to S. 3370, a bill introduced by Senator Bentsen to suspend certain Treasury Department and Internal Revenue Service action dealing with State and local financing (arbitrage bonds). Essentially, S. 3370 would negate the proposed amendments to the income tax regulations under Section 103 of the Internal Revenue Code, which were published in the Federal Register of May 8, 1978, and the holding in Revenue Ruling 78-302, by declaring them invalid. The object of the Bill would be suspend further rulings and regulations in this area in order to enable Congress to review the entire area and make appropriate policy decisions.

Ernst & Ernst comments.—We are already on record as being in agreement with the objectives of S. 3370. In that regard, Ernst & Ernst testified on July 25, 1978 in opposition to the proposed regulations at an Internal Revenue Service hearing on the matter. We opposed the proposed regulations because they represented poor administrative practice and urged that they be withdrawn for the following reasons:

Computation of yield.—The permissible rate of earnings on investments purchased with tax-exempt bond proceeds under the proposed amendments can be significantly lower than the issuer's effective borrowing cost. Also, the costs of purchasing, carrying and selling investments are to be disregarded in computing yield on the investments and will result in artificially high yields.

Invested sinking funds.—The proposed amendments will place severe limitations on the general investment and bond financing programs of local governmental units. This is so because investments of revenues or taxes in any fund

that could be deemed to be a sinking fund would be considered to be "bond proceeds" subject to aribitrage yield restrictions.

Reliance on opinions of bond counsel.—The regulations are unclear and will cast doubt on the validity of opinions issued by bond counsel as to the tax-exempt status of an issue. Investors have come to rely on the opinion of bond counsel and therefore any uncertainty could result in higher interest costs to overcome the increased risks perceived by investors.

Congressional intent.—The regulations establish limitations beyond what Congress intended.

We would be happy to provide complete copies of the comments which we submitted to the IRS on this subject.

If you have any questions regarding these comments and if we can be of further assistance, please contact either Robert G. Skinner or Edward D. Ryan in Cleveland, Ohio, 216-861-5000; or Joel Forster in Washington, D.C., 862-6000.

STATEMENT OF EMPLOYEE RELOCATION COUNCIL

The Employee Relocation Council (ERC) appreciates this opportunity to submit written testimony urging the enactment of Section 406 of H.R. 13511 relating to rollover of gain on sale of a principal residence in connection with commencement of work at a new principal place of work. It is respectfully requested that the following statement be included in the record of the Senate Hearings on H.R. 13511 before the Committee on Finance.

ERC is a non-profit organization concerned with the various problems surrounding the transfer of employees between various work locations. Its membership currently consists of 582 corporations and government agencies. Last year, the aggregate transfer volume of our members was approximately 150,000 employees per year. As such, ERC is deeply concerned with the problems of changing one's employment location.

UNINTENTIONAL EFFECT OF 1975 TAX REDUCTION ACT

Section 406 corrects a troublesome, unintended effect caused by the Tax Reduction Act of 1975. This Act amended Section 1034 of the Internal Revenue Code of 1954, "Sale or Exchange of Residences," by lengthening from twelve months to eighteen months the replacement period for reinvesting the proceeds from the sale of a principal residence without incurring tax on any gain from such sale. Congress, in amending Section 1034, intended to benefit taxpayers by allowing them more time to relocate and invest in new residences while deferring capital gains tax. However, because of some parallel amendments to certain rules of detail of Subsections 1034(c)(4) and 1034(d), the 1975 amendment has had the opposite and unintended effect of increasing the tax burden of some relocating employees.

Under the 1975 amendment, individuals who sell more than one principal residence within an eighteen-month period are subject to tax on the net gain from the second and subsequent sales. Consequently, taxpayers who transfer for employment purposes more than once in an eighteen-month period, and purchase and sell homes accordingly, are faced with an increased tax burden. An example of how this situation may occur follows:

Assume that an employee realizes a $5,000 gain on a sale of house A for $30,000 in month 1, purchases and occupies house B for $30,000 in month 2, sells house B for $45,000 in month 17, and purchases house C for $45,000 and occupies it in the same month. In such event, the $15,000 gain with respect to house B would be taxable, pursuant to section 1034(d) while the $5,000 gain with respect to house A would be deferred. Prior to the 1975 amendment, the gain with respect to both houses A and B would have been deferred.

Requiring taxpayers who relocate for employment purposes to recognize gain upon the sale of their homes is inequitable. Imposition of tax in such a situation may well result in a taxpayer not having sufficient after-tax funds to afford a new residence comparable to his prior residence. Such a result is a deterrent to the mobility of the American worker.

CHANGES MADE BY SECTION 406 OF H.R. 13511

Section 406 corrects the above inequity by waiving the eighteen-months rule of Subsection 1034(d) when the sale of a principal residence is connected with commencing work at a new principal place of work. As such, Section 406 is a highly beneficial provision which will significantly lessen the burdens of American workers in relocating.

ERC RECOMMENDATION

We strongly urge the adoption of Section 406.

FAMILY SERVICE ASSOCIATION OF AMERICA,
Washington, D.C., August 14, 1978.

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

DEAR SENATOR LONG: It is our understanding that your Committee will be meeting on the 21st of August to consider, among other tax matters, S. 3111 sponsored by Senators Daniel Moynihan and Bob Packwood. This legislation would amend the Internal Revenue Code of 1954 to allow the charitable deduction to taxpayers whether or not they itemize their personal deductions.

As you may know, recent years have seen the erosion of the financial base of the nonprofit voluntary sector of our country. This has occurred because of inflation and the changes in federal tax policy which have led to greater use of the standard deduction by most taxpayers. These two factors have contributed to a loss of approximately $5 billion from the nonprofit sector since 1970. The increased use of simplified income tax returns poses a serious problem for charities by eliminating a major incentive for charitable giving. This bill addresses that problem.

Our National Board voted in May to endorse the provisions of this legislation. It is our belief that a free, pluralistic society is strengthened and enhanced by a strong voluntary sector. Our country is unique in that philanthropy plays a far larger role in the United States than in any other country. This nonprofit segment of the private sector reaches into almost every field of human interest supporting an incredible variety of institutions including symphonies, museums, libraries, universities, as well as social services organizations. We believe, as do the sponsors of this legislation, that it is important to maintain the nonprofit sector as a balance to big government in a democratic society.

We urge your support of S. 3111 both in the Finance Committee and on the Floor of the Senate.

Thank you for your kind attention.

Sincerely,

PATRICIA LANGLEY,
Washington Representative.

STATEMENT OF ROBERT D. HEDBERG, CHAIRMAN, AD HOC COMMITTEE, FINANCIAL ANALYSTS FEDERATION

The 14,500 member Financial Analysts Federation (FAF) is the professional association of securities analysts and portfolio managers. We believe our members play a significant role in the allocation of investment capital in this country and that we have a unique expertise to offer the Committee as it considers changes in the taxation of the corporate income stream: reducing the corporate tax rate, reducing the capital gains tax rate, and possible reduction in double taxation of dividends. We have prepared a study which compares the effects of these three tax change proposals. A table summarizing the results of that study is attached.

We were curious as to which of the various and controversial tax proposals would be most effective in increasing equity capital formation. We decided we would try to find out where the truth lay by doing what we do professionally, analyzing companies and making investment decisions. We decided to apply the

techniques of securities analysis to corporations as a whole, treating the combined data for this country's corporations as though it were one company, and adjusting the data to reflect the various tax cut proposals. (The data we used were for non-financial corporations as compiled by the Department of Commerce and the Federal Rseerve Board.) They include all of our country's corporations except financial companies such as banking and insurance. The data base is, therefore, America's businesses from the smallest mom and pop corporation to General Motors.

As any good analyst does, we worked the data six ways to Sunday to examine the effects of reducing the corporate tax rate, reducing the capital gains rate, and reducing double taxation of dividends.

The results are very disturbing. We found that at present tax rates investment in our country's non-financial corporations would be unattractive to investors in tax brackets paying more than a 25% capital gains tax rate. Their after tax returns from dividends and capital gains would be less than they would get from municipal bonds where the investment risk is lower. In other words, as investment professionals we could not recommend investment in our country's non-financial corporations to those paying more than a 25% capital gains tax rate and on a risk adjusted basis possibly not even to those in lower tax brackets. Risk taking has become unattractive.

We found that reducing the corporate tax rate would only minimally increase the attractiveness of investment. Reducing the double taxation of dividends would have some beneficial effects on investors in the lower tax brackets. Studies show such investors tend to invest largely for dividends. For higher tax bracket investors, reducing double taxation of dividends would have about the same impact as reducing the corporate tax rate.

Our study's findings suggest that in the current high interest rate environment we must have a significant cut in the capital gains tax rate if we are to have the investment funds available to finance new companies, new technology, and new competition to keep our established companies competitive in world-wide markets and to create a large economic pie for all our people to share. Without it we may face a vicious cycle of decaying, obsolete plants, rising prices, increasing unemployment, and a declining relative standard living.

I would like also to address some of the questions which have been raised by others in regard to these tax considerations.

There are no windfall profits. At the end of 1977 the market value of non-financial corporations was virtually the same as it was ten years ago. With the exception of 1974 and 1975, most equity investments made during that time show a loss.

A cut in the capital gains tax is not a giveaway to the rich. Neither they nor anyone else has capital gains to tax until money is invested and the investment is later sold at a profit. As our study shows, at current tax rates equity investment is simply unattractive to investors in the higher tax brackets. We believe the economy and the country need this equity investment and are poorer without it.

Estimates of the cost in Treasury revenue resulting from a cut in the capital gains tax rate are not realistic. Without capital appreciation, there are no capital gains, and on average there has been no capital appreciation in the market value of nonfinancial corporations over the last ten years. If as a result of tax changes, the stock market goes up, as we believe it would, there would then be capital gains to tax and an increase in Treasury revenues.

We can generate significant increases in equity capital only by bringing more investors back to equity investments. A reduction in the corporate tax rate even to 44% would increase corporate equity capital by less than $10 billion. In contrast, at the end of 1977 the market value of all stocks listed on the New York Stock Exchange was $796.6 billion. A mere 1% increase in the value would increase equity capital by $8 billion, a 10% increase by $80 billion.

On May 6, 1978, the Board of Directors of the Financial Analysts Federation unanimously adopted the following resolution. I quote:

"We believe that a high level of capital formation is essential to (1) create ample employment opportunities, (2) limit inflation, and (3) maintain a rising standard of living for the American people, and

"We, therefore, urge federal government action, both executive and legislative, to stimulate capital investment by appropriate policies, including reduction in the tax burden on corporate earnings and on the dividend and capital gains income of investors."

Our study completed since then finds that a significant reduction in the capital gains tax rate would be the most effective tax change to stimulate capital formation. We have, however, provided the Committee with a table demonstrating the relative effects of three possible tax changes.

While we cannot, at this point, statistically support our feeling, we urgently request that if the maximum capital gains tax rate is not reduced to 25%, the alternative tax provision be re-instated. Eliminating the alternative tax provision would fall heavily on middle-income investors, a group important to this country in many respects, and further discourage investment by them in equities.

Attachment.

U.S. (NONFINANCIAL) CORPORATIONS: PROJECTED RETURN COMPARISONS

[In percent]

	Nonfinancial corporations projected returns						Fixed-income investment alternatives		
	48 percent corporate tax rate		46 percent corporate tax rate		44 percent corporate tax rate				
	Without dividend interest	With 10 percent dividend interest	Without dividend interest	With 10 percent dividend interest	Without dividend interest	With 10 percent dividend interest	3-mo Treasury bills [1]	Bell System bonds [1]	Municipal bonds [1]
PRETAX RETURNS									
Capital gains return [2]	6.2	6.2	6.5	6.5	6.7	6.7			
Dividend/interest return [3]	6.5	6.5	6.7	6.7	7.1	7.1	6.7	9.0	6.6
Total return	12.7	12.7	13.2	13.2	13.8	13.8	6.7	9.0	6.6
AFTERTAX RETURNS									
50 percent or more of capital gains taxed:									
Present maximum rate:									
50 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	3.2	3.2	3.3	3.3	3.4	3.4			
Dividend/interest return [3]	2.0	2.2	2.0	2.2	2.1	2.3	2.0	2.7	6.6
Total return	5.2	5.4	5.3	5.5	5.5	5.7	2.0	2.7	6.6
H.R. 13511 maximum rate:									
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.1	4.1	4.2	4.2	4.4	4.4			
Dividend/interest return [3]	2.0	2.2	2.0	2.2	2.1	2.3	2.0	2.7	6.6
Total return	6.1	6.3	6.2	6.4	6.5	6.7	2.0	2.7	6.6
Hansen/Steiger maximum rate:									
25 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.7	4.7	4.9	4.9	5.0	5.0			
Dividend/interest return [3]	2.0	2.2	2.0	2.2	2.1	2.3	2.0	2.7	6.6
Total return	6.7	6.9	6.9	7.1	7.1	7.3	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	4.7	4.7	4.9	4.9	5.0	5.0			
Dividend/interest return [3]	3.3	3.6	3.4	3.7	3.6	4.0	3.4	4.5	6.6
Total return	8.0	8.3	8.3	8.6	8.6	9.0	3.4	4.5	6.6

12½ percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.5	5.5	5.7	5.7	5.9	5.9			
Dividend/interest return [3]	4.9	5.4	5.0	5.5	5.3	5.8	5.1	6.7	6.6
Total return	10.4	10.9	10.7	11.2	11.2	11.7	5.1	6.7	6.6
40 percent of capital gains taxed at ordinary income rates:									
28 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.5	4.5	4.7	4.7	4.8	4.8			
Dividend/interest return [3]	2.0	2.2	2.0	2.2	2.1	2.3	2.0	2.7	6.6
Total return	6.5	6.7	6.7	6.9	6.9	7.1	2.0	2.7	6.6
20 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	5.0	5.0	5.2	5.2	5.4	5.4			
Dividend/interest return [3]	3.3	3.6	3.4	3.7	3.6	4.0	3.4	4.5	6.6
Total return	8.3	8.6	8.6	8.9	9.0	9.4	3.4	4.5	6.6
10 percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.6	5.6	5.8	5.8	6.0	6.0			
Dividend/interest return [3]	4.9	5.4	5.0	5.5	5.3	5.8	5.1	6.7	6.6
Total return	10.5	11.0	10.8	11.3	11.3	11.8	5.1	6.7	6.6
30 percent of capital gains taxed at ordinary income rates:									
Long proposal:									
20 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	5.0	5.0	5.2	5.2	5.4	5.4			
Dividend/interest return [3]	2.0	2.2	2.0	2.2	2.1	2.3	2.0	2.7	6.6
Total return	7.0	7.2	7.2	7.4	7.5	7.7	2.0	2.7	6.6
15 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	5.3	5.3	5.5	5.5	5.7	5.7			
Dividend/interest return [3]	3.3	3.6	3.4	3.7	3.6	4.0	3.4	4.5	6.6
Total return	8.6	8.9	8.9	9.2	9.3	9.7	3.4	4.5	6.6
7½ percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.7	5.7	6.0	6.0	6.2	6.2			
Dividend/interest return [3]	4.9	5.4	5.0	5.5	5.3	5.8	5.1	6.7	6.6
Total return	10.6	11.1	11.0	11.5	11.5	12.0	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

Notes: Projections are based on 1977 data for nonfinancial corporations from Department of Commerce and Federal Reserve Board. Using techniques of securities analysis, 1977 pretax and aftertax return on equity capital and dividend payout ratios are projected and adjusted to reflect *different corporate tax rates. Stock market prices are assumed to increase commensurate with rise in aftertax profits.*

For full discussion of methodology see: Investor Returns and Tax Policy, a study by Marilyn V. Brown, C.F.A., for the Financial Analysts Federation Ad Hoc Tax Committee, July 5, 1978.

Source: Table prepared by Marilyn V. Brown, C.F.A., for the Financial Analysts Federation Ad Hoc Tax Committee, Aug. 16, 1978.

Statement of the Financial Executives Institute [1]

SUMMARY STATEMENT

Financial Executives Institute (FEI) believes that H.R. 13511, as passed by the House of Representatives, is an economically sound "step in the right direction" in our national tax policy. Taken in its entirety, the bill provides a long overdue change toward encouraging additional savings and investment and away from the strong bias in favor of consumption.

We believe an overall tax cut somewhat higher than that contemplated by H.R. 13511 would allow for the stimulation that will be needed in the economy and would not contribute to inflation, provided the cut is accompanied by offsetting reductions in federal expenditures.

FEI strongly supports the reduction in the corporate tax rate from a top rate of 48 percent to 46 percent. We feel, however, as we have expressed to the Senate Finance Committee in earlier testimony, that a permanent rate reduction to 42 percent should be phased in over time, consistent with sound fiscal planning. We believe that if additional rate reductions are implemented on a timely basis, any "revenue loss" will be more than offset in a very short time by additional revenues from the increased employment that will result from new investment generated by additional equity in the form of increased retained earnings.

The reduction in taxation of capital gains will also stimulate new investment and increase the availability of equity capital. It is essential that both new and established businesses be able to finance more necessary new investment with equity capital rather than debt capital. FEI also supports the provision that makes the 10 percent investment credit rate permanent, and expands its availability to rehabilitation of structures and its application to 90 percent rather than 50 percent of income tax liability. We believe, however, that the building of new structures, as well as the rehabilitation of old structures, should be eligible for the credit and that the phase-in period to reach the 90 percent level of application should be considerably shortened from four years to no more than two.

FEI favors the idea of further aiding small business enterprises in their struggle to prosper and expand. We recommend, however, that rather than adding graduations at the lower income scale in the income tax rates for corporations, this assistance should be accomplished more simply and soundly by increasing the amount of income subject to the surtax exemption. The increase should be to an amount which gives at least as much stimulus to small business as the proposal passed by the House.

Our more comprehensive comments which follow on these and several other provisions of the bill are directed toward those which directly affect corporate business. Nevertheless, we support the concept that personal income tax reductions should give relief to the often forgotten "middle income" taxpayer. We suggest that any changes that may be considered by the Senate Finance Committee in this area should retain this relief.

FEI recognizes that policies we have proposed in earlier communications with the Senate Finance Committee, such as a flexible capital cost recovery allowance system (depreciation reform) and mitigation of double taxation of dividends, will have to await consideration on another day. We do wish to emphasize our belief, however, that tax changes to stimulate capital formation and new investment are of paramount importance to our country's economic growth.

CORPORATE RATE REDUCTIONS

The current 48% tax rate for corporations should be reduced. The most direct and effective tax change to increase cash flow to all corporate business, large and small alike, comes through rate reduction. This increase is immediate and is an aid to both capital and labor intensive corporations. This stimulus will help ease inflationary pressures by increasing productive capacity as well as worker productivity. It is now generally recognized that the U.S. lags its competitor industrial countries in new investment by almost any comparative measurement criteria. We must begin immediately to increase the percentage

[1] Financial Executives Institute is the recognized professional association of 10,000 senior financial and administrative executives in more than 5,000 companies, large and small, representing a broad cross section of American national and international industry.

of our wealth spent on new and more productive industrial capacity. It is also most essential that business expand through equity rather than debt financing. Corporate rate reduction will increase much needed cash flow, and will assist business to more successfully finance expansion with additional equity, since the reward for risk taking will be enhanced. This is particularly desirable since the long time bias in favor of debt financing has led many businesses to be nearing the practical limits of their capacity to finance in this way. We do urge, however, that the corporate rate be reduced to a maximum of 42% rather than 46%, over a fiscally responsible phase-in period.

The rate reduction specifically intended to assist small business is most welcome. We do not agree, however, that increasing the number of steps in the graduation in rates is the most effective or efficient way to accomplish this. Not only does the method adopted in H.R. 13511 increase the complexity of the tax code, but it also moves in the direction of economic inefficiency. Putting more "steps" or "brackets" between the lowest and the highest tax rate for corporations will not solve the "penalty for growth" problem. It will inevitably create more pressures for additional "brackets" or "indexing" for selected corporations which we believe should be avoided. The simpler and more efficient method is to raise the amount of income exempt from the corporate income surtax to a more realistic level. In this way, a business can grow to a more substantial and sound income threshold before the surtax is assessed.

CAPITAL GAINS

As discussed above, it is imperative that our corporate business be able to finance additional expansion with a sound balance of both debt and equity. We have for too long ignored the significant impact of the tax laws on the financial market. Just as many provisions of the corporate tax law inhibit equity financing, the personal income tax changes of recent years have also had a serious adverse impact on the individual's capacity and incentive to save or invest at risk. The changes which are advocated in H.R. 13511 are not only significant but necessary to encourage formation of the much needed venture capital to revitalize our industrial economy. And even though the change may be significant, it should only be considered a start toward removing the burden which our tax laws put on risk capital. It should be kept in mind that even if these changes are implemented, the United States will still have a higher tax on capital gains than most competitor industrial nations.

INVESTMENT CREDIT CHANGES

We believe that it is highly desirable to continue the current investment tax credit of 10% on a permanent basis. The effectiveness of the investment tax credit as a stimulus to investment and job creation is proven. It is also apparent that its effectiveness is greatest when the taxpayers, many of whom have significantly long lead times for planning and construction, have some assurance of tax policy for the future. This change will give the investor such assurance.

Extension of the credit to cover expenditures for the rehabilitation of existing structures is also sound. In most instances, investment in structures is an integral part of the total expenditure necessary to provide the tools essential for job creation or retention. The provision in the House bill should not, however, exclude new structures. We do not believe that restricting the credit to rehabilitation will have any noticeable impact pro or con relocation of business facilities. If both rehabilitation of old and construction of new facilities are covered, location will still be a neutral factor just as it is under present law. If rehabilitation of structures is covered and new structures are not, few, if any, situations will exist where rehabilitation rather than replacement would be marginally preferable.

We do not believe that this difference will have significant impact where a move to another location is desirable for other business reasons. The other factors such as market proximity, labor availability, etc., would in almost all cases far outweigh the one time initial credit. The credit could, however, make a significant impact on the ability to make any investment.

The 90% tax liability limitation is a favorable change in the investment credit provisions. This will allow cyclical and developing businesses to get more effective utilization of the investment credit. To more effectively assist those

businesses which cannot use all of the credit under current law to increase cash flow for immediate new investment, it is suggested that the phase-in period be removed or in the alternative be reduced to no more than two years.

The provision which will allow the full 10% investment credit when eligible pollution control facilities are amortized over a five-year period is desirable. We would recommend deletion of the condition that eliminates this option if the expenditure is financed with industrial revenue bonds. FEI does not believe that there should be any penalty attached to arranging the most desirable financing for mandated facilities which are in the public interest and are not productive assets. There is no "economic" life to these facilities to justify other than an immediate writeoff for these investments. It is therefore unjustified and not in the public interest to make more difficult the financing of these very significant mandated expenditures.

SMALL BUSINESS PROVISIONS

FEI supports the provisions of the House bill designated specifically for small business as well as the increase in the limit on small issues of industrial development bonds. We would point out, however, that the provision wherein additional first year depreciation would in the future be restricted to taxpayers with an adjusted basis in depreciable assets under $1 million should not be adopted. Strictly arbitrary provisions such as this can be self-defeating. A taxpayer that is capital intensive and that really needs the additional depreciation will be the first to be cut off under this proposal while a less capital intensive business with more cash flow and higher profits could continue receiving the additional depreciation on new investments. We recommend that the dollar limit of the present provision simply be increased to recognize the higher level of prices existing today.

EMPLOYEE BENEFITS

Deferred compensation under private nonqualified plans or arrangements

The provision of the bill barring IRS from finalizing its proposed deferred compensation regulations issued on February 3, 1978 is a sound corrective measure. Those regulations would have eliminated most nonqualified deferred compensation arrangements contrary to longstanding regulations, rulings, and established case law. Therefore, we strongly urge adoption of this provision.

As a companion measure it is proposed in the bill to extend the existing rules governing deductibility of employees' deferred compensation to deferred payments for services performed by independent contractors. Without commenting on the propriety of this proposal, we do not believe it is proper to include it in the bill as piecemeal legislation. Consideration of its merits would be more appropriate at a later date.

CASH OR DEFERRED PROFIT-SHARING PLANS

The bill permits a participant in a qualified "cash or deferred" profit-sharing plan to defer tax on amounts paid into the plan. This proposal fills a void which has been in existence much too long. There is no sound reason why properly tax-qualified cash or deferred profit-sharing plans should be considered in the same light as salary reduction plans. Unfortunately, this has been the situation since the issuance in 1972 of proposed regulations relating to salary reduction plans. Enactment of this provision would reclarify an area which should not have been made uncertain in the first place.

TAXATION OF FOREIGN INCOME

FEI endorses the exclusion from H.R. 13511 of any provisions that would increase taxes paid by U.S. coroprations on income from foreign operations by phase-out of deferral and DISC as originally proposed by the Administration.

The Senate Finance Committee has received expert testimony from others as to the importance of U.S. exports in providing U.S. employment and the critical role in promoting U.S. exports played by foreign subsidiaries of U.S. corporations. Elimination of deferral would impose a tax burden on earnings of foreign subsidiaries of U.S. corporations not borne by foreign based multinationals, thus impairing the ability of U.S. companies to compete in world markets. This could only lead to a reduction in U.S. exports, a weakening of the U.S. economy and a further deterioration in our balance of payments position.

Although the amount is difficult to determine, DISC has contributed substantially to the growth in U.S. exports. Further, it is the only positive offset the U.S. has to tax policies of other governments in support of their export industries. Particularly in view of the U.S. trade deficit, it would be ill advised for the U.S. to phase out this provision of current law, an action which would have an adverse impact on U.S. exports.

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION,
Washington, D.C., August 11, 1978.

Senator RUSSELL B. LONG,
Russell Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: In your announcement of hearings on the President's tax cut bill to begin August 21, you pointed out that testimony presented in earlier hearings on capital gains tax cuts was already part of the record and, therefore, you expressed hope that new testimony would not duplicate that previously submitted.

In deference thereto, the Forest Industries Committee on Timber Valuation and Taxation will not present testimony although, clearly, the capital gains issue is one which has a major effect on timber growers.

The Forest Industries Committee on Timber Valuation and Taxation strongly urges the adoption of pre-1969 capital gains rates for both individuals and corporations and hopes that in its deliberations, the Senate Finance Committee will recognize the importance of that change to the over four million timber growers in the United States and to the nation's housing and other timber product needs.

All forecasts of timber supply and demand, both private and public, indicate substantial under-investment in reforestation and that timber supply is falling short of our long-term needs.

I am taking the liberty of enclosing a copy of our testimony which we presented to Senator Byrd's Subcommittee on July 14, 1978 which, in turn, encloses a copy of our testimony to the Committee on Ways and Means on March 9, 1978.

We would be pleased to cooperate with you and your colleagues as the legislation proceeds.

Sincerely yours,

WILLIAM K. CONDRELL,
General Counsel.

Enclosure.

STATEMENT OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION—JULY 14, 1978

This statement is presented on behalf of the Forest Industries Committees on Timber Valuation and Taxation, a voluntary organization of over 4,000 timber growers of all sizes and from every region of the country. The Committee was formed in the early 1940's for the purpose of overcoming then existing inequities in the capital gains treatment of timber. It has served since that time to advocate federal income, estate and capital gains tax policies which will make possible sufficient investment in timber growing enterprises to meet the nation's expanding need for lumber, paper, chemicals and the many other products of our forest resources.

Seventy-two percent of the nation's commercial timber is in private ownership. Fifty-nine percent is owned by individuals, farmers, partnerships and small corporations. Thirteen percent is owned by integrated forest products companies. All have a stake in the development of tax policies which adequately take into account the long investment cycle and the extraordinary risks in timber growing.

On many occasions in the past we have had the opportunity to report to your Committee and other Committees of Congress on the specific economic and social benefits which have resulted from the application of capital gains tax rates to the full spectrum of capital transactions in timber. In 1944, before Congress corrected inequities in the law, there existed powerful disincentives for sustained-yield management of private timber tracts. The decline in the nation's timber growing stock prior to 1944 reflected that unwise policy. The

dramatic reversal in investment patterns subsequent to 1944 clearly demonstrates that, when given fair treatment in relation to other capital investment opportunities, timberland owners are able to respond to consumer demands for forest products.

The specific details of this renaissance in private sector timber management is a matter of record. To provide you with the most recent accounting, we are including with this statement a copy of our March 9, 1978 testimony before the House Committee on Ways and Means. In it we relate the improvements which have occurred in the private timber sector resulting from the application of Sections 631 (a) and (b) of the Internal Revenue Code. These provisions ensure that capital gains applies to the full range of transactions common to the production and disposal of timber, including those required for sustained-yield management. In those hearings we also provided our analysis of President Carter's proposed changes and our recommendations regarding capital gains, the minimum tax, and the investment credit as they would affect timber investments.

GENERAL CAPITAL GAINS DISCUSSION

It is the purpose of your hearings to examine general capital gains provisions and their impact on the full range of capital investment. Therefore, we will not repeat those details with respect to the justification for Section 631 (a) and (b) treatment of timber transactions and which are a matter of record in past hearings.

It is appropriate, however, that timber investments be cited as a unique example of the need for more moderate capital gains tax rates. We know of no other single enterprise where the time required to bring an initial investment (forest plantings) to economic maturity is so great. Depending upon the quality of the growing site, the region of the country, species and other factors, that period can range from 25 to 75 years. During the growing period the investment generates no income, only expenses. The risks of loss by fire, disease, windstorm and other natural causes is high; and insurance against such losses is unobtainable. The liquidity of such an investment is very poor. Imputed interest costs for the lock-in of capital for such long periods without current income is extremely high. The after-tax rate of return on timber growing has historically been unacceptably low. The rate of return in the forest industries sector for all functions, including manufacture, has averaged below that of the manufacturing sector generally.

With all of these built-in handicaps to the attraction of capital, the timber growing sector is an illustration of what is happening in many areas of capital investment today—and what could well happen in more favorable investment areas in the future unless adequate recognition is given in tax policy to capital formation requirements.

To summarize briefly: during that period when the maximum capital gains rate for both individuals and corporations was 25 percent, the nation's timberland owners were investing in improved timber management at a rate sufficient to keep up with expanding consumer requirements and at the same time build a cushion of supply for the future. The latter is essential because of the length of time required to nurture a timber crop to economic maturity. Trees which were planted in the late 1940's and early 1950's are only now becoming available for harvest and some that were planted during that period won't be harvested for another 10, 20 or 30 years. The timber investment activity of the 30-year period following 1944 had the beneficial effect of warding off a "timber famine" which had been predicted by government and private experts to be upon us by the 1970's and 1980's.

But the timber supply-demand relationship continues to be a major concern. The U.S. Forest Service predicts that by the year 2000 we will need 20 billion board feet more timber each year than will reach normal harvest stage each year. (That amount of wood would satisfy the needs of 400,000 single-family dwellings.) But the same tax incentives which were in effect from 1944 to 1969 are no longer there.

INCENTIVE EFFECTS OF CAPITAL GAINS

The essence of the capital gains incentive is the differential between the applicable capital gains rate and corresponding ordinary income taxe rate. Among other things that differential serves two vital functions in the process of capital formation and retention: (1) It encourages capital savings and investment, and

(2) it mitigates the effects of inflation on nominal gains and reduces the amount of real capital taxed away by the government.

In the United States today there is a real need for both functions. Of all the major industrial nations of the free world, the United States has the lowest ratio of savings to income. On the second point, the tax on inflated gain and subsequent reinvestment in value-inflated assets often leave the investor with less real capital after a transaction than before. This not only deprives the taxpayer of his savings—on which taxes have already been paid—but also robs our economy of the benefits of real growth in capital assets.

With both of these factors working against us, it is simply not possible for our economy to do what is needed to provide the capital stock to support a growing labor market, to provide the innovations and efficiencies needed to hold down the prices of consumer products, and to provide the overall economic growth necessary to meet the revenue needs of local, state and federal governments for essential public services.

It is no accident that the sluggish growth in the nation's capital stock coincides with the diminution of the differential between capital gains and ordinary income taxes.

DIMINUTION OF CAPITAL GAINS BENEFITS

Savers and investors have seen the capital gains tax differential shrink dramatically over a period of less than ten years.

Prior to 1969, the effective capital gain rate for individuals was 50 percent of the ordinary rate, with a maximum of 25 percent. For corporations, it was a flat 25 percent. The 1969 Revenue Act and subsequent enactments departed from that historic pattern. The differential for corporate capital gain, i.e., the difference between ordinary income tax rates and capital gains tax rates has been reduced from the 27 percent that prevailed for many years to 18 percent at the present time. Earlier this year, President Carter submitted a series of tax recommendations to the Congress which, if adopted without change, would further reduce the differential to only 14 percent.

While the basic inclusion of "one-half the gain" in the ordinary income tax calculation is still in the law for individual capital gains, the elimination of the alternative 25 percent tax on all but the first $50,000 of gain and the adoption of the Minimum Tax on Tax Preferences have reduced the overall incentive for risk investments by individuals.

The extent to which recent enactments have diminished the stimulus for savings is greater than most people realize. The so-called Minimum Tax alone has resulted in a 60 percent increase in the maximum rate of capital gain of individuals. If President Carter's recommendations were adopted, it would be even higher. When you consider the effect of treating one-half of long-term capital gains as a preference for computing the Maximum Tax on Earned Income as well as the Minimum Tax on Tax Preferences, the maximum tax rate on capital gain of individuals has almost doubled in less than 10 years.

The following table illustrates this dramatic shift in federal tax policy on capital gain.

Maximum rate on individuals per $100 of long-term capital gains

	Percent
Effect of minimum tax on tax preferences:	
Pre-1969	25
1969 act	36.5
1976 act	39.875
Carter proposal	42.5
Effect of both maximum tax on earned income and minimum tax on tax preferences:	
Pre-1969	25
1969 act	45.5
1976 act	49.125
Carter proposal	52.5

Thus, when both the minimum and maximum taxes are considered, the top rate on capital gains is neary 50 percent. This hardly squares with the rhetoric we so frequently hear. Nor does it square with sound national policy. When political cliches are put aside and our need for capital is viewed realistically, it is abundantly clear that present policies are not adequate for the task.

CAPITAL GAINS DIFFERENTIAL FOR CORPORATIONS

When we consider the corporate capital gains structure, the detrimental erosion of the past several years is even more dramatic.

Prior to 1964, the differential in corporate capital gain was 27 percent, representing the difference between the statutory 52 percent corporate rate and the flat 25 percent capital gain rate. When the corporate tax rate was reduced to 48 percent, the differential was thereby narrowed to 23 percent. In 1966, the corporate capital gain rate was increased to a flat 30 percent and corporate gain was also made subject to the minimum tax, making the differential between ordinary income and capital gain 18 percent or less. If President Carter's corporate tax reduction proposal is adopted without a corresponding reduction in the corporate capital gains rate, the differential would be only 14 percentage point—approximately one-half the pre-1964 capital gains incentive * * * and it affects all corporate gain, whether ordinary earnings are high or low.

RECOMMENDATIONS

It is apparent from the history of recent tax changes that the importance of capital investment has not been fully recognized in the evolution of our tax laws. Certainly for timber growers—and just as likely for investors in other types of assets—the capital gains incentive has been gradually eroded to the point where it is grossly inadequate to meet national needs. The trend toward closing the differential between capital gain and ordinary income represents a direct tax on capital. The trend must be reversed.

The Forest Industries Committee on Timber Valuation and Taxation reiterates its long-held position that the capital gains structure should be returned to its pre-1969 status. We see absolutely no conflict in this position with the concept of tax equity or with the need of government entities to generate sufficient revenue to provide public services. To the contrary, history amply demonstrates that economic activity expands as incentives for capital formation are enacted. As economic activity expands, so do revenues for every level of government and so do the opportunities for gainful employment and for capital savings by a larger segment of the population.

We congratulate you, Mr. Chairman, and the members of your Subcommittee for conducting these hearings. A full examination of policies affecting the taxation of capital gains and the impact of those policies on our economic vitality is greatly needed. We hope the information we have provided and the suggestions made will be helpful to you in that process.

SUMMARY STATEMENT OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION—MARCH 9, 1978

PURPOSE OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION TESTIMONY

To oppose changes in the Internal Revenue Cost which will diminish the capability of landowners to invest in modern forest management practices and to urge adoption of new capital recovery provisions which will help make possible the needed high level of investment in the nation's forestlands to meet predicted future needs for wood and fiber.

PRESIDENT CARTER'S RECOMMENDATIONS

The President's proposal to revise the minimum tax and to eliminate the capital gains alternative tax represent a continuation of the steady erosion that has occurred in the capital gains tax benefit over the past several years. When coupled with the failure to recommend a reduction in the corporate capital gain rate to correspond with the proposed reduction in the ordinary income tax rate, the President's tax package would further diminish capital investment incentives at a time when the balance has already been tipped too far against savings and investment.

FEDERAL TAX POLICY AND TIMBER SUPPLY

The historic relationship between fair timber tax policies and improvement in the nation's private sector timber supply is clearly demonstrable. There is vivid contrast between the pre-1944 era (when capital gains treatment was denied to

timber owners who managed their lands for continuous production) and the post-1944 era during which capital gains treatment has served as the cornerstone of a remarkable renaissance in the management of the nation's private forest resources.

PROJECTED DEMANDS FOR TIMBER

Government studies clearly indicate that substantial shortages of timber will begin to affect our economy within the next two decades. By the year 2000, the shortfall is projected to be 20 billion board feet per year—enough to build 1,400,000 single family homes each year. If we wait until the shortage is upon us it will be too late because it takes from 25 to 50 years to produce timber suitable for conversion to lumber and plywood.

TIMBER IS A UNIQUE RESOURCE

Because it is constantly renewable, timber is unlike any other basic raw material. Public policies which fail to recognize and capitalize on that renewability by making it economically advantageous to accelerate the regeneration and growth processes are shortsighted policies. On the other hand, the adoption of specific measures designed to overcome the natural and economic risks involved in long-term timber investments will bring dividends of an assured future supply of a critical commodity, both short-term and long-term job creation, and higher future tax revenues to all levels of government.

DIFFICULTIES OF ATTRACTING CAPITAL

It is estimated that $16 billion in capital is needed now and in the very near future to enable private timber owners to bring their commercial timberlands to an adequate level of production to prevent shortages of supply. Approximately $13 billion of this is needed on the 59 percent of commercial timberland controlled by individuals and farmers. The historical low rate of return and the long-term illiquidity of funds invested in timber will make it virtually impossible to attract that much capital under present conditions.

RECOMMENDATIONS

The Forest Industries Committee on Timber Valuation and Taxation:

1. Recommends that the minimum tax concept be reevaluated and if it is to be retained that it be converted to a true "minimum" tax instead of being an additional tax on already taxed income as at present. If the existing concept is retained in the law, the deduction for "other taxes paid" should be restored to 100 percent instead of being eliminated as proposed by the President;
2. Recommends retention of the capital gains 25 percent alternative tax;
3. Recommends reduction in the corporate capital gain rate by 4 percentage points to correspond with the proposed reduction in the corporate ordinary income tax rate; and
4. Recommends that the 10 percent investment tax credit be extended to capitalized forest regeneration expenses and that such expenditures be amortized over a seven year period.

STATEMENT OF FOREST INDUSTRIES COMMITTEE OF TIMBER VALUATION AND TAXATION—MARCH 9, 1978

This statement is presented on behalf of the Forest Industries Committee on Timber Valuation and Taxation, a voluntary organization of over 4,000 timber owners who support the adoption and maintenance of federal tax policies which are compatible with the economics of intensive regeneration and management of the nation's private timber resources.

Represented among the Forest Industries Committee's supporters are timberland owners of all sizes and from all timber producing regions of the country—from small tract owners and forest farmers to the largest of the integrated forest products enterprises. Our industry is easily the least concentrated of the resource based industries with approximately 80 percent of the privately-held commercial forest acreage being in the hands of non-industrial owners.

There is no question about the unanimity among all sectors of the industry when it comes to the important role of federal tax policy in determining the quantity of growing timber which will be available for harvest in future years

and in determining the extent to which the resource can be managed for higher productivity. Virtually all growers have a stake in those policy decisions—in proportion to their contributions to the nation's supply of wood for processing into consumer products.

PRESIDENT CARTER'S RECOMMENDATIONS

It is our intention in this statement to address several specific aspects of President Carter's income tax recommendations of January 20, 1978 as well as the general impact on timber producers of present and proposed federal income, estate and capital gains tax provisions.

It is the President's purpose, as stated in his message, that proposed tax reductions and improvements in the investment credit provisions "will provide the consumer purchasing power and business investment strength we need to keep our economy growing strongly and unemployment moving down."

We applaud the proposed individual and corporate tax reductions as being generally conducive to those objectives. However, there are other elements of the President's proposal—and there are omissions in the proposal—which would adversely impact timber growers in relation to other sectors of the economy.

PROBLEMS IN PRESIDENT CARTER'S RECOMMENDATIONS

The capital gains provisions of the Internal Revenue Code—specifically Sections 631(a) and 631(b)—have historically served to help overcome the extraordinary natural and economic disincentives for long-term capital investment in timber growing. Other incentive provisions of the Tax Code which are intended to benefit raw material production do not apply to timber. Nor does the investment credit currently apply to capital investments in reforestation. Capital gains treatment is the sole existing tax incentive.

Yet, in three major aspects, the pending proposal would significantly reduce the incentive effects of capital gain. Each of these will be covered in detail in this statement but our concerns can be summarized as follows:

The essence of the capital gain incentive is the differential between the applicable capital gain rate and the corresponding ordinary income tax rate. Prior to 1969, the effective capital gain rate for individuals was 50 percent of the ordinary rate with a maximum of 25 percent. For corporations, it was a flat 25 percent. The 1969 Revenue Act and subsequent enactments departed from that historic pattern. The differential for corporate capital gain, i.e., the difference between ordinary income tax rates and capital gains tax rates, has been reduced from the 27 percent that prevailed form any years to 18 percent at the present time. If the President's recommendations are adopted, the differential would be further reduced to only 14 percent. Our testimony will demonstrate that the risk capital needed to meet national goals for timber supply is not likely to be forthcoming under such conditions.

While the basic 50 percent factor is still in the law for individual capital gain, the elimination of the alternative 25 percent tax on all but the first $50,000 of gain and the adoption of the minimum tax on tax preferences have reduced the incentive for risk investments by individuals. The largest acreage of timber in the United States is in individual or farm ownerships. These offer the greatest potential for improved supply if the owners can afford to implement the current state of the art in forest management. But, the trend of reductions in capital gain benefits and the constant threat of even greater adverse actions have made it more difficult for these owners to justify higher investments in reforestation and intensive management. The President's proposal would—in two significant ways—contribute to those difficulties.

The first of these is the proposed complete elimination of the alternative tax for individuals which will affect those who can best afford to practice intensive forestry on their lands.

The second is the proposed change in the minimum tax which would further reduce the capital gains incentive—and certainly would give non-industrial, individual timber owners even more reason to question the advisability of instituting timber management programs.

Therefore, while the President says his intention is to provide "business investment strength," the specifics of his proposal would clearly have the opposite effect on the potential of timber growers to generate the large amounts of capital required to meet public policy objectives.

SUMMARY OF RECOMMENDATIONS

Ultimately, the nation can realize the full potential of its privately owned forests only through a carefully formulated combination of incentives. These incentives must recognize the long-term commitment necessary to forest management and the greater—and different—risks imposed by this unique requirement.

Therefore, the Forest Industries Committee on Timbe Valuation and Taxation makes the following recommendations which are explained in greater detail at the conclusion of our statement.

We recommend that the maximum rate for timber capital gains should not exceed one-half the rate for ordinary income and, in the case of individuals, should be limited to a rate of 25 percent.

The corporate capital gain rate should be lowered by the same number of percentage points as the ordinary corporate rate is reduced. This would maintain the level of incentive which currently exists—a level already critically low because of changes in the capital gains structure brought about by recent enactments.

If the so-called minimum tax is to be retained in the law, it should be made a true minimum tax rather than an additional assessment on specific forms of income which have already been taxed at the full statutory rate. Since the greatest negative impact of the Minimum Tax is on capital gain, another solution would be to eliminate capital gain from the definition of "preference income."

In the area of estate taxation, it is important that we emphasize the need to avoid such burdens as to force the breaking up of private timber holdings. Specificially, the "carryover of basis" rule should be repealed.

Finally, we believe the President's proposal to extend the 10 percent investment tax credit to new classes of property should include capitalized reforestation costs, along with a seven-year amortization of those expenditures.

These policies would more adequately recognize the existing need for heavy initial investment in reforestation as well as the long period required before the investor realizes a return on that investment.

With that introduction, we wish now to recount briefly the historical relationship between federal tax policy and private sector timber supply, the difficulties of attracting capital investment to timber growing, and the crisis that is certain to develop within the next 2 or 3 decades if those difficulties are not overcome. And, finally, we will address the specific proposals pending before your Committee as they relate to the timber producing sector of the economy.

FEDERAL TAX POLICY AND TIMBER SUPPLY

There is probably no more dramatic example of the direct relationship between tax policy and producer response than is clearly evident in the history of the timber economy throughout the 20th century.

It is common knowledge that the nation's timber resource was in a state of alarming decline during the period up to the early 1940's. For the most part, timber operations were conducted similar to mining or petroleum production . . . the emphasis was on extraction. There was a difference with timber, of course, and the difference was that the harvested timber resource could be regenerated—either by natural means or by careful management to accelerate the reforestation and growth processes. Unfortunately, the federal income tax policies then in effect weighed heavily against the latter.

Prior to 1944, timber was recognized as a qualified capital asset—along with land and improvements for farm or business use, commercial properties and equity interest in other enterprises—but only if the timber was liquidated by the owner in a lump-sum transaction. If, on the other hand, the owner chose to manage the resource on a sustained yield basis—if he replanted or managed it as an ongoing investment through selective or periodic harvests—the owner was denied capital gains treatment. Also, if the owner harvested timber for processing in his own plant, he was denied capital gains treatment. These anomalies came about because of a ruling by federal tax authorities that such transactions indicated that the timber was not a capital asset but instead was being held primarily for sale to customers in the ordinary course of trade or business. In other words, sustained yield timber operations—which in some areas required up to 50 years or more to complete a marketing cycle—were viewed for tax purposes the same as a food crop planted in the Spring and harvested in the Fall or as inventory in a hardware store.

Thus, the tax laws of the time fostered a continuation of economically wasteful and counter-productive practices on private forestlands. In effect, they imposed a severe tax penalty on those who wished to manage their lands wisely. As a consequence, there was too much indiscriminate cutting; soil and watershed values were lost; vast acreages were abandoned for taxes because the owners could not afford to do anything with them; and far too much timberland was converted ot marginal farm production—with sorrowful consequences for both the land and the operators.

1944 ACT OF CONGRESS

In 1944, Congress eliminated this major disincentive to sustained yield private forestry. By extending capital gains treatment of timber transactions to sales of managed timber and to the transfer of timber assets for manufacture in a mill operated by the timber owner, Congress declared it to be in the public interest to stimulate capital reinvestment and improved management of timberlands.

The response of timberland owners must have surprised even the most optimistic advocate of the tax reform. Up until 1944, the inventory of growing stock on private forestlands was declining by 7 billion cubic feet per year.[1] This trend was dramatically reversed immediately following Congress' action, demonstrating that landowners were philosophically committed to the proper management of their lands but had simply not been able to justify it economically. In the 33 years since adoption of what are now Sections 631(a) and 631(b) of the Internal Revenue Code, the nation's inventory of standing timber has increased by more than 175 billion cubic feet. Planting of seedlings—which was almost nonexistent prior to 1944—is now in the hundreds of millions each year. In some of the better managed lands, 5 or more seedlings are planted for each mature tree harvested.

In the years immediately preceding 1944, government and private experts were predicting a "timber famine" by the 1960's and 1970's. And, the predictions were based on what have since proven to be substantial underestimates of consumer demands for wood products. But, in spite of those unexpected demands, the timber growers of the country have not only kept pace with the needs of our economy, they have actually grown more each year than is harvested.

TIMBER SUPPLY AND DEMAND TO THE YEAR 2000 AND BEYOND

Now we face a new crisis. In its 1973 comprehensive report, "The Outlook for Timer in the United States", the U.S. Forest Service tells us where we are going in terms of what is currently known about consumer requirements and the state of the nation's timber resources. The study concludes that by the year 2000, the United States could experience a shortfall in timber production of over 20 billion board feet per year.[2] That amount of lumber would build 1,400,000 single-family homes each year. But, homebuilding is not the only sector which would be adversely affected by such a damaging shortage of timber. Over 5,000 consumer products are derived from our forests—commodities which are essential to education, communication, sanitation and health and many of which contribute in unique ways to the maintenance of the American standard of living.

Enlightened tax policies have made significant contributions in the past to the development of our renewable forest resources. But, now, more than ever, there is need to avoid tax changes which will make that development more difficult; and there is need to make substantial improvements if national objectives are to be achieved.

Just as an earlier timber famine was avoided by the adoption of wise public policies, current predictions of future shortages can also be thwarted. But, it will require foresight on the part of those responsible for enacting and implementing the nation's laws.

TIMBER IS A UNIQUE RESOURCE

Because timber is fully renewable, it differs from other basic raw materials which are finite in supply. A forest, in its natural state, is in a constant cycle of destruction and renewal. And, contrary to some popular misconceptions, man has yet to devise harvesting techniques which are as fast and "efficient"

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[1] There are approximately 6 board feet per cubic foot.
[2] There are approximately 6 board feet per cubic foot.

as those brought to bear by nature through fire, infestation, or disease. But, regardless of how a forest is brought to the renewal stage—whether by man's harvesting or by natural means—the natural process of regeneration is too slow and too haphazard in most cases. Man's intervention through reseeding, planting, protection from pests and disease, and other practices can have enormous beneficial impact. Active management, while a young forest grows to maturity, can more than double the volumes of usable wood produced on a given acreage.

Since these facts have been amply demonstrated in recent years, it may well be asked, "Why doesn't every timber grower adopt these practices?"

The answer is twofold.

1. Difficulties of attracting capital

The renewability of forest resources and their potential abundance in this country are strengths enjoyed by few other nations. Yet the commitment of major amounts of capital over unusually long periods of time is required to develop, maintain and utilize that resource in the most efficient way. It has been reliably estimated that $16 billion or more is required for investment now and in the very near future if we are to meet projected market requirements in the year 2000 and beyond.

The principal deterrent to capital investment in forest productivity is the long period before investment in a forest can be recovered. In the West, the capital invested may lie in a dead account for 30 years only then to be amortized over the harvest cycle—a total of 50 years or more. In the South, capital is held in a dead account for 13 or more years only then to be amortized over the harvest cycle—a total of 25 years or more.

Coupled with the extraordinarily long investment cycle is the historically low rate of return on timber investments. Federal Trade Commission reports indicate the return on timber, paper and allied products for the period 1966–75 was 5.8 percent compared with a return of 6.5 percent for all durable and nondurable goods produced. University and government studies show comparable low rates of return on timberland in all regions of the country and in all categories of ownership. (These figures are shown in greater detail on page 5 of the attached material entitled "America's Renewable Resources."

The risks involved in timber management are unusually high. Compare, if you will, the situation of two landowners who suffer total destruction of standing timber by fire. One had left his land to natural regeneration and, therefore, his loss was limited to the delay in future income he could expect to receive. The other, however, had invested large sums in seedlings, mechanical site preparation, spraying, fertilizing, thinning and other practices. He had constructed roads and bridges to make it possible to conduct an intensive management program. He had employed the counsel of professional foresters and had expended a great deal of his own productive time in the development of the young timber resource. Consequently, he lost not only the anticipated income from the property but all of his capital investment and all of the money expended for non-capital costs. He collected no insurance because insurance is simply not obtainable to cover such a loss by a timber owner. And, current tax laws restrict the amount of his deduction for such a casualty loss to his original cost basis rather than the economic value of his loss. Clearly, the owner who was doing the best job of managing his timberland would suffer the greater loss in such a catastrophe.

It has to be concluded, therefore, that the timber capital gains incentive has not been a windfall to timber growers. At best, the tax incentive can be said to have only partially offset the negative factors of an extraordinarily long investment cycle, ongoing carrying costs, high risks, and potentially slender economic return.

These are the handicaps which must be addressed by the Congress and by the Executive Branch if it is to be our national policy to properly anticipate and prepare for the timber supply needs of the United States by the year 2000 and beyond * * * because we cannot wait until the shortage is upon us to take remedial action. We will never find a way to grow a tree in that short a time.

2. Capital gains erosion—in general

As stated earlier, the incentive impact of the capital gain tax rate is in direct proportion to the differential between capital gain and ordinary income tax rates. Traditionally individual capital gains have been taxed at one-half of ordinary rate with a maximum of 25%. The corporate capital gain rate was for many years, prior to 1969, a flat 25 percent.

Starting in 1964 and 1965 and continuing through the Tax Reform Act of 1976, the capital gains differential for corporations has been steadily eroded. And, starting with the Revenue Act of 1969, a similar erosion has occurred in the area of individual capital gain.

a. *Individual incentives.*—In 1969, the 25 percent alternative tax for individuals was eliminated on all but the first $50,000 of capital gain. This becomes a significant factor when applied to the typical, medium-sized timber growing operation. There are two valid reasons for this: (1) There usually must be substantial income before there is even the possibility of an individual investing in timber, and (2) the pattern of income (capital gain) from small and medium-sized timber ownerships is generally such that it will be "bunched" rather than being distributed evenly over the years. The combination of these factors makes it more likely that the individual's tax liability on timber income will exceed the traditional 25 percent maximum which had been in effect for many years.

Also in 1969, the so-called "minimum tax" was adopted. While its stated purpose was to put an end to tax avoidance through use of certain tax deductions, it has not had that effect. Many of those who paid no taxes on substantial incomes still pay no taxes. But, many who were already paying the full statutory rate on capital gain have had their tax liabilities increased through the minimum tax assessment. When first adopted, the minimum tax at least allowed the taxpayer to fully deduct "other taxes paid". Then, in 1976, this deduction was cut in half. The President's pending proposal would eliminate entirely the deduction for such taxes paid, stripping away completely the pretense that it is indeed a "minimum" tax and clearly making it an additional levy on income which has already been fully taxed under the law.

While the list of "tax preferences" subject to the minimum tax is extensive, in reality—according to Treasury Department studies—it boils down to being essentially an additional tax on capital gain. Over 80 percent of minimum tax collections from individuals is attributed to higher assessments on capital transactions.

The increasing tax burden on capital gains due to the minimum tax can be illustrated by the following table:

Maximum rate on individuals per $100 of long-term capital gains

Effect of minimum tax on tax preferences only:	*Percent*
Pre-1969	25
1969 act	36. 5
1976 act	39. 875
Carter proposal	42. 5

Thus, the effect of the Carter proposal is to raise maximum capital gains rates to a level 70% above pre-1969 levels. The increase is even more dramatic when you consider the effect of treating one-half of long-term capital gains as a preference for computing the maximum tax on earned income as well as the minimum tax on tax preferences.

Maximum rate on individuals per $100 of long-term capital gains

Effect of both maximum tax on earned income and minimum tax on tax preferences:	*Percent*
Pre-1969	25
1969 act	45. 5
1976 act	49. 125
Carter proposal	52. 5

Thus, when both the minimum and maximum taxes are considered, the top rate on capital gains will exceed 50 percent. This would still be true even if the rate cuts in the President's Tax Program are considered. The effect of the Carter Proposal, therefore, with both the minimum and maximum taxes considered, is to increase the maximum tax on capital gains to a level 110 percent higher than pre-1969 levels.

Therefore, through the combination of restrictions on the use of the alternative tax, the imposition of higher taxes on capital gain by means of the minimum tax, and through changes in the maximum tax on earned income, many non-corporate timber growers have seen the capital gains incentive whittled down from what they had anticipated when they first made their investment and others have very likely been discouraged from making such investments because of the pattern of steadily decreasing benefits.

b. *Corporation capital gain rate differential.*—In the corporate capital gains structure, the detrimental erosion of the past several years in timber tax treatment is even more dramatic.

Prior to 1964, the differential in corporate capital gain was 27 percent, representing the difference between the statutory 52 percent corporate tax rate and the flat 25 percent capital gain rate. When the corporate tax rate was reduced to 48 percent, the differential was narrowed to 23 percent. In 1969, the corporate capital gain rate was increased to a flat 30 percent and corporate gain was also made subject to the minimum tax making the differential between ordinary income and capital gain 18 percent or less.

President Carter now proposes that the corporate rate for ordinary income be phased down to 44 percent but he has not asked for a reduction in the corporate capital gain rate. Without a corresponding change in the corporate capital gain rate, the differential, which is the essence of the incentive to make risk investments, would be only 14 percentage points—approximately one-half the pre-1964 capital gains incentive.

As stated earlier, we believe the President's proposed individual and corporate tax reductions will have beneficial impact on our economy. They will help stimulate general economic activity. However, if they are not balanced by proportional incentives for new capital investment, they will not accomplish their full intended effect.

The proposed changes in the investment tax credit, by making the 10 percent rate permanent and by extending its application to industrial buildings, will have a salutory effect on some segments of the economy. But, as presently constituted and as the President has proposed it be changed, the investment tax credit would not alleviate the critical need for greater capital investment in timber growing. We believe it is logical to bring about a better balance in its stimulus impact by extending it as well to the capitalized planting costs for timber.

It is apparent from this history of recent tax changes that the importance of capital investment to timber growing has not been fully recognized in the development of tax policy. The incentive that was enacted into law in 1944—and which served so superbly in the national interest—has gradually been made less effective until it is now inadequate to offset the unique problems of timber growing.

Therefore, we are urging that ceretain elements of President Carter's tax recommendations be rejected by the Congress, that the historic differential between capital gain and ordinary income taxes be restored and that additional incentives be provided to make possible the level of investment needed to keep America's renewable forest resources as productive as possible in our national interest.

RECOMMENDATIONS

The Forest Industries Committee on Timber Valuation and Taxation, after thorough consideration of President Carter's tax package, urges that the Congress make several changes which we believe are fully consistent with the President's intentions and with the acknowledged need to stimulate new investment in timber growing.

1. We recommend that the "minimum tax" concept be reevaluated to determine its impact as a disincentive for taxpayer investments or activities which have been determined by Congress to be socially or economically desirable. If the concept is to be retained, the formula should be revised to make it a true "minimum" tax rather than an additional tax on certain forms of income as at present. One way of accomplishing this would be to adopt the formula in the Ways and Means Committee tax reform draft of September, 1974. This proposal was an alternative tax on "economic income" rather than an added tax on preferences. If the existing formula is to be retained, we strongly urge that capital gain be deleted from the definition of "preference income". And, we strongly oppose the President's suggestion that the existing minimum tax be retained and made even more regressive by eliminating the provision for deducting a portion of "other taxes paid". Indeed, the deduction which was reduced last year to 50 percent should be fully restored if the present system is to remain in the law.

2. We recommend that the alternative tax on the first $50,000 of capital gain be retained. The revenue impact of eliminating the alternative tax is minimal yet, in our particular industry, there is considerable reliance on investment funds from individuals who would be affected by the change. We believe the potential benefits in terms of individual timber ownerships far outweigh any arguments we have heard for repeal.

3. We recommend that the corporate capital gain rate be reduced by 4 percentage points to maintain the present differential between the capital gain and the proposed ordinary corporate income rate. We believe a point-for-point reduction is fully justified until corporate capital gain is taxed at one-half of ordinary income.

4. Even with capital gains benefits fully restored to the pre-1969 level, economic studies indicate that the investment needs of the forest products sector will likely be met only if another major impediment to investment is eliminated from the tax laws. Cost recovery (depletion) on timber is now delayed until the timber is sold or harvested—which, as we have indicated, may be 50 or more years from the time of the investment in planting. For this reason, we recommend that the 10 percent investment tax credit be extended to capitalized forest regeneration expenses and that such expenses may be amortized over a seven year period. The investment credit has been remarkably effective in increasing capital investment in various other sectors of the economy and we believe it also can be beneficial in stimulating productivity and creating new jobs in the timber growing sector. We recommend specifically that such costs as site preparation, planting, timber stand improvement and other activities related to forest productivity be treated the same as other job producing capital. The resulting increase in timber supply will benefit the nation in many respects, not the least of which is the future increase in tax revenue.

5. Although somewhat apart from the central theme of your current hearings, the issue of estate taxation—and particularly the implementation of the carryover basis provisions of the Tax Reform Act of 1976—warrant attention by the Congress. The overall effect of the carryover basis provisions on closely held businesses and farm operations have been well publicized. We point out that, in some respects, the impact on timber assets in an estate can be more severe than on other types of capital assets. Premature liquidation of timber assets will be the result in some instances and the locking-in of such assets after the death of the owner will likely result in other instances. The carryover basis provision results in a form of double taxation through payment of an inheritance tax on the market value of the timber at the time of inheritance and payment of a capital gains tax at the time the timber is sold based on the difference between the original cost and market value at the time of death. In no case can we see any compensating revenue or public interest benefits to offset the wrenching disruption that the new carryover provisions will bring to individual ownerships and to closely held timber owning companies.

CONCLUSION

Several times in recent years we have appeared before your Committee on various tax proposals giving you our views on how they would affect the timber growing business. Many of the points made in earlier testimony have not been repeated in this statement. Such factors as the environmental benefits of wood utilization compared to substitute products, the energy conserving characteristics of wood products processing and manufacture and the broadly based economic and employment patterns of our industry throughout every region of the country have been covered in detail in the past. There is, however, one significant factor that deserves repeating on this occasion.

Other nations have moved far ahead of the United States in their recognition of the unique importance of timber resources in this era of resource decline. In those free market economies where forest taxation practices have been studied, there has been a universal acceptance of the concept that timber producing property is a uniquely valuable capital asset and that tax incentives are essential to overcome the inherent handicaps to investment and higher productivity. The trend in such countries as Great Britain, Norway, Sweden, Holland, West Germany, France, Finland, Switzerland, Brazil, Australia, New Zealand and Japan, in fact, in all free nations which have been studied, is not to reduce tax incentives for timber production but to broaden and improve them.

Existing conditions in the United States are discouraging sufficient investment in timber growing to meet tomorrow's needs. And, every year of delay in implementing more adequate policies means a year of delay somewhere into the future in realizing the tangible benefits in terms of needed wood supplies.

Therefore, we take this opportunity to urge a new and fresh look at the problems outlined in this statement. We hope that the information provided and the suggestions made will be helpful to the Committee in that process.

Thank you.

STATEMENT BY MARTIN R. GLICK, DIRECTOR, CALIFORNIA EMPLOYMENT DEVELOPMENT AND CHAIRMAN, UNEMPLOYMENT INSURANCE COMMITTEE INTERSTATE OF EMPLOYMENT SECURITY AGENCIES, INC.

I am Martin R. Glick, Director of the California Employment Development Department (EDD) and Chairman of the Unemployment Insurance (UI) Committee of the Interstate Conference of Employment Security Agencies, Inc. (ICESA). As Chairman, I represent the State Administrators of the 53 State Employment Security Agencies on unemployment insurance matters. The following statement is being submitted in my capacity as Chairman of the ICESA Unemployment Insurance Committee and as Director of EDD.

We oppose the provisions of HR 13511 which would tax unemployment insurance benefits. ICESA and California are opposed to taxation of UI benefits for the following reasons:

1. Such a tax would impact most individuals when they could least afford it. Many workers would have come up with additional monies for taxes while they were unemployed or when they are returning to work after a period of unemployment. The alternative, a "withholding" system, is simply unworkable.

First, to withhold some portion of an unemployed worker's UI check defeats the very purpose of the system, i.e. to temporarily replace an urgently needed portion of the wages of a worker who has lost his/her job through no fault of his/her own. Secondly, every UI claimant would have to have a portion of his/her UI benefits withheld, as there would be no way to identify which individual workers who were receiving unemployment insurance benefits actually met the annual income definition, until the end of the tax year.

2. This bill has been advanced as a measure which affects only "the rich" who don't need unemployment benefits." We don't believe that to be true. However, even if it were true, this proposal would inject an element of "need" into an insurance program that historically has provided benefits based solely on work history. Present guidelines provide that UI benefits should replace 50 percent of lost wages. Taxation of UI benefits would be inconsistent with such guidelines because it would reduce the present wage replacement rate. We believe that the recipt of UI benefits should remain a right to those who qualify irrespective of annual income.

More importantly, however, it is simply not true that the unemployment insurance tax proposal here applies only to the wealthy. First, it is based on last year's income (the tax year) not current income. As pointed out above, many persons will be unemployed, receiving no income at the time the tax is due. Second, two-wage-earner families earning $25,000 are not "rich" in today's economy, especially in families with children. Thirdly, since there is no provision in HR 13511 which would "index" this $25,000 line, such a definition of "the wealthy" will shortly become even less valid as inflation moves people into higher earnings brackets. Finally, HR 13511 provides that families with two workers who now file separately to take advantage of state, and sometimes federal, tax laws are fully taxed regardless of their income. These workers are thus placed in a category whose unemployment insurance benefits are completely taxed whether or not they meet the arbitrary "wealthy" standard set out in this bill.

3. As stated above, while the $20,000 and $25,000 thresholds contained in HR 13511 may seem high today, inflation will quickly draw many more employees into taxed status, especially in families with more than one wage earner. We would also expect taxation of unemployment insurance benefits to result in substantial pressure to increase unemployment insurance benefits, to offset the proposed income taxes. Taxes paid to the internal revenue service on unemployment insurance benefits would not accrue to the federal or state trust funds which support the UI program. This in turn would mean increased employer payroll taxes which are highly undesirable in a period when the nation should be attempting to encourage full employment, not provide tax disincentives to employers.

4. Taxation of unemployment insurance benefits would also create massive administrative problems. The Internal Revenue Service would need to be notified of unemployment insurance benefits paid to each individual annually, and recipients would also need statements of benefits received. This would require a multitude of additional record keeping systems since unemployment insurance is paid on a "benefit year" determined by the date of one's unemployment and, obviously, rarely coincides with either a taxable year or a calendar year.

5. Lastly, there is an alternative to the provisions contained in this bill. The National Commission on Unemployment Compansation, established by the Congress in PL 94–566, is currently making a comprehensive study of a large number of unemployment insurance issues, including taxation of unemployment insurance benefits. The Commission will report its findings to Congress in the near future. The Commission's study and recommendations should not be preempted by this proposal.

For all of these reasons, I would urge you, on behalf of ICESA and California, to oppose the provisions of H.R. 13511 which would tax benefits as income.

TESTIMONY BY HENRY J. NORD, SENIOR VICE PRESIDENT, GATX CORP.

My name is Henry J. Nord and I am the Senior Vice President of GATX Corporation of Chicago, Illinois. I appear before you today to present the views of GATX on the investment credit provisions of H.R. 13511, the "Revenue Act of 1978."

GATX is a publicly owned corporation whose principal activity is the supply of railroad freight cars to approximately 900 customers through the manufacture, ownership maintenance and lease of approximately 61,000 freight cars, principally tank cars, representing the largest fleet of privately owned tank cars in the world. Through its subsidiaries and affiliates, GATX is also engaged in other activities, including the ownership and leasing of additional transportation equipment in the United States and abroad.

As a major manufacturer and supplier of capital intensive equipment, GATX has consistently encouraged the passage and continued retention of the investment tax credit. We believe it to be an economically efficient means of motivating business to modernize and expand this country's productive capacity. We also believe that modernization of the productive capacity of U.S. business and consequent reduction of unit costs with accompanying increased employment is essential to improve the competitive position of U.S. business in respect of imports and simultaneously to improve the competitive position of U.S. enterprise in export markets. Greater capital formation, leading to more efficient production, will have a significant impact in reducing the rate of inflation and strengthening the U.S. dollar in foreign exchange markets.

Despite the demonstrated capital generating capability of the investment tax credit. Congress has not yet seen fit to structure it so that its complete potential can be realized. This is particularly so in the case of a capital intensive company such as GATX.

Because the credit has been limited to 25 and now 50 percent of taxable income, our company has not yet been able to utilize fully credits which have been available to us for any taxable year. Even though the statute provides a limited carryover of unused credits, we find that the overhang and possible expiration of these credits is a severe deterrent preventing GATX from fully realizing our capital generating potential.

To cope with part of this problem, GATX often elects to pass the credit through to its lessees of railroad and other equipment. Unfortunately, however, this lease mechanism, although helpful, has not permitted full utilization of the credit, since the prime users of GATX and other manufacturers' equipment are industrial producers whose businesses are themselves frequently in an excess investment credit position or whose size or profit levels are such that they cannot benefit from the credit. On the other hand, enterprises which are not capital intensive generally have ample room to benefit from the credit but do not have the need for capital investment the credit was designed to induce. Thus, all too often the benefit of the credit accrues only to those who need it least as an incentive. Although Congress has enacted special rules easing the limitations on the availability of the credit for airlines and railroads, these liberalizing rules are not available to lessors or lessees of the railroad and airline equipment unless, in effect, they are common carriers. Because GATX leases primarily to industrial users, such as producers of liquid commodities, these special provisions are of limited benefit to our company and others like us.

GATX believes that a rule of equality of treatment for investment credit purposes should apply universally—without discrimination—as between railroads and airlines and any other special interest, on the one hand and the corporate manufacturer of tank cars on the other hand. Railroads, for example, do not furnish tank cars which carry liquid commodities for others. Normally,

the producer of the liquid commodity leases a tank car from a car manufacturer such as GATX. The liquid is then carried in the tank car on railroad lines at the producer's direction. In that case, the railroad furnishes track and locomotion and the producer pays freight for the movement.

To assure that all parties to this important business transaction (the railroad, the manufacturer of the tank car, and the producer of the liquid commodity), maintain a normal relationship in which the impact of the investment credit is neutral as between each of them, a corporation, such as GATX, which is in the business of supplying tank cars, should qualify for the investment credit in the same manner and on the same basis as the railroad. The producer of the commodity, will, of course, benefit equitably, since the amount charged for car rental will always reflect full utilization of the credit. We are here maintaining that economic equity dictates the same treatment for a railroad or an airline and an equipment manufacturer-lessor. The use of leased cars (especially tank cars and other special purpose cars) is a well established and efficient business practice. There is simply no conceivable reason to disturb the present business pattern by putting manufacturer-lessors of such cars at a disadvantage (tax wise) in comparison to the railroads. If equality between the suppliers of freight cars is not established, then we believe no special rule should apply to railroads or airlines.

In light of the foregoing, GATX recommends that the following action be taken by this Committee with respect to the investment credit provisions in H.R. 13511.

1. PERMANENCY OF THE 10-PERCENT CREDIT RATE

GATX urges enactment of the provision in H.R. 13511 to make permanent the 10 percent rate of investment credit in order to assure a positive and continued stimulus for capital investment.

As an executive of a highly capital intensive company, I can assure you that certainty about future financial burdens is an absolutely necessary climate for the making of critical long-range investment decisions. The history of the investment credit—and therefore its efficacy as an investment stimulus—has been impaired by the tax uncertainty that surrounds its impermanence, its rate fluctuations and its availability. If this tax quicksand is eliminated by making the credit permanent, this company at least and I feel certain that countless others similarly situated, would be in a much better position to predict cash flow, to measure future tax cost and to expand the scope of capital commitments.

2. INCREASE IN LIMITATION TO 90 PERCENT OF TAX LIABILITY

One of the most artificial and distorting aspects of the investment credit has been the limitation on the use of the credit which may be claimed to an amount based upon a percentage of tax liability. In the case of a company such as GATX, which produces capital equipment for use by others, the percentage limitation particularly inhibits the investment credit's function as a stimulus. Capital intensive industries such as ours almost invariably have large capital expenditures in relation to taxable income.

Therefore, it is in the very industries where the potential impact of the credit is greatest that the inhibiting effect of the present limitation is most severe. If the stimulator effect which the credit is intended to have is to be fully felt, the credt cannot go unused. To the exent that the cost of capital investments is reduced through the allowance of the credit as an offset against an additional 40 percent of federal income tax liability, GATX can make significantly greater capital investment commitments which it would not otherwise be in a position to do.

Obviously, a 90 percent limitation on tax liability is far superior to the current 50 percent limitation. We believe, in fact, that no such limitation should be imposed. Taxes which are offset by the investment credit will not only produce more investment, but will also reduce the cost of equipment, thus directly tending to reduce the rate of inflation and aid the country's foreign trade position.

GATX therefore strongly supports enactment of the provision in H.R. 13511 to increase the percent limitation on the amount of tax liability that may be offset by the investment credit from 50 percent to 90 percent. However, GATX urges that the proposed phase-in of the increased limitation over a four-year period contained in such provision be eliminated and that instead the 90 percent

limitation be made fully applicable beginning in the taxable year ending after December 31, 1978. The availability of the full increase in the limitation beginning in 1979 would be an extremely effective stimulus to capital investment by GATX and other companies in capital intensive industries. We believe that the revenue cost of elimination of the proposed phase-in will be far outweighed by the positive impact upon our economy which would result from substantial capital investments generated by the ability to utilize a greater portion of investment credit beginning in 1979 rather than in 1982.

Alternatively, we recommend that the limitation applicable to railroads and airlines should be made applicable to corporations engaged in the business of manufacturing railroad cars and leasing them to third parties for use over the tracks of railroads. GATX believes that such equality of treatment between corporate manufacturer-lessors and the railroads is essential to permit the railroads to obtain the full benefit of the investment credit and to increase the supply of cars as rapidly as possible. It is worth noting that the original Senate version of the provision here in question applied to railroad property and was not restricted to taxpayers which are railroads. (Section 1701(c) of H.R. 10612 as originated by the Senate Finance Committee and passed by the Senate on August 6, 1976.) Later, in the Conference, without explanation, the provision was amended to restrict it to railroads. We strongly believe that the original position of this Committee was sound and that therefore the Committee should reassert it. However, the proposed amendment should be limited to corporate *manufacturer-lessors* to prevent the use of the credit as a "tax shelter."

In conclusion, GATX supports enactment of the provision of H.R. 13511 to make the 10 percent investment tax credit rate permanent. While GATX supports enactment of the provision to increase the limitation on the use of the credit to 90 percent of the taxpayer's tax liability, we strongly urge that the phase-in of the increased limitation be eliminated and that such 90 percent limitation be made fully applicable beginning in the taxable year ending after December 31, 1978.

Finally, if the intention is make more equipment available to railroads and airlines, corporate manufacturer-lessors of such equipment should be treated exactly the same as railroads. This will primarily benefit the railroads, which will thus be assured of an adequate (and suitable) supply of cars to operate with.

Written Statement Accompanying Testimony of Henry J. Nord, Senior Vice President, GATX Corp.

This statement is submitted on behalf of GATX Corporation, its subsidiaries and affiliates. GATX is a major United States industrial corporation. Its principal offices are located in Chicago, Illinois.

SUMMARY

GATX's position on the investment tax credit provisions of H.R. 13511, "The Revenue Act of 1978", is as follows:

1. We support the permanent extension of the 10 percent rate of investment credit.
2. While we support the increase in the limitation to 90 percent of tax liability, we urge that such increase be made fully applicable beginning in the taxable year ending after December 31, 1978.

ECONOMIC REASONS

Our position, stated above, is based on our strong conviction that enactment of these proposals is the *most effective* way that Congress and the Administration can create jobs and the capital formation necessary for that purpose. We believe that modernization of the productive capacity of U.S. business and consequent reduction of unit costs with accompanying increased employment is essential to improve the competitive position of U.S. business in respect of imports, and simultaneously to improve the competitive position of U.S. enterprise in export markets. We conclude that capital formation, leading to more efficient production, will have a significant impact in reducing the rate of inflation and strengthening the U.S. dollar in foreign exchange markets.

The balance of this statement discusses the position of GATX Corporation as a capital intensive company, presents our view of the past benefits and prob-

lems of the Investment Tax Credit and outlines our detailed recommendations. However, this presentation necessarily has a narrower focus and we emphasize our conviction that the recommended Congressional action on the Investment Tax Credit is in the broadest national interest of the United States.

GATX BACKGROUND

Founded in 1898, GATX maintains its executive offices at 120 South Riverside Plaza, Chicago, Illinois. GATX's principal activity is the supply of railroad freight cars to approximately 900 customers through the ownership, maintenance, and lease of a fleet of approximately 61,000 freight cars, principally tank cars.

Other activities include:

The operation of public terminals at various locations in the United States and abroad with facilities for the storage and handling (including mixing, blending, packaging and drumming of liquid commodities) of chemicals, petroleum and other liquid products.

The design, manufacture and sale of pneumatic conveying systems, cooling and heat recuperating equipment, dust and fume control equipment and other industrial compressors.

The design, fabrication and field erection of facilities for storage of various products (principally liquids).

The finance and finance leasing of transportation and industrial equipment in the United States and abroad.

Operation of self-unloading bulk carriers on the Great Lakes.

The ownership, chartering, and operation of nonsubsidized United States and foreign flag ocean-going vessels.

Research and development for GATX's operating subsidiaries as well as the Federal government and others.

POSITION OF INVESTMENT CREDIT IN GENERAL

As a major manufacturer and supplier of capital intensive equipment, GATX has consistently encouraged the passage of investment tax credit legislation, as an economically efficient means of motivating business to modernize and expand the country's productive capacity. In GATX's direct experience, the investment tax credit has functioned very effectively. Expenditures by GATX for railroad cars in 1961 were $31 million. In 1977, this figure amounted to $84 million. In the period between April 1969 and August 1971, when the credit was temporarily terminated, expenditures were reduced by 42 percent, based on levels immediately preceding the termination period.

Despite the demonstrated capital generating capability of the credit, the Congress has not yet seen fit to structure it so that its complete potential could be realized. This is particularly so in the case of a capital intensive company such as GATX.

Because the credit has been limited to 25 and now 50 percent of taxable income, our company has not been able to utilize fully credits which have been available to us for any taxable year. Even though the statute provides a limited carryover of unused credits,[1] we find that the overhang and potential expiration of these credits is a severe deterrent to capital modernization and expansion.

To cope with a part of this problem, GATX has often elected to pass the credit through to its lessees of railroad and other equipment. Unfortunately, however, this lease mechanism, although helpful, has not permitted full utilization of the credits, since the prime users of GATX and other manufacturers' equipment are industrial producers whose businesses are frequently in an excess credit position or whose size or profitability are such that they cannot benefit from the credit. On the other hand, enterprises which are not capital intensive generally have ample room to benefit from the credit but do not have the need for capital investment the credit was designed to induce. Thus, all too often the benefit of the credit accrues only to those who need it least as an incentive. Although Congress has enacted special rules easing the limitations on the availability of the credit for airlines[2] and railroads,[3] these liberalizing rules are not available to lessors or lessees of railroad and airline equipment unless, in effect, they are common

[1] See generally section 46(b).
[2] Section 46(a)(9).
[3] Section 46(a)(8).

carriers. Because we lease primarily to industrial users, such as producers of liquid commodities, these special provisions are of limited benefit to our company and others like us.

In fact, those special rules affecting railroads, airlines, as well as those enacted in 1975 affected public utilities, while specifically helpful to those industries, in effect alter the distributional impact of the credit, and thus, constrain its overall incentive impact. Not only do these rules discriminate among types of equipment eligible for the credit but, without substantial justification, they discriminate, based on the nature of the user's business, among users of the same type of equipment used for the same purposes. Therefore, investment decisions are based on considerations having little to do with President Kennedy's stated goal in proposing a credit 17 years ago: "to provide the largest possible inducement to new investment that would not otherwise be undertaken."[4] Rather than targeting capital expenditure incentives on industries with the greatest growth potential, as the original credit did, the credit as now structured targets capital expenditure incentives on industries where future investment promises the greatest tax savings.

GATX believes that a rule of equality of treatment for investment credit purposes should apply universally—without discrimination—as between railroads and airlines and any other special interest, on the one hand and the corporate manufacturer of tank cars or the producer of the commodity carried in the car, on the other hand. Railroads, for example, do not furnish tank cars which carry liquid commodities for others. Normally, the producer of the liquid commodity leases a tank car from a car manufacturer such as GATX. The liquid is then carried in the tank car on railroad lines at the producer's direction. In that case, the railroad furnishes track and locomotion and the producer pays freight for the movement.

To assure that all parties to this important business transaction (the railroad, the manufacturer of the tank car, and the producer of the liquid commodity), maintain a normal relationship in which the impact of the investment credit is neutral as between each of them a corporation such as GATX, which is in the business of supplying tank cars, should qualify for the investment credit in the same manner and on the same basis as the railroad. The producer of the commodify, will, of course, benefit equitably, since the amount charged for car rental will always reflect full utilization of the credit. We are here maintaining that economic equity dictates the same treatment for the railroad and the airline and the equipment manufacturer (as lessor or seller) and the equipment user (as lessee or buyer). If that equality is not established, then we believe no special rule should apply to railroads or airlines.

Dr. Lyle E. Gramley, a member of the Council of Economic Advisors, in testimony on behalf of the Carter Administration before the Senate Finance Committee in June of last year, cogently made the point to which GATX strongly subscribes:

"Business investment plays a dual role in the workings of the economic system. It directly creates job opportunities, income in the capital goods industries and in the firms which supply them in the process that adds to the overall demand for goods and services. But as it adds to demand, new investment also increases supply. Because business investment affects both demand and supply, it plays a crucial role in the simultaneous achievement of our several economic objectives."

The Carter Administration has forcefully recognized the crucial role which the investment credit can play in creating jobs and income as well as expanding our nation's productive capacity. We strongly support the Administration's proposals.

SPECIFIC RECOMMENDATIONS

GATX recommends that the following action be taken by this Committee with respect to the investment credit provisions in H.R. 13511:

1. Permanency of the 10 Percent Credit Rate

As an executive of a highly capital intensive company, I can assure you that certainty about future financial burdens is an absolutely necessary climate for the making of critical long range investment decisions. The history of the invest-

[4] President's 1961 Tax Recommendations: Hearings on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, Apr. 20, 1961, Before the Committee on Ways and Means, 87th Cong., 1st Sess. 5 (1961–1962) (Message of President Kennedy).

ment credit—and therefore its efficacy as an investment stimulus—has been impaired by the tax uncertainty that surrounds is impermanence, its rate fluctuations and its incomplete availability. If this tax quicksand could be eliminated, this company at least and I feel certain that countless others similarly situated, would be in a much better position to predict cash flow, to measure future tax cost and to expand the scope of capital commitments.

GATX, therefore, urges enactment of the provision in H.R. 3511 to make permanent the 10 percent rate of investment credit in order to assure a positive and continued stimulus for capital investment.

2. Increase in Limitation to 90 Percent of Tax Liability

One of the most artificial and distorting aspects of the investment credit has been the limitation on the use of the investment credit which may be claimed to an amount based upon a percentage of tax liability. In the case of a company such as GATX, which supplies capital equipment for use by others, the percentage limitation particularly inhibits the investment credit's function as a stimulus. Capital intensive industries such as ours almost invariably have large capital expenditures in relation to taxable income. Therefore, it is in the very industries where the potential impact of the credit is greatest that the inhibiting effect of the present limitation is most severe. If the stimulator effect which the credit is intended to have is to be fully felt, the credit can not go unused. To the extent that the cost of capital investments is reduced through the allowance of the credit as an offset against an additional 40 percent of federal income tax liability, GATX can and will make significantly greater capital investment commitments which it would not otherwise be in a position to do.

Obviously, a 90 percent limitation on tax liability is far superior to the current 50 percent limitation. We believe, in fact, that no such limitation should be imposed. Taxes which are offset by the investment credit will not only produce more investment, but will also reduce the cost of equipment thus directly tending to reduce the rate of inflation and aid the country's foreign trade position.

GATX therefore strongly supports enactment of the provision in H.R. 13511 to increase the present limitation on the amount of tax liability that may be offset by the investment credit from 50 percent to 90 percent. However, GATX urges that the proposed phase-in of the increased limitation over a four-year period contained in such provision be eliminated and that instead the 90 percent limitation be mdae fully applicable beginning in the taxable year ending after December 31, 1978. The availability of the full increase in the limitation beginning in 1979 would be an extremely effective stimulus to capital investment to GATX and other companies in capital intensive industries. We believe that the revenue cost of elimination of the proposed phase-in will be far outweighed by the positive impact upon our economy which would result from substantial capital investments generated by the ability to utilize a greater portion of investment credit beginning in 1979 rather than 1982.

Alternatively, we recommend that the limitation applicable to railroads and airlines should be made applicable to corporations engaged in the business of manufacturing and supplying railroad cars and airplanes to such railroads and airlines. GATX believes that such equality of treatment between corporate manufacturer-lessors and the railroads and airlines is essential to permit the railroads and airlines to obtain the full benefit of the investment credit and maintain their competitive position.

For the convenience of the Committee and its staff, a draft of an amendment which gives the same acceleration in the phase-in to corporate lessors of railroad cars as the House Bill grants to railroads is attached. A draft of a suitable short explanatory statement is also attached.

CONCLUSION

GATX supports enactment of the provision of H.R. 13511 to make the 10 percent investment tax credit rate permanent. While GATX supports enactment of the provision in H.R. 13511 to increase the limitation on the use of the credit to 90 percent of the taxpayer's liability, we urge that the phase-in of the increased limitation be eliminated and that the 90 percent limitation be made fully applicable beginning in the taxable year ending after December 31, 1978, or at least that corporations in the business of supplying railroad cars and airplanes to railroads and airlines should qualify for the same limitation as is available to such railroads and airlines.

AMENDMENT TO H.R. 13511

Section 312(b)(7) of the bill *strikes* IRC Sec. 46(a)(8) (and Sec. 46(a)(9)). *Adds a new* Sec. 46(a)(8) which includes five subparagraphs, (A) to (E)
Amendment of bill:

Strike newly proposed subparagraph (8)(D) of sec. 46(a) (entitled "RAILROAD PROPERTY DEFINED"

Substitute the following:

"(D) RAILROAD PROPERTY DEFINED.—For purposes of this paragraph, the term 'railroad property' means—

(i) in the case of a railroad, section 38 property used by the taxpayer directly in connection with the trade or business carried on by the taxpayer of operating a railroad (including a railroad switching or terminal company)

(ii) in the case of a manufacturer of railroad cars, railroad cars manufactured by it and leased to others for use over the tracks of railroads.

STATEMENT TO ACCOMPANY CHANGE IN BILL TO GIVE MANUFACTURER-LESSORS OF RAILROAD CARS THE SAME ACCELERATION IN THE USE OF THE INVESTMENT CREDIT AS RAILROADS

The House Bill will make the investment credit usable against 90 percent of the tax (instead of the present 50 percent). However, for most taxpayers this will be phased-in over four years.

In the case of railroads which have a large percentage of their investment in railroad cars, the phase-in will occur much faster. This is appropriate because of the extraordinary need for more railroad cars. However, many railroad cars are owned by commercial manufacturer-lessors who lease them to manufacturers and processors for use over the carriers' tracks. These cars are just as useful to the railroads as the cars owned by them. In many cases these cars are designed and built for special purposes and could not economically be built and supplied by the railroads. For this reason, the provision accelerating the phase-in of the 90 percent use of the credit is expanded to include corporate manufacturer-lessors of railroad cars. The provision applies only to corporate manufacturer lessors so that no "tax-shelter" possibilities are created.

GREEN GIANT CO.,
Chaska, Minn., September 1, 1978.

MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washintgon, D.C.

DEAR MR. STERN: Thank you for your mailgram regarding submission of a written statement by us regarding tax leigslation involving accruable coupon redemption expense. Please consider our statement under H.R. 13511 and related tax legislation matters.

Green Giant Company requests that proper consideration be given to the tax accounting treatment of expenses of redeeming trading stamps and coupons.

Green Giant Company is a manufacturer of processed vegetables and the use of coupons in its business represents a substantial portion of its promotional program to promote the sale of its product as well as furnishing those families taking advantage thereof to hold down the costs of its foodstuffs.

From the beginning Green Giant Company has followed and relied upon the well established interpretation and application of Treasury Regulations which govern the accounting for coupon expenses.

Recently, the Internal Revenue Service has attempted to reverse these long-standing rules by merely re-interpreting them. We would like the regulations 1.451-1 codified to asure us of the accounting treatment we believe we are presently entitled to.

We understand that the Finance Committee has already undertaken to provide partial relief to an amendment to H.R. 3050 but this should be expanded to eliminate retroactive revocation and restore the accounting rule that has applied for over 50 years.

Thank you for your consideration in this matter.

K. A. JOHNSON,
Director, Taxes/Risk Management.

GENERAL TELEPHONE & ELECTRONICS CORP.,
Stamford, Conn., September 6, 1978.

Re H.R. 13511

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

DEAR MR. CHAIRMAN: We at General Telephone & Electronics Corporation (GTE) have followed with keen interest development of the current tax bill in the Ways & Means Committee and in your Committee on Finance. GTE companies, you may recall, employ over 200,000 persons in forty-one States and fifteen foreign countries. GTE has more than 500,000 common stockholders, and the GTE companies have an aggregate capital investment currently totalling about $15 billion.

We are heartened by the increasing recognition in recent months of the role of a sound tax structure in stimulating capital investment to sustain and expand economic growth.

In order to provide the proper incentive to investors to invest, and to business to increase capital spending, to the degree necessary to meet national economic goals, the tax laws must be reformed to help remove the existing disincentives to capital formation and personal investment.

We respectfully urge the Committee to report an amended bill containing the following provisions pertaining to capital formation—

Investment Tax Credit.—Permanently increase the investment tax credit (ITC) to 12 percent for all businesses and raise the limitation on the credit to 90 percent. Since its inception the ITC has proved to be one of the most effective incentives to capital formation and a beneficial economic tool generally by directly stimulating investment and helping to reduce unemployment and fight recession.

The ITC is capital specific, *i.e.*, there is no tax benefit without the taxpayer investing in productive facilities.

ESOP's.—ESOP's and employee ownership give employees a stake in the business and businesses another way to raise new capital. GTE believes that the provisions of S. 3241 should be incorporated in H.R. 13511, *viz.*:

Expansion of available ITC from 1 percent to 2 percent will increase an employee's stake in his company;

Broadening the ESOP provisions to include labor-intensive businesses (ITC equal to 1% of total compensation) offers the same stock ownership opportunities to employees of those businesses;

The deductibility of dividends paid on ESOP shares will provide further incentive for companies to institute ESOP plans;

Inclusion of provision regarding public utilities ensure that benefits go where Congress intends them to go—to employees; and,

Requiring that at least one-half of securities transferred to ESOP be new issue—securities will encourage new capital formation.

Automatic Dividend Reinvestment.—Stockholders should be permitted to reinvest their dividends in newly issued stock of the dividend-paying corporation without being penalized by having to pay a tax on dividends before they are actually received. Treating reinvested dividends in the same way as stock dividends would eliminate the Code's present discrimination in favor of high growth, low payout companies and against low growth, high payout companies. Any reduction in the effective tax rate on capital gains on corporate stock would exacerbate the existing discrimination. It is anomalous to speak of a proposal's favoring capital formation if it discriminates against the most capital intensive industries of all, namely the utilities.

Moreover, automatic dividend reinvestment would more directly encourage capital investment because it is capital specific, *i.e.*, unlike a reduction in the capital gain rate, which is available to a taxpayer liquidating his investment, the taxpayer must *reinvest* his dividends in order to get the tax benefit.

Obviously, a reduction in capital gain rates will encourage capital investment in the long term by raising the effective incentive to the investor (and we do not oppose a balanced tax package including a reduction in the capital gain rate), but inclusion of automatic dividend reinvestment would yield a more balanced and effective mechanism overall.

Automatic dividend reinvestment would effect another balance by conferring a benefit on nonemployees, who cannot participate in ESOP's.

Dividend reinvestment plans are particularly well-suited to the needs of the small investor, because they provide a convenient, systematic, and inexpensive means of investing. Furthermore, in an increasing number of plans, participants pay no brokerage commissions or service charges. The popularity among small investors is illustrated in the case of GTE's plan, wherein 84 percent of the participants own 100 shares or less. 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 tax-exempt securities.

Appended to this letter is statutory language embodying GTE's proposal on automatic dividend reinvestment, which is similar to Senator Nelson's bill, S. 3430.

We respectfully commend the foregoing elements as essential ingredients for an effective, efficient, and balanced approach to capital formation in the 95th Congress.

Respectfully yours,

THEODORE F. BROPHY.

Attachment.

AMENDMENT TO SECTION 305: ENCOURAGEMENT OF REINVESTMENT OF DIVIDENDS
SECTION ——. ENCOURAGEMENT OF REINVESTMENT OF DIVIDENDS.

(a) AMENDMENT OF SECTION 305.—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) DIVIDEND REINVESTMENT IN CERTAIN COMMON STOCK.—

"(1) IN GENERAL.—Notwithstanding any other provision of this section, subsection (a) shall apply to any distribution of eligible stock by a corporation pursuant to a qualified dividend reinvestment plan.

"(2) ORDINARY INCOME ON CERTAIN DISPOSITIONS.—If the amount of any distribution of stock was excluded from the gross income of any taxpayer under subsection (a) by reason of paragraph (1), and if the taxpayer disposes of such stock within 12 months of its distribution to him, then notwithstanding any provision of this subtitle other than section 116, an amount equal to the amount excluded from gross income under subsection (a) in respect of the stock so disposed of shall be included in the taxpayer's gross income for the taxable year in which such disposition occurs. Such amount shall be treated as a dividend for purposes of this title. The adjusted basis of such stock immediately before such disposition shall be an amount equal to the amount includible in gross income by reason of this paragraph. For purposes of this title any stock to which this paragraph applies upon the disposition thereof shall be deemed to be disposed of before any other stock of the same class.

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

"(A) QUALIFIED DIVIDEND REINVESTMENT PLAN.—The term 'qualified dividend reinvestment plan' means a written plan adopted by a corporation under which—

(i) its shareholders who so elect may receive any distribution otherwise payable in property only in shares (including fractional shares) of eligible stock equivalent in value (determined as of the record date of such distribution) to the dividends waived;

(ii) dividends waived in respect of any distribution must be used exclusively for the construction, reconstruction, erection or acquisition of section 38 property; and

(iii) in the case of a parent corporation, the value of eligible stock distributed under the plan (determined as of the record date of each distribution) during any taxable year of such corporation may not exceed the dividends received during such year from members of the affiliated group of which such corporation is the common parent corporation.

A written plan of a parent corporation shall be deemed to satisfy the requirements of subparagraph (ii) of this paragraph if the amount referred to in such subparagraph must be used exclusively for the purposes referred to in that subparagraph by such parent

corporation or by one or more of the members of the affiliated group of which such corporation is the common parent corporation.

"(B) DIVIDENDS WAIVED.—The term 'dividends waived' means, with respect to any distribution, the amount which would have been distributed to shareholders electing to receive eligible stock pursuant to a qualified dividend reinvestment plan if such shareholders had received the same amount of property per square as shareholders of the same class not making such election.

"(C) ELIGIBLE STOCK.—The term 'eligible stock' means common stock of the same class as the stock with respect to which such stock is distributed.

"(D) SECTION 38 PROPERTY.—The term 'section 38 property' has the same meaning as when used in section 48.

"(E) PARENT CORPORATION.—The term 'parent corporation' means a common parent corporation of an affiliated group.

"(F) AFFILIATED GROUP, ETC.—The term 'affiliated group' and 'common parent corporation' have the same meaning as when used in section 1504(a)."

GAMA,
Arlington, Va., August 30, 1978.

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

DEAR SENATOR LONG: In deliberations of the Senate Finance Committee on H.R. 13511, I would ask your consideration of two points on which the members of our Association have special interest and expertise.

(1) For homeowners, their space heating unit is the largest energy using appliance—and therefore offers the largest potential annual home operating cost savings.

PROPOSAL

That the tax credit be extended to new energy saving furnaces and boilers which not only reduce homeowner's annual operating costs of heating their homes but will also help to conserve the nation's energy supply of oil and gas.

The Gas Appliance Manufacturers Association urged this view in direct testimony at your hearings of September 12, 1977 on the National Energy Act. We continue to feel that it is an extremely important, safe, effective option for homeowners who are trying to do something to help themselves. (A copy of GAMA's September 12, 1977 testimony is included for your convenient reference.)

(2) To stimulate increased productivity, the tax credit should be extended to space heating of commercial and industrial structures. Over the years, the tax credit has encouraged capital expenditures for more efficient production equipment without providing an equal incentive for energy saving efficiencies affordable by more efficient space heating options for these facilities. To the extent the cost of energy rises in the years ahead, the benefits of this provision would become proportionately more valuable to industry as an offset to higher energy costs. We would urge, therefore:

PROPOSAL

(a) That if the Committee endorses the extension of the investment credit to new structures, that space heating controls and equipment be included. (We would also assume that space cooling equipment should be included as being essential to productive activity in sections of the country.)

We would recommend alternatively:

PROPOSAL

(b) That if the Committee does not extend the credit to structures, that space heating controls and equipment be allowed to qualify for the credit on its own merit—on the same basis as the credit is now available for production equipment.

This could help business upgrade the utilization of its existing industrial facilities or help offset the capital costs of new facilities.

This point was also urged in our September 12, 1977 testimony before the Senate Finance Committee.

The appliance industry stands at the threshold of providing new energy-efficient space heating and cooling options. The availability of tax credits, often

the critical factor in management capital expenditure decisions, could cause a significant swing to energy conservation in this country.

Sincerely yours,

HARRY A. PAYNTER,
President.

STATEMENT OF GAS APPLIANCE MANUFACTURERS ASSOCIATION TO THE SENATE COMMITTEE ON FINANCE ON THE NATIONAL ENERGY ACT

(By Stanley W. Schroeder)

SUMMARY OF TESTIMONY OF GAS APPLIANCE MANUFACTURERS ASSOCIATION

(1) The best use of the *residential tax credit* may be to give a homeowner the option to replace (not retrofit) an existing residential furnace or boiler with a new energy-savings heating unit.

(2) The best use of the *business tax credit* may be to encourage replacement with energy-saving units in commercial or industrial facilities rather than try to recapture wasted heat with add-on equipment. Energy saving in space heating, and not only in manufacturing processes, should be encouraged.

By way of introduction, I am Stanley W. Schroeder, Director of Legislative Services of the Gas Appliance Manufacturers Association (GAMA). With me is John P. Langmead, GAMA's Director of Technical Services. The Gas Appliance Manufacturers Association has thirteen divisions including manufacturers of gas and oil furnaces, and gas boilers, burners, direct space heating, industrial forced air, infrared heating, and controls. Our members manufacture approximately 95 percent of all gas-fired products sold in this country in these areas. These firms have survived in the marketplace as a result of their knowledge of the safe and efficient use of energy. They would like to offer their observations based on this knowledge.

GAMA believes that the pending legislation has overlooked opportunities for substantial national energy conservation in the residential energy savings credit and in the business investment credit for "specially defined energy property."

Residential energy credit

In looking at what the Administration proposal and the House have listed as qualified energy conservation expenditures under proposed new Section 44C of the Internal Revenue Code, we applaud providing a credit for home insulation, but are concerned that when the homeowner turns to improving his heating unit his options will be limited to four specific measures for retrofitting existing heating units; namely, by adding on flue dampers, intermittent ignition devices, clock thermostats and/or replacing the burners of furnaces. What has been overlooked is the possibility of replacing his old furnace with a new furnace that will include one or more of these listed measures or other energy conserving features, and additionally offers the possibility of having a properly sized furnace suited to the heating requirements of the home *after* the benefits of insulation have been taken into consideration. Incidentally, one of the retrofit measures in the House passed legislation will be worthless to many homeowners—namely, replacing burners on gas furnaces will not save energy and simply reducing the input of energy to the furnace can even waste energy.

Advantages of the "New Furnace Option"

A. Safety to the Consumer—There is serious concern that improper installation of add-on retrofit measures to furnaces out in the field can cause fire, explosion or asphyxiation of the homeowner and his family. To the homeowner this is personal tragedy. To the furnace manufacturer, even though he had nothing to do with the modification of his furnace out in the field by someone else, it means involvement in product liability lawsuits, which because of the "deep pocket" theory are likely to result in verdicts that can mean financial ruin to small manufacturers. It would be a bitter irony if the Congress in an honest attempt to help the homehowner reduce his energy bills and the Nation's energy consumption, steered him down only the retrofitting path when there were safer ways to go.

B. Cost to the Consumer and Manufacturer—Retrofitting an old furnace can be much like filling potholes when a new road surface might cost no more and provide a smoother, longer lasting surface. Sometimes patching potholes is a

good idea; other times it is not. Utility programs exploring furnace retrofit possibilities have found that a substantial number of furnaces out in the field are not suitable for retrofitting. For many that are approaching the end of their useful life, retrofitting will provide no useful return on investment. The bottom line is what have you got for your money. We believe that in many cases, if he had the option, the homeowner would find that a new furnace is cost competitive with retrofitting—on an installed cost basis—or would be competitive if the residential energy credit were available for replacement as well as retrofit.

The attached GAMA Memorandum on the "New Furnace Option for Homeowners" was worked up with reference to the Administration Bill on the House side. While better data will be forthcoming as time goes on, the Memorandum sets forth some useful estimates of the comparative costs and energy savings potentials of both the retrofitting measures and new furnace options as well as the outside limits of the possible effects of each on the Federal Revenues. Obviously, no taxpayer could get more than the $400 tax credit (under the House bill) which he must allocate for both insulation and "other energy conserving measures." Actually, if we assume that the average energy saving replacement gas furnace will cost around $650, only $130 of this credit would be used (if a flat 20 percent rate were allowed). This $130 would help the homeowner to purchase more efficient home heating equipment. Inasmuch as about 1 million gas furnaces are normally replaced in this country annually, this would provide a substantial opportunity for the residential energy conservation program to get off to a fast start. It would provide an immediate incentive, rather than wait until new furnaces are produced to meet the minimum efficiency standards that will be mandated in Title I of the National Energy Act. Historically, most homebuilders of large housing developments have installed the cheapest model they could purchase and will probably continue to do so. That leaves existing homeowners, replacing furnaces in their own homes, who are likely to be the best market for the more efficient furnaces. If this potential market becomes a reality it will be a tremendous incentive to research and development within the industry.

Timing and Priorities

We note that the House-passed bill has an open-ended energy tax credit provision (which we hope the Senate will also do) so that other items can be added to the list that the Secretary of Energy specifies as being of a kind that increase the energy efficiency of the dwelling. There is no doubt in our minds that furnace replacement by a unit with improved seasonal efficiency should end up as one of the items on that list. However, it is quite obvious that items listed specifically by the Congress in the Act will receive first priority in scheduling the Energy Agency's workload before the Energy Agency even begins to focus on what other items should be on the list. If furnace retrofitting has a one or two year head start over replacement furnaces, many consumers who are anxious to move ahead with home heating improvements will have to do so without a chance to consider what may be some of their best options. Having spent their money for retrofitting they will understandably delay replacement with a new seasonably efficient furnace thereby delaying the national movement towards energy conservation.

Suggested Amendment

GAMA, therefore, respectfully requests that the list of items specified for the residential energy savings credit include:

"( ) Heating units that replace or supplement existing heating units, incorporate one or more of the items in this list or other energy-saving components and provide a substantial energy saving to the residential user;

In addition, in order to insure that other energy-saving measures have a chance of being considered, the list should be open-ended by adding as the last item:

"( ) An item of a kind which the Secretary specifies by regulations as increasing the energy efficiency of the dwelling."

Business Investment Credit for Specially Defined Energy Property

GAMA would like to point out an apparent misdirection of effort contained in the list and qualifications for "specially defined energy property" available for the proposed business energy-saving credit.

Most of the items on that list could be categorized as waste heat recovery equipment. This overlooks the other way of conserving energy—not wasting it in the first place. Much expertise among GAMA Members could make this a significant area of national energy saving—if the list is made open-ended and not limited by principal purpose tests that foreclose energy saving opportunities. The House Bill, for example, limited the items listed to applications connected with an industrial or commercial *process*, thereby overlooking the energy savings possibilities in heating the industrial or commercial facility itself.

Suggested Amendment

Add to the list of "specially defined energy property":

"( ) Heating units that replace or supplement existing heating units and provide a substantial energy saving to the commercial or industrial facility;

"( ) Any other property of a kind specified by the Secretary by regulations: the principal purpose of which is reducing the amount of energy consumed in any existing industrial or commercial *facility* and which is installed in connection with an existing industrial or commercial facility that is not subject to energy use limitations contained elsewhere in this Act."

With such language the smaller industrial and commercial facilities would receive a significant assist to convert to energy-saving heating units.

As with the residential energy conservation credit the Secretary's approval would be needed for items to be added to the list. We are asking for a chance to make our case to the Secretary and that he not be limited by misguided principal purpose limitations imposed by the Congress that would fail to recognize available energy conservation possibilities to avoid wasting heat in the first place.

Thank you for the opportunity to share our insights. We would welcome any questions you may have.

GROOM AND NORDBERG,
Washington, D.C., September 6, 1978.

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

(Attention Mr. Michael Stern, Staff Director, Committee on Finance.)

DEAR MR. CHAIRMAN: An August 2, 1978, the Committee on Finance issued Press Release No. 56 announcing that it would hold hearings on the President's tax cut bill. The release also announced that the Committee would receive and consider written testimony from persons or organizations who wish to submit statements for the record. We are submitting this statement on behalf of The Prudential Insurance Company of America in response to that announcement in the press release.

On June 22, 1978, Senator Bentsen introduced S. 3218. That bill would make perfecting amendments to the Internal Revenue Code similar to the amendments made by section 2137 of the Tax Reform Act of 1976. That section enabled mutual funds that investment in municipal bonds to pass through the character of the tax-exempt interest earned on such bonds to their shareholders. S. 3218 would extend equal treatment to individuals who invest in municipal bonds through separate accounts of life insurance companies. The Prudential Insurance Company of America urges the Finance Committee to adopt S. 3218 in connection with its consideration of the Administration's pending tax cut bill.

Senator Bentsen's statement concerning S. 3218 in the Congressional Record of June 22, 1978, gives four reasons for the Senate to adopt this legislation. Briefly stated, the four reasons are:

First, the proposal would broaden the market for municipal bonds. This would help reduce the financing costs of state and local governments and thereby reduce the costs of necessary public improvements. This is particularly important in light of the significant, and increasing borrowing needs of state and local governments.

Second, this legislation would remedy the competitive disadvantage created for life insurance companies by the 1976 Tax Reform Act. Prior to the 1976 Act, investments in municipal bonds were made through fixed investment trusts, and to a lesser extent, bank common trust funds and limited partnerships. As a result of the 1976 Act, such investments can now be made through mutual funds. Through what we regard as an oversight, life insurance companies were not in-

cluded in this provision and thus are the only financial intermediaries excluded from the municipal bond market. Our amendment would remove this competitive discrimination.

Third, our proposal would satisfy needs not being met by other financial intermediaries. For example, annuities would offer retired persons the assurance of a lifetime income. Also, insurance companies would be able to offer fixed-dollar annuities with investment guarantees now missing from the exempt-interest market place.

Since the enactment of the 1976 Act, municipal bonds funds have grown at an extraordinary rate, with more than thirty funds having net sales of more than $2.3 billion as of March of this year. This growth indicates both the effectiveness of the 1976 Act in providing funds to the municipal bond market and the competitive disadvantage that has been created for life insurance companies which compete to some extent with mutual funds in the individual investor market.

As in the case of the mutual fund proposal, it is estimated that this proposal will involve no revenue loss.

We express our appreciation for this opportunity to submit a written statement for the record in support of S. 3218.

Very truly yours,

THEODORE R. GROOM,
Attorney for the Prudential Insurance Co., of America.

CITY OF PHOENIX,
OFFICE OF THE MAYOR,
August 29, 1978.

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

(Attention Michael Stern, Staff Director)

DEAR SENATOR LONG: As Mayor of the City of Phoenix, I would like to submit comments on S. 3370 which was introduced by Senator Lloyd Bentsen and was the subject of a hearing held by the Committee of Finance on August 24. I would like to request that this letter be made a part of the hearing record on S. 3370.

Introduction of S. 3370 and the hearing should not have been necessary. The Treasury Department in the past year has issued a series of arbitrage and industrial development bond regulations relating to the purposes of Sections 103(c) and 103(b) of the Internal Revenue Code of 1954. Most of these regulations were issued with little or no consultation with State and local governmental officials as to their impact on State and local financing. The furor created by Treasury Department actions in recent weeks has resulted in issuance of "clarifying" regulations and "reclarifying" regulations. Had Treasury Department officials consulted in good faith with State and local government officials and their representatives, this situation probably would not have developed.

I support the thrust of S. 3370 which is to restrict Treasury Department authority to promulgate regulations, which exceed statutory authority and place greater restrictions upon issuance of State and local bonds than those contemplated by legislation enacted by the Congress.

At the same time, almost all State and local government officials recognize the validity of some arbitrage regulations. Many organizations of State and local government officials have supported such regulations in the past and have worked with the Treasury Department in developing them. All have stated their willingness to do so in this instance.

Thus, I feel that all Treasury Department regulations, issued from December 1977 to date, with respect to arbitrage bonds and industrial development bonds, should be rescinded or be revised to be acceptable to State and local officials. Attached are some specific comments prepared at my request by Selden G. Kent, Administrative Services Manager.

In closing, State and local governmental officials appreciate the responsiveness of the Committee on Finance in considering these matters. I appreciate the opportunity to submit these comments and hope that this matter can be resolved in the near future.

Sincerely,

MARGARET T. HANCE,
Mayor.

To: Marvin A. Andrews, City Manager.
From: Selden G. Kent, Administrative Services Manager.
Subject: S. 3370 and Treasury Department regulations.

With respect to the Treasury Department regulations, which are the subject of S. 3370, we wish to submit the following specific comments:

1. The principal purpose of the regulations is to eliminate use of invested sinking funds as a municipal financing technique. Monies paid into such sinking funds, of course, are not bonds. These monies are either local taxes or other revenues, which have been pledged by the governmental unit to assure bond holders that their principal will be available in the sinking fund when the bonds become due to retirement.

Treasury declares that such local revenue placed in a sinking fund will be "treated" as bond proceeds, despite the fact that they obviously, are not bond proceeds. These tax receipts and other monies are received on an annual (actually on a monthly, weekly, and daily basis) and should not be subject to Treasury Department regulation.

2. The regulations make no distinction between the use of invested sinking funds for refunding bond issues and for new bond issues. This is the case despite the fact that Treasury's concern about invested sinking funds undoubtedly stemmed from use of the technique in connection with refunding bond issues.

While Treasury's authority to regulate invested sinking funds used in refunding bond transactions may be a valid question, the recent regulations also extend the restrictions to such funds established to repay principal and interest on new bond issues issued for new local capital improvement projects. We see no justification for making new debt subject to such restrictions.

This is perhaps the most flagrant way the proposed regulations exceed Treasury Department prerogatives. It results in direct regulation of State and local financing practice.

Arizona local governments have been using invested sinking funds for a number of years to finance new local debt. We understand that the Treasury Department regulations would cost local taxpayers in one Arizona city over $20,000,000 in financing recently approved bond issues. Thus, the Treasury Department regulations will result in increased costs for local taxpayers and consequently will mean higher taxes or service charges or both for their taxpayers.

3. Despite its concern over invested sinking funds and arbitrage in connection with refunding bond transactions, the Treasury Department apparently has ignored the use of securities acquisition agreements in combination with an invested sinking fund. This practice is relatvely new in refundings, but is not addressed by Treasury regulations.

Under this procedure an issuer enters into securities acquisition agreements with a third party investment firm to secure long-term investments for a sinking fund and agrees to buy them at specified intervals over a number of years for the sinking fund. An issuer, with no capital to make such long-term investments, and with no risk on its part, is able to assure itself of long-term, high-yield investments. This then does guarantee the issuer a profit in the sinking fund.

Perhaps this practice should be looked at by Treasury. It may be more at the root of Treasury's problem with invested sinking funds used in refundings than the sinking funds themselves.

We know of no Arizona governmental unit using invested sinking funds that has used securities purchase agreements. Initial investments for a sinking fund have been made with the governmental unit's own funds and future investments will be bought for the sinking fund at the then prevailing market. Yields on investments, made 5, 10, or 15 years from now, will depend on rates existing when those investments are made.

4. Another area covered by the regulations concerns the certification process. The regulations would tremendously increase the detail required in arbitrage certifications and could result in even higher costs for an issuer.

Investors must be able to rely upon municipal officials as to the facts regarding the use of bond proceeds. If there are errors, investors will have to suffer the consequences, and some investors may withdraw from the market rather than run that risk, thereby increasing bond prices for all state and local government issuers.

The extent of the increased risk for investors is illustrated in "example 4" of the regulations, which states that despite an arbitrage certification, if an "artifice or device" is used to produce arbitrage profits then the bond issue will not be

tax-exempt. Should Treasury ever tax investors under this example, the consequence would be immediate and create turmoil throughout the market. This cannot be allowed to occur.

The Treasury Department ruling process would create excessive delay, complexity, and expense for local governments in issuing their securities. Most important, it would have to result in Treasury becoming more involved in State and local government matters. Regardless of intentions, inevitably this would mean more Federal regulation of State and local governments.

5. Under the proposed regulations, administrative costs of issuance are to be eliminated from yield calculations, which again will increase expenses for State and local government issuers. The Treasury Department appears to be concerned that the present regulations result in high issuing costs. We are also concerned about costs, but the complexity of Treasury regulations themselves are the basic cause.

Costs of issuance should be taken into account in determining the yield calculations. Rather than eliminate costs as an element in yield calculations, a better approach would be to set a realistic ceiling on the costs that can be recovered.

SELDEN G. KENT,
Administrative Services Manager.

HENKEL & LAMON, P.C.,
Atlanta, Ga., September 1, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: Pursuant to the Committee's press release of August 2, 1978, the following statement on the Revenue Bill of 1978 (H.R. 13511) is submitted on behalf of the National Association of Pension Consultants and Administrators, Inc. We request that this statement be included in the record of the Committee's proceedings regarding the bill.

1. Section 124 of H.R. 13511.—Section 124 sets forth the general rule that under a "cafeteria plan", employees will not be subjected to income tax merely because one of their options under the plan is to take benefits in a form which would otherwise be taxable, except to the extent that the employee elects a taxable form of benefit.

We have no objection to this general rule, and indeed, there are sound arguments in its favor. Most importantly, the rule would permit needed flexibility in the establishment of employer-sponsored welfare plans since it would give to each employee the flexibility to choose the mix of benefits most needed because of his or her particular family or financial status.

However, section 124 of the bill would go far beyond this general rule and would attempt to introduce into the law the unworkable concepts originally proposed by the Administration for all employer-sponsored welfare plans. We strongly oppose these features of section 124.

(A) DEFINITION OF "CAFETERIA PLAN" IS AMBIGUOUS

Sub-section (d) of section 124 defines a cafeteria plan as one under which:

"(A) All participants are employees; and

"(B) The participants may choose among two or more benefits."

The referenced sub-section further provides that the term "does not include any plan which provides for deferred compensation." The definition is so loosely drawn that it will be extremely difficult for many employers, particularly small employers, to determine whether or not a particular welfare plan is or is not covered by the term "cafeteria plan". The effect of this uncertainty will be to convert what was clearly meant as a special relief provision into a trap for the unwary. Our concern in this regard is heightened by the policy exhibited by the Internal Revenue Service in recent years of interpreting statutory language in the manner most detrimental to taxpayers and often in derogation of the clear intent of the Congress.

For specific examples of the ambiguity of the definition, consider the following:

(1) It is not unusual for an employer to provide that if his or her employees choose to contribute some small part of the cost, the employer will pay the bal-

ance of the cost of group life insurance, group medical insurance, or group disability insurance. Does the fact that employees must be willing to contribute a part of the cost to obtain such coverage mean that "the participants may choose among two or more benefits", thereby constituting the program a "cafeteria plan"?

(2) Assume an employer institutes a group term life insurance program. At the time it is instituted, the employer has an informal arrangement for continuing salaries while an employee is ill. Will the wage continuation arrangement and the group term program constitute a single plan with separate benefits or will each be considered a separate plan? Suppose an employee must contribute a small part of the cost to participate in the group term program. Does this voluntary contribution feature mean that the employee has a choice, thereby constituting the entire arrangement a "cafeteria plan"?

These are not fanciful examples, but are very common situations whose status would be clouded under section 124. The examples are by no means exhaustive.

It must be recognized that legislation in such an important field as employer-sponsored health and welfare plans is not limited in its coverage to large employers with sophisticated knowledge of the law and with formal plans and programs. There are many small businesses which cannot afford professional guidance as to complicated laws, and who may not even be aware that their wage continuation and vacation policies may constitute welfare plans. If such employers become generally aware of "traps" and complexities in such plans, in many cases they will simply not adopt a plan rather than incur the considerable expense of counsel to avoid the traps.

If the restrictive provisions of section 124 are enacted, there will be a chilling effect on adopiton and continuation of employer-sponsored welfare plans, particularly by small employers. With employee benefit plans in general still struggling with the *unintended* fallout of the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act (ADEA), this is clearly not the time for additional complexities and restrictions.

(B) DISCRIMINATION PROVISIONS ARE VAGUE AND IMPRACTICAL

The "traps" to section 124 are contained in its discrimination provisions. While there is an obvious appeal to the idea of enacting laws which prohibit "discrimination" in favor of highly compensated participants in welfare plans, the implementaion of the idea leads into a morass of problems which will discourage many employers, particularly those in the small business area, from becoming involved in or continuing such plans. The discrimination rules, if enacted, will generate much litigation and controversy, will curtail the adoption of welfare plans, and will result in unfair tax assessments in situations where the taxpayer has no control over the matter.

The design and enforcement of anti-discrimination rules in connection with qualified retirement plans has resulted in much controversy, audit disputes and litigation. These rules, which have been applied in the retirement plan area for a number of years, are still the subject of extensive comment and controversy despite the fact that retirement plans tend to fall into a limited number of categories. Welfare plans, on the other hand, are of infinite variety and combination. Such plans run the gamut from a simple oral statement at a hiring interview that the employer will pay wages for a limited period while an employee is absent due to illness, to highly developed, well-articulated, printed plans of large corporations involving literally scores of fringe benefit programs. Applying vague discrimination rules to such a myriad of plans and arrangements will be extraordinarily difficult for both the Internal Revenue Service and taxpayers.

There seems to be no quarrel about the proposition that it is in the public interest that employers be encouraged to adopt and expand plans under which, at employer expense, employees are given protection against financial losses occasioned by death, accident or illness. However, except in very limited circumstances, there is no law which requires an employer to adopt or expand a welfare plan. Any legislation which makes the adoption or expansion of such plans more expensive and more complicated, and particularly legislation which poses penalties, will discourage the spread of such plans.

The proposed anti-discrimination rules in section 124 are vague to say the least and undoubtedly will lead to confusion and bizarre results for those who attempt to comply with them.

Part of the problem is that while *section 124 prohibits discrimination, it does not define it.* Section 124(c) simply states that a plan does not discriminate where benefits or employer contributions do not discriminate. Section 124(g) (2) states that a health plan is not discriminatory if it meets certain "contribution" criteria, and Section 124(g)(3) states that a participation requirement is not discrilmnatory if it meets certain "years-of-service" critrela. While the section thus gives a partial definition as to what is nondiscriminatory, nowhere does it define what *is* discriminatory. This definition is apparently left up to the Internal Revenue Service. Delegation of such administrative discretion is patently unwise and undoubtedly will result in more of the bizarre positions for which the Internal Revenue Service has become infamous in recent years.

For example, it would appear under the proposed rules that the following could be discriminatory:

A small corporation maintains a medical expense reimbursement plan and a contributory accident and health insurance plan covering the stockholder-employee and his two clerical employees. During a given year the clerical employees are healthy. However, the stockholder incurs significant medical expenses not covered under the insurance plan. The medical expense reimbursement plan pays these expenses. For that year, it could be argued that the medical expenses reimbursement plan discriminated as to benefits in favor of the stockholder. This result would be preposterous, but does not appear to be prohibited under section 124.

The Ways and Means Committee held public hearings with respect to the Administration's proposals regarding tax reform. A great number of people knowledgeable in the area of welfare plans submitted comments to the Committee. Most of these comments were to the effect that the Administration's proposal regarding welfare plans constituted an unfair discrimination against small business and would result in many small businesses terminating employer-sponsored welfare plans. The comments to the Ways and Means Committee also pointed out that the Administration proposals in these areas could lead to absurd results in many specific cases.

After careful consideration, the Ways and Means Committee wisely decided not to adopt the Administration proposals regarding welfare plans. The proposal regarding "cafeteria plans" was adopted as a last minute compromise and it is questionable whether the Committee was aware of all its implications or was aware that it could be construed to apply to plans other than formally designated "cafeteria plans".

If the Congress intends to take such fundamental action in the welface plan area as reflected in section 124, it should do so only after particular study and after opportunity for substantial public comment. It should not act precipitously in an area which affects so many, particularly when it is questionable whether many small employers are even aware that the action is contemplated.

2. Non-Qualified Deferred Compensation Arrangements.—Non-qualified deferred compensation arrangements fulfill a number of valid objectives both from a business standpoint and a retirement standpoint. Although the Administration has withdrawn proposed regulations which would essentally eliminate such arrangements, and although its subsequent legislative proposals were soundly rejected by the House of Representatives, we are concerned that the Administration may attempt to revive its proposals in the Senate. The Administration proposals would significantly alter long-standing concepts of cash-basis accounting, and would appear to take no accounting of the role non-qualified deferred compensation arrangements take in the broader spectrum of public and private employlee benefit plans. The proposals would have a particularly detrimental impact on small businesses and the self-employed.

We urge that the House passed provisions of H.R. 13511 (Sections 122 and 123) be retained, and that no additional legislative changes be made in laws dealing with nonqualified deferred compensation arrangements.

3. S. 3007.—S. 3007 was approved by the Senate Finance Committee, as amended by Printed Amendment 3408, on August 4, 1978 and subsequently passed by the Senate as H.R. 7320, on August 23, 1978. The bill is designed to relieve persons, who have acted in good faith, from the punitive effects of retroactive IRS employment tax audits pending final resolution of the employee/independent contractor problem by the Congress. The bill would accomplish this in two ways. First, it would prohibit the IRS from applying a new or changed position in the area which is inconsistent with a general audit position,

regulation, or ruling in effect on January 1, 1976. Second, it would recognize the independent contractor status of individuals who have been treated consistently and in good faith as independent contractors in reliance on rulings, cases, past IRS audit practices, industry practices, or the taxpayer's own long-standing practices. The bill would provide relief which is specific, administrable, and certain. No relief would be given if the taxpayer's treatment of an individual as an independent contractor constituted negligence, fraud, or intentional disregard of rules and regulations. The bill would, until replaced by subsequent legislation, control independent contractor/employee determinations for employment tax purposes and would provide Congress with time to study this area.

More importantly, it would relieve taxpayers who relied in good faith on existing law from the crushing burdens of actual or threatened assessments. Since even threatened assessments must be disclosed and can have a very harmful effect on the stock values or credit of a company, this proposal would provide essential relief which could not be provided by a mere suspension of actual assessments. Finally, the bill would, by continuing the law as it existed before the IRS's change in position, preserve the traditional independence of many small businessmen.

We urge continued Senate attention to H.R. 7320 (S. 3007). If the bill is not addressed expeditiously by the House of Representatives, we urge that it be included as a Senate amendment to the Tax Reform Bill of 1978. S. 3007 addresses a matter which is in dire need of immediate Congressional action and its passage should not be delayed.

Respectfully submitted.

HARRY V. LAMON, Jr.,
General Counsel.
STANLEY H. HACKETT,
Associate General Counsel.

STATEMENT OF FORTESCUE W. HOPKINS

Mr. Chairman, members of the Committee, I appreciate this opportunity to present to the Committee my suggestions as to the Effective Date and other relief from the Minimum Tax Amendments of the Tax Reform Act of 1976 in the case of amounts of long-term capital gain received after July 27, 1978 (date of first consideration by the House Ways and Means Committee of minimum tax relief) pursuant to binding contracts entered into on or prior to July 27, 1978.

For reasons which follow, I recommend that the minimum tax changes made in TRA 76 with respect to the foregoing tax preference items be amended as follows:

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That subsection (g) of Section 301 of the Tax Reform Act of 1976, is amended by adding at the end thereof the following new subparagraph:

"(5) Special rule for installment sales and other dispositions. In the case of capital gains preference items received after July 27, 1978, and on or before December 31, 1978, which are realized as a result of a binding contract entered into prior to July 27, 1978, the amendments (except for paragraph (2) above) made by this section shall not apply. The one-half tax offset provided under subsection (c) shall first be applied to reduce preference income received before July 27, 1978 and any unused balance thereof together with the remaining half tax offset being applied against preference income received on or after July 27, 1978."

The sole intended effect of the foregoing proposed legislation is that with respect to the foregoing preference items, the taxpayer will receive an offset equal to his total tax liability for that year. However he would not be permitted to take advantage of any tax carry over provision contained in the minimum tax law prior to 1976.

Why should the recipients of installment sale proceeds be entitled to this relief and not be required to wait for relief until the effective date set forth in H.R. 13511—January 1, 1978? The answer seems quite easy. Those who have prospective gains can now wait until January 1, 1979 to make their sales but those who are receiving installment proceeds cannot make the election to wait until Janu-

ary 1, 1979. Thus, with respect to them, H.R. 13511 acts in a discriminatory manner.

In the case of an increase in capital gains taxes there is precedent for relief for installment sales made prior to the enactment of the law. For example, in the Internal Revenue Act of 1969, limiting the 25% rate to the first $50,000.00 of capital gains was, in the case of binding contracts entered into prior to October 9, 1969, not applicable to installment sale proceeds.

In 1977, Senator Curtis introduced S. 1955, a bill to delay the effective date of the minimum tax changes of TRA for one year. His comments concerning this legislation (Cong. Record July 28, 1977, p. S13005) bear further reconsideration, as follows:

"As you may recall, the Tax Reform Act raised the tax rate and lowered the tax exemption applicable to minimum tax. The Reform Act became law on October 4, 1976, but the minimum tax provisions were made effective retroactively to January 1, 1976. This retroactively has had a severe adverse effect on many individuals and small businesses who made personal and business decisions relying on the law as it was at that time.

Now they find themselves with unexpected tax liabilities, not because the taxpayer acted on the facts but because Congress acted after the fact.

There is precedence for delaying the effective dates that were originally made retroactive. This Congress corrected the retroactive effect of the repeal of the sick pay exclusion because we believed that it was basically unfair to impose a tax burden on individuals without giving them the opportunity to plan for it. The same equities apply in this situation. If we expect the taxpayer to voluntarily comply with our tax laws, then those laws must be as fair as possible. Mr. President, the intent of the minimum tax was to insure that all citizens paid some income tax regardless of the nature of their income. The law was never intended to apply to citizens who have paid taxes over their working lives and upon retirement sell their homes, businesses, or farms.

Yet it has come to my attention that many farmers, small businessmen, and even homeowners were subject to the retroactive application of the minimum tax in 1976.

We must assure the taxpayer that if he acts in accordance with present law we will not later change the law to his detriment. I urge my colleagues to support me in this bill."

From the foregoing, it appears that in 1976 Congress, departing from a reasonable precedent, unfairly and most inequitably his installment and other sales with retroactive minimum tax increases. What Congress has put on retroactively, equity would seem to suggest that Congress can take off retroactively. However, What is being asked for here is not retroactive relief to January 1, 1978, although it is certainly warranted, but, rather that those who are locked into installment and other receipts for the rest of 1978 not be further discriminated against after the date of public notice of minimum tax relief (July 27, 1978). For an actual illustration of the 1977 tax effects of the retroactive minimum tax changes of TRA 76 on a ten year installment sale of a family held business based on a binding contract of March 4, 1975, please see my statement filed with the House Ways and Means Committee on April 3, 1978.

The revenue effect of this proposal as it concerns proceeds from prior years installment sales would be minimal. Secretary Blumenthal's statement dated June 28, 1978, reflects proceeds from prior year installment sales for 1973 at 9.7 percent of total capital gains. In 1962, however, the percentage of such gains in excess of $10,000.00 was only 62 percent (see IRS Statistics of Income—1962, Sale of Capital Assets pp. 47 & 49). Therefore, only 6 percent, 9.7 x 62) would be subject to minimum tax but the half tax offset would reduce that figure by an unknown amount (possibly as much as 50 percent). Therefore, as far as proceeds from prior years installment sales are concerned, it would be reasonable to estimate the revenue cost as low as 3 percent of 1978 minimum tax.

Although it cannot be estimated, the revenue effect with respect to transitional sales should also be quite minor (binding contracts between January 1, 1978 and July 27, 1978, but proceeds not received until after July 27, 1978). However, if it should be the decision of this Committee to grant the relief requested, but to put the binding contract date back to December 31, 1977, then the minimum tax relief granted should also be retroactive to January 1, 1978.

In H.R. 13511, the effective date of relief from capital gains tax (and minimum tax) on personal residences was set at July 26, 1978. The equity for granting

the same effective date (July 27, 1978) for taxpayers who cannot defer installment or other proceeds until January 1, 1979, appears to me, at least, to be equally as great (if not as politically attractive). Of course, if Congress should, for all capital gains, accelerate the date of minimum tax relief to July 27, 1978, or to January 1, 1978, then the relief here requested would be moot.

Respectfully submitted.

FORTESCUE W. HOPKINS.

STATEMENT REGARDING SEPARATE DEDUCTION FOR MEDICAL EXPENSES BY HEALTH INSURANCE ASSOCIATION OF AMERICA

This is a statement on behalf of the Health Insurance Association of America, representing a membership of over 300 insurance companies which write approximately 85 percent of the health insurance written by insurance companies in the United States.

We appreciate this opportunity to state our views in support of the present separate deduction for health insurance premiums under the medical expense deduction and against the elimination of that provision by the House-passed tax bill, H.R. 13511.

Under present law, a taxpayer who itemizes his deductions may deduct one-half of his health insurance premiums up to a maximum deduction of $150. The rest may be aggregated with his other medical expenses and deducted to the extent the sum exceeds 3 percent of the taxpayer's adjusted gross income. Under the provisions of H.R. 13511, as passed by the House of Representatives, the separate deduction for health insurance premiums would be eliminated. A taxpayer's health insurance premiums would be deductibe only to the extent that, when aggregated with other medical expenses, they exceed 3 percent of the taxpayer's adjusted gross income.

The proposed elimination of this deduction is intended to simplify the individual tax return. While we endorse the general concept of simplification, we strongly believe that this must be accomplished in a manner which preserves tax equity and is consistent with sound tax policy. The proposed elimination of the deduction for health insurance premiums does not meet these standards.

First, the present deduction (outside the medical deduction floor) for one-half of a taxpayer's health insurance premiums was added in 1965 in order to equalize to some degree the tax treatment as between an individual who purchases health insurance and one who chooses to self-insure. Without this deduction, it is likely that the taxpayer who purchases health insurance would never qualify for a medical expense deduction since his medical expenses are essentially averaged out over a period of years and will usually fall below the medical expense deduction floor. On the other hand, the medical expenses of taxpayers not covered by insurance tend to be concentrated in particular years, thereby making it likely that they will exceed the medical expense deduction floor in these years and qualify for a deduction. It was felt by the Ways and Means Committee in 1965 that such a disparity in tax treatment "may have the effect of discouraging the provision of insurance protection against future medical bills." (See Ways and Means Committee Report on H.R. 6675, 89th Congress, page 137.) For this reason, the existing deduction was added in 1965. And it would seem even more important, in view of the rising health costs, that it be maintained at this time.

The need for upgrading and broadening health insurance coverage is universally recognized. To destroy the present incentives in the tax law for the purchase of health insurance as part of a tax reform or simplification bill, while considering the best means to assure all Americans the best health insurance coverage, is contradictory. The Treasury and the public would be better served if Americans provided more, rather than less, health insurance for themselves.

To argue that the increased taxes on those persons providing their own defenses against the catastrophic financial impact of major illness will be offset by an increased standard deduction or otherwise lowered tax rates for all is no answer to those adversely affected.

Many of those affected, particularly those struggling to buy their own homes (and thus taking substantial interest and tax deductions) will have their tax increased through the loss of the deduction, but will get no benefit from an increased standard deduction. Similarly, a general tax deduction spread over all taxpayers would only partially offset the increase in tax suffered by those losing the health insurance premium deduction.

The adverse results of this change will be magnified by the resulting increase in city, county, and State income taxes which are based on the Federal law.

Elimination of the separate deduction for health insurance does not mean a simplified return for all taxpayers. Millions of taxpayers take the health insurance premium deduction without taking a deduction for their other medical and dental expenses. For many of these, repeal of the simple health insurance deduction will eliminate one line of the tax form (a minimal simplification at best), but at the price of higher taxes. For others, adding health insurance on to the other medical deductions will bring them over the "floor". Then, to claim a smaller medical deduction, they will have to justify not only their health insurance premium payments but all their varied medical and dental expenses which bring them up to the "floor". Thus, the life of some taxpayers would be simplified at a price, but for others it would be made much more complicated.

RECOMMENDATION

If the Committee wishes to further simplify the return, we suggest the elimination of the existing limitation (50 percent or a maximum of $150). This would not only help those individuals who provide their own health insurance protection, it would simplify both the preparation and the audit of the return. Particularly it would simplify the return for the person who now has to make two computations instead of one.

The revenue effect of this proposal as it concerns proceeds from prior years installment sales would be minimal. Secretary Blumenthal's statement dated June 28, 1978, reflects proceeds from prior year installment sales for 1973 at 9.7 percent of total capital gains. In 1962, however, the percentage of such gains in excess of $10,000.00 was only 62 percent (see IRS *Statistics of Income—1962, Sale of Capital Assets* pp. 47 and 49). Therefore, only 6 percent (9.7 x .62) would be subject to minimum tax but the half tax offset would reduce that figure by an unknown amount (possibly as much as 50 percent). Therefore, as far as proceeds from prior years installment sales are concerned, it would be reasonable to estimate the revenue cost as low as 3 percent of 1978 minimum tax.

Although it cannot be estimated, the revenue effect with respect to transitional sales should also be quite minor (binding contracts between January 1, 1978 and July 27, 1978, but proceeds not received until after July 27, 1978). However, if it should be the decision of this Committee to grant the relief requested, but to put the binding contract date back to December 31, 1977, then the minimum tax relief granted should also be retroactive to January 1, 1978.

In H.R. 13511, the effective date of relief from capital gains tax (and minimum tax) on personal residences was set at July 26, 1978. The equity for granting the same effective date (July 27, 1978) for taxpayers who cannot defer installment or other proceeds until January 1, 1979, appears to me, at least, to be equally as great (if not as politically attractive). Of course, if Congress should, for all capital gains, accelerate the date of minimum tax relief to July 27, 1978, or to January 1, 1978, then the relief here requested would be moot.

Respectfully submitted.

FORTESCUE W. HOPKINS.

HANIGSBERG, STERN & KEISER, P. C.,
CERTIFIED PUBLIC ACCOUNTANTS,
New York, N.Y., August 30, 1978.

SENATE FINANCE COMMITTEE,
Dirksen Senate Office Building,
Washington, D.C.

GENTLEMEN: A broker-dealer in securities commonly receives large amounts of dividend and interest income from inventories of securities held for sale to customers in the ordinary course of business and from interest received on customers' margin accounts and other common securities business operations. Although this dividend and interest income is largely offset by interest expense on debt incurred to finance said securities inventories and other securities business operations, the presence of gross interest and dividend income on a large scale in relation to other gross income from the day-to-day business of brokerage, consulting and underwriting, could cause such a business to be treated as a personal holding company (hereinafter referred to as "PHC") if the stock ownership test is also met.

Secs. 541 et seq. of the Internal Revenue Code of 1954, and their predecessor dating back to 1934, deal with personal holding companies on a definitional basis centering around corporate gross income characteristics without any regard for bona fide business and economic circumstances. In the broker-dealer situation, although the net amount resulting from the differential between interest income and expense is nominal in comparison to the total gross income, the entire corporate taxable income (net of the attendant federal tax liability) would (if the PHC rules applied) to be subject to mandatory distribution as a dividend or, in the alternative, a 70 percent penalty tax.

The PHC provisions were first enacted in the Revenue Act of 1934 (P.L. 216, 73rd Cong., 2nd Sess.), and were directed at corporations controlled by a limited number of shareholders and deriving their income from certain specified sources. Congress had concluded that such corporations could be used to avoid the personal graduated income tax.

The PHC rules originally defined a PHC as one where 50 percent of the stock was owned by 5 or fewer individuals and at least 80 percent of its gross income was derived from royalties, dividends, interest, annuities and gains from sales of stock or securities (except dealers). Rents were included in the House version of the legislation [H. Rep. No. 704, 73rd Cong., 2nd Sess., CB 1939-1 (Pt. 2), 562], but the Senate struck out rents as PHC income on the basis that real estate concerns are in ". . . the nature of operating companies [rather] than mere holding companies." [S. Rep. No. 558, 73rd Cong., 2nd Sess., CB 1939-1 (Pt 2), 596].

The House report, supra, also noted that new provisions ". . . should work no real hardship upon any corporation except one which is being used to reduce [taxes] upon its shareholders" "It is believed that a majority of these corporations are in fact formed for the sole purpose of avoiding the imposition of [tax] upon the stockholders." The new system enacted gave the Treasury the power to levy a penalty tax on a PHC or compel a distribution ". . . without any necessity for proving a purpose of avoiding [taxes]."

There were corporations in certain industries which were legitimate operating companies, but which became subject to the PHC rules merely due to the nature of their income. Over the years, as Congress saw that the PHC statutes were producing harsh results, it corrected these situations by providing exceptions for certain industries. Section 542(c) excepts from the PHC definition banks, life insurance companies, surety companies, lending and finance companies, and small business investments companies ("SBIC").

In the case of the SBIC, the PHC statutory exception was enacted subsequent to the Small Business Investment Act of 1958, and apparently only after the problem was called to the attention of Congress by a special interest group.

An SBIC, by the very nature of its purpose to provide loans and equity capital to small business ventures, will have income consisting entirely of interest and dividend income. A mechanical application of the PHC gross income rules to such a situation, where the PHC shareholder requirements are met, yields a harsh result. This is documented in Rev. Rul. 59-69, 1959-1 CB 142, which seems to have given initiative to the legislative process that, in 1959, excepted SBIC's from PHC status by virtue of an addition to Sec. 542. This ruling, terse and to the point, and without any sympathy, refused to relieve SBIC's from PHC status.

There was a series of events that followed closely on the heels of Rev. Rul. 59-69, since the PHC relief for SBIC's was enacted in September of 1959, effective for years beginning after December 31, 1958. Not only was Congressional action swift, but also, by virtue of the effective date of the legislation, not one SBIC was ever subject to the PHC rules.

It is interesting to note that no exception is currently provided for brokers and dealers in securities. Due to the nature of the securities business, large amounts of dividend and interest income are generated from the securities held for sale to customers and from charges made on customers' margin accounts. This income, mechanically and inescapably, falls within the definition of PHC income. Thus a corporation in the brokerage business is forced either to distribute dividends or pay the 70 percent penalty tax. This deprives these corporations of operating capital at a time when the entire securities industry is suffering from well-known capital problems.

Perhaps this situation was not as acute in the past when brokerage operations were conducted through partnerships. However, the modern trend has been toward incorporation and many of the smaller brokerage houses are faced with this problem. Legislative relief should be available.

We have proposed that all brokers and dealers in securities, as defined by state licensing law, or gauged by appropriate and existing SEC standards, be excepted from PHC status by adding a new paragraph (9) to existing Code Section 542(c). This section would be patterned after the existing legislation dealing with lending and finance companies. A bill is currently being drafted for consideration by the House Ways and Means Committee. However, we feel that this bill deserves the immediate attention of the Senate Finance Committee for inclusion in its draft of current tax legislation.

Very truly yours,

LAURENCE KEISER.

KING & SPALDING,
Atlanta, Ga., August 22, 1978.

Re Senate finance committee hearings on H.R. 13511.

Mr. MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: Pursuant to my telephone conversation with a member of the Staff of the Senate Finance Committee, I have agreed not to appear at the public hearing on H.R. 13511 but to state my position in writing for the record so that it can be printed and distributed to members of the Finance Committee.

I wish to urge the Congress to increase the exempt small issue limits in Section 103(b)(6) of the Internal Revenue Code of 1954, as amended, of $1,000,000 and $5,000,000 to $2,000,000 and $10,000,000, respectively.

Amendment of the exempt small issue limits is essential to offset the effects of inflation and to restore to small issue industrial development bonds the incentive value Congress intended them to have when it established the present limits in 1968. According to every official price index, the costs of commercial and industrial construction have almost doubled in the last ten eyars. Perhaps the most accurate measure of the effect of inflation on construction costs during the relevant period (1968–1978) in the GNP Deflator for Business Fixed Investment, published in *The Survey of Current Business* by the United States Department of Commerce. This index shows that the purchasing power of a dollar for plant and equipment expenditures has fallen from a base of $1.00 in 1967 to $.507 in the second quarter 1978.

Other official measurements of the Department of Commerce support these figures. The Consumer Price Index shows that the purchasing power of a dollar for consumer goods has dropped from a base of $1.00 in 1967 to $.512 in April 1978, and the Construction Cost Index shows that the purchasing power of a dollar for commercial and factory buildings has fallen from a base of $1.00 in 1972 to $.621 in April 1978.

There can be no serious challenge that an increase in the exempt small issue limits is required to offset the effects of inflation, and I urge that this be done.

Respectfully submitted.

POPE B. MCINTIRE.

STATEMENT OF THE INTERNATIONAL ASSOCIATION OF REFRIGERATED WAREHOUSES

The International Association of Refrigerated Warehouse (IARW) is a nonprofit trade association representing the public refrigerated warehousing industry. The association's membership consist of 408 warehouses throughout the United States which operate approximately 75 percent of the public refrigerated warehouse space in the country. In addition, there are 248 members in twenty-eight other countries and territories.

The 408 U.S. members freeze, store and distribute an estimated 19 billion pounds of frozen food products annually and are an indispensable part of the country's perishable food marketing system.

As passed by the House, H.R. 13511 would make the 10 percent investment credit permanent. IARW strongly supports this action. The on-again, off-again aspect of the investment tax credit in recent years has created uncertainty, made long-range planning difficult and discouraged capital investment.

The bill would also extend the investment credit to the rehabilitation of existing structures, including industrial and office buildings, retail structures and ware-

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houses. Extending the credit to rehabilitation only is not very helpful as far as public refrigerated warehouses are concerned as it fails to help the problem which this industry faces of attracting capital for new construction.

Excluding refrigerated warehouses is also illogical and discriminatory. Why should a food processor be able to take advantage of the investment tax credit on his new buildings while the public warehouseman, who freezes and/or stores the processor's product, be excluded from the same tax advantage with respect to his new warehouse building? Certainly, freezing is as much a part of the food processing procedure as cleaning, chopping, blending, packaging, canning, etc., which are carried on in the food processor's building. Refrigerated storage is also a continuation of the process, for without it perishable foods would quickly spoil and be useless.[1] In these circumstances, a public refrigerated warehouse is as much an industrial building as a factory or utility which can apply the credit to new construction.

Another factor which makes exclusion of new warehouses from benefits of the investment tax credit unfair is the high cost of construction of refrigerated space. The cost of construction generally has outpaced the cost increases for machinery and equipment, and present allowable depreciation rates are already inadequate. However, unlike an ordinary factory or utility building, a refrigerated warehouse requires specialized construction calling for such extra features as heavy insulation, vapor barriers, underfloor warming (to prevent frost heaving), heavy refrigerator doors and other special features unique to such buildings. The cost of constructing a refrigerated warehouse today in a metropolitan area is easily $40–$50 a square foot exclusive of land, considerably more than for most other types of industrial buildings.

A further problem is that the public refrigerated warehousing industry has a much lower return on investment (an average of only 6½ percent *before taxes*) than most manufacturing industries. Available capital tends to flow to those industries with a higher rate of return making it extremely difficult for the refrigerated warehousing industry to obtain needed capital.

The great majority of public refrigerated warehouses are small family-owned or closely held businesses which adds further to the difficulty of obtaining needed capital. One of the main purposes of the investment tax credit is to assist small businesses in meeting their capital requirements for expansion and the creation of additional jobs.

It is grossly unfair to deny the benefits of the tax credit for new construction to such small businesses, especially one so vital to our nation's food economy, while making it available to others. It also defeats one of the major purposes of the credit.

The food industry in our country is vital, dynamic and changing rapidly and constantly. Frozen food production is growing, new products are continually coming on the market, markets shift, distribution patterns change. Thus, the refrigerated warehousing industry which serves the food industry is not, and cannot be, static. It must constantly expand to provide new service, create additional capacity or establish warehouses in new locations. There is a definite need for a greater and continuing flow of capital into the industry and anything which can be done to encourage this should be done. These changes also mean that the refrigerated warehouse which is in the right location today may be in the wrong location tomorrow or become inefficient or even obsolete because of changes in materials handling technology. Under these conditions, rehabilitation is not the answer.

For these reasons, we cannot urge too strongly that the investment tax credit be made applicable to the construction of new refrigerated warehouses.

Statement on Freezer (0°F) Storage as an Essential Part of Food Processing

(By Amihud Kramer, Professor Food Science and Director of TRRF Laboratory, University of Maryland, College Park, Maryland)

All raw foods cannot be consumed at time of harvest. Thus, in order to provide an adequate year-round food supply, most food must be *processed*, i.e., *preserved* for up to a year, and in some instances, much longer. Foodstuffs are preserved

[1] See attachment, "Statement on Freezer (0°F) Storage as an Essential Part of Food Processing."

primarily to retain life sustaining nutrients; however, the food supplies must also remain organoleptically and functionally acceptable until consumed. Above all, the stored food must remain *safe*, that is, free of pathogenic microorganisms.

Microbial spoilage can be looked upon as a kind of chemical spoilage in which a living organism is the catalyst of a chemical reaction. Most chemical reactions are temperature-dependent; i.e., they proceed more rapidly as the temperature is increased (up to a point where one or more of the reacting substances is chemically changed by the high temperature) and more slowly as the temperature is decreased. This is the basis of preservation by refrigeration. As the temperature is reduced, the enzymatic processes which control the growth and reproduction of microorganisms proceed at a slower rate until they either do not grow at all or grow so slowly as to do little harm to food. While inhibiting microbial growth low temperature also retards other chemical and physiological reactions that cause sensory and nutrient losses. Thus, refrigeration comes very close to the ideal method of food preservation; i.e., it maintains the food in an unchanged state until it is used.

Freezing, which is a form of refrigeration, not only slows reaction rates, but also sequesters water by crystallizing it so that the bacteria which would grow slowly at low temperature (the psycrotrophs) do not have sufficient water available for their life processes. [1]

In addition to bacterial inactivation, the freezing process consists of prefreezing treatments, freezing, *frozen storage*, and thawing. This method of long-term food preservation is generally regarded as being superior to canning or dehydration when judged on the basis of retention of sensory attributes and nutritive properties. However, this in no way suggests that the freezing process is perfect, since it is well known that significant amounts of some vitamins are lost during the freezing process. Losses of nutrients during freeze processing can result from physical separation (e.g., peeling and trimming during the prefreezing period, or exudate loss during thawing), leaching (especially during water blanching), or chemical degradation [2]. The seriousness of these losses depends on the initial quality levels, the material involved, as well as the rate of freezing and, perhaps, the most important—the time and temperature of storage. Extensive studies on losses in sensory quality as influenced by time and temperature of storage were performed at the USDA Western Regional Laboratory in the 1960's [3], and at the Swedish Institute of Food Preservation in the 1970's [4]. Effects of storage temperatures on nutrient retention was thoroughly reviewed by Fennema [2] and Kramer [5] in 1977.

Even fluctuations in freezer storage temperatures were considered, with the tentative conclusion that temperature fluctuations of ±5°C (9°F) damaged sensory quality but they did not add to the main temperature effect on nutritional quality [6]. A recent attempt was made to establish an actual per cent gain (+) or loss (—) in market value where frozen product is stored at a specified temperature [7]. Thus, for example, 2.1 percent of the value of Salisbury steak could be preserved each month it is held at —20°F instead of 0.0°F, but only a gain of 0.7 percent per month for macaroni and cheese. Obviously, if either product were stored for just a few days at above 5°C (41°F), it would not only be worthless from the sensory quality standpoint but could become a hazard to health, since microorganisms were inactivated during freezing but not destroyed.

But even if frozen foods were packaged in a hermetically sealed container, they would still be subject to spoilage unless stored in the freezer. During the usual freezing operation, raw foodstuffs undergo drastic physical changes in that water and other liquids go through a change of state. In this process, ice crystals damage cell walls and release enzymes which cause serious quality deterioration if the product is not stored in a solid, that is, a frozen state, preferably at 0°F or below; also, a portion of the microorganisms that survive the freezing process become reactivated and may cause spoilage when product temperature is raised above freezing.

Thus, another view of this situation can be obtained by comparing the importance of the container to the safety of canned food; to the continued freezer storage of frozen foods to their safety. Since frozen foods are not usually hermetically packaged and sterilized, frozen storage for frozen foods is as important and as much a part of the freezing process as maintaining the integrity of the can, that is, keeping it in a hermetically sealed container, is an integral part of the canning process.

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5. Kramer, A. 1977. Effect of Storage on Nutritive Value of Food. J. Food Quality, 1, 1, 23.
6. Moleeratanond, W. et al. 1978. Effect of fluctuating temperatures on energy consumption and quality changes of palletized frozen food during storage. Paper No. 98, Proceed. IFT meeting, Dallas.
7. The Refrigeration Research Foundation. 1978. Cost/Benefit Relationships. New Research Findings #78-1, p. 2.

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1. Fennema, O. R.; Powrie, W. D.; and Marth, E. H. 1973. Low-Temperature Preservation of Foods and Living Matter, Marcel Dekker, N.Y.
2. Desrosier, N. W. and Tressler, D. K. 1977. Fundamentals of Food Freezing, Avi.

STATEMENT OF W. THOMAS KELLY, PRESIDENT, INVESTMENT ANNUITIES INSTITUTE, INC.

SYNOPSIS

As reflected in the Chronology and Summary that follows, the IRS' issuance of Revenue Ruling 77-85 is directly contrary to:

(a) The cogent viewpoints and urgent written requests of many Senators and Representatives, and

(b) The IRS' own, insisted upon, position for the prior 14 years and over 70 public and private rulings, and

(c) The expressed will of the Senate by a vote of 57-26, and

(d) The clear intent and letter of the law in regards to this specific matter as decided by the U.S. District Court, District of Columbia, and

(e) The expressed will of the House Ways and Means Committee by a vote of 22-14.

Through its contemptuous acts the IRS has killed a fine, innovative company and industry thereby inflecting millions of dollars of totally unwarranted loss upon thousands of shareholders, agents, employees, and policyowners. Of far more serious consequence, however, is the resultant IRS killing of a very fine, innovative, legitimate "Annuity" that was specifically designed to provide a better means for our citizens to enjoy life's later years by living on (using up) the capital and income of their individually selected investment(s) over their exact lifetime(s).

The Treasury's 1978 tax proposals to Congress attempted to tax all annuities in the manner illegally imposed upon the Investment Annuity. These proposals were soundly rejected by the House Ways and Means Committee, and such proposals have been dropped in the Treasury's comments to the Senate on the House passed tax bill, HR 13511. Thus, the Investment Annuity stands out as being grossly and illegally (as per U.S. District Court) discriminated against by the Treasury and the IRS.

It is entirely proper and equitable for the Senate Finance Committee and Senate to correct this grave injustice by including in the 1978 Tax Bill (HR-13511), appropriate corrective language along the lines of HR-12173 as included herein (Exhibit F).

CHRONOLOGY

1962.—The Internal Revenue Code was amended to permit life insurance companies to establish "separate accounts" to facilitate the underwriting of variable annuities.

Under all variable annuities the policy owner's cash values and benefits "vary" directly with the investment results (appreciation, depreciation and income) of the related "separate account." Therefore, while the insurer underwrites the very important expense and longevity (mortality) risks of the variable annuity, the policy owner assumes the investment risk regardless of whether the insurer manages the "separate accounts" portfolios or whether the insurer delegates that investment management to others.

1963.—An innovative form of variable annuity was developed and a new life insurance company was organized to underwrite, sell and administer such variable annuities. Appropriate tax rulings for the insurer and policy owners were requested of the National Office of the IRS. Under these variable annuities the insurer established a separate account for each policy owner and delegated, under prescribed conditions established by the insurer, the investment management of the separate account to the policy owner or to the policy owner's chosen investment manager. The IRS recognized from the start that a new company and a new segment of the life insurance industry was to be bottomed upon the National Office tax ruling to be issued.

1965.—From the start of its consideration of this tax ruling matter in 1963 until it issued its first basic ruling in 1965, the IRS consistently insisted that the annuity under consideration was simply a variable annuity falling fully within the separate account provisions of the law recently enacted in 1962. Every relevant department of the IRS contributed to the IRS' very thorough two-year consideration; and it was specifically concluded by the IRS that the delegation of investment management to the policy owner by the insurer did not change any elements of variable annuity taxation to the insurer or to the policy owner.

At about this time the brand name "Investment Annuity" was coined for this innovative form of variable annuity. This was done solely for legitimate business identification purposes and the name of the insurance company was changed to First Investment Annuity Company of America (FIAC). (See Exhibit A for a brief description of the Investment Annuity.)

1965–1977.—During this twelve-year period the National Office of the IRS issued over 70 public and private rulings covering different Investment Annuity contracts for different markets. All rulings consistently reaffirmed and reinforced the basic rulings established in 1965. Nine or ten other insurers emulated this form of variable annuity during this period and secured appropriate and consistent National Office tax rulings.

1976.—The IRS announced a reconsideration of its prior Investment Annuity rulings and requested comments from interested parties on three specific areas of importance to their reconsideration. The entire Investment Annuity industry responded with relevant facts and complete, conclusive answers to the IRS' important questions; said answers clearly showing that the IRS' historic position was correct legally, actuarially and in accord with industry practice in regards to other variable annuities.

1977.—The IRS issued Revenue Ruling 77–85 that completely reversed its historic, 14-year position as reflected in over 70 previous rulings! In issuing Rev. Rul. 77–85 the IRS ignored the very questions it said in 1976 were so important to its reconsideration!

Revenue Ruling 77–85 effectively and immediately closed down the entire Investment Annuity industry and thereby put the innovative, pioneering company (FIAC) completely out of business.

1977.—The Senate passed Amendment 243 to HR 3477 by a strong vote of 57–26 (see Exhibit B) that deferred the effective date of Revenue Ruling 77–85 for one year to protect the legitimate interests of the Investment Annuity industry and to give Congress the necessary time to consider the matter. Many members of the Senate Finance Committee as well as other members of Congress were very concerned about the precipitous and ruinous IRS action that completely reversed longstanding tax law administration that had become imbued with the force of law. (See Exhibits C, D and F1.)

This Amendment 243 was subsequently dropped in the House/Senate Conference Committee due to Treasury Department lobbying and the House/Senate bargaining over resolving the House/Senate differences on HR 3477.

1977.—Following the Conference Committee's dropping of Amendment 243, FIAC sued the Treasury Department and the IRS in the U.S. District Court, District of Columbia, for arbitrary, capricious and illegal acts in issuing Revenue Ruling 77–85.

After thorough consideration, the Court decided that the IRS' act was illegal and unreasonable; that the IRS had exceeded its statutory authority; was motivated by theories of tax reform which was Congress' business; and the substantial deference to the expertise of the IRS in this matter was unwaranted. In plain language the Court clearly stated that the IRS, our Nation's administrator of our tax laws, didn't know what it was talking about! (See Exhibit E.)

The Treasury Department and the IRS appealed the District Court decision and stated that anyone purchasing an Investment Annuity during the time span of their appeal would be taxed retroactively if the IRS won its appeal. This IRS threat precluded FIAC starting up its business again even though FIAC had won a very strong victory in court on the merits. The only hope the Treasury and IRS have for their appeal is upon the highly technical court jurisdiction question. The court appeals can drag on for years.

1977-78.—The day after the favorable Court decision was issued, a major insurer made a bid to purchase FIAC's corporate shell at liquidation value. When FIAC was unable to secure any taxation accommodations from IRS and Treasury for renewed selling, pending the outcome of the Treasury/IRS appeal, the majority owner of FIAC (from the United Kingdom) voted to accept the liquidation bid. All employees have been terminated. The acquiring insurer has stated it has no intention to sell Investment Annuities.

The $380 million company that had evolved from the development and marketing of a fine innovative product in the public interest has been destroyed by the illegal, arbirtary act of the IRS. All employees have, of necessity, been terminated. Over 4500 agents were left without the annuity to sell. Shareholders have lost at least $20 million! (Investment Annuity stock was selling over $5 per share and incerasing in value when the IRS's illegal actions started; such stock is being liquidated at less than $1.75 per share—at least a $3.25 per share loss x 6.3 million shares outstanding equals $19.5 million.)

1978—President Carter's 1978 tax proposals included taxing all annuities generally in the manner the IRS illegally forced on FIAC. The Treasury Department's rationale for those tax proposals was basically the same the Court found to be erroneous in the Investment Annuity matter. These tax proposals were rejected by the House Ways and Means Committee in April, 1978; and, by a strong 22-14 margin, the Committee voted to reestablish the Investment Annuity as it had existed for 14 years prior to the illegal IRS reversal in March of 1977 via Rev. Rul. 77-85. (see Exhibits 1 and 2). Procedural constraints subsequently precluded this victory from being reflected in the 1978 Tax Bill (HR-13511) as finally voted out of that Committee.

1978.—As the 1978 Tax Bill is considered by the Senate an opportunity properly exists for the Investment Annuity to be included therein. In such event the matter will subsequently become a subject for consideration by the House/Senate Conference Committee that resolves the differences between the House and Senate versions of the Bill.

SUMMARY

The Investment Annuity clearly provided an innovative, very attractive, badly needed form of variable annuity underwriting for the American public. This has been proven in the marketplace.

The IRS properly insisted upon variable annuity taxation for the Investment Annuity from 1963 until 1977 and reaffirmed its own conclusions via over 70 public and private rulings prior to its arbitrary and illegal reversal of position.

Relevant law was established in 1962 contemporaneously with the original IRS considerations. Relevant laws has not changed one iota during the past 16 years; nor have the relevant facts changed one iota since the IRS' basic rulings commenced in 1965.

The Court had adjudged the IRS' Rev. Rul. 77-85 to be illegal and unreasonable and that the IRS usurped Congress' prerogatives to establish and change the law. In spite of the strong Court decision and the Court's stated "confident assumption that the defendants will proceed appropriately, in good faith, and in a manner fully consistent with the declaratory relief granted herein," the Treasury Department and the IRS thwarted renewed sales by their threat to tax purchasers retroactively if these regulatory agencies win their appeal. As a result of these illegal acts, and threats, the innovative company that had built up a fine, legitimate $380 million business and who sued the IRS and won, has nevertheless been brought to its knees and sold at a great loss.

Subsequent to the Court victory in the Investment Annuity and the IRS threat of retroactive taxation, the Ways and Means Committee (a) rejected the Treasury's proposals to tax all annuities in the manner forced upon the Investment Annuity segment of the Annuity industry by the illegal Rev. Rul. 77-85 and (b) voted to reestablish the Investment Annuity as it existed prior to the IRS' illegal Rev. Rul. 77-85 (see Exhibit F). Committee procedural constraints precluded this victory from being included in HR-13511 as presented to the Senate. Thus, the Investment Annuity segment of the insurance industry has been and continues to be grossly and illegally discriminated against and abused by bureaucratic anarchy.

The Senate can and should correct this severe inequity and injustice by reinstating the Investment Annuity tax treatment as it was properly insisted upon by the IRS for 14 years and over 70 rulings prior to the issuance by the IRS of its illegal Revenue Ruling 77-85. A copy of HR-12173 as considered and accepted by the Ways and Means Committee during their April 19th mark-up, is appended hereto (Exhibit F).

EXHIBIT A

THE INVESTMENT ANNUITY FORM OF VARIABLE ANNUITY

Briefly, the Investment Annuity form of variable annuity may be described as follows:

(a) Any annuity is a very long term contract easily spanning 3, 4, or 5 decades. Everyone knows that.

(b) A "fixed" dollar annuity loses purchasing power with inflation. Everyone knows that.

(c) Not everyone knows about "variable annuities". A variable annuity accumulates and pays benefits just like any other annuity (e.g. for life) except that the annuity reserves (assets) are, according to law, placed into one or more "separate accounts" of the insurance company and the variable annuity's benefits and values move up or down in direct relation to the market value of the separate account. If the separate account is invested in equities, the policy values and benefits enjoy the opportunity for growth to keep up with inflation. However, the annuitant also bears the risk of diminution if the separate account market value declines. In all other respects, a variable annuity is identical in format to a fixed dollar annuity, e.g. settlement options, non-forfeiture rights and values, etc.

(d) The Investment Annuity is an innovative form of variable annuity designed explicitly in the public interest. The "variable annuity's" problem was that the annuitant was often "locked into" the roller coaster of equity values and he couldn't get off the roller coaster without surrendering his valuable rights under the annuity by cashing in his policy. And, after benefits commence, he couldn't even surrender his policy to get off the roller coaster if he wanted to.

The Investment Annuity very simply and adroitly solved this very serious problem for the annuitant by merely having the insurer delegate the investment management of its variable annuity separate account to the policy owner, or to the policy owner's chosen investment manager. Many insurers delegate investment management on many occasions. In actuality, the insurance company establishes a separate account for each annuitant. This is more expensive, of course, but it provides a much better annuity for the general public. The Investment Annuity approach cuts through the Gordian knot of providing a truly suitable annuity to meet everyone's objectives as these objectives change over time.

Delegation of investment management within prescribed limits established by the insurer creates no taxation elements for the insurer for the policy owner that are more or less advantageous or onerous than any other variable Annuity. The government's tax revenue is the same under any variable Annuity.

As would be expected, some variable annuity policy owners are equity oriented, others are very conservative and some fall in between. No insurer can offer just one annuity and expect it to meet the needs and desires of all the American people; particularly, as those annuity needs and desires will undoubtedly change over the many decades annuity contracts can remain in force. Just think back over the past three, four or five decades and reflect upon the changes you've seen in interest rates, bond prices and stock prices, etc., as well as changing personal circumstances and family. Annuities easily stretch over that timespan.

Investment Annuities are an excellent product for Mr. & Mrs. Average American that permits them to adjust their annuity's investment(s) to fit their individ-

ualized needs and desires as these will undoubtedly change over the years. Investment Annuities fulfill a very real need to the great advantage of the American public.

EXHIBIT B

SENATE ACTION UPON THE INVESTMENT ANNUITY MATTER

Prior to and following the issuance of Revenue Ruling 77-85, many Congressmen (including many members of the Senate Finance Committee) urged the Treasury Department and the IRS to defer the issuance or implementation of Revenue Ruling 77-85 until Congress had had an opportunity to consider this matter. These urgings went unheeded.

Subsequently, by a vote of 57 to 26, the Senate passed Amendment 243 to HR 3477, Tax Reduction and Simplification Act of 1977, that deferred the effective date of Revenue Ruling 77-85 "for a period of one year to give Congress—which should make the change if a change is to be made—an opportunity to check into this matter and see what is involved" (Congressional Record S6747, April 29, 1977).

The Rollcall Vote No. 125 Leg. supporting (57) the Investment Annuity position is as follows:

SENATE FINANCE COMMITTEE MEMBERS

Allen (s), Baker, Bartlett, Bellmon, Bentsen, Burdick, Byrd, Robert C., Chiles, Cranston, Curtis, DeConcini, Dole, Eagleton, Eastland, Ford, Garn, Goldwater, Gravel, Griffin, Hansen, Hatch, Hatfield, Hayakawa, Heinz (c), Helms, Hollings, Huddleston, Jackson, Laxalt, Leahy, Long, Lugar, Magnuson, Mathias, Matsunaga, McClure, Melcher, Packwood, Pearson, Percy, Randolph, Ribicoff, Roth, Sasser, Schmidt, Schweiker (c), Sparkman, Stafford, Stone, Talmadge, Thurmond, Tower, Wallop, Weicker, Williams, Young, and Zorinsky; s—sponsor, c—co-sponsor (FIAC's senators).

Not Voting (17): Abourezk, Bumpers, Byrd, Harry F., Cannon, Case, Church Domenici, Durkin, Haskell, Humphrey, Inouye, Johnston, McClellan, Morgan, Stennis, Stevens, and Stevenson.

EXHIBIT C

Mr. ALLEN. I certainly agree with the distinguished Senator.

Mr. CURTIS. I am somewhat familiar with this general problem.

I have written the Treasury expressing the view that they ought not do it.

I believe the distinguished Senator's proposal to delay it a year is a very modest and reasonable one and it should be adopted by the Senate.

It is not fair to treat people and let an arrangement go on on and on for more than a decade, cloaked with all the approval that can be given it and then up and change it.

So I commend the Senator for offering the amendment.

Mr. ALLEN. I thank the distinguished Senator.

I inquire of the distinguished Senator if he is not also impressed by the fact that to continue the status quo that has existed for some 11 or 12 years would not cost the Treasury one single penny; does that not also impress the distinguished Senator from Nebraska?

Mr. CURTIS. Mr. President, will the Senator yield further for me to have printed in the RECORD a communication to the Secretary of the Treasury on this very subject?

Mr. ALLEN. Yes, I am delighted to yield.

Mr. CURTIS. Mr. President, I ask unanimous consent to have printed in the RECORD a copy of the letter addressed to Secretary Blumenthal, bearing date of February 7, 1977, signed by the distinguished Senator from Texas (Mr. Tower), and the Senator now speaking; and a letter that went to Dr. Woodworth of the Treasury Department, signed by the distinguished chairman of this committee, Mr. Long, by the distinguished Senator from Connecticut (Mr. Ribicoff), by the distinguished Senator from Wyoming(Mr. Hansen), by the distinguished Senator from Texas (Mr. Bentsen), and by the Senator now speaking.

Mr. President, I ask unanimous consent they be incorporated in the RECORD as part of the colloquy between the distinguished Senator from Alabama and myself.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

WASHINGTON, D.C.,
April 6, 1977.

Hon. LAURENCE N. WOODWORTH,
Assistant Secretary, Department of the Treasury,
Washington, D.C.

DEAR DR. WOODWORTH: We urgently request that the Internal Revenue Service defer publication and application of Revenue Ruling 77–85 for 90 days or until the Congress can consider a proposal to postpone application of such ruling pending congressional consideration of this problem. Revenue Ruling 77–85 reverses more than a decade of IRS rulings as to the tax treatment annuity contracts. See attachment which covers some of these rulings.

We are informed that a bill will be introduced shortly which will have the effect of continuing for a limited time the longstanding IRS ruling until the IRS has completed its study of annuities and the Congress has had an opportunity to consider this area.

Sound tax administration should avoid the result of causing irreparable harm to the investment annuity industry, unless the law is clear, and then certainly not prior to the time that the Revenue Service has a firm position on the law governing alternative areas that offer the affected taxpayers some chance of surviving this administrative change of longstanding IRS rulings.

Temporary continuation of the longstanding rulings will simply allow time for a more orderly resolution of an admittedly complex problem and will permit an equitable disposition of the matter.

Thank you for your consideration. Please keep us advised with respect to this matter.

With kindest personal regards.

Sincerely,

RUSSELL B. LONG,
Chairman.
ABE RIBICOFF.
CARL T. CURTIS.
CLIFFORD P. HANSEN.
FLOYD BENTSEN.

WASHINGTON, D.C.,
February 7, 1977.

Hon. W. M. BLUMENTHAL,
Secretary of the Treasury, Washington, D.C.

DEAR MR. SECRETARY: Through this letter we wish to register our strong opposition to a possible reversal by the Internal Revenue Service with respect to Revenue Ruling 68–488 and letter rulings which involve the tax treatment of investment annuity contracts. We understand that such a reversal is a possible outcome of the IRS reconsideration of Investment Annuity taxation as indicated in IRS News Release IR–1679 dated October 20, 1976. A reversal in the Service's longstanding position concerns us as did the recent proposed changes that were being considered with respect to fringe benefits and tuition remission.

Because of our continuing interest in the significant role played by the Investment Annuity segment of the life insurance industry throughout the nation, we have considered the possible impact of such a reversal and are satisfied that it would be inconsistent with the very long-standing position of the Revenue Service. Moreover, implementation of this new and adverse interpretation of the treatment of investment annuities would strike an unnecessary and unwarranted blow at this growing segment of the insurance industry. Accordingly, we believe that the proposed reversal should be withdrawn.

As you are probably aware, the "investment annuity" is a descriptive term applied to a form of variable annuity contracts that require the policyholder, rather than the insurer, to select the investments that make up the policyholder's own annuity policy reserve: in actuality, a "separate account" is established for each policyholder pursuant to Section 801(g) of the Internal Revenue Code.

The attraction to the policyholder of this form of variable annuity is that the individual is not locked-in to a fixed dollar benefit subject to the erosion of inflation as is the case with the "fixed dollar annuity" nor is the policyholder

locked-in to a simple pooled equity fund selected or managed by the insurer with the policyholder being at risk investment-wise as is the case with the usual "variable annuity." Under an "investment annuity" the policyholder (or the policyowner's chosen investment manager) can be as equity oriented or as a conservative as desired, and the investment selection or the investment manager can be changed by the policyowner at any time. This personalized investment flexibility is the only element that differentiates the so-called "investment annuity" form of variable annuity from the usual variable annuity.

In 1963 a new life insurance company, formed solely to offer this annuity to the general public, requested the IRS to rule whether the element of policyowner investment control would establish that investment income would be taxed to the policyowner or taxed to the insurer.

We are advised that after two years of study by the IRS, the Service determined that the so-called Investment Annuity was a more flexible form of variable annuity, and therefore would be taxed as a variable annuity, i.e., (1) investment results would be taxed to the insurer pursuant to Section 801(g) of the Code and (2) the benefits would be taxed to the annuitant as variable annuity benefits pursuant to Section 72 of the Code. No new law was created. The Investment Annuity taxation is therefore identical with every other form of annuity underwritten by life insurers pursuant to the Internal Revenue Code.

For eleven years thereafter until 1976 the IRS issued many letter rulings pursuant to its historical position. It also published Revenue Ruling 68-488, all of which repeatedly reaffirmed the position conclusively established by the IRS in 1965 that the investment annuity was a variable annuity. These rulings encompassed the widest variety of annuity uses with the full knowledge by the IRS that the insurers and the others involved would base their business decisions and their contractual obligations with others in reliance on those rulings.

During this interval of over a decade an important new segment of the insurance industry has been developed. The annuity has established itself in the marketplace as being an attractive, more responsive annuity for many individuals. The originating insurer, whose sole business is the underwriting of this annuity, now has over $300 million of assets under investment annuities, and other insurers approximate this level for their investment annuity business. Tens of thousands of policyowners, agents, employees and their families now enjoy the benefits arising from the use or sale of this annuity product.

We understand that the IRS, at the end of 1976, recommended that the Service's tax position be reversed so that the policyowner would be directly taxed on the investment of the separate account rather than having these investments being taxed to the insurer. This would seriously damage thousands of persons and institutions that have relied upon the established government position.

It is, and has been, our view that IRS rulings are merely the position of the Commissioner of Internal Revenue. However, it is our further strong position that when such rulings are repeatedly reaffirmed over such a lengthy period of time as in excess of a decade, they become imbued with the force of law and must not be changed except by the expressed direction of Congress pursuant to the legislative process.

We are enclosing a copy of Senator Long's recent letter to former Secretary Simon that also expresses his concern about the procedure for changing the long-standing tax treatment of Investment Annuities.

The present IRS recommendation which is not as yet in force, has, we understand already gravely damaged the ability of Investment Annuity underwriters to market their product because even the presumed possibility of administrative change destroys sales and sales momentum. Thus, may we urgently request that the IRS be instructed to resume the issuance of rulings based upon its historic position. If the Treasury is interested in pursuing any changes in the IRS position, the Treasury should proceed to do so in the proper legislative manner.

Sincerely yours,

CARL T. CURTIS,
JOHN TOWERS,
U.S. Senators.

EXHIBIT D

BY MR. GRAVEL (FOR HIMSELF, MR. THURMOND, AND MR. MATSUNAGA):

S. 1939. A bill to amend the Internal Revenue Code of 1954 to provide that the U.S. Tax Court may issue a declaratory judgment with respect to the correctness

of a precedential revenue ruling issued by the Secretary of the Treasury which modifies a revenue ruling issued at least 5 years earlier, and for other purposes; to the Committee on Finance.

Mr. GRAVEL. Mr. President, the legislation which I introduce today is designed to remedy a problem in the administration of our tax laws which has vexed taxpayers for many years. In the time I have spent on the Senate Finance Committee I have seen several examples on internal Revenue Service administrative action which has caused difficult and unnecessary problems for taxpayers. I am sure that most of my colleagues are aware of the problem of which I speak, having been approached at different times by affected taxpayers. The problem to which this legislation is directed is the periodic revision by the Internal Revenue Service of long-standing interpretations of the tax law.

The Internal Revenue Service issues revenue rulings which interpret our tax laws. These rulings are intended for the guidance of taxpayers and IRS agents in the preparation and auditing of tax returns. These rulings do not have the force or authority of law. But, they do have far-ranging influence on the daily operation of thousands of businesses in our country.

The Internal Revenue Service takes the position that revenue rulings are interpretive only and therefore subject to change at any time. The Service maintains that theoretically a ruling currently in effect reflects the law as it has always been. Of course, the concept of a ruling as correctly reflecting what the law has always been is a fiction since rulings are subject to change. Indeed, rulings are often revised as the Internal Revenue Service reinterprets the law in light of changing business climates, and personnel. But, throughout this process, the revenue rulings which are current represent the Service's position as to the meaning of a particular tax law provision.

Now, since the IRS and taxpayers both rely on revenue rulings for the ordering of their affairs, a change in an existing ruling can have drastic consequences. If a taxpayer has built up a business based on existing interpretations of law and then those interpretations are revised, he may find himself suddenly out of business. Such an event has occurred recently and many of my colleagues have been approached by the affected taxpayers in the investment annuity industry. Now, I do not wish to speak here to the substance of the claim made by the investment annuity industry, but I would like to tell you something about how that industry came to seek congressional redress during the recent consideration of the Tax Reduction and Simplification Act of 1977.

In 1963 a new life insurance company was formed solely to offer investment annuities a type of variable annuity. The company requested the IRS to rule whether the element of policyholder control of investments would cause investment income to be taxed to the policyholder or to the insurer. The company took the position that it should be taxed to the policyholder. The Service ruled that there was not sufficient investor control to require the income to be taxed to the investor and therefore the income would be taxed to the company. The decision was based on section 801(g) of the Internal Revenue Code.

The Service issued its original ruling in this area in 1965. Again in 1968 it published a ruling reaffirming the position established in 1965. The Service knew full well that investors and businessmen were making daily decisions on these revenue rulings.

In reliance upon these rulings a significant new industry developed, the investment annuity industry. The investment annuity established itself in the market as a desirable investment on the part of many Americans. One company specializing in such annuities had over $300 million in assets under its policies. On March 9, 1977 disaster struck. The Internal Revenue Service reversed itself on investment annuities. In revenue ruling 77-85 the IRS took the position that the income from the investment annuity was taxable to the policyholder rather than to the company.

This position is just the reverse of its original holding of 11 years standing. It is a position which the Service rejected in 1965 when it issued its original ruling. Neither the facts nor the law had changed in the interim—the IRS had simply changed its bureaucratic mind.

The issuance of revenue ruling 77-85 completely and immediately stopped the sale of investment annuities. Agents were laid off, salesmen terminated, policyholders were left with investments of questionable value, and at least one company was faced with bankruptcy. The affected company sought to ameliorate the IRS decision first through conversations with the Service and then through

action in Congress. We here in the Senate acted to give some relief to this beleaguered industry. We adopted an amendment to the Tax Reduction and Simplification Act of 1977 allowing a delay in the effective date of the ruling, but this amendment was dropped in conference. The investment annuities industry was left with no effective recourse in its disagreement with the Internal Revenue Service.

Why, you might ask, did the industry not take the IRS to court over this revenue ruling? It certainly could and I understand has now done so, and won—and it still does not solve the problem! But this does not solve the problem for industry. Under the law as it now stands, even if the industry challenges the ruling it remains in effect until a court decision holds it to be invalid. It might take years for the affected taxpayer to receive redress through tax court proceedings. In the meantime the revenue ruling stands to prevent operation of the taxpayer's business. This is because an injunction against the IRS is specifically prohibited by a Federal statute, the Anti-Injunction Act.

Now, Mr. President, I am not here to champion the investment annuity industry or any other special interest. The investment annuity industry is not the only industry which has been adversely affected by a reversal of an Internal Revenue Service ruling. I was personally involved in the legislative solution to another revenue ruling reversal which affected the operators of private water companies. Some public utilities obtain a substantial portion of their capital needs through contributions in aid of construction from taxable income. Then in 1975 the IRS revoked the 1958 ruling in revenue ruling 75–557. The change in the IRS ruling increased substantially the taxes of those utilities which had treated contributions in aid of construction as nontaxable contributions to capital. These utilities had their taxes substantially increased by IRS reinterpretation of the law. But because they operated as regulated utilities, they would not be able to pass the cost of this increased tax through to their customers in a timely fashion. Since the utilities, like the investment annuities industry, could not obtain an injunction against the issuance of this new ruling, its only recourse was through the courts or the Congress. Unlike the investment annuities industry, the utilities were fortunate Congress responded to their plight and passed remedial legislation as part of the Tax Reform Act of 1976.

The two examples I have cited here are not unique. The IRS constantly reviews revenue rulings and revises or reissues them. But rulings of long standing are relied on by taxpayers and the Service alike, and by virtue of their age take on the color of law.

Mr. President, relief through the courts from an incorrect revenue ruling reversal is a time consuming and costly process. During the entire appeals process the challenged ruling remains in effect by virtue of the anti-injunction statutes. If the ruling reversal is a real threat to the taxpayer's business or investment, that business or investment may well have disappeared before legal redress is obtained. Victory for the taxpayer in court, if victory comes, may be a hollow and bitter experience when it comes too late to save his investment.

The legislative process provides limited redress to taxpayers. Indeed, the utilities industry found solace within the Congress and a solution to its problem. But, that is rare. If the ruling reversal affects only a small group, or a group without the financial resources necessary to wage a major legislative campaign, Congress may well turn a deaf ear to the taxpayer's problem. The bill I propose today, Mr. President, will provide taxpayers with redress through the courts while at the same time allowing him to continue in the pattern established by the Internal Revenue Service in earlier rulings until the courts have determined that the IRS reversal of position was well founded in law.

Mr. President, I would like to summarize this legislation for the Senate. The bill creates a new section of the Internal Revenue Code, section 7478. The section provides that in the case of an actual controversy involving a ruling by the IRS in which the IRS has reversed a published ruling of 5 years' standing or more, an affected taxpayer may file a suit for declaratory judgment with the Tax Court to determine whether the ruling is consistent with the Internal Revenue laws to which the ruling relates. I would emphasize, Mr. President, that this law only applies to reversals of rulings which have been IRS policy for 5 years or more. The bill also provides that when the IRS issues a ruling reversing, repealing, or revising a ruling of 5 years' standing or more, the new ruling may not be effective retroactively and may not become effective until 90 days from the day of publication. During the 90-day period any taxpayer directly affected may file a suit

with the Tax Court. Filing suit in the Tax Court suspends the effective date of the ruling beyond the 90 days until a determination is made by the Tax Court and any appeal of that decision is final.

Some will argue that delaying the effective date of the challenged ruling will allow taxpayers affected by the ruling to operate under a fire sale approach, filing suit only to give themselves a few more months to market a tax shelter or avoid a tax. Mr. President, if that is necessary for justice to be done under our tax laws, so be it. However, I would point out that this legislation does not apply to the issuance of new rulings by the IRS. It does not apply to situations where the IRS has not had the opportunity to act. Mr. President, this right of appeal with the delay of the effective date only applies where the Service, having acted in the past and established the precedent under which the taxpayer operates, then reverses its position for whatever reason. In the situation where the IRS reverses a long held position I think it only fair that the burden of proof regarding the correctness of its new position be carried by the Service before such a new position becomes effective.

And so, Mr. President, in conclusion I would like to say that I hope my colleagues here in the Senate will adopt this much needed correction in the balance between the power of the Government and the protection of our people. This bill will do a small part in helping to restore the faith of the American people in our system of raising revenues. It will, in its own small way, reconfirm that there is justice in America.

EXHIBIT E

THE COURT ADJUDGED ILLEGALITY OF IRS REVENUE RULING 77-85

The United States District Court, District of Columbia, declared in Judge Charles R. Richey's Memorandum Opinion of November 9, 1977:

"Revenue Ruling 77-85 is an erroneous and unreasonable interpretation of the Internal Revenue Code, and, in view of this fact that substantial deference to the agency's expertise is not warranted by the facts of the case, the court will declare the ruling to be unlawful and beyond the Services' statutory authority."

"Revenue Ruling 77-85 is unlawful and beyond the Service's statutory authority in that its determination that the policyowner, rather than the issuing life insurance company, is the owner of the investment annuity custodial account assets is erroneous and unreasonable."

"The Service's decision in Revenue Ruling 77-85 was not contemporaneous with the enactment of Section 801(g)(1)(B), does not reflect a long-standing agency position, and is inconsistent with earlier pronouncements and even one subsequent announcement, of the agency. Accordingly, substantial deference to the Service's expertise is unwarranted in the instant case.

"Substantial deference to the Service's expertise is also unwarranted because the Service was improperly motivated by considerations of tax reform when it issued Revenue Ruling 77-85."

Judge Richey's Order stated that:

"Ordered, adjudged and decreed, that Revenue Ruling 77-85 issued by the Internal Revenue Service on March 9, 1977, be, and the same hereby is, declared to be unlawful and beyond the statutory authority of the Internal Revenue Service; and it is

"Further ordered, adjudged and decreed, that the custodial account assets of plaintiff FIAC's investment annuity contracts be, and the same hereby are, declared to be owned by the issuing life insurance company for Federal tax purposes; and it is

"Further ordered, adjudged and decreed, that plaintiff's FIAC's investment annuity contracts be, and the same hereby are, declared to be 'contracts with reserves based on a segregated asset account' within the meaning of 26 U.S.C. Section 801(g)(1)(B)."

The IRS and Treasury refused to abide by this crystal clear Court Opinion and Order and appealed. Clearly, as the Court had determined, "the Service was improperly motivated by considerations of tax reform" in its illegal issuance of Revenue Ruling 77-85. Obviously, too, that Court adjudged "illegal motivation" continues to exist as reflected in (a) the IRS' appeal and (b) the Treasury's subsequent proposals to Congress to tax all Annuities in the manner illegally imposed by the IRS upon the Investment Annuity. These Treasury proposals were soundly rejected, and properly so, by the House Ways and Means Committee.

Thus the IRS' and Treasury's appeal of their Court adjudged illegality in the Investment Annuity matter has maintained their gross and illegal bureaucratic abuse of the Investment Annuity.

Congress can and should remove this illegal and discriminatory abuse by re-establishing the tax treatment of the Investment Annuity to the format of any other variable annuity and as insisted upon by the IRS for fourteen years and over 70 rulings prior to the IRS' issuance of its illegal Rev. Rul. 77-85. This can be accomplished in the manner utilized in H.R. 12173 (Exhibit E).

Exhibit F1

Extensions of Remarks

LEGISLATION ON AN IRS ANNUITY RULING

Hon. Barber B. Conable, Jr., of New York, in the House of Representatives, Monday, March 13, 1978.

Mr. Conable. Mr. Speaker, I have introduced legislation, H.R. 11182, designed to remedy an injustice in the administration of our tax laws.

From 1963 to 1965, when the IRS issued basic rulings on this matter, all relevant departments of the national office of the Internal Revenue Service insisted that an innovative form of annuity upon which the IRS had been asked to rule was purely and simply a variable annuity pursuant to the separate account laws that had been recently enacted in 1962. (For sales identification purposes this variable annuity subsequently became known as the investment annuity.)

During the ensuing 12 years after 1965, the IRS reaffirmed its basic position over 70 times, including the issuance of revenue ruling 68—488 pertaining to deferred annuities. On March 9, 1977, the IRS issued revenue ruling 77-85 that completely reversed its long-standing rulings upon which an important segment of the life insurance industry relied. The result was, and continues to be, devastating to this segment of the industry.

Many Representatives and Senators protested this action to the Treasury and the IRS. On April 29, 1977, the Senate passed by a vote of 57-26 amendment No. 243 to H.R. 3477, the Tax Reduction and Simplification Act of 1977, that would have deferred the effective date of revenue ruling 77-85 for 1 year in order to permit Congress the opportunity to study the matter and to legislate, if appropriate. Amendment No. 243 was dropped in subsequent negotiations on H.R. 3447 by the House-Senate conference committee.

Immediately after the conference committee completed its deliberations, one insurance company, the originator of the investment annuity and whose entire business was destroyed by the IRS reversal, sued the Internal Revenue Service in the U.S. District Court, District of Columbia, for arbitrary, illegal and capricious acts.

On November 9, 1977, the Court ruled that revenue ruling 77-85 was unlawful and beyond the statutory authority of the Internal Revenue Service. The judge expressed the "confident assumption" that he IRS would proceed to rectify its error without the need for the issuance of an injunction.

The IRS refused, stated tha it would appeal any injunction issued and would retroactively tax any annuities sold during the interim of the appellate process should the IRS win on appeal.

The President's 1978 tax program proposes the taxation of all nonqualified deferred annuities in the same fashion as that contemplated under revenue ruling 77-85 which has been ruled unlawful in district court. The program encompasses within it those annuities subject to revenue ruling 77-85. Therefore, pending congressional action on the administration's proposal which may take a considerable period of time this one segment of the annuity industry continues to be singled out and irreparably harmed by the IRS's action.

Thus, H.R. 11182 has been introduced to reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of revenue ruling 77-85. I believe this precipitous action by the IRS in this matter has resulted in severe inequities and injustice. The Government should not deal with its citizens in such a high-handed manner. I hope that the House Ways and Means Committee will consider this matter promptly to assure a reasonable and equitable resolution of the differences which now exist.

EXHIBIT F2

[H.R. 11182, 95th Cong., 2d Sess.]

A BILL To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in the case of annuity contracts which have related amounts based on a segregated asset account, the tax treatment of such contracts under section 61 of the Internal Revenue Code of 1954 (defining gross income) and section 801(g)(1)(B) of such Code (relating to contracts with reserves based on a segregated asset account) shall be determined—

(1) without regard to Revenue Ruling 77-85 (and without regard to any other regulation, ruling, or decision reaching the same result as, or a result similar to, the result set forth in such Revenue Ruling); and

(2) with full regard to the rules in effect before Revenue Ruling 77-85.

STATEMENT OF DR. JAMES WHALEN, PRESIDENT, ITHACA COLLEGE

Mr. Chairman, members of the committee: As President of Ithaca College, an independent co-educational college of approximately 4400 students located in Ithaca, New York, I am pleased to have the opportunity to present this testimony. My basic tenet is that the administration's proposal to eliminate or curtail deductions for casualty losses, medical expenses, and sales, gasoline and personal property taxes will have a negative impact on charitable giving by increasing the number of taxpayers who will take the standard deduction on their income tax returns. Using Ithaca College as but one representative of institutions of higher education, I hope to demonstrate the magnitude of lost revenues which could result from this proposed reform. My testimony will also stress concern about what seems to be very dangerous, underlying principles of these tax reform proposals, the results of which appear to contradict other federally sponsored programs which have as their primary objective to provide an incentive for charitable giving. Finally, my testimony will offer strong support for the Fisher-Conable Bill, House No. 10795, which would extend to all taxpayers a deduction for charitable contributions. The Fisher-Conable Bill speaks in a very direct way to the importance of sustaining the strong role that private philanthropy has played in the development of this country and opens the door for all citizens to participate in the services of public good if they choose.

I will not go into a long narration of the very real benefits that private philanthropy has provided this nation, past and present. Statements to this effect have been very adequately attested to by John Gardner and certainly stated forthrightly by Congressmen Conable and Fisher in the preamble of their House Bill.

Allow me to begin my remarks, however, by elaborating on the general impact which tax reform proposals have had on charitable giving in this country as the number of people who take the standard deduction when filing their income tax form has increased from 50 percent to 77 percent over the past seven years. Charitable giving decreased by 6 billion dollars during this same period. Now we have before us a series of tax reform proposals which will have the effect of further reducing the number of people who itemize their income tax return by an estimated six million persons. It can be expected that this will have a further negative impact on charitable giving. We all recognize the importance of altruism in considering any gift, however, the concomitant tax incentive plays a very important role in encouraging individuals to make these gifts.

If these present proposals are enacted, it is estimated that an additional six million taxpayers will no longer have tax incentives to make a charitable contribution. Due to the elimination of several of these deductions, people will be forced to switch from itemizing their deductions to taking the standard deduction. Thus, the percentage of taxpayers who itemize their deductions will further decrease from 23 percent to 16 percent. The trend which this action may perpetuate in future years is of great concern to us. As fewer and fewer taxpayers itemize their deductions, charitable gifts will decline proportionately and will slowly become a privilege of the "wealthy" taxpayer. As this occurs, the charitable deduction will loom larger and larger as a tax "loophole" and stand a

good chance of being eliminated altogether. This indeed has very serious implications for the vitality of our institutions of higher education as we know them today. All institutions of higher education benefit from the receipt of private contributions. The range of these benefits is considerable, estimated to be as high as 50 percent of operating budgets for some institutions down to 10 to 12 percent for others. In addition to assuring the plurality of the higher educational systems, these gifts speak directly to the outstanding quality and vitality of our colleges and universities.

In the case of Ithaca College, annual gifts in support of our current operations represent a very important and growing source of annual revenues. In fact, these gifts represent the income on an endowment that we do not have. They come from a broad base of support in that 60 percent of our total annual giving dollars come from approximately 80 percent of our donors. We are very proud of this broad base of support and strive each year to broaden it even further. However, it is exactly this group of donors that will be most affected by the tax reform proposals currently under consideration. These individuals are in the $15,000 to $25,000 income range and contribute from $25 to $250 each year to the College. According to our alumni surveys, fully two-thirds of this group itemize their tax returns. We estimate that the new tax proposals would reduce this group who now itemize by at least 60 percent. In a recent random sample of 100 of these alumni, 84 indicated that beyond the inherent desire to make a gift to their Alma Mater, the tax deduction did provide an important incentive. They indicated that they would be less inclined to give if they were to take the standard deduction. Upon further questioning, many indicated that although taking a standard deduction may not eliminate their charitable gifts completely, it would certainly reduce them in amount. Several of our alumni who presently make equal though modest gifts to several institutions, stated that under the standard deduction condition they would make smaller gifts to fewer (or perhaps only one)institutions.

Herein lies the real danger of this new type of tax legislation. For, we not only benefit from the dollars which we receive from private sources but from increasing the numbers of persons who contribute. Beyond the individuals whom we ask to support us through their contributions, we are able to attract support from corporate funds and private foundations on the basis of the breadth of our constituent support. We fear the implications of this legislation in diminishing these sources of support. Can we assume that these "matching" sources will be likely to diminish as the charitable deduction's life comes into jeopardy?

If so, we are ever more confused. For, recent actions by the federal government have led us to believe that the "challenge" mechanism was receiving its support. In announcing the new challenge programs within the Endowments of Arts and Humanities, former President Ford asserted that "The private sector must assume the major responsibility for sustaining (cultural) institutions; but it is the Federal role to exercise leadership, to point the way." These programs require that the sponsoring institution raise three dollars to every one federal dollar they are awarded in support of humanistic or artistic activity. Most of those matching dollars will come from small donors. By reducing the number of persons in the general citizenry who will be able to claim tax deductions for such contributions, Congress is striking at the very mechanism which these programs have endorsed to insure the ongoing life of these organizations.

Ithaca College itself is presently involved in a "challenge" year. Through the generosity of a major private foundation, our alumini are being asked to increase their contributions to the college by 41 percent in this fiscal year. We are confident that our graduates will rise to that challenge. Nearly two-thirds of the increase will be produced by gifts of under $250. We know the challenge mechanism works. Its viability under the condition of reduced tax deductability is not, however, assured.

We know that many of you are familiar enough with the support bases of non-profit organizations to know that a significant portion of an organization's charitable gifts come from relatively few wealthy individuals. However, allow me to remind you that these "leading" donors generally began their involvement in the benefitting organizations through small gifts at a time when they were members of the income group whose further participation in private philanthropy is not in question.

The one bright spot that I see on the horizon is the Senate Moynihan-Packwood Bill S 3111. This Bill embodies the exact recommendation that I would make to the committee and therefore I am pleased to lend my full support to this Bill. By moving charitable deductions "above the line" without a floor we truly encourage all of our citizens to exercise their own choice in the field of private philanthropy.

ITEL CORP.,
September 8, 1978.

Re Proposal in H.R. 13511, the Revenue Act of 1978, To Extend the "At Risk" Provisions to Closely-Held Corporations.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
2227 Dirksen Senate Building, Washington, D.C.

DEAR SENATOR LONG: We are a publicly-owned business services company headquartered in San Francisco, California, with offices in many principal cities throughout the United States.

In the proposed Revenue Act of 1978, which your Committee is now considering, there is a provision which would extend the "at risk" provisions to closely-held corporations in which five or fewer shareholders own 50% or more of the stock that engage in equipment leasing and certain other activities. This provision would affect many closely-held corporations which provide financing in lease transactions because non-recourse borrowings, which do not meet the "at risk" requirements, are an integral aspect of lease financing. Moreover, the proposal to extend the "at risk" provisions to closely-held corporations engaged in equipment leasing operations by requiring them to be "at risk" on the debt financing would not only effectively preclude some closely-held corporations currently engaged in lease financing from doing so in the future, but it would also deter many other closely-held corporations from undertaking equipment leasing as a new business activity. A brief description of the lease financing business and the role of closely-held corporations in it is attached as Exhibit A.

We oppose this proposal for the following reasons:

1. It would interfere with legitimate business activities and discriminate unjustifiably against smaller corporations.
2. By restricting some present lessors and preventing new lessors from entering into equipment leasing activities, competition in the marketplace would be reduced. Lessees would thus be deprived of lower financing costs and lessors of attractive investments.
3. There is no evidence of which we are aware that the "at risk" provisions as they now exist have permitted tax abuse by closely-held corporations engaged in leasing, either at the shareholder level or in the accumulated earnings area.

A fuller discussion of these reasons is attached in Exhibit B.

The desirability of leasing in furthering the goal of enhancing capital investment in our economy has been widely recognized. In the last few years, closely-held corporations have helped advance this goal by increasing competition among lessors, thereby providing more attractive financing to lessees and enabling equipment to be leased to less creditworthy lessees, who often cannot obtain as attractive financing from large banks or other institutional lessors. These benefits should not be discarded by Congress without sound reason.

We believe tax law changes should address real problems and abuses, not imaginary ones. Moreover, even if the perceived tax abuses are realistic abuses, appropriate corrective legislation should be designed to directly eliminate the abuses themselves, in a fashion that does not adversely affect the legitimate business activities of small businesses, does not unjustifiedly discriminate against small businesses, and does not inhibit capital formation, as the extension of the "at-risk" provisions to closely-held corporations would most certainly do. The rules for leasing by corporations should be the same for all, unless valid reasons exist for different treatment. The "at risk" extension proposal in question would not enhance fairness in the tax laws or close any loophole. On the contrary, it would lessen competition in the leasing marketplace, retard capital formation and further complicate the tax laws.

We do not believe that excepting from the extension of the "at risk" provisions those closely-held corporations regularly or actively engaged in leasing as a trade

or business, as some have proposed, is sufficient, since the "at risk" requirement would still prohibit new lessors from participating in equipment leasing. We recommend instead that the "at risk" extension not be extended to closely-held corporations at all, or at the very least not apply to leasing activities.

A substantially identical letter has been submitted to the Senate Finance Committee for the records of the hearing.

Thank you for considering our comments and giving us this opportunity to submit our views to you.

Very truly yours,

THOMAS F. MURPHY,
President.

EXHIBIT A

THE EQUIPMENT LEASE FINANCING BUSINESS

Lease financing is a method of financing the capital equipment needs of American business. For example, during the last eight years, Itel has arranged lease financing for capital equipment costing nearly $3 billion. A brief description of a lease financing transaction, the parties involved and the benefits to them follows:

1. The lease broker (such as Itel)—The broker arranges the lease financing by bringing together the three principal parties to the transaction, i.e. the capital equipment user (lesseee), the owner of the equipment (lessor), and the provider of the non-recourse debt financing to the lessor (lender). The broker presents a lease proposal to the prospective equipment user who then evaluates the proposal with other leasing proposals and other methods of financing the equipment. If the user selects the broker's lease proposal, then the broker obtains a lessor and lender so that the equipment may be purchased from the manufacturer and leased to the lessee upon the terms and conditions contained in the proposal. The broker supervises the preparation of all documents for the lease transaction, arranges for the necessary legal and tax opinions and handles all administrative aspects of the financing. For its services, the broker receives a fee from the lessor.

2. The lessee.—The types of businesses that have engaged in leveraged lease financing, whether or not arranged by Itel, cover a broad range, and potentially include all companies with needs for new capital equipment having a value generally in excess of $1 million. Approximately 10 years ago, when leveraged leasing initially became a popular method of financing capital equipment, leasing was utilized primarily to finance railroad rolling stock and data processing equipment, but since then the amount of equipment financed and the number of businesses engaged in leveraged leasing have grown significantly, such that in 1977 in excess of $6 billion of equipment was lease financed by hundreds of different lessees. Although there is no inherent limitation on the size of a leveraged lease transaction or the type of equipment leased, usually the cost of the equipment subject to leases arranged by Itel is between $1 and $20 million and typically involves transportation or data processing equipment. Similarly, although leasing can be and has been engaged in by a great variety of businesses, such financing tends to be more attractive to less creditworthy companies, often providing such companies with greater financing flexibility than would otherwise be available.

3. The lessor.—The lessor owns the capital equipment and contributes 20–40 percent of the cost of the equipment. Its return on the investment is comprised of the cash flow in excess of debt service, the value of the equipment after the expiration of the lease term, and the tax benefits associated with the transaction, which include the investment tax credit, the depreciation deduction and the interest deduction on the non-recourse debt. The debt is provided by a lending institution. It is non-recourse to the lessor with the lender looking solely to the rent to be paid by the lessee to service the debt and to a security interest in the equipment as collateral for the loan.

Initially, the lessor in a lease financing was nearly always a credit corporation or a large bank. However, as lease financing has grown, it has become necessary to expand the number of lessors. These new lessors are often small banks or industrial corporations. In many instances 50 percent or more of their stock is owned by 5 or fewer shareholders. This expanding group of lessors has several advantages: First, it increases competition among lessors, thereby providing more attractive financing to lessees. Second, some lessees who could not otherwise obtain lease financing are now able to do so. Third, lessors are able to make

attractive investments in lease transactions which generate cash for use in their businesses.

In summary, a lease financing transaction represents a sound economic investment on the part of the owner-lessor, constitutes a productive use of funds to purchase capital equipment, and provides the lessee with the use of needed equipment on a financial basis which is attractive to it.

EXHIBIT B

DISCUSSION OF OPPOSITION TO PROPOSED EXTENSION OF "AT-RISK" RULES TO CLOSELY-HELD CORPORATIONS

It would interfere with legitimate business activities and discriminate unjustifiedly against smaller corporations.

The proposed legislation clearly deters closely-held corporations from engaging in leveraged lease financing, which historically has been considered an economically desirable business activity, not only for the participants themselves, but also for society at large. Indeed, the Treasury Department itself has recognized that equipment leasing in an activity which should be encouraged, because leasing has the desirable effect of making the tax incentives to new investment more efficient.

Since equipment leasing is a desirable activity, and there is no evidence of tax abuse, at least of which we are aware, by closely-held corporations engaged in leasing, foreclosure of leasing as a business activity to such corporations is unreasonably and unjustifiably discriminatory. Although economic discrimination is not impermissible in itself, it is so when there is no demonstrable evidence that the discrimination will serve a societally desirable end, and there is no such evidence that the extension of the "at risk" rules to closely-held corporations will result in the societally desirable goal of curtailing tax abuse. We believe that the basis for legislation should be evidence of its necessity, not an absence of evidence that it is not needed.

By restricting some present lessors and preventing new lessors from entering into equipment leasing activities, competition in the marketplace would be reduced. Lessees would thus be deprived of lower financing costs and lessors of attractive investments.

As discussed in Exhibit A—The Equipment Lease Financing Business—until fairly recently most equipment lessors were credit corporations or large banks. Several years ago many lease brokers began marketing investments in lease transactions to closely-held corporations in order to increase the suppply of funds available to invest in leasing and to increase competition in the marketplace thus providing more attractive financing rates and terms to lessees. Additionally, some lessees which previously could not obtain lease financing or for whom the rates or terms were unacceptable have now been able to obtain attractive lease financing of their capital equipment requirements.

Finally, many smaller corporations are now able to compete with large corporations, large banks, and credit companies in making attractive investments as lessors in equipment leasing transactions. These transactions then generate cash for use in their businesses.

There is no evidence of which we are aware that the "at risk" provisions as they now exist have permitted tax abuse by closely-held corporations engaged in leasing, either at the shareholder level or in the accumulated earnings area.

Although it may be possible to construct hypothetical situations in which tax abuse might be possible in leasing activities by corporations in which five or fewer shareholders own 50 percent or more of the stock, we are not aware of, and nor can we realistically imagine, such a situation. Proving the absence of all potential for abuse is of course difficult, if not impossible, but proving that something does not exist, at least theoretically, is frequently impossible. It should not be necessary to prove the theoretical absence of tax abuse, such as avoidance of the accumulated earnings tax; it should be necessary, however, to require that there be some evidence of a realistic abuse. As the tax law currently exists individuals and corporations are treated differently for tax purposes. Thus, items of income and deduction in any leasing investment by either a closely-held corporation or a widely held corporation are taken at the corporate level, and such tax treatment is unrelated to taxes imposed upon shareholders.

Statement of Timothy W. Stanley, President, International Economic Policy Association

Mr. Chairman: The International Economic Policy Association is a nonprofit research organization established in 1957 which has conducted authoritative analyses of issues affecting the U.S. balance of payments, trade, investment, foreign taxation, and raw materials questions. We have appeared before and submitted views to the Senate Committee on Finance over the last two decades on various of these topics but particularly on issues concerning the taxation of foreign-source income.

During my last apearance before this Committee[1] during consideration of the Tax Reform Act of 1976, we included an analysis drawn from a survey of our member companies. We updated that survey in the spring of this year and the annex to this brief submission contains the results of this latest undertaking.

Our survey's aggregated results showed that the worldwide tax burden of this representative sample of American international companies is higher than that for all American nonfinancial corporations. Treasury Department studies also show that the nation's biggest firms (assets of $1 billion or more) pay taxes that, on average, amount to between 36.9 and 43.8 percent of their income.[2]

This means that U.S. multinationals do pay a fair share of taxes in their income. This should help counter the misconception that international companies have tax breaks which enable them to evade their fair share of tax obligations.[3]

American international business is concerned with the significant changes in the taxation of foreign-source income proposed by the Carter Administration. But the effect on American competiveness overseas[4] of these proposals should be of special concern to the Senate and to this Committee, given our current and prospective trade and balance of payments deficits.

The U.S. need to earn foreign exchange has been highlighted by the previous six-months' fluctuation in the value of the dollar. It has been estimated that every 10 percent depreciation of the dollar is responsible for at least one and as much as two percentage points of price increases. To the extent that we inhibit the earning of foreign exchange for the United States, we increase our balance of payments deficit and further weaken the dollar, lowering the returns to U.S. national income, and affecting the overall economic and inflationary performance in this country. For example, based upon the nominal increase in the GNP between 1976 and 1977 of approximately $183 billion, two percentage points of additional inflation would equal $3.7 billion taken from national income.

The two most significant changes which the Administration has proposed are the phaseout of the DISC and the elimination of the so-called "deferral." With

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[1] See Tax Reform hearings before the Senate Committee on Finance, Apr. 9, 1976.

[2] See the article by Art Pine, "Biggies Pay Taxes, Two Surveys Indicate," in The Washington Post, Feb. 10, 1978.

[3] The prevalence of this belief is confirmed by a 1978 Yankelovich survey indicating that "There is a widespread public sense that multi-nationals are paying less than their fair share of taxes." In part, there is a failure here to distinguish between U.S. and foreign taxes paid; for foreign governments have a clear and prior right to tax income earned within their jurisdictions, as part of their gross domestic product, by operations which benefit in many ways from government and public services in those countries. And under the well-established principles of avoiding double taxation, other governments give a tax credit for such taxes. Tables, such as those inserted into the Congressional Record on Jan. 26, 1978, p. E-168 show only American taxes paid against worldwide income; and for some companies, this can be a very small amount, for the above reason. The misleading nature of such comparisons has been confirmed by the above cited Treasury analysis.

[4] There are of course other aspects of concern as well. One example is the Section 911 provision applicable to Americans working overseas, which involves significantly higher costs for American firms than for their foreign competitors. News articles earlier this year describe the bidding for a $3-plus billion telephone contract in Saudi Arabia in which two American-led consortia unsuccessfully bid against one headed by Phillips of The Netherlands. Among the reasons for this outcome, according to an article, was that: "The Americans also were obliged to raise their bids by tacking on large contingency funds to pay the income taxes of Americans who would have come here to work and faced heavy tax burdens under a proposed U.S. income tax law change." See "U.S. Firms Fail to Gain Saudi Phone Job," The Washington Post, Feb. 26, 1978, p. K-14. In addition, the withdrawal of Americans (especially engineers and other technical persons) from overseas jobs because of the increased costs to U.S. companies, gives us a much lower presence from which to promote our exports. The increased costs to American companies from the application of the new Section 911 on those persons retained abroad are of course deducted as a business expense, reducing the total tax revenue to the government. Finally, some of the proposals to amend the restrictions in the Tax Act of 1976 on service earnings—namely, overseas convention attendance—may add to the problems of American companies operating in a highly competitive world.

regard to DISC, this seems more an issue of trade than of tax policy, even though DISC does involve postponement of taxes on income from certain export earnings. The Administration contends that DISC is not very effective; other studies indicate contrary results.[5] Yet the fact that a number of European countries have made formal complaints under GATT that DISC is an export subsidy, suggests that it must be having its intended effect in maintaining American export competitiveness. One of the original reasons for establishing DISC was to provide American firms with some counterpart to the rebate of VAT enjoyed by Europeans and others. Given the continuing contentiousness of that issue in international trade circles, notwithstanding the recent decision of the U.S. Supreme Court in the Zenith case, it would seem ill-timed for Congress to abolish this measure.

In the long term, some negotiated agreements between the United States, Europe and Japan on what forms of tax rebate (or in the U.S. case, postponement) are consistent with fair trade under GATT may be desirable. At that time and in such context, it might make sense to discuss changing the U.S. DISC system. But to do so unilaterally now appears unwise.

In the meantime, I would suggest that Congress review the specific trade issues involved in the value added tax rebates used by other countries, versus the non-rebated direct taxes of the United States and the necessity to seek alternative solutions to the problems facing U.S. exporters in today's markets.

Unlike the case of DISC, the proposal to repeal "deferral" would not be eliminating a special exception enacted by Congress. Rather, it would change the normal tax incidence under the corporate form of organization; for the present practice is based on the universal principle that income is taxed when it is received by the taxpayer. The U.S. taxpayer is of course, the American corporation, not its foreign corporate subsidiary. To end so-called "deferral" would therefore actually involve "premature taxation" of a type which would not be accepted in other areas of American life. It would be a departure for the IRS to tax a shareholder's pro rata share of the income of a domestic corporation before it had paid him a dividend, except in special circumstances. Yet this is what is being proposed with respect to the income of legitimate foreign business corporations which are not being used in a tax-haven context.

This would involve the extension of American tax jurisdiction in ways which are bound to be harmful to American competitiveness, will produce illusory gains in Treasury revenue,[6] and can only exacerbate our tax relationships overseas.

I have often wished that Congress would ask itself what the reaction in this country would be if, let us say, Volkswagen of Pennsylvania had its normal cash flow (on which the host region was counting for maintenance and expansion of local facilities and jobs) substantially reduced by an obligation imposed from abroad to pay German taxes before any of its U.S. profits had been remitted. I believe that the Senators and Representatives from that state would be among the first to protest. Yet, in effect, this is exactly what we are proposing to do with earnings in other countries!

The response of such other countries is predictable: They would simply increase the rates or timing incidence of their dividend withholding taxes or block the remittance of funds—and if other countries do not, minority stockholders in some situations may be entitled to do so by law. The net result, then, would be to pose an additional tax burden on the American parent which must cut into its own revenues, including those which might be earmarked for domestic expansion, to pay the tax—or else borrow the funds at home or abroad—as companies did to meet the former OFDI regulations—thus adding to the corporate debt burden. No other country[7] taxes the undistributed earnings of foreign subsidiaries, except in clear tax-haven situations (as does the United States through Subpart F). Why should the United States do so—especially when the principal losers will be the U.S. companies (and their shareholders) which are doing the best job in competing in markets around the world?

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[5] See testimony of Special Committee for U.S. Exports before the Senate Finance Committee, Aug. 21, 1978; also see White Paper: The Increased Importance of DISC As An Element of U.S. Policy in International Trade, Special Committee for U.S. Exports, August 1977.

[6] See: "Elimination of 'Deferral': The Effects of Additional Foreign Tax Payments on U.S. Treasury Revenues and Company Tax Costs." Arthur Andersen & Company, April 1978.

[7] Some countries do not tax foreign corporate earnings at all, and those that do so wait until those earnings have been repatriated (based on analyses in the "Tax and Trade Guide" as published for various countries by Arthur Anderson & Co.).

At a time when the state of the world economy, the health of American competition in that economy, the dollar, and the real growth of the American economy itself are all subjects of anxiety, why should Congress take a step which can only have an adverse impact on all of them. We will only succeed in harming America's earning assets base at a time when the dollar problem demands that we protect our potential exchange earnings.

The Administration's proposal regarding "deferral" is not well founded in either tax theory, economics,[8] or public policy. Instead it seems a political "shibboleth" based upon outdated concerns. To the extent that the concern is U.S. jobs, it is not the concern that is outdated but rather the allegation of job loss from overseas invesment.[9]

We appreciate this opportunity to submit these brief comments because of the critical impact of the Administration's proposals on American international business.

TABLE 1.—TAX EXPENDITURE[1] ESTIMATES FROM FISCAL YEAR 1979 BUDGET COMPARED WITH PRESIDENTIAL AND TREASURY STATEMENTS ON TAX REFORM PROPOSALS

[In millions of dollars]

	Under present law[2]		Under 1979 budget proposals[2,3] fiscal year 1979 (col. 3)	Fiscal year increase in revenue gain (col. 2 minus col. 3)	Fiscal year 1979 receipts per Blumenthal testimony[4]	Calendar year 1979 tax liability per President's tax message[5]
	fiscal year 1978 (col. 1)	fiscal year 1979 (col. 2)				
Deferral of income of DISC's	1,135	1,235	870	465	249	664
Deferral of CFC's	615	665	495	170	40	88
Exclusion for citizens abroad (911)	360	385	365	20	(6)	(6)

[1] Tax expenditures are defined by the Congressional Budget Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of tax liability."

[2] Special analyses, Budget of the U.S. Government, fiscal year 1979 (GPO, Washington, pp. 158 and 169, tables G-1 G-2). Treasury tax statement, Jan. 30, 1978. Presidential tax message, release of Jan. 20, 1978.

[3] Includes ⅓ elimination in each of next 3 yr (beginning in calendar year 1979) for deferral and DISC; also 1976 amendments of exclusion for U.S. citizens abroad (911) effective Jan. 1, 1978.

[4] Statement before the House Ways and Means Committee, Jan. 30, 1978, table 9.

[5] President's tax message, Jan. 20, 1978, table 2.

[6] Not available, separately.

SUBMISSION OF THE INTERNATIONAL ECONOMIC POLICY ASSOCIATION, SEPTEMBER 1, 1978

ANNEX

SURVEY ON CHANGES IN TAXATION OF FOREIGN-SOURCE INCOME: RESULTS AND ANALYSIS

The International Economic Policy Association limits its membership to a select group of U.S.-based companies with substantial international experience and interests. It is, we believe, broadly representative of the international sector of the U.S. economy as a whole, except that it does not have any oil majors among its members. In order to bring specific facts to bear on the questions being raised

[8] The U.S. Treasury initially estimated that the prospective revenue gain in fiscal year 1979 would be somewhere between $40 million and $170 million (see table 1). The Arthur Andersen study referred to earlier indicates that under the most reasonable assumptions, the Treasury would gain no revenue at all, but rather than a full distribution of foreign earnings in the 1976 tax year, for which the study was undertaken would have cost the U.S. Treasury $235 million!

[9] The latest IEPA survey showed that in tax year 1976 this representative sample of leading companies (approximately one-twentieth of the "universe" of U.S. industrial activity) paid $1.9 billion in foreign and domestic income taxes out of a pre-tax consolidated income of $4.5 billion—higher than the effective rate for all U.S. nonfinancial companies. They exported $2.6 billion of which 36 percent was exported to their own manufacturing subsidiaries and affiliates abroad. Thus, of the 120,000 jobs directly and indirectly related to exports in the sample of companies, nearly 43,000 were related to the existence of those subsidiaries and affiliates—whose future viability could be affected by the premature U.S. taxation of their earnings.

in connection with the taxation of foreign-source income, a survey was conducted among the companies represented in IEPA in 1975[1] using tax year 1973 data. This new 1978 survey was performed with a comparable base of companies, using the tax year 1976. Like the previous one, it was conducted in a way which preserved the confidentiality and the anonymity of individual company responses.

THE STUDY'S RELATIONSHIP TO TOTAL INDUSTRIAL ACTIVITY

The relationship of the IEPA sample to the larger universe of U.S. industrial activity remains approximately 1 to 20, as in the prior survey. From a base of 20 companies surveyed, the 12 actual respondents had total consolidated sales of $55.2 billion and consolidated pre-tax income of $4.5 billion. These sales represented 5.7 percent of those of the Fortune 500[2] largest industrial companies list, which in turn accounts for about 80 percent of all U.S. manufacturing sales.

Because of the anonymity and aggregation procedure, we do not know which companies were unable to complete the questionnaire in time to meet the deadline necessitated by the Ways and Means Committee hearings schedule.[3] The actual respondents, therefore, are unlikely to be entirely the same group as the respondents in the previous survey (who were fifteen in number) making comparisons difficult between the two surveys. With that caveat, however, the current aggregated sales figure appears to have increased by about 40 percent over the three-year period, with a doubling of consolidated pre-tax income. A substantial part of the increase, of course, reflects the recent high rates of inflation.

EXPORTS

The respondents' export sales of U.S. manufactured goods and services totaled $2.6 billion, 4.7 percent of total reported consolidated sales, and $937.5 million (36 percent of exports) were sales to the companies' manufacturing subsidiaries and affiliates abroad. This percentage of export sales to their subsidiaries and affiliates represents a substantial increase over the 29.5 percent recorded in the previous IEPA survey. Some of it may reflect previous devaluations of the dollar, allowing for the normal time lag. This figure is also substantially higher than the last available Department of Commerce survey figure which showed that 23.4 percent of all export sales of U.S. manufactured goods and services was to MNC subsidiaries or affiliates abroad.[4] We understand that the Department of Commerce is now engaged in collecting updated statistics under the authority of the International Investment Survey Act and we would expect that the previous figures, based on now obsolete data, would be significantly increased due, in part, to the intervening devaluations of the U.S. dollar.

MNC'S AND "EXPORT PLATFORMS"

The total foreign subsidiary and affiliate sales of responding companies was $20.4 billion. It is important to note that the repatriated income from these foreign operations is a substantial plus for the U.S. balance of payments—in addition to the contribution which exports from the U.S. make to the balance of trade. Of these sales only $348 million, or 1.7 percent, was exported to the United States and the remainder, 98.3 percent, was sold in the country of production or third countries. It should be noted that the reported exports to the United States may have included some raw materials as well as transporttaion equipment from Canada, part of which is subject to the special U.S.-Canadian Auto Agreement.

For comparison purposes, the U.S. Department of Commerce Survey of Current Business reports that in 1975, 6 percent of total sales of manufactured products ($192 billion) by majority-owned foreign affiliates (MOFA's) was exported back to the United States. If transportation equipment exports from Canada (covered by our special agreement with them) are also excluded, the percentage of manufactured exports to the United States from MOFA's equals 3.1 percent. Since the IEPA membership sample contained no companies that

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[1] See Tax Reform hearings before the Senate Committee on Finance, Apr. 9, 1976.
[2] Fortune's Directory of the 500 Largest U.S. Industrial Corporations, Fortune, May 1977.
[3] Of the 20 companies polled, all but 4 are represented in the 1976 500 list and over half are within the first 100 companies.
[4] Survey of Current Business, U.S. Department of Commerce, Dec. 1972, p. 25.

actually manufacture automobiles (but the respondents could have included some companies involved in the trade of automotive parts and accessories), we would expect our percentage to be lower than the overall 6 percent and close to, if not below, the 3.1 percent excluding all Canadian transportation equipment.

The survey's actual percentage of 1.7 percent is only half that recorded in the previous survey which, again, may be due to unavoidable differences in the composition of the two groups of respondents. But the effects of the dollar devaluation through the downward float between 1974 and the end of 1976, as well as the steadily increasing costs of production overseas, may also be reflected. In particular, total labor costs (which for much of Europe now exceed U.S. levels) would result in production shifts from foreign affiliates to domestic facilities where this was possible and profitable. (That pattern would also be consistent with the growth in the sample's percentage of exports to foreign affiliates.) For example, in the automotive area, the announcements that the Chrysler Corporation has started to produce the Dodge Omni and Plymouth Horizon here in the United States rather than abroad, and Ford's reported plans to start producing the imported Fiesta in the United States are confirmations of a trend toward producing in the United States for the U.S. market when there is an adequate profit margin.

MNC TAXES

The total pre-tax consolidated income of respondents to our current survey was $4.5 billion, which was 25 percent higher than the response received on the previous survey, of which part is certainly the effects of recent inflation, given the slightly smaller number of responding companies. Total foreign and U.S. taxes of $1.85 billion were paid on their income for an effective tax rate of 40.7 percent. This counters the popular misconception that large multinational companies are tax evaders, since the effective rate of taxation for all U.S. corporations was 40.6 percent in 1976, according to the Department of Commerce December 1977 Survey of Current Business. This finding that these international firms paid slightly more, rather than less, taxes than the U.S. average confirms the pattern of the previous survey. And, of course, the respondents also paid many other taxes as well, which would include excise, TVA, and social security taxes which are not usually counted in the "income" tax category, making their total tax burden even higher.

It should also be noted that arguments about "fair" tax shares based only on U.S. taxes paid are inherently unsound. Under long accepted international taxation principles, host governments have a prior right to tax the income earned in their jurisdictions—which income benefits from government services of many types, and home governments either do not tax the income again at all, or else grant a credit to prevent double taxation. The worldwide tax burden is thus a fair measure; and on this basis, this international sample shows that MNC's do pay their share—and more.

EMPLOYMENT

It would appear that the differences in the 1975 and 1978 responding samples skew the employment results so as to invalidate comparisons between them, probably reflecting the absence of one or more large domestic employers in the most recent aggregation. This, however, showed employment in U.S. operations as 567,000 of which nearly 80,000 (14 percent) were directly related to exports or other international operations and some 40,000 (7 percent) indirectly, for a total of 120,000,[6] or 21 percent of the aggregate U.S. employment. With 36 percent of the sample's exports going to subsidiaries and affiliates abroad, it can be inferred that over 43,000 U.S. jobs were related to the existence of those overseas affiliations. Extrapolating this to the larger manufacturing universe (by the factor of 20, as explained earlier) would give a figure of 860,000 U.S. jobs directly and indirectly related to the operations of MNC's foreign affiliates, primarily due to their "export-pull" effect. This, of course, does not include secondary employment in supporting but unrelated firms.

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[6] Varied government statistics have indicated that each $1 million of exports supports anywhere from 30 to 50 jobs, depending on the degree of labor intensiveness; so the IEPA survey's 120,000 jobs appear commensurate with the sample's $2.6 billion in exports, which, by this measure, should support between 80,000 and 130,000 jobs.

THE COST OF TAXATION CHANGES

In 1976 the Congress made several significant changes with regard to foreign taxation in the Tax Reform Act of 1976. In particular they changed the DISC rules, repealed Section 921, and amended the law permitting the recapture of overall losses. The combined effects of these actions on the companies in our survey was $21.7 million. However, if the Congress had repealed the Domestic International Sales Corporation, the combined effect on our sample would be an additional $23.2 million. In the 1975 survey, eliminating so-called deferral and changing the foreign tax credit to a deduction was estimated to involve a potential cost to the responding companies of $336.4 million. However, the 1978 survey discussed only the former (i.e., an assumed requirement to include in the company's income each year its proportionate share of all of the income of each controlled foreign corporation in which its own stock, actually or constructively). This estimated cost (for the sample's 1976 tax year) aggregated $111 million.

Thus it is clear that there is a substantial cost involved in proposals to tax currently (i.e., prematurely) the unrepatriated income of U.S. subsidiaries abroad. It has been argued that this "reform" would increase the capital available for domestic investment in the United States. However, four-fifths of the survey's respondents indicated that if "deferral" were eliminated, the tax liability would be paid all or mostly from U.S. funds and that, in many cases, they would be blocked from repatriating funds from their overseas subsidiaries either by statutory limitations, increased foreign withholding taxes, or local cash flow requirements.

In addition, the responding companies indicated that there could be a reduction in U.S. jobs if "deferral" or DISC were eliminated, totaling some 8.4 thousand positions. Of interest to this Committee would be the states listed in Appendix Table 1 (grouped according to the intensity of the detrimental effect from lost jobs and business) most affected by the impact which elimination of deferral and DISC would have on the responding companies' operations. Because some of the respondents do not have DISC's, each aspect is shown separately.

The effect of U.S. tax actions on overseas employment is also an important consideration. It has been argued that, over time, U.S. Treasury tax gains from such changes would be illusory as the higher tax rates imposed on U.S. firms abroad (in comparison with their local and international competitors) would lead to a loss of markets and of profitability.

The same reasoning suggests that there would be significant reductions in the sample's 515,000 foreign employees—which would worsen local unemployment without resulting in any U.S. employment gains. In fact, with the entire industrial world now beset by problems of excess capacity, high unemployment and related protectionist pressures, such actions would lead to even greater efforts by foreign countries to substitute for U.S. exports and seek larger shares of the U.S. market, neither of which would be beneficial to U.S. employment.

OTHER TAX ISSUES

One of the major changes made by the Congress in the Tax Act of 1976 dealt with repealing Section 911 on expatriate workers. As a result, U.S. corporations have had to boost their bids to cover the cost of maintaining Americans overseas. These increased costs have resulted in a loss of competitiveness in foreign markets, particularly in service industries and in manufacturing under service contracts.

Among the IEPA respondents, the projected cost of changes as made by the Congress on Section 911 was estimated at $20.8 million. If Section 911 were completely repealed, the cost to the companies could jump substantially to over $36 million. This could force some of these companies completely out of certain competitive areas, especially high-cost locations.[6]

Before the 911 changes were made, all survey respondents provided cost-of-living adjustments, housing allowances and tax equalization for their employees. The changes in 911 have meant that to make their U.S. employees "whole," U.S. firms would have had to increase the amount of corporate funds spent on this

[6] A much more comprehensive survey is contained in the General Accounting Office's Feb. 21, 1978 report to Congress on "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas." The GAO urges continuing tax incentives "at least until more effective policy instruments for promoting exports and commercial competitiveness abroad are identified and implemented."

which would presumably increase their U.S. corporate tax deductions. The resulting net increase in revenues to the government resulting from the changes in Section 911 is therefore probably relatively small. A recent U.S. Treasury study showed that the largest percent (over three quarters of the individuals who took advantage of Section 911 during the year surveyed, earned $30,000 or less, and were not what would be termed high-paid executives. In fact, our survey showed that among the companies responding (with aggregate foreign subsidiary and affiliate sales of $20.4 billion) there were only 2,300 U.S. expatriate employees. This means that in the 272 manufacturing operations and the 359 sales facilities located abroad by the companies responding, and out of total overseas operation employment of 515,000 individuals, less than half of one percent were Americans. This small number suggests that those who do work abroad perform essential managerial or technical functions.

Our survey revealed that, if 911 were replaced with cost-of-living adjustments, dependent allowances or moving costs refunds and/or other types of allowances, their order of importance would be that shown in Appendix Table 1. This table also shows the average cost of the individual items from the responding companies' previous experience.

Another substantial expense for U.S. corporations has been the tax cost of the final IRS Section 861 regulations, estimated at $13 million for the IEPA respondents. Our survey shows (Appendix Table 3) the ranking of concerns with regard to the important areas involved in the 861 regulations; with allocation of R&D expenses heading the list.

CONCLUSION

This 1978 survey confirms the key findings of the earlier IEPA survey regarding a small but representative sample of major U.S. companies engaged in worldwide business: A significant part (over one-third) of their exports are to foreign subsidiaries and affiliates and would clearly be reduced without those relationships. Those exports and other international activities provide 120,000 U.S. jobs—one in five of the sample's aggregate U.S. employment. Of the total foreign subsidiary and affiliate sales, less than 2 percent was exported back to the United States. The respondents' combined total taxation was at an effective rate of 40.7 percent in the 1976 tax year—slightly higher than for all U.S. corporations.

Understandably, the respondents were deeply concerned with the proposals for tax "reform" which would undercut their international competitiveness. "Deferral," DISC, Section 911 and the Section 861 regulations were of the greatest concern, in that order. Their priorities for desired tax reforms were, in order, tax rate reduction, extended (or permanent) investment credit, and revised accelerated depreciation rules. Significantly, these preferences and concerns were all rated above "integration" or elimination of double taxation of corporate profits. No respondent would favor "integration" if a consequence were basic changes in the taxation of foreign-source income to balance its revenue impact.

As a final observation, the Carter administration has issued a policy statement[7] on direct international investment flows calling, in effect, for neutrality—neither incentives nor disincentives in government policy so that investment flows can be determined by economic and market forces. A package of tax proposals which consists on the one hand of reductions in taxes on U.S. income and on the other of premature or penalty taxation of the foreign-source income of America's most internationally competitive sector seems oddly inconsistent both with this policy objective and with the current global concern over the U.S. balance of payments deficit.

APPENDIX

TABLE 1.—*States affected most severely by elimination of "Deferral" and DISC*

"Deferral".—Group I, Alabama, Arizona, California, Colorado, Connecticut, Indiana, Iowa, Minnesota, New Jersey, New York, Ohio, Rhode Island, South Carolina, Tennessee, Texas, and West Virginia.

Group II, Georgia, Louisiana, Massachusetts, Michigan, Oregon, and Washington.

DISC.—Group I, Alabama, California, Kentucky, Michigan, New York, Ohio, Rhode Island, South Carolina, Texas, and West Virginia.

[7] Department of State statement of July 6, 1977 on "U.S. Government Policy on Direct International Investment."

Group II, Georgia, Indiana, Kentucky, Louisiana, Massachusetts, Michigan, New Jersey, North Carolina, and Pennsylvania.

APPENDIX

TABLE 2.—*Order of preference for specific exclusions for the costs of U.S. employees abroad*

[Average Cost From Previous Experience]

Tax Equalization	$12,357.00
Housing subsidy	6,814.00
Cost-of-living adjustment	5,357.00
Moving costs	11,416.00
Vacation transportation and travel allowance	4,214.00
Dependent allowance for education	3,500.00

APPENDIX

TABLE 3.—*Areas of major concern under section 861 regulations for U.S. Corporations*

(In order of importance)

1. R&D expense.
2. Interest costs.
3. Stewardship.
4. Legal and accounting costs.
5. Income taxes.
6. Losses on sale or exchange or other disposition of property.
7. Net operating loss deduction costs.

LAW OFFICES GATENBEY, LAW & LEAGUE,
Chicago, Ill., September 7, 1978.

Re Section 314 of H.R. 13511, and H.R. 8244 and S. 2216.

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

DEAR SENATOR LONG: We represent Cooperative Food Distributors of America (CFDA), a national, non-profit trade association located at 2340 Des Plaines Avenue, Des Plaines, Illinois. The members of CFDA consist of approximately 64 retailer-owned wholesale food distributors serving approximately 28,000 independently-owned food retailers. These wholesale distributors operate on a cooperative basis in accordance with the provisions of Sections 1381 through 1388 (subchapter T) of the Internal Revenue Code and pay patronage dividends to their stockholder-members each year in proportion to the volume of business done by each such member with the cooperative organization.

The purpose of this letter is to request that the Senate Finance Committee, in conjunction with its consideration of the provisions of H.R. 13511 dealing with the extension of the investment tax credit to expenditures made in connection with the rehabilitation of qualified rehabilitated buildings, incorporate into this legislation the provisions of Section 2 of S. 2216 introduced in the Senate by Senator Curtis on October 19, 1977. S. 2216 is identical with H.R. 8244, which was introduced in the House on July 12, 1977 by Representative Neal Smith of Iowa and 23 other Representatives.

Section 2 of each of S. 2216 and H.R. 8244 would remove the long-standing inequity presently imposed upon cooperative organizations by subsections 46(e)(1)(C) and 46(e)(2)(C) of the Internal Revenue Code which limit the amount of the qualified investment of a cooperative organization for investment tax credit purposes to the cooperative's "ratable share". Under these two Bills no such limitation would be applicable and the investment tax credit could either be claimed in whole or in part by the cooperative or allocated to its patrons based upon the business done by it with or for such patrons.

Under Section 46e) of the Code, a cooperative's "ratable share" is determined by multiplying the cooperative's qualified investment by a fraction having taxable income as its numerator and having as its denominator its taxable income

increased by the patronage dividend distributions which it has deducted in accordance with the provisions of Section 1382(b) of the Code. Since most retailer-owned grocery cooperative organizations (as well as similar organizations engaged in the distribution of other consumer products such as hardware and drugs) distribute to their member-stockholders all, or practically all, of the earnings realized by them on the purchases made from them by their member-stockholders in the form of patronage dividends, the amount of investment tax credit available to such a cooperative organization in connection with qualified investments made by it becomes reduced either to zero or to a relatively nominal sum by application of the "ratable share" formula.

The effect of the persent limitation is illustrated by the following example concerning an investment of $50,000 in eligible property made by a cooperative organization which distributes all but $1,000 of its earnings of $100,000 as patronage dividends:

$1,000 (taxable income) over $100,000 (taxable income of $1,000 plus $99,000 patronage dividends distributions) times $50,000 (amount of investment) equals $500.

Thus, on an actual investment of $50,000, the cooperative would have a qualified investment of only $500 and would be entitled to an investment tax credit of only $50.

One of the effects of the "ratable share" limitation on utilization of the investment tax credit by cooperatives has been to cause cooperative organizations to enter into lease arrangements with leasing corporations which can purchase equipment which is eligible for the investment tax credit and can claim the full amount of the credit which the cooperative would have been entitled to claim if it purchased the equipment itself and was not subject to the inequitable limitation on use of the credit which is imposed by the "ratable share" provision. Although use of such a leasing procedure usually enables the cooperative to finance its acquisitions of major equipment items such as computer systems and inventory handling and order filling systems at costs below those which would be incurred in conventional debt financing, the freedom of choice of the cooperative in obtaining the last cumbersome and most economical financing for its major equipment items is substantially restricted.

Moreover, there would seem to be no justification for the continuation of a restriction such as the "ratable share" limitation contained in Section 46(e) of the Code which has as its primary practical effect a considerable enhancement of the number of transactions which are financed through leasing arrangements which provide additional profits to those who are able to furnish that particular type of financing. Among other things, additional expenses must be incurred by a cooperative organization which utilizes the leasing method of financing due to the many detailed and technical provisions which ordinarily are included in the group of legal documents to be executed in connection with the transaction.

Section 314 of H.R. 13511 which would extend the investment tax credit to rehabilitation expenditures for certain qualified buildings is basically a very desirable provision which could provide a considerable stimulus for the rehabilitation and modernization of existing warehouse facilities operated by food wholesalers and of existing stores operated by their member-retailers. However, the provisions of Section 314 will be of little or no use to cooperative organizations with respect to rehabilitation of their warehouse facilities so long as the ratable share limitation provisions applicable to such organizations remain in the Code. Moreover, because of uncertainty as to the status under Section 314 of H.R. 13511 of rehabilitation expenditures paid by a lessee, an additional problem might exist with respect to rehabilitated warehouse buildings occupied by retailer-owned cooperative organizations by reason of the fact that many such organizations lease their warehouse facilities under long-term net leases whereby all expenses related to the facilities (including capital expenditures made for rehabilitation) are paid for by the lessee.

Therefore, we submit that the provisions of H.R. 13511 relating to extension of the investment tax credit to expenditures for the rehabilitation of qualified buildings should first be modified to make it clear that rehabilitation expenditures paid for by a lessee will qualify for the investment tax credit even though the lessee has not owned the building for at least 5 years from the time it was placed in service, provided that the lessee has occupied the building for at least

such a 5-year period. It is believed that such clarification is extremely important, since many warehouse facilities are built by developers who then lease them to the wholesale distributors who commence to use them as of the time they are placed in service.

The foregoing clarification would be an act of futility, however, insofar as cooperative organizations are concerned, unless the Code is simultaneously amended by repeal of the provisions of Section 46 limiting the amount of the investment tax credit which can be claimed by a cooperative organization to its "ratable share". Incorporation into the Code of the provisions of Section 2 of S. 2216 and H.R. 8244 would have the effect of affording cooperative organizations the same treatment with respect to the investment tax credit as is presently available to subchapter S corporations and partnerships, whose income, like that of cooperatives, is basically taxed only once for federal income tax purposes.

Even in the case of many large cost items such as inventory handling equipment and systems, delivery equipment and computer equipment which presently basically qualify for the investment tax credit, retailer-owned cooperative organizations and the member-stockholders who purchase from them are at a distinct competitive disadvantage in that their opportunities to make use of the investment tax credit are drastically limited by the "ratable share" provisions of the Code, whereas large integrated chain organizations which compete with such retailer-owned organizations and their retailer members can presently claim the maximum investment tax credit on purchases of these types of property. If it were not for the "ratable share" limitation, retailer-owned organizations and their retailer members would have been entitled to many millions of dollars of investment tax credits in the year 1977 alone which they have been prevented from claiming by reason of such limitation.

Accordingly, in the interests of equity and fairness and of furthering competition and improvement of efficiency in the distribution of consumer products, we hereby respectfully request on behalf of CFDA that the provisions of Section 2 of S. 2216 and H.R. 8244 be incorporated into H.R. 13511 by the Senate Finance Committee. We are not familiar with the requirements of the Committee in connection with the submission of written statements of this type, but we are nevertheless enclosing 5 additional copies of this letter for the convenience of the Committee and its staff.

Respectfully yours,

By Fred H. Law, Jr.

Statement of the Lutheran Council in the U.S.A., on Behalf of the American Lutheran Church, Lutheran Church in America

This statement is presented by the Lutheran Council in the USA on behalf of the following church bodies:

The American Lutheran Church, Minneapolis, Minnesota, 2,437,000 U.S. members. Lutheran Church in America, New York, New York, 2,990,000 U.S. members.

These church bodies and their over 11,000 member congregations have a significant supporting relationship to thirty colleges and universities, twelve theological seminaries, 100 day schools, 150 camps and conference centers, and over 300 hospitals, retirement homes and social service agencies. As such, they form a significant portion of the charitable community in this country and provide a variety of social, health and educational services to thousands of Americans every year.

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

The Lutheran churches are concerned over the impact that certain proposed alterations in the U.S. tax code would have on charitable giving. Our review of the "Revenue Act of 1978," as approved by the House of Representatives, indicates several proposed changes that would adversely affect—albeit indirectly—the level of charitable giving. These are: (1) the proposed increase in the zero bracket amount—formerly called the standard deduction—to $2,300 from $2,200 for single persons and to $3,400 from $3,200 for married couples; (2) the elimination of itemized deductions for state and local motor fuel taxes and political

contributions; and (3) somewhat tightened itemized deductions for personal medical expenses. These changes would continue a trend towards encouraging taxpayers to use the standard deduction. Yet by discouraging itemization, they would also reduce the number of taxpayers able to take a deduction for their charitable gifts. As outlined below, this would in turn reduce the total level of charitable giving.

The Lutheran churches believe that a good tax structure should be simple, easily understood and equitable. Consequently, we support the goal of simplification in the preparation of tax returns.

We also believe that a good tax structure should advance sound social goals and should safeguard the freedom of voluntary organizations to fulfill them in a responsible manner. The continued erosion in use of the charitable deduction threatens this aim. For these reasons we urge the Congress to recognize the uniqueness and social value of the charitable deduction by allowing all taxpayers to take a deduction from gross income for their charitable gifts, whether they itemize their other deductions or not. No limitations other than those in existing law should be placed on the use of this deduction.

Specifically, we endorse the approach found in S. 3111 introduced by Senators Daniel P. Moynihan of New York and Bob Packwood of Oregon. We encourage the Committee on Finance to include this form of targeted tax relief as a component of the general tax relief measure now under consideration.

We base our support of this change on the following reasons:

(1) Negative impact of recent reforms on total giving.—The decline in the number of taxpayers who itemize and who are therefore eligible to use the charitable deduction from 54 percent in 1969 to an estimated 23 percent in 1977 has had a negative impact on the total level of charitable giving. Econometric studies by Professor Martin Feldstein of Harvard University have shown that the charitable deduction is an important incentive for charitable donations. He estimates that charities have lost $1.357 billion in 1977 due to changes made in the standard deduction since 1970. His studies suggest that charities have lost about $5 billion in contributions during the 1970–77 period. Estimates by the American Association of Fund Raising Counsel show that charitable contributions as a percentage of gross national product fell from 1.98 percent in 1969 to 1.80 by 1974, with the decline the sharpest for givers in the $10,000–$25,000 income range.

(2) Uniqueness of the charitable deduction.—Relative to other currently itemized deductions, that deduction allowed for charitable gifts is unique and entitled to special treatment. When persons contribute to charities, they voluntarily reduce their income or net worth, whatever the tax treatment. Charitable contributions have nothing in common with economic transactions such as interest payments, nor with mandatory payments such as state and local taxes. Contributions are clearly distinguishable from medical payments. A charitable donation is an expenditure whose essential characteristic is the advancement of voluntary activities in the public interest. Treating charitable contributions as a deduction from gross income conforms to the reality of the contributor's option in reducing his or her net income. Moving expenses and alimony already receive such treatment.

(3) Democratization of the charitable deduction.—Recent statistics show that over 80 percent of all charitable giving comes from those itemizing their tax returns and using the charitable deduction—currently an estimated 23 percent of the population. Reserving this tax treatment to a shrinking number of high income taxpayers works against the preservation of a democratic pattern of giving and threatens to transform public perception of the charitable deduction into that of an "elitist" tax loophole reserved for the wealthy. Allowing all taxpayers to take the charitable deduction in addition to the standard deduction would restore equity in the tax treatment of charitable gifts and encourage broader citizen participation in the voluntary sector. The philosophy behind the charitable deduction, when introduced in 1917, was that the income tax should be imposed only on consumable income and not on that portion which goes to public uses rather than to the giver's personal advantage or enrichment. We urge the Congress to reaffirm that approach.

(4) The voluntary sector: its value and future.—Churches and other voluntary organizations have proven their social value repeatedly in reducing suffering, pioneering in social services, pointing to injustice and invigorating and diversfying our nation's public life. They have also formed a cushion against the

awesome and sometimes impersonal power of ever more centralized government. Voluntary organizations are basic to a free and open society and serve as a training ground for democracy. Religious organizations make a special contribution by providing a moral basis for society.

However, we must also stress the serious financial impact recent developments have had on the voluntary sector. Inflation has struck at program costs. Recently enacted Social Security tax increases affected disproportionately non-profit organizations which had previously elected coverage for their employees. Where private business can write off up to 48 percent of added FICA costs as a business expense and compensate for the remainder with higher prices, non-profit organizations must bear the full brunt of the extra expenses. Cutbacks in programs will in many cases result. The eroding base of the charitable deduction and the resulting decline in income further affects the ability of the voluntary sector to deliver services to the American public. Those receiving these services—the poor, the sick, the disadvantaged—will suffer the most. Pressure on the governmental sector—and the Federal treasury—will also grow.

(5) Generating new support.—Professor Feldstein's study indicates that for each dollars of taxes lost by virtue of the deduction, charitable organizations receive between $1.15 and $1.30. He projects that allowing all taxpayers to take the charitable deduction would increase giving by approximately $3.8 billion annually with a revenue loss to the Treasury of less than $3.2 billion. In addition, personal involvement follows financial support. The 1975 Report of the Commission on Private Philanthropy and Public Needs found that an equivalent dollar's worth of personal volunteer activity is generated for each dollar donated to a charity. We should also note here that charitable organizations are labor intensive. Therefore a large of charitable income *is* taxed through individual federal income tax withholding.

(6) The indispensability of deductibility.—Preservation of existing patterns of giving, as much as the stimulation of new donations, is involved when we argue for universal application of the charitable deduction. Current economic and governmental policy trends present a long-term threat to the ability of our donors to give. Inflation gnaws away at real income and results in an artificial tax increase by pushing taxpayers into ever higher tax brackets. Recently enacted Social Security tax increases hit all employed persons with another major tax increase. The governmental sector continues to consume a growing share of total national income. Every indication suggests that these trends will continue, if not accelerate, in the future. Recognizing the deductible nature of all charitable contributions will help preserve the ability of all donors to give.

In sum, we believe that allowing all taxpayers to take the charitable deduction in addition to the standard deduction does not constitute subsidy. Rather, it is sound social policy. Any resulting revenue loss, we believe, would be more than offset by the increased flow of resources and personal commitment to voluntary activity on behalf of the whole nation. Such treatment would require only a simple computation on the front of the tax form.

We believe that this change would reconcile a valuable incentive for charitable giving with the commendable goal of tax return simplification; democratize the base of the charitable deduction; increase Americans' propensity towards charitable giving; and strengthen the whole voluntary sector to the advantage of all Americans.

We have appreciated this opportunity to make our views known to the Committee.

Statement of Herbert I. Lazerow, Professor of Law, University of San Diego

This testimony addresses only § 404 of H.R. 13511, capital asset basis increases for inflation. It raises problems for the Committee's consideration in its further deliberation on § 404.

1. Should there be inflation adjustments in the income tax?

Inflation adjustments introduce further complexity and inequity into the tax system. In a country where inflation is minimal, no such adjustment should be made because the problem is not great and the solution poses difficulties. With less than a 6 percent inflation rate annually, Congress can adjust tax rates, brackets, and other fixed amounts to roughly compensate for inflation. Congress

has done so over the past 20 years. Likewise, the inflationary increase in asset value is not generally great. Most assets would be turned over before significant inflationary gains have occurred. Because of this, the complications of inserting provisions to take care of inflation would outweigh the benefits to be derived from them.

The converse is true when the rate of inflation exceeds 10 percent. With 10 percent inflation, an asset held for five years will, because of the compounding effect, increase its nominal value by 55 percent, while experiencing no real economic increase in value. Salaries can be expected to do the same. Such nominal changes, unaccompanied by real economic increase, substantially change the percentage of the individual's real income retained after taxes under our progressive tax system. Because of the rapidity with which changes must be made Congress is unlikely to act quickly enough with respect to rates and rate brackets. Other items such as the taxation of gains, inventories, depreciation, and loans will be significant in amount, and worth correcting. They will require structural, rather than rate, changes if they are to be meaningful.

2. Should inflation adjustments be divorced from each other?

It can be argued that the wage earner is more in need of inflation adjustment than the holder of property. The assumption is that the capital owner is in a high income bracket, and his gains are more or less regularly taken, while the wage earner depends on his income for survival, and finds that while his nominal income is rising, his real income after taxes falls because the progressive rate structure relieves him of a large percentage of his real income. Further, it can and has been argued that the principal reason for taxing capital gains at a lower rate than ordinary income is because many nominal capital gains have a substantial inflationary component which is not real gain. In the light of these views, it can be suggested that the first inflation adjustment should be for wages. Thereafter, there should be inflation adjustments for business assets that figure in the income statement, such as inventories and depreciation, and last in line should come capital gains. In the alternative, it may be argued that there should be no capital gains inflation adjustment as long as capital gains are taxed at a favorable rate.

On the other hand, it can be argued that while wages and other income can be adjusted for inflation simply by changing the rates, no such easy solution is available for capital gains. In order to be remotely accurate, the capital gains inflation adjustment must be structural, adjusting either basis, sales price, or the tax. It can further be argued that the problems of adjusting depreciation and inventory for inflation are enormous, and the impact of inflation on both those items considerably less than its impact on capital gains. This is particularly true of inventory, which normally turns over within a short period. Finally, it can be argued that the lower rate on capital gains represents more than simply a response to inflation. These gains accrue over a period of years and the lower rate is an averaging, and may be necessary to encourage the sale of assets and to avoid people being locked into them.

I do not wish to enter the debate on this issue. Rather, having exposed the issue, I wish to mention some technical problems of an inflation adjustment for capital gains.

3. What type of inflation for capital gains should be adopted?

The literature discusses three types of inflation adjustments. One type is a lowered tax rate such as is provided by the 50-percent capital gains deduction. While such a simple adjustment is easy to administer, it does not respond precisely to the problem. The rate reduction is the same regardless of the inflation that has been suffered since the asset was purchased. While it is possible to apply graduated rates depending on the length of time the asset has been held, such a provision complicates the law and fails to encourage disposal of the asset when that is most economic.

A second proposal to adjust gain for inflation is to reduce the sales price and depreciation back to constant dollars at the time of purchase. While such a proposal has some appeal, it is less convenient in the case of a gain than inflating the basis to the year of sale because tax must be paid on the gain. It seems inappropriate to compute the gain in dollars of ten years ago, then to pay tax in today's dollars.

The preferable system would inflate the purchase price to the time of sale. Time-of-sale dollars are the dollars in which the tax will be paid so adjustment to time-of-sale dollars will place the tax payment, the sales price, and the basis on the same scale.

Such inflation adjustment (called indexing) encounters a number of practical problems. Most of the following problems are caused by conflict between two very desirable goals—accuracy and practicality. Accuracy asks that indexing as faithfully reflect inflation as possible so that only real gains are taxed. Accuracy calls for indexing based on the cost of living index in taxpayer's locality adjusted as closely as possible to the dates of purchase and sale as possible. Practically, on the other hand, realizes that the income tax exists in an imperfect world, and that complications cause additional costs for both taxpayer and government. Practicality demands that the indexing be simple and easy to do; that it be easy for the Revenue Service to audit; and that it be easy to explain to the average taxpayer. The tax provision that results is inevitably a compromise between accuracy and practicality.

A. Should there be a threshold before indexing occurs?

At best, indexing is a complicating element. Such complications are not justified for minor inflation. Where inflation is minor, it would be better to avoid the complications of indexing.

Where should the line be drawn? I have suggested above that less than 6 percent inflation does not justify indexing, while more than 10 percent does. Any number between can be chosen, and the indexing made available only if the annual rate from purchase to sale exceeds the chosen percentage.

Also, a holding period could be required before permitting any inflation adjustment. While a two-year period might be suggested, such a suggestion really assumes no greater than current rates of inflation. Few people would suggest that a one-year adjustment is inappropriate if the inflation rate were 50 percent per year. Thus, the only appropriate theoretical floor is the inflation rate. But given our historical experience, it seems appropriate to require at least a one-year holding period, as for capital gains.

B. What measure should be used for the indexing?

Section 404 of the Revenue Bill of 1978 calls for an adjustment based on the consumer price index of the month in which the asset is purchased and the month in which the asset is sold. Such an adjustment requires precise mathematical computation by the taxpayer. It also requires that the Revenue Service print extensive tables in taxpayer instructions and program its computers to catch the many mathematical errors likely to occur. While businesses will deal easily with such a provision, individual taxpayers will not. It will be preferable to have a provision somewhat less precise, but easier to apply. For instance, all assets bought during a particular calendar year might have a base at the consumer price index at some mid-point of that year, such as June 30. The same would be true for the year in which the asset is sold. Thus, the Revenue Service need only print a factor by which the basis would be multiplied to be used for the sale of an asset bought during a particular year. That factor would change each year depending on the cost of living. For assets sold in 1981, the factor might be 1.2 if the asset were acquired in 1980 and 1.4 if acquired during 1979. Such a system is less precise than the system in H.R. 13511, but much easier to administer. It is used in the French indexing law. An alternative reaching the same end would use the average for a 12-month period. Some lag here would be required, as forms must go to press before figures are available for the last months of the calendar year.

The consumer price index nationally, which is chosen by H.R. 13511, seems to be the correct measure for the index. As noted above, the index for taxpayer's locality would be more accurate, but would also be more difficult for taxpayers to discover and get correct, and for the Revenue Service to audit. Further, we do not make other tax distinctions by locality, even though the cost of living varies widely from Austin to Anchorage.

The consumer price index is more logical than any of the many other indices compiled by the federal government because we envisage the bottom line of investment as the generation of funds for future consumption.

C. How should increases in basis from subsequent investment be indexed?

The bill takes the sensible viewpoint that increases in basis should be considered new invetments at the time of the increase, and indexed from date of investment to date of sale. Such a provision is preferable to securing an adjusted basis, then indexing the entire basis from the date of the first investment. The latter would give taxpayer the benefit of indexing even on dollars invested at later, inflated times.

D. How should basis reductions, primarily depreciation, be treated?

Under H.R. 13511, depreciation is simply removed from the original basis before the basis is indexed. This gives the taxpayer less benefit than would accurately

reflect real inflation where, as with depreciation, there are continuing payments. For example, where the cost of living index goes from 100 to 150 in a straight line increase over five years, taxpayer invests $100, and the taxpayer has depreciated 20 percent of the declining balance each year, his indexed basis under the bill would be $49.16. A basis taking into account the year in which the depreciation was taken would be $68.93, or roughly 40 percent higher. (See tables 1 and 2). Taxpayer has a lower than accurate basis because H.R. 13511's system backdates depreciation too far. In addition, the system is asymmetrical, providing accurate measurement when that is not to taxpayer's advantage.

Despite the fact that the depreciation adjustment in H.R. 13511 is less accurate than the ideal, it is much easier to handle. The necessity to constantly recalculate is avoided. Such simplification is useful, especially when a new provision is first enacted.

D. Should assets bought with borrowed funds be indexed.

The House excluded loans from the inflation adjustment, both for the lender and the borrower. The two items offset each other. However, when property is purchased with borrowed money, no inflation adjustment should be accorded because the borrowed money is subject to reverse adjustment. Put another way, where an asset is totally financed through borrowed funds, and the entire loan principal discharged with proceeds of the sale, there is no inflation loss because taxpayer will pay off the loan in dollars worth less than those he borrowed. The net result is that the taxpayer should be entitled to a full inflation adjustment only in the absence of borrowing to purchase the asset.

In real life, matters are not that simple. Few can borrow the full cost of assets we purchase. Nor do most people purchase major assets without some financing. Matters are further complicated because loans taken out to purchase assets are often paid off gradually. Real estate mortgages are normally paid off at a rate which is not constant. The difficulty in computing the degree of payoff would be extreme.

Three possibilities emerge from these difficulties. First, accuracy demands that the basis be adjusted for inflation, and that a countervailing adjustment be made as the loan is paid off. Such a ru'e would cause great difficulties in computation and require information not normally known by the homeowners or, if known, not normally retained.

Second, the law could ignore the fact that the asset was financed. This is the path taken by H.R. 13511. This has the virtue of simplicity, but it is hard to see why a person who has suffered no inflation loss should benefit by indexing.

The third and best course would be to establish certain broad categories for use if property is purchased with borrowed money. Property with less than 25% financing at purchase might be indexed as though unfinanced; property financed between 25% and 75% of its purchase price might receive 50% of normal indexing; property with more than 75% financing might not be indexed at all. Obviously, other numbers could easily be chosen. Though such measures are rough rather than precisely accurate, they provide some equity without complicating indexing too much.

E. How does indexing interact with depreciation recapture?

§§ 1245 and 1250 of the Internal Revenue Code of 1954 provide for some recapture of depreciation previously taken if a depreciable asset is sold at a gain. H.R. 13511 mentions nothing about these provisions. Presumably, under the bill as presently drafted, no change is contemplated under §§ 1245 or 1250. But the logic of indexing indicates that the amount to be recaptured should be indexed also, thereby forcing the taxpayer to include at ordinary income rates not the nominal depreciation formerly taken, but the real economic depreciation.

Perhaps the failure to consider this is the converse of the discussion in C above. Depreciation is simply not indexed for any purpose.

F. Should indexing apply for purposes of losses as well as for gains?

H.R. 13511 applies indexing to losses as well as gains. A nominal gain may easily become a real loss through indexing up the basis. While some argue that losses should not be created by indexing, the economic principle of indexing applies regardless of whether the net result is gain or loss.

The no-indexing-to-create-loss position might be buttressed by the fact that such losses will offset other income, on which there is no indexing. But the fact that the taxpayer is denied a benefit in one area is no reason to deny him a benefit in another.

G. For what years should indexing be available?

H.R. 13511 limits indexing to gains accrued after 1978. Thus, 1979 is the base year for all assets, no matter when acquired. Such a provision has little logic to recommend it, except that it minimizes revenue losses in early years. Standing as we are at the foot of five years of heavy inflation and lackluster stock market performance, retroactive application of indexing might create huge losses in the first year. Such a view assumes immediate liquidation, which may not be in the offing.

H. Should indexing apply to deflation also?

H.R. 13511 only applies indexing when it helps the taxpayer. But if taxpayer suffers a loss through unindexed inflation, he equally has a gain through unindexed deflation. The two sides of the coin should be similarly treated.

TABLE 1.—BASIS WITH DEPRECIATION INDEXED SEPARATELY

Year	Cost-of-living index	Depreciation taken	Inflation factor	Deduct from basis
1	1.1	$20.00	1.36	$27.20
2	1.2	16.00	1.25	20.00
3	1.3	12.80	1.15	14.72
4	1.4	10.24	1.07	10.96
5	1.5	8.19	1	8.19
Total		67.23		81.07

Note: Indexed cost is $150 ($100×1.5), less indexed depreciation $81.07, leaves indexed basis of $68.93.

TABLE 2.—*Basis with depreciation indexed with cost*

Cost	$100.00
Less depreciation taken	−67.23
Adjusted basis	32.77
Inflation factor	×1.5
Indexed basis	49.16

MACALESTER COLLEGE,
St. Paul, Minn., August 14, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: The following statement, in support of S. 3111, is submitted to the Senate Committee on Finance by Dr. John B. Davis, President, and Madison L. Sheely, Director of Planned Giving, Macalester College, Saint Paul, Minnesota.

Five copies are enclosed for your convenience.

STATEMENT IN SUPPORT OF S. 3111

Perspective: Private, non-profit institutions such as Macalester College are dependent in large part on private philanthropy to sustain their public service functions. Such private philanthropy is a great tradition in the United States of America, where citizens have looked to one another to provide for the common good.

The earliest institutions of higher learning in this country were privately organized and privately funded. Endowments today—in the billions of dollars—have come from private sources, the charitable gifts of citizens from every walk of life.

Since the adoption of the 16th amendment in 1913 there has been a continuous interaction between federal tax policy and philanthropy. This interaction continues to be of vital concern to privately supported institutions, since tax laws and tax policies affect the ability of such institutions to raise the funds so vitally important if they are to meet their goals and serve the public at large.

Current Issue: S. 3111 proposes permiting all taxpayers to deduct their charitable contributions on their tax returns whether or not they itemize their deductions.

I believe this amendment to current tax laws to be in the national interest as well as in the interest of charitable institutions.

Rationale: 1. Fairness for all taxpayers. Charitable contributions are a voluntary transfer of private resources to public uses for the common good. As such they should be exempt from taxation, since they represent neither personal consumption nor personal saving. This exemption, already available to those who itemize deductions, should be available to all taxpayers.

It has been documented repeatedly over the past eight years, that the increase in the number of taxpayers taking the standard deduction (zero bracket amount) has been followed by a corresponding decrease in charitable giving. As Senator Moynihan observed in introducing S. 3111, Professor Martin Feldstein estimates that charities have lost about $5 billion in contributions since 1970, primarily as a consequence of changes in the tax code. Much of this decline has come in the contributions of middle income taxpayers, who would be especially helped by S. 3111.

2. Importance of philanthropy. Federal tax policy should be an encouragement to private philanthropy and should underscore the uniqueness of private giving as the keystone of our pluralistic society. Making the charitable deduction available to all taxpayers would serve these important purposes. Saving taxes is not the primary motivation for philanthropy, but federal tax policy does set a climate which either encourages or discourages philanthropy. The present situation, in which only a small minority of taxpayers itemize their deductions and thus receive a charitable deduction, is both unfair and a discouragement to giving.

The charitable deduction should not be viewed as a tax "loophole", but as basic tax policy in support and encouragement of private philanthropy.

3. Effect on major donors. Most privately supported institutions are dependent on those few large gifts which make up the bulk of gift income. While continually attempting to broaden the base of support, we also recognize that major gifts form the cornerstone of gift income. Such gifts are definitely tax-oriented. That is, the size of such gifts, their form and timing, are all influenced by tax considerations. Changes in the tax laws in the area of charitable deductions affect our ability to secure major gifts.

Conclusions: Private philanthropy is influenced by federal tax policy. Tax laws which restrict or reduce the charitable deduction also constrict funding for privately supported charitable institutions. We believe that broadening the availability of the charitable deduction by adoption of S. 3111 will substantially enlarge our ability to secure gifts in support of our institution. We also believe that losses to the federal treasury by reason of S. 3111 will be more than made up by increased support for all charitable institutions.

JOHN B. DAVIS, Jr.,
President.
MADISON J. SHEELY,
Director of Planned Giving.

MAYER, BROWN & PLATT,
Washington, D.C., August 23, 1978.

Re Section 201 of the Revenue Act of 1978 (H.R. 13511).

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

DEAR MR. CHAIRMAN: Section 201 of H.R. 13511 as passed by the House would generally extend the "at risk" provision in Code section 465, but make it inapplicable to "the holding of real property (other than mineral property)". Currently, the "at risk" provision in Code section 704(d) does not apply to any partnership "the principal activity of which is investing in real property (other than mineral property)" and the activities to which section 465 now applies do not include holding or investing in real estate.

Regardless of the merits of the proposed extension, it should be borne in mind that there are important business considerations which often dictate the use of single and multitier real estate partnerships. This was recognized by the staff of the Joint Committee on Taxation in footnote 7 on page 97 of its General Explanation of the Tax Reform Act of 1976. There it was made clear that the present "at risk" provisions do not apply to a partnership whose primary activity is investing in real property either directly or through other partnerships. We

understand that no change in existing law is intended in this regard by section 201 of the House bill.

Nevertheless, consistent with this policy, if the section 704(d) at risk provision is repealed and the section 465 provision is extended, it will be important to assure that the new provision does not apply to a partnership substantially all the activities of which relate to the holding of real property for sale or rental either directly or through other partnerships. This could be done either by language in section 465 or by an appropriate statement in the Finance Committee report. We would welcome an opportunity to work with your staff in this regard.

I am submitting this with five copies for inclusion in the record of your hearings. If you have any questions or need any additional information, please contact me.

Respectfully,

JERRY L. OPPENHEIMER.

MAYER, BROWN & PLATT,
Washington, D.C., August 23, 1978.

Re H.R. 13511—The Revenue Act of 1978.

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

DEAR MR. CHAIRMAN: These comments on those provisions of the pending Revenue Act (H.R. 13511) and related bills which affect employee benefits are submitted on behalf of The ERISA Industry Committee (ERIC). Its ninety members include half of the nation's fifty largest industrial companies and represent a cross-section of the nation's largest retailers, utilities, banks and insurers.

ERIC members are genuinely concerned about the wellbeing of their employees. The approximately 8.5 million participants in pension plans sponsored by ERIC members represent about twenty percent of all participants in private pension plans. Welfare plans sponsored by ERIC members cover about 22 million individuals, over ten percent of the nation's population. ERIC members also maintain a variety of nonqualified deferred compensation programs.

For the sake of brevity, these comments are summary, and we anticipate that they will raise questions. Accordingly, we would welcome the opportunity to amplify them through supplemental submissions, to confer with members of the Committee and its staff, and generally to make the experience of ERIC's members and counsel available to the Committee.

I. NONQUALIFIED DEFERRED COMPENSATION

ERIC strongly supports section 122 of H.R. 13511 which would reaffirm that nonqualified deferred compensation plans of private employers are to be governed by the principles in effect on February 1, 1978. The confusion and unsettling atmosphere engendered by the lack of clarity in the Treasury regulations proposed on February 3, 1978, can be quieted only by clear Congressional endorsement of these longstanding rules. ERIC would strongly oppose, however, applying the Code section 415 limitations to such arrangements as proposed in section 121 of S. 3321.

II. SIMPLIFIED PENSION PLANS, DEDUCTIBLE EMPLOYEE CONTRIBUTIONS, AND SPECIAL MASTER AND PROTOTYPE PLANS

ERIC generally supports proposals which would foster the growth of private plans, increase employee savings, and encourage capital formation. Thus, ERIC generally supports the goals of the special master and prototype plan and simplified pension plan concepts embodied in S. 3017 and S. 3140, respectively, and supports the concept of deductible employee contributions to qualified plans, such as those contemplated in S. 3288 and S. 3017. ERIC, however, urges that arbitrary and unnecessary limitations on gross income for eligible employees, such as those in section 303 of S. 3017, be rejected.

In addition, ERIC strongly urges that plans be given the option, and not be required as contemplated by section 303 of S. 3017, to accept employee contributions. Attached is a copy of the August 23, 1978, comments we filed on behalf of ERIC for the record of the recent joint hearings of the Subcommittee on Private

Pension Plans and Fringe Benefits and of the Human Resources Subcommittee on Labor on the several bills pending before those Subcommittees. On pages 20 through 22 of those comments we noted the significant problems which would result if plans were required to accept employee contributions.

ERIC is also concerned that, as proposed, S. 3140 would deny participants in simplified pension plans important benefits enjoyed by participants in other plans. Because simplified pension plans would, in essence, be individual retirement accounts, the lump sum distribution treatment provide by Code section 402 and the estate tax exclusion provided by Code section 2039(c) would not be available. Furthermore, contributions to simplified pension plans would be limited under the proposal to the limits currently applicable to H.R. 10 plans. ERIC strongly urges that participants in all qualified plans, should, at most, be limited by Code section 415 and should enjoy the lump sum distribution treatment and estate tax exclusion.

III. OTHER PROVISIONS AFFECTING EMPLOYEE BENEFITS

ERIC strongly supports the House decision to reject the President's proposals to revise significantly the rules governing integration of Social Security and private retirement plans, to establish complex and unworkable new antidiscrimination rules for welfare plans, and to repeal the $5,000 death benefit exclusion.

* * * * * * *

We are submitting this with five copies for inclusion in the record of your hearings. We would welcome the opportunity to answer any questions you, the members of the Committee or your staff might have.

Respectfully submitted.

JERRY L. OPPENHEIMER.
ROBERT H. SWART.

COMMENTS OF THE ERISA INDUSTRY COMMITTEE (ERIC), SUBMITTED BY JERRY L. OPPENHEIMER; ROBERT H. SWART; MAYER, BROWN & PLATT; GEORGE J. PANTOS; AND VEDDER, PRICE, KAUFMAN, KAMMHOLZ & DAY

INTRODUCTION

These comments are submitted on behalf of The ERISA Industry Committee (ERIC). Its ninety members include half of the nation's fifty largest industrial companies and represent a cross-section of the nation's largest retailers, utilities, banks and insurers.

ERIC members are genuinely concerned about the wellbeing of their employees. The approximately 8.5 million participants in pension plans sponsored by ERIC members represent about twenty percent of all participants in private pension plans. Welfare plans sponsored by ERIC members cover about 22 million individuals, over ten percent of the nation's population.

For convenience, these comments generally follow the order of S. 3017 and are not necessarily in the order of importance to ERIC. For the sake of brevity, they are summary and do not deal with every provision of each of the pending bills. We anticipate that the comments will raise questions. Accordingly, we would welcome the opportunity to amplify them through supplemental submissions, to confer with members of the Subcommittees and their staffs, and generally to make the experience of ERIC's members and counsel available to the Subcommittees. We also hope to comment subsequently on proposals not considered herein.

I. MULTIPLE JURISDICTION (S. 901 AND S. 3017)

S. 3017 would consolidate in a new agency all responsibility for administering Titles I and IV of ERISA and certain sections of the Internal Revenue Code. S. 901 would allocate responsibility for various aspects of ERISA to either the Treasury Department or the Department of Labor.

The principal multiple jurisdiction problems arose immediately after passage of ERISA. Those problems have been largely resolved. and the multiple jurisdiction matter is not now of major concern. There are now more pressing matters pending before these Subcommittees and the Internal Revenue Service, Treasury Department, Department of Labor, and Pension Benefit Guaranty Corporation. Accordingly, we urge that this matter be deferred at least until the Administration's recent reorganization plan has been implemented and there has been a reasonable opportunity to assess its operation.

II. REPORTING AND DISCLOSURE (§ 4 OF S. 901, §§ 2-4 OF S. 1745, §§ 221-29 OF S. 3017 AND S. 3139)

ERIC generally supports the various proposals to simplify reporting and disclosure requirements. More specifically, ERIC supports the proposed (1) simplified and cyclical annual reporting, (2) consolidation of Form ESB-1 and the Form 5300 series, (3) elimination of the summary annual report, and (4) simplification of reporting of participants' benefit rights. These revisions should reduce costly and unnecessary requirements, facilitate more efficient administration of plans without reducing ERISA protections, and may encourage plan adoptions and retard plan terminations.

Section 2 of S. 901 should eliminate problems resulting from the undue specificity in ERISA section 103. If, however, the present specificity is retained, the proposed delineation of accountants' and actuaries' responsibilities envisioned by sections 226 and 228 of S. 3017 should also reduce unnecessary duplication and expense. Nevertheless, we would prefer to see these professions reach a satisfactory accord without further government intervention.

We make three additional suggestions.

A. *Consolidation of Forms (§ 224 of S. 3017 and § 2 of S. 3193).*—There is no present requirement that a plan obtain an advance determination letter that it is a tax qualified plan. The proposal to combine Labor's Form EBS-1 (the plan description form) with the Service's Form 5300 series (determination letter applications) should be carefully tailored so as not to require a plan to obtain a determination letter from the Service before its tax qualification is recognized or effective.

If a plan were not qualified until a determination letter was issued, given the normal delay in obtaining a determination, there would often be no basis for claiming a deduction for contributions made during the taxable year of adoption of or amendment to a plan unless the contributions were recognized by the employees as income when made. Thus, for example, plan adoptions and amendments, particularly at year-end, could be hindered or precluded. In addition, if plans were required to obtain determinations, the Service would have to be required to rule with respect to all plans and all plan provisions. It has not always been willing or able to do this in the past.

B. *Notice to Interested Parties.*—ERIC strongly urges the repeal of Code section 7476(b)(2) which, in effect, requires the notification of interested parties prior to the filing of any request for a determination letter. ERIC supports the proposition that participants and beneficiaries be informed of amendments which affect them, but, as suggested by Senator Bartlett in his testimony, this notification requirement is unduly burdensome and expensive, serves no useful purpose, is generally ignored or misunderstood by participants, and duplicates other reporting requirements.

Under the regulations, the request for a determination letter must be filed within a certain period of time after notification is given. This significantly reduces flexibility in adoptng plan amendments, particularly, for example, when the amendments must be approved by a board of directors. If timely notice cannot be given, amendments may be delayed from one plan year to the next. Moreover, giving notice is often expensive where many work sites or retirees are involved.

Participants and beneficiaries may object to a request for a determination letter only on grounds that the plan is not qualified. This is a matter the Service can well decide without assistance from participants and beneficiaries. A provision cannot be rejected merely because a participant or beneficiary "doesn't like" it.

Participants and beneficiaries receive notice of amendments through the annual report, the summary of the annual report (which would be eliminated by the current proposals), and updates to the summary plan description. If the Service were ever erroneously to approve a plan or plan amendment, a participant or beneficiary could obtain corrective action by civil enforcement under ERISA section 502.

In short, little, if any, benefit is derived from these notices. Accordingly, and in furtherance of simplifying ERISA compliance and reducing unnecessary costs, the requirement of notice to interested parties prior to filing a request for a determination letter should be eliminated.

C. *Reporting and Master Trusts.*—ERISA section 103 should be amended to reverse the Labor Department regulations requiring plans of related employers which invest through a single master trust to allocate on Forms 5500 assets of the master trust to the individual plans. The required allocation is contrary to generally accepted accounting principles, misleading to plan participants, expensive, and unnecessary. Each participating plan should be able to report its undivided interest in the master trust, accompanied by the trust's full financial statement, as is permitted for common or collective trusts which commingle the assets of plans of unrelated employers.

III. RECIPROCAL AGREEMENTS (§ 231 OF S. 3071)

ERIC understands that the purpose of the proposal is to permit mobile, short-term employees, such as construction workers, to rely on a single plan for retirement benefits. Generally, employer contributions for a specific employee are readily ascertainable under multiemployer plans, and the proposal contemplates the immediate transfer of such contributions to the "home plan" prior to the employee's accruing any service related rights in the "away plan".

As drafted, however, the proposal might apply to a long-term participant in any collectively bargained plan, including a single employer plan, even though his share of employer contributions may not be readily ascertainable and his entitlement to benefits may depend on complex actuarial assumptions and formulae. Most employees, especially participants in single employer plans, do not frequently change employment, and pension plans are appropriately designed to benefit primarily long-term employees. ERIC is concerned that the proposal might foster more rapid employee turnover. Accordingly, it should be restricted to its original purpose and to multiemployer plans.

IV. REDUCTIONS IN RETIREMENT DISABILITY BENEFITS (S. 250 AND § 237 OF S. 3071)

ERIC strongly opposes the proposal to prohibit the reduction of pension benefits by the amount of worker's compensation awards. Plans have been designed with the knowledge that such offsets are permitted (see Rev. Rul. 68–234, 1968–1 C. B. 157), and there is no reason now to prohibit elimination of potentially very costly duplication of benefits.

The policy against double benefits has long been extant in Social Security (see 42 U.S.C.A. §§ 402(k)(2)(B), (k)(3), and 424(a)) and was recently reaffirmed by Congress by requiring reduction of Social Security survivors' benefits for persons receiving Civil Service annuities (see section 334(b)(2) of the Social Security Amendments of 1977, P.L. 95–216).

Worker's compensation eligibility is determined solely by State panels, but the cost is borne entirely by employers. Many employees take normal retirement and subsequently receive worker's compensation. If disability benefits cannot be offset, they may well be eliminated from retirement plans to the detriment of employees, particularly those who are disabled in other than work related injuries.

V. JOINT AND SURVIVOR ANNUITIES (§ 238 OF S. 3017)

ERIC strongly objects to the proposal, in effect, to amend significantly ERISA's vesting rules and require retirement plans which provide annuity options to provide life insurance for all who are more than fifty percent vested. This proposal would increase plan costs, might lead to reduced benefits, and would conflict with existing life insurance programs.

Most participants who would be affected are relatively young. Their accrued benefits are generally based on compensation and length of service. A 30 to 40 year old with 10 or 20 years of service will generally not be in the higher compensation ranges. Thus, the "insurance" benefit the surviving spouse would receive (one half of the accrued vested benefit) would be relatively small. Furthermore, no amount would be paid the surviving spouse until the employee would have reached his earliest retirement age which often would be 20 or 30 years after his death. Typical employees would not consider such "insurance" very valuable. Nonetheless, foregoing forfeitures on the death of participants would, in the aggregate, increase funding costs. Furthermore, costs associated with administering elections, maintaining accounts, and paying annunities could be significant.

The proposal to eliminate the option of reducing benefits if a preretirement survivors' annuity is provided would force all participants, even those who are

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not married or otherwise do not receive this death protection, to share the costs. We note that current law extends the "insurance" benefit only to those who could have retired with joint and survivor benefits before death.

Furthermore, participants are commonly covered by group life insurance programs, without any waiting period for vesting, which provide death benefits of two or three times compensation, regardless of age or length of service. The proposal's increased cost could force many employers either to reduce benefits under the plan or to terminate group insurance arrangements. In any event, the proposed death benefit does not justify the increased costs.

ERIC also opposes the proposal to require lump sum payments to surviving spouses of participants who are more than fifty percent vested from plans which do not provide annuity payments. In addition to the "insurance" objections raised above, we are troubled that the proposal apparently would not permit participants in such plans to decline lump sum payments. Employees should have flexibility in their estate plans. Indeed, due to divorces, subsequent remarriages, tax and other factors, the surviving spouse may be the least appropriate beneficiary.

Moreover, many participants may wish to avoid the operation of Code section 2039(c) which includes in a decedent's gross estate benefits payable in a lump sum on death from a qualified plan. The required payment within sixty days after the end of the year in which the participant dies also seems superfluous in view of ERISA section 206(a) and Code section 401(a)(14).

ERIC proposes that all profit sharing, thrift and similar plans which currently provide that a participant's entire account will be vested on death be made exempt from any joint and survivor annuity requirements. Many such plans provide for annuity payments and, therefore, must now provide joint and survivor annuities, unless the employee elects otherwise. However, because the survivor is assured of the total accrued benefit, even if not vested before death, the supposed ERISA protections are unnecessary and unnecessarily increase the costs of maintaining such plans.

VI. ELAPSED TIME (§ 239 OF S. 3017)

The proposal would remove any remaining doubt that ERISA permits (as affirmed by Automated Packaging Systems, Inc., 70 T.C. No. 20 (May 15, 1978)) use of the elapsed time system of crediting service. It is used by many plans to measure employee service by reference to the time elapsed between the date of hire and the date of termination.

We urge, however, the deletion of that part of the proposal which would require regulations to assure "that employees whose service is measured in terms of elapsed time are, in the aggregate, not disadvantaged by the use of such system" (emphasis added). An "aggregate" test would raise troublesome issues such as (1) who are "disadvantaged employees"; (2) whether the measurement would be made location by location, plan by plan, or for all participants with a common employer; and (3) whether actual service records would be required to justify the use of the elapsed time method.

VII. FUNDING OF FUTURE BENEFITS (§ 251 OF S. 3017)

ERIC strongly opposes the proposal to require that after 1980 a plan's funding method take into account provisions of a plan which are not yet effective. It could significantly alter customary collective bargaining practices, would accelerate the cost of funding plans (and thus contribute to inflation), would result in significant and unnecessary additional complexity, and could, therefore, result in additional plan terminations.

The explanation of this proposal indicates that employers would be able to reduce contributions immediately in the event that an amendment were adopted to reduce benefits in the future. The explanation, however, ignores the fact that plans would be required to fund immediately future benefit increases.

Collectively bargained benefits typically are phased in over several years. The commencement date of increased benefits is frequently as important as (or more important than) the amount of the increase. The proposal would negate any advantage of deferring increased benefits to future years and would therefore make bargaining more difficult.

Furthermore, the proposal would engender controversy and further complexity. The proponents recognized that an amendment might never become effective. Thus, the explanation suggests that regulations would be issued for "appropri-

ately" adjusting the funding standard account in the event any provision is not actually implemented. This would add further complexity to funding standard accounts.

Finally, we note that the proposal would deem any provision "adopted but contingent on a future event" as not effective prior to the occurence of the event. This provision, although necessary, would be difficult to apply. More specifically, it would exempt contingent provisions from immediate funding requirements, but what contingencies are contemplated? Would increased benefits subject to confirmation by a board of trustees or by any employer qualify? In any event, future benefit increases customarily might be made contingent on some event, even though it was virtually certain that the event would occur. Thus, administering the proposal could be difficult.

VII. FIDUCIARY RESPONSIBILITY (§§ 9–11 OF S. 1745 AND PART 4 OF S. 3017)

ERIC generally supports the proposal in section 264 of S. 3017 to revise the cofiduciary responsibility provisions.

Plans are established to provide important coverage for participants and beneficiaries, and only incidentally to support other objectives, regardless of how laudable. Accordingly, ERIC strongly opposes legislation to authorize or require investment of plan assets in specific types of businesses or categories of assets example, in new, small, regional or medium sized businesses or in low or moderate income housing. Such legislation would inevitably lead to weakening the financial resources relied upon for retirement security.

IX. IMPACT OF INFLATION ON RETIREMENT BENEFITS (§ 273 OF S. 3017)

ERIC strongly oppose any authorization of a Labor Department study regarding requirements for cost of living adjustments to private plan benefits. The effect of inflation cannot be isolated from a consideration of related issues, such as the definition of an adequate" retirement income, the role of Social Security and other government programs, their relationship to private pension plans, the mechanisms for funding future benefits, and the effect of indexed benefits on inflation, capital formation, and economic growth.

Congress last year created a National Commission on Social Security to report within two years on the adequacy of retirement income provided by public and private plans, including the need for, and financial impact of, an inflation index for the elderly.

Similarly, after a Labor Department study was proposed, the President established a Commission on Pension Policy to develop within a year national retirement policy. It is to focus on financing and benefit structures and effects on private capital formation and economic growth.

In addition, the Advisory Council on Social Security is focusing on the retirement income goals for Social Security and private plans, the impact of inflation, and alternatives to the present system. The Council's reports are due on October 1, 1979.

Accordingly, any additional Labor Department study would duplicate the work of these three bodies, would be completed significantly after their reports have been made, and would unnecessarily dissipate resources.

X. THE DANIEL CASE (§ 274 OF S. 3017)

ERIC strongly supports the proposal to clarify that Federal and State securities laws do not apply generally to the interest of an employee in an employee benefit plan. However, the proposal also must clearly cover profit-sharing and thrift plans except for voluntary employee investments in employer securities. As emphasized in its testimony before the Labor Subcommittee on October 14, 1977, ERIC believes that legislation is imperative if the Daniel[1] case is not reversed by the Supreme Court.

Daniel raises the prospect of massive liability for unions and employers alike, is at variance with ERISA, promises interference with labor-management relations and collective bargaining, applies yet another body of law to the regulation of employee benefit plans, and needlessly involves another agency in a most comprehensive regulatory scheme.

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[1] *Daniel* v. *International Brotherhood of Teamsters*, 561 F.2d 1223 (7th Cir. 1977), *cert. granted*, 98 S.Ct. 1232 (Feb. 21, 1978).

XI. ERISA PREEMPTION (S. 1383)

ERISA clearly and appropriately preempts State laws relating to employee benefit plans. Nonetheless, recent court decisions have seriously eroded ERISA preemption with regard to State mandated benefits and assignment or alienation of benefits. Accordingly, ERIC urges (1) an appropriate reaffirmation of Congressional intent and (2) the rejection of S. 1383 which would exempt health plans from the ERISA preemption provision.

A. *State Mandated Welfare Benefit.*—*Wadsworth* v. *Whaland* [2] held that a New Hampshire law mandating the inclusion of mental health coverage in all group insurance policies issued in that State was not preempted because ERISA section 514(b)(2)(A) permits state regulation of 'insurance". Pennsylvania recently adopted a law that would require medical plans to cover physical therapists services. Other States require coverage for the services of psychiatric social workers and chiropractors. Disparate State laws are particularly troublesome for multistate employers who frequently transfer employees (whose benefits and coverage may thus change) and may have employees who live in one State but work in another which imposes different requirements.

The States rarely reflect on the inflationary consequences of their laws or recognize that resources available for employee benefits are limited. Mandating one type of coverage often requires discontinuing another. For example, the trustees of the plan in a companion case to *Wadsworth* now provide mandated New Hampshire mental health coverage, but they were forced to discontinue previously provided dental and vision protection. In effect, these State laws preclude employers and employees from determining which benefits should be provided. Thus, they conflict with free collective bargaining.

Employes and their dependents suffer from these State laws regardless of how well intended. Faced with mounting costs, unwieldy administration and vexatious litigation, some employers will terminate or curtail plans; others will not adopt or expand them. ERISA's purpose to encourage the growth of plans is thus frustrated. Moreover, *Wadsworth* has encouraged employers to self-insure in order to avoid the reach of State laws. Such action, particularly in the case of small or marginal employers, could be most unfortunate for participants who could look only to the resources of their employers for protection.

Significant confusion over the role of the States has been fueled by pending litigation regarding, for example, the health insurance laws of California, Hawaii, and Minnesota. ERIC strongly recommends that this confusion (and litigation) be terminated by an appropriate reaffirmation of the ERISA preemption provisions.

B. *Assignment and Alienation of Benefits.*—ERISA provides that benefits payable to a participant may not be assigned or alienated and would seem to preempt any State law to the contrary. Nevertheless, the anti-assignment and preemption provisions have not been properly applied in many family support and divorce proceedings.

For example, in *Cartledge* v. *Miller*, pending before the U.S. District Court for the Southern District of New York, the plan administrator contested the attempted garnishment of a participant's plan benefits. In an *amicus curiae* brief, the Department of Justice argued that Congress intended to prohibit certain involuntary transfers but also intended an implied exception for family support orders. ERIC submits that no such exception was intended.

As a second example, we note that California courts now permit an employee's spouse to join a plan in which the employee has an interest, whether or not vested, as a party to a divorce action. The plan may challenge the joinder only upon a showing that the employee has no interest in the plan or that the order grants different rights than those to which the employee is entitled, requires present payment of future benefits or payments after the spouse's death, or awards the spouse more than his community property interest in the plan.

Retirement plans are now being routinely joined in California divorce actions. One ERIC member has been joined more than 40 times. Unless a plan is prepared to accept whatever may transpire in these proceedings, it must appear and protect its interests through an attorney. The costs involved are high, but so are the risks of not appearing. Indeed, acquiescence in a court ordered assign-

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[2] *Wadsworth* v. *Whaland*, 562 F.2d 70 (1st Cir. 1977), *cert. denied*, 46 U.S.L.W. 3645 (Apr. 18, 1978).

ment may jeopardize a plan's tax status. In short, the burdens and risks presented by these proceedings are borne by other plan participants.

ERIC appreciates the financial problems of a dependent family or divorced spouse, but it believes that Congress intended plans to make unencumbered payments to participants and to have all creditors enforce their rights against the participant. We submit that an appropriate Congressional reaffirmation of this policy is urgently needed.

XII. LUMP SUM DISTRIBUTIONS (§ 301 OF S. 3017)

ERIC supports the principle that "defined benefit plans shall be considered separately from defined contribution plans for purposes of determining the balance to the credit of an employee under the lump sum distribution rules." The proposal should not be limited to multiemployer plans.

Generally, defined contribution and defined benefit pension plans of a particular employer cover different groups of employees or serve different purposes. For example, one plan may be the "primary" pension plan and the other may be a savings plan in which participation might be voluntary. An employee should not be required, for example, to withdraw in a lump sum (with adverse impact on savings) his interest in the "primary" defined benefit pension plan merely to assure that a withdrawal of his interest in the savings plan is treated as a lump sum distribution. ERIC strongly urges that all defined benefit plans of a single employer be treated as a single plan, separately from defined contribution plans of that employer, as would be the rule for multiemployer plans.

We also suggest that the proposal be clarified by inserting the word "multiemployer" before the word "plan" in each place it appears in proposed Code section 402(e) (4) (C) (ii). Otherwise, the proposal might be read to require that an employee who has rights under both a defined benefit multiemployer plan and a defined benefit single employer plan of the same employer might have to receive distributions from both plans to qualify for lump sum treatment.

Finally, we note that no employer "maintains" a multiemployer plan. By definition, such plans are maintained pursuant to collective bargaining agreements with more than one unrelated employer. Thus, the words "contributed to" should be inserted for "maintained" in proposed Code section 402(e) (4) (C) (ii).

XIII. DEDUCTIBLE EMPLOYEE CONTRIBUTIONS, SPECIAL MASTER AND PROTOTYPE PLANS, AND SIMPLIFIED PENSION PLANS (§ 303 AND TITLE IV OF S. 3017, S. 3140 AND S. 3288)

ERIC supports proposals which foster the growth of private plans, increase employee savings, and encourage capital formation. Thus, ERIC generally supports the goals of the special master and prototype plan and simplified pension plan concepts embodied in S. 3017 and S. 3140, respectively, but objects strongly to the proposal to apply the limits and other constraints applicable to H.R. 10 plans to simplified pension plans. All plans, large or small, should, at most, be limited by Code section 415 and the other constraints applicable to corporate plans.

More specifically, ERIC supports the concept of deductible employee contributions to qualified plans, such as those contemplated in S. 3288 and S. 3017, but urges that arbitrary and unnecessary limitations on gross income for eligible employees, such as those in section 303 of S. 3017, be rejected.

In addition, ERIC strongly urges that plans be given the *option*, and not be required as contemplated by section 303 of S. 3017, to accept employee contributions. The substantial associated administrative costs could dictate the choice of a defined contribution rather than a defined benefit plan. For smaller employers, it might even lead to the termination of existing plans. Even with defined contribution plans, employee contributions require separate accounts for employer and employee contributions and, thus, entail additional costs. Accordingly, many employers do not permit employee contributions even for individual account plans.

Indeed, the additional costs may exceed many employees' voluntary contributions. Lower compensated employees generally do not take maximum advantage of such programs. An election to contribute could be made annually. Once made, however, the individual account would be maintained until the employee's interest terminated. Thus, costs would be incurred indefinitely, even though a particular employee might make a single contribution of less than $1,000.

The cost inefficiencies would be exacerbated if an employer maintained more than one qualified plan for the same group of employees. For example, many larger employers maintain a defined benefit plan as the primary pension plan, a savings plan, and a stock bonus plan. If each such plan were required to accept contributions and employees were allowed to elect to which plan contributions were made, the amount contributed to any particular plan could be relatively minor, and employees might elect to disperse their contributions among such plans.

The voluntary contribution proposal presents other problems. For example, it does not state whether employee contributions can be withdrawn or the effects of such a withdrawal. Nor does it indicate that a terminated employee may be "cashed out" if he has no nonforfeitable rights to employer contributions. Administering small sums in such situations would be costly.

XIV. CREDIT FOR SMALL EMPLOYERS FOR ESTABLISHING PLANS (§ 304 OF S. 3017)

The proposal to grant credits to small businesses which establish plans is technically deficient and unfairly discriminates against larger employers and against small employers who have responsibly established plans. Employers who have not established plans would be "rewarded" at the expense of others (including competitors) who have been more responsible. Moreover, no employer should be denied a credit merely because it employs more persons who benefit from the plan, has greater annual receipts, or is affiliated with another employer and, thus, is a "large" employer.

The definition of "small business" under section 112 of the Small Business Administration Act varies for different purposes (*e.g.*, government procurement, lease guarantees, loans, etc.) and for different industries. Thus, there would be no certainty which employers might benefit from the proposal. Finally, although proposed Code section 44C(e) would attempt to deny the credit to employers who terminate plans, adjustments to the years for which a credit was claimed may be barred by the statute of limitations. For example, if an employer who claimed the credit terminated his plan in the ninth year following its establishment, all of the years in which the credit was taken generally would be "closed", and we understand that the Service does not normally retain returns of individuals or partnerships once the statute of limitations expires.

XV. CREDIT FOR IMPROVED PLANS (§§ 124 AND 305 OF S. 3017)

ERIC also opposes the proposal to grant income tax credits for "improved plans" which permit "significantly earlier participation" and "significantly more rapid" vesting than required by ERISA or if there is some other similar "significant improvement" in benefits and rights.

This proposal would discriminate perversely against those "enlightened" employers who have in the past maintained plans which exceed the requirements of ERISA by rewarding employers (including competitors) who have previously maintained minimally qualified plans.

In addition, the proposal would be difficult, if not impossible, to administer. How would the "significance" of an improvement be measured? A change in the vesting schedule for one plan may have a far greater effect on the number or percentage of vested participants than the same change by another plan. For example, even a change from ten to five year "cliff" vesting may have very little effect in some cases. Similarly, what would be a "significant improvement" in benefits? Would a "normal" increase pursuant to collective bargaining qualify?

XVI. RETROACTIVE DISQUALIFICATION OF PLANS (§ 307 OF S. 3017)

ERIC strongly supports the proposal to prohibit the Service from retroactively disqualifying a plan unless it is determined that the failure to meet the qualification requirements in preceding years was the result of an intentional failure or willful neglect on the part of the person maintaining the plan.

Prior to ERISA, a plan could be disqualified under the Code if, even inadvertently, it entered into a prohibited transaction or otherwise failed to meet the strict qualification standards. ERISA eased his draconian rule somewhat by substituting excise taxes for disqualification as the penalty for certain prohibited transactions. The proposal would further ease the burdens on persons who make good faith efforts to comply with ERISA and would further reduce the cases

where innocent beneficiaries and participants are hurt by disqualification. In *Aero Rental*, 64 T.C. 331 (1975), to a limited extent, the Tax Court applied a similar rule, and its statutory adoption would be welcomed.

XVII. ACTUARIAL/ACCOUNTING STANDARDS (S. 2992)

ERIC generally supports efforts to provide meaningful data to all interested parties. Nonetheless, we are troubled by the proposal to require the promulgation of "uniform standards for calculating and reporting the assets and liabilities of pension plans and for disclosing actuarial assumptions used in such calculations".

We are particularly concerned and confused that the proposal would amend Code section 412 which deals with minimum funding. Although generally accepted reporting standards might be useful for some purposes, we question the need for further government intervention (with all the ensuing regulations and cost) in this area and submit that flexibility in selecting actuarial methods and assumptions is imperative, especially for funding purposes.

The Labor Department intends to propose within a month new reporting standards and the American Academy of Actuaries, at the invitation of the Financial Accounting Standards Board, is studying these and related issues. S. 2992 should be deferred while these activities are ongoing and until the purposes of, need for, and implications of the proposal are better understood.

Economic Impact Analysis of a Capital Gains Tax Rate Reduction: Recommendation of Senator Russell B. Long—Merrill Lynch Economics, Inc.

I. INTRODUCTION

This report summarizes the economic impacts of a change in the calculation of long-term capital gains taxes recommended by Senator Long in a speech before the National Press Club in Washington, D.C., on July 26, 1978. The Senator's proposal calls for a reduction in the taxable portion of long-term capital gains from the current 50 percent level to 30 percent for individuals. This taxable portion would be taxed at ordinary income tax rates ranging from 14 percent to 65 percent. This part of the proposal is identical to that put forth in 1963 by President Kennedy as part of the Administration's recommendation for what became The Tax Reduction Act of 1964. However, the proposal did not survive in the final version of that Act.

Though not completely described in Senator Long's remarks it seems his intention to continue, in some form, the inclusion of capital gains as a preference income item for the individual Minimum Tax ". . . to assure that no millionaire would escape taxation." Current indications are that his final proposal will include an "Alternative Minimum Tax" for individuals, details of which have not yet been specified as of this writing. It is also likely that the corporate capital gains tax rate will be reduced in the final proposal—by an amount yet to be determined.

Therefore, for the purposes of this study we assume that the personal Minimum Tax and corporate capital gains tax structure will remain unchanged from present law.[1] Accordingly, the analysis described here assesses only the economic impact arising from the personal 30 percent inclusion and the 14 percent to 65 percent tax rate schedule versus the current 50 percent inclusion and tax schedule. Only these capital gains elements of the proposal are assessed. That is, no other tax rate cuts on ordinary income are assumed, even from the proposed downward shift in the income tax schedule.

The Senate Finance Committee staff indicates that the static estimate of revenue loss from these elements of Senator Long's proposal would amount to about $3.1 billion for the next fiscal year. This estimate takes no account of the dynamic effects of increased capital gains and realizations which are likely to ensue once the tax rate is cut. Nor does it include the likely effects of increased personal and corporate income tax receipts which the stimulated economy will generate. These factors can only be assessed in the context of a complete economic simulation, results of which are presented in the next section.

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[1] Also, the capital gains preference item remains at 50 percent, not 70 percent of long-term capital gains as other elements of the Long proposal might imply.

In assessing the economic implications of this tax rate reduction, we have used the Merrill Lynch Economics Macro Econometric Model employing substantially the same methodology applied in earlier studies of the Steiger-Hansen[2] and Jones[3] capital gains tax proposals. Use of this common approach allows the direct comparison of economic impacts across the three proposals.

II. SUMMARY OF RESULTS

Exhibit I presents the key economic impacts through 1980, of Senator Long's proposal in a comparison with the Merrill Lynch Economics Basic Forecast.[4] The tax rate cut is assumed to be effective in the third quarter of 1978.

In particular, the column headed "Senator Long" shows that his proposal accelerates real growth through increased real business fixed investment while creating over 300,000 new jobs by 1980. The stimulated economy results in hightened tax receipts such that the Federal Budget Deficit falls by nearly $4 billion in 1980. As in the earlier studies, the capital gains tax rate cut is essentially revenue-neutral and therefore does not, itself, contribute to the Federal deficit. That is, the capital gains tax rate reduction directly stimulates the stock market (up 6 to 7 percent) generating potential incremental capital gains tax liabilities sufficient to offset the statistically-calculated revenue shortfall of about $3.1 billion.

EXHIBIT I.—COMPARATIVE ECONOMIC IMPACTS OF ALTERNATIVE CAPITAL GAINS TAX RATE PROPOSALS

[Versus MLE Basic Forecast: 1978 third quarter to 1980 fourth quarter]

	Alternative proposals		
	Senator Long	Steiger-Hansen	Representative Jones
1. Acceleration in Real GNP Growth (percent)	0.3	0.2	0.1
2. Additional jobs in 1980 (thousand)	312	205	100
3. Reduction in the unemployment rate in 1980 (percent)	.3	.2	.1
4. Increase in real business fixed investment (billions of 1972 dollars)	$4.6	$3.2	$1.5
5. Reduction in Federal budget deficit in 1980 (billions)	$3.9	$2.3	$1.4
6. Increase in stock prices (percent)	6–7	4–6	2–3
7. Decline in long-term bond rates (basis points)	9–14	5–10	4–5
8. Increase in Federal funds rate in 1980 (basis points)	15	10	5
9. Increase in inflation rate in 1980 (percent)	.1	.1	0

In addition to these near-term impacts, longer term beneficial impacts can be inferred from the enhancement of real business investment. Heightened plant and equipment investment outlays serve to improve productivity—the well-spring of an improving standard of living—while expanding the overall activity of the economy to produce goods and services. As a bonus, both these effects would combine to ameliorate the inflation problem in the longer term.

As in the earlier studies, Senator Long's proposal results in virtually no adverse economic impact. Key exceptions include a slight acceleration in price inflation (up about 0.1 percent) and a small increase in the key short-term interest rate (Federal Funds) resulting largely from the assumption that Federal Reserve monetary does not accommodate the increased economic activity with easier money.

In general, Senator Long's proposal results in more beneficial economic impacts than the proposals assessed in the earlier studies. Exhibit I allows direct comparisons across the key economic indicators in the columns headed "Steiger-Hansen" and "Rep. Jones". The main reason for this result is that, unlike the other two proposals which cut tax rates only for the upper income individuals, Senator Long's proposal effectively cuts the tax rate for all taxpayers having long-term capital gains. Thus *all* taxpayers would face a reduced capital gains tax rate which instills a much more broadly-based incentive to invest and realize capital

[2] Gary L. Ciminero. "Economic Impact Analysis of the Investment Incentive Act of 1978 (S 3065)." Statement of Testimony prepared for the Senate Committee on Finance, Hearing of June 29. 1978. Merrill Lynch Economics, Inc.

[3] ———. "Economic Impact Analysis of the Capital Gains Tax Reduction: Proposal of Rep. Jones." Merrill Lynch Economics, Inc. June 27, 1978.

[4] The Basic Forecast of May, 1978 is used to allow a comparative assessment with the earlier proposal studies.

gains and a more pervasive distribution of tax benefits across income brackets. Accordingly, the statistically-estimated revenue loss is highest for the Long recomendation.[5] However, as indicated above, incremental capital gains resulting from the stock market increase alone are sufficient to generate additional potential tax liabilities in excess of this static revenue loss.

Finally, any further reduction in capital gains tax rates from current levels, whether in the personal Minimum Tax or the corporate ceiling rate, would likely enhance the economic benefits above the levels reported here.

MIDWEST COUNCIL FOR INTERNATIONAL ECONOMIC POLICY,
Chicago, Ill., September 5, 1978.

Hon. RUSSELL LONG,
Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The Midwest Council for International Economic Policy was organized in 1973 by a group of Illinois-based companies with international interests as a vehicle by which Midwest companies would study and express their views on international economic policy problems and thereby help in the development of sound solutions to such problems. Our activities have included testifying and presenting our views on key international issues with committees of the Congress.

Our membership has become increasingly concerned about continuing unfavorable trends in inflation and capital formation in this country, particularly with respect to the manner in which our national tax policy often exacerbates those trends. The attached statement of the Midwest Council demonstrates how the Midwest in particular suffers economically as a result of the hesitant progress of the current business recovery. In addition, the statement discusses the tax reform measures which we feel will encourage the economic recovery we all hope is forthcoming.

While the principles in this statement are a general consensus of our membership, they do not purport to be the company policy of each member. Some of the members have adopted specific corporate policies on the issues involved. We believe the paper will be of interest to you as it represents the views of Midwest businesses which have substantial business operations throughout the United States and in more than fifty other countries. Our member companies are listed at the bottom of our letterhead.

We hope this statement will be of use to the Committee as it begins deliberations on the Revenue Act of 1978. We would be pleased to meet with any Committee members or staff to discuss our experience and views should someone on your committee desire such discussions. Please feel free to contact us should you have any questions or wish further input.

Respectfully,

RICHARD A. HOEFS,
Chairman.

Enclosure.

STATEMENT OF THE MID-WEST COUNCIL FOR INTERNATIONAL ECONOMIC POLICY, WASHINGTON, D.C.

I. TAX REFORM IN AN ERA OF INFLATION AND GREAT CAPITAL NEEDS

Economic objectives of tax reform

Few will disagree with President Carter's stated concern that the U.S. needs tax reform to stimulate economic improvement and capital formation. We share these views for four basic reasons:

First, to stimulate the economy in the short term;
Second, to promote regular growth in the long term;
Third, to provide a sound foundation for private sector expansion;
Fourth, to get the revenue necessary to finance government needs.

The Midwest and the Nation

The Midwest is particularly concerned about the hesitant progress of the current business recovery because the national business cycle has a greater impact on the Midwest than on any other section of the country.

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[5] Long: $3.1 billion; Steiger-Hansen: $2.2 billion; Jones: $1.8 billion.

During the postwar period, U.S. nonfarm personal income grew at an annual average rate of 7.6 percent during expansions and 1.9 percent during recessions, the cyclical swing being the difference or 5.7 percentage points. Taking 5.7 percent as a base of 100, the cyclical swing in each state can be expressed as a percentage of the U.S. average swing.

Which are the most cyclically sensitive states? At the top of the list is Michigan with its cyclically sensitive auto industry at 195 percent of the U.S. average. Indiana, largely due to the cyclical sensitivity of its steel mills, is second at 191 percent; and Ohio with its heavy industry is third at 160 percent. Illinois is ninth at 122 percent and most Plains states are far lower. The attached Exhibit 1 demonstrates the cyclical sensitivity of broad economic regions of the country. The table shows that the Midwest and Southeast are the most sensitive to cyclical swings, but the Midwest stands out far above all others.

The Midwest also has a special relationship to the nation in regard to the balance of trade. The Midwest as a whole provides over half of the U.S. exports of agricultural products, transportation equipment, and machinery. These industries account for 55–60 percent of total U.S. exports. Success in exporting industrial goods in very competitive markets requires that U.S. export firms enjoy fair and consistent tax treatment of foreign income and expenses.

Capital needs and inflation

The position of the Midwest Council is that the key problems faced by the busines community today—whether in the Midwest or in the nation as a whole—are: The need for capital; and the impact of inflation on business and capital formation.

The United States needs to increase the share of its resources devoted to capital investment in order to increase productivity and real wages and to provide jobs for a growing labor force. The farmer, who at the end of the year finds that his revenue exceeds his costs, can either spend the net proceeds on consumption or he can invest in new equipment. With that equipment he can increase his productivity in future years. It is much the same for the industrialist or any businessman as it is for the farmer.

A declining rate of investment in plant and equipment has recently been slowing down growth in productivity and real wages. A congressional Budget Office study shows the growth rate of plant and equipment per worker fell from 2.6 percent in 1965–70 to 1.6 percent in 1970–75. Reflecting this drop, the growth rate in worker productivity fell from 2.4 percent in 1965–70 to 1.0 percent in 1970–75. The slowdown in productivity growth has in turn resulted in slower growth in real wages. Since 1969, real hourly wages have grown by less than 1 percent a year. The U.S. needs to reverse this downtrend and can begin doing so by reversing the tilt in the tax structure against business investment.

An additional reason noted above for increasing capital investment is to provide jobs for a growing labor force. Each year on the average, there are 1.5 million workers to be equipped with the tools of production. According to a Commerce Department study of 1975, the U.S. needs to devote 12 percent of real G.N.P. to business investment during 1975–80 in order to reduce unemployment to 5 percent. However, between 1965 and 1974, business investment averaged only 10.5 percent of G.N.P., and between 1975 and 1977, it averaged only 9.3 percent. Thus, business investment must be accelerated to 13 percent or more if G.N.P. is to reach economic and employment goals.

The U.S. lags other nations in investment, economic growth, and productivity growth. This is shown in Exhibit 2. As would be expected, the nations in which investment as a percentage of G.N.P. is largest are near the top in productivity growth and G.N.P. growth and, incidentally, most have large favorable trade balances. One will note from the chart the U.S. is overall last and the second to last country is the United Kingdom.

In the U.S., investment is financed principally from corporate savings, and the adequacy of corporate cash flow is much more important to maintaining a viable level of investment in the U.S. than in other industrial countries. Data in Exhibit 3 suggests that nearly two-thirds of domestic capital investment originates from corporate sources, substantially more than for any other country shown.

The inadequacy of domestic investment has been a persistent problem since the mid-1960's. It is the key weak spot of the present business recovery. A major cause of this stubborn problem is the inflation which has eroded both the incentives and the means for domestic investment. Reported profits of nonfinancial

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corporations, after taxes, have increased 115 percent since 1965. But when adjusted for inflation (underdepreciation and phantom inventory profits) they have actually declined 5 percent. Real return on investment (adjusted for inflation) has eroded. As shown in Exhibit 4, it was 3.7 percent in 1976—hardly an incentive to invest at today's cost of money.

The effective corporate tax rate, adjusted for phantom inventory profits and underdepreciation, peaked in 1974 and in the period 1974–76 substantially exceeded the statutory 48 percent rate based on Commerce Department statistics. Corporate tax cuts enacted since the 1950's have simply been insufficient to offset the ravages of inflation.

II. POSITIVE ASPECTS OF THE REVENUE BILL OF 1978, H.R. 13511

The tax reduction features of H.R. 13511 represent a step in the right direction because they seem to reflect a recognition of the capital formation problem. In justifying the business tax proposals contained in President Carter's initial tax package, the Treasury Department's Detailed Descriptions and Supporting Analysis states, "First, and of overriding importance, is the stimulation to capital formation both in the near future and over the longer term. . . There has been a downward trend in the rate of return on reproducible assets since the mid-1960's, a trend that must be reversed."

As the Treasury Department analysis goes on to say, reducing the tax burden on businesses has two effects. First, it increases cash flow and thus makes it easier to finance capital expenditures. Second, lower tax rates and net tax payments increase after-tax profits on investment, and this is an incentive for companies to increase capital spending.

A reduction of the corporate tax burden has an additional effect: it helps to offset the cost of inflation, which itself acts like an additional "tax" on profits.

This additional cost of inflation stems from the fact that businesses can deduct only the historical cost of their utilization of physical assets (fixed assets and inventory). In order to replace assets used up in production during a period of inflation, higher prices must be paid than the historical prices paid for the old assets. In other words, as mentioned earlier, much of reported profits are fictitious since costs of production have been understated. Thus, profits are overstated for tax purposes and corporations pay higher taxes than if their assets could be charged off in real terms.

For these reasons, we support the idea of cutting the basic corporate tax rate from 48 percent to 46 percent after 1979 and the reduction in the taxation of capital gains.

We also endorse making the investment tax credit permanent at 10 percent, extending it to the construction or rehabilitation of industrial and utility structures, and permitting investors to apply these credits to offset up to 90 percent of tax liability in any one year. And, because we are all aware of the government-imposed burden of increased capital expenditures for pollution control facilities, we are pleased that the government wants to liberalize the investment credit provisions to cover these facilities.

III. PROPOSED REFORMS IN INTERNATIONAL TAX AREA

U.S. international business faces severe competition

Even though H.R. 13511 does not propose revision of the existing taxation of U.S. international businesses, since the President proposed changes in such taxation, we would like to comment on the issues involved.

When changes in the law relating to U.S. international business are considered, it is essential to remember that the international business arena is highly competitive. The game is played in the other team's stadium and under its rules. Most important, the other team is a very competent one. Every major economy in the free world involves strong competitors of many countries, local companies and others. While we like to think U.S. business dominates the world economic scene, that idea is far from a fact.

To illustrate this point, let's look at four countries where almost one-half of U.S. foreign investment is located—Canada, the United Kingdom, Germany and France (See Exhibit 5). In those four countries there are over 280 local companies, owned by local persons or multinationals of other countries, with annual

sales exceeding $500 million. Even in Canada, a nation of only 23 million people, there are 30 non-U.S. owned companies with over $500 million sales. In that country, over 25 percent of U.S. foreign investment is located, and many people mistakenly believe that U.S. business has everything to itself. Looking to the next country where 10 percent of U.S. investment is concentrated, the United Kingdom, there are 118 non-U.S. owned companies of such size. In Germany and France there are almost 140 such size companies. In Europe in total there are over 250 companies of such size; over 35 percent of U.S. investment is in Europe, including countries not shown in the Exhibit.

Even this small examination of the world business scene is sufficient to illustrate that the competition is strong. Historically, it has been assumed that U.S. industry dominates world markets. While that once may have been true, particularly because of the ravages of World War II, it no longer is true. The relative position of U.S.-based multinational companies has declined significantly, particularly in the last ten years. Exhibits 6 through 10 illustrate some facts and trends regarding the world economic scene.

As Exhibit 6 demonstrates, in 1965 68 of the top 100 companies in the world were American; in 1976 the number had declined to 48, a drop of 22 percent. If petroleum companies are excluded, the drop is even more pronounced (See Exhibit 7). In 1965, of the 87 companies of the world's top 100 which were not in the petroleum industry, 57 or 66 percent were American. In 1976, of the 75 such companies, only 33, or 44 percent were American, a drop of almost 30 percent.

Another way to examine the trend is to compare the sales and assets of the top American companies with the sales and assets of the top foreign companies. Between 1965 and 1976 the total sales of the top fifty foreign companies grew from 46 percent to 76 percent of total sales of the U.S. top fifty. The asset growth of the top ten foreign companies compared to the top ten U.S. companies was similar, going from 35 percent in 1965 to 67 percent in 1976 (See Exhibits 8 and 9). As is evident from the lists in Exhibits 8 and 9, the foreign competitors are generally well known and are from Europe and Japan.

A third way of reviewing the trend would be to look at a bigger picture, the world gross national product (See Exhibit 10). In 1960, the U.S. economy produced 34 percent of world G.N.P. In 1975 we produced 25 percent. In contrast, the share of the European Economic Community rose by almost 5 percent and Japan rose over 5 percent.

Clearly, U.S. business no longer is the only big kid on the block, if it ever was. The local kids have grown up and, aided by the active support of their governments, have become top flight competition. In that competition, the taxation of the competitors is a vital factor in determining which will survive and continue to have an important share of the market. A significant additional tax imposed on one competitor will put it in a weaker competitive position. That weakness will be quickly recognized by the competition and exploited in many ways. If the weakness is large enough and the competition is astute enough, in a short time the competition will take over the market. When a competitor gains strength in the market in one country, it will probably use that strength to increase its position in markets in other countries. Eventually it could reach the posture of being a strong competitor for the market in the home country of the competition which had to pay the additional tax.

How do other countries determine taxable income?

If the United States taxes the unremitted earnings of foreign subsidiaries of U.S. business, it would be imposing a tax which the competitors will not face (See Exhibit 11). A comparison of the tax systems of seven countries where the principal competition is located shows that none of them tax such unremitted earnings other than on a Subpart F basis. Of equal importance is the fact that, in six of the seven countries, a business can earn income abroad under conditions where that income is not even taxed in the home country when that business brings it home as a dividend or foreign branch profits. Not shown in the chart is the fact that every country but Belgium and the U.S. allows special deductions for investments in or losses of foreign operations carried out through foreign subsidiaries. Clearly, U.S. business is barely even with the competition under present tax laws. If the U.S. tax law is changed as the President proposes, certainly the competitive balance will be tipped in favor of the foreign competition.

How do other countries tax foreign subsidiaries?

How important is the change in taxation of foreign subsidiaries likely to be? Will the change merely eliminate "incentives" offered by other countries to attract U.S. investment and thus help keep that investment here? Many of the countries where U.S. business invests have high corporate tax rates and one would think that the foreign tax credit would eliminate the U.S. tax if deferral were eliminated. Such a conclusion assumes, fallaciously, that our income tax law works the same as the laws of other countries.

How do other countries determine taxable income? Under U.S. tax rules, the taxable income in the other country will have to be restated to our taxable income principles in determining the U.S. tax against which the foreign tax credit applies. The four countries we looked at earlier where almost one-half of U.S. investment is located are a good sample of how other countries determine taxable income (See Exhibit 12). All four countries allow special writedowns of inventory with both Canada and the United Kingdom allowing it to compensate for inflation. Three of the countries allow special depreciation deductions and other fixed asset tax differences which significantly impact taxable income in a manner different from the United States. The U.K. allowance of a 100 percent write-off of the cost of new machinery and equipment probably presents the greatest difference from U.S. principles, but Canada also allows a 50 percent write-off. Two countries allow special reserve for estimated liabilities and two treat capital gains much differently than we do.

All these countries are high-tax countries and therefore the allowance of such adjustments to taxable income costs their national treasury significant revenue. Thus the countries have made decisions which say that all businesses operating there are entitled to pay less taxes. Those decisions are based on their economic considerations, their political systems, their level of inflation and numerous other national considerations. They are aimed at their many local businesses (as well as foreign-owned businesses) and thus are obviously not particularly aimed at stimulating U.S. investment there. Any U.S. Government action which would effectively wipe out the consequences of such decisions on profits earned in those countries could result in the accusation that the U.S. is violating the sovereignty of the countries involved.

Conclusion

As the charts so graphically illustrate, elimination of deferral would significantly hinder U.S. business in its competition in world markets. We strongly believe that not only would we be strengthening foreign competitors in markets in other countries but in our own domestic marketplace as well. We, therefore, oppose any change in the taxation of foreign subsidiaries of U.S. companies.

IV. ELIMINATION OF DISC

A second "reform" which has often been proposed by the President and which would be detrimental to business in particular and to the U.S. economy in general is the elimination of the Domestic International Sales Corporation, or DISC, tax incentive for exports. There are several reasons for our opposition to this proposal.

First, elimination could not come at a more inappropriate time, when the country has continued to incur its largest trade deficit in history. As a matter of interest, our official deficit counts imports on a F.O.B. ("free on board") basis, which takes into consideration only the value of imported goods as they leave the country. Most countries, including our major trade competitors, calculate imports on a C.I.F. (cost, insurance, freight) basis, which adds to the value of the goods the cost of insurance and shipping. If we did the same, the $26.7 billion U.S. trade deficit in 1977 would be revised to over $36 billion.

Quite aside from the dimensions of the trade deficit is another problem that has been ignored by the Administration, the steady decline in the U.S. share of world exports, from over 20 percent in the early 1950's to about 12.5 percent in 1977. By contrast, Japan's share has more than doubled in the past 15 years to 8.0 percent. Germany's share has increased from 5 percent in 1950 to 11.5 percent currently. Among major world commercial nations, only the United Kingdom's share has declined as rapidly as that of the U.S.

It has been frequently asserted that the trade deficit in large part is due to recent increases in U.S. petroleum imports. But is this the complete story? An

examination of the trade statistics shows that the real problem is not only imports, but also exports, and specifically a slowdown in the growth rate of our exports in recent years.

During the years 1969 to 1977, U.S. imports have grown on an average of 4 percent to 4.25 percent each year. Exports, on the other hand, have slowed down; from 1969 to 1974 they grew at an annual average of 8.3 percent, but since then the annual average has fallen to only 1.75 percent, far below the growth rate for imports.

In sum, the United States has steadily been losing ground to its competitors as an exporting nation, and recently its rate of export growth has slowed appreciably—yet the Administration wants to remove a key export incentive!

This leads to a second argument in favor of DISC, namely, that it is one of the few incentives that U.S. exporters can take advantage of, in comparison to what is available to exporters in other countries. Without DISC, U.S. exporters are left with very few stimuli to sell overseas—chiefly the direct loan, guarantee, and insurance programs offered by the Export-Import Bank and the Foreign Credit Insurance Association.

Other major trading nations offer a great variety of export incentives, both in terms of taxes and in other benefits. Looking strictly at tax incentives, many countries offer what amounts to tax subsidies for exporters (See Exhibit 13) either through regional investment incentives or via rebates of value-added taxes on goods that are exported. This latter feature is the heart of the European Common Market's tax system. There is no U.S. counterpart.

Furthermore, beyond the tax incentives that countries offer specifically for exporting, their tax systems often operate to the advantage of exporters in ways that the United States has chosen to avoid. Most countries refrain from taxing the profits of trading subsidiaries located outside the home country. This means that a French or Dutch company, for example, can set up an offshore exporting company through which all export earnings are channeled. These earnings can then be used to finance other exports or foreign investments and not be taxed as long as they are not remitted to the home country. The United States, on the other hand, undermined such export companies in 1962 with the adoption of the so-called Subpart F provisions of the tax code.

Furthermore, in the case of The Netherlands, Belgium and France, even when export earnings are returned to the parent company they are either not taxed or taxed only nominally.

DISC, in a sense, was a partial restoration of the deferral of tax on export earnings. But since other countries effectively allow 100 percent deferral of tax on export earnings, U.S. exporters are still competing literally with one hand tied behind our back.

Outside the tax area, the differences are even greater. (See Exhibit 14). Most countries not only offer programs like those of the Export-Import Bank, but go well beyond. So-called "mixed" credits are offered exporters—a blend of low-interest-rate, long-term foreign aid money along with more commercially priced traditional export financing. Interest subsidies are common, and some countries, such as France, Germany, Italy and Canada, also offer outright capital grants in addition to loans on guarantees.

By contrast, the United States Eximbank loans are not subsidized, and the Bank's interest rates are based on the cost of the money Eximbank borrows. Foreign aid financing through the Agency for International Development is available only for specific projects in certain less developed countries, and is not "mixed" with straight export financing. The United States has no capital grant program for exports.

This, then, is what United States companies face in competition for export markets. The same facts are also relevant in another matter, the multilateral trade negotiations now going on in Geneva.

One of the most difficult topics of discussion in Geneva is the issue of export subsidies. Our trading partners want the U.S. to change its countervailing duty law, which allows us to retaliate against subsidized exports of other countries sent to the United States. In return the U.S. is asking for elimination of their most blatant export subsidies. The trading partners claim that DISC is also an export subsidy, which makes DISC something over which to bargain, along with the countervailing duty law. In other words, retaining DISC is one of the few weapons the U.S. has in the fight to eliminate foreign export subsidies, which some U.S. industries have complained are hurting them. Does it make sense

from a negotiating point of view to give up DISC unilaterally, when we have the opportunity of getting something in return for it at Geneva?

Finally, only two years ago Congress amended the DISC system to meet criticism that DISC was an unearned windfall to large exporting companies. The argument against DISC was that these companies were already exporting prior to DISC, so DISC merely gave them a reward for something they would have done anyway. Since the 1976 changes, however, DISC deferral has been granted only to export income that exceeds the annual average of a five-year base period. In other words, now a business only gets DISC benefits if it increases exports over what it was doing in previous years. As it now stands, DISC acts as an incentive to keep exports expanding, which was its original purpose.

If Congress were to change the ground rules for a third time in six years, it would only increase the uncertainty that business faces in planning. The last change is two years old. The new DISC system should be given time to see how it actually works to stimulate exports. We oppose any further increase in the taxation of DISC income.

Cyclical sensitivity of districts of the United States

Area:	*Cyclical swing*
U.S.	100
Northeast	89
Southeast	99
Midwest	121
Southwest	83
Mountain	38
West	79

NOTE.—Total stability would be represented by a zero swing. The normal swing of 5.7 nationwide is represented by 100 above.

EXHIBIT 2.—INVESTMENT RATIOS COMPARED WITH GROWTH IN OUTPUT AND PRODUCTIVITY

[Average 1960–76]

	Investment/GNP		GNP growth rate		Manufacturing productivity growth	
	Percent	Rank	Percent	Rank	Percent	Rank
Japan	33.0	1	8.8	1	9.2	1
France	24.4	2	5.0	2	5.9	2
West Germany	24.2	3	3.9	5	5.9	2
Canada	22.6	4	5.0	2	3.7	5
Italy	21.0	5	4.6	4	5.7	4
United Kingdom	18.6	6	2.5	7	3.4	6
United States	17.7	7	3.6	6	2.6	7

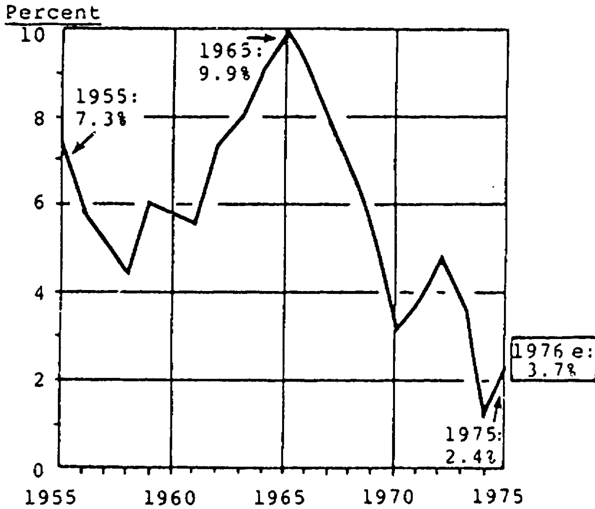
EXHIBIT 3.—FINANCING CAPITAL INVESTMENT

[Percent of total savings]

		Noncorporate		
	Corporate	Individual	Government and foreign investors	Total
United States	65.5	31.4	3.1	100.0
Canada	58.2	24.4	17.4	100.0
United Kingdom	59.7	37.7	2.6	100.0
West Germany	47.2	37.3	15.5	100.0
France	52.7	32.5	14.8	100.0
Netherlands	41.7	39.4	18.9	100.0
Belgium	42.1	52.4	5.5	100.0
Sweden	56.2	21.7	22.1	100.0
Australia	30.1	50.5	19.4	100.0
Japan	41.2	38.9	19.9	100.0

Data source: "U.N. Yearbook."

EXHIBIT 4



* After-tax profits, excluding inventory profits, and adjusted to reflect economic depreciation (double declining balance, .75 Bulletin F service lives) as a percent of plant, equipment, and inventories valued at replacement cost.

SOURCE: Calculated from Commerce Department by the Business Roundtable.

EXHIBIT 5.—COUNTRIES IN WHICH U.S. BUSINESS INVESTS AND COMPETITION LOCATED THERE WITH SALES EXCEEDING $500,000,000

Country	Percent of U.S. investment located there	Number of local companies
Canada	25.4	30
United Kingdom	10.3	215
Germany	6.7	81
France	4.9	56
Total European countries	21.9	252
Total	47.3	282

Sources: Commerce Department, London Times, Financial Post (Canada).

EXHIBIT 6.—DISTRIBUTION OF THE WORLD'S 100 LARGEST INDUSTRIAL COMPANIES

[Ranked by sales]

Country	Number of companies		
	1965	1970	1976
United States	68	63	48
West Germany	12	10	12
Japan	2	8	11
France	3	3	8
United Kingdom	9	7	7
Italy	2	3	3
The Netherlands	1	2	2
Other	3	4	9
Total companies	100	100	100

Source: Fortune, various issues.

EXHIBIT 7.—DISTRIBUTION OF THE NONPETROLEUM COMPANIES THAT ARE AMONG THE WORLD'S 100 LARGEST INDUSTRIAL CORPORATIONS

[Ranked by sales]

Country	Number of companies		
	1965	1970	1976
United States	57	49	33
West Germany	12	10	12
Japan	2	8	10
France	3	2	6
United Kingdom	8	6	6
Italy	2	2	2
The Netherlands	1	2	2
Other	2	3	4
Total companies	87	82	75

Source: Fortune, various issues.

EXHIBIT 8.—TOTAL ASSETS OF THE 10 LARGEST NONPETROLEUM INDUSTRIAL COMPANIES

[Ranked by sales in 1976]

U.S.-based companies	1965	1976
General Motors	$12,586	$24,442
Ford Motor	7,597	15,768
International Business Machines	3,745	17,723
General Electric	4,300	12,050
Chrysler	2,934	7,074
International Telephone & Telegraph	2,022	11,070
U.S. Steel	5,452	9,168
E. I. du Pont de Nemours	2,848	7,027
Western Electric	2,303	5,178
Procter & Gamble	1,337	4,103
Total	45,124	113,603

Source: Fortune, various issues.

EXHIBIT 9.—TOTAL ASSETS OF THE 10 LARGEST NONPETROLEUM INDUSTRIAL COMPANIES

[Ranked by sales in 1976]

Foreign-based companies	Country	1965	1976
Unilever	United Kingdom	$3,105	$7,794
Philips'	The Netherlands	2,728	12,245
Renault	France	524	2,733
Hoechst	West Germany	1,157	8,754
Basf	do	1,051	6,579
Daimler-Benz	do	556	3,566
Volkswagenwerk	do	1,137	6,144
Bayer	do	1,165	8,517
Nippon Steel	Japan	2,278	11,625
Siemens	West Germany	1,401	8,230
Total		15,602	76,187
Ratio of assets of top 10 foreign companies to assets of top 10 U.S. companies (percent)		34.6	67.0

Source: *Fortune*, various issues.

EXHIBIT 10.—SHARES OF WORLD GROSS NATIONAL PRODUCT

[In percent]

Country	1960	1970	1975
United States	33.7	30.7	25.0
EEC (excluding United Kingdom)	12.8	15.8	17.1
United Kingdom	4.7	3.8	3.6
Japan	2.6	6.2	8.3
All other countries	46.2	43.5	46.0
Total	100.0	100.0	100.0

Sources: "International Economic Report of the President," 1976, and OECD data.

EXHIBIT 11.—TAXATION OF INTERNATIONAL BUSINESS

Home country	Does country tax profit of foreign subsidiary— When unremitted	When paid as dividends	Earnings of foreign branch	Is foreign tax credit given	Are foreign earnings taxed as a practical matter
Belgium	No	No	No	Not needed	No.
France	No	No	No	do	No.
Germany	No [1]	Yes	Yes	Yes	No.
Italy [2]	No	Yes	No	Partially	Partially.
Japan	No [1]	Yes	Yes	Yes	No.
The Netherlands	No	No	Yes	Yes	No.
United Kingdom	No	Yes	Yes	Yes	No.

[1] Germany has limited subpart F type of provisions. Japan will have limited subpart F type provisions effective Apr. 1 1978.

[2] Italy only taxes foreign branches which do not have separate management and accounting. It only allows foreign tax credits for taxes paid on branch income and for withholding taxes.

EXHIBIT 12.—SUMMARY OF UNUSUAL TAX DEDUCTIONS OR EXEMPTIONS IN 4 KEY COUNTRIES WHERE U.S. BUSINESS INVESTS

Nature of item	Canada	France	Germany	United Kingdom
Corporate tax rate (percent)	42 or 48	50	44 to 61	52
Arbitrary inventory write down	X	X	X	X
Very fast depreciation	X			X
Depreciation of goodwill	X			
Tax free reinvestment of gains on fixed assets	X		X	
Office buildings not depreciable				X
Investment tax credit	X			
Reserves for estimated expenses		X	X	
Capital gains specially taxed	X	X		

EXHIBIT 13.—TAX INCENTIVES FOR EXPORTS

	United States	Canada	Japan	United Kingdom	France	Germany	Netherlands
Taxation of foreign branch income.	Fully taxable at usual rate (48 pct). Foreign tax credit.	Fully taxable at usual rate (46 pct). Foreign tax credit.	Taxable at usual rate (effective tax rate of 52 pct). Favorable foreign tax credit system.	Taxable at usual rate (52 pct). Foreign tax credit.	Exempt [1] (corporate tax rate is 50 pct).	Normal tax rate (51 pct) plus foreign tax credit or, in certain cases, imposition of a flat 25 pct tax rate.	Taxed at usual rate. Favorable foreign tax credit system.
Taxation of foreign subsidiaries.	Yes, under subpart F provisions.	Yes, but under conditions less stringent than under subpart F income.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None except if election is made. No subpart F income equivalent.	Yes, but under conditions less stringent than the U.S. subpart F provision.	None. No subpart F income equivalent.
Deductibility of foreign branch losses.	Fully deductible	Fully deductible	Fully deductible	Fully deductible. Deductible against foreign source business income only when carried over to following years.	Not deductible [2]	Fully deductible even though foreign income is exempt under tax treaty.[3]	Fully deductible.
Taxation of foreign source dividends.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Exempt when foreign subsidiary is controlled (50 pct). Partial exemption from 1976. Foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	95 pct exclusion if French company owns 10 pct or more of stock.	Fully taxed at usual rate. Foreign tax credit and deemed paid foreign tax credit under certain circumstances.	Exempt in majority of cases.
Special deferrals of taxable domestic income.	About 25 percent of taxable income may be deferred under the DISC provisions.	None	Income may be deferred for: Overseas market development; overseas investment losses; foreign exchange losses.	None	Income may be deferred for: Losses of certain foreign business; cost of investment in certain business in LDC's; export credit extended to foreign buyer.	Income may be deferred for: Losses of foreign branches whose income is tax exempt; losses of foreign subsidiaries; profits realized upon an exchange of property for stock of a foreign corporation.	None.

Specific export tax incentives	None aside from DISC.	None	Reserves for overseas market development—deduction of overseas investments. Reserves for foreign exchange losses. Special deductions for certain overseas transactions.	Deduction of business entertainment expenses connected with export activities.	Joint export programs—election to compute income on a worldwide basis. All special deferrals. Exclusion from the "inflation levy."	None	Tax credit for withholding tax on interest and royalties paid by resident in certain nontreaty LDC's.
Intercompany pricing rules	Strictly enforced, including against export industry. Important cases against exporters pending.	None	Favorable treatment for exporting companies.	Not actively used	As a general rule, not enforced against exporters.	Usually enforced although relaxation may be granted in special circumstances.	Usually enforced but special agreement used. May be negotiated with the tax authorities.
Border tax adjustments (VAT)	None at Federal level	None	None	VAT (8-pct rate up to 25 pct for luxury items). Zero rate on exports.	VAT (20-pct rate up to 33 pct for luxury items). Zero rate on exports.	VAT (11 pct rate). Zero rate on exports.	VAT (16-pct rate). Zero rate on exports.
Tax incentives indirectly benefiting exports.	Accelerated depreciation. Investment tax credit (10 pct).	Tax reduction for manufacturing income. Accelerated depreciation.[1] Investment tax credit.	None	Favorable rates of depreciation.[1]	Accelerated depreciation. Exemption from local business tax. Reduction of registration taxes.[4]	Accelerated depreciation. Reduction of corporate tax rate and VAT rates.[4]	Accelerated depreciation.[4] Investment tax credit from 8 pct to 16 pct of cost of certain capital assets.

[1] Foreign branch income is taxable at usual rate if the French company elects to be taxed on a worldwide or consolidated basis.

[2] Losses of foreign branches are deductible when the domestic company elects to be taxed on a worldwide or consolidated basis.

[3] When the income has not been taxed abroad, the amount deducted for foreign losses must be put back into income after a number of years.

[4] Most of the tax incentives are granted in connection with industrial and regional development.

Source: Special Committee for U.S. Exports.

EXHIBIT 14.—NONTAX INCENTIVES FOR EXPORTS

	United States	Canada	Japan	United Kingdom	France	Germany	Netherlands
Nontax incentives indirectly benefit exports.	None, except limited agricultural subsidies.	Cash grants [1]		Grants. Investment subsidies. Interest subsidies [1] Employment subsidies.[2]	Grants. Investment subsidies.[1]	Grants [1]	Investment subsidies. Interest subsidies. [1]
Financing assistance	Discount at medium rates. Guarantees. Long-term export credit financing at interest rates from 8.24 to 9.5 pct. No mixed credits. Financing of 30 to 55 pct of contract value.		Direct loans for medium-term sales. Long-term credits at preferential rates (from 7.5 to 8.75 pct). Financing of contract value from 48 to 64 pct. Mixed credits.	Guarantees. Interest rate subsidies. Portfolio refinancing. Support granted on a supplier and buyer basis. Interest rate born by borrowers: 7.8 pct. Financing of up to 100 pct of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Financing of up to 100 pct of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Preferential rates of 10 pct. Financing of up to 80 pct of contract value. Mixed credits.	Discount at low rates. Guarantees. Subsidized medium and long-term export credits. Average interest rate borne by exporters is 9.5 pct. Financing of up to 90 pct of contract value.
Insurance assistance	Are insured: Commercial risks; exhibition expenses; political risks. Risks are covered up to 95 pct.		Are insured: Production risks; commercial risks; political risks; currency fluctuations; loss of foreign investment. Risks are covered from 60 to 80 pct.	Are insured: Commercial risks; political risks; production risks; inflation risks; currency fluctuations; performance bonds. Risks are covered up to 100 pct.	Are insured: Production risks; commercial risks; political risks currency fluctuations; market development; exhibition expenses; inflation risks. Risks are covered from 80 to 100 pct.	Are insured: Production risks; commercial risks; political risks; currency fluctuations; inflation risks. Risks are covered from 80 to 100 pct.	Are insured: Commercial risks; political risks; currency fluctuations. Insurance fully covers from 75 to 100 pct of the risks.

[1] Most of the nontax incentives are granted in connection with industrial and regional development.
[2] Granted to order to encourage employers to retain employes.

Source: Special Committee for U.S. Exports.

STATEMENT OF MARIE NAHIKIAN, TENANT COMMISSIONER, DISTRICT OF COLUMBIA RENTAL ACCOMMODATIONS COMMISSION

My name is Marie Nahikian, and I am a tenant representative on the District of Columbia Rental Accommodations Commission. I am presenting this testimony because I want you to take into account a viewpoint which you have not considered and apparently do not think worth much of your time. This is the viewpoint of people struggling to make ends meet and to get onto the home ownership ladder in the neighborhoods of this nation's cities.

You have before you billions of dollars in proposed capital gains tax cuts. These have been cast onto the public stage in the familiar costuming of jobs and economic growth, but in fact only a small portion of the cuts would serve that end. The rest would be nothing more than tax cuts for the rich decked out in the verbiage of economic growth. But benefits for rich people are not my main concern. My main concern is that the economic impact of these tax breaks could be devastating to probably millions of people, most of whom do not know that these hearings even exist. You have heard from industrialists, realtors, developers, and virtually every conceivable interest with a buck to make from this tax bill. You have heard from a few public interest representatives. But you have heard nothing from the people whose lives are going to be affected by the provisions of the proposals before you.

Economics is about people. It is about people's needs and how these needs are met. I want to bring the discussion down from the grandiose macro-economic ego-tripping and condescending trickle-down economics which have held the floor, and I want to talk about what giant capital gains tax cuts are going to mean to the tenants and lower-income homeowners with whom I have been working on the streets of Washington for the last eight years.

My testimony will not focus upon any of the particular capital-gains-cut proposals before you. It will discuss instead the dangers of indiscriminate capital gains cuts of any kind.

Congress has been talking about capital gains as though they were all one thing, and that, uniformly good. The public has been subjected to vague and lofty generalities equating capital gains breaks to "capital formation", jobs, economy in government, balanced budgets, a brake on inflation, and—for all I know—relief from neuritis and neuralgia. The trouble is that capital gains are not all one thing. In fact only a quarter of them arise from the sale of corporate stock, and are therefore related—arguably—to capital formation. An equal percentage represents gains from real estate. And this is my concern.

In the District of Columbia, in many other cities across the country, and in many rural areas as well, we are suffering from a plague of capital gains in real estate. Only we do not use the sanitized expression "capital gains." We call this activity what it is—speculation. Speculation in inner city real estate is driving up housing prices beyond the reach of most middle-income home buyers. It is forcing lower income tenants from their neighborhoods. By inviting higher property tax assessment increases, it is forcing our elderly and lower income home owners to sell. Speculation has become so severe that our City Council recently enacted a special tax on this activity. The state of Vermont did so several years ago, and numerous states and cities are considering such proposals actively.

The last thing we need in the District is indiscriminate capital gains tax breaks for real estate speculators. Selected breaks for specific kinds of investment, such as low income housing, might be advisable. But not across-the-board breaks for anyone desiring to take a speculative ride on the over-heated real estate market. Our speculation problems are already, to a degree, tax-law induced. The indulgence of the federal tax laws towards real estate investment, combined with the lethargic stock market, has encouraged millions to put their money into real estate. A home is no longer a home—it is a hedge. Now this Committee seems on the verge of making matters worse.

Speculation in real estate is fundamentally different from other kinds of capital investment. When a corporation issues stock and uses the proceeds to invest in plant or equipment, it is creating something. It is providing productivity. It is adding to wealth. It may be making a net addition to employment. Real estate speculation by contrast, creates nothing. The supply of land is fixed. Investment in land does not create land. It simply increases the price of the land that exists. Another name for this is inflation.

Such inflation, in turn, has a disastrous effect upon jobs and inner city housing. When developers, entrepreneurs' of any sort, have to pay exorbitant land

costs, they have that much less money to put into the structure, be it a house, an office building, or a factory. In other words, high land costs drain capital from job-creating structures on land. Builders in the District have told me that site costs [1] in some D.C. neighborhoods are becoming so high they can economically build only the highest-price housing, if indeed they can afford to build anything at all.

If land costs could be lower, there would be more money available for construction, which creates housing and jobs. Furthermore, since land costs comprise between 20% to 25%, or more, of much new housing, the cost of housing could be reduced substantially.

The only way to reduce land, or site, costs is to make land less attractive to speculators. This is simple supply-demand economics. The supply of land is fixed. If it is a very attractive investment, many people will want it who have no intention of building upon it or making improvements. They will simply hold it off the market until they sell for a gain. If many people want it, the price goes up. Cut out the speculators' profits and speculators stop competing against homeowners and developers for the limited available land and housing. With demand down, prices will go down also.

The testimony of Mr. James H. Shimberg of the National Association of Homebuilders on this point was patently absurd. Mr. Shimberg argued that cutting capital gains taxes would reduce land costs by encouraging land owners to sell their property. Whatever inducement such a cut would have on owners to sell their land—and I am skeptical—it would be more than outweighed by the increased demand for land that the cuts would spur.

In fact, given the stale stock market, I suspect that a big capital gains tax cut would encourage many investors to bail out of the stock market and get into real estate—increasing demand instead of supply, and producing absolutely the opposite impact from that the proponents of this cut profess.

In California, much of the impetus behind Proposition 13 arose not from a "tax revolt" but from an "assessment" revolt. Soaring housing costs were causing property tax assessments to soar as well. Far from curbing this trend, Proposition 13 seems to be inflaming it. By reducing ownership costs, Proposition 13 has made homes even more attractive investments than they were before, for speculators as well as for homeowners. As a result, home prices continue to increase.

Cutting capital gains taxes for real estate speculators would have a similar effect.

The debate over this tax cut bill has been obsessed with what the economists call "capital formation." I do not want this Congress to forget that for millions of Americans, including the people for whom I am speaking, the prime and possibly only form of capital formation is a home. And the tax cuts before you would do more to put a home beyond the lower and middle income person's reach than practically anything I can imagine. Consider:

a. First, the tax cuts in the House-passed bill are tilted severely toward the upper income levels. When social security tax increases are taken into account, people in the middle and lower brackets end up not with a tax cut but with a tax increase. This means that these people, who have the most difficulty scraping together the down payment for a home, will be even less able to save.

b. At the same time, capital gains tax breaks, along with other provisions in the House bill, promise to inflate the price of homes at a time when lower and middle income people can least afford it.

c. The crowning irony, of course, is that federal subsidy programs will be necessary to bridge the widening gap to help lower and middle income people with their housing costs. Tax breaks for wealthy investors and corporations will mean that the funds for these subsidy programs will come increasingly from the pockets of the very taxpayers for whom the subsidies will be necessary.

Perhaps the crowning absurdity of the House-passed bill, as it applies to real estate speculators, is the "indexing" provision. Under indexing, the speculator would be allowed an inflation adjustment each year. A part of his profit would be declared tax-free, an "inflationary" gain instead of a "real" gain. Now consider. Real estate speculation is a cause of inflation. It makes land and housing prices go up. To treat inflation by rewarding one of its causes makes about as much sense as attacking arson by providing a tax break for arsonists. It may fly with the real estate lobby but it shouldn't with anyone else.

In short, the reality of these proposed capital gains tax cuts does not match their pretensions. This is true not only of the real estate area but of other kinds

[1] By "site" costs I mean both the land and any structures on the land when these are in need of substantial rehabilitation.

of capital gains as well. The tax cuts are promoted as encouraging job-producing investment. In the District of Columbia this is of great concern to us because our youth unmployment rate is alarmingly high. We need job-producing investments, and it is especially bitter to us to find the capital gains tax cuts to be a fraud.

Nothing in the proposed cuts limits them to job producing investments. To the contrary, they go to any kind of capital gain even if actually contrary to job creation. Mere transfers of existing corporate shares (as opposed to purchases of new issues) do not create jobs, but they qualify. When people sell their shares of stock and invest in land, antiques, gold, or vacation homes in the Bahamas, inner city jobs are not created. Yet all such diversions of capital would qualify for this new tax break. Such a measure will be as effective in encouraging job creation as would dropping dollars from a blimp.

If the purpose of this tax bill really is to encourage job creation, then the benefits should be limited to investments which actually have that effect—for example, purchases of newly-issued stock.

The fraud of the capital gains proposals is still worse because the District, lik numerous states, follows federal law in the treatment of capital gains. In other words, what Congress does in this area, we do also, even though it will be directly contrary to our interests. States have been under substantial pressure in recent years to conform their tax laws entirely to the federal code. If Congress wants this to happen, it had better show more concern for the impact of its tax laws on states and cities than it has shown in considering this year's tax bill.

RECOMMENDATIONS

My recommendations are very simple:

1. First, you must lay aside the macro-economic fantasy of assuming all capital gains are uniformly good. You must be willing to examine the social impact of each major kind of capital gain and especially real estate speculation.

2. Second, following up on No. 1, you must conduct a study of the relationship between capital gains tax breaks and the inflation which is driving up housing costs and which is forcing lower and middle income people from their homes.

3. Third, you must completely ban capital gains tax breaks for real estate speculators. In fact, you must impose tax penalties upon such speculators. You could do this by taxing speculative real estate gains as they accrue each year instead of waiting until the property has been sold. Also, tax rates on such speculative gains should be increased.

If real estate speculation were no longer profitable, investors would take their money out of real estate and put it into more productive forms of investment. This would free up land for productive use. It would reduce the demand for productive use. It would reduce the demand for residential property, thereby lowering the cost.

I am presenting here only the broad outlines of an approach. Certain problems would have to be worked out, problems such as the definition of a "speculator" and the transition rules to avoid penalizing investors who relied in good faith upon the existing laws. Such problems are surmountable. The people who wrote the incredible complexity into the existing income tax laws certainly can deal with details such as these.

4. Finally, capital gains tax breaks must be carefully tailored to the kinds of investment, such as low and moderate income housing, which our cities in particular need most. I read with alarm the testimony of shopping center representatives, urging still greater capital gains breaks to encourage more shopping centers. Shopping centers have been the death knell for center city business districts. Do we really want to encourage more of them at a time when we are trying both to discourage gasoline consumption and bring economic life back to our inner cities?

CONCLUSION

I conclude where I began. Congressional glad-handing with indiscriminate capital gains tax breaks threatens to disrupt the lives to millions of Americans. It will drive up the price of homes. It will cause property tax assessments to inflate, forcing lower income homeowners to sell. It will drain capital from job-creating investments into land costs. Congress must stop dealing in grandiose generalities about capital formation and begin to deal with the real impact tax law changes have upon Americans in the communities in which they work and live.

NATIONAL ASSOCIATION OF MANUFACTURERS,
Washington, D.C., August 31, 1978.

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

DEAR MR. CHAIRMAN: These comments on those provisions of H.R. 13511 which would be tax unemployment compensation benefits are submitted on behalf of the National Association of Manufacturers (NAM) in addition to our general testimony of August 21.

The NAM opposes the provision of H.R. 13511 which would subject a portion of unemployment compensation and disability benefits to taxation. A National Commission on Unemployment Compensation is studying the Unemployment Compensation system to provide more in-depth information on this subject. We recommend that Congress take no action in the direction of taxing unemployment compensation benefits until the study by the National Commission is completed.

At present, there is no domestic experience with taxation of unemployment compensation benefits upon which to evaluate this proposal. Our comments will list briefly some of the problems which this proposal could create in the underlying principles of taxing benefits, the method of taxing benefits, the equity of the present proposal and the effect upon state unemployment insurance systems.

Unemployment Compensation is a contributory insurance program to provide replacement wages for temporary periods of unemployment. Benefits are therefore a matter of right not of deed. The specific proposal in H.R. 13511 could introduce a means test into the program which is contrary to the principles upon which social insurance programs are based and would set a precedent for taxing benefits received under other social insurance programs.

Administratively, reporting the payment of unemployment compensation benefits would have to be undertaken by either states or employers. The administrative burden upon either states or employers is unjustified to tax a small percentage of all unemployment compensation recipients.

The wage earners affected by these provisions receive the least replacement for their earnings of all unemployment compensation recipients. Consequently, the work incentive is already likely to be highest for workers in this group. Additional taxes to increase the work incentive of unemployment compensation recipients is not appropriately targeted at these workers.

States may be inclined to raise unemployment compensation benefits to offset income loss to individuals. Many States' unemployment insurance funds are repaying outstanding loans from the federal unemployment insurance fund. Any increased outlays by states without increased revenues will aggravate many states unemployment compensation systems' financial problems.

We are submitting this with five copies for inclusion in the record of your hearings.

Sincerely yours,

RANDOLPH M. HALE,
Vice President and Manager,
Industrial Relations.

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.,
Washington, D.C. August 29, 1978.

Re The Impact of the Present Capital Gains Indexing Provisions of H.R. 13511, the "Revenue Act of 1978", upon real estate investment trusts.

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

DEAR MR. CHAIRMAN: I am writing to you on behalf of the National Association of Real Estate Investment Trusts, Inc., of which I am President, to alert you to the devastating impact which certain provisions of H.R. 13511, the "Revenue Act of 1978", would have on the real estate investment trust industry. H.R. 13511, recently enacted by the House of Representatives, provides an inflation adjustment ("indexing") for certain assets when computing capital gain or loss on

sale. Indexed assets include common stock, tangible personal property and real property, with certain exceptions.

As drafted, H.R. 13511 denies indexing to shares of REITs, making those shares virtually unique on the stock exchanges of America. No industry could survive such a crippling blow. REITs would find it almost impossible to raise funds in the capital markets through sales of shares.

Further, enactment of H.R. 13511 in its present form would impose a substantial immediate loss on the more than 300,000 holders of REIT shares, as the capital markets adjusted to this change in the law.

We cannot believe that Congress intends such a result. The legislative history of Public Law 86-779, the 1960 legislation which created the REIT industry, is clear. Real estate investment trusts were designed to enable small investors, through pooling, to make capital investments in real estate. REITs give small investors the advantages of diversification of investment, the opportunity to secure the benefits of expert investment counsel, and the means to finance projects collectively which they could not undertake individually. Prior to the 1960 legislation, these advantages were available only to large investors.

The 1960 legislative history makes clear that Congress considered the encouragement of investment in real estate by small investors through real estate investment trusts particularly important, ". . . because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels. At the present time the financing of these real estate equities and mortgages is dependent largely on Government-guaranteed money, and investments by special groups, such as insurance companies, and pension trusts." (Report No. 86-2020, House of Representatives, 86th Congress, 2d Session (1960) at page 4). This worthy legislative purpose would be completely frustrated by excluding REITS from the benefits of indexing.

H.R. 13511 would exclude from indexing shares in a "qualified" real estate investment trust, regulated investment company, Subchapter S corporation and other so-called "conduits". In the report of the Committee on Ways and Means on H.R. 13511 (Report No. 95-1445, House of Representatives, 95th Congress, 2d Session (1978) at page 127), the Committee stated that the exclusion is based on the fact that, "These are essentially flow-through entities, and the value of their shares directly relates to the assets that they hold. Their shareholders will receive the benefits of the inflation adjustment on the indexed assets sold by the entities when the gain is distributed to shareholders. Thus, allowing the adjustment to apply to interests in the flow-through entities is largely unnecessary and would result in considerable complexity, particularly with respect to entities which hold substantial non-indexed assets."

As was pointed out very clearly in testimony given before the Committee on Finance, on behalf of the Investment Company Institute, on August 22, 1978, the effect of the House bill is not to deny a double indexing benefit to the so-called "conduits", but to deny any indexing benefit at all. To the extent that testimony given by the Investment Company Institute supports full indexing for shareholder investments in REITS and regulated investment companies (in situations where the "conduit" has only indexed assets in its portfolio), we agree with it. Further, we are advised that the staff of the Joint Committee on Taxation now recognizes the inequitable impact of the present provisions of H.R. 13511 as to the indexed portion of a "conduit's" portfolio.

However, we cannot endorse the stated position of the regulated investment companies with respect to the indexing of shares of a "conduit" that has a significant portion of its portfolio invested in non-indexed assets. In their testimony, the regulated investment companies suggested that a number of proportional indexing rules would be appropriate and would not have a significantly detrimental effect on them. For the real estate investment trust industry, however, any proportional indexing approach is both inequitable and completely unworkable.

The Ways and Means Committee, in denying indexing to regulated investment companies and real estate investment trusts, said that, ". . . the value of their shares directly relates to the assets they hold." This is true in the case of regulated investment companies. Indeed, the value of shares in most mutual funds can be computed from hour to hour by direct reference to the underlying value of stocks and bonds in a mutual fund's portfolio. However, even a cursory examination of the real estate investment trust vehicle reveals the absence of a comparable relationship.

The underlying assets of a REIT, generally substantial equity and mortgage positions in real estate, are not valued by the marketplace from day-to-day, or even from year-to-year. The REIT portfolios do not themselves consist of publicly traded securities and the value of a REIT share on the stock market is determined by a host of factors, including earnings, dividends, and growth expectations, just as is the stock of any other publicly traded company.

Therefore, although it may be appropriate to deny total indexing of capital gains to a mutual fund with a mixed portfolio of indexed and non-indexed assets (in order to avoid placing the mutual fund investor in a better position than an individual directly investing in stocks and bonds), this is not appropriate for REITS. Individual investors simply do not have the opportunity, as an alternative to investing in a REIT, to invest in a $20 to $30 million mortgage on a modern office building or apartment complex providing housing for thousands of people. Granting full indexing on real estate investment trust shares, which we regard as critical if capital gains are to be indexed, would, therefore, not create a "loophole" in the sense of giving preferential tax treatment to the REIT investor, which treatment is not also available to individuals investing directly in the real estate market. Just as ordinary business corporations will receive indexing on shares of their common stock, even though their investments may include substantial non-indexed assets, so should real estate investment trusts.

Therefore, although we take no position regarding the merits of indexing capital gains, if indexing is to be included in the major tax bill now pending before your Committee, we urge your support for an amendment which would provide full indexing for shares in real estate investment trusts.

At your convenience we would greatly appreciate the opportunity to meet with you and your staff to discuss this extremely serious problem facing our industry. Should either you or your staff require information additional to that set forth in this letter, please contact me or Walter Laessig, General Counsel of NAREIT, at our Washington office.

Sincerely,

ARTHUR G. VON THADEN,

President, National Association of Real Estate Investment Trusts, Inc. Chairman and Chief Executive Officer, BankAmerica Realty Services, Inc.

STATEMENT OF THE NATIONAL ASSOCIATION OF WATER COMPANIES

Mr. Chairman and members of the Committee on Financé, my name is Wm. Neal MacKenzie and I am submitting this statement on behalf of the National Association of Water Companies, an association of investor-owned water utilities. I would like to discuss four amendments to the tax law which our association believes necessary in light of current developments affecting our industry.

First, the 5-year amortization provisions for pollution control facilities (§ 169 of the Internal Reveune Code of 1954) should be expanded to apply to all new equipment required by laws or government regulations. The investor-owned water supply industry is required to invest large sums of money to install expensive but nonproductive facilities in order to improve the quality of water consumed in this country. These rules are being mandated under such laws as the Safe Drinking Water Act and other Federal laws and by various State and local laws. This equipment is being installed because public policy requires it. However, very little consideration is being given to the cost and impact on the companies that supply, and the users that consume, water. Our industry is made up of a large number of small companies serving primarily small- to medium-sized communities. These companies have a limited ability to raise additional funds to make these capital improvements. As the situation develops, companies will be finding it increasingly difficult to stay in business.

There have been a number of sales of small- to medium-sized companies to local municipalities because of this financing problem. There are government grants and low interest loans available to the municipalities to make these improvements. We believe that expansion of the 5-year amortization provisions that already apply to pollution control facilities will aid the companies in meeting these public policy objectives and will permit them to do so without forcing the sale of the company. As stated in the General Explanation of the Tax Reform Act of 1976, in describing the need for these special provisions relating to pollution control equipment, the Congress stated:

The equipment is placed in service because public policy now requires that the cost of dealing with pollution be included in the prices of products as a cost of production. This transfers the cost burden of removing pollution created by the production process to the consumers of the product from the victims of pollution. The producers must install equipment that frequently is expensive and may not increase productivity. In recognition of this addition to a businessman's capital costs because of public policy, Congress believes that continuing this assistance in reducing the cost burden is appropriate.

We believe that our proposal fulfills the intent of Congress.

Second, the normalization rules already present in the investment tax credit should be made applicable to the 5-year amortization provisions. As you are aware, the normalization rules have the effect of allowing the companies to retain the benefits of the investment tax credit where otherwise they would be forced by State and local regulatory commissions to pass these benefits through to their consumers. Such a flow through defeats the intent of Congress in enacting this type legislation and does not provide the cash flow benefits to fund the construction of the facility that was intended.

This problem is equally present with respect to the 5-year amortization provisions. If mandatory flow through continues, the 5-year amortization provisions are of no help in raising the funds to make the improvements. Therefore, the normalization rules should be extended to the 5-year amortization provisions. The provisions will help finance the improvements and the customers will receive a benefit as the improvements can be financed at a lower capital cost.

Third, we propose that the minimum tax be amended to delete, as a tax preference item, the tax benefits derived from the 5-year amortization provisions for pollution control and (as expanded) other governmentally mandated facilities. While Congress has enacted the 5-year amortization provisions on the one hand, it has also included the tax preference items derived therefrom in the minimum tax. We understand the problems Congress has faced in dealing with the so-called "tax shelter" and other situations which led to the development of the minimum tax. However, because of their social desirability and the public policy reasons of governments which mandate these type of facilities (which are nonproductive and are not incurred at the option of the taxpayers involved) we believe that it serves no useful purpose to include this item in the minimum tax.

As long as the minimum tax includes benefits derived from the fast amortization provisions, it will increase the burden on the companies to comply with Federal, State, and local laws and perhaps even slow this compliance down. The companies do not want this to occur and for that reason, we are asking Congress to delete this item from the minimum tax.

Fourth, we believe, just as others have testified, that a full investment tax credit should be made available for pollution control and other governmentally mandated facilities.

We would also encourage you to retain the tax exempt bond provisions relating to pollution control facilities and industrial development facilities. Currently, these provisions permit tax exempt bonds to be issued for air and water pollution control facilities, facilities for the furnishing of water, and for sewage and solid waste disposal facilities. As we have stated, these type facilities are highly expensive and their financing through the normal and already tight financial markets available to water companies is very difficult. The availability of this type of financing is important to the investor-owned water industry and will help to finance these governmentally mandated facilities.

Thank you for the opportunity of letting us submit this statement to the Committee on behalf of the investor-owned sector of the water industry.

Statement of the National Cattlemen's Association Presented by Latimer Turner, Chairman, Taxation Committee, National Cattlemen's Association

Summary

Position of the National Cattlemen's Association With Respect to the Revenue Act of 1978

Capital gains

NCA supports actions by Congress to lower the tax rate on capital gains and to remove capital gains from the minimum tax—effective immediately.

Farm accounting rules

NCA is strongly opposed to the Administration's proposal to change the accounting rules for farming syndicates and family farm corporations.

Because of the broad definition of a farming syndicate, two or three people can join together, with no tax motives involved, to raise or feed livestock or to grow wheat, corn, soybeans, etc., and unknowingly find themselves subject to the complicated and expensive accrual accounting method.

Family farm corporations should not be required to use the accrual method of accounting. Many of these corporations have been in existence for years, primarily for ease of transferring interests on the death of members of the family and for other estate planning purposes. Why should these families be required to use different accounting rules than their neighbors who chose not to incorporate?

Investment tax credit

NCA supports making the 10 percent investment tax credit permanent. We also recommend that it be extended to cover farm buildings, as well as the cost of rehabilitating existing buildings.

NCA also recommends that the present law be amended to make it clear that certain single purpose livestock and poultry facilities are eligible for the investment tax credit under the present law, as provided in Senator Talmadge's bill, S. 3433.

Carryover basis and technical corrections bill

NCA recommends that repeal of the carryover basis provision, or at least postponement until 1980, and other provisions of the Technical Corrections Bill be incorporated in the Revenue Act of 1978.

Small business modifications

NCA urges the adoption of the modifications included in the House passed bill which liberalize the rules for Subchapter S corporations and increase the maximum allowable amount of first-year depreciation in the case of small businesses.

Game hunting expenses

NCA opposes the Administration's proposal to deny deductions for maintaining hunting facilities and certain other facilities. Many ranchers and farmers lease their land for wild game hunting and this rent is an important source of income.

Rate reductions

NCA supports both the individual and corporate rate reductions but also urges Congress to reduce spending in like amounts.

Statement of the National Cattlemen's Association

Mr. Chairman and members of the Commitee, my name is Latimer Turner and I am Chairman of the Taxation Commitee of the National Cattlemen's Association. Thank you very much for allowing me this opportunity to present NCA's views to the members of the Committee regarding the Revenue Act of 1978.

The National Cattlemen's Association was created on September 1, 1977, by the consolidation of the American National Cattlemen's Association and the National Livestock Feeders Association. It is the national spokesman for all segments of the nation's beef cattle industry—including cattle breeders, producers and feeders. The National Cattlemen's Association represents approximately 280,000 professional catlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 13 affiliated national breed organizations.

Capital gains

The NCA strongly supports the action of the House of Representatives to reduce the tax rate on capital gains by removing capital gains as a tax preference item subject to the 15 percent minimum tax. The minimum tax, together with the effect it has on reducing the benefits under the 50 percent maximum tax on earned income, has frequently caused hardships on cattlemen who have had to sell farm land or other capital assets in order to meet operating needs, settle an estate, or pay estate taxes or who were forced to sell the land by reason of condemnation or some other type of involuntary conversion. As most of you are

aware, the cattle industry has been through hard times over the past several years which forced many individuals to liquidate assets in order to meet cash requirements.

While the House bill is certainly a big step in the right direction, NCA supports efforts to lower the tax on capital gains still further. Senator Long's proposal to exclude 70 percent of the gain from being taxed rather than the 50 percent presently allowed, deserves serious consideration.

NCA also supports the provision in the House bill which allows the basis of property to be adjusted for inflation when computing the amount of capital gain subject to tax on the sale of land and certain other assets. Farm land which has been held for a period of years has often appreciated more because of inflation than because of any other reason. Thus, when farm land is sold to meet cash requirements or sold for some other reason, the tax on the gain is nothing more than paying a tax on inflation.

Alternative Minimum Tax.—While NCA supports the concept that everyone should pay their fair share of taxes, we do have some concerns about the alternative minimum tax in the House-passed bill. However, in making this statement we hasten to add that the alternative minimum tax in the House-passed bill is far superior to the present minimum tax.

Our concern centers around the situation where a cattleman has operated at a loss for the year because of economic conditions or draught, and sells land or other capital assets at a gain in order to raise needed funds. If the gain is over $20,000, he may be subject to a 10% alternative minimum tax even though he has no income or losses from any other source. For example, assume an individual has a $30,000 loss for the year from his cattle business—which is his only business. He sells farm land in order to raise cash which results in a $50,000 capital gain. He will pay an alternative minimum tax of $1,500 (10% x (½ x $50,000 less than $10,000 exemption)).

FARM ACCOUNTING RULES

In his testimony before the Senate Finance Committee, Secretary of the Treasury Blumenthal urged the Committee to adopt two provisions relating to farm accounting rules which were proposed by the Administration and rejected by the House Ways and Means Committee.

NCA opposes any attempts to restrict further the use of the cash method of accounting by cattlemen and farmers. The vast majority of agricultural producers presently use the cash method of accounting because of its simplicity and relatively low maintenance cost. Moreover, many cattlemen and farmers are not capable of using any other accounting system and a number of them could not afford the expense of professional accounting assistance necessary for the utilization of more complex accounting methods. In fact, in some rural communities such professional accounting assistance would not be readily available. With all these problems inherent in using accounting systems other than the cash method, still there are efforts exerted to restrict the use of the cash method by cattlemen and farmers. These proposals advanced in the President's tax program would have this effect and are, therefore, opposed by NCA.

Farming Syndicates.—One Administration proposal would require all "farming syndicates" to use the accrual accounting method. This is an extension of a provision enacted in 1976 which prohibits farming syndicates from deducting prepaid feed and other prepaid items, requires such syndicates to capitalize the development cost of orchards and vineyards, and requires syndicates engaged in poultry operations to spread the cost of the chickens over their useful life. There still are no regulations under this provision and thus no IRS guidance on what is meant by "farming syndicates".

Under the definition now in the Tax Code, a farming syndicate has a very broad meaning. The definition includes any business enterprise (other than a regular corporation) engaged in farming which has more than one person involved if over 35 percent of the losses pass through to limited partners or to one or more persons who do not actively participate in the management of the business.[1]

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[1] Certain persons are deemed to be active participants, including one whose principal activity is farming, or has an interest in a farm business in which he has actively participated for five years or more, or lives on the farm where the farm activity is located, or actively raises livestock and the farm business is a further processing, or is a member of the family of one who meets one of the active participant tests.

Because of the broad definition of a farming syndicate, two or three people can join together, with no tax motives involved, to raise or feed livestock or to grow wheat, corn, soybeans, cotton, etc., and unknowingly find themselves subject to the complicated and expensive accrual accounting method—and therefore find themselves at a competitive disadvantage.

We oppose the change to the "farming syndicate" provision because:

(1) It will adversely affect many farmers and ranchers who are not using the tax laws as a shelter. Many of the people who will be affected will not realize it until the IRS challenges their tax return;

(2) The provision which limits losses to the amount of capital at risk, as well as the limitation on prepaid feed and other prepaid items (noted above) are adequate safeguards against abuses;

(3) It is just another backdoor approach to forcing farmers off the cash method.

Requiring family farm corporations to use accrual accounting.—The second Administration proposal would require all corporations (except Subchapter S corporations) engaged in farming to use the accrual method of accounting if their gross receipts are over one million dollars. Again, this broadens a provision enacted in 1976 for which no regulations exist. The 1976 provision had an exception for family farms and the new proposal would eliminate this exception.

We also oppose this amounting change for family farm corporations. The family farm exception should be continued. There are many family farm corporations which have been in existence for years, primarily to make the transfer of interests in the business easier on the death of members of the family or for other estate planning purposes. Why should these families now be required to use different accounting rules than their neighbors who have chosen not to incorporate?

INVESTMENT TAX CREDIT

We support the House bill to make the investment tax credit permanent at the 10% rate. We also support the extension of the credit to cover the rehabilitation cost of farm buildings and other buildings used for farming or other productive activities.

We further support the extension of the credit to cover the costs of new farm buildings, as originally proposed in the President's tax message.

Clarification of the credit with respect to certain existing livestock facilities.—Certain single purpose livestock and poultry structures have been denied the investment tax credit because the IRS has taken the position that such structures are buildings and therefore are not eligible for the credit under the present law. In our judgment, which has been confirmed by a series of court decisions, the Internal Revenue Service position is contrary to the intent of Congress as expressed in the Senate Finance Committee report when the credit was restored by the Revenue Act of 1971.

Senator Talmadge has introduced legislation (S. 3433) to correct this inequity. We respectfully request that the Finance Committee include the substance of Senator Talmadge's bill in the Revenue Act of 1978.

CARRYOVER BASIS AND THE TECHNICAL CORRECTIONS BILL

The Technical Corrections bill (H.R. 6715) includes certain provisions which clarify or correct the 1976 Tax Reform Act. These provisions need to be enacted and NCA urges that these provisions be attached to the bill presently under consideration.

Even more importantly, the Technical Corrections Bill would postpone until 1980 the effective date of the provision requiring the basis of property to be carried over at death. We strongly urge the Committee to at least include postponement of the effective date of the carryover basis provision in the present bill. It would be even better if carryover basis were repealed altogether.

The views of NCA regarding carryover basis are more fully stated in our statement to the Subcommittee on Taxation and Debt Management Generally, which was presented on October 31, 1977.

SMALL BUSINESS MODIFICATIONS

The House bill liberalizes the rules for Subchapter S corporations by initially allowing 15 shareholders, treating a husband and a wife as one shareholder, and

allowing a longer period of time to make the election to be treated as a Subchapter S corporation. The House bill also raises the maximum allowable amount of first year depreciation to $5,000 ($10,000 in the case of a joint return) if the total amount of depreciable assets does not exceed $1 million at the beginning of the year.

These changes for small businesses will benefit ranchers and farmers and the NCA urges their enactment.

GAME HUNTING EXPENSES

In his Statement, Secretary Blumenthal also urged the Committee to deny any deduction for maintaining hunting facilities and certain other facilities. NCA opposes this proposal.

Many ranchers and farmers lease their land for wild game hunting and this rental income can sometimes make the difference between a profit and a loss situation. To deny a deduction for leasing such land would mean that this valuable source of income to ranchers and farmers would be curtailed.

RATE REDUCTIONS

The House bill reduces individual tax rates and also reduces corporate tax rates. NCA supports both of these reductions. However, NCA also believes Congress should reduce spending in a like amount in an effort to stop the continuing huge deficits that plague our economy and fuel the inflationary spiral.

CONCLUSION

In summary, NCA strongly supports amendments to the tax laws (1) which reduce the capital gains tax, (2) which make the 10% investment tax credit permanent and extend it to the cost of rehabilitating farm buildings, (3) which liberalize the Subchapter S rules, and (4) which reduce individual and corporate tax rates. NCA also respectfully requests the Committee to make it clear that the investment tax credit applies to single purpose livestock and poultry facilities. We also urge the Committee to include the provisions of the Technical Corrections Bill—including repeal or at least postponement of the effective date of the carryover basis provision—in the House-passed bill.

On the other hand, NCA strongly opposes proposals made by the Administration which (1) would make farming syndicates and some family corporations use the accrual accounting method and (2) deny any deduction for maintaining hunting facilities.

Again, thank you for allowing us to present our views.

NATIONAL CLUB ASSOCIATION,
Washington, D.C., September 8, 1978.

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

DEAR SENATOR LONG: We are pleased to submit, as part of the record on consideration of HR 13511 now before your Committee, our statement in support of the deductibility of club dues and other ordinary and necessary business expenses.

Legal and valid business expenses which meet the requirements of IRC Section 274 should be deductible from gross revenue regardless of where they are incurred. It is intellectually dishonest for the Administration to characterize the deduction of legitimate marketing costs, such as business meals and club dues, in a manner designed to make one group of taxpayers envious of another, clearly for political gain.

It would be most unfortunate if Congress were to arbitrarily deny one or two deductions, while keeping others, because Congress will have taken on the endless and impossible task of trying to define as "acceptable" the practices of each and every business person and professional in this country.

We ask that valid business expense deductions be kept intact and that fees to clubs be extended the same treatment as expenses incurred at commercial

restaurants, hotels, or sporting and theater tickets and other legitimate marketing costs.

The private club industry, in fact, the entire hospitality industry, is looking to you to reject this initiative by the Administration.

Sincerely,

MILTON E. MEYER, Jr., *President.*

Enclosure.

COMMENTS BY THE NATIONAL CLUB ASSOCIATION, WASHINGTON, D.C., CONCERNING THE DEDUCTIBILITY OF CLUB DUES AND OTHER ORDINARY AND NECESSARY BUSINESS EXPENSES

A. Income tax is a tax on net income; a taxpayer should continue to have the right to reduce the amount on which he's taxed by the ordinary and necessary expenses incurred in the expectation that his income will be increased.

B. Congress recognized club dues as proper business deductions. See H.R. Rep. No. 1447, 87th Cong., 2nd Sess., 1962, p. 22.

C. Trasury Regulations, Section 1.274-5(c)(6)(iii) prescribes stringent expense substantiation requirements. The law is not vague; the burden of proof is on the taxpayer.

D. IRC Section 274 sets forth that a club must be used primarily for business before any allocated deduction is allowed. And even then only that portion which is attributable to business use is deductible.

E. The Treasury is merely guessing at the magnitude of improper deductions. It is unlikely the revenue at issue is significant enough to a $500 billion budget to warrant the annihilation of deductions. If there is a recognizable problem with unauthorized deductions better audit enforcement is the solution, not disallowance. If the tax laws discourage taking certain marketing approaches, future expenditures in other marketing channels would rise up to meet the total dollars available, with the possible result that no appreciable new tax dollars would be generated.

F. Taxpayers at large do not subsidize business entertaining expenses any more than they subsidize all salaries paid, national advertising expenditures, rent payments, employee benefits, or transportation costs, etc. Does the Senate wish to set standards on the deduction levels of these expenses, too?

G. Meal, entertainment and dues expenses related to clubs are discretionary, deductible marketing tools in the same sense as are business meals at a commercial restaurant, pre-tax dollars spent in advertising, or costs incurred in travelling to a client in lieu of calling or writing. Only the business person on the firing line can determine which expenses are beneficial for him or her in terms of company objectives; most members of the public who oppose entertainment deductions have little or no sense of client relationships or what it takes to sell a product or service in today's marketplace.

H. In his State of the Union address, President Carter said "Our proposals will increase opportunities . . . jobs for women, . . . black people, Hispanics. . . ." These proposals could prompt club revenue losses ranging 15–50%, much higher for some, such as city clubs. Because most clubs' revenues are geared to only meet expenses, possibly more than one thousand clubs, moderate and high priced, will close if valid deductions are disallowed and the operation of two out of four clubs could be needlesly impaired. It would not be surprising that up to 150,000 fulltime employee-taxpayers, mostly minority hospitality workers, could lose their jobs.

I. Most clubs can be viewed as "mutual" enterprises wherein members share the costs; therefore, the combined costs of dues and meals at a club would ordinarily be no greater than the cost of meals alone taken regularly at many restaurants.

J. The deduction of valid meal and entertaining expenses should not be predicated on where the expenses are incurred. The private club industry asks that its related expenses receive the same tax treatment as those incurred at restaurants and hotels.

The comments below represent the position of the private club industry and its six million private club members from coast to coast concerning the deductibility of club dues and other entertainment expenses, where the use of a club by the taxpayer is primarily for business purposes. President Carter's Tax Reform proposals called for the elimination of those deductions. Following exten-

sive public hearings, the House denied the President's request and passed HR 13511 without any provisions with regard to such deductions. We ask the members of the Senate Finance Committee to likewise reject the President's proposals because they are prejudicial toward valid business practices, are not supported by any convincing testimony that such a radical approach is warranted, constitute a superficial approach to tax reform designed to pit one group of taxpayers against another, and will cause great economic harm to clubs, restaurants and hotels which operate within the law.

We were stunned at Treasury Secretary Blumenthal's blatant attempt to attack clubs when, after he quoted a national poll that 76% of "the public" opposes a full deduction for business lunches, 75% were against sporting and theater ticket deductions and 69% would like to deny dues deductions, he asked the Senate Finance Committee to ". . . at least deny a deduction for the expenses of maintaining facilities such as yachts, hunting lodges and swimming pools and for fees paid to social, athletic or sporting clubs," suggesting that deductions for business meals and entertaining, theater and sporting tickets, the supposed larger issues, be left untouched. It is incredible that the Treasury Department would attack club related expenses, as opposed to business lunches, while supposedly seeking tax equity in the name of the "average" taxpayer. This new twist in proposed tax policy cannot be justified in any way. The club industry casts its lot with valid deductions at restaurants and hotels—deductions for dues and business entertaining expenses at clubs, which must meet stringent tests of IRC Section 274, should be treated the same at those incurred at commercial locations.

We believe . . . the proposals arbitrarily seek to deny the deduction of valid business expenses merely because of the possibility of abuse by a few or because Administration officials find them personally offensive. Business men and women, professionals and taxpayers from all walks of life, use their club facilities for a variety of purposes, not the least of which may be entertaining associates, clients and prospects because they feel the setting will be the best atmosphere in which to conduct their business at that particular time. Such valid meal, entertainment and dues expenses incurred there are discretionary, deductible marketing tools in the same sense as are business meals at a commercial restaurant or hotel, pre-tax dollars spent in advertising, or costs incurred in traveling to a client in lieu of calling or writing. What may appear to some tax officials to be high living on the part of a host is in reality serious business; the marketplace is a cruel arena—if a taxpayer's business expense deductions are not directed toward achieving a profit objective, his business life will be short lived. Therefore, denying valid dues and expense deductions at clubs, while leaving meals at restaurants and hotels untouched, will place the Government in the role of telling millions of taxpayers they must change their profitable, tax-generating marketing style into some other mode which tax policy officials today deem less offensive, but offensive nonetheless. Once club dues and expense deductions are disallowed, what's to stop Treasury from asking you to deny the business meal next year, the costs of advertising not thought to be efficient the next year, and so on?

That documentation safeguards installed by the Ways and Means Committee in 1962 and regulations thereunder are sufficient restraints to curb abuses; if there are abuses (Treasury has not released any reliable data) the answer to whatever problem may exist could be found in greater audit enforcement. The law is not vague; documentation is the responsibility of the taxpayer.

That if business people/professionals are forced to reorder the way in which they sell their products and services, available marketing dollars will find their way into other (still) deductible channels, such as advertising and public relations costs. No tax dollars will be saved.

Taxpayers at large do not subsidize business entertaining expenses any more than they subsidize all salaries paid, national advertising expenditures, one anothers office rent payments, employee benefits, or transportation costs, etc. Surely the Senate does not wish to set standards on the deduction levels of these expenses, too?

That these proposals will cause massive business and job losses. Even if the business meal deduction were continued, the denial of dues deductions alone will cause more than 60% of the city clubs and 40% of the golf clubs to suffer revenue losses in excess of 30%, a blow from which most could not recover.

Once that happens the job of 150,000 full-time and 80,000 part-time marginally skilled workers would probably be lost. And while many of those taxpayer/workers will eventually be absorbed into other lower paying and entry level jobs (too few of which are available today as it is) their personal disorientation and the new unemployment burden on local budgets will be enormous. All this in the name of symbolic tax reform?

The stated reasons for the requested denial of deductions for social clubs and other entertainment expenses are many. There is a feeling in the Administration today, even among some persons familiar with the fundamental concepts of tax law, that if an activity is enjoyable (or even if it is possible that it might be enjoyable under the proper circumstances) then the value of the activity should be taxable to the individual receiving it, and deductions for the expenses incurred in connection with the activity should be denied to the taxpayer incurring them. This feeling seems to be a distortion of the more widely accepted notion that an activity generally considered enjoyable provides an opportunity for abuse, and, therefore, the taxpayer who has incurred expenses for such activity may reasonably be required to carry a greater burden of proving that the expenses were incurred for a business purpose.

The Administration has concluded that expenses which are inherently personal, such as meal expenses, should not be deductible, even if ordinary and necessary, because: (1) they suspect abuse and (2) because the taxpayer might have to incur that expense anyway. The first of these concerns (the rate of abuse) is more properly addressed through more effective enforcement of present law. To the second point, incidental personal benefit has never been considered a bar to the deduction of expenses which are incurred primarily for business reasons, when those expenses may also be undertaken on nonbusiness occasions solely for personal reasons.

A consistent position in the Administration's proposals is that the taxpayers are being called upon to subsidize deductible expenses which other taxpayers incur. This argument is based on the premise that all revenues belong to the Government except those which the Government allows the taxpayer to spend in business deductions or to keep after taxes are paid. This philosophy permits the Government to claim that every taxpayer, in some way or another, subsidizes the expense burden activities of every other taxpayer. And, therefore, the Government is compelled to enter into and judge every business decision in terms of its effect on dollars flowing to the Treasury. We do not accept the premise that all monies belong to the Government and Congress should not be misled by arguments based upon this faulty premise.

Both Congress and the Internal Revenue Service have recognized that club dues are proper business deductions. See H.R. Rep. No. 1447, 87th Cong., 2nd Sess., 1962, p. 22.

Prior to 1962, a taxpayer was allowed a deduction if he could prove that entertainment expenses were incurred for a business purpose, even if he could not prove the exact amount of the expense. Section 274 of the Internal Revenue Code of 1954, enacted in 1962, now requires extensive documentation of all deductible entertainment expenses. Under present law, an individual seeking to deduct dues paid to a social, athletic or golf club bears the burden of proving that his use of the club is primarily (more than half of the time) in pursuit of his business. To do this, the taxpayer must come forward with detailed records as to the number and duration of occasions on which the facility was used during the taxable year for business, and the number and duration of occasions on which the facility was used during the year for nonbusiness activities. If the taxpayer fails to make this showing, it will be presumed that the facility was used primarily for personal purposes and no deduction will be allowed. See Treas. Reg. Section 1.274–5(c)(6)(iii).

In addition to the substantiation requirement of Section 274 and the regulations thereunder, the deduction of club dues must satisfy the test applied to all business deductions, that is, that the expense is ordinary and necessary to the conduct of the taxpayer's business. For purposes of club dues, this means that the taxpayer must show that he uses the club for business purposes and that the taxpayer's business has benefited (or is reasonably expected to benefit) in some specific way beyond the development of goodwill.

Under these rules, if the taxpayer shows that the use of the club is an ordinary and necessary expense of his business, and that he uses the club primarily for business, he may deduct that portion of his dues which corresponds to the portion

of his use of the club which is devoted to business. This percentage will be computed from the detailed records described above. It is distressing to observe the Administration, in its public utterances and official communications, characterize the practices of businesspersons in such a derogatory manner, and particularly with respect to the impact of current regulations on those practices. The Administration's Fact Sheet on entertainment expenses states that "the cost of tickets to theaters and sports events is deductibe under present law merely because the previous morning or the next day the parties talk business. The cost of meals eaten by people who happen to have business relationships are deductible even though no business is done or discussed." To the contrary, Section 274 of the Internal Revenue Code of 1954 states as follows: "With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item directly related to, or, in the case of an item directly preceeding or following a substantial bona fide business discussion (including business meetings at a convention or otherwise), that item was associated with, the active conduct of the taxpayer's trade or business . . . " Specific and stringent rules are prescribed by the regulations to determine when an expenditure is "directly related" to the taxpayer's business. In general, this requires a finding that during the activity to which the expenditure relates, the taxpayer "actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction other than entertainment."

The regulation goes on to state: "Any expenditure for entertainment in any such case is considered not to be directly related to the active conduct of the taxpayer's trade or business unless the taxpayer clearly establishes to the contrary."

Alternatively, the taxpayer may show that an entertainment expenditure was "associated" with the conduct of his business and "directly preceded or followed a substantial and bona fide business discussion . . . " Regulation Section 1.274-2(d). In order to show that an activity precedes or follows a substantial bona fide business discussion, the burden again is on the taxpayer to show the substantiality of the business discussion and that it was "substantial in relation to the entertainment." In general, the discussion with which the expenditure is associated must take place on the same day. If not, the taxpayer faces an even heavier burden of showing that the entertainment expense directly preceded or followed and was associated with the business discussion.

As can be seen, the regulation's statement of the law is substantially different from that of the Administration. It is not necessary to impose an illogical statutory restriction on deduction of ordinary and necessary business expenses where administrative action prescribing more stringent enforcement of the requirements of substantiating the business relationship of such expenditures would serve equally well.

CLUB DUES ARE ORDINARY AND NECESSARY TO THE CONDUCT OF SOME TAXPAYERS' BUSINESS

The "integrity of the tax system" has been put forward as one of the primary goals of "tax reform;" like that of any other system of laws, it depends upon the uniform application of consistent principles.

The basic concept of tax law reflected by the deduction of club dues is that the income tax is a tax on net income. It therefore follows that the taxpayer should be allowed to reduce the amount on which he is taxed by all expenses incurred in the expectation that his income will be increased. To our knowledge, no responsible critic (including the Treasury Department) has suggested that the use of an entertainment facility, such as a club, cannot contribute to the maximization of income. For this reason, any suggestion that deductions be denied for club dues is inconsistent with the net income principle and with the principle that all expenses ordinary and necessary to the production of income be deductible.

The desire to modify the present rules may also grow out of a feeling that deductions for lavish entertainment by business and professional people causes public resentment. The question has been asked, "Why should such an individual be allowed to deduct the cost of lunch for himself and a client or business associate, when the ordinary employee must pay for his own lunch?" The difference in treatment between the two taxpayers simply results from a difference in the fashion in which they earn their income. One may ask why a fishing boat captain should be allowed to deduct the expenses of his gasoline, while a steel worker could not be so allowed. The simple fact is that the gasoline necessary to propel his boat is necessary to the production of the fishing boat captain's income, while

to the steel worker it would be a totally personal expense. Likewise, the entertainment of potential customers or clients, when reasonably thought necessary to obtain their business, is an ordinary and necessary expense of producing income for the businessman or professional and should be deductible by him, while such a situation would not present itself to the steel worker.

Legislation denying deductions for expenses which are otherwise ordinary and necessary constitutes the creation of specific exceptions to the general rule of deductibility and such legislation should be adopted only for compelling reasons. The deduction of club dues does not offend the public interest in any manner which would justify even the consideration of legislative denial. The attack on club dues and meal deductions can only be justified as part of an overall reversal of the tax code on all deductions, such as rents, advertising, employee benefits, salaries, transportation costs, and the like.

Logic dictates that only that portion of the current deductions of club dues which constitute an abuse should be denied. Thus, if it is argued that a substantial rate of noncompliance with the present statute and regulations exists, then only the amount of those deductions which arise from such noncompliance would be considered in determining the amount of revenue loss from the present deduction. Again, we do not have access to any Treasury figures regarding the rate of noncompliance with the present regulations. Certainly total dues figures are of such limited consequence that the elimination of those deductions which are illegitimate is not going to raise any significant revenue for the U.S. Treasury.

The deduction of club dues is inextricably tied to the deduction of other entertainment expenses. If business meal expenses are left undisturbed, it would certainly be inconsistent to disallow deductions for dues and entertainment expenses at clubs because, to the taxpayer businessman, they are interchangeable elements of the same marketing strategy process. Likewise, there's no difference from a dollar consideration; dues defray the overhead cost of providing the meals and in some cases, other amenities; thus, a restaurant includes the cost of its facilities in its meal prices, but such costs are not so included in the meal price at a private club. The combined cost of dues and meals at a club would ordinarily be no greater than the cost of regular meals at many restaurants.

For many club members the arbitrary elimination of the deductibility of dues would make their club membership cost prohibitively expensive and would prompt resignations, which then could prompt club revenue losses ranging 15%-50%, and eventually much higher for some clubs. Such reduction in membership support would cause the clubs' remaining members to take on a higher per share burden in dues and fees, causing another wave of resignations and more disrupted operations. The former club members would continue to conduct their business entertaining activity elsewhere.

In terms of total business expense dollars deducted, the essence of the denial of dues deductibility would be to deny ordinary and necessary business expenses just because they take place at a private club. If the deductibility of business meals remains intact, the denial of club dues as a deduction would effectively shift an amount equivalent to that expended in dues and fees by former club members into the public sector. To the extent that certain business expenses are disallowed by Congress, other deductible marketing expenditures will rise up to meet the newly available dollars, with the result that no new tax dollars will be captured.

The Administration's proposal submitted to the House contained several inaccurate statements describing present law. For instance, it is stated that most costs of country club memberships, lunches, dinners, world series or super bowl tickets, and vacation trips are claimed as deductions, despite the restrictions on entertainment deductions enacted by Congress in 1962. No specific evidence is presented for this claim, but it appears doubtful on its face.

The Administration's Fact Sheet also stated: "Disallowance of the deduction is the substantial equivalent of taxing the income to those who enjoy the benefit." This statement is nonsense. To disallow the deductibility of an ordinary and necessary expense to an individual or organization which does not personally benefit from such expense is not at all equivalent to taxing the recipient who may benefit. It is difficult to imagine what the Administration had in mind when making this statement.

The proposal also states that "reasonably priced" restaurants (whatever that may mean) will not suffer from this provision. It is our impression that most business meals are taken at reasonably priced restaurants and, if this proposal reduces the amount of business entertainment, it is fair to assume that its ramifications will be felt at most economic levels. No evidence is presented by the Treasury Department to substantiate its remarkable assurances to the contrary.

In summary, present law seems perfectly adequate to the task of insuring that business entertainment and club dues expenses are ordinary and necessary expenses of conducting a taxpayer's business. Businessmen should not be denied deduction of valid expenses because of vague accusations of inequity unsupported by convincing data or because the business expense is incurred at a private club rather than at a restaurant.

DISALLOWANCE OF DEDUCTIONS WILL INCREASE UNEMPLOYMENT

The National Club Association rejects any inference that a practice which is illegal or deemed not in the public interest should be tolerated just because of its effect on employment. Conversely, however, the Government must be certain that, when an action it is considering may have a devastating effect on its citizens, such as those who have invested in the hospitality industry or workers in that field, the Government can justify such action only as a final response to a nationwide problem.

The estimated 8,000 private golf, city, yacht, tennis, social and athletic clubs in this country with a full time manager represents an estimated 380,000 full-time (women and minorities) and 175,000 part-time workers (mostly minorities and students). These employees, in the main, are the very ones who need job security the most—women coming on to the job market, blacks and a growing number of Latin-American workers who have difficulty with the language and have few skills for anything other than hospitality industry positions.

Because most clubs are budgeted to break-even, their financial posture is so precarious that any diminuation of support could force many clubs (possibly thousands) out of existence. Industry surveys show that two out of three city clubs and two out of five gold clubs could be forced to close if entertaining and dues deductions were disallowed, with the result that 150,000 full-time workers'
The National Club Association urges the Senate to withhold any further
their jobs.

The National Club Association urges the Senate to withhold any further action on these tax reform proposals in order to more accurately assess the scope of illegitimate deductions and to exhaust all attempts to more vigorously enforce existing documentation requirements and audit procedures.

NATIONAL COMMISSION ON UNEMLOYMENT COMPENSATION,
Washington, D.C., August 16, 1978.

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

DEAR MR. CHAIRMAN: This is in reference to the tax bill H.R. 13511, which has passed the House of Representatives and is pending before your Committee, and which includes a provision to tax unemployment insurance benefits.

As you know, the Congress has established this statutory Commission to review the entire unemployment insurance system. The Commission has unanimously voted to recommend that the Congress defer legislative action on any proposals that would affect the Federal Unemployment Tax and could tax unemployment benefits until the Commission has had the opportunity to study these matters and report its findings. Both proposals have implications for broader policy considerations which were enumerated in the provisions of the statute creating the Commission.

I should be glad to supplement this recommendation with oral testimony if you so wish.

Sincerely,

WILBUR J. COHEN, *Chairman.*

STATEMENT OF DONALD E. GRAHAM, VICE PRESIDENT-GENERAL COUNSEL, NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. Chairman and Members of the Committee: The National Council of Farmer Cooperatives is a nationwide association of cooperatives which are owned and controlled by farmers. Members of the Council provide supplies and credit services to farmers, and market their food and fiber production.

Cooperatives are the off-farm extension of the farming operation, making available on a non-profit, cooperative basis those services which most farmers cannot afford as individuals. The U.S. Department of Agriculture estimates that five out of every six American farmers belong to one or more farmer cooperatives, 93 percent of which had annual sales volumes of less than $5 million during 1971-72, the latest reporting period. Thus, the vast majority of farmer cooperatives are relatively small business enterprises.

The purpose of this statement is to urge this Committee to include, in any tax bill it reports out to the full Senate, appropriate language to remove existing restrictions on the availability of the investment tax credit to farmers and their cooperatives.

The Internal Revenue Code provides a subsidy for most U.S. business firms by allowing them a credit against federal income taxes of up to 10 percent of the purchase price of their acquisitions of certain depreciable property, having an estimated useful life of three or more years, and used as an integral part of the production prcess. However, cooperatives are not treated equitably in their ability to use this invesment tax credit because Section 46(e) of the Internal Revenue Code requires that cooperatives reduce their credits by multiplying the value of such purchases they make each year by a fraction, the numerator of which is taxable income and the denominator of which is taxable income plus patronage refunds. Thus, is a cooperative has $1 million in net earnings and distributes $900,000 to its farmer-patrons, it has $100,000 in taxable income. Under present law it may claim only 1/10 of the credit a non-cooperative (such as General Motors, IBM or Exxon) could take on the same investment in identical property.

$$\left(\frac{\$100{,}000}{\$100{,}000 + 900{,}000}\right)$$

Most businesses which are subject to single tax treatment, such as partnerships, Subchapter S corporations and trusts, are entitled to a full investment credit which is passed through to the owners and beneficiaries. To restrict the investment credit for cooperatives is particularly unfair.

Corrective legislation has been introduced in the House (H.R. 8244). A companion bill is before the Senate (S. 2216).

These bills would permit cooperatives to take full advantage of the investment tax credit by allowing them to claim the credit without regard to patronage refunds. The farmer-owned cooperatives would have the choice of applying the credit to taxes owned by the cooperative association or passing some or all of the available credit on to its farmer-patrons. This flexibility would maximize the benefits of the credit to farmers, cooperatives, and the rural communities in which they do business.

There can be no doubt that the industry of agriculture is in a cost-price squeeze creating a serious economic condition for farmers. The U.S. Department of Agriculture in recently issued preliminary data for 1977 farm income estimates that realized net farm income dropped last year to $20.4 billion, compared with $21.9 billion in 1975 and a peak of $30 billion in 1973. Farm production expenses continued their persistent climb outstripping gains in income. Farmer production costs last year were $85.7 billion, up $4 billion from 1976 while gross income was up only $2.5 billion from 1976.

From the above data it is readily apparent that agriculture is in need of the economic stimulus which the investment tax credit was designed to provide.

The National Council has just completed a survey to ascertain the revenue implications of this proposal. Eighty-seven of 117 recipients (71.8%), including all of the larger full service and supply cooperatives throughout the country, responded to our questionnaire.

Respondents purchased $335 million of section 38 property which, under the proposal, would have entitled the cooperative and their patrons to a maximum tax credit of $33.5 million. Because of the restrictions of existing laws, these cooperatives were able to claim only $4.5 million in investment tax credits. Thus, if the proposed legislation had been in effect in 1976 the loss to the Treasury would have been approximately $29 million for all farmer cooperatives.

There is strong economic justification for giving farmer cooperatives full access to the investment tax credit. The Bureau of Labor Statistics reports that non-metropolitan, non-farm unemployment has nearly doubled in the past four years, and economists generally agree that hidden unemployment in this sector may be greater than hidden unemployment in metropolitan areas.

Conventional input-output analysis indicates that if the full $29 million were used at the cooperative level it would generate 1,500 new jobs every year that the full investment tax credit was available. This figure indicates only full time jobs created in the non-metropolitan, non-farm sector. In addition, these new jobs are conservatively estimated to have a multiplier effect of two. In other words, at least 3,000 new jobs would be created in total. Of course, this figure would be even higher if Congress liberalizes the general rules applicable to this credit.

It is important to note that 45 percent of these jobs would be created in the hard hit construction industry. Because of the high monetary value associated with construction employment, it is reasonable to project that the use of the investment tax credit by farmer cooperatives would be worh approximately $30 million in income generation alone. This equals the amount of the additional credit.

It is also important to note that cooperatives would probably use this credit to expand export facilities. This is particularly important in view of the fact that economists believe exports may be decreasing in value in 1978. Further, such an approach would be consistent with the Form G loan pooling program made available by the U.S. Department of Agriculture.

The desired results could be achieved by adopting the following amendment to H.R. 13511.

H.R. 13511, Revenue Act of 1978 is amended as follows:

(1) Section 314. Investment credit allowed for certain rehabilitated buildings is changed to section 315;

(2) Section 315. Targeted jobs credit is changed to section 316;

(3) A new section 314 is included as follows:

Sec. 314. Limitations with respect to certain persons.

(a) Section 46(e) is amended by striking "and" at the conclusion of subsections 46(e)(1)(B) and 46(e)(2)(B) and repealing subsections 46(e)(1)(C) and 46(e)(2)(C).

(b) Part III of subchapter T is amended by adding at the end thereof the following new section:

Sec. 1389. Investment tax credits of cooperatives.

The credits allowed by section 38 and subpart B of part IV, subchapter A of this chapter with respect to qualified investment may be claimed either in whole or in part by the cooperatives or may be allocated to the patrons based upon business done with or for such patrons.

(c) The amendments made by this section shall apply to taxable years ending after December 31, 1977.

The case for removing the restriction on use of the investment tax credit by cooperatives was succinctly in a letter dated October 27, 1977, from the late Senator Hubert H. Humphrey to the President, urging inclusion of this proposal in the Administration's Tax Reform bill:

"While this is not a significant loss of federal revenue, it would be of substantial benefit to our farmers and their cooperative associations. At the current time of high unemployment and insufficient economic growth, the incentive provided by removing the limitation on investment credit applicable to cooperatives can help to stimulate employment and enable cooperatives to modernize and expand facilities. Because many cooperatives are located in rural areas which are suffering high unemployment, removing the limitation would be a particularly effective stimulus to the economies of rural areas."

The investment tax credit is now available to all businessmen except those who choose to operate on a non-profit, cooperative basis. It is time to eliminate this discriminatory provision from the federal tax code.

STATEMENT OF THE NATIONAL COUNCIL OF JEWISH WOMEN

The National Council of Jewish Women, a volunteer organization of 100,000 women is dedicated, in the spirit of Judaism, to advancing human welfare through a program of education, service and social action. NCJW's Resolutions, adopted at its Biennial Convention in 1977, recognize the importance of the voluntary sector of our society, stating in part: ". . . it is essential that volunteers continue to work in partnership with the public and private service sectors . . . The National Council of Jewish Women believes that the economic priorities, policies and program at all levels of government should be designed to develop our full human, social and economic potential."

Developing that partnership requires maintaining the strength, viability and independence of the voluntary sector; and the voluntary sector, dependent upon private contributions for its vitality and diversity, is significantly affected by Federal tax policies.

Tax law revisions in recent years have seen a steady increase in the dollar value of the standard deduction with a concommitant increase in the number of taxpayers claiming that deduction—from 50% in 1970 to more than 75% in 1977. In effect, the taxpayer who elects to take the standard deduction receives credit against income for contributions regardless of whether any such contributions were made. Clearly this removes the incentive to contribute.

Therefore, the National Council of Jewish Women supports and urges your support for the Moynihan/Packwood bill which permits taxpayers who elect the standard deduction to also itemize and deduct their contributions to charitable organizations.

Data developed in a study by Harvard Professor of Economics, Martin Feldstein, indicated that changes such as those proposed in the Moynihan/Packwood bill would generate an increase of some $3.8 billion in charitable contributions, more than offsetting an estimated loss to the Treasury of $3.2 billion. Other data from the same study indicate that the loss to charitable organizations which has resulted from increases in the standard deduction since 1970 now amounts to approximately $6 billion.

Perhaps equally as important as the generation of increased charitable contributions is the fact that such a change in tax policy will restore the strength and independence of the voluntary sector, tending to reduce its dependence on governmental dollars. It is one of the special attributes of the voluntary sector that it is often in a position to address needs which government cannot serve, needs which, though valid, lack the broad base of public appeal which is needed to justify expenditures from the public coffers. We must preserve this unique contribution.

The encouragement of giving by individuals at all income levels is one of the most constructive aspects of a national tax policy, contributing to the pluralism of our society, and tending to open up the voluntary sector rather than to make it dependent upon the generosity of the very rich.

In a T'me Magazine Essay (August 7, 1978), they quoted a 1974 survey conducted with the help of the Census Bureau that 37 million persons over the age of 13 had performed volunteer work during the year with an estimated value of $33.9 billion. We at NCJW can well document the many hours of volunteer effort in the servicing and administration of our many programs. The value of each dollar raised, therefore, is enhanced and used to benefit the recipients, since 90% of the work of the organization is performed by volunteers, a much better return than our tax dollar in service programs.

Enactment of the Moynihan/Packwood bill would restore the incentive for charitable giving which has been eroded by changes in tax policy over the recent past.

STATEMENT OF JOHN W. SCOTT, MASTER OF THE NATIONAL GRANGE

Mr. Chairman and Members of the Committee: I am John W. Scott, Master of the National Grange, with offices at 1616 H Street, N.W., Washington, D.C.

The Grange is more than a farm organization. It has a heterogenous membership—farmers, ranchers, rural and urban residents are represented in our half-million members located in 41 states and nearly 7,000 local communities. One of the purposes of the Grange is to serve the total interest of its diversified membership. Thus, policies and programs of the Grange encompass a broad array of circumstances affecting the lives of rural and suburban Americans; they result from member action generated by total community and national interest—not by agricultural interest alone.

The National Grange has an interest in a uniform investment tax credit because we are an organization that has small business people and farmers among its half-million members. Because farmers and small businesspeople are most likely to invest in assets with useful lives of 3 or more but less than 7 years, the discrimination under the present investment tax credit law is of importance to the Grange.

The present law on investment tax credit allows only partial credit for investment in property that has a useful life of under 7 years. By only allowing ⅓ credit for property with a useful life of 3 or 4 years, and only a ⅔ credit on property with a useful life of 5 or 6 years, the law discriminates against the farmer and small businessperson. A simple example illustrates the unfairness of the present law. A large farmer buys a $9,000 asset with the useful life of 9 years and he is allowed a tax credit of $900.

A small family farmer buys a $3,000 asset with a useful life of 3 years, replaces the asset at the end of each 3-year period, so that at the end of 9 years the family farmer also has spent $9,000, but the small family farmer is allowed 3 credits of $100 each, totalling only $300, giving the large farmer a $600 tax advantage. In effect, the large farmer's tax credit is 10%, while the small family farmer's is only 3⅓%.

In addition to the financial advantage the present law provides the large farmer over the small family farmer, the present law does not carry out the true purpose of the investment tax credit. The purpose of the credit is to stimulate business spending and the creation of jobs. A dollar spent by a business for shorter-lived equipment is at least as productive as a dollar spent for equipment with a longer use span; indeed, shorter-lived assets are among our nation's most productive. Moreover, present law can actually discourage replacement of assets before they are held 7 years, thereby making the investment tax credit for the small business person and small family farmer counterproductive to the economic stimulus the investment tax credit should provide.

The National Grange therefore recommends the enactment this year of an amendment that would allow a full investment tax credit (and terminate operation of the recapture rules) for investment in property with a useful life of 3 years placed in service on or after January 1, 1978.

The National Grange also supports the extension of investment tax credits to farmer-owned cooperatives. Like any other business, cooperatives have difficulty in capital formation, and being able to utilize the investment tax credit would assist farmer cooperatives in better serving their patrons and customers. It is also true that if the intent of the investment tax credit is to stimulate the economy, then co-op dollars will add as much stimulus to the economy as non-co-op dollars.

We would appreciate these three amendments being made a part of the 1978 Tax Reform package. The nation's agricultural economy is at a level that needs this extra assistance in financing new productivity.

In addition, the National Grange supports the extension of investment tax credit to farm structures. It is important in today's agricultural programs to have on-farm storage available to store the farmer-owned grain reserve. The 1978 crop of feed grains will be a record and storage space will be critical. Storage will be so tight that farmers will not be able to utilize the loan and reserve provisions of the farm programs because of the lack of storage, both on-farm and commercial, The new or old grain will be forced onto the market at harvest time, further depressing farm prices.

The on-farm storage facility loan program administered by the Department of Agriculture has been a help, but it cannot possibly service the needs of farmers. An investment tax credit provision will encourage farmers to finance the construction of on-farm storage and other facilities to increase agricultural productivity in an efficient and effective manner.

The Grange, representing family farmers, opposses a reduction in the capital gains tax rate below the present 49 percent. This position was adopted by the delegate body at our last Annual Meeting, held in November of 1977.

The Grange believes that any government tax action that encourages people to try to convert ordinary income into capital gains would not be a healthy situation for family farm agriculture. At the present time we already have strong incentives in the capital gains tax rate to attract "investment" in cattle feeding, cattle raising, fruit trees and other agricultural ventures.

The Grange has supported in the past changes in the tax laws that have reduced the attractiveness of farming to doctors, movie stars and other well-to-do individuals seeking tax shelters or loopholes. A reduction in the capital gains rate

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would surely bring forth new schemes for converting ordinary income into capital gains.

We agree with Emil Sunley, Assistant Secretary of the Treasury, who stated that only 28 percent of the capital gains taken each year are on corporate stock. The rest are on sales of real estate, timber, cattle and other capital assets. Lowering capital gains taxes, making land investment more attractive, would not produce more productive investments, but only bid up the price of land.

The bidding up of the price of farm land may be of benefit to the farmer who wants to retire, but it has no advantage to the young farmer who wants to stay on the land or to those who want to enter agriculture. They have little chance of converting ordinary income into capital gains. It is the speculators and nonfarm cattle operators who derive the benefit from a reduction in the capital gains tax rate.

The Grange is aware of the need to create investment capital. It is needed in agriculture as well as in industry. However, we firmly believe that tax reform that results in capital investment to bring about increased productivity (rather than speculative investment) is in the best interest of the nation and of controlling inflation.

Therefore, in summary, we recommend that instead of a reduction in the capital gains rate, changes be made in the Federal Tax Code that would: (1) make the 10% investment tax credit permanent and equalized the investment tax credit for small business; (2) extend the investment tax credit to structures and remove the restrictions on the eligibility for tax credit on sales to "spouses, ancestors, and lineal descendants"; (3) provide a more adequate depreciation allowance; (4) provide a more speedy recovery of the cost of pollution abatement equipment and cost of meeting requirements of the Occupational Safety and Health Administration regulations (example: cotton and grain dust removal); (5) reduce corporate rates including increasing the surtax exemption to encourage small business investment; and (6) extend the investment tax credit to farm cooperatives.

In our judgment the above changes in the tax code will do more to create investment capital that will lead directly to improved productivity than any cut in the capital gains rate.

We appreciate this opportunity to express our views on how a cut in the capital gains tax rate will adversely affect the family farm structure of American agriculture and to recommend needed changes in the tax code to better meet the needs for capital formation.

Statement of the National Homeowners Association

The National Homeowners Association (NHA), Washington, D.C., an organization representing the interests of America's 55 million homeowners, appreciates this opportunity to submit the following testimony regarding the Revenue Act of 1978 (H.R. 13511).

This association respectfully requests that Congress consider the positive social and economic benefits of the bill's provision which grants a one time ($100,000) exemption of capital gains on the sale of a homeowner's principal residence.

Specifically, the exemption would ease the intense demand for costlier housing that the existing roll-over provision artificially creates.

By eliminating the dubious "need" to buy another, more expensive home in order to avoid capital gains taxation, the exemption would provide for a more realistic housing demand, and subsequently less inflated housing prices.

In addition, it would free the homeowner from the burden of paying the higher interest rates, mortgage payments, insurance premiums, utility bills, property taxes and other operating/maintenance expenses attendent with larger, costlier homes.

With households becoming smaller, and operating/maintenance costs higher, homeowners should have the unencumbered choice of smaller, less expensive homes.

The recent HUD Task Force on Housing Costs reports that family income is not keeping up with the cost of buying and/or maintaining either new or existing homes. NHA believes that many homeowners, faced with capital gains taxation of highly inflated profits, are becoming unwilling prisoners of homeownership.

In conclusion, NHA believes that the one-time exemption is the most equitable means of alleviating a number of social/economic burdens inherent in the present

capital gains treatment of homeownership. The exemption gives citizens the freedom to choose, without penalty, their future as a homeowner. It slows the dangerous cycle of housing inflation fueled by the present "need" to trade-up. And, to the advantage of every American, not just homeowners, subsequently helps reduce this country's overall inflation.

On behalf of American homeowners, NHA thanks this Committee for its thoughtful consideration of the preceding comments.

SUPPLEMENTARY STATEMENT OF THE NATIONAL REALTY COMMITTEE

The National Realty Committee testified before the Finance Committee concerning H.R. 13511, the proposed Revenue Act of 1978, on August 25, 1978. As noted in our testimony, we respectfully submit this supplementary statement, consisting primarily of technical and drafting comments and recommendations, for consideration by the Finance Committee.

I. AT RISK RULE

A. Section 201(a) of H.R. 13511, adding Internal Revenue Code Section 465 (c)(3)(D):

H.R. 13511 (the "Bill") currently provides for applying the exclusion for real property from the proposed extension of the at risk rule only to activities described in subparagraph (A) of subsection (c)(3), thus denying the exclusion in the case of activities described in I.R.C. Section 465(c)(1).

We are not aware of any good reason for not applying the exclusion for real property to the activities described in Section 465(c)(1). Failure to extend the exclusion to such activities creates ambiguities where the holding of real property may be involved in connection with a Section 465(c)(1) activity, and may be deemed inconsistent with the following sentence in the House Committee Report explanation of the proposed provision: "In situtations where a trade or business involves both the holding of real property (other than mineral property) and the provision of personal property and services which are not incidental to making real property available as living accommodations, the holding of the real property will be treated as a separate activity which is not subject to the at risk rule." (House Report, page 70.)

We suggest, therefore, that the first two lines of this provision be amended to read: "(D) Exclusion for Real Property.—In the case of activities described in this subsection (c), . . ."

B. Section 203 of H.R. 13511, adding Internal Revenue Code Section 465(e):

The first sentence of proposed I.R.C. Section 465(e)(1) commences with the phrase: "If zero exceeds the amount which the taxpayer is at risk in any activity . . .". Under our understanding of current law, a taxpayer's basis for property under the Internal Revenue Code may never be reduced below zero. In the Report of the Senate Finance Committee to the Tax Reform Act of 1976 (Report No. 94–938, 94th Cong, 2nd Sess.), page 48, the following statement appears: "In applying the at risk limitation, the amount of any loss which is allowable in a particular year reduces the taxpayer's risk investment (but not below zero) as at the end of that year and in all succeeding taxable years with respect to that activity."

If Congress intends to create negative at risk accounts, we suggest that the statute be amended to specifically so provide and to specify the circumstances under which such result would eventuate.

II. INVESTMENT CREDIT

Section 314 of H.R. 13511, adding subsection (g) to Internal Revenue Code Section 48:

Proposed I.R.C. Section 48(g) refers throughout to a building "which has been rehabilitated" and to "rehabilitation", without defining the terms "rehabilitated" or "rehabilitation" with adquately specicity.

Subsection (g)(1)(D) provides that "rehabilitation includes reconstruction" and various other portions of subsection (g) limit the definitions of "qualified rehabilitated building" and "qualified rehabilitation erpenditure", but these limitations do not succeed in distinguishing a "rehablitation" from a capitalized

repair or replacement. The reference in proposed subsection (g)(1)(B) to the passage of at least 5 years since a prior rehabilitation before another rehabilitation can qualify appears to be intended to distinguish between a "rehabilitation" and a mere succession of capitalized repair and maintenance expenditures but in our judgment is adequate for this purpose. A time limit will merely cause grouping or bunching of expenditures in order to meet its requirements and will nevertheless fail to eliminate controversy in distinguishing rehabilitation expenditures from other capital expenditures.

The references in subsection (g)(1)(B) to measuring the five-year period from the date the rehabilitated building was placed "in service" imply that the draftsman may have intended that a building must be taken "out of service" to constitute a qualifying "rehabilitation". If this was intended, we would suggest that the statute be clarified to make this intent clear, although such an interpretation would appear to be unduly restrictive. Assume for example the necessity to "rehabilitate" a retail store property upon the expiration of a long term lease. If the property is going to be leased to a new tenant, should the issue of whether or not a qualifying rehabilitation can occur depend upon whether or not the work is incurred in order to continue the current tenant in occupancy or to secure a new tenant? In any event, it is unclear how a building would be taken "out of service", particularly in the case of a partial rehabilitation.

The House Committee Report states that "rehabilitation" is to include "renovation" and that the five-year rule should not be interpreted to include allowing the credit where there are delays between phases of a rehabilitation plan. (House Report, page 87). Where a building is "rehabilitated" in stages, a portion at a time, when is "the date such building was placed in service in connection with . . . (the) rehabilitation" for purposes of proposed subsection (g)(1)(B)(ii)(II)?

In view of these problems, we suggest either that all capital expenditures be included as qualifying expenditures or that some fixed minimum expenditure, such as that contained in I.R.C. Section 167(k)(2)(B), be substituted for the 5 year requirement of proposed Section 48(g)(1)(B). This would also obviate the necessity for subsection (g)(1)(C) and thereby eliminate another ambiguity and source of future controversy.

Proposed I.R.C. Section 48(g) provides, in subsection (g)(1)(A)(iii), for restricting the term "qualified rehabilitated building" to a building "75% or more of the existing external walls of which are retained in place as external walls in the rehabilitation process."

Since most modern construction does not utilize external walls as structural or loadbearing members, but rather as a curtain over a steel, concrete or wood frame, it would seem more appropriate in distinguishing "rehabilitation" from what would essentially be new construction to substitute, for the retention of 75% or more of existing external walls, retention of the foundation and footings and 75% or more of the existing structural members.

Proposed Internal Revenue Code Section 48(g) is not clear in dealing with instances in which rehabilitation work may be undertaken by lessors and/or lessees. Code 46(e)(3)(A) limits the investment credit in the case of noncorporate lessors where the property "has been manufactured or produced by the lessor . . . .". We would suggest that to correlate Section 46(e)(3)(A) with new proposed Section 48(g), the phrase "or rehabilitated by the lessor in accordance with Section 48(g)" be added to Section 46(e)(3)(A).

From the standpoint of a lessee rehabilitating a portion of a building occupied by such lessee, should qualification of the expenditures made by the lessee depend upon whether or not the balance of the building is being "rehabilitated" by the lessor or other lessees? How is the five year time period to be applied in such a case? Does it depend upon whether or not the lessee in question leases a "major portion of a building" within th meaning of Section 48(g)(1)(C)? What is a "major portion of a building"?

As indicated above in our discussion concerning distinguishing qualifying rehabilitation expenditures from other capital expenditures, we would recommend a liberal statutory rule as being consonant with the purpose of the statute and for the purpose of minimizing ambiguities and future controversy.

III. INDEXING OF ASSETS

Section 404 of H.R. 13511, adding Internal Revenue Code Section 1024:

Proposed I.R.C. Section 1024(b)(1) defines the term "indexed asset" to mean certain stock, tangible personal property, and real property which has been held

for more than 1 year and is a capital asset or property used in the trade or business.

The proposed provision does not define the term "real property". While the term "real property" is utilized in certain other I.R.C. provisions such as, for example, Section 189 and proposed Section 465(c)(3)(D), the term is not specifically defined in the Code and is distinguishable from, for example, Code Section 1250 property which is defined. There is no indication in the House Committee Report as to the intended meaning of the term "real property" for purposes of proposed Section 1024(b)(1)(C), other than the statement that; "for this purpose, the term 'real property' includes land, structures and various mineral interests in real property, but does not include any contract rights with respect to real property which do not themselves constitute real property". (House Report, page 126.) If local law is to determine what constitutes an interest in real property, variations will occur which are arguably inappropriate for purposes of applying a federal income tax statute. For example, a leasehold interest in real property may constitute an interest in real property, a so-called chattel real or simply personal property depending upon the term of the leasehold, the purpose for the characterization and the jurisdiction in which the property is located.

Of even greater concern is the failure to include a partnership interest in the definition of the term "indexed asset", at least to the extent that such interest reflects an interest in partnership "indexed assets". Where, for example, an individual sells an interest in real property held as a tenant in common, he would be considered to have disposed of an "indexed asset" provided that the tenancy in common did not constitute a partnership for federal income tax purposes. However, since many tenancies in common do constitute partnerships" for federal income tax purposes, such a disposition could be treated as the disposition of a partnership interest and, therefore, as the disposition of an asset not included within the term of "indexed asset".

Distinctions of this sort would appear to provide unnecessary ambiguities and opportunities for controversy.

The National Reality Committee appreciates this opportunity to record these supplementary views and recommendations for consideration by the Committee, and will be pleased to supply any additional information which the Committee may wish in connection with the proposed Revenue Act of 1978—H.R. 13511.

MEMORANDUM OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION FOR THE SENATE FINANCE COMMITTEE

The National Retail Merchants Association ("NRMA") respectfully submits this memorandum to the Senate Finance Committee for consideration with the Revenue Act of 1978. The NRMA is a non-profit trade association representing over 35,000 leading department, chain and specialty stores throughout the United States. The aggregate annual sales volume of NRMA members is in excess of $95 billion.

INVESTMENT TAX CREDIT

The general merchandise retail industry believes that is essential for the investment tax credit to be extended to store buildings. The retail industry needs the incentive provided by the investment tax credit to help finance its current and future growth. Because retailing occupies a key position in the country's distribution system, additional investment in retail buildings will generate substantial benefits throughout the nation's economy. The NRMA therefore urges the extension of the investment tax credit to new as well as to rehabilitated commercial structures.

Importance of retailing

Retailing is a large and growing part of the national economy. Total retail sales are in excess of $700 billion per year, and account for over $200 billion, or 10%, of the nation's GNP and over 37% of the total value of the nation's output of goods. In terms of employment, retailing accounts for one out of every six workers throughout the nation—almost 14 million persons—in over 1.9 million retail establishments. In the period 1970 to 1976, 2.2 million of the 9 million new jobs, or 1 in every 4, were in the retail sector. Retail trade also is one of the fastest growing employers. From 1965 to 1976, retail employment increased over

a third faster than total employment, at a rate of 31.6% as compared to 23.2% for the economy as a whole.

Retailing is thus a large and important force in the economy. But its importance does not lie solely in its size, or in its contribution to the GNP, or in the extent to which it provides jobs, significant as these measurements may be. Rather, retailing's importance is structural, and lies in the role it plays in bringing goods from producer to consumer. The retail function is essentially a distributional function; like transportation, retailing's place in the economy lies midway between production and consumption linking the two together. But because retailing does not, except incidentally, physically transport goods from one place to another, its function and the value it adds to consumer goods are often not fully appreciated.

The economic value retailing provides is substantial. In the first instance, it is the retailer, by placing the order, who causes goods to be brought from the place of origin to the market where they ultimately will be consumed. The retailer erects the store, staffs it with employees, orders, pay for and stocks the goods—in many cases before the consumer is even aware that a particular product is available. After bringing the goods to market, the retailer advertises and displays them along with other, similar goods to facilitate the consumer's comparison and choice, and offers them for sale at times when and at locations where those goods are accessible and convenient to the ultimate buyer.

In this manner the retailer adds economic value to consumer goods just the same as does the manufacturer when he creates them out of raw materials or does the railroad or trucking company when it transports them. For example, the value of a dress in a loft in New York's garment center, or of a chest of drawers in a warehouse in the Carolinas, is much less to a potential consumer in, say New Orleans than the same dress or chest of drawers when it is on display at a downtown store or suburban shopping center just a short distance from his home or office. The retailer perform these value-adding functions because he can do so more efficiently than can any individual consumer. The retailer thus adds value to consumer goods by bringing goods to the consumer when and where the consumer wants them, and in sufficient variety to facilitate an informed choice.

This is the sense in which the retailer stands in an economically pivotal position, midway between the two ends of the economy: it is the retailer that many goods flow from the manufacturer to the consumer in a cost- and energy-efficient manner. An efficient retail sector lowers the final cost of a product, exerting a strong "pull-through" demand for manufactured goods and so stimulating production. Conversely, an inefficient retail sector adds to the final cost of manufactured goods and depresses demand, vitiating any productivity gains achieved in the manufacturing sector.

Needs of retailers

In light of the crucial role retailing plays in the economy, this industry would be expected to fare well under the tax code. However, it does not. For example, retailers must maintain great numbers of employees on their payroll; as a result, they have been severely affected by recent increases in payroll taxes. In addition, although they have large capital requirements and must commit much of their capital to carrying inventories and customer receivables, neither of these uses of capital qualifies for either of the two major tax incentives: accelerated depreciation or the investment tax credit.

Even though retailing is highly labor-intensive and commits much of its scarce capital to payroll and receivables, retailers also have large fixed capital costs. The largest such fixed capital cost is the retail structure itself—the store. Here, too, Congress cannot be said to have treated the retail industry with any kind of favoritism. For example, in 1969, Congress significantly altered the tax treatment of retail structures by adding Section 167(j) to the Internal Revenue Code. This provision limits the depreciation allowance for retail structures to the 150% declining balance method, disallowing the use of such accelerated capital recovery methods as the 200% declining balance method that previously had been allowed.

Moreover, the store, like most of the retailer's other capital requirements, remains ineligible for the investment tax credit. While it is true that general-purpose structures never qualify for the investment tax credit, some kinds of tangible property—good examples are air conditioning units used for temperature and humidity control, and parking lots—qualify for the investment tax

credit when used by a manufacturer but not when used by a retailer, solely because of such retail use. Because the bulk of a retailer's fixed capital investment is devoted to uses that do not qualify for the investment tax credit—the structure constitutes a greater proportion of fixed investment for retailers than for other businesses, like manufacturers—retailers receive substantially less benefit from all the major investment incentives that Congress has designed to aid the nation's economic recovery.

Retailers, like most businessmen, finance a large portion of their capital needs internally, with retained earnings. These earnings represent after-tax dollars. Yet, as a reflection of the lack of tax incentives available to them, retailers pay federal income taxes at the highest effective rate of any industry group. Their tax burden is all the more significant in light of the current rate of inflation. Retailers are paying taxes on "income" that represents merely inflationary gains.

When weighing the advisability of making a major capital investment, businessmen, including retailers, consider its anticipated rate of return. The rate of return reflects, among other things, the timing of the income to be realized by the investment and current and anticipated tax rates.

In inflationary times, such as the present the rate of return of long-lived assets suffers much more than it does in the case of short-lived assets. This occurs because the costs of a long-lived asset are written off over a longer period of time, but the dollars deducted in future years are worth much less than they were when the asset was acquired. In essence, a company that invests in a long-lived asset measures its future income by deducting a small number of expensive dollars (depreciation on an earlier acquired asset) from a large number of cheap dollars (inflated future income). In paying income tax on the difference, the company pays tax, in part, on its invested capital.

The most important fixed capital investment of the retailer is the store, an asset that, for tax depreciation purposes, is considered to have a relatively long anticipated useful life. It follows that retailing suffers more in this regard than do industries that invest a larger part of their capital in relatively short-lived assets, such as machinery and equipment. This effect is particularly pronounced because the cost of structures has risen half again as fast as inflation generally; from 1960 to 1976, the cost of all commercial structures rose 154.9%, while the GNP deflator rose only 95%. Inflation thus acts to dampen investment in retail structures. Retailers have a particularly acute need for a tax incentive to stimulate investment and thereby to provide for the distributional needs of the economy.

The NRMA believes that an incentive of proven effectiveness—the investment tax credit—is therefore necessary. The investment tax credit should be made available for new retail construction.

Positive Effects on Economy

Extending the investment tax credit to new retail structures, and so stimulating their construction, will have several beneficial effects. Newly constructed stores generally incorporate the most modern design techniques and are sited where they can perform the retail function most efficiently. Typically, new stores devote a larger portion of their floor space to selling than do older stores, thereby making more efficient use of space. New stores generally are more energy-efficient than older stores. In addition, new stores can be located nearer to consumer markets, as those markets have shifted geographically or changed in character. Since retailing is a highly competitive industry, such inefficiencies translate into cost savings for the consumer.

These efficiencies also translate into greater productivity at the manufacturing level, because lower prices for consumer goods accentuate the "pull-through" demand effect on manufacturing and lead to increased investment in that sector of the economy as well.

Of particular importance is the effect of an expanded retail investment tax credit on employment. When a store is built, jobs are created. The employment effect occurs in the first instance in the construction industry and in industries that supply the fixtures and other capital goods that are incorporated into the structure. After the initial construction phase, however, the employment effect is particularly pronounced. The number of jobs on an ongoing basis that each dollar of retail construction supports is unusually high. After a store is opened, large numbers of clerks, sales and delivery persons and supervisory personnel all need to be employed. In fact, retail investment supports three times the

number of permanent jobs, dollar for dollar than does manufacturing investment. Retail investment is thus an efficient and less costly means of stimulating the nation's employment.

In addition, retail investment stimulates employment of a special kind: a large proportion of jobs in retailing can be filled by those persons in the unemployment pool who are least likely to find other kinds of work—for example, the unskilled, and married women, students and older persons, who may wish or be able to work only part-time. Many retail jobs are suitable for these persons, who otherwise would be unable to find work in other industries. It is these persons, often referred to as the "structurally unemployed", that are most resistant to other employment-stimulating measures; they will not be as efficiently removed from the unemployment rolls unless legislation designed to stimulate employment applies to the retail sector. The investment tax credit, a measure whose positive effect on employment is well-documented, must therefore be extended to retail investment if its full employment-stimulating effects are to be realized.

Moreover, new retail building construction stimulated by an expanded investment tax credit can be expected to have an impact in every geographical region of the nation. Retailing is a nationwide activity, and stores are located, and employees are needed, wherever there are people. In addition, new stores add significantly to the local tax base, paying property, income, and special assessment taxes, and employment taxes, as well as by vitalizing the local economy by paying wages to their employees.

The House Bill

The House-passed Revenue Act of 1978 extends the investment tax credit solely to costs incurred in the rehabilitation of existing older business structures. It does not make eligible for the credit newly-constructed buildings. The provision was so limited, according to the House Report, in order to provide a narrowly targeted incentive for the cities, and so to help reverse the demographic and economic trends that have led to the decline of central cities and older neighborhoods.

The NRMA applauds the investment tax credit provision of the House-passed bill, but believes that it does not go far enough, in terms of either its stated aims or the needs that face both the retail industry and the economy as a whole. It should be apparent, for example, that the deterioration of a central city could be halted or reversed as much by a newly-constructed store as by a rehabilitated store. New shopping malls are often located in a part of a central city that has been razed and subject to an urban renewal program, and often serve as the centerpiece of urban revitalization. Yet the House bill would not give the retailer the necessary incentive to build a new store in the downtown area, even though doing so is as fully consistent with the goal of central city renewal as is an investment tax credit limited to rehabilitation.

In fact, the rehabilitation of older structures often may not be economically practicable, even with the investment tax credit. Advances in merchandising and building techniques in recent years have rendered older stores obsolete not merely because their fixtures may look old-fashioned, but because their basic construction is not suited to adaptation to current merchandising methods. For example, building materials may not be energy-efficient, older supporting structures may be inadequate to support new equipment, or transportation facilities (*e.g.*, loading docks) may not be sited properly. The most efficient use of scarce capital, either in revitalizing a downtown area or in providing retail services to a new neighborhood, is not necessarily in the rehabiltaton of exsting older structures. Accordingly, the House bill should be modified to make both older structures as well as new buildings, wherever constructed, eligible for the investment tax credit.

Other Provisions of the Bill

The NRMA supports the provisions of the House bill that would reduce the top corporate income tax rates. A reduction in corporate rates is necessary to reduce unemployment and stimulate economic growth. However, the NRMA believes that a rate reduction of at least an addition 2%—to 44%— is necessary to accomplish these goals.

Many NRMA members are small businessmen. For them, inflation has taken a particularly heavy toll. They have become subject to the highest corporate income tax rates due solely to inflationary increases in their incomes. Congress

has in the past recognized the necessity of a lower tax rate for small businesses, to allow them to retain more of their earnings for reinvestment and expansion. Accordingly, NRMA believes the surtax exemption should be increased, and the tax rates graduated as provided in the House bill, to allow small business again to maintain the necessary levels of investment of after-tax income. The NRMA also supports the other measures of the House bill intended to aid small business, such as the increased "bonus" depreciation allowances, and the liberalization of the subchapter S qualification and election rules.

Representatives of the NRMA would be pleased to work with members of the Committee and its staff towards the enactment of our proposals.

Statement of the National Retired Teachers Association and the American Association of Retired Persons

I. General Comments on the Administration's Tax Reduction and Reform Proposal and H.R. 13511

Four factors necessitate the development of a tax cut package that will reduce federal income tax liability for individuals and business in 1979. First, there is need to strengthen and maintain the ongoing economic expansion and thus perpetuate the downward trend in unemployment. Second, there is a need to offset the increasing income tax burden that results from the combination of inflation-induced income increases and the progressive tax rate structure. Third, business investment is in need of stimulus; it has lagged appreciably since the economy began to recover from the bottom of the recession in 1975. Finally, increases in payroll taxes for social security and unemployment insurance need to be offset.

Our Associations have supported the individual and corporate income tax reductions that have been enacted during the past few years to facilitate economic recovery. But we would also point out that past tax cut legislation, as shaped by the Congress, did not return the same amount of real income to each household that it has lost as a result of inflation—induced increases in tax liability. Instead, tax reductions have been concentrated on lower and middle income households resulting in a redistribution of the income tax burden among income groups.

Unfortunately, the context in which the 1978 tax cut package is proposed is more complicated than in past years. The 1977 Social Security Financing Amendments have scheduled enormous increases in payroll taxes to shore up the social security system beginning next year. Both the House and Administration bills are proposing to cut income taxes to offset the adverse economic consequences that will result from higher payroll taxes in 1979.

Our Associations believe it makes better sense and creates fewer problems to introduce some limited use of general revenues into the cash benefit programs to deal with the short-term financial imbalance problem. We are opposed to the development of a public policy of increasing social insurance payroll taxes on the one hand and cutting income taxes on the other. First, such a policy will increase the share of federal government revenue derived from regressive payroll taxes relative to that derived from progressive income taxes. Second, at a time when continued reduction in unemployment is a primary economic goal, it makes no sense to discriminate against labor by enacting legislation that schedules enormous increases in payroll taxes. Higher payroll taxes increase the cost of labor (relative to the cost of capital) and make reducing unemployment that much more difficult. Third, many households will lose more from payroll tax increases than they will gain from income tax cuts; households not subject to the payroll tax increases will gain a windfall via the income tax cuts. Finally, the inflationary pressures generated by increased payroll tax burdens are not likely to be offset by concomitant income tax cuts.

The excess of outgo over income for the social security system—a situation that has existed since 1975—is primarily attributable to the impact of elevated rates of inflation and unemployment. Since benefits move up automatically with inflation, the higher the inflation level, the higher the outgo from the system. As consumer purchasing power declines (as a result of inflation, higher taxes, etc.) unemployment increases and payroll tax contributions to the system fall

below anticipated levels. The public policy answer to the social security short-term financial imbalance should have responded, but did not, to the economic causes of the problem.

Since 1975, our Associations have advocated a limited (and hopefully temporary) use of general revenues to fund a portion of the cost of automatic benefit increases to the extent that those increases exceed a specified level (for example, 4 percent). As the rates of inflation and unemployment decline and the difference between the rate of inflation and the rate of increase in average covered wages in social security covered employment increases, the annual general revenue contribution should gradually phase out automatically. In addition to our own proposal, last year we endorsed the Administration's proposal that would have used general revenues to replace income lost to the social security system as a result of unemployment rates in excess of 6 percent. As unemployment declines below that figure the annual general revenue contribution for this purpose would also phase out automatically.

Our Associations continue to espouse these two specific uses of general revenues for the cash benefit programs. First, these two general revenue devices—one on the outgo and one on the income side of the social security ledger—will serve to protect the system from the two-fold threat posed by high rates of inflation and unemployment over the long term. Second, they will assist sound financial planning for future payroll tax needs by assuring a minimum amount of income to the system each year. They will also assure that the payroll tax mechanism will only be called upon to fund the cost of automatic benefit increases up to a specified maximum level; the annual cost of automatic increases in excess of that level would come from the general fund. Third, by desensitizing the socal security system to adverse economic developments, not only would the system be better protected, but beneficiaries and workers would have greater assurance of its ongoing viability. Fourth, by introducing general revenues into the cash benefit programs, some of the inflation and unemployment pressures that payroll tax increases produce could be avoided. Finally, some of the revenue potential of the payroll tax mechanism would be "freed up" for the purpose of funding the cost incident to a transition to a "reformed" social security system—a system better prepared to accomodate the changing and future needs of the next generation of older persons.

In view of the foregoing, it should be clear that our Associations believe the Congress, by choosing to rely almost exclusively on payroll tax increases to deal with the short-term financial imbalance in the social security system, made a serious mistake. Tax cut legislation should be tailored to introduce some general revenues into the system as a substitute for at least some of the payroll tax increases now scheduled under current law. We fear that, if our recommendation is ignored, a crisis between the generations will be precipitated as scheduled payroll tax increases become effective and FICA payments become larger and more visible on pay stubs of current workers.

II. COMMENTS ON SPECIFIC ITEMS CONTAINED IN THE TAX CUT PROPOSALS

A. *Individual cuts.*—Our Associations support proposals to reduce the marginal tax rates and increase zero bracket amounts for individual income taxpayers to counteract the tendency of inflation to increase the share of personal income that taxpayers pay in federal income taxes. We also support the increase in the personal exemption to $1,000 as proposed by H.R. 13511. However, we oppose the House bill's elimination of the $35 general tax credit; we favor retention of this credit to avoid adversely affecting lower-income individuals.

With respect to the Administration's proposal to substitute a 240 credit per exemption for the present deduction of $750 per exemption and the general tax credit, our Association would suggest modifying this proposal to give the taxpayer a choice between the combination of the deduction for personal exemptions and the general tax credit and the proposed new 240 credit per exemption. We agree that credits are more in accord with ability-to-pay principles than deduction in that they grant equal tax relief at all levels of income, but the Administration's proposal would help lower-income elderly taxpayers but hurt other elderly taxpayers.

The tabe on the next payge shows that, in terms of an aged couple, both of whom are age 65 and over, the "breakeven" point (i.e. the point at which the couple is neither helped nor hurt by the proposed substitution of the 240 credits for the $750 personal exemptions and the general tax credits) is an AGI of $20,200.

We would suggest that while an aged taxpayer with AGI in excess of $20,200 may be "higher income" statistically, he does not necessarily think of himself as being so. Indeed, the majority of this group of elderly taxpayers probably think of themselves as in need of more, not less, tax relief because those income components that make them "higher income" are more vulnerable to the impact of inflation. Since middle and higher income workers are being penalized more heavily by scheduled payroll tax increases and since all taxpayers are being penalized by the combination of inflation-induced income increases and the progressive rate schedule, we see no reason to penalize higher income taxpayers even further in the name of tax reform at this time.

B. Medical deduction.—Our Associations oppose the Administration's proposal to eliminate the existing deduction for medical care expenses and substitute a single hardship loss deduction (with a threshold amount) for such medical care expenses and casualty and theft losses. We would point out that in taxable year 197, 27 percent (2 million) of all returns filed by persons age 65 and over (7.4 million) claimed the medical expense deduction. The rising cost of health care is imposing an increasing expenditure burden upon the elderly, among whom the incidence of chronic illness is high.

EXAMPLE OF OPERATION OF THE PROPOSED $240 PER CAPITA CREDIT AND THE BREAK-EVEN LEVEL

	Current law	Proposed (assuming current law rate schedule)
Adjusted gross income	$20,200	$20,200
Less 2 personal exemptions and 2 aged exemptions	3,000	
Taxable income[1]	17,200	20,200
Tax before credits	2,766	3,546
General tax credit	180	
Less 4 per capita		960
Tax after per capita credit but before credit for the elderly	2,586	2,586

[1] The example assumes the taxpayer has no itemized deductions in excess of the zero bracket amount.

With respect to medical expense deduction changes proposed by H.R. 13511, our Associations support the repeal of the 1 percent floor for drugs, but oppose repeal of the flat deduction for the first half of medical insurance premiums.

We recognize that the Administration and House proposals to tighten the medical expense deduction are advanced, in part, in the name of tax simplifications. We support retention of the present medical expense deduction but, in order to achieve some degree of simplification, the 1 percent floor for medicine and drugs (IRC Section 213(b)) and the 3 percent floor (IRC Section 213(a)) for other medical expenses should be eliminated at least with respect to the elderly taxpayers.

C. CAPITAL GAINS EXCLUSION FOR SALE OF A RESIDENCE

Our Associations strongly support the provision of H.R. 13511 which exempts up to $100,000 of the capital gain on the sale of a personal residence, regardless of the taxpayer's age. This provision is a significant improvement in the amount of tax relief available under present law (IRC Section 121) which exempts all or a portion (if sales price exceeds $35,000) of the gain for taxpayers age 65 or over. Inflation, increased housing costs and rapidly rising property values necessitate a liberalization in current law especially for elderly taxpayers who often realize a substantial gain in the sale of a residence simply because they have held on to those residences for so many years. In addition, many elderly who retire cannot take full advantage of the present rollover provision because in retiring they tend to replace their residence with a less expensive dwelling or move to rental quarters.

Our Associations urge this Committee to adopt Section 405 of H.R. 13511, but with the following important alterations. First, the effective date of his section should be for sales of personal residences after December 31, 1977 (not July 26, 1978). In filing tax returns for the 1978 tax year, the July cut-off

date will appear blantantly discriminatory and inequitable to elderly (as well as non-elderly) taxpayers who unknowingly sold their homes prior to July 1978 and therefore, are required to use the less generous provisions of current law. Moving back the effective date of Section 405 to the beginning of the tax year would avoid this situation and greatly simplyify tax filing instructions as well as reduce the number of tax forms.

Second, in order to qualify for the new capital gains exclusion, elderly taxpayers should be permitted to use the current law's (IRC Section 121) rules relating to the length of time a person is required to own and use his or her residence. Under current law, an elderly taxpayer must own and use his or her residence for at least 5 years during the 8-year period preceding the sale. The revision proposed by H.R. 13511 shortens the residence period to at least 2 years during the 3-year period preceding the sale. It is possible that some elderly persons, who have experienced difficulty and delay in selling their homes, have been relying on the current law's definition and have waited to sell their homes until this year or will wait until some future year. These persons are still eligible for the current law (Section 121) exclusion even though they have not resided in their homes during the last three years. However, if H.R. 13511 is adopted as is, those elderly taxpayers who have not resided in their homes during the past 3 years would receive no tax break at all—but would have received one under the continuation of current law. To solve this problem, our Associations suggest that elderly taxpayers be permitted to choose either the current 5 out of 8 or the proposed 2 out of 3 rule in qualifying for the $100,000 exclusion. This would thereby protect elderly taxpayers who might be denied any tax relief during the transition from old to new rules.

D. Targeted jobs credit.—Our Associations strongly support Section 314 of H.R. 13511 which would provide a credit to employers hiring individuals who are recipients of Supplemental Security Income (SSI) (as well as individuals who are recipients of other cash welfare programs). We are hopeful this provision will provide an incentive to businesses to hire low income older workers by reducing somewhat the cost of employing them. The recognition by our tax structure of older workers as a group experiencing high unemployment rates and having special employment needs is long overdue.

III. ADDITIONAL ITEMS NOT INCLUDED IN PENDING TAX CUT PROPOSALS

There are certain issues which both the Administration's package and H.R. 13511 fail to address but which are of importance to the elderly. We hope this Committee will consider these issues.

A. Tax credit for the elderly.—Our Associations previously testified before this Committee regarding the need to expend the Tax Credit for the Elderly (TCE). As a result of hearings held on the subject, the Committee approved a proposal offered by Senators Hathaway and Dole. We urge this Committee to attach this proposal to the tax cut legislation in order to prevent non-social security retirees from falling behind their social security counterparts in terms of tax relief provided to them.

The Hathaway/Dole proposal would raise the maximum amounts currently used to compute the credit from $2,500 to $3,000 for single taxpayers 65 or over and from $3,750 to $4,500 for married couples.

In addition, the Hathaway/Dole measure would increase adjusted gross income limits imposed on the tax credit from $7,500 to $15,000 for individuals and from $10,000 to $17,500 for married couples. Currently, taxpayers 65 or over must reduce the amount used to compute the credit by $1 for every $2 of adjusted gross income in excess of $7,500 for individuals and $10,000 for married couples.

While the Associations applaud the Finance Committee action to liberalize the present elderly tax credit, we support the more ambitious provisions of S. 2128 introduced by Senator Daniel Inouye which would eliminate the AGI limits entirely. The existence of any limits in the TCE law blatantly contradicts the law's stated objective of equal tax treatment of non-social security and social security retirees because social security retirees receive tax free benefits regardless of the level of their total income. In addition, S. 2128 would cost-index the new base amounts according to increases in the CPI so that the TCE would keep pace with automatic social security benefit increases.

While the Hathaway/Dole proposal would raise the base amounts used by retirees age 65 or over, it would not raise the base amounts used by public retirees

under age 65 who qualify for the credit. If the base amounts were raised for persons age 65 and over and not for persons under age 65, then this different set of TCE rules based on age would further aggravate the disparity which already exists in the tax treatment of these two groups of retirees.

A single taxpayer under age 65 would be entitled to a credit that could be as much as $75 less than the credit received by a single taxpayer age 65 or over with the same amount of total income. Our Associations urge this Committee to correct this potential disparity that would result from passage of the Hathaway/Dole proposal in its current form by providing equal increases in the base amounts (to $3,000 and $4,500) used by public retirees under age 65.

B. Sick pay exclusion. The 1976 Tax Reform Act revised the rules governing the use of the sick pay exclusion. These changes had the effect of restricting the exclusion's availability to persons retired on disability. Now the $5,200 maximum exclusion is available only to persons under age 65 who are permanently and totally disabled; moreover the amount otherwise excludable must be reduced dollar-for-dollar for all adjusted gross income in excess of $15,000 (in the case of both single persons and married couples).

Although our Associations understand what prompted Congress to impose these restrictions, we feel that some of the new provisions result in overly harsh tax treatment of certain disabled persons. We suggest the following liberalizations. First, we support passage of S. 2628, introduced by Senator Bumpers to eliminate the requirement that married couples must file joint returns in order to use the exclusion. Second, the reduction of the $5,200 maximum exclusion on a dollar-for-dollar basis should be liberalized to a $1 for $2 reduction.

C. Tax treatment of annuities and the exclusion ratio problem. Under current law, if the taxpayer can receive back in life annuity payments within three years or less all that he contributed toward that annuity, then all payments received are excluded from gross income until he has recovered those contributions. However, if he would not have recovered those contributions within the three year period, then he may exclude from gross income only that portion of payments received during the course of his taxable year as determined under an "exclusion ratio" that spreads out his recovery of contributions over his remaining life (as determined in accordance with IRS life tables).

In order to assure that the taxpayer recovers fully his contribution (something that he does not do under current law if he fails to live as long as the IRS life tables project him to) and to simplify the tax treatment of this form of income, our Associations recommend that the taxpayer be allowed to exclude from gross income all amounts received as annuity payments during the course of his taxable year until such time as he has fully recovered his contributions. After that, the annuity payments would be includable in gross income. In effect, this recommended change would merely eliminate the present 3 year limitation on the taxpayer's eligibility to avail himself of that set of rules under IRS Section 72 that allows him to recover his contributions initially.

IV. TAX PREPARATION PROBLEMS OF THE ELDERLY

Every year many older persons make errors in preparing their federal income tax returns and sometimes overpay their taxes either because they are unaware of the special benefits available to them or because they are unable to understand complex tax provisions. Upon reaching age 65, the older taxpayer is faced with an entirely new and complicated set of tax rules and forms which make reporting income and computing tax liability a difficult task.

In response to this problem, Senator Frank Church introduced the Older Americans Tax Counseling Assistance Act (S. 835) which is strongly supported by our Associations. Senator Floyd Haskell is a cosponsor of this bill and is expected to offer it as an amendment to H.R. 13511 during Finance Committee markup. Nearly identical legislation was approved by the Finance Committee during markup of the 1976 Tax Reform Act, but was unfortunately dropped in conference.

Senator Haskell's amendment would authorize $2.5 million in 1979 for the Internal Revenue Service to enter into training and technical assistance agreements with non-profit groups for the purpose of preparing volunteers to provide tax counseling assistance to elderly taxpayers. Volunteer counselors would be reimbursed for out-of-pocket expenses incurred in giving assistance and IRS would also be authorized to conduct special alerts to make elderly taxpayers aware of beneficial tax relief measures.

For nine years, our Associations have sponsored a national "Tax-Aide Program" which provides free tax preparation assistance to a large number of older adults. This program utilizes older volunteer counselors who are trained by the IRS and specialize in elderly tax problems. Last year 9,019 volunteer counselors participated in the Tax-Aide Program, assisting in the preparation of over 613,000 federal and state tax returns.

Our experience with the Tax-Aide Program indicates that the elderly taxpayer, because of his limited mobility, is best served by a taxpayer service which can adapt to his special needs. Assistance must be provided at locations convenient to older persons (senior citizen centers, churches) and counseling on federal, state and local tax matters should be available at one location, thus relieving the elderly person of the burden of visiting several offices for assistance.

When seeking advice at a local IRS district office, the older taxpayer must compete against other taxpayers and is often required to stand in line for hours after traveling a long distance to receive assistance. The pace at a Tax-Aide site is much slower and volunteer counselors generally have more time and patience to provide thorough assistance. In contrast to Tax-Aide counselors, IRS taxpayer service representatives are oriented toward responding to specific questions rather than providing comprehensive assistance in preparing the taxpayer's entire return, making sure taxpayers take advantage of their full legal tax benefits.

The rapid growth of our Tax-Aide program over the past nine years has convinced our Associations of the need for expanding present elderly tax counseling assistance programs. Although our program is effective, it has not been able to reach the millions of elderly taxpayers in need of assistance. Senator Haskell's amendment would permit an expansion of current services by increasing the financial and administrative support available to IRS to encourage more privately-sponsored volunteer programs.

Statement of Robert D. Partridge, Executive Vice President and General Manager, National Rural Electric Cooperative Association

Mr. Chairman and members of the Committee, my name is Robert D. Partridge. I am Executive Vice President and General Manager of the National Rural Electric Cooperative Association (NRECA). NRECA is the national service organization that represents nearly 1,000 consumer owned rural electric systems in 46 states, delivering electric power to approximately 25 million people in the rural and sparsely populated areas of 2,600 of the nation's 3,100 counties.

Among those services offered by NRECA, is the administration of benefit programs for employees of the member cooperatives. One such program is affected by the bill before you today—deferred compensation. Our program, briefly, is as follows:

An employer (an NRECA member cooperative) and an employee, agree to defer a portion of the employee's compensation until she/he leaves the service of the employer. The agreement is made before the employee renders the service for which the compensation is deferred. The money so deferred, is held in a single bookkeeping reserve administered by NRECA to be paid out over the number of installments as agreed by the employer and employee. The money is not held in trust; and the agreement is merely an unsecured promise to pay at a later date.

Nationally, NRECA administers the deferred compensation benefit plan for approximately 900 electric cooperative employees who deferred approximately one and three quarters million dollars ($1.75 million) in compensation during 1977.

When the original House bill was printed, Subtitle C—Deferred Compensation provisions described programs for employees of state and local governments (Section 121), private employers (Section 122) and independent contractors (123). Contained in the definition of private plans was a specific exclusion of employees of organizations, exempt from tax under Section 501(c) of the Code. Rural electric cooperatives fall within Section 501(c)(12) and 501(c)(4) and NRECA, the administering organization, and the cooperative's state associations are exempt under 501(c)(6).

During House consideration of H.R. 13511, the rural electric cooperatives, fearing that legislation omission would place the existence of deferred compensation plans in jeopardy, asked for an amendment to place our deferred compensation plans in Section 122, the private sector. However, apparently, as a sort of compromise, we were classified as public employees in Section 121. This means

that under H.R. 13511 employees of rural electric cooperatives are limited in their deferred compensation to $7,500 per year 33⅓% of includible compensation whichever is less; a limitation that applies to no other private sector employee group.

What we ask, therefore, is that the Senate Bill place employees of electric cooperatives and their affiliated organizations in the private sector along with all other employees of non-government entities. We believe that private classification for our employees is fully justified for the following reasons:

1. All benefit plans administered by NRECA for its member cooperatives fall within the definition and consideration of private sector benefit plans. These programs include pension, savings and insurance. We believe that deferred compensation should be treated similarly.
2. The proposed legislation imposes no limit whatever on the amount of salary that may be deferred by employees of investor-owned electric utilities. These companies, like electric cooperatives also enjoy substantial Federal Tax advantages. Our members are trying to attract and retain the same kinds of skilled employees as are the power companies, and the proposed differential treatment for identical types of employees is therefore, in our judgment, grossly unfair.
3. Rural electric cooperative employees negotiate with NRECA's member cooperatives over wages, salaries, terms and conditions of employment just as employees of other private sector organizations. Salaries are not fixed as in the public sector.
4. Employees of cooperatives are in danger of forfeiting their deferred compensation if the employer faces insolvency. Any deferred compensation claim against the employer's assets rests on no firmer grounds than those of other creditors. This is again identical to private sector situations.
5. Rural electric cooperatives do receive Federal guarantees and Federal insurance from REA to secure the repayment of their debt capital. However, many other types of business enjoy the same benefit including small businesses of all kinds and big business in housing and shipbuilding. The employees of these businesses are not limited in their deferred compensation under the proposed bill nor has Treasury proposed any such limitation.

Treasury has argued that the tax-paying employer cannot deduct from taxable income funds placed in a deferred compensation program. This fact, Treasury asserts, serves as a restraint on the amount private sector employers will allow their employees to defer. We suggest that any such restraint, if it indeed exists, is more than offset by the generally much higher salary levels of employees in the private sector who are likely to defer income, and by the fact that many big private sector types of businesses enjoy special advantages which reduce their tax liability to the point that the restraint to which Treasury refers would be minimal. Let me also point out that electric cooperatives do not and cannot use profit-sharing or stock bonus plans as do employees of some types of business. Of course, disparity among the employees of various groups will occur with respect to employee benefits, but to legislation such disparity is, in our view, highly inappropriate.

We have also wondered why the $7,500 amount? In 1969, the House-passed tax bill included provisions addressing the deferred compensation issue. The bill provided continuation of current treatment—taxation of deferred compensation the year received—but any amount over $10,000 deferred was to be taxed at a rate applicable to the year in which earned. The section on deferred compensation was dropped during the Senate consideration as Treasury recommended deleting these provisions indicating that further analysis was needed. Our point is, if in 1969 Congress considered $10,000 as a reasonable cut off, why $7,500 in 1978?

The Consumer Price Index has risen 76 percent since 1969, so $10,000 in 1969 would now amount to $17,600. Yet, Congress is seriously considering limiting public employees and employees of electric cooperatives to deferred compensation employee benefits of $7,500, with no indexing for inflation.

Let me suggest that if the Committee cannot accept the proposition that electric cooperative employees should be treated as being in the private sector, one solution to the problem would be to delete from the House Bill the "lesser of" provision of $7,500 or 33⅓ percent. This would allow our employees to defer up to ⅓ of salary or $7,500 at their option. The dollar amount limitation really works to the disadvantage of those employees who work in necessarily higher salaried areas such as Alaska. Our employees in this case would be severely discriminated against

whereas other private sector employees could defer salary without any limitation. On the other hand, the percent limitation works against those lower salaried employees to whom 33⅓ percent is less than $7,500.

Mr. Chairman, in summary what we ask is that for purposes of deferred compensation, (1) employees of electric cooperatives be treated the same as other private sector employees, or (2) that the limitation for electric cooperative employees be substantially raised to at least the lesser of $20,000 per year or one-third of salary, or (3) that the words "lesser of" in the House Bill be deleted.

I thank the Committee for the opportunity to present NRECA's views on this subject.

Regional Planning Council

PERSONAL

September 1, 1978

Senator Russell B. Long
Chairman, Senate Finance Committee
Room 2227 DSOB
Washington, D.C. 20510

Milton H. Miller, Chairman
C. Bowie Rose, Sr., Vice Chairman
Frederick L. Dewberry,
Executive Director

701 St. Paul Street
Baltimore, Maryland 21202
(301) 383-5838

Dear Senator Long:

Everyone knows that inflation is the nation's major economic problem. But even you may not know that the problem could be solved, in part, by a simple amendment to HR 13511.

That bill currently contains a provision calling for a reduction in the corporate tax rate from 48% to 45% after December 31, 1978. It should be made a variable function of the average annual rate of wage increases for a period of several years until inflation is brought under control.

The economic justification for such a tax-based incomes policy (TIP) was stated by expert witnesses who testified at hearings of the Proxmire Committee on May 22-23, 1978. Administration officials are considering recommending such a policy in the report on inflation which is to be submitted to the President by September 15.

Before you complete the hearings on HR 13511, I hope you will give formal consideration to such an amendment.

Sincerely,

John Snell
Chief Economist

Enclosure

cc: Members of the Senate Finance Committee

Baltimore City Anne Arundel County Baltimore County Carroll County Harford County Howard County State of Maryland

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1977 or other taxable year beginning ...., 1977, ending ...., 19...
(PLEASE TYPE OR PRINT)

1977

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See Page 8 of instructions)

Use IRS label. Otherwise print or type.

Name
Number and street
City or town, State, and ZIP code

NO CHANGE

D Employer identification number
E Date incorporated
F Enter total assets from line 14, column (D), Schedule L (See specific instructions)
$

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction N

GROSS INCOME

1	Gross receipts or gross sales .... Less: Returns and allowances	1
2	Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)	2
3	Gross profit	3
4	Dividends (Schedule C)	4
5	Interest on obligations of the United States and U.S. instrumentalities	5
6	Other interest	6
7	Gross rents	7
8	Gross royalties	8
9	(a) Capital gain net income (attach separate Schedule D)	9(a)
	(b) Net gain or (loss) from line 9, Part II, Form 4797 (attach Form 4797)	9(b)
10	Other income (see instructions—attach schedule)	10
11	TOTAL income—Add lines 3 through 10	11

DEDUCTIONS

12	Compensation of officers (Schedule E)	12
13	Salaries and wages (not deducted elsewhere)	13
14	Repairs (see instructions)	14
15	Bad debts (Schedule F if reserve method is used)	15
16	Rents	16
17	Taxes (attach schedule)	17
18	Interest	18
19	Contributions (not over 5% of line 30 adjusted per instructions—attach schedule)	19
20	Amortization (attach schedule)	20
21	Depreciation from Form 4562 (attach Form 4562) ...., less depreciation claimed in Schedule A and elsewhere on return ...., Balance ▶	21
22	Depletion	22
23	Advertising	23
24	Pension, profit-sharing, etc. plans (see instructions) (enter number of plans ▶ ....)	24
25	Employee benefit programs (see instructions)	25
26	Other deductions (attach schedule)	26
27	TOTAL deductions—Add lines 12 through 26	27
28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)	28
29	Less: (a) Net operating loss deduction (see instructions—attach schedule) ... 29(a)	
	(b) Special deductions (Schedule I) ... 29(b)	
30	Taxable income (line 28 less line 29)	30

TAX

31	TOTAL TAX (Schedule J)	31
32	Credits: (a) Overpayment from 1976 allowed as a credit	
	(b) 1977 estimated tax payments	
	(c) Less refund of 1977 estimated tax applied for on Form 4466 . ( )	
	(d) Tax deposited with Form 7004 (attach copy)	
	(e) Tax deposited with Form 7005 (attach copy)	
	(f) Credit from regulated investment companies (attach Form 2439)	
	(g) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)	
33	TAX DUE (line 31 less line 32). See instruction G for depositary method of payment	33
34	OVERPAYMENT (line 32 less line 31)	34
35	Enter amount of line 34 you want Credited to 1978 estimated tax ▶ Refunded ▶	35

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which the preparer has any knowledge.

▶ Signature of officer Date

▶ Paid preparer's signature and identifying number (see instructions)

▶ Title

▶ Paid preparer's address (or employer's name, address and identifying number)

Form 1120 (1977) Page 3

Schedule J Tax Computation

CHANGE SCHEDULE J AS INDICATED

1 Taxable income (line 30, page 1)
2 Enter line 1 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)
3 Line 1 less line 2
4 Enter line 3 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)
5 Line 3 less line 4
6 20% of line 2
7 22% of line 4
8 ~~48% of~~ line 5 times (%) tax rate from line 12, Schedule N
9 Income tax (Sum of lines 6, 7 and 8 or alternative tax from separate Schedule D, whichever is lesser)
10 (a) Foreign tax credit (attach Form 1118)
(b) Investment credit (attach Form 3468)
(c) Work incentive (WIN) credit (attach Form 4874)
(d) New jobs credit (attach Form 5884)
11 Total of lines 10(a), (b), (c), and (d)
12 Line 9 less line 11
13 Personal holding company tax (attach Schedule PH (Form 1120))
14 Tax from recomputing a prior year investment credit (attach Form 4255)
15 Tax from recomputing a prior year WIN credit (see instructions—attach computation)
16 Minimum tax on tax preference items (see instructions—attach Form 4626)
17 Total tax—Add lines 12 through 16. Enter here and on line 31, page 1

Schedule K Record of Federal Tax Deposits Tax Class Number 503 (List deposits in order of date made—See instruction G)

Date of deposit	Amount	Date of deposit	Amount	Date of deposit	Amount

G Did you claim a deduction for expenses connected with: (Yes / No)
(1) Entertainment facility (boat, resort ranch, etc.)?
(2) Living accommodations (except for employees on business)?
(3) Employee's families at conventions or meetings?
(4) Employee or family vacations not reported on Form W-2?
Enter total amount of deduction(s) on Form 1120 that are claimed under section 274 (entertainment, gifts, etc.) ▶

H (1) Did you at the end of the taxable year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).)
If "Yes," attach a schedule showing:
(a) name, address, and identifying number;
(b) percentage owned; and
(c) taxable income or (loss) (e.g., if a Form 1120: from line 28, page 1, Form 1120) of such corporation for the taxable year ending with or within your taxable year.

(2) Did any individual, partnership, corporation, estate or trust at the end of the taxable year own, directly or indirectly, 50% or more of your voting stock? (For rules of attribution, see section 267(c).)
If "Yes:"
(a) Attach a schedule showing name, address, and identifying number.
(b) Enter percentage owned ▶
(c) Was the owner of such voting stock a person other than a U.S. person? (See instruction S.)
If "Yes," enter owner's country ▶

I Did you ever declare a stock dividend?

J Taxable income or (loss) from line 28, page 1, Form 1120 for your taxable year beginning in
1974 , 1975 , 1976

K Were you a member of a controlled group subject to the provisions of section 1561? (Yes / No)
If "Yes," check the type of relationship:
(1) ☐ parent-subsidiary (2) ☐ brother-sister
(3) ☐ combination of (1) and (2) (See section 1563)

L Refer to page 8 of instructions and state the principal:
Business activity
Product or service

M Did you file all required Forms 1087, 1096 and 1099?

N Were you a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.)
If "Yes," attach Form 3646 for each such corporation.

O Was this firm in business at the end of 1977?

P How many months in 1977 was this firm in business?

Q During this taxable year, did you pay dividends (other than stock dividends and distributions in exchange for stock) in excess of your current and accumulated earnings and profits? (See sections 301 and 316.)
If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliation Schedule, for each subsidiary.

R If you are a farmers' cooperative, check type:
☐ purchasing ☐ marketing ☐ service
☐ other (explain) ▶

S Did you, at any time during the taxable year, have any interest in or signature or other authority over a bank, securities or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)? If "Yes," see Instruction V.

T Were you the grantor of, or transferor to, a foreign trust during any taxable year, which foreign trust was in being during the current taxable year, whether or not you have any beneficial interest in such trust? If "Yes," you may be required to file Forms 3520, 3520-A, or 926.

Schedule N. Tax Rate

1. Compensation of officers (line 12, page 1 of Form 1120) ________
2. Salaries and wages (line 13, page 1 of Form 1120) ________
3. Employee benefit programs (line 25, page 1 of Form 1120) ________
4. Profit sharing and other remuneration paid for services of employees (from line 24, page 1 of Form 1120) ________
5. Total of lines 1-4 (includes salaries, wages, commissions, fees, bonuses, vacation allowances, salaries and wages paid to temporary or part-time employees, the value of goods, lodging, food and clothing, etc.) ________
6. Number of person-hours (including overtime) worked during the year by all employees, including consultants, part-time employees, etc. (from corporate records) ________
7. Line 5 divided by line 6 ________
8. Total remuneration in previous year ________
9. Number of person-hours worked during previous year by all employees ________
10. Line 8 divided by line 9 ________
11. $\left(\frac{\text{Line 10}}{\text{Line 7}} - 1\right) \times 100$ ________
12. Using this rate of wage increase (line 11) determine the applicable tax rate from the following table. For example, if wages increased by 9% during the taxable year 1981, then the corporate tax rate would be 49%. Enter the rate here and on line 8 of Schedule J (page 3 of Form 1120). ________

Average Rate of Wage Increase (from line 11 above)

Year	< 2%	2.1-4%	4.1-6%	6.1-8%	8.1-10%	> 10.1%
1980	45%	45	45	45	45	45
1981	45	46	47	48	49	50
1982	46	48	50	52	54	56
1983	46	49	52	55.5	59	63
1984	47	51	55	60	64	70
1985+	47	52	58	64	71	78

Suggestions for Further Reading

Annual Report of the Council of Economic Advisers, 1978, pp. 151-2.

Hearings before the Senate Committee on Banking, Housing and Urban Affairs, May 22-23, 1978.

Okun, Arthur M. (ed.)
Brookings Papers, 1978/2

Seidman, Laurence
"A New Approach to the Control of Inflation"
Challenge (7-8/76)

Wallich, Henry C. and Weintraub, Sidney
"A Tax-based Incomes Policy", Journal of Economic Issues (6/71)

Weintraub, Sidney
Capitalism's Inflation and Unemployment Crisis
Addison-Wesley (1978)

ABSTRACT

APPLYING THE BRAKES TO INFLATION: $Y = m \cdot e^{nx}$

by John N. Snell*

Continued growth in 1978, some additional turbulence in 1979, and probably another recession by 1980 is the current economic forecast of the Regional Planning Council, based on the assumption that efforts to control inflation will take the form of more restrictive monetary and fiscal policies.

Such policies should be complemented by new legislation which would make the corporate tax rate a variable function of the annual increase in average hourly earnings. The recommended formula is $y = m \cdot e^{nx}$.

Consumers would favor such a tax-based incomes policy (TIP). Producers -- management and especially labor -- would oppose it. There are a lot more consumers than producers in those private profit-making corporations with a taxable income greater than $50,000 who would be directly affected by TIP.

Initially, firms would face only a moderate increase in their tax rate if they allowed hourly earnings to continue escalating at current rates (8-10% per year). But several years into the program, the tax incentives to limit increases in hourly earnings would become significant. To illustrate, the corporate tax rate corresponding to such an increase in hourly earnings would be only 49% in 1981; by 1984, it would be 64%.

Faced with such a tax schedule -- which should allow no exceptions -- wage increases in the dominant private corporate sector of the economy would become progressively smaller over time. Econometric models indicate, and the U.K. experience among others tends to confirm, that a slowdown in the rate of wage increases would be accompanied by a slowdown in the rate of price increases, and that this pattern of reduced inflationary pressures would be emulated in other sectors of the economy.

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* Chief of Economic Research, Regional Planning Council, Baltimore, Maryland. The views expressed in this paper are his own.

APPLYING THE BRAKES TO INFLATION: $Y = m \cdot e^{nx}$

Continued growth in 1978, some additional turbulence in 1979, and probably another recession by 1980 -- this is the current economic forecast of the Regional Planning Council for the Baltimore region and the nation.

This scenario assumes that efforts to control inflation will take the form of more restrictive monetary and fiscal policies by the Federal government.

Conceivably, pressures to reduce taxes more rapidly than expenditures could provide additional fiscal stimulus in the short run, thereby delaying the onset of the recession, but adding to the likelihood of a resurgence of double-digit inflation soon thereafter.

Or even more restrictive monetary policies might be necessary in order to deal with the nation's balance of payments problem. This could produce a recession as early as next year.

'Balanced budgets and tight money' was the prescription of many economists in the early '30s as a remedy for the Great Depression. Those remedies weren't effective. They are being prescribed again as a solution to our current problem of stagflation, though there are not many economists who believe that the result would be reduced inflation and increased employment.

To achieve those two goals under the conditions which are most likely by 1980 -- 7.4% unemployment and 8.6% inflation -- requires additional action by the Congress in the current legislative session.

The Congress should enact a measure which would make the corporate tax rate a variable function of the annual increase in average hourly earnings.

Such a tax-based incomes policy (TIP) has been seriously discussed by economists during the past decade, early versions were tried with mixed results in the U.K. and Hungary, and improved formulas are now available for consideration.

The TIP formula which I personally would recommend, based on a comprehensive review of the literature, conversations with leading economists at professional meetings on the subject during the past year, and my own studies is: $y = m \cdot e^{nx}$.

A technical explanation of this formula is given in an appendix at the end of this paper. It would be applicable only to those larger private profit-making corporations with a taxable income greater than $50,000.

Such corporate incomes are currently taxed at a flat rate of 48%. With a TIP, the rate could be either higher or lower, depending on how rapidly average hourly earnings (including fringe benefits) were being increased.

All employees want to earn more each year. Nobody likes restrictions. Therefore producers -- management and especially labor -- are likely to be opposed to a TIP.

As Dr. Albert Sommers observes in a recent Conference Board publication (across the board, August 1978), "Nobody really loves an incomes policy -- but nobody loves inflation either."

The number of people who, as consumers, dislike inflation is far greater than the number of people who, as producers, would be opposed to the adoption of a TIP or a return to wage and price controls.

Of those two alternatives -- a TIP on taxable income or wage/price controls -- the one which is most consistent with our economic system is TIP. Wage/price controls are more appropriate in socialistic economies; they probably are workable in the U.S. only in the short run. TIP would be a permanent addition to the tools available to the Federal government for moderating the cyclical fluctuations that are inherent in a capitalistic economy.

Initially, because TIP is an innovative solution to the problem of inflation, it could be authorized on a provisional basis. The program would not become effective if economic conditions in 1979 prove to be better than currently anticipated in terms of the average rate of unemployment and the rate of inflation for the year as a whole.

If the forecasted conditions for 1979 prove to be reasonably accurate, that would reinforce the argument for additional stimulus in 1980 to moderate the prospective weakness of the economy in that year, provided this were done as part of a comprehensive program to improve the prospects for strong economic growth in 1981 and future years.

For 1980, the proposed TIP formula would reduce the tax rate on corporate income in excess of $50,000 from 48% to 45%. This would make it possible for management to offer, and for labor to accept, a relatively large increase in wages in 1980 in return for smaller wage increases in successive years.

For 1981, the proposed TIP formula would impose a mild tax penalty on those firms which did allow average wages to increase between 1980 and 1981. Typical values (as given in the table in the appendix) would

be as follows:

For a percentage increase in average hourly earnings between 1980 and 1981 of:	...the tax rate for 1981 on corporate income over $50,000 would be:
3%	46%
6%	47.5%
9%	49%

For 1982, a steeper tax schedule would apply, so that there would be an even greater incentive for managers to offer, and hopefully for unions and corporate executives to accept, an increase in wages and salaries that would be consistent with actual increases in productivity.

The average increase in productivity is estimated to be on the order of 2 - 3% per year. For increases in average hourly earnings in 1983 that were greater than this amount, the corporate tax rate would be higher than 48%.

That mangers would try to keep the corporate tax rate from going higher than 48% seems like a reasonable assumption. But of course they may not be successful in doing so in the face of union pressure for higher wages. The penalties for yielding to such pressure would become progressively greater with the passage of time.

For 1984, the proposed TIP formula would impose a severe tax. penalty on those firms which allowed average hourly earnings to increase significantly between 1983 and 1984. Typical values (as given in the table in the appendix) would be as follows:

For a percentage increase in average hourly earnings between 1983 and 1984 of:	...the tax rate for 1984 on corporate income over $50,000 would be:
3%	51%
6%	57%
9%	64%

By 1985 -- possibly sooner, and certainly well before the end of the decade -- the rate of inflation would be down to normal. The appropriate TIP tax schedule could then be chosen like any other fiscal or monetary policy variable.

Note that it will take several years to get inflation down to a normal level. Those who are looking for instant cures for the problem of inflation should look elsewhere. TIP is not a panacea or a substitute for responsible fiscal and monetary policies. But it is, in theory, a very effective remedy for inflation.

How has TIP worked in practice? In the U.K., I understand, it worked well enough initially, but then the authorities began to grant exemptions and make exceptions for special cases until eventually the whole system had to be replaced by the 'social compact' which apparently is now in the process of breaking down.

The lesson from this early experiment, which used a different type of TIP than the one described in this paper, is: Keep it simple and don't grant exceptions. At least don't grant any exceptions until such time as inflation has been reduced to an acceptable level. Such inequities as may arise under a TIP aren't going to be any greater than those which exist under the present flat 48% system or indeed any conceivable corporate tax.

As for the side effects of a TIP, the ones which have been identified thus far seem generally benign: an incentive to hire additional low-wage employees; a restraint on the natural tendency for management to increase executive salaries relative to those of other employees; an incentive for those in rapidly-growing industries to reduce prices or re-invest

earnings in long-term growth, rather than in short-term salary increases. Not all of these side effects would be rated "good" by everyone, and there are some -- e.g. the possibility of increased strike activity -- that clearly are not. But continued stagflation or a continuation of the boom and bust cycle are far worse alternatives than any of the TIP side effects, real or imagined, which have been discussed thus far by anyone.

If TIP is indeed part of the solution to what a majority of the people consider to be the nation's #1 problem, astute politicians would be well advised to latch on to it as a way of retaining or obtaining higher office. People in America will not long tolerate, nor will people in other countries who look to the U.S. as the leader of the free world long accept, a continuation in this country of inflation at the high rates of recent years.

<u>Summary</u>

Economists have discovered a formula for reducing inflationary wage increases in the dominant private corporate sector of the economy. They believe that a slowdown in the rate of wage increases will be accompanied by a slowdown in the rate of price increases. They expect that this pattern will be emulated in other sectors of the economy.

Now we must see whether there is enough political support in the Congress, as the representatives of the people, for passage of such legislation. If conditions warrant it, the law could then become effective at some future date, after everyone had a chance to become familiar with the new rules governing collective bargaining.

What is needed at this stage are statesmen willing to lead the nation in passage of such legislation. It will require a bi-partisan effort, for neither the problem of inflation nor its possible solutions respect traditional party lines. Statesmen, where are you?

8/23/78

Technical Appendix

APPLYING THE BRAKES TO INFLATION: $Y = m \cdot e^{nx}$

A tax-based incomes policy (TIP) is analyzed, using the formula

$$(1) \qquad y = m \cdot e^{nx}$$

where
- y = the variable corporate tax rate (currently a flat 48%) for taxable income greater than $50,000
- m = the intercept value of y when $x = 0$ ($m = 0.45$)
- n = the number of years after enactment of TIP legislation ($n = 0 \ldots 5$)
- $e = 2.718 \ldots$
- x = the average rate of wage increase, as defined in equation (2)

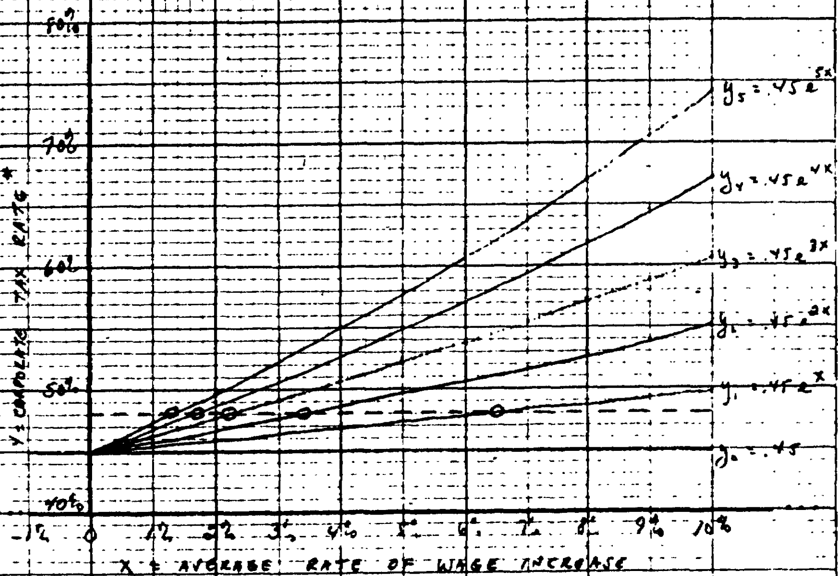
$$(2) \qquad x = \frac{w_n}{h_n} + \frac{w_{n-1}}{h_{n-1}} - 1$$

where
- w = earnings of all employees (salaries, wages, commissions, fees, bonuses, vacation allowances, other benefits)
- h = number of person-hours worked during the year by all employees (including labor, management, and contractual personnel)

With such a program in effect, managers would try to avoid an increase in the tax rate from the current 48% by limiting nominal wage increases during the first year to approximately 6.5%, to 3.0% during the second year, and to 2.0% during the third and successive years of the program.

Used in judicious combination with fiscal and monetary restraint, this kind of a tax-based incomes policy should be able to reduce the rate of inflation in the U.S. (currently running at a 10% annual rate) to less than 2% within a period of five years after enactment of enabling legislation.

BRAKING INFLATION: TAX SCHEDULES



Y = CORPORATE TAX RATE*	1%	3%	5%	7%	9%	11%
YEAR 0	45%	45	45	45	45	45
YEAR 1	45	46	47	48	49	50
YEAR 2	46	48	50	52	54	56
YEAR 3	46	49	52	55.5	59	63
YEAR 4	47	51	55	60	64	70
YEAR 5+	47	52	58	64	71	78

* APPLIES ONLY TO CORPORATIONS WITH TAXABLE INCOME > $50,000.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1977 or other taxable year beginning ...., 1977, ending ...., 19......
(PLEASE TYPE OR PRINT)

1977

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See Page 8 of instructions)

Use IRS label. Otherwise print or type.

Name
Number and street
City or town, State, and ZIP code

NO CHANGE

D Employer identification number
E Date incorporated
F Enter total assets from line 14, column (D), Schedule L (See specific instructions)
$

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction N.

GROSS INCOME

Line	Item	No.	Amount
1	Gross receipts or gross sales .... Less: Returns and allowances	1	
2	Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)	2	
3	Gross profit	3	
4	Dividends (Schedule C)	4	
5	Interest on obligations of the United States and U.S. instrumentalities	5	
6	Other interest	6	
7	Gross rents	7	
8	Gross royalties	8	
9	(a) Capital gain net income (attach separate Schedule D)	9(a)	
	(b) Net gain or (loss) from line 9, Part II, Form 4797 (attach Form 4797)	9(b)	
10	Other income (see instructions—attach schedule)	10	
11	TOTAL income—Add lines 3 through 10	11	

DEDUCTIONS

Line	Item	No.	Amount
12	Compensation of officers (Schedule E)	12	
13	Salaries and wages (not deducted elsewhere)	13	
14	Repairs (see instructions)	14	
15	Bad debts (Schedule F if reserve method is used)	15	
16	Rents	16	
17	Taxes (attach schedule)	17	
18	Interest	18	
19	Contributions (not over 5% of line 30 adjusted per instructions—attach schedule)	19	
20	Amortization (attach schedule)	20	
21	Depreciation from Form 4562 (attach Form 4562) ...., less depreciation claimed in Schedule A and elsewhere on return ...., Balance ▶	21	
22	Depletion	22	
23	Advertising	23	
24	Pension, profit-sharing, etc. plans (see instructions) (enter number of plans ▶ ....)	24	
25	Employee benefit programs (see instructions)	25	
26	Other deductions (attach schedule)	26	
27	TOTAL deductions—Add lines 12 through 26	27	
28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)	28	
29	Less: (a) Net operating loss deduction (see instructions—attach schedule) 29(a) .... (b) Special deductions (Schedule I) 29(b)		
30	Taxable income (line 28 less line 29)	30	

TAX

Line	Item	No.	Amount
31	TOTAL TAX (Schedule J)	31	
32	Credits: (a) Overpayment from 1976 allowed as a credit		
	(b) 1977 estimated tax payments		
	(c) Less refund of 1977 estimated tax applied for on Form 4466 ( )		
	(d) Tax deposited with Form 7004 (attach copy)		
	(e) Tax deposited with Form 7005 (attach copy)		
	(f) Credit from regulated investment companies (attach Form 2439)		
	(g) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)		
33	TAX DUE (line 31 less line 32). See instruction G for depositary method of payment	33	
34	OVERPAYMENT (line 32 less line 31)	34	
35	Enter amount of line 34 you want Credited to 1978 estimated tax ▶ Refunded ▶	35	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which the preparer has any knowledge.

▶ Signature of officer   Date

▶ Title

▶ Paid preparer's signature and identifying number (see instructions)

▶ Paid preparer's address (or employer's name, address and identifying number)

Schedule J Tax Computation CHANGE SCHEDULE J AS INDICATED

1 Taxable income (line 30, page 1)
2 Enter line 1 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)
3 Line 1 less line 2
4 Enter line 3 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)
5 Line 3 less line 4
6 20% of line 2
7 22% of line 4
8 ~~48% of~~ line 5 times (%) tax rate from line 12, Schedule N
9 Income tax (Sum of lines 6, 7 and 8 or alternative tax from separate Schedule D, whichever is lesser)
10 (a) Foreign tax credit (attach Form 1118)
(b) Investment credit (attach Form 3468)
(c) Work incentive (WIN) credit (attach Form 4874)
(d) New jobs credit (attach Form 5884)
11 Total of lines 10(a), (b), (c), and (d)
12 Line 9 less line 11
13 Personal holding company tax (attach Schedule PH (Form 1120))
14 Tax from recomputing a prior year investment credit (attach Form 4255)
15 Tax from recomputing a prior year WIN credit (see instructions—attach computation)
16 Minimum tax on tax preference items (see instructions—attach Form 4626)
17 Total tax—Add lines 12 through 16. Enter here and on line 31, page 1

Schedule K Record of Federal Tax Deposits Tax Class Number 503 (List deposits in order of date made—See instruction G)

Date of deposit	Amount	Date of deposit	Amount	Date of deposit	Amount

G Did you claim a deduction for expenses connected with: (Yes / No)
(1) Entertainment facility (boat, resort ranch, etc.)?
(2) Living accommodations (except for employees on business)?
(3) Employee's families at conventions or meetings?
(4) Employee or family vacations not reported on Form W-2?
Enter total amount of deduction(s) on Form 1120 that are claimed under section 274 (entertainment, gifts, etc.) ▶

H (1) Did you at the end of the taxable year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).)
If "Yes," attach a schedule showing:
(a) name, address, and identifying number;
(b) percentage owned; and
(c) taxable income or (loss) (e.g., if a Form 1120: from line 28, page 1, Form 1120) of such corporation for the taxable year ending with or within your taxable year.

(2) Did any individual, partnership, corporation, estate or trust at the end of the taxable year own, directly or indirectly, 50% or more of your voting stock? (For rules of attribution, see section 267(c).)
If "Yes:"
(a) Attach a schedule showing name, address, and identifying number.
(b) Enter percentage owned ▶
(c) Was the owner of such voting stock a person other than a U.S. person? (See instruction S.)
If "Yes," enter owner's country ▶

I Did you ever declare a stock dividend?

J Taxable income or (loss) from line 28, page 1, Form 1120 for your taxable year beginning in:
1974 ...., 1975 ...., 1976 ....

K Were you a member of a controlled group subject to the provisions of section 1561?
If "Yes," check the type of relationship:
(1) ☐ parent-subsidiary (2) ☐ brother-sister
(3) ☐ combination of (1) and (2) (See section 1563.)

L Refer to page 8 of instructions and state the principal:
Business activity ....
Product or service ....

M Did you file all required Forms 1087, 1096 and 1099?

N Were you a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.)
If "Yes," attach Form 3646 for each such corporation.

O Was this firm in business at the end of 1977?

P How many months in 1977 was this firm in business? ....

Q During this taxable year, did you pay dividends (other than stock dividends and distributions in exchange for stock) in excess of your current and accumulated earnings and profits? (See sections 301 and 316.)
If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.

R If you are a farmers' cooperative, check type:
☐ purchasing ☐ marketing ☐ service
☐ other (explain) ▶

S Did you, at any time during the taxable year, have any interest in or signature or other authority over a bank, securities or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)? If "Yes," see instruction V.

T Were you the grantor of, or transferor to, a foreign trust during any taxable year, which foreign trust was in being during the current taxable year, whether or not you have any beneficial interest in such trust? If "Yes," you may be required to file Forms 3520, 3520-A, or 926.

Schedule N. Tax Rate

1. Compensation of officers (line 12, page 1 of Form 1120) ________
2. Salaries and wages (line 13, page 1 of Form 1120) ________
3. Employee benefit programs (line 25, page 1 of Form 1120) ________
4. Profit sharing and other remuneration paid for services of employees (from line 24, page 1 of Form 1120) ________
5. Total of lines 1-4 (includes salaries, wages, commissions, fees, bonuses, vacation allowances, salaries and wages paid to temporary or part-time employees, the value of goods, lodging, food and clothing, etc.) ________
6. Number of person-hours (including overtime) worked during the year by all employees, including consultants, part-time employees, etc. (from corporate records) ________
7. Line 5 divided by line 6 ________
8. Total remuneration in previous year ________
9. Number of person-hours worked during previous year by all employees ________
10. Line 8 divided by line 9 ________
11. $\left(\frac{\text{Line 10}}{\text{Line 7}} - 1\right) \times 100$ ________
12. Using this rate of wage increase (line 11) determine the applicable tax rate from the following table. For example, if wages increased by 9% during the taxable year 1981, then the corporate tax rate would be 49%. Enter the rate here and on line 8 of Schedule J (page 3 of Form 1120). ________

Average Rate of Wage Increase (from line 11 above)

Year	≤ 2%	2.1-4%	4.1-6%	6.1-8%	8.1-10%	>10.1%
1980	45%	45	45	45	45	45
1981	45	46	47	48	49	50
1982	46	48	50	52	54	56
1983	46	49	52	55.5	59	63
1984	47	51	55	60	64	70
1985+	47	52	58	64	71	78

BIOGRAPHY

John Snell (B.A. Amherst, B.S. MIT, M.A. Antioch) is currently Chief of Economic Research for the Regional Planning Council in Baltimore. After serving with the US Army in Korea (1952-54), he worked as a Program Officer for the Agency for International Development (1955-64) on economic stabilization programs in Europe and economic development programs in Africa. After completion of a research project at the University of Chicago (1965-66), he worked for the City of Baltimore as Chief of Program Development for the Department of Housing and Community Development (1967-76). He is a member of various professional associations and the author of several major government studies, including A Study of Housing and Community Renewal Policies.

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Yeo, Edwin, U.S. Treasury Undersecretary, Statement before Joint Economic Committee: "The major source of the present financial and fiscal problems which afflict elements of the state and local government sector is inflation." (1/22/76)

**Seidman, Laurence, "A New Approach to the Control of Inflation" Challenge (7-8/76)

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- -The mandatory controls of the Korean War period, which had a moderate role in shaping economic conditions and dampening inflation.
- -The largely voluntary guideposts of the 1960s, which worked fairly well in moderating price and wage increases through 1965.
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**Approval by the Regional Planning Council of a General Development Plan which included a strategy statement in support of "federal legislative programs which are designed to stimulate economic growth with a minimum increase in inflation" which related to a discussion in the text of a tax-based incomes policy. (12/16/77)

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Sun editorial on the possibility that "inflation could become the city government's downfall." (4/5/78)

Greenspan, Alan quoted in the Baltimore Sun as saying that if the Administration did not set in motion a credible anti- inflation policy, the nation could face severe difficulty. (4/10/78)

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Time article on inflation. (4/17/78)

**Brookings Conference on Inflation. Brookings Papers, 1978/2 issued 7/78. (4/20-21/78)

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Baltimore Sun article on a statement by Louis Harris that "Americans are willing to make individual sacrifices in their life styles to help battle inflation and have lost confidence in government and other institutions... By a 54-to-32 margin, Americans would accept smaller pay increases 'with some assurance that the cost of living were being brought under control... Sixty-five percent 'think it is very important for Congress in 1978 to have the courage to ask people to make sacrifices where necessary.'" (4/27/78)

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Wall Street Journal article: "The seemingly unstoppable march of inflation is causing many Americans to lose faith in the future, in the government and in themselves". (8/23/78)

Statement of the Rochester Tax Council

This statement is submitted on behalf of the Rochester Tax Council, which was formed in 1969 as a voluntary organization of companies having strong affiliations with the Rochester, New York area. The Council membership includes:

Bausch & Lomb, Inc., Champion Products, Corning Glass Works, Eastman Kodak Company, The R. T. French Company, Gannett Company, Inc., Garlock, Inc., Gleason Works, Schlegel Corporation, Security New York State Corporation, Sybron Corporation, and Xerox Corporation.

The members of the Council collectively carry on manufacturing activities in a wide variety of high technology facilities. Although these companies have substantial facilities in the Rochester, New York, area, they also have major facilities in over half the states in the United States.

The Council generally favors the provisions in H.R. 13511 that are intended to increase business investment and capital formation. However, we believe that these provisions should be expanded in order for the underlying purposes of the legislation to be realized.

The members of the Council are concerned by the shortage of investment capital, which is urgently needed by American industry to sustain its current levels of economic growth and employment and its position in world commerce. The long-term effects of inflation, the proliferation of governmental regulations, and rapid technological change have substantially increased the capital required to sustain prolonged economic growth. At the same time, such traditional sources as retained earnings, depreciation reserves and new equity issues are frequently not sufficient to meet future capital needs, and there is a growing necessity for business to rely on debt financing. In view of these problems, tax legislation that would promote new sources of capital formation must be enacted, as is recognized in H.R. 13511.

A. Capital Formation Provisions in H.R. 13511

1. *Corporate tax rate reductions.*—Rate reductions along the lines contained in section 301 of H.R. 13511 are urgently needed because they would have an immediate impact on corporate after-tax income and make available funds for expansion and replacement of obsolete facilities. In addition, a reduction in corporate rates would ameliorate, to some extent, the existing double taxation of corporate income. However, more than a 2 percentage points reduction in the current 48 percent maximum rate is recommended to help meet capital formation needs.

2. *Investment tax credit.*—The proposal in section 311 to make the 10 percent investment tax credit permanent will greatly assist business in planning its future capital expenditures. Consideration should be given to increasing the credit generally to 12 percent with full credit allowed for investment in depreciable assets having a life of three years or more. Also, consideration should be given to the Administration's recent proposal to extend the investment credit to industrial structures placed in service or rehabilitated after December 31, 1977.

We should also like to take this opportunity to register our strong objection to adding so-called tax expenditures, such as the investment credit, to the "Sunset" legislation (S. 2) which may shortly be considered by the Senate. To be effective, the investment credit must be a permanent feature of the tax laws. An automatic five-year termination date for the investment credit, as proposed by a minority of the Senate Committee on Governmental Affairs, would work at cross-purposes to this desired goal and should be rejected.

3. *Capital gains tax reductions.*—The Council supports the concept of reducing the impact of capital gains taxation, and thereby increasing the funds available for capital investment by the private sector. The reductions proposed in section 401(a) of the Bill by removal of capital gains from both the minimum and maximum tax provisions and the indexation of capital gains taxes to offset inflation are helpful and should be enacted. The proposed repeal of the alternative 25 percent tax on the first $50,000 of capital gains of individuals introduces a disincentive to middle income investors and should be eliminated from the Bill. The Council supports the proposal sponsored by Senator Hansen and a substantial majority of the Senate that would reduce the maximum capital gains tax to 25 percent.

B. CAPITAL FORMATION PROPOSALS NOT CONTAINED IN H.R. 13511

In view of the urgent capital requirements of American industry, the Council urges that consideration be given to additional changes in the tax laws not contained in H.R. 13511 which would facilitate capital formation, including the following:

1. Shorter depreciation lives.—To reflect rapid technological change and inflation, and to bring capital cost recovery provisions into line with those of most other major industrialized nations, the capital cost recovery period for all productive machinery and equipment should be no more than five years, with no cutback in the investment credit provisions. Alternatively, the ADR range should be increased from 20 percent to 40 percent. Also, no more than a 20-year recovery period should be provided for industrial buildings.

2. Rapid write-off of Government mandated capital expenditures.—In view of the unproductive nature of expenditures such as EPA and OSHA mandated expenditures, rapid write off of these facilities, with full investment credit, should be permitted. The members of the Council urge that the provisions of S. 3404, introduced by Senator Bentsen, dealing with rapid depreciation for mandatory OSHA expenditures be added as an amendment to H.R. 13511.

If provisions along the lines contained in H.R. 13511 amended in the manner outlined above are enacted, there is no question that the study authorized by section 407 of the Bill will show additional investment in American business with increased growth in the economy and increased employment.

C. OTHER TAX CONSIDERATIONS

1. DISC.—The Council is pleased that the House Bill omits the Administration's ill-conceived proposal to phase-out DISC. In our experience, the DISC provisions have been instrumental in increasing United States exports and employment in export-related areas. Any shortcomings that may have existed in the original DISC legislation were eliminated in the revisions made in the Tax Reform Act of 1976, which revisions were supported by the Council. Any further cutback in DISC benefits would cause exports and export-related jobs to suffer and therefore counteract the benefit to be gained from the provisions in H.R. 13511 to stimulate the American economy.

2. Taxation of retained earnings of foreign subsidiaries.—The Council also believes that the existing law in this area should be continued and is opposed to any changes in the tax law that would extend beyond present Subpart F the taxation of earnings of foreign subsidiaries before they are remitted to the United States. The international operations of American companies have a favorable impact on United States employment, exports and the balance of payments, and such operations should be encouraged. Any legislation similar to the Administration's proposal to tax currently the unremitted earnings of foreign subsidiaries would discourage investment abroad, both because of the economic and administrative burdens that any such legislation would impose. American business should not have its hands tied competitively abroad.

In conclusion, the Council urges prompt action on H.R. 13511. If the provisions contained therein, amended as discussed above, become law, American business will be in a better position to increase employment and productivity.

STATEMENT OF WALTER S. ROGOWSKI, VICE PRESIDENT AND GENERAL COUNSEL, THE MARMON GROUP, CHICAGO, ILL.

To the Members of the Senate Finance Committee, U.S. Congress: I am Walter S. Rogowski, Vice President and General Counsel of the Marmon Group, Chicago, Illinois. The Marmon Group compromises autonomously operated units that make and market consumer, automotive, industrial and building products; manufacture mining, transportation, institutional and agricultural equipment; refine, process and market metals; fabricate metal components for consumer and industrial products; mine, prepare, transport and sell coal; and perform related services. We have relied to a great extent upon industrial development revenue bond financing for our expansion needs. Since 1957 when our first expansion occurred in Jonesboro, Arkansas, the several companies within the Group have utilized this medium of financing a total of thirty-two times. Of those companies

which are now in full production, a total of 2,800 jobs have been provided, present annual payroll exceeds $126,500,000, with gross annual sales of $187,000,000, all being directly attributable to industrial development revenue bond financing. In addition, the Group has had approved another $16 million in industrial development revenue bond monies for nine other companies.

As you may know, small issue IDBs are bonds issued by state and municipalities for the purpose of acquiring or building industrial or commerical facilities for subsequent lease or sale to private companies at a price sufficient to amortize and pay debt service on bonds. The tax exemption afforded these bonds has provided an effective incentive in the past for industrial and commercial expansion by reducing the interest cost of borrowed "seed money" and, consequently, has encouraged the creation of new jobs.

Limitations were set in 1968 of $1 million for IDBs not subject to the capital expenditure limitations and $5 million maximum capital expenditures limitation. For a number of years, we were able to build new facilities, acquire machinery and equipment and expand existing factories within these limitations. Construction and capital equipment expenditures have increased substantially, however since 1968, and we have either chosen not to expand or have delayed expansion or capitalization of facilities because capital costs have increased substantially since 1968 and it is difficult for us to utilize IDB financing because of the $5 million capital expenditure limitation.

Although we would undoubtedly have expanded our operations and increased sales over earlier years without IDB financing, such expansions and increases certainly would not have been as extensive. Many of our expansions have resulted from being landlocked in a location or being an out-dated facility. With the relatively attractive financing available from IDB's, we have built new factories or modernized existing ones. The alernative without such financing would have been to allow these facilities to atrophy. We have found also that once available employment has peaked in an area, we have chosen to expand by building a facility elsewhere where unemployment is high and communities are looking for industry.

It has been our experience that industrial development revenue bond financing in its present form is a proven method and permits expedient expansion. The results are consistent, financing is readily available, and with company guarantees, the risk to governmental authorities is slight.

As one example of the results of such financing, for one of our recent bond issues, a site was located, an inducement resolution was obtained from an Authority formed for that purpose, and funds were received a total of twenty-six days after the date of the inducement resolution. The new facility was constructed during the winter months in the Midwest, and went into production within four months of the resolution. That facility within three years is employing 200 people in a community which was actively seeking employment for its citizens.

We urge that interest on industrial development revenue bonds issued for pollution control and industrial parks keep their tax-exempt status. We strongly oppose the proposed limitation on use of "small issue" bonds, to "economically distressed areas". We have seen no definition of such terms and a narrow definition of "economically distressed areas" will be of little benefit regardless of the proposed increase in the ceiling on small issue bonds. Such a definition would limit their use to large urban areas only, and we believe that, with our own experience in small towns and rural areas being highly successful and mutually beneficial, limitations like the ones originally proposed under the Tax Program would severely hinder companies like ourselves which rely heavily on industrial development revenue bonds. Thank you.

AUGUST 29, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. STERN: This letter is to present a formal petition to the Committee on Finance to give serious consideration to making a change in one provision of the Revenue Act of 1978, H.R. 13511. Specifically, in the provision which allows a once-in-a-lifetime exclusion of up to $100,000 in profits on the sales of a taxpayer's principal residence, I respectfully request that the effectivity date be made January 1st, instead of July 27th, 1978.

My reasons for making this request are contained in the following excerpts from a letter, dated August 10th 1978, which I sent individually to Senator Long and other members of the Committee on Finance and of the Senate:

". . . It is my understanding that any tax bill ultimately approved by both branches of the Congress would become the 1978 tax law. Changes adopted in the tax law such as rate schedule, exemptions, etc., would be effective for all of 1978, not just the last 5 months! Accordingly, I ask you to support the homeowners provision and to see that it, too, becomes effective for all of 1978!

"Let me explain my position. . . . I guess my wife and I represent a classic case of homeowners who need immediate 1978 tax relief on the proceeds from the sale of our home. I was forced to retire this year on disability at age 58, due to a heart problem; we have raised 10 good children, with 4 girls still at home in high school and college; we are of moderate means by today's standards though, like everyone else, suffering inroads from inflation. Earlier this year, we agreed to sell our home, finally closing on July 14th, 1978. We sold for two reasons, (1) we needed to take the almost entirely inflationary "profit" dollars and invest them for income, and (2) I could no longer physically contribute adequately to house and yard care. Though we made out well on the sale price as compared to cost, the capital gains tax we must pay under present law represents a very significant financial sacrifice in our particular situation. We have purchased a smaller, less expensive home which I hope will be manageable. In any case, as a result of these circumstances, I have been writing over the past several months to members of the Ways and Means Committee, others in the government and out, and even the President, hoping some action would be taken to help us and others like us. . . ."

More general reasons are contained in the following rationale. First, let me say that it is my understanding that tax legislation is usually based on the day that the legislation is approved by the House Ways and Means Committee. That date, I am informed, has traditionally been set in order to avoid special benefits that might accrue to anyone who could take action anticipating approval by the Committee, or between the time of Committee action and enactment into law. However, he specifics of the provision in question are not ones which had much, if any, advance notice. More importantly, even if some handful of people *had* advance notice, this particular provision deals with citizens homes, which are least likely to have become involved in waves of speculation as a result of any advance knowledge, or to provide people with the opportunity for so-called "windfalls" to which they were (or are) not entitled.

Probably most people (like ourselves) who sold their homes at a profit during the first 7 months of 1978, did so in full anticipation of paying a capital gains tax on the most inflationary "profit", however inequitable that particular tax feature seems to be. But since the $100,000. exclusion has been at least tentatively written into the Revenue Act of 1978, why shouldn't we benefit from it the same as those selling in the last 5 months of 1978?

The question may logically be raised that, if the $100,000. exclusion is made effective January 1st, 1978, why not go back further to '77 or '76, or before? There may well be arguments to support that in some form, but it is the Revenue Act of 1978 which is at issue here; and correcting an inequity in the present law (which, by their incorporating this provision, the House Ways and Means Committee seems to be attempting to do) should, it seems to me, be made effective at least as early as the first day of 1978.

By so doing, the Congress would be sacrificing relatively little federal revenue, would be harming no one, and would be helping a significant—and for the most part, older—segment of the citizenry to retain the bulk of the dollars they have (or will have) realized from the principal investment most have ever made.

Please consider the foregoing carefully, and change the effectivity date of the homeowners provision to January 1st, 1978.

Thank you for your attention.

Sincerely,

FRED C. ROBERTSHAW,
Cincinnati, Ohio.

TO THE COUNCIL OF THE CITY OF LOS ANGELES

YOUR INTERGOVERNMENTAL RELATIONS COMMITTEE REPORTS AS FOLLOWS

Your Committee considered a communication from the City Treasurer recommending that the City support S. 3370 (Bentsen) which would abolish certain

income tax regulations dealing with arbitrage and industrial development bonds and prevent others in these areas from being issued.

The regulations at issue, would require the holders of revenue bonds, under certain conditions, to pay income tax on the interest they receive from their municipal bonds. Prior to the proposed Treasury Department regulations, all municipal bonds were tax exempt. The regulations also affect joint powers bonds, refunding and advance refunding bond issues. In addition, they redefine industrial development bonds so that the Harbor, Airports and Water and Power Departments' advance refunding bonds would become industrial development bonds. The State of California has no law allowing local governments to issue industrial development bonds. Current pending state legislation would allow local governments to issue industrial development bonds for private industry projects and for certain electric power supply project.

The City Treasurer recommended that the City support S. 3370 as the proposed regulations will inhibit the City's ability to sell revenue bonds and force the City to invest reserve fund monies in investments meeting only the cost of interest of the bonds to the City. This will have an adverse impact on the City's financial integrity.

Specifically, the proposed regulations would redefine the City's profits on its investments, which are put into the reserve fund to guarantee the financial integrity of the bond, as "proceeds of the bond issue." The City would not be taxed on these proceeds, but the bond holder would be taxed on his once tax exempt bonds. This would inhibit the sale of these bonds, as they are generally purchased for tax shelter purposes.

The proposed regulations would also limit the amount of permissable interest the City's investment can earn to equal the amount of interest the bond holder receives exclusive of the amount of interest attributable to the cost of issuing the bond. This reduces the percentage on investments the City can earn. Since the City would be unable to use its investment profits to guarantee the financial integrity of the bond or to pay for the administrative cost of the issuance, it would have to use outside revenue sources for this purpose.

Finally, the regulations would also limit the size of the reserve fund to 15 percent of the issue. In the last year of the bond issues when most of the bonds are reaching maturity, the reserve fund would need much more than 15 percent in order to pay off the bond's debt.

WE THEREFORE RECOMMEND that the City's 1977-78 Legislative Program include SUPPORT of S. 3370 (Bentsen), and/or any other legislation having a similar effect, which would abolish certain income tax regulations and prevent others from being issued which would inhibit the City's ability to sell municipal revenue bonds, or jeopardize the City's financial integrity, or redefine the term industrial development bond to include City bond projects.

Respectfully submitted,

INTERGOVERNMENTAL RELATIONS COMMITTEE.

STATEMENT OF PAUL R. SCHEERER, JR., CHAIRMAN, BOARD OF DIRECTORS, SOUTHAMPTON HOSPITAL ASSOCIATION, SOUTHAMPTON, N.Y.

Mr. Chairman and members of the committee: I greatly appreciate the opportunity to file this written statement, on an important aspect of tax policy. for consideraion by the Committee and for inclusion in the printed record of the Committee's hearings.

I am making this statement on behalf of myself and the other members of the Board of Directors of the Southampton Hospital Association, a private, voluntary, not-for-profit, tax-exempt institution. The names of the other officers and the members of the Board of Directors are appended to this statement. I wish to address myself, as I have said, to an important aspect of tax policy, namely, S. 3111, introduced by Senators Moynihan and Packwood. This bill, if enacted into law, can have a highly favorable impact on charitable giving, and specifically on the present and future financial position of our Hospital. This in turn would have a similar favorable impact on our ability to continue to provide the high standard of health care and services that the Hospital is able to supply at the present time.

Southampton Hospital is the only hospital serving the communities on the South Fork of Eastern Long Island, a fifty-mile stretch from Westhampton Beach to Montauk, with a year-round population of more than 50,000 persons, which increases by three times in the period May-October, with the arrival of part-time residents, visitors and tourists.

Southampton Hospital, which treats all who seek admission, is a very modern community hospital with excellent medical and nursing staffs. Like thousands of similar hospitals throughout the nation, it depends heavily on tax-motivated charitable giving for several important purposes. First, such giving aids in meeting our heavy mortgage obligations. Second, it covers unavoidable operating deficits, due principally to the fact that reimbursements from Blue Cross/Blue Shield, Medicare and Medicaid do not, in the face of costs which constantly rise (in spite of rigid cost-containment measures by the Hospital Administration), cover the actual expenditures for patient care; the Hospital is forbidden by contract from recouping from patients the difference between actual patient costs and the reimbursements by the "third-party" agencies I have just named. Thirdly, charitable contributions help the Hospital to maintain and improve the health care it provides to the communities in its area.

In recent years the percentage of taxpayers who utilize the standard deduction has been steadily rising. When the Administration submitted its original tax proposals in 1977, it was estimated by the Administration itself that these proposals, if enacted into law, would cause six million taxpayers to switch from itemizing their deductions to taking the standard deduction. The present percentage of taxpayers who itemize their deductions is 23 percent; under the Administration's proposals, the percentage would have dropped to 16 percent. As the Committee is well aware, taxpayers who do not itemize their deductions have no tax incentive to make charitable gifts; thus, a reduction in the number and percentage of taxpayers who can take charitable gift deductions inescapably reduces the volume of charitable gifts.

I therefore have the honor to urge most strongly that the Committee support the enactment into law of S. 3111, so as to allow a charitable gift deduction for all taxpayers—both those who utilize the standard deduction and those who itemize their deductions. (In the case of gifts of securities or other property, the charitable deduction allowed should continue to be the full fair market value, at the time of the gift, of the property contributed.) Charitable gifts should be made deductible from gross income, rather than from adjusted gross income. This is not blazing a new trail. The Congress has already allowed some deductions to all taxpayers, whether or not they itemize their deductions. For example, moving expenses and alimony are allowed as deductions from gross income to all taxpayers. Surely, allowing an income tax charitable gift deduction, without a dollar or a percentage floor, to all taxpayers, so that they will be encouraged to support worthy charitable institutions, is in the deepest American tradition of private benevolence for the public good. I think that this issue is not just financial, but is moral and philosophical as well, having to do with the very nature of our free and self-reliant society. To put the issue in its most basic terms, if the services now provided by private charitable giving were to be curtailed or eliminated, the resulting gap in services would have to be filled by governmental action at various levels; this would mean higher governmental expenditures and higher taxes.

Speaking broadly of the function of private charitable action in American life, Dr. Alan Pifer, the President of the Carnegie Corporation of New York, has put the issue in striking and, I think, correct terms. He said in his Annual Report for 1972 that such private charitable action " . . . provides certain qualities which are indispensable to the humane, enlightened and free society, which is the American ideal. Charitable institutions can provide diversity, free choice and competition. They can experiment and set standards. They can enter fields too controversial for governmental bodies and can monitor governmental performance. They can fill vital gaps in publicly provided services. They can offer the means for participation by lay citizens in social action. They can help to safe-guard intellectual and artistic freedom and civil liberties. And, finally, they can engage in the definition and preservation of the society's highest values, especially those of a spiritual and religious nature."

After this broad and eloquent statement, which covers the entire area of private charitable giving, I have nothing to add from my particular vantage point except to stress again, as I have already done, the very great importance

of tax-motivated charitable giving to our Hospital. Any legislation which increases the incentives to make tax-motivated gifts would have a highly favorable impact on our Hospital, on the thousands of other hospitals and similar institutions which similarly depend heavily on charitable gifts, and on the moral and philosophical values of which I have already spoken.

I shall be most grateful, Mr. Chairman and members of the Committee, if you can act favorably on the specific proposal I have made today with respect to the charitable contribution deduction, namely, to support the enactment into law of S. 3111.

With great respect, I thank you again for the opportunity you have afforded me to make this statement.

PAUL R. SCHEERER, Jr.,
Chairman, Board of Directors.

SOUTHAMPTON HOSPITAL BOARD OF DIRECTORS

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STATEMENT OF DAN THROOP SMITH, SENIOR RESEARCH FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

The 1978 major tax legislation now before you makes a good start towards improving the nation's income tax structure. The modest relief for capital gains taxation—a tax which is in many respects a capital levy rather than an income tax—is particularly constructive. Further relief in this area would be a significant contribution to the nation's economic well-being. Your Committee has a great opportunity to build on the House bill, with confidence that on this aspect of tax legislation lower tax rates would actually increase tax revenues.

From an economic standpoint, the controversy regarding a five or ten billion dollar difference in the proposed tax reduction suggests a belief in the sort of fine-tuning which was generally discredited a decade or more ago. Ten billion dollars is a vast sum, but it is only one-half of one percent in a two trillion dollar economy. A difference of that small a fraction of the total is less important than the variations which are inevitable among the various categories of expenditures by consumers and business.

*Member of the executive committee.

The indirect effects of a tax reduction on consumer attitudes regarding current consumption and indebtedness, and on business policies regarding inventories and capital expenditures, are more important than the direct effect of a change of several billion dollars in the size of the deficit. It may not be unduly cynical to say that whatever reduction is proposed by those who are known to be "big spenders" would be too much because many people would expect its adoption to lead to still more inflation.

Attempts to stimulate the economy by artificial increases in deficits have at last come to be recognized as more likely to lead to inflation than to sustained growth. Inflation, in fact, is recognized as leading to unemployment. A succession of short-term economic stimuli by injections of more and more deficit spending is as destructive for an economy and a society as a succession of ever-larger injections of dope for an individual seeking sustained stimulation.

A major reduction of income taxation, as in the Kemp-Roth bill, would represent sound policy, provided that it serves as an additional constraint on government expenditures. Lower tax rates should over time bring in more revenues. Diminishing returns exist in taxation as in many other things; this has been known for a long time. The recent emphasis on the destructive effects of excessive taxation by Prof. Laffer has had a most salutary popular and political appeal. But tax reduction should not be used as an initiation to continue government expenditures on the presumption that lower tax rates will immediately bring in more revenue.

The benefits of less repressive taxation will in the long run increase economic vitality and thereby permit larger expenditures of many sorts on a non-inflationary basis, but control of government expenditures continues to be urgent. No general tax reduction may be counted on to be promptly self-financing.

The overwhelming adoption of Proposition 13 in California indicates the widespread resentment—one may even say disgust—at runaway government expenditures. The reduction in a single form of taxation—the property tax—is an inefficient and perhaps a somewhat ineffective way to control expenditures. Certainly the adoption of Governor Reagan's Proposition 1 a few years ago would have dealt with the combined problem of expenditures and total taxation more fundamentally. Other states may follow that route. But whatever form of limitation on government expenditures and taxation is politically acceptable deserves support.

The most encouraging feature in the entire tax area is the widespread and great momentum in the Congress for a reduction in the taxation of capital gains. It is particularly impressive that the initiative comes from both parties in the Congress, in spite of the surprising objections of the Carter administration. Since any realization of a capital gain is a voluntary act which may be and often is postponed indefinitely, a high tax is likely to be immediately counter-productive of revenue.

Capital gains taxation might be reduced in any of several ways. The Steiger—Hansen amendment which would put the rate back to the pre-1969 maximum of 25 percent has gotten the most attention. Its adoption would be splendid. The House bill, incorporating the Jones amendment, with a maximum of 35 percent, would be a useful but distinctly second-best modification. It would at least get rid of the indirect and somewhat sneaky ways in which the effective rate has been raised in many instances to over 49 percent without any forthright statement to that effect in the tax law.

A sliding scale in which lower tax rates apply as assets are held for longer periods would be reasonable and effective in reducing the adverse effects of excessive capital gains taxation. My own preference is for an extension to individual security holdings of the existing provisions for tax-free rollovers of reinvested capital gains. To the extent that capital gains are reinvested, a tax on them is a capital levy rather than an income tax.

Here again, whatever form of relief is politically feasible deserves the widest support. Discussion about the relative merits of different forms of relief should not go to a point where it provides an excuse for postponement of some relief now. Any of the various proposals recently attributed in the press to Senator Long would build positively on the good start made in the House bill.

Liberalization of the investment credit is a useful interim measure pending a fundamental revision of the law to allow capital recovery allowances to take account of inflation. With a resumption of double-digit inflation, a 10 percent investment credit is merely a rough equivalent to letting a business buy its capital

equipment at prices prevailing a year previously. Thus stated, the tax relief is neither generous nor adequate.

STATEMENT OF STATE TREASURER CLIFFORD A. GOLDMAN

The State of New Jersey is the only urban, northeastern state with a AAA credit rating. Our financial policies are pruduent and conservative. We believe that the State and all of its subdivisions are interdependent parts of one financial family. Therefore, my office works closely with local governments, school districts, and authorities—particularly when problems arise.

In 1976, we devised and enacted a Qualified Bond program when some of our cities, burdened with short-term notes, had no access to the bond market and when others were paying exorbitant interest rates on general obligation bonds. Under that program, Newark has attained an A rating and interest rates under 6%. Jersey City's interest rate fell from 10 3/8 to 5 3/4. (In about 1 yr.)

We have also reformed our authorities. Our Housing Finance Agency had over $250 million of notes outstanding at the end of 1975. Now, it has none. Neither, by the way, does Newark. Our Health Care Facilities Authority had financed a State medical school with costly revenue bonds, which were really backed indirectly by State appropriations.

We went to our Capital Planning Commission, our Legislature, and our electorate with a plan to refinance the medical school with State bonds. Now, we are designing a second medical school which will be built free from the proceeds of that refinancing, and the taxpayers and health care users will save some $47 million besides. The New Jersey Turnpike had sold bonds for a new road which was later deemed to be environmentally and financially unsound. The plan was abandoned and the bonds were refinanced to elimniate the obligation to build the road. Our financings are purposeful. They are undertaken through democratic processes.

New Jersey has already forwarded extensive comments on the proposed amendments to the proposed regulations. I assume that our submission is part of the record of this proceeding. The point of my remarks is to explain that your attempt to regulate what you consider to be abuses has disrupted our careful financial planning and has created unnecessary problems.

Our financial procedures are deliberate. As in the successful undertakings I have cited, we need time to plan, to secure the approval of an independent Capital Planning Commission, the Legislature, and often the voters. We need a stable, sensible environment.

That we have hearings on "proposed amendments" to "proposed regulations", when those proposed amendments have long since taken effect by fiat and the proposed regulations have been effective for years is, in itself, an indication of a muddled state of affairs, that is not conducive to the kind of deliberate financial management of which New Jersey is proud.

These proposed regulations have aborted our efforts in New Jersey to help financially distressed cities reduce their interest costs.

That result, which is so perverse and so clearly contrary to the urban rehabilitation efforts of all levels of government, was—I must assume—unintended and unforeseen.

The fact remains, though, that the very communities in my state which are most in need of financial relief have been denied the right to refund outstanding debt at significant interest savings. That denial aborted a lengthy process which involved a year of study, a proposal in the Governor's State of the State Message in January, and the enactment of four pieces of legislation.

I'm not referring to advance refundings where high coupon bonds are used to refund lower coupon debt. I'm talking about municipal issuers which were forced to convert notes or meet other essential obligations by selling bonds during the 1975–76 market crisis.

These cities and school districts sold bonds at exorbitant rates—9 and 10 percent; even 10⅝ percent rates were recorded. In many cases, the issuer had to sacrifice normal call provisions—giving up the opportunity to employ a straight refunding issue when circumstances were right.

These issuers—and their taxpayers—are being penalized now by the sweeping regulations on invested sinking funds. Our lawyers tell us that these regulations are bad law, that they are unsupported by statutory authority. Applied to overtaxed municipal issuers, they are certainly bad public policy.

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I would urge that the proposed amendments concerning invested sinking funds be withdrawn in light of their questionable legal base and their damaging impact on municipal finances.

As my written comments indicate, it is my judgment that the amendments affecting the treatment of administrative costs in yield computation and the changed certification procedures are similarly ill-advised.

They have been formulated without proper regard for their market and financial planning consequences. For example, we have proposed a refunding of our outstanding Sports Authority bonds with State guaranteed bonds. The plan requires voter approval in November. We cannot rush to market to meet an arbitrary September 1 date which was imposed in the middle of our work on this project. And, we see no logical or legal basis for you to consider the costs of issuance as arbitrage profits.

I would emphasize one other point made in my written comments. The process that has evolved in recent years of publishing, without prior consultation, periodic revisions of proposed regulations has had a pernicious effect on the municipal market and has become a major obstacle to orderly public financial planning.

This immediate set of amendments announced with an effective date, apparently chosen to comfort a few favored issuers, produced a run to the market in such volume that some of our long-scheduled routine financings were adversely affected. And, the September 1 deadline has produced another rush to refinance anything that ever might conceivably be refinanced.

This kind of procedure confirms what the substance of the amendments already suggests—that these actions are being taken with insufficient knowledge of, or regard for, their real impact. The remedy is more abusive than the purported abuses being addressed.

I would press upon you the need for a better procedure for a thorough, practical and informed analysis of public policy regarding municipal finance.

The State does not believe that Congress intended when it adopted the arbitrage bond provisions to force governmental issuers to secure the Treasury Department's prior approval to the issuance of their bonds. But that is exactly what will be accomplished in many cases by the combination of the proposed change in the certificate procedure and the failure of the Proposed Regulations to provide a comprehensive and comprehensible set of rules implementing the arbitrage bond provisions. Nor does the State believe that the inability of the Treasury Department to prescribe clear rules for dealing with the relatively few abuse situations justifies casting a pall on the tax-exempt status of all governmental issues through an in terrorem device such as the artifice or device rule.

Whatever one's view may be of the constitutional basis for the tax-exempt status of interest on governmental obligations, there can be no question but that restrictions on such tax-exempt status should be interpreted and administered in a way that minimizes the potential for higher borrowing costs for governmental issuers and disruption to the market for governmental obligations. Undisciplined regulation of governmental financings, such as that occasioned by the May 3, 1978 revision of the Proposed Regulations, is just the kind of interference that justifies the position that any restriction of the tax-exempt status of tax-exempt bonds violates the constitutional protection of the independence of State Government.

The State of New Jersey urges that the proposed amendments to Proposed Treasury Regulations sections 1.103–13, 1.103–14 and 1.103–15 be withdrawn as promptly as possible, not postponed, so as to end the intolerable confusion and the arbitrary, legally-unfounded intrusion into the financial affairs of State and local governments.

Statement of A. H. Snyder, Jr., Dallas, Tex.

I am 57 years old, a Professional Engineer and a moderately successful business man.

The House passed tax legislation offers a little encouragement in starting to remove tax inequities and features that discourage initiative.

Such encouraging changes are the raising of the surtax exemption for business—making investment credit permanent—reduction in the maximum capital gains tax—reduction in personal income taxes—exclusion of up to $100,000 in capital gain on the sale of a home on a one time basis—removal of minimum tax on capital gains.

However, maximum rates are still excessive. For example, I worked very long hours for over 20 years to build a business. Now that I am getting pay-off in dividends, I am taxed at a higher rate than if I were getting paid in salary for what I did. In addition, corporation taxes have also been paid before dividends can be paid so that, along with all investors receiving dividend income, the government is really taking me to the cleaners.

The reduction in capital gains tax is almost negligible and would not be enough to encourage me to take any appreciable risk of substantial sums. If you win, the government takes the lion's share but, if you lose, the $3000 allowable capital loss deduction can result in a lot of years to deduct the loss so in effect the government is collecting taxes on a person's loss.

Investment credit is nice and accelerated depreciation helps a little but neither does much in compensating for higher and higher equipment replacement costs.

The one time exclusion on the sale of a home is nice unless, as one grows older, the jump to retirement quarters is taken in more than one step and the taxpayer is stung because the didn't make it in one as decreed by his government.

The biggest problem is that there has been no indexing for inflation and the deficit financing of the Federal Government for so very many years has simply resulted in the increase of income taxes in a geometric progression and Congress has essentially shown no restraint in spending even more than the increases in tax take.

The proposal to index capital gains for inflation in 1980 is commendable as a start but it is interesting that Congress does not hesitate to slip in a little expost-facto taxation when the shoe is going the other way as you did to me in 1978 but delay a just revision such as this.

It is sad when rules such as the standard deduction are set up as a political expediency so that it is more advantageous for a couple to "live together" than to get married—when such deduction gives those that do not give to charity or make expenditures that enhance the economy money in their pockets. You can't really believe that all of those good people give that much or pay that much interest. It would appear that Congress encourages immorality and turning from charity where each dollar does so much more than the government welfare dollar.

The automatic "in contemplation of death" if a person is so unfortunate as to die within three years of making a gift is a sorry commentary on the Federal Government straining to get the last dollar even if unreasonable and unjust. This is particularly true on the case of property given that grows in value if the poor giver happens to be so unfortunate as to die within three years of the gift.

If Congress would exercise some discipline and cut out some of the fantastic waste—and it is bull to deny there are not billions in lousy stewardship of the taxpayers money—and get Federal taxation down to digestive levels, needed confidence so necessary to the future of the United States could be restored. It is amazing what has been accomplished even in the face of Federal discouragement of initiative but "Proposition 13" speaks loudly that government has gone way too far.

Statement of the Taxation Section of the State Bar of California

These comments on the Revenue Bill of 1978 (H.R. 13511) are directed primarily towards emphasizing the need for simplification of our income tax laws and reflect a concern with the sometimes overwhelming complexity of existing tax legislation, particularly in recent years. In addition, we have included a number of comments relating to technical aspects of the legislation, comments relating largely to draftsmanship. Thus the scope of our comments is limited to areas in which lawyers are expected to have peculiar expertise; we have tried to avoid comments on matters involving social, economic or political issues.

Complexity we believe, perhaps as much as any other factor including inequality and high tax rates, threatens our self-assessment income tax system. While many provisions are admirable in concept, complexity may make them extremely difficult to apply or even unworkable. As tax practitioners we dislike devoting a significant amount of time and large amounts of taxpayers' money interpreting needlessly intricate provisions. It is particularly distressing to both practitioners and the public when, even after devoting the time and money, clear answers cannot be elicited. Moreover, Internal Revenue Service personnel, particularly at lower levels, frequently are unable to deal with the complexities of the Internal Revenue Code, a fact which inevitably leads to poor and uneven administration and even more taxpayer expense. We nevertheless recognize

that some complexity is inherent in our income tax laws, and that Congress must balance the need for simplification against many competing considerations. Our comments emphasizing provisions which we believe unnecessarily complex reflect an attempt to assist in this balancing process.

We have sought in the draftsmanship area of our comments to concentrate on language which may be ambiguous or inconsistent and which creates the uncertainties and potential disputes. Whenever possible we have recommended substitutes or additional language.

The comments which follow are in the order of the sections of the Bill.

Act § 112 (*Code § 213*)—While in concept the revision of the medical expense deduction represents a simplification, additional complexity and uncertainty will result from the two new definitions. The definition of "prescribed drugs" uses the word "requires" with respect to the prescription but fails to say required by whom. We suggest that a phrase such as "under applicable state of United States law" be inserted in Act Section 112(b)(2) between the words "which" and "requires." Also, "physician" is defined with reference to the Social Security Act, a separate document, thereby not only incorporating the complexities of that Act into the Internal Revenue Code but also adding significantly to the burden of a taxpayer or practitioner trying to understand Code Section 213. The definition of "physician" should be self-contained, thereby eliminating an unnecessary cross reference. We suggest: "The term 'physician' shall mean any person licensed under the laws of a particular state or jurisdiction to issue prescriptions for medicine and drugs."

Act § 114 (*Code § 85*)—(1) We assume the revenue to be derived from taxing unemployment compensation will be sufficient to justify the addition of an entire new Section 85 to the Code and the additional complexities it will impose on relatively lower income taxpayers. However, we oppose this provision solely from the standpoint of complexity.

(2) The cross reference "without regard to section 105(d)" is at best confusing; if we understand the purpose expressed in the Report of the Ways and Means Committee (page 48), the cross reference could be better expressed by the words "including all disability income eligible for exclusion under Section 105(d)."

(3) Not only do we believe the section is in general poorly drafted and will add complexity, we believe the rationale for the harsh treatment of married taxpayers who do not file joint returns is vulnerable to criticism and difficult to understand. We recommend that the exclusion limitation parallel the general treatment of married taxpayers who do not file joint returns, namely, that they be treated as separate taxpayers but limited to one-half of the maximum exclusion that could be taken on a joint return.

Act § 123—If more than one person who is an independent contractor participates in a deferred compensation plan, the deduction for compensation is allowed only if separate accounts are maintained for each person. The tax treatment is unclear under proposed Code Section 404(d)(2) if contributions are made to a plan in which more than one person participates but where separate accounts are not maintained for each participant. It would seem that the requirement for separate accounts could be eliminated since if the amounts taxable to an independent contractor they should be deductible.

Act § 124—We oppose the provisions relating to "cafeteria plans" solely from the standpoint of complexity and vague statutory language. These provisions, which include some of the terms used in the qualified pension and profit-sharing plan area and found in ERISA, will create difficult questions of interpretation as well as many administrative problems and will present taxpayers with many potential and costly disputes. For example, the definition of "cafeteria plan" is far from clear. One need not delve deep to conjure up factual situations where it will be unclear whether an employer has a "plan" or whether "the participants may choose" among benefits. Moreover, neither the Bill nor the Committee Report sheds any light on how the various benefits (taxable and nontaxable) provided under a cafeteria plan should be valued to determine whether a plan is discriminatory. An obvious method would be to compare the cost of each type of plan benefit, but other methods may be more appropriate.

(2) The provisions will create further uncertainty by extending the rules relating to discrimination in favor of highly compensated employees to a new area, rules which after many years are still the subject of extensive controversy and uncertainty. Defining "highly compensated" employees under Code Section

401(a) has always been very difficult, and we can expect the definitional problems to be no less under proposed Code Section 124(a). Also, the reference contained in proposed Code Section 124(g)(2)(A)(i) to "highly compensated participants similarly situated" is undefined and ambiguous.

(3) While the larger employers will be able in most cases to deal with the additional complexity by retaining and paying for competent professional advice, we believe it would be a mistake to impose this sort of legislaton on those smaller businesses which are not in a position to afford to comply or are understandably unwilling to pay for the cost of compliance.

Act § 201—(1) Since Subparagraph (i) of proposed Code Section 465(c)(3)(A) requires an activity engaged in "by the *taxpayer*," it is not clear that a partnership carrying on a trade or business will implement the at risk rules, at least with respect to a partner who is not actively participating in management. We recommend that the language be changed to "engaged in by any *person*."

(2) A provision should be added correcting a glaring deficiency in the Tax Reform Act of 1976 in the correlation of losses disallowed under the "at risk" rules of Code Section 465 and the reduction of the basis of a partnership interest under Code Section 705(a)(2)(A) or of the basis of depreciable property outside a partnership. Under present Code Section 465 as well as under the proposed changes, there could be a basis reduction despite the disallowance of losses. Thus if there was a $45,000 partnership loss, a one-third partner is not permitted to deduct his $15,000 distributive share of the loss because of Code Section 465, while the partner's basis of his partnership interest is nevertheless reduced by the disallowed $15,000 loss. If at the beginning of the next year the partner sold his partnership interest, he could have an illusory gain of $15,000. The problem is not confined to partnership. Thus assume an individual is engaged in the trade or business of leasing Section 1245 property, that his cash income exactly equals his cash expenses and that he has a net loss resulting from depreciation. Assume also that the Section 1245 property was purchased with non-recourse financing and that there is no amount "at risk." Any loss resulting from the depreciation would not be deductible under Code Section 465, but presumably the depreciation would nevertheless reduce the adjusted basis of the Section 1245 property for purposes of gain or loss. Unless that depreciation is restored to basis at the time the property is sold, the taxpayer would have Section 1245 recapture income even though the prior loss was never deducted.

In the case of partnerships interests the simplest solution to this problem might be to amend Code Section 705(a)(2)(A) to provide that no basis reduction occurs for losses disallowed under Code Section 465 by adding the word "allowable" before the word "losses." Or alternatively, a partner could be treated as becoming at risk to the extent of gain realized on the disposition of his partnership interest. With respect to assets outside a partnership, basis provisions will have to provide that a loss disallowed under Section 465 will be restored to basis for purposes of determining gain upon a sale.

(3) The aggregation principles in proposed Code Section 465(c)(3)(B) in general appear to simplify the application of the at risk rules and yet protect the provisions from abuse by use of the active participation in management concept. However it is questionable whether these provisions will be useful when the Internal Revenue Service is given the power to adopt regulations overriding them. This delegation and reliance on regulations will create a long period of uncertainty on the part of taxpayers and administrators and will generate substantial complexity by potentially requiring isolation of the various separate activities that comprise almost any business. Even the possibility of regulations requiring the segregation of the activities of a single business will require a well-advised taxpayer to maintain a separate set of schedules, by activity, repeating the concepts of basis, depreciation, recapture and capital gain for their at risk basis as well as for their normal basis. To reduce the burden on businesses generally and the uncertainties of whether a particular business will be broken into its separate activities, we oppose the road delegation to the Internal Revenue Service.

(4) The extension of the at risk rules to all types of activities, when coupled with the present definition of "amounts at risk", may make proposed Code Section 465 overly broad in its application. For example, an individual who borrows say $10,000 from his family and adds his life savings of $5,000 for the purpose of opening a book store, hardware store, plumbing business or the like, would only be allowed to take deductions to the extent of $5,000. To make every sole proprie-

tor and small partnership subject to the at risk provisions, especially in light of the complexity of the rules and recordkeeping requirements, is inconsistent with the concept of simplification of tax reporting. While the present definition of "amounts at risk" worked when the section applied only to specifically enumerated types of activities, activities generally thought of as tax shelter activities, they do not fit well when applied to other types of businesses whether tax shelter oriented or not.

(5) Additional complexity arises from the fragmentation concept in proposed Code Secton 465(c)(3)(D). Separating the holding of real property (other than real property used as living accommodations) from the incidental personal property and services activities will involve difficult problems of allocation and uncertain factual determinations. From the standpoint of simplificaton, consderation should be given to treating all real property alike or to limiting the application of the fragmentation rules to trade or business deal property.

(6) The language used in proposed Code Section 465(c)(3)(D) excluding real property is ambiguous. We believe the intent of the provision could be better expressed by changing the language to read "the construction, holding or leasing of real property (other than mineral property), directly or indirectly, for sale, rental, investment, or use in a trade or business."

(7) The at risk exception for "real property (other than mineral property)" arguably excepts timber property. In Revenue Ruling 77-400, the Internal Revenue Service held that timber property was not "mineral property" under Treasury Regulations Section 1.612-3(b)(3), while under Code Section 464(e) timber property is not "farming." This should be clarified in the Committee Report.

(8) The recapture concept of proposed Code Section 465(e) is understandable when read in the Committee Report, but the proposed statutory language is difficult to track. It refers to gain being realized "If zero exceeds the amount which the taxpayer is at risk in any activity at the close of any taxable year. . . ." It is hard to imagine a situation where zero exceeds the amount the taxpayer is "at risk." If the taxpayer has withdrawn all of the amount "at risk," his remaining amount "at risk" is zero and cannot be less. The draftsman is trying to use a concept somewhat like that of the negative capital account in a partnership, but it will not work in this situation.

The word "not" should appear after "refund may" in the last sentence of proposed Code Section 6501(g)(1).

Act § 314 (Code § 48)—*(1)* There is a possible inference from the use in proposed Code Section 48(g)(1)(A) of the words "which has been rehabilitated" that the rehabilitation must be completed before an investment credit is allowale. We believe the relationship between this provision and existing Code Secton 46(d) relatng to qualified progress expenditures needs to be clarified. If a building has been "rehabilitated" once, would Section 46(d) then be available with respect to second or third rehabilitations? Apart from the problems of Section 46(d), if a building were to be rehabilitated floor by floor with each floor placed in service as completed, would the costs for each floor be eligible for credit as completed, even though the entire building was not rehabilitated in one year? If intended, the section should be revised by adding a provision clearly permitting application of Section 46(d) or permitting a credit each year on a piecemeal renovation of a building.

(2) The use of the term "prior rehabilitation" in connection with the five-year rule for proposed Code Section 48(g)(1)(B) is ambiguous. With respect to a piecemeal but continuous, planned rehabilitation of an existing structure, if a credit is allowed prior to completion (for example by reason of Section 46(d)), this provision literally could prevent a credit in a subsequent year. Also it is unclear whether the five-year rule is intended to prevent rehabilitation of the same area space within five years or is instead intended to mandate that an entire building be rehabilitated in a single project? If intended, the section might be clarified by providing that the five-year rule applies only to rehabilitation of the same area space.

(3) The extent to which a building must be rehabilitated to be a "qualified rehabilitated building" is unclear. Would rehabilitation of one floor qualify or must the entire building be rehabilitated? The inference from proposed Code Section 48(g)(1)(C) is ambiguous since the provision could be intended to make clear that a "major" rehabilitation is permissible or could be read negatively as excluding minor rehabilitations.

Act § 315—(1) While the inclusion of the provisions relating to the targeted jobs credit presents the broad issue of the use of tax credits, we oppose the provisions solely on the grounds of complexity and administrative feasibility. Will the Secretary of Labor be responsible for informing an employer whether or not a particular individual qualifies as a "targeted group" member? If not, and if the burden is to be placed instead on the employer, then proposed Code Section 51(c) will present an enormous obstacle to the employer's eligibility for the credit, since it would first be required to consult the complex language of the section and then make a determination whether the particular person seeking employment qualifies as a member of one of the categories incluuded in the targeted group.

(2) With respect to the definition of "hiring date" in proposed Code Section 51(c)(11), the day an individual is hired is frequently unclear. The definition could be simplified by defining "hiring date" with the same language as is used in computing qualified wages, that is, the day the individual begins work for the employer."

Act § 336(b)—(1) We recommend that the words "tangible personal" be inserted after the word "depreciable" in proposed Code Section 179(c)(1) so that the limitation determined with reference to the tangible personal property of the taxpayer rather than all real and personal property. For example, it appears to be both logical and proper for a taxpayer purchasing qualifying Section 179 property to be entitled to the additional first-year depreciation allowance even though he may have real property valued at more than $1,000,000. The use of the $1,000,000 adjusted basis standard for the assets of the taxpayer does not take into account the different forms of leverage which different taxpayers might be utilizing, and therefore could encourage those taxpayers who do not utilize leverage while discouraging those who do.

(2) We also recommend that the phrase "depreciable" in proposed Section 179(c)(1) be omitted and the phrase "section 179" be inserted, causing the limitation to be on qualifying Section 179 property. It appears that any Section 179 property owned by a corporation would have been acquired after December 31, 1957, and therefore at the effective date of this section, any property not included within this limitation would have to be more than 21 years old. This alternative provides simplicity and maintains a symmetry of definition within the specific Code section.

Act § 401—(1) Repeal of the alternative tax for individuals is desirable from the standpoint of simplification since it will reduce to some degree the complexity both of the Code and of the tax computations necessary under present law. A cosmetic improvement would remove the caption "Corporations" at the beginning of Section 1201(a); no clarity is lost because Section 401(a)(3) of the Act adds "for corporations" to the title of Section 1201.

Act § 402—(1) Since the untaxed half of capital gains represents overwhelmingly the largest portion of tax preferences under present law, consideration should be given to repealing the remaining tax preference provisions solely from the standpoint of simplification. The disadvantage of the great complexity of these provisions may outweigh the advantages of equitably imposing at least some tax on taxpayers who might otherwise pay little or no tax and of raising a minor amount of revenue.

(2) Paragraphs (10) and (11) of Section 57(a) of the Code should be renumbered downward.

(3) The elimination of Code Section 57(a)(9) effective for "taxable years beginning after December 31, 1978" creates some uncertainty in the case of an installment sale during 1978. Conceivably, capital gain realized in 1978 could be treated as a tax preference item on the theory that the law at the time of the realization controls that determination, even though the gain is not recognized and taxed until a subsequent year by reason of Code Section 453. Although the Committee Report (page 120) states that gain reportable in years after 1978 will be taxed in accordance with the provisions of the Act regardless of when the sale or exchange took place, it would be desirable to make clear, if this is what is intended, that a determination of whether capital gain is a tax preference item is to be made on the basis of the law in effect when the gain is recognized.

(4) To conform to the removal of capital gains from the list of tax preference items, the use of the word "items" both times it appears in the last sentence of existing Code Section 58(g) should be changed to the singular.

Act § 403—(1) To conform with general usage throughout the Code, we suggest "½" be replaced by the words "one-half."

(2) We suggest the word "any" be inserted between "account" and "gain" in proposed Code Section 59(c).

(3) The new paragraph to be added by Act Section 403(b)(1) should be added as Section 5(a)(5) instead of Section 5(a)(6); Section 401(b)(2) of the Act proposes to eliminate Section 5(a)(3) which is now a cross reference to the alternative tax under present Section 1201(b).

(4) In Act Section 403(b)(3) amending Code Section 443(d), the words "(relating to minimum tax for tax preferences)" should be inserted following "section 56" in subsection (1) and the words "relating to separate minimum tax on capital gains)" should be inserted following "section 59(a)" in subsection (2). Also "each" should be inserted between the words "shall" and "be reduced to."

(5) In Act Section 403(b)(4), we suggest striking out "subsection (b)" and inserting in lieu thereof "this section" and striking out "items" and inserting in lieu thereof "capital gains."

(6) In Act Section 403(b)(5), we suggest striking out "or by section 59" and inserting in lieu thereof "against the tax imposed by section 59."

(7) In act Section 403(b)(6), we suggest striking out "section 56 or 59" and inserting in lieu thereof "taxes imposed by sections 56 and 59."

Act § 404—(1) The indexing provisions would add considerable complexity to the Code. It is unlikely that the average taxpayer could determine his taxable gain from the sale or exchange of an "indexed asset" without the aid of a tax return preparer, a result which we believe is clearly undesirable. Thus from the standpoint of simplification, we oppose the indexing concept. While the amendments themselves are inherently complex, the draftsmanship is commendably brief and straightforward.

(2) In proposed Code Section 1024(b)(1)(A), the inclusion as an "indexed asse"t of stock which "possesses most of the attributes of common stock" is vague and unnecessarily ambiguous. Based on the Ways and Means Committee Report (page 126), the statutory language could be improved by changing the reference to read either "stock with respect to which no fixed dividends are required to be paid by the issuer" or, as an alternative, "stock which is not preferred stock," permitting the regulations to define what is preferred stock (perhaps by reference to the definition in Code Section 247(b)(2)).

(3) In proposed Code Section 1024(b)(1)(B) and (C), the limitation of the term "indexed asset" to certain stock, tangible personal property and real property seems unnecessarily narrow in light of the explanation in the Ways and Means Committee Report (pages 125–126) of its purpose. Many types of intangible property are not monetary in nature in the same way that a savings account or a bond is, while stock, tangible personnal property and especially real property are frequently collateral for loans used to pay the cost of acquisition, thereby calling for the very type of offsetting adjustment referred to in the Committee Report for the advantage of inflation to the borrower. We believe the purpose could be better achieved by excluding from the term "indexed asset" those items of property which the law characterizes generally as "choses in action"—the right to receive a fixed amount of money.

(4) In proposed Code Section 1024(b)(1)(C), the use of the term "real property" as an indexed asset leaves ambiguous the treatment to be given to a leasehold. While common law referred to a lease as a chattel real and intended to treat it as a species of personal property, the laws of many states now refer to leases as interests in real property. Further clarification in the statute or at least in the Committee Reports would be desirable.

(5) It appears that Subchapter S stock is excluded from the indexing provisions for two possible reasons. One would be that it is unfair to allow indexing where the basis of Subchapter S stock has increased substantially because taxable income has not been distributed. In other words, if the original basis were small and it had increased over the years because the corporation has previously taxed income which has not been distributed, the previously taxed income should not be taken into account in basis. Perhaps the other reason for excluding Subchapter S is that basis is constantly changing each year since it is reduced by losses and increased by undistributed taxable income, and indexing might therefore be complicated.

We suggest that both of these problems can be taken care of by including Subchapter S stock as an indexed asset and providing that the basis to be indexed is the lower of the original investment or the basis at the time of the sale. This

would effectively exclude any increases in basis due to the corporation having previously taxed income, and it would take care of reducing the basis in situations where the corporation had incurred losses. For example, if the original investment were $25,000 and the corporation had three successive years of other hand, if the original investment were $25,000 and the corporation had three successive years of losses aggregating $15,000, the basis to be indexed would be $10,000. On the other hand, if the original investment were $25,000 and the corporation had previously taxed income of $50,000 (so that the basis is $75,000), the basis to be indexed would be $25,000. Thus, the computation would be very simple, negating any argument that to index Subchapter S stock would be too complicated, and at the same time the computation does not give an unfair advantage to Subchapter S corporations accumulating taxable income.

(6) In proposed Code Sections 1024(b)(2)(A)(iv) and (v), a "foreign corporation" is not included as an indexed asset in order, according to the Committee Report (page 127), to prevent tax avoidance by incorporating non-indexed assets, This purpose would be more precisely carried out if the exclusion were limited to stock in a "foreign personal holding company (as defined in section 552)." Limiting the exclusion to foreign personal holding companies would then parallel the next exclusion having a similar purpose—the exclusion of stock in a domestic personal holding company. Also the exclusion of foreign corporations which are not personal holding companies fails to further the legislative purpose since a domestic corporation which is not a personal holding company could be used just as well to incorporate non-indexed assets.

(7) In proposed Code section 1024(c)(2), determination of the "applicable inflation ratio" by reference to the CPI for the calendar months in which the asset is acquired and in which it is sold provides a modicum of precision at the expense of a substantial increase in complexity. The provision as proposed requires the use of intermediate arithmetic which is probably beyond the ability of the average taxpayer and which in any event should not be expected of taxpayers. We prefer the less precise but more manageable ratio in Legislative Recommendation 1975-4 of the American Bar Association Tax Section, which keys to the ratio which the CPI for December of the year of acquisition bears to the ratio for December of the year *preceding* the year of disposition. One advantage of this approach is that the instructions to Form 1040 published by the Internal Revenue Service could readily be printed on time (without waiting for publication of the CPI for December of the taxable year) and could contain, in a single table, the appropriate inflation ratio for all sales during the calendar year, arranged by the year of acquisition. The taxpayer would have to handle only a single multiplication of his adjusted basis by the appropriate ratio rather than calculating for himself the ratio to use and then its application to his basis. This is no small saving in view of the likelihood that many assets will be comprised of multiple basis segments (see, for example, proposed Code Section 1024(e)(1)).

(8) Referring to proposed Code Section 1024(e)(1)(A), while the desire to reduce to a minimum the number of segments into which the adjusted basis of a single asset must be divided is understandable, the term "a substantial improvement to property" is ambiguous, and we believe a statutory definition, or at least a safe harbor, should be provided.

(9) In proposed Code Section 1024(e)(1)(B), dealing with a substantial contribution to or a reduction in capital, the reference to "the case of a corporation" is confusing. It appears literally as though a reference is intended to assets owned by a corporation, while the reference is probably supposed to be to a sale by a shareholder of common stock *of* a corporation. We suggest the reference be changed to read "in the case of stock."

(10) Clarification of proposed Code Section 1024(e)(1)(C) is needed where the partial recognition of gain or loss occurs under Code Section 356(a)(1) since, under Code Section 356(a)(2), the gain may or may not be treated as a dividend which should probably not be indexed.

(11) The "click in-click out" rule of proposed Code Section 1024(e)(2)(A) reducing the ratio for periods during which an asset was not an indexed asset might be interpreted, in view of the treatment of a sale of stock of a collapsible corporation in proposed Code Section 1024(b)(2)(B), to require a determination as to what periods of time a corporation may have been collapsible under Section 341(b)(1) of the Code. The Committee Report (page 130) indicates that the type of situation in mind for the rule was a Subchapter S corporation and

presumably it was not intended to require a determination of periods of collapsibility. The Code should make that intention unmistakable.

(12) Referring to proposed Code Section 1024(e)(2)(A), under the general rule, no adjustment to basis is called for if an asset, at the time sold, has ceased to be an "indexed asset" without later resuming that character. This seems to be an unnecessary inequity which could be readily cured at this point in the statute. Along the same lines, the intention appears to be that if an asset was not an "indexed asset" at the time acquired, but later became one, the proper CPI to use is not that stated in proposed Code Section 1024(c)(2)(B) but rather the one for the month in which the conversion to "indexed asset" status occurs. This might be explained in the statute, or at least in the Committee Report.

(13) The effect of the indexing provisions is to substitute a new basis for the adjusted basis referred to in Code Sections 1001(a) and 1011. It would be advisable to give the unwary taxpayer a bit of warning by adding to the cross reference in Code Section 1001(f) some hint that adjusted basis" may not be all it seems. The wording of Code Section 1011 is inadequate for this purpose since it tells where in the Code to find the adjusted basis, but not what to use in place of it.

Appendix to Comments on the Renenue Bill of 1978 (H.R. 13511) on Behalf of the Taxation Section of the State Bar of California

SELECTED COMMENTS OF INDIVIDUAL SECTION MEMBERS

I. Sections 111–115— Itemized Deductions

A. Section 111.—This section repealing the deduction for state and local taxes on gasoline and other motor fuels, is probably justified on a pure simplification basis. Surely all our efforts should be bent toward reducing the number of itemized deductions, translating these deductions into the amount allowed as a "standard deduction", and thereby increasing the number of taxpayers who will elect to file a short form return.

B. Section 112.—(1) (a) This section is adequately drafted.

(b) It is a step toward simplification as it eliminates the several categories of medical expenses and their differing deductibilities.

(c) It is a step toward complexity as it adds two new definitions to the Code—"prescribed drug" and "physician"—without, I believe, any need to do so.

(2) The section might best do away with the deduction for medical, dental and other expenses entirely. More and more taxpayers have their medical expenses covered by insurance, through Medicare or Medi-Cal, through employer paid health insurance plans, or through insurance purchased by the taxpayers themselves. It seems clear that the trend is toward more insurance on a national level rather than less.

In any event, the proposed amendment to Section 213 is a typical tax writing atrocity and should be substantially revised before enactment. I suppose that simply referring to "prescription drugs" is not possible. Although the term would seem to have a sufficiently specific meaning for the Internal Revenue Code, without further definition, it is always possible that people will start running to their doctors for prescriptions for aspirin, Kotex or whatever. Nevertheless, the attempted definitions go far beyond what is necessary. In the first place, defining "physician" with reference to the Social Security Act simply imports the complexities of that Act into the Internal Revenue Code and makes the Internal Revenue Code subject to amendment every time they tinker with the Social Security Act. As a general rule, I think we should try to make the Internal Revenue Code a self-sufficient code and do away with references to other laws whenever possible. Secondly, the definition of "prescribed drugs" is relevant only in the sense that it uses the word "requires" with respect to prescription, but doesn't say required by whom. For the foregoing reasons, I think the entire concept they are driving at could be best handled by amending subsection (b) of Section 213 to read as follows:

"Limitation with respect to medicine and drugs.—An amount paid during the taxable year for medicine or a drug shall be taken into account under subsection (a) only if such medicine or drug is insulin or is a drug or biological which, under applicable State or United States law, requires a prescription of a physician for its use by an individual."

(3) Unfortunately, an ambiguity arises in subsection (b) of the Section, "Definition of Prescribed Drug". Generally, one of the inherently complex aspects of

the Code is its reference to other sections and subsections, often by way of limitation, without setting forth the limitation directly. In the case of this section, the term "Physician" is defined by reference to the Social Security Act [42 U.S.C. 1395X(r)], a wholly separate document. It may be better to authorize regulations which would track the definition contained within the Social Security Act.

(4) First, new paragraph (2) of subsection (e) of Section 213 inserts a new definition "prescribed drug" into the code, in lieu of "medicine and drugs" which was not defined except in the regulations. Treas. Reg. Section 1.213-1(e)(2). In addition to insulin, prescribed drug includes any "drug or biological" requiring the prescription of a "physician." Second while biological is not defined, physician is defined by reference to the Medicare provisions of the Social Security Act. As the term biological has not had previous usage in the Code and is not defined in the Medicare provisions, it might be well to retain former language "medicine or drugs" and limit these to items which require the prescription of a physician. This will eliminate possible confusion as to whether a prescription item is a drug or biological from both the taxpayer and the IRS point of view.

(5) The consolidation of the medical expense deduction into a single deduction subject to the limitation of 3 percent adjusted gross income is a major simplification for both taxpayers and the IRS. See Committee Report at 43. In addition, the limitation of medicine and drugs to prescription items and insulin will further simplify the computation and record keeping for individuals who must keep records of minor remedies such as aspirin and other non-prescription medicines which are purchased in numerous instances at a small expense. As alluded to in the previous paragraph, the consolidation has added a complexity into the law by incorporating a new definition both of "prescribed drug" and "physician." The cross-reference to a Medicare provision excludes many professions presently considered under state laws as doctors (for example, in California, chiropractors and specialists in acupuncture). To require an individual taxpayer to familiarize himself with the definition of physician and then to determine whether the presecrption is a drug or biological seems unnecessary. It is recommended that prescribed drug be defined as "a medicine or drug which requires the prescription of a physician." The definition of physician should in lieu of the reference to the Social Security Act be defined as follows: "The term physician shall mean any individual licensed under the laws of the particular state or jurisdiction to issue prescriptions for medicine and drugs."

B. Section 113.—(1) This section is adequately drafted and is a step toward simplification as it eliminates the deduction alternative for political contributions.

(2) It is a simplification in one sense, although the increasing tendency to grant credits represents an unfortunate trend insofar as further complexity is concerned.

(3) The section is clear enough on its face, but I wonder if the conforming amendments are all inclusive. There appears to be no change in the tax credit allowable for political contributions currently authorized in Section 41. Eliminating the itemized deduction and leaving the credit removes a choice and simplifies the handling of political contributions. It subtracts an option and possibly an advantage from those who are able to itemize.

C. Section 114.—(1) (a) This section is adequately drafted.

(b) It is a step toward increased complexity in the tax law as it adds two new definitions to the Code—"base amount" and "unemployment compensation"—and it establishes a formula for determining what percentage of unemployment compensation is to be included in the taxable income of the taxpayer. It could be simplified by providing that all or some fraction of unemployment compensation is includable. The formula approach may be justified on policy grounds but will add complexity to the preparation of income tax returns.

(2) The section provides for the taxation of unemployment compensation benefits for taxpayers whose total income exceeds certain levels. I suppose there are studies which show that a significant amount of revenue will be derived as a result of the enactment of new Section 85 of the Internal Revenue Code, but I wonder if it is sufficient to justify having a new section and all of the concepts involved. Furthermore, there seems to be a total inconsistency and unfairness in proposed Section 85(b) because, as I read the section, a married taxpayer who does not file a joint return is penalized severely and I don't understand why this should be so. Although it would be perhaps more complicated, I think it would be better to have a base amount of $25,000 for any married taxpayer and require the income of both spouses to be counted in order to see if the base amount has been exceeded.

(3) (a) The section gets low marks for clarity. I have several changes in form to suggest. I would rewrite the first paragraph as follows:

"(a) In general.—Gross income[1] includes unemployment compensation when the sum of the adjusted gross income of the taxpayer and the unemployment compensation exceeds the base amount. Include in gross income an amount equal to the lesser of—

(1) the amount of the unemployment compensation, or

(2) one-half of the amount of the excess of *such sums* over the basic amount."

In plain language the rule should come first, then the condition or exception. This is a more direct form than the proposed language which puts the weaker dependent clause first. The word "when" is a little stronger than the word "if".

My suggested language eliminates the material in the parenthesis which I found more confusing than clarifying. I spent too much time trying to analyze the language "determined without regard to this section and without regard to section 105(d)". I suppose determined without regard to this section means adjusted gross income is found without including unemployment compensation. If gross income has not previously included unemployment compensation, what are you adding by this phrase? While "without regard to this section" seems useless, "without regard to section 105(d)" is outright confusing. By disregarding section 105(d) are you eliminating disability income from adjusted gross income entirely? I think the intent is to include disability income in gross income to the same extent and under the same principles as section 105(d). If so, you are not disregarding that section but incorporating it. If the term "adjusted gross income" already includes the disability income concept outlined in section 105(d), what is the purpose of mentioning it here? Who would be satisfied making a determination under section 85 without checking back to the numbered section you are told not to regard? If a reference is considered essential here, and assuming I have correctly guessed the intent, I suggest this language instead—after "adjusted gross income" on line 5 page 23 insert "(which includes any disability income includable in gross income under section 105(d))".

Under paragraph (a) I have reversed the order of the amounts (1) and (2). It reads more smoothly to have the reference to base amount just immediately preceding the definition of base amount.

(b) I recommend some minor changes in the language defining base amount. Paragraphs (2) and (3) under (b) are not really subordinates or exceptions to paragraph (1). They appear to be three provisions of equal weight. Therefore paragraph (b) could read:

(1) $20,000, or

(2) $25,000, in the case of a joint return, or

(3) zero, in the case of a taxpayer who is married at the close of the taxable year (within the meaning of section 143) but does not file a joint return for such year, and does not live apart from his spouse at all times during the taxable year.

I removed the language "under section 6013". Why qualify the term 'joint return'? Are there joint returns other than under section 6013? If there were, what is the reason for excluding them here? Is section 6013 mentioned to suggest the notion of only one having income? If the mention of section 6013 is merely gratuitous, it should be omitted.

Lastly, I call attention to paragraph (b)(3) I have combined (A) and (B) since they must both occur together. To separate them is more confusing as it suggests unrelated rather than concurrent conditions. The married taxpayers who live apart from their spouses at all times during the taxable year will each be able to use $20,000 as the base amount. Where does the married taxpayer who lives apart from his spouse for part of the year fall? Apparently under (3).

(c) Zero under paragraph (b)(3) is a rather harsh alternative for married taxpayers who do not wish to or cannot file a joint return, and who may have lived apart most of the year. They are treated very differently from taxpayers who may have lived together most of the year but are divorced at the end of the year. The purpose of paragraph (b)(3) is to deny the benefit of $20,000 each to married taxpayers who file separately, but some other amount would be more equitable than zero. I'm not sure these classes of taxpayers raise constitutional questions, but they do at least raise equitable treatment questions.

I think the three categories in the definition of the base amount need some further thought and possible exceptions. Not entirely divorced from economic and political considerations, I cannot help commenting that periods of unemploy-

ment bring added stress and increased marital breakdown. Not all couples have the foresight to split on December 31. The poor taxpayer is unemployed and separated and now he will have to include all his unemployment compensation in gross income if he cannot get his estranged spouse to sign a joint return. I predict that if enacted in substantially the same form, this provision will prove very unpopular for more reasons than one would care to name.

(4) The amendment adds new Section 85 to the Code as an additional item specifically included in gross income. A key drafting problem faced in establishing this provision was to define "unemployment compensation." Section 85(c) provides that for purposes of the Section unemployment compensation means any amount received under a law of the United States or of a state which is in the "*nature of unemployment compensation.*" This definition is rather vague. However, its necessity is explained in the Committee Report. Historically, there has been no specific provision in the Code excluding from gross income unemployment compensation benefits. However, since 1938 the IRS has consistently excluded such payments if made under a government-sponsored as opposed to a private plan.

I believe the drafting ambiguity is substantially eliminated by the Committee Report (pp. 48–49) which expands on the definition and incorporates references to prior rulings. It is recommended that the Treasury regulations under this section incorporate the definitions in the Committee Report in order to avoid any subsequent ambiguity.

(5) While not a problem in the draftsmanship, which is clear, the provisions designed to tax benefits in excess of a certain amount may result in an additional confusion with respect to married taxpayers filing separate returns. The provisions as drafted provide that the amount of unemployment compensation included in income will be limited to one-half of the excess of the sum of the taxpayer's AGI, unemployment compensation and excludable disability income over the taxpayer's "base amount." The "base amount" or exclusion is $25,000.00 in the case of joint returns and $20,000.00 in the case of all other individuals except married individuals filing separate returns who are living together. The operation of the exclusion limitation on a joint return is set out in the following example from the Report:

> The operation of these rules may be illustrated by the following example. H and W are married taxpayers. He is disabled and receives $4,500 of disability income of a type eligible for exclusion under section 105(d). W works for part of the year and earns $20,000, but is laid off and receives $5,000 in unemployment compensation under a government program during the remainder of the year. H and W file a joint return. Their income including disability income and unemployment compensation is $29,500 (the sum of $4,500 disability income, $20,000 salary, and $5,000 unemployment compensation). The excess of $29,500 over their base amount, $25,000, is $4,500, and one-half of the excess is $2,250. Accordingly, $2,250 of W's $5,000 of unemployment compensation is included in adjusted gross income and the remaining $2,750 is excluded.

A problem develops when applying the same rules to two married taxpayers filing separate returns. In the previous example, the filing of such separate return would result in the entire $5,000.00 of unemployment compensation being included as income. This then creates a "tax trap" for the married taxpayers who file separate returns. While often such filings are the result of particular tax planning, they may result in many cases from a mid-year separation of the parties not followed by divorce effective before the end of the taxable year. In such cases, the parties are often faced with the practical inability of having the other spouse join in a joint return or unaware in a circumstance where unemployment compensation is received of the potential tax trap. It is recommended that the exclusion limitation should parallel the general treatment of married taxpayers who do not file joint returns, namely that they are treated as individual taxpayers but limited to one-half of the maximum exclusion that could be taken on a joint return. This would avoid both complexity and confusion.

II. Sections 121–125—Deferred Compensation

A. Section 121.—(1) The provisions purporting to deal with the deferred compensation plans are, in my opinion, ambiguous and fail to resolve the problems that currently surround the Non-Qualified Deferred Compensation area. Proposed Code Section 457, as presently drafted, fails to deal with the whole area of nonqualified deferred compensation for it is only a piecemeal approach to the subject matter. Numerous references to the concepts of Code Section 83 are made, while

Code Section 83 property is deemed excluded from the Section 457 rules. The term "substantial risk of forfeiture," although incorporated into the new statute, does not encompass the entire definition that surrounds it in Code Section 83.

(2) The term "otherwise made available" has presented numerous problems since it gives the Internal Revenue Service considerable flexibility as to when property or funds are deemed made available to the participant. In my opinion, a definition of this term should be implemented or else the term should be deleted all together. One of the major goals of the present administration is to clarify our tax laws so that the average person can better understand them. I'm afraid that this aim is not met by the present section which would further complicate our tax laws and make them less understandable.

(3) The term "unforeseeable emergency" which is to be defined by Internal Revenue Service is another example of a broad term that can have numerous interpretations and leaves the Service with ample flexibility to challenge an early distribution.

B. Section 124.—(1) Proposed Code Section 124(g)(3) sets forth a "safe haven" rule for purposes of determining whether the plan's eligibility provisions are non-discriminatory. Proposed Code Section 124(g)(3)(B) makes reference to "*years of employment* with the employer or employers maintaining the plan as a condition of participation in the plan . . . ." (Emphasis added). With respect to qualified plans, similar provisions regarding eligibility requirements are expressed in terms of "years of service". In the qualified plan area, the Regulations set forth lengthy and complex definitions of "years of service". If the use of the term "years of employment" here (rather than "years of service") is intentional, hopefully the intent is also to depart from the tortuous definition of "service" used in the context of qualified plans in favor of a simpler and more easily administered and comprehended definition of "years of employment". Also, the rules in proposed Code Section 124(g)(3)(B)(ii) (setting forth mandatory entry dates for cafeteria plans) are simpler and would be more easily administered than the entry date provisions applicable to qualified plans.

III. Sections 201-212—Tax Shelter Provisions

A. Generally, repeal of the last two sentences of Code Section 704(d) is an excellent start. Many almost insurmountable interpretative problems and anomalies will be eliminated, e.g., whether "personal liability" under Code Section 704(d) is synonymous with "at risk" under Code Section 465, as legislative history suggests, despite the difference in wording; the meaning of "principal activity"; and the fact that Code Section 704(d) applied to general as well as limited partnerships despite the unlimited liability of general partners. Further, the proposed amendment would eliminate post-1976 Reform Act shelters such as books, master recordings, coal, gold, uranium, and research and development, and would apply to shelter partnerships that avoided Code Section 704(d) by election out under Code Section 761.

B. There is added complexity under the proposed recapture provisions, but they close a truckhole, i.e., use of recourse loans, subsequently becoming nonrecourse, to provide temporary "at risk" amounts for deduction of losses.

C. The aggregation rule of proposed Code Section 465(c)(3)(B) is excessively complex and raises several interpretative problems, e.g., "trade or business", "actively participates in the management", "losses . . . allocable". Does the latter phrase require that the allocable losses have substantial economic effect? Also, the proposed rule would permit an individual to aggregate non-Section 465(c)(1) activities, and to treat Section 465(c)(1) activities separately; yet would apply the converse rule to limited partnerships, where Section 465(c)(1) activities of the same type may be aggregated under present law but non-Section 465(c)(1) activities would generally be segregated. This inconsistency appears on the face of the statute. Moreover, it appears that the Commissioner by regulation may override the aggregation rules under new Section 465(c)(3)(C), so why have them in the first place? Generally, requiring partnerships to segregate activities, while eliminating the offsetting of non-at-risk losses with income from other partnership activities, raises complex allocation and tax reporting problems.

D. The real property exception of paragraph (D) is poorly drafted. The "holding of real property" language arguably covers lessees, and the words "for sale or rental" would clear up this ambiguity. Also, why permit inclusion only of personal property and services incidental to living accommodations? Are managerial services and personal property incident to the rental of commercial and industrial real estate to be excluded from the exception? This limitation should

be eliminated, perhaps by incorporating the perhaps by incorporating the phrase "activities *that relate to* the holding of real property for sale or rental", as per the 1977 Technical Corrections Act.

E. Recapture regulations and legislative history should make clear that at risk amounts are reduced by, among other things, the repayment of a recourse loan, a shift from recourse to nonrecourse liability, and partnership distributions in excess of at risk amounts. Also, the at risk amount should be restored to zero when negative at risk amounts are included in income. These are technical complexities that can be covered by regulations, but are necessary to a proper working of the statute.

F. The effective date rule for recapture is retroactive, i.e., pre-1979 negative at risk amounts are taxed in 1979. This may be justifiable as clarification of existing law, but perhaps further thought should be given the problem.

G. There is no transition rule for post-1978 at risk activities, as per the 1976 Reform Act, which provided that pre-1976 losses should be treated as first reducing that portion of basis attributable to amounts not at risk. The same rule should apply here.

H. The amendment of Section 465(a) applies "at risk" only at the partner level, rather than at both partnership and partner level as is arguably the case under present law. This is a helpful and fair clarification, but in case of Subchapter S corporations, both corporate and shareholder "at risk" accounts are examined. Is this intended? If so, is it equitable?

I. Is a taxpayer's "at risk" account transferable? Are suspended losses not allowed on disposition of a partner's interest allowed to the transferee partner? The better rule is to extinguish the suspense account, as per previously expensed income under Subchapter S provisions.

J. The Internal Revenue Service should promulgate regulations providing that suspended losses allowed in subsequent years retain their character (as IDC, interest, depletion, accelerated depreciation) in the year of deduction; similarly with respect to the new recapture rule. Deductible and non-deductible portions of particular items should be determined on a pro rata basis, as per the House Committee Report in 1976 Act.

K. There is an inconsistency between permitting at risk to the extent of basis of property contributed to the activity (Section 465(b)(1)(A)) and the fair market value of property pledged as security for borrowings used in the activity (Section 465(b)(2)(B)). The statute should arguably permit the value of contributed property to be counted as at risk. Also, regulations should not permit taxpayers to get a fresh start by substituting higher-valued collateral for property originally pledged.

L. The flat disallowance of borrowings from related and interested parties (Section 465(b)(3)) is too severe, especially if an analogy to Section 265(2) rules is intended. A better rule would be to establish a rebuttable presumption that such borrowings are not at risk, or give the Commissioner broad authority to promulgate regulations determining when the rule is applicable. Proposed Section 465(c)(3)(E) permits such regulations only with respect to post-1978 non-Section 465(c)(1) activities, and hence discriminates against Section 465(c)(1) activities. This is probably an oversight. Flat disallowance has an in terrorem effect even in situations where personal liability is clear.

M. The Section 465(c)(2) flush language should be amended to make clear that in the case of a partnership only activities of the same type may be aggregated, as per the Joint Committee Staff General Explanation, p. 38.

N. This section is amended to reflect the concept of a "federally registered partnership." The result is to extend the statute of limitations to a four year period and to aid in the administrative functioning of extensions of the statutes of limitations with respect to same. Our subcommittee believes that the definition of a federally registered partnership is ambiguous since it is not always clear whether a partnership is required to be registered with the Securities and Exchange Commission due to the uncertainty of the applicable exemptions. It also believes that the benefits of allowing general partners to function with the service far outweigh the burden of a four year statute of limitations and therefore recommended that the statute be extended to all partnerships. If the statute is not extended to all partnerships, there are two alternative recommendations for the definition of a partnership subject to this section:

Recommendation No. 1: Merely require any partnership with more than "n" number of partners (for example, more than 10 partners) to be subject to the provisions of subparagraph q; or

Recommendation No. 2: Replace proposed Section 6501(q)(4)(A) and (B) with:

"(A) Interests which have been offered for sale at any time during such taxable year or a prior taxable year pursuant to any offering registered under the Securities Act of 1933, as amended, or

(B) Which, at any time during such taxable year or a prior taxable year, was reporting pursuant to the requirements of the Securities and Exchange Act of 1934, as amended."

O. There should be a mechanism whereby a partner can notify the Commissioner in his individual capacity that he is a partner in a partnership and thereby start the statute running as to him. As proposed Section 6501(q) is now drafted, if the general partner in a limited partnership fails to file a return, there is nothing the other partners can do to start the statute running. By notifying the Service of the name and address of any partnership (and the general partners thereof) of which he is a partner, an individual should be able to start the statute running. Otherwise he has no protection against either an inadvertent or a willful failure to file by the general partners.

P. I conclude this period of studying the "at risk" provisions of H.R. 13511 with a feeling of some dismay. The Code is being made excessively complicated to take care of the abuse of deductions in excess of the amount invested in property or the amount which the taxpayer is truly "at risk". The suspended deduction (which reduces the adjusted basis of a partnership interest and reduces the adjusted basis of depreciable property) of a loss in excess of the amount "at risk" and the recapture of previously allowed losses when the amount of risk is reduced "below zero" certainly do not make life any easier. Perhaps some brand new thinking needs to be done with a different approach to the problem. One approach would be to deny basis for that portion of the purchase price of property (whether a partnership interest or Section 1245 property) which are represented by nonrecourse debt. This has its own special set of complications but perhaps are not as great as going along the route of suspending the deduction of an amount because in excess of the amount "at risk". It is not an easy problem and the solution of the 1976 Act and of the 1978 Bill are not neat and simple.

IV. Section 314—Investment Tax Credit

A. A "qualified rehabilitated building," with regard to which rehabilitation expenditures are allowable, must be a building "which has been rehabilitated." (Section 48(g)(1)(A)). This definitional provision suggests that the rehabilitation must be completed before the investment credit is allowable for the expenditure. If this were the case, Section 46(d) (permitting investment credit on qualified progress expenditures prior to completion of Section 38 property) will not apply to rehabilitation expenditures. However, if the building "has been rehabilitated" at least once before a second or third rehabilitation with regard to which a credit is to be taken, then literally Section 46(d) would apply to the second or third rehabilitation. Viewed differently, if a building were to be rehabilitated floor by floor (while still occupied) with each floor placed in service as completed, would the costs be eligible for credit as completed, even though the entire building is not rehabilitated in one year? I am not sure what the statutory intent is on either subject, but the section could be easily clarified by an additional provision which clearly permits application of Section 46(d) or a credit each year on a piecemeal renovation of a building as the floors are placed in service.

B. In defining a "qualified rehabilitated building," Section 48 does not make clear the extent to which a building must be rehabilitated in order to qualify for the credit. Would rehabilitation of one floor qualify or must the entire building be rehabilitated? There is some indication that the latter is the case, since Section 48(g)(1)(6)) states that where there is a separate rehabilitation of a major portion of a building, such major portion shall be treated as a "separate building." One reason for the provision would be to make sure that such a "major" rehabilitation qualified, i.e., absent enactment of Section 48(g)(1)(D), there would be an argument that a building is not rehabilitated unless the entire building is rehabilitated (at least if the building has not been completely rehabilitated once before in the past). It seems to me that there should be some clarification as to the intent, such as a provision which defines a "qualified rehabilitated building" as one with regard to which rehabilitation

expenditures are incurred or one which is "completely" rehabilitated in substantial part, depending upon the purpose. As an aside, I see a tax trap (or tax planning device, as the case may be) if only the rehabilitation of a major portion qualifies. Arguably, if the remainder of a building is rehabilitated a few years after the major rehabilitation, that remainder would qualify for the credit because if the major portion is a separate building the remainder of the building is likewise a separate building which will have been renovated in its entirety or, alternatively, the entire building will have been completely renovated and therefore the remainder will qualify. If the reverse were the case (a minor rehabilitation followed by a separate major rehabilitation) there would be no argument that the first rehabilitation qualified.

C. Section 48(g)(1)(B) does not permit rehabilitation expenditures to qualify unless there is a five-year lapse between the present rehabilitation and the date the building was last placed in service in connection with a prior rehabilitation with respect to which a credit was allowed by reason of Section 48(g)(1)(C). I would assume that if qualified progress payments were allowed in one year under Section 46(d), the next year's portion would be disallowed under Section 48(g)(1)(B), since the rehabilitation would be a "present" not a "prior" rehabilitation. Similarly, on a piecemeal but continuous planned rehabilitation of an existing structure, Section 48(g)(1)(B) would not prevent use of the credit in the year succeeding the year a credit might be taken for the first completion (assuming that the building would receive a credit before it is complete). Some clarification would be helpful, for example, by stating that Section 48(g)(1)(B) has no application to a rehabilitation which is "in progress." On a different subject, is this Section 48(g)(1)(B) intended to prevent rehabilitation on the same area space unless a lapse of five years occurs or is it intended to mandate that an entire building must be rehabilitated in one planned development? I might add here that if the latter were the case Section 48(g)(1)(B), that defines a major portion of a building which is rehabilitated as a "separate building," might permit a separate minor portion rehabilitation to qualify even if within five years, provided the rehabilitation succeeds the major portion (but not if it precedes it), since the rehabilitation of the minor portion arguably is the rehabilitation of a separate building with regard to which no prior credit was taken. This whole issue could be resolved by merely providing that the same area space may not be rehabilitated more than once in a five-year span.

I believe the question is whether the legislation is intended to encourage only complete renovation, planned in advance. I see no logical reason as a policy matter that this should be the case. I recognize, of course, that the credit is a compromise over the obvious alternative of permitting an investment credit for new buildings, a politically unsatisfactory solution for the present time. Thus, perhaps, the desire is to limit the credit as much as possible by providing for its application only to complete rehabilitations. If this is the case, the statute should so state.

V. Section 315—Targeted Jobs Credit

A. Subsection (b) of Proposed Code Section 51 presents no difficulties with reference to the language itself. However, it does raise a number of outside questions:

1. What incentive is provided under proposed Code Section 315 after the initial two-year credit period to prevent an employer from discharging a qualified individual after having taken advantage of the Section 315 credit? Is any type of recapture or penalty provision to be provided for such a situation?

2. Suppose an employer hires a qualified individual, takes advantage of the credit, discharges the individual, and then rehires the same individual later. Is the employer once again entitled to make use of the two-year credit for the rehired, qualified individual?

B. The definitions of the "targeted group" members set forth in Subsection (c) do not appear to be ambiguous. I do, however, see possible administrative difficulties inherent in the determination of whether an individual fits within a targeted group. Subsection (c) seems to imply that the burden of determining whether an individual is a "targeted group" member will be placed on the Secretary of Labor or some other designated body. Will the Secretary of Labor be responsible for informing an employer whether or not a particular individual

qualifies as a "targeted group" member? If the Secretary of Labor is responsible for making such a determination, one wonders what procedures he will initiate in order to make certification a simple procedure that will not cause undue delay in the employer's decision to hire a particular individual.

C. In Subsection (g)(1)(A), the language contained in the first four lines is confusing. Perhaps it would be more easily understood and accomplish the same objective by phrasing the provision in an alternative manner: "If more than *one-half the services performed* by any employee for an employer during any day period . . . taken into account with respect to any year constitute agricultural labor . . ." Note, though, under my proposed language, the applicability of Subsection (g)(1)(a) would be based on "one-half the services performed" rather than on "one-half of any pay period."

VI. Sections 331-334—Subchapter S

A. The amendments to the Subchapter "S" provisions on the whole are concise, clear and very beneficial to taxpayers electing Subchapter "S" status.

B. Under Section 333, the time for electing Subchapter "S" status, in my opinion, should be liberalized to call for the filing at any time within the taxable year of the corporation including extensions for filing granted by the Service. Thus, shareholders could elect Subchapter "S" treatment provided they file the election within the time called for the filing of the income tax return and extensions thereof. This rule would be much clearer and easy to administer than the 75-day rule. It would also cut down on the language of the Subsection since the results stemming from a late filing would not be necessary.

VII. Sections 401-407—Capital Gains

A. Section 401.—This section seems well drafted. The repeal of the alternative tax on net long-term capital gains has the desired virtue of reducing in some minor degree the complexity of the Code provisions dealing with capital gains. In addition, this proposal is progressive in that it takes away a benefit currently enjoyed only by those noncorporate taxpayers whose income is subject to marginal tax rates exceeding 50%. Accordingly, I believe Section 401 should be endorsed in its present form.

B. Section 403.—(1) Proposed Section 59 introduces yet another—and perhaps superfluous—definitional concept into the Code—the "regular tax." In the interest of tax simplification, it is recommended that the proposed Section 59(a) be enacted to read as follows:

(a) General rule.—In the case of a taxpayer other than a corporation, if—

(1) 10% of an amount equal to (A) one-half of the net capital gain for the taxable year, reduced by (B) $10,000, exceeds;

(2) The net tax liability of such taxpayer computed without regard to this part, part VI and the taxes imposed by sections 72(m)(5)(B), 402(e), and 408(f) for the taxable year, then there is hereby imposed (in addition to such tax liability) a tax equal to the amount of such excess.

By redrafting proposed Section 59(a) in the foregoing manner, the necessity for proposed Section 59(d) is minimized, and indeed would be obviated were the following language added to proposed Section 59(e):

". . . nor shall credits under sections 31 ,39 and 43 be allowable in computing a taxpayer's net liability for purposes of paragraph (a)(2) hereof."

(2) It is difficult to understand the reasoning behind computing a taxpayer's regular tax liability without regard to the taxes imposed by section 72(m)(5)(B), 402(e) and 408(f). While such taxes are, in effect, taxes on "special events," calculating the Section 59(a)(2) tax without regard to such taxes, has an excessivly punitive effect, which may not have been intended at the time of their enactment.

(3) The title of Part VII should be amended by striking out "separate" and inserting the word "alternative." This conforms with the language of the Committee Report accompanying the Bill and highlights the fact that this tax applies only if it exceeds the taxpayer's regular tax liability.

(4) It is noted that the credit under Section 32 for withholding on nonresident aliens and on tax-free covenant bonds is not removed from the list of credits which reduce "regular tax." It appears the payor of such a withholding tax could have a net capital gain, and ought to get credit for the tax against the separate minimum tax, just as he does against the existing minimum tax on tax preferences (*cf.* Section 56(c)).

C. Section 404.—(1) With regard to the definition of indexed assets under section 1024(b)(1), subparagraph (A), which presently includes as an indexed

asset "stock which is common stock or possesses most of the attributes of common stock," is vague and should be changed to read "stock with respect to which no fixed dividends are required to be paid by the issuer." The definition would then be consistent with that found in the Report of the House Committee on Ways and Means (page 126). This suggested change is based on the strong conviction that practitioners working with statutes should not be forced to rely on legislative history for basic definitional terms and that the statutes and the regulations thereunder should be so clearly drafted as to speak for themselves.

(2) With respect to the exclusion of certain property from the definition of "indexed assets," exclusions which are found in proposed Section 1024(b)(2), it is noted that the explanation contained in the Committee Report for the exclusion of stock of a foreign corporation is based on an attempt to prevent persons from placing non-indexed assets in a foreign corporation and receiving an inflation adjustment for those assets by selling their stock in the foreign corporation at a later date. It is not clear either (i) why use of a domestic corporation could not accomplish the same end or (ii) why the exception is necessary in view of the fact that shareholders of a foreign corporation which itself holds indexed assets can receive the benefit of indexing on the sale of those assets where proceeds are distributed to shareholders. Finally, the relationship between proposed Section 1024 and Section 1023 (relating to carryover basis) appears on its face unclear and will doubtless be confusing to practitioners already grappling with the intricacies of Section 1023. Accordingly, in line with the Committee Report (page 128), it is suggested that proposed Section 1024(e)(1)(A) be amended to add at the end thereof: "including without limitation, the aggregate of any carryover basis adjustments made pursuant to section 1023."

(3) Section 404 is clearly the most controversial of the capital gains provisions. Apart from Section 415(d) (relating to cost-of-living adjustments to contribution limitations in the case of qualified profit-sharing and pension plans), Section 404 would introduce the concept of "indexing" into the Code for the first time. The section would add considerable complexity to the Code so that the determination of taxable gain from the sale or exchange of "indexed assets" would become extremely difficult, a clearly undesirable result.

(4) Indexing could arguably be beneficial to the economy by encouraging taxpayers to liquidate investments which they might otherwise feel locked into by reason of the existence of a large "paper gain" resulting primarily, if not exclusively, from inflation. If Congress wishes to encourage taxpayers to dispose of capital assets more readily so that savings can be invested more productively, it has available a simpler and equally effective mechanism, *i.e.*, reduction of the rate at which capital gains are taxed. Inflation is one reason which justifies capital gains rates which are lower than the tax rates imposed on ordinary income. Hence, the bill's introduction of indexing with respect to capital gains coupled with its concurrently reducing the maximum capital gains tax rate applicable in the case of noncorporate taxpayers from a maximum of 49.12 percent, in general, to a maximum of 35 percent, in general, seems to confer a double benefit on those who have capital gains.

(5) In its present form, Section 404 is unfair in three respects. First, it limits the availability of indexing to those taxpayers who have capital gains, generally the most well-to-do, while it denies the use of indexing to those who have ordinary income but no capital gains. Second, Section 404 also unfairly discriminates between two investors similarly situated where one invests in corporate stock, an indexed capital asset, while the other invests in a debenture. Thus, the Section may have a significant impact on the capital markets by encouraging equity investments while discouraging debt investments. Congress should focus carefully on what the impact of Section 404 may be and whether it is desirable. Third, as drafted, the term "indexed assets" would include corporate common stock but would not include stock in a Subchapter S corporation or a partnership interest. This seems to confer an unfair benefit upon corporations and may result in many entities either incorporating or revoking Subchapters S elections solely for the purpose of benefiting from indexing. There is no readily apparent social benefit to be gained from business entities operating as corporations as opposed to partnerships or Subchapter S corporations, hence it is questionable whether Section 404 should encourage this development.

(6) While Section 404 would add considerable complexity to the computation of capital gains with respect to indexed assets, it would not result in a taxpayer reporting his true economic gain or loss as a result of the sale or exchange of

the indexed assets. This follows from the fact that (i) there is no deflation adjustment if the Consumer Price Index decreases and (ii) there is no consideration given to the fact that an asset may have been purchased on credit and thus paid for with inflated dollars over time.

(7) There seems little justification for adopting Section 404 in its present form. As discussed, the principal objective of Section 404 could be substantially realized by simply lowering the capital gains rates if such objectives are deemed appropriate. Moreover, in view of the fact that Section 407 of the Bill specifically directs the Secretary of the Treasury to submit a report on the effectiveness of the changes in the tax treatment of capital gains, I suggest (i) that this report be expanded to specifically focus on the impact which indexing might have throughout the economy, including the likelihood that it will add further fuel to the inflationary fires and (ii) that any further action on this subject be deferred until Congress has had the opportunity to review this report.

(8) As a cosmetic matter, it would be desirable if the Senate Finance Committee Report commented that a "taxable transaction" includes one where gain or loss would have been recognized if any were realized, but where none is realized because the indexed basis exactly equals the sales proceeds. The same problem arose in the interpretation of Code Section 355(b)(2)(C) and is, so far as is known, unanswered to this day.

(9) While the Committee Report makes it fairly clear that no separate adjustment is necessary for depreciation, the statutory language of proposed Code Section 1024(e)(1)(D) is sufficiently vague that some future Treasury Department may be encouraged to insist that depreciation may be separately treated if it will increase the revenue to even the slightest degree. Either an express negation of any such desire or a tightening up of the statutory "all other cases" language would be desirable.

(10) Proposed Code Section 1024(e)(1)(C) appears to be improperly drafted when, in referring to transactions resulting in partial recognition of gain, it requires that the recognized gain or loss be attributed to some portion of the asset. The intent—to treat separately an amount representing the recognized gain—is clear, but the recognition of gain does not relate to a particular portion of the asset disposed of or acquired in exchange. Thus, in an exchange under present Code Section 1031, the receipt of boot triggers recognition of some or all of this realized gain in the asset being exchanged, but the gain to be recognized cannot be directly related to some specific portion of the asset. Presumably, the gain to be recognized will be reduced by indexing a pro-rata portion of the asset's adjusted basis and recomputing the realized gain now being recognized, but this should be made clear in the statute.

(11) Treatment of transferred or substituted basis for the assets acquired in these types of transactions should also be specifically dealt with in the statute, to clarify, for example what the step-up for recognized gain will be be under Code Section 1031(d) and whether the amount of that step-up will be deemed a substantial increase in investment or substantial improvement for purposes of indexing the adjusted basis of the new asset. Although proposed Code Section 1024(a) provides that the indexed basis is to be used only for determining gain or loss on the transaction and for no other purpose, it is unlikely that it was intended to ignore the impact of the use of that indexed basis on other applicable sections, especially in view of the reference in the House Report (p. 131) to the use of the inflation adjustment in determining the amount of ordinary income under Code Sections 1245 and 1250. Actual intent should be more clearly indicated, and any inconsistencies between that intent and the statute eliminated.

D. Section 405.—(1) The wisdom of Section 405 is certainly subject to question. While existing Section 121 may be too restrictive with respect to those for whom it affords relief, in its present form Section 405 would apply to all taxpayers regardless of need. Indeed, while the underlying assumption of existing Section 121 appears to be that those taxpayers age 65 and over require some relief, Section 405 appears to benefit most those who have profited the greatest from wise investments in their homes and who presumably have the least need.

(2) The Bill would also offer yet another incentive for investment in housing and thereby stimulate demand for such housing. While there would presumably be a short-term increase in the number of the homes offered for sale in order to take advantage of this provision, in the long run Section 405 would have the

affect of encouraging investment in housing and diverting it from other possibly more productive investments.

(3) Section 121(b)(1) should be amended by striking out "($50,000 in the case of a separate return by a married individual)." It seems illogical to limit the amount of the gain excluded from gross income in the case of a married individual filing a separate return since had such person been single he could have elected to exclude up to $100,000. Note that Section 121(c) requires a married taxpayer to obtain the consent of his spouse in order to file an election under Section 121(a). Hence, the Bill's present limitation on the case of the separate return by a married individual appears to lack any justification.

(4) Section 121(b)(3) should be clarified by inserting after "any election made" the phrase "under this section."

(5) Subsection (b) of Section 121 should be amended by adding a new paragraph (4) thereto to read as follows:

"(4) In determining the amount of the taxpayer's gain excluded from gross income under subsection (a) there shall be taken into account the effect which any election previously made under sections 1033 (relating to involuntary conversion) and 1034 (relating to roll over of gain on sale of principal residence) may have had on the taxpayer's basis in such principal residence."

This would clarify the fact that relief under Section 121 would be available to those who had previously made elections under Sections 1033 or 1934.

E. Section 406.—If the problem is that a taxpayer's employer finds it necessary to move him around frequently, without enough advance notice to warn him not to bother purchasing a residence at each new job location (or alternatively, if the taxpayer's self-employment is such as to remove any such advance warning), it does not seem logical to limit the relief of the amendment to cases where the taxpayer puts in 39 weeks of work at the particular job location to which he moves, rather than at that location, plus the next, and the next. It is suggested that the restriction on relief be limited to a move of at least 35 miles (Code Section 217(C)(1)).

F. Section 407.—I would amend Section 407 by adding thereto the following sentence:

"In addition, the report shall also include a study of alternative ways in which 'indexing' might be used in the Internal Revenue Code of 1954, and the economic and fiscal impact which the various types of indexing would be likely to have."

Statement of the Shell Oil Co.

Summary

This statement represents the views of Shell Oil Company with respect to H.R. 13511 (the Bill) and related tax proposals. The following is a summary of the items discussed.

I. The corporate and personal income tax rate reductions contained in the Bill are a positive step toward stimulating the economy and reducing the adverse effects of inflation and the scheduled social security tax increases. However, a greater reduction in the top corporate tax rates may be necessary to meet national economic and employment goals. A substantial permanent corporate rate reduction would represent significant progress in overcoming problems of capital formation and duplicate taxation of corporate dividends.

II. Permanent extension of the 10 percent rate of investment tax credit will provide a stable and more favorable investment climate. In addition to this and the other constructive changes, considerations should be given to further improvements in the investment tax credit.

III. A proposal to eliminate tax-emempt industrial bond financing for pollution control facilities was rejected by the House but is being urged again by the Administration. Such a change would aggravate the difficulty of assembling capital for these largely non-productive projects.

IV. The net effect of the Bill would be to improve the taxation of capital gains; however, repeal of the 25 percent alternative tax on capital gains up to $50,000 would increase tax rates on capital gains for some people. The provisions relating to capital gains from the sale of a principal residence are favorable, but a revision concerning effective dates should be made. The treatment of capital gains

would be further improved by adopting a proposal to make 30 percent of long-term capital gains subject to tax.

V. The new "alternative minimum tax" on capital gains is less onerous than the current minimum tax. However, the application of any type of alternative or penalty tax on any of the so-called tax preferences will tend to undermine the purposes of the tax incentives legislated by Congress. Further, the Administration's proposal for a complex progressive minimum tax should be rejected; and, a provision should be included in the bill to eliminate intangible drilling and development cost deductions from classification as a preference item.

VI. The Bill would impose an addition of one year to the statute of limitations as applied to some partnership items. The provision, aside from being unnecessary, contains confusing and unduly broad language which could be interpreted as conferring unwarranted and potentially abusive power. In view of the fact that the Bill imposes a new civil penalty on the failure to file partnership returns, it would appear to be more logical to wait until the effect of the new penalty becomes known before embarking on this additional avenue.

STATEMENT

General comment

We fully concur with those parts of the Administration's proposals and of the House-passed H.R. 13511 (the Bill) which would provide economic stimulus to offset partially the adverse effects of inflation and the scheduled social security tax increases. Substantial income tax rate reductions and favorable investment credit modifications, if not encumbered by controversial so-called tax "reform" measures, would be a simple and efficient mechanism for accomplishing this objective.

A number of the tax revision proposals contained in the Administration's original program once again are being proposed before this Committee. Some of these proposals may be politically appealing; however, to the extent that they affect adversely some segment of the business sector, they are apt to undermine the general level of business confidence and reduce substantially the potential effectiveness of the tax rate reductions. The "value" in terms of Treasury revenues of such proposals may be more than offset by the uncertainties and economic hardships which are sure to result from the enactment of the so-called reform proposals.

The House has rejected most of the so-called reform measures in favor of a relatively clean tax reduction package. It is our hope that this Committee will narrow even further the so-called reform provisions of the Bill and will concentrate on providing more relief from increasing tax rates and more incentives for investment.

I. CORPORATE AND INDIVIDUAL INCOME TAX RATE REDUCTIONS

The Bill provides that beginning in 1979, the corporate tax rate on taxable income in excess of $100,000 would be reduced by two percentage points (from 48 percent to 46 percent). Also, the Bill eliminates the surtax exemption and substitutes a five-step graduated corporate rate schedule of: 17 percent on the first $25,000; 20 percent on the second $25,000; 30 percent on the third $25,000; 40 percent on the fourth $25,000; and $46 percent on corporate taxable income in excess of $100,000.

The two percent reduction in the top corporate tax rate is a step in the right direction. However, a further two percentage point reduction, as proposed in the Administration's bill may be required to achieve vital national goals including higher employment levels and increased production of domestic energy resources, as well as to offset partially the adverse effects of inflation on effective tax rates and the scheduled social security tax increases. Each percentage point of reduction in the corporate tax rate provides about $2 billion of additional cash flow as a source of investment funds for industry—not including the ripple effects on economic growth and employment which would result from new investment. A substantial tax reduction would facilitate long-range investment planning and would help overcome the problems of caiptal formation and duplicate taxation of corporate dividends. If the additional two percentage point reduction is not enacted, an additional two percent should be added to the 10 percent investment tax credit.

In an attempt to provide relief from the effects of inflation, the House adopted a significant change in the structure of the corporate income tax which is designed

primarily to help small business—a five-step graduated corporate rate schedule. While this new graduated rate schedule does afford some measure of relief, a better and more rational approach would be to increase the existing exemption from $50,000 to $100,000. This would maintain the current exemption without imposing the concept of graduated progressivity on the corporate tax system.

This concept of graduated progressivity has meaning only as it applies to individuals, the ultimate taxpayers. It is based on an "ability-to-pay" concept which clearly is inappropriate to the corporate tax system. For example, a corporation with $100,000 total income may earn a much lower rate of return on investment than a corporation with $25,000. Thus, the corporation with income of $100,000, after paying their shareholders a reasonable rate of return on investment, may actually has less ability to pay taxes than the corporation with income of $25,000; therefore, a graduated progressive corporate tax rate actually may be regressive with respect to the individual shareholders who are in fact the ultimate taxpayers. Moreover, the shareholders of a corporation with income of $100,000 do not necessarily have higher personal income than do shareholders of a corporation with income of $25,000.

The bill also provides a reduction in individual tax rates which is helpful to the individual taxpayer. The widening of individual income tax brackets by approximately six percent and the increase in the personal exemption recognize the impact of inflation on individual taxpayers in a manner that does not increase the present bias in the tax system against savings and investment.

II. INVESTMENT TAX CREDIT

The bill provides improvements in the investment tax credit. These include making the 10 percent rate permanent, permitting investment credits to offset up to 90 percent of tax liability, extending the credit to rehabilitation of existing non-residential business structures, and under some circumstances granting the maximum credit for certified pollution control equipment even though the special five-year amortization is elected.

These provisions are a step in the right direction and should make the investment tax credit an even more effective incentive for capital investment and result in increased productivity. Consideration should be given to further improvements in the investment tax credit. These would include the following items:

(1) Extension of the credit to include new industrial buildings. Investment in this type of structure serves the same social and economic objectives as investment in machinery and equipment; namely, increased productivity and increased employment. The business purpose of industrial buildings are frequently so closely related to the business purpose of qualifying machinery and equipment that there is no rational basis for distinction. This fact is reflected in the tremendous number of audit issues and the court cases which have evolved from attempts by the IRS to make this a dichotomy.

(2) The Bill makes available the full 10% investment tax credit even if the five-year amortization provision is utilized unless the facilities are financed through tax-exempt bonds. Unfortunately, however, this action by the House to encourage broader utilization of the five-year amortization provision was significantly diluted by providing that the investment tax credit will continue to be halved where the facilities are financed by the sale of tax-exempt bonds. With respect to most facilities, the present value benefits of tax-exempt financing will exceed those available through the amortization provision. Thus, in most instances this aspect of the House's action will thwart the objective of promoting capital formation through increased reliance on the amortization provision. Moreover, in those remaining cases where election under the amortization provision is more beneficial, the result will be the back-door elimination of the tax-exempt bond provision as a capital formation tool. The limitation in the Bill on investment tax credit when amortization is elected and tax-exempt bonds are utilized should be removed.

We believe that two additional legislative steps are required to render these two provisions to be meaningful aids to capital formation. The amortization provision suffers from the requirement that to be eligible for the election, the facility must be certified by the State authority having jurisdiction, and this is sometimes impossible for reasons totally irrelevant to the purpose of the tax incentive. A definition of pollution control facilities should be substituted for the certification requirement. The other needed improvement is closely related:

the definition of eligible facilities under the tax-exempt bond provision should be broadened to coincide with those under the amortization provision. This would represent a tremendous step in reducing the complexity of the tax laws.

(3) The ESOP provisions relating to the investment tax credit should be extended permanently and increased from 1 percent to 2 percent as proposed in S. 3241. This provision would encourage broad-based equity ownership by employees and would be an aid to capital formation. S. 3241 also provides that dividends paid by the corporation with respect to employee stock would be deductible to the extent such dividends are distributed to the employees of the stock plan. This will provide the employees immediate benefit from their ownership in the company and will eliminate double taxation on the earnings from which those dividends are paid.

III. TAX-EXEMPT BOND FINANCING FOR POLLUTION CONTROL FACILITIES

The Administration's 1978 Tax Program contained a proposal to repeal the provisions permitting tax-exempt industrial bond financing for pollution control facilities. This proposal was rejected by the House in its passage of the Bill. Despite this action, Secretary of the Treasury Blumenthal, in his testimony before your committee, has continued to urge repeal of these provisions. This proposal once again should be rejected.

The elimination of tax-exempt industrial bond financing for pollution control facilities would further aggravate the capital formation problem facing the United States economy. Compliance with requirements of Federal law and EPA regulations involves heavy capital investment in non-productive assets. This additional demand for capital resources would fake it even more difficult for the industrial sector to generate and attract sufficient investment capital to ensure continued economic growth and employment opportunities for the increasing work force.

As justification for this change, the Administration concludes that since the pollution control facilities are mandated by Federal law, no tax relief need be given. It is conceded that industry will make the necessary expenditures to comply with the law, whether or not tax-exempt bond financing is available; however, such expenditures will reduce the level of business spending which otherwise would have resulted. Thus, the amount of investment in productive assets is certain to be reduced if the cost of financing pollution control facilities is increased through the elimination of tax-exempt bond financing.

It is only fair that assistance in some form be given to the taxpayer who is required to make substantial outlays for facilities which typically produce no revenue. The Administration has recognized this as reflected in the fact that it agrees with the Bill's proposal to extend in some cases the full 10% investment tax credit to certified pollution control facilities amortized under the special provision. However, the benefits of this provision would have been more than offset by the loss of tax-exempt bond financing.

In conclusion, it is highly desirable to retain tax-exempt bond financing as one optional means of partially offsetting the heavy capital requirements for pollution control facilities.

IV. CAPITAL GAINS

The net effect of the provisions of the Bill would be to reduce the tax burden on capital gains. The recognition of the effects of inflation, the liberalization of provisions for the sales of residences, and the revision of the minimum and the maximum taxes are positive steps in stimulating capital investment. However, repeal of the 25 percent alternative tax on the first $50,000 of capital gains is not a desirable change because it would increase the capital gains tax rate for some people.

Inflation discourages saving and investment and thus constitutes an obstacle to capital formation. The provision in the Bill for indexing capital gains will not only ease the problem, even in the face of continued inflation, but also will prompt the evil of inflation to be brought to the fore. However, whether the forces needed to come to grips with inflation will be aided or hindered by any further indexing in the tax system is a matter which must be weighed very carefully. Any move which would attempt to provide relief at the price of producing complacency about inflation would have unfortunate results in the long run.

This Committee has before it a proposal to limit capital gains taxation to 30 percent of long-term capital gains. This recommendation has been given serious

consideration in prior years and seems particularly appropriate at this time.

The Bill authorizes a taxpayer to make a once-in-a-lifetime election to exclude from income up to $100,000 of any gain from the sale or exchange of a principal residence. It also provides that a taxpayer who relocates for employment purposes will not be subject to the limitation of current law under which the tax-free rollover of gain from the sale of a principal residence may be elected only once every 18 months. These favorable tax provisions should be retained.

Unfortunately the rollover provision carries an effective date of July 27, 1978, rather than the logical and practical date of January 1, 1978. It is obvious that the assigning of arbitrary mid-year and mid-month dates complicates the administration of the tax law and can be justified only if needed to prevent manipulation or advantage-taking by taxpayers in some form or another. No such justification applies in this situation. Moreover, this change is a remedial one, aimed at rectifying the unintentional imposition of a penalty. It should therefore have the earliest effective date consistent with simplicity of Administration. The earliest effective date which would avoid amended returns and claims for refunds would be January 1, 1978.

The Administration has proposed that corporations should continue to be subject to minimum tax on capital gains and that a new type of minimum tax be imposed on individuals. The latter proposal is apparently aimed at producing progressivity in the taxation of capital gains. The result is a provision so complex that it is impossible to fathom its full implications. The one thing about it that is certain is that it will discourage investment—a result diametrically opposed to one of the Administration-stated objectives.

The Bill would eliminate capital gains as an item of so-called tax preference for purposes of determining minimum and maximum taxes. For individuals, a new "alternative minimum tax" on capital gains would be assessed. It would apply to the extent that 10 percent of the untaxed portion of capital gains in excess of $10,000 exceeds normal taxes payable. This new alternative minimum tax is less onerous than the current minimum tax. However, it must be recognized that the application of any type of alternative tax or penalty tax on any of the incentive provisions which have been labeled as preferences automatically produces a tendency in exact opposition to the objective which prompted the incentive provision in the first place.

V. MINIMUM TAX

The reference above to the fact that the minimum tax has perverted the capital gains tax provisions is paralleled in other incentive-type provisions as well. An important example of this is the application of the minimum tax to intangible drilling and development cost (IDC) deductions. Incidentally, these deductions, unlike permanent reductions in tax, are merely deferrals of tax; that is, IDC expenditures may be deducted currently instead of over the life of a well. Thus, the only preference involved is the interest value of the deferral of tax until some later period.

When Congress as a part of the Tax Reform Act of 1976 added IDC as a "preference" item, the full impact of that move was not recognized. When investors became aware of the full implications of that change (including even in some cases the disinclination to produce a well rather than abandon it) the effect was to discourage investment in energy resources at a time when encouragement for such investment should have the highest priority.

Congress reacted to this problem by enacting a temporary relief provision which subjected IDC to a minimum tax only to the extent that it exceeded a taxpayer's net income from oil and gas properties for the same tax year. This provision expired on December 31, 1977. In recognition of the urgent need to protect the IDC deduction, Congress has included provisions in both the House and Senate versions of the National Energy Act (H.R. 8444 and H.R. 5263) which would make permanent the temporary provisions referred to above. Although the permanent extension of these provisions as a minimum step is critical, a better approach would be to eliminate IDC from classification as a preference item. It is most important that the Bill be amended to reinforce this essential tax incentive.

VI. PARTNERSHIP PROVISIONS OF H.R. 13511

The Bill provides for the extension of the period of limitation for the assessment of deficiencies or the claiming of credits or refunds relating to "partnership

items" of "federally registered partnerships." The Bill also would establish a civil penalty for the failure to file partnership returns. A penalty of $50 per partner per month would be assessed against the partnership, not to exceed a maximum of five months. Both of these changes are ostensibly designed to encourage compliance and to minimize audit problems of the Internal Revenue Service. However, the penalty alone should be a sufficient incentive to attain that goal. Thus, any consideration of a change in the period of limitation should be deferred until a conclusion can be made as to the effect of the new penalty provisions in enforcing partnership filing requirements. This is especially true when one considers that the proposed change in the period of limitation will affect not only those who may have abused current filing requirements, but also the vast majority of taxpayers who have fully complied with the law.

Besides being unnecessary and unfairly burdensome to those who comply, the provisions extending the period of limitation applicable to partnership items of "federally registered partnerships" are deficient in other respects. The period of limitation, in no event would expire before four years after the date of filing a partnership return. (If the name or address of a taxpayer/partner is not on the partnership return as filed, the period of limitation applicable to that partner would be additionally extended until one year after such information is provided to the Secretary.) This new special period of limitation may be extended by the consent of any general partner, unless the Secretary is notified otherwise by the partnership. Any person authorized to do so by the partnership in writing may also provide such consent. Thus, a majority vote of the partners (or whatever voting margin is required under the agreement to constitute partnership action) can operate to consent to an extension of the period of limitation applicable to all individual partners, even though some partners may oppose such consent. The audit problems given as reason for such provisions do not justify such a serious impairment of the rights of individual taxpayers to determine their own tax liability. No one partner of any substantive or procedural rights, whether the forum be administrative or judicial.

In addition, certain provisions of the Bill as drafted may not correctly reflect the legislative intent of the House as expressed in the Report of the Committee on Ways and Means. Section 212 of the Bill establishes the new special period of limitation applicable to partnership items of a federally registered partnership "with respect to any *person*," and allows for extension of this new period "with respect to any *person*" by consent. (Emphasis supplied) The Committee Report states such provision is to apply with respect to "any *partner*." The language of the Bill should be changed to avoid any ambiguity in this respect. Attempts to improve partnership audit procedures should not involve third parties.

The section of the Bill which provides for extensions of the period of limitation "insofar as they relate to partnership items" should read "insofar as they relate to partnership items of federally registered partnerships." This change would make clear that the new extension provisions do not apply generally to all partnership items but only to those of a federally registered partnership.

The Bill also defines "partnership item" as: (A) any item required to be taken into account for the partnership taxable year under any provision of Subchapter K of Chapter 1 *to the extent that regulations prescribed by the Secretary provide that for purposes of this subtitle such item is more appropriately determined at the partnership level, than at the partner level*, and (B) any other item to the extent affected by an item described in Subparagraph (A). (Emphasis supplied.)

This language goes far beyond what is necessary to accomplish the purposes of the Bill.

The definition of the term, "partnership item," is not only unnecessary but ambiguous and misleading. There is no question under current law as to what "partnership items" must be reported on the annual returns. Subchapter K and regulations promulgated by the Secretary cover extensively the reporting requirements of all partnership items. Furthermore, partnerships are not taxable entities under current law, and all items of income and expense of the partnership flow through to the partners. As a result, current law requires that any audit of these items be made at the individual partner level with a separate assessment of any deficiency. However, the underlined language of section 212 of the Bill appears to grant the Secretary the power to require by regulation the determination of items of income and expense at the partnership level. This power implies that each partner may also be bound by this determination. Such a radical and fundamental

change in the determination of partnship items is clearly unwarranted and was, in fact, rejected by the House Committee on Ways and Means. Comprehensive legislative language in the Administration's original proposals to Congress spelled out provisions which would have accomplished this result; but the Committee on Ways and Means chose to exclude these provisions from the bill as passed.

Even though the Administration's original proposals were rejected by the House, Secretary of the Treasury Blumenthal urged this Committee to adopt the Administration's proposals for sweeping and fundamental change in the treatment of partnerships for tax purposes. Excerpts from our testimony before the Committee on Ways and Means commenting on those proposals are set out in the Appendix.

APPENDIX

PARTNERSHIP PROVISIONS PROPOSED BY THE ADMINISTRATION

Under the Administration's proposal, the partnership would be treated as an entity for audit, administrative settlement, and judicial review purposes, even though the tax on partnership income is paid at the partner level. Such a separation of these functions from the imposition of the tax would be impractical and violative of the fundamental concept of the taxation of partnerships.

Moreover, under the proposal, each general partner would be "presumed authorized to act for the partnership" at the audit level and have the power to consent to a waiver of the statute of limitations for the partnership, thereby keeping each partner's return open for changes attributable to the partnership. The proposal would require the Internal Revenue Service to notify all partners at the beginning of an audit and at the conclusion of the administrative proceeding in order that they be given an opportunity to participate in the determination. This opportunity to participate may be illusory, however, because any general partner would be "presumed authorized" to bind the partnership, despite any objective of the remaining partners.

The oil and gas industry utilizes several types of arrangements which fall within the partnership definition of section 7701 of the Internal Revenue Code. These arrangements include: (1) co-owners operating through joint operating agreements who have elected out of the partnership provisions of Subchapter K pursuant to section 761(a); (2) co-owners operating through joint operating agreements who have not elected out of Subchapter K; and (3) formal limited partnership formed under state statutes comparable to the Uniform Limited Partnership Act. It appears that this audit proposal would apply to all of these arrangements.

(1) *Co-owners electing out.*—In the first of these arrangements, co-owners of oil and gas properties can elect to be excluded from these partnership provisions of the Code if the operation is for the joint production, extraction, or use of property but not for the purpose of selling services or property produced or extracted, provided that the income of the members of the organization may be adequately determined without the computation of partnership taxable income. Once co-owners have elected out of the partnership provisions, no annual partnership return is required. Each participant determines its own income and expenses relating to co-owned property and reports it directly on its own tax return. Since one of the prerequisites of electing out is that there is no joint marketing of the production, there is no income at the partnership level and each co-owner may realize a different amount of income from its sale of its share of production. Under present law, each co-owner is responsible for reporting its own income and expenses from such co-owned property, and no partnership records exist which summarize total income and expenses of all co-owners of the property from which a partnership return could be prepared. For these reasons, the proposal regarding the audit of partnerships would be unworkable for co-owners electing out of the provisions of Subchapter K.

(2) *Co-owners not electing out.*—Some co-owners of oil and gas property may either choose not to elect out from the provisions of Subchapter K or may be ineligible to do so. Partnership tax returns are filed for these ventures, but the co-owners generally each take in kind and separately sell their share of the production from the joint operation so that the basic underlying records to support the income of the joint operation are in the books of the individual co-owners and not in the partnership books. Consequently, as in the case of co-owners

electing out of Subchapter K, the audit function can be performed most efficiently at the individual co-owner level.

(3) *Formal limited partnerships.*—Oil and gas properties are sometimes developed by limited partnerships established under statutes comparable to the Uniform Limited Partnership Act. These limited partnerships have been able to attract needed equity capital for high risk activities because they offer investors limited liability for partnership debts and because deductions can be allocated to the limited partners who put up the necessary funds. However, even these formal limited partnerships are not taxable entities; accordingly, a partnership level audit is not appropriate.

The fact that the Internal Revenue Service finds it difficult to audit taxpayers operating through partnerships does not provide sufficient basis for such a radical and fundamental change in the tax laws of the United States. Indeed their difficulties would be worsened rather than improved under the proposal. An examination of the facts demonstrates that joint audits would be unworkable and would severely impair the rights of individual taxpayers to determine their own tax liability. This is true whether or not the joint operations have elected to be excluded from the provisions of Subchapter K. In no event should any one partner be able to bind all partners and thereby deprive any individual partner of any procedural or substantive rights whether the forum be administrative or judicial.

The Administration's proposal would treat a partnership or any other unincorporated organization (except low-income housing partnerships) formed or expanded after the effective date as a corporation for tax purposes if the partnership or organization has more than fifteen limited partners. The use of certain syndicated partnerships as tax shelters is cited as the reason for the proposal. The conclusion is reached that, because substantive differences between syndicated partnerships and corporations are minimal, the same tax rules should apply in both instances. However, the proposal could result in many joint operations in the petroleum industry being taxed as corporations even though these organizations are not formed for tax shelter purposes.

The arbitrary classification of these joint operations as corporations would partially eliminate or defer deductions or credits incident to exploration and development, and would impose an additional tax at corporate rates on the total earnings from the operation. In the case of unsuccessful drilling operations, ordinary deductions might be converted into capital losses with the strong likelihood that these losses would be unavailable for use by corporate participants and only partially usable, if at all, by individual participants. Most importantly, if these are capital losses, they would not be usable against income from other oil and gas operations. On successful ventures, under the present tax rate structure corporate participants would be subjected to an effective tax rate increase to almost 52%, and non-corporate participants would be subjected to effective rates as high as 84%. Such added tax burdens would completely disrupt convention operating relationships and would frustrate efforts to increase domestic energy production.

The need for joint operations in the petroleum industry arises in a variety of ways. For example, the co-owners of undivided operating mineral or working interests in a single oil and gas property must join together, either voluntarily or by operation of law, to develop the property and produce the minerals. Such action has nothing to do with "tax shelters" and it no way resembles formation of a "syndicated partnership" as that term is generally understood.

Similarly, the owners of adjacent properties may need to join together to develop and produce an oil and gas reservoir underlying their properties. Each working interest owner in a particular deposit or reservoir theoretically possesses the right to drill a well. However, due to state regulations to promote conservation, only one well may be drilled to drain a particular portion of the reservoir. These spacing rules quite often result in several working interest owners being compelled to enter into a drilling unit under a joint or unit operating agreement. A common desire for efficient development and operation of a reservoir and for maximizing oil and gas recovery may also result in the several interest owners entering into a joint or unit operating agreement. For example, most secondary and tertiary recovery methods must be implemented on a reservoir-wide basis. Thus, each owner of an interest in the reservoir must agree to the implementation of the recovery program and the manner of operation and sharing of costs and production attributable to the program. All of these arrangements have objective consistent with the national interest.

What threatens to bring such arrangements within the category of limited partnerships under the proposal is the fact that the liability of some co-owners is in some situations indeed limited. Under the typical joint or unit operating agreement, one of the interest owners is designated as operator. The operator agrees to conduct the operations and may look to each of the other working interest owners for his share of the drilling, development and operating costs. The operator, of course, has full liability to suppliers for all expenses arising out of his actions. However, the liability of non-operators to suppliers under these circumstances may be limited by local law. Several court decisions in cases brought by suppliers of a defaulting operator against the non-operators have established the limited liability of the non-operator. However, in other jurisdictions, the courts have either reached an opposite result or not faced the issue.

The difficulty of determining the extent of a non-operator's liability in all states should not be underestimated. Unless the limitation of liability has been clearly established by case law or by statute, considerable uncertainty may result from the potential classification of joint operations as limited partnerships taxable as corporations. Even if limited liability has been established, a slight change in the fact may result in a different classification. In view of existing differences in the law of various states, the proposal would result in comparable oil and gas operations in various states being treated differently for Federal income tax purposes.

The added tax burden on oil and gas joint and unit operations in states in which the non-operators have limited liability would make it much more difficult to obtain agreement to unitize all of the properties in a reservoir. As a result, many such projects would not go forward and the nation would lose potential domestic petroleum production. Moreover, the uncertainty caused by the proposal would add enormous complexity to the planning and operation of jointly-owned mineral properties.

Given these uncertainties, the proposal to treat limited partnerships with more than fifteen members as corporation should be rejected.

Statement of the Spokane Area Chamber of Commerce

Summary

The purpose of this report is to present a broad program of real tax reform which will represent the interests and opinions of the membership of the Spokane Area Chamber of Commerce, keeping in mind that business in the Spokane area is mostly small business, owned and operated by middle-income people. The proposals in this memorandum represent the collective experience of individual members of the Chamber, although the views of key congressmen, administration officials, and academic economists have, of course, been considered.

Nine primary problem areas were considered. The problem areas and proposed solutions are as follows:

1. Individuals rates, deductions and credits. Proposed solutions:
   (a) Reduce the current 14–70 percent tax brackets to 12–50 percent;
   (b) Index tax rate brackets, the personal exemption and the standard deduction annually for inflation;
   (c) The personal exemption deduction should remain a deduction rather than being converted to a credit; and
   (d) The current deductions for state and local sales taxes and state and local gasoline taxes should remain in the Internal Revenue Code.
2. Double taxation of corporate dividends. Proposed solution: Corporations should be allowed to deduct dividends paid as a cost of capital in the same way that interest on corporate debt is currently deducted.
3. Relationship of shareholder to closely-held corporation. Proposed solutions:
   (a) All corporate income should be taxed at a uniform rate equal to the maximum individual income tax rate, which we proposed at 50 percent;
   (b) Repeal the accumulated earnings tax and the personal holding company tax;
   (c) Modify Subchapter S:
      (i) To apply to all corporations with one hundred or fewer shareholders;
      (ii) To allow any type of entity to be a shareholder;

(iii) To allow the corporation to have passive investment income in any amount;

(iv) To allow small business corporations to issue more than one class of stock; and

(v) To allow an election to be made on a annual basis to treat all undistributed income for that year as having been distributed to the shareholders in any lawful manner and recontributed to the capital of the corporation in the same amounts.

4. Treatment of capital gains and losses. Proposed solutions:

(a) Repeal the current 50 percent long-term capital gain deduction and the alternative tax:

(b) Index basis for computation of capital gains for inflation;

(c) To compensate for the bunching problem, liberalize and simplify the present income-averaging rules;

(d) Defer taxing gain on sale or exchange of business or investment properties where the proceeds are reinvested with a prescribed time period;

(e) Allow immediate and unlimited capital loss deductions with unlimited carryover, including one to the taxpayer's estate and heirs.

5. Capital cost recovery. Proposed solutions:

(a) Remaining undepreciated capital cost of assets should be indexed for inflation annually;

(b) Adopt a depreciation system similar to that used in Canada, classifying all capital assets in fifteen classes with short lives ranging from one to fifteen years;

(c) Allow taxpayers to carry over unused capital cost recovery allowances to later years if not needed in the current year;

(d) Repeal accelerated depreciation, ADR (asset depreciation range) and first-year bonus depreciation for small purchases;

(e) Repeal the investment tax credit.

6. Carryover basis at death. Proposed solution: Repeal section 1023.

7. Municipal bond interest. Proposed solution: The administration's proposal for a taxable bond option with 25 to 40 percent subsidy from the federal government should be rejected.

8. Tuition tax credit. Proposed solution: We take no position on this issue at this time.

9. Business travel and entertainment expenses. Proposed solutions:

(a) Business and entertainment expenses should remain fully deductible as at present;

(b) First-class air travel should remain deductible;

(c) Foreign conventions (except in Canada and Mexico) should be deductible only if the sponsoring organization has a compelling reason for holding the convention outside the United States.

The arguments supporting these proposals appear on the following pages. The proposals presented have been developed as an integrated package. If one part were removed, others would have to be removed or modified. For example, taxing capital gains as ordinary income is unacceptable unless basis is indexed for inflation, tax on reinvested proceeds is deferred and corporations are allowed to deduct dividends paid. On the other hand, the dividend deduction is essential to the repeal of the corporate surtax exemption and also is probably not politically feasible unless some concession is made on capital gain.

DETAILED DISCUSSION

A. *Individual rates, deductions and credits*

In our opinion, individual rates should be reduced. Inflation is steadily pushing taxpayers into higher tax brackets, resulting in unlegislated tax increases. We also believe that the top individual tax rate should not exceed the top corporate tax rate (see part C of this report). For these reasons, we would reduce the current 14–70 percent tax brackets to 12–50 percent. We strongly believe that no more than half of any income should be taken in taxes. Beyond that, it is no longer taxation but confiscation.

However, we believe that mere reduction does not go far enough, because it gives only temporary relief from increasing real tax burdens. If one projects a 6 percent inflation rate beyond 1978, there will be annual tax increases for families at all levels, assuming that their real income before taxes keeps pace with

the inflation rate. The increase in nominal dollar earnings will automatically push all taxpayers into higher tax brackets because of the progressive nature of the income tax.

For those families on fixed incomes, the effect is even worse. They will continue to pay taxes at the same rate, but their real income will decrease. For example, if a widow has a taxable income of $10,000, her marginal tax rate is 27 percent. If in ten years her nominal income remains the same but there is 75 percent inflation (as we have had in the last ten years), her real income is decreased to $5,700. The marginal tax rate on $5,700 should be only 21 percent, but she is still paying taxes at the 27 percent rate designed for a $10,000 income. The result is a real tax increase on a declining real income. A very large proportion of the elderly fall into this category. Since real incomes for retired people will be declining, there will be greater pressure for increased social security benefits. The larger benefits will result in increased government spending, creating greater deficits, which will lead to further inflation. This is a particularly vicious circle.

The Chamber strongly believes that Congress should not allow effective tax rates to increase without voting on the matter. The most effective way to solve the problem of the hidden tax increases would be to adopt an effective anti-inflation policy based on sound management of the federal budget and the money supply. If this is not done, however, we believe that the most realistic alternative is to index tax rate schedules (tax brackets), the standard deduction, and the personal exemption deduction in much the same manner that many labor contracts are currently linked to increases in the consumer price index. The index figure could be either the implicit deflator for the gross national product or the consumer price index. If the tax system were so indexed, the increase in tax rates could not exceed the increase in real income.

The Carter administration has proposed a tax bill which purportedly would reduce taxes for lower- and middle-income families. Table 1 shows the effect of the administration tax bill, plus the social security tax increases that were passed in late 1977, on a typical family of four:

Table 1.—One Earner Family of Four

[Net Tax Change from 1977 to 1979]

Adjusted Gross Income:	
$10,000	$−284
15,000	−216
20,000	−9
25,000	−59
30,000	117
40,000	221
50,000	359
100,000	1,049

These figures which were furnished by the Joint Committee on Taxation of the United States Congress, support to demonstrate that for such a family the break-even point—the point at which there would be no change in tax burden—is on income somewhere between $25,000 and $30,000. Below this break-even point, the family would have a net tax reduction, and above the break-even point the family would have a net tax increase.

This analysis, however, is based on the assumption that the dollar has a constant value. This assumption is totally unrealistic. The Tax Foundation estimates that if one assumes a continuation of the present inflation rate of 6% per year, and also assumes that the family's income will rise at the same rate, the break-even point drops to somewhere around $17,000 per year. In other words, those families with an income above $17,000 per year in 1977 would have a net tax increase if their real income remained constant. Also, those families with income less than $17,000 would receive less of a tax reduction than the figures furnished by the Joint Committee on Taxation would indicate.

Table 1 also reveals that the administration tax bill would substantially increase the progressive nature of the income tax. This cannot help but have an adverse impact on capital formation. This will come about because the tax reduction going to lower income families will necessarily be consumed, while the tax increase on middle- and upper-income families will probably be divided between consumption and savings. Since capital formation can only come from savings, capital formation must be adversely affected by the bill. Capital forma-

tion is probably the weakest area of our economy at the present time, and further adverse impact on it would clearly be unwise at this time.

The primary cause of the increased progression is the conversion of the $750 personal exemption to a $240 credit. The deduction is subtracted from income in arriving at the tax; the credit would be subtracted from the tax itself. The administration's reason for proposing the change is that the deduction is worth more to high-income taxpayers than it is to low-income taxpayers, while the credit would be of equal value to all taxpayers. This argument has a certain superficial appeal if one assumes that equality is necessarily the same thing as justice. However, it conveniently ignores the fact that the tax system is already heavily progressive and the burden falls most heavily on the middle class—those with annual income of from $10,000 to $50,000. This is dramatically demonstrated by Table 2, compiled by the Conference Board:

TABLE 2.—ESTIMATED TAX RATES BY INCOME LEVELS

[Taxes as a percentage of income]

Family income	Federal taxes	State and local taxes	All taxes or (2)+(3)	Government transfer payments	Net taxes or (4)+(5)
(1)	(2)	(3)	(4)	(5)	(6)
Under $2,000	22.7	27.2	50.0	106.5	−56.5
$2,000 to $4,000	18.7	15.7	34.6	48.5	−13.9
$4,000 to $6,000	19.0	12.1	31.0	19.6	11.4
$6,000 to $8,000	19.4	10.7	30.1	8.6	21.5
$8,000 to $10,000	19.1	10.1	29.2	5.5	23.7
$10,000 to $15,000	19.9	9.9	29.8	3.9	25.9
$15,000 to $25,000	20.7	9.4	30.0	3.0	27.0
$25,000 to $50,000	25.0	7.8	32.8	2.1	30.7
$50,000 and over	38.4	6.7	45.0	.4	44.7

Because increased progressiveness of the tax rate structure creates a heavy tax burden on the middle class (who are by and large the most productive and energetic members of our society) and would have an adverse effect on capital formation, the Chamber opposes the conversion of the personal exemption from a deduction to a credit.

There are two other relatively minor provisions in the administration tax bill that will have an adverse impact upon business in the Spokane area. One is the proposal to repeal the personal deduction for state and local sales taxes. This will obviously discriminate against residents of a state like Washington, which relies heavily upon the sales tax and does not have a personal income tax. Regardless of one's opinions of the relative merits of state financing by sales taxes or income taxes, the Chamber does not believe that the Federal Government should dictate to the states their method of state financing. Therefore, we oppose the repeal of the deduction for state and local sales taxes.

The administration also wishes to repeal the state and local gasoline tax. Washington has the highest gasoline tax in the nation—11¢ per gallon. As in most western states, the automobile is a necessity for most personal transportation in the Spokane area. A repeal of the state gasoline tax deduction would tend to discriminate against people in the Spokane area as opposed to the large eastern cities where public transportation is economical. This is strictly sectional legislation, and the Chamber opposes it.

B. Double taxation of corporate dividends

It is our opinion that double taxation of corporate dividends deters capital formation. It does this primarily by chasing capital away from corporate stock into other forms of investment. I also encourages debt financing as opposed to equity financing. It makes the accumulated earnings tax and personal holding company tax necessary, resulting in a more complex tax structure. Furthermore, it is a matter of real dispute who pays the corporate income tax—stockholders, employees, consumers or some combination of the three.

Several possible solutions to the problem were proposed. The first is the concept of "full integration", in which the corporate income tax is repealed and shareholders themselves are taxed on their prorated share of corporate earnings,

whether or not distributed in the form of dividends. This proposal has the advantage of being the most equitable in theory. However, in our opinion it is impractical. It would result in a tremendous amount of corporate paperwork in informing each shareholder what his share of the earnings of the corporation for the year were. Furthermore, the amount would be subject to change due to tax audits and due to the fact that form 1099 is issued in January but most corporations file their income tax returns in June or even later. If the corporation did not declare a dividend, the shareholder would have to scramble for the money to pay the tax on the corporate earnings which he had never received. This would put additional pressure on the corporation to pay its earnings out in dividends rather than retaining them for further capital formation. It was our general consensus that this proposal would work to the disadvantage of small corporations.

The second alternative considered was "partial integration," in which the corporate income tax remains in effect, but the shareholder would get a credit for his share of the corporate taxes paid. Mechanically, this would mean that any dividend received would be increased on the shareholder's income tax return by his pro rata share of the corporate income tax paid on earnings for the year. His tax would then be computed and the tax would then be reduced by the amount of credit which was added to the dividend. Partial integration, if adopted in its purest form, has all of the disadvantages of full integration plus it would further complicate the process of computing the shareholder's federal income tax. Some of the shortcomings could be reduced by simply having a fixed statutory estimate of the corporate income tax effect on each dividend as proposed by Chairman Al Ullman of the House Ways and Means Committee. This would reduce the corporate paperwork problem, but would not alleviate the complicated process the shareholder would have to go through in computing his income tax. It would also result in inequities, because shareholders in corporations having a relatively high effective tax rate would be penalized compared to shareholders in corporations having a relatively low effective tax rate. Furthermore, the credit would be of no value at all to tax-exempt shareholders such as pension trusts.

Instead, we favor simply allowing every corporation a deduction for dividends paid to its shareholders. This is by far the simplest method, because it results in no additional paperwork for either the corporation or the shareholder. It also creates equality of treatment with debt financing, thus reducing the pressure on corporations to finance by means of debt rather than equity. This could result in lower debt structures and sounder corporations. It would be of the same value to tax-exempt shareholders as it would for taxpaying shareholders. Although there might be some increased pressure for declaring dividends, there would also be additional funds available with which to pay them.

Arguably, the proposal would be of no advantage to companies whose rates of return on capital are regulated, such as the shareholder-owned public utilities. Rate-making bodies could be expected to require that the dividend deduction be passed on to the consumer in the form of lower rates. Congress could solve this problem by providing that, if the rate-making body considers the dividends paid deduction in establishing the rate of return, the utility will lose the deduction. This is one area where state regulatory bodies should not be allowed to frustrate a sharply defined national policy of encouraging capital formation.

It could also be argued that capital-intensive industries in general would be unable to use the deduction because it would reduce their taxable income against which they can offset their investment credits. In other words, the dividends paid deduction would reduce the value of the investment credit to these companies. If the subcommittee proposals on capital cost recovery (see part "E" of this report) are adopted, the investment credit would no longer be needed and would be repealed.

Would any of this tax saving created by the dividends-paid deduction be passed through to the shareholder? One of the ways corporate chief executives measure their success is by the price of their stock on the market. Increased earnings per share will create pressures for higher dividends. Higher dividends will result in higher stock prices, making it easier to sell stock. Since executives are frequently shareholders, their stock will go up in value also. As a practical matter, part of the tax saving would probably be passed through to the shareholders and part retained in the company as a source of additional capital formation.

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The major disadvantage to the proposal is political—it gives the appearance of reducing the tax burden on corporations more than either of the other two methods. We are of the opinion that this is a problem which will simply have to be faced head-on by explaining the role of profits on job-creating capital formation.

C. Relationship of shareholder to closely-held corporation

Tax practitioners spend a great deal of time working with clients to determine the tax advantages and disadvantages of the corporate form of doing business. Once the corporate form has been chosen and the corporation established, still more time is spent assisting them to get the maximum tax advantage from their corporations. One of the greatest contributions that could be made to the reform of the Internal Revenue Code would be the simplification of this area. Allowing the corporation a deduction for dividends paid is a necessary first step in the simplification process. However, it is not enough. We propose the following further steps:

1. *Corporate Income Tax Rates and Surtax Exemptions.*—Practitioners spend entirely too much time trying to juggle income between closely-held corporations and their shareholders so as to reduce the overall tax burden to the minimum possible amount. This is brought on by the fact that the corporate income tax rate schedule and the individual income tax rate schedule are out of phase. Individual income tax rates are progressive between the rates of 14 percent and 70 percent. Corporate income tax rates, on the other hand, are currently 20 percent on the first $25,000 of income, 22 percent on the next $25,000, and 48 percent on all income above $50,000. If the shareholder is in a lower income tax bracket than the corporation, efforts are made to channel income from the corporation to the shareholder by means of higher salaries, leases of property to the corporation, loans to the corporation, etc. The Internal Revenue Service attacks these attempts by contending that the payments by the corporation to the employee-shareholder are really distributions of corporate profits to the shareholder (dividends) rather than reasonable compensation.

On the other hand, if the corporation is in a lower tax bracket than the individual shareholder, attempts are made to accumulate income in the corporation. The Internal Revenue Service fights these attempts by means of the accumulated earnings tax and the personal holding company tax, both of which are penalty taxes upon the corporation for accumulating earnings in the corporation without paying them out to the shareholders to be subject to taxes at higher rates.

Making dividends deductible to corporations would substantially reduce the use of these devices by taxpayers and consequent IRS need for the unreasonable compensation, accumulated earnings tax and personal holding company tax weapons. One further step is necessary to remove these completely. This is that the corporate income tax rate should be set at the maximum individual income tax rate, which should not be more than 50 percent. In this manner, the pressure would always be to distribute earnings to the shareholders who would never be in a higher tax bracket than the corporation. To do this effectively would require that all corporate income be taxed at the rate of 50 percent. There would be no lower tax rate for the first $25–50,000 of income (currently known as surtax exemptions). To remove the surtax exemption would eliminate some rather complicated provisions in the Internal Revenue Code limiting the use of surtax exemptions in the case of multiple corporations.

Some may argue that small corporations should not have to pay the higher income taxes that might result if their shareholders were in a higher income tax bracket than the current surtax exemptions. In other words, new corporations and businesses should be subsidized to some extent to allow them to get over the first difficult years. If this is true, it could be more efficiently accomplished by the use of tax holidays, such as are used in some less developed countries and by the Commonwealth of Puerto Rico.

2. *Subchapter S Corporations.*—To take advantage of the deductibility of corporate dividends, it would be necessary under current law to actually pay out the dividend to the shareholder. The shareholder would pay tax at a lower rate on the dividend than the corporation would pay on the retained earnings if they were not distributed as dividends. However, in many cases, the corporation does not have the cash with which to pay the dividends, and needs the retained earnings in the corporation to finance expansion or simply to keep up with inflation.

Under current law, some small corporations could solve this problem by electing to be taxed as a small business corporation under subchapter S. The subchapter S provisions are at once too complex and too restrictive to be of great value in this respect. Therefore, they should be amended and simplified.

First of all, the definition of small business corporation should be expanded. It currently applies to corporations with 10 or fewer shareholders. It should apply to all closely-held corporations, which could be rather easily defined as those which are not subject to the registration requirements under the Securities Act of 1933. In the alternative, the number could be raised to 100 or even more.

Second, if a share of stock is acquired by a partnership, a trust, or a corporation, the election is immediately lost under the present law. Furthermore, if the corporation is judged to have a second class of stock, the election is lost. It is also lost if the maximum number of shareholders allowed by statute (currently 10) is exceeded, or if the corporation has more than 25 percent of its income from passive investment sources. Once the election is lost, it cannot be elected again for the next five years without the approval of the Commissioner of Internal Revenue. These restrictions should be removed.

Third, at the present time, income which is taxed to the shareholders but not distributed by the corporation becomes what is called "previously taxed income". It becomes in effect "locked in" and poses a constant threat to the shareholder. It is personal to the shareholder, and loses its character if the stock changes hands, which may lead to double taxation. This is a trap for the unwary which is currently solved by sophisticated tax practitioners by having the corporation and the shareholder exchange checks, a largely useless exercise. Instead, the corporation should be allowed to elect on an annual basis to treat all or any portion of its income (which has not actually been distributed) as having been distributed to its shareholders in any manner that it sees fit and which is otherwise lawful, and to treat the distributed income as having been recontributed by the same shareholders to the capital of the corporation in the same amount. In this way, the corporation will be able to have its income taxed to the shareholders at their lower tax brackets and at the same time retain the use of the money for the reasonable needs of the business. This should also substantially improve the balance sheets of small corporations and assist them to avoid one of the major reasons that new small businesses fail—the lack of adequate capital.

It is our opinion that these changes in the corporate tax laws would substantially improve the climate for capital formation and the formation of new businesses.

D. Tax treatment of capital gains and losses

We first considered why capital gains should get any tax preference. The reasons advanced were as follows:

(1) A good portion of capital gain is not true income, because it simply is due to an increase in price caused by inflation rather than any increase in real value;

(2) Capital gains are often bunched into one taxable year, causing a distortion by pushing the taxpayer into an unusually high tax bracket for that year;

(3) Tax preference is necessary to spur capital formation by compensating the investor for the increased risk that he takes by investing his capital rather than loaning it out.

We then considered to what extent the present system of capital gains taxation effectively deals with these problems. The consensus was that the system does not work particularly well. The calculation of capital gains tax plus minimum tax plus penalties against maximum tax on earned income is so complicated that it is almost impossible to do any tax planning without a computer. Consequently, because businessmen are unable to predict what the tax effects of their activities will be, they are discouraged from investing risk capital. Furthermore, with all the penalties involved, in many cases there is no "preference" at all, but capital gain tax (in real terms) may be higher than ordinary income tax would be. In many cases, there may even be taxes on gains which never occurred.

For example, let us assume that a married taxpayer has earned income of $50,000 in 1978. In 1968, he purchased a piece of land for $50,000, which he sold in 1978 for $100,000. Under the present method of taxing capital gains, his total tax would be $30,307, as illustrated in Table 3 on Page 12.

Present method of computing tax

Ordinary income	$50,000
Sale of capital assets:	
Selling price	100,000
Basis	50,000
Long-term capital gain	50,000
Total income	100,000
Less long-term capital gain deduction	25,000
Taxable income	75,000
Tax	28,710
Plus minimum tax on tax preferences	1,597
Total tax	30,307

However, this tax is arrived at by subtracting the basis in 1978 dollars from the selling price in 1978 dollars. The Chamber believes that this is totally inequitable, because much of the gain that is being taxed is brought about solely by the decline in the value of the dollar. As a result, the government is taxing inflation. The Chamber proposes that, to remove this tax on inflation, basis for purposes of determining gain or loss should be increased at the date of sale by an inflation factor. In our example above, if the Chamber's proposal were adopted, the taxpayer's total tax would be $21,929 (as shown by Table 4):

TABLE 4.—*Chamber proposal*

Ordinary income	$50,000
Sale of capital assets:	
Selling price	100,000
Original basis, inflation factor	
Original basis, $50,000 times inflation factor, 175 percent	87,500
Long-term capital gain	12,500
Taxable income	62,500
Tax	21,929

The resulting tax saving from the Chamber's proposal would be $8,378, even if the real capital gain were taxed at ordinary income rates rather than at one-half of ordinary income rates as under present law.

The saving would be even more dramatic if we were to use, as an example, a sale of stock purchased in 1968 instead of land. Assume that the same taxpayer sold no land, but rather sold stock in 1978 for $100,000 which he purchased in 1968 for $80,000. His tax computed under the present method would be $20,604 as shown by Table 5:

TABLE 5.—*Present method of computing tax*

Ordinary income	$50,000
Sale of capital assets:	
Selling price	100,000
Basis	80,000
Long-term capital gain	20,000
Total income	70,000
Less long-term capital gain deduction	10,000
Taxable income	60,000
Tax	20,604

If the Chamber's proposal were adopted, his tax would be $1,152, as illustrated by table 6:

TABLE 6.—*Chamber proposal*

Ordinary income	$50,000
Sale of capital assets:	
Selling price	100,000
Original basis, $80,000 times inflation factor, 175 percent	140,000
Subtotal	−40,000
Taxable income	10,000
Tax	1,152

The resulting tax saving is $19,452, because, as adjusted for inflation, the taxpayer actually suffered a real loss in capital rather than a nominal gain.

These examples clearly demonstrate that many, if not most, capital gains are taxed at greater than ordinary income rates today. In many cases, there are even taxes on gains which never occurred, which results in a direct tax on capital. Such a capital tax cannot help but have a discouraging effect on capital investment. Therefore, the Chamber recommends that basis for computing gain or loss be adjusted so that only real gains are taxed.

As a protection against the bunching effects, the present system is inequitable, because it gives the same protection for an asset which has been held only one year and a day as it does to an asset which has been held for twenty or thirty years. Furthermore, it gives the same protection to an investor who rolls over his portfolio regularly as to one who invests risk capital in a new venture and holds onto it. In short, it may give bunching protection for a taxpayer who has no bunching problem. This problem can be solved by liberalizing and simplifying the present income-averaging rules.

We also believe that the tax on capital gains itself is wasteful and inhibits capital formation by inhibiting the free movement of capital. Under present law, when an investor sees a better opportunity for an investment, he is reluctant to sell his old one because he will have to pay tax on the gain. In order to attract that investor, the new opportunity will have to be sufficiently better than the old investment to pay the capital gains tax. This makes it that much more difficult to raise new venture capital to invest in new enterprises which will create new jobs.

To solve this problem, we suggest that, whenever a business or investment asset is sold, only that portion of the gain which is not reinvested within a prescribed period of time—e.g., 18 months or two years—should be taxed. The rest should be deferred. This would parallel present treatment on personal residences and property which is destroyed or taken by condemnation. In our opinion, the result would be greater mobility of capital and a more dynamic economy.

Furthermore, the tax on capital gains tends toward concentration of business. When a successful small businessman gets ready to retire and sell out, he frequently faces a substantial capital gain tax. To avoid this, he will frequently arrange for a tax-free merger with a large national corporation instead of selling to other local businessmen or even his own employees in a taxable transaction. If he could roll his profit over into passive investments, it might remove at least one of the current incentives to merge with big business.

If all these things are done, the 50% long-term capital gain deduction and the alternative tax are no longer necessary and can be repealed. This would simplify the Internal Revenue Code by allowing repeal of at least 37 heavily litigated code sections.

However much the foregoing proposals may correct inequities in capital gains treatment, they are incomplete without some attention to the inadequate treatment of capital losses. Currently, they can only be deducted from capital gains, except that one-half of $4,000 can be deducted from ordinary income each year (the other half is lost). If the loss exceeds these amounts, it can be carried over to later years to be applied in the same way. But if the taxpayer dies with unused capital losses, the carryover dies with him and the government pockets the money.

We feel this is unfair. Capital losses hurt, and they hurt now—not later. The only reason losses cannot be fully offset against ordinary gain is that the treasury department is worried about the revenue loss. We believe that capital losses should be fully deductible in the year incurred. The revenue loss will be a one-time thing as the system changes. Furthermore, we believe that unused

capital loss carryovers should pass to the taxpayer's estate or his beneficiaries at his death.

In summary, we propose the following actions:

(1) Repeal the current 50 percent long-term capital gain deduction and the alternative tax;

(2) Index basis for computation of capital gain for inflation—in other words, tax only real gains;

(3) To compensate for the bunching problem, liberalize and simplify the present income-averaging rules;

(4) Defer taxing gain on sale or exchange of businesses or investment properties where the proceeds are reinvested within a prescribed time period.

(5) Allow immediate and unlimited capital loss deductions with an unlimited carryover including one to the taxpayer's estate;

(6) This plan will automatically remove the untaxed portion of capital gain as an item of tax preference for maximum tax on unearned income purposes and minimum tax purposes.

E. Capital cost recovery

Under present law, capital cost recovery is accomplished through the deduction for depreciation. The general theory is that capital cost should be recovered over the useful life of the asset in equal amounts each year. An exception is made in the form of accelerated depreciation in the early years on certain types of assets. Also, a very complicated system called "asset depreciation range" (ADR) is available which allows a taxpayer to select "class lives" for classes of assets and depreciate assets within the classes over shorter periods. However, ADR is so complex that only large corporations with heavy investments in computers can afford to use it. In addition to depreciation, there is the investment credit of 10 percent on new equipment.

We see several problems with the present system. First, because of inflation. usually the total cost of an asset in real terms is never entirely recovered by depreciation. For example, a taxpayer in 1968 purchases a machine for $25,-000 which has an expected 10-year useful life. In 1978 the useful life expires and the taxpayer must now buy a replacement machine for $50,000. The taxpayer based his depreciation deduction upon his original historical cost of $25,000. Because the value of the dollar has decreased steadily over the years, the taxpayer's depreciation deduction has actually declined in value every year. This means that he has understated his cost of doing business over the past 10 years, which results in an overstatement of his taxable income and an overpayment of his taxes.

This inequity also has an adverse effect on capital formation. Reducing the value of the depreciation deduction reduces retained earnings which will be available for increased capital investment. Therefore, the Chamber recommends that basis for depreciation purposes be adjusted for inflation annually so that depreciation deductions will more closely reflect actual costs of doing business.

Second, the system is overly complex. Different assets may be depreciated by different methods (200 percent declining balance, 150 percent declining balance, 125 percent declining balance, sum-of-year-digits, straight-line, units of production, etc). Furthermore, the useful life of an asset is always subject to argument. At the very least, the computation of depreciation on large numbers of assets is time-consuming and expensive.

Third, the investment tax credit is subject to constant stop-and-go political pressure. Since it was originally passed fifteen years ago, it has been suspended once, repealed once, and increased once. Businessmen find it difficult to plan for. At present, it is scheduled to expire at the end of 1980. The investment credit only partially offsets the inflation loss, because in periods of high inflation it is inadequate to cover the total capital cost and in periods of low inflation it over compensates. We are also of the opinion that the credit is not as valuable for small business as it is for big business.

We propose that the system be made at once simpler, more flexible, and more liberal. This could be done by adopting a system similar to that used in Canada. The Canadian system classifies all capital assets into fifteen classes. Short lives are used ranging from one to fifteen years. Each asset fits into only one class. The taxpayer reports the total depreciation for each of the classes of assets which he owns. If, because of low earnings, a taxpayer is unable to use all of his capital cost recovery allowance in any particular year, he is able to

carry over the unused capital cost recovery allowance to a following year until it is all used up. Thus, he is not required to use up depreciation allowances unless they are actually of tax value to him.

Again, the public utilities might be faced with a problem in using this type of approach. The short lives proposed would probably not be acceptable to them for rate-making purposes. We propose the same type of solution for this problem as for their problem with the dividends-paid deduction. The short lives depreciation should be used for tax purposes only—not rate-making—and Congress should specify that the tax-saving will be lost if the regulatory agencies require that it be passed on to the consumer. This should free up additional retained earnings for the building of more plants.

As part of this program, we propose that accelerated depreciation, ADR, and first-year bonus depreciation for small purchases be repealed. To compensate for the inflation problem, we propose indexing the undepreciated capital cost of assets for inflation each year and eliminating the investment credit. Each year, the remaining undepreciated capital cost of each class of assets (cost less depreciation previously deducted) would be increased by the percentage inflation rate for the year. For example, if the inflation rate (GNP deflator or consumer price index) were 7 percent, the unrecovered cost would be multiplied by 10 percent, and the resulting figure would be divided by the remaining class life of the asset to determine the maximum depreciation for the year.

If these proposal are adopted, the investment credit can be repealed. If depreciation is indexed for inflation so that all cost is recovered, and short lives are used so that all cost is recovered in the early years, the investment credit is not needed. This would remove the stop-and-go political pressure on what, up to now, has been an important factor in capital formation.

In summary, we propose the following:

(1) Remaining undepreciated capital cost of assets should be indexed for inflation annually;

(2) Adopt a depreciation system similar to that used in Canada, classifying all capital assets in fifteen classes with short useful lives ranging from one to fifteen years;

(3) Allow taxpayers to carry over unused capital cost recovery allowances to later years if not needed in the current year.

(4) Repeal accelerated depreciation, ADR (asset depreciation range) and first-year bonus depreciation for small purchases;

(5) Repeal the investment tax credit.

F. Carryover basis at death

One of the most complex and far-reaching provisions of the Tax Reform Act of 1976 is new section 1023 of the Internal Revenue Code—carryover basis at death. Prior to 1-1-77, inherited property took a basis equal to fair market value at date of death. After 12-31-76, inherited property takes a basis equal to the decedent's adjusted basis subject to some complicated adjustments. This usually results in a higher tax when the heir sells the property.

Section 1023 results in several major problems. First, in many cases, it is difficult if not impossible to determine what the decedent's adjusted basis is. The decedent may have known, but no one else does, and his records may be in disarray at date of death regardless of the fact that the law has for many years required him to keep records.

Second, the computation of the necessary adjustments for each individual asset is extraordinarily complex, requiring as much as six pages each. Third, for jointly-owned or community property, basis after death will be different for the decedent's half than for the surviving spouse's half—even though the surviving spouse may now own both halves. Fourth, basis is different for purposes of determining gain and for determining loss, and different still for depreciation purposes: each asset may have as many as three different bases. Fifth, the law requires the executor to notify each beneficiary of the basis of each asset acquired (and IRS also if the total is over $60,000) even though no federal estate tax return may be required—a heavy burden.

We examined a number of proposals that have been put forth to simplify and lessen the burden of carryover basis. All were found inadequate to solve the problems. Consequently, we believe that the only possible alternative is outright repeal.

G. Municipal bond interest

The administration has proposed giving states and localities the option of issuing bonds with taxable interest. At present such bonds pay interest which is tax-exempt. In return for issuing taxable-interest bonds, state and local governments would receive a subsidy from the federal government of 35–40 percent of the interest cost.

The reasons given for the proposal are that it would eliminate a loophole used primarily by high-income taxpayers and that it would open up new markets for municipal bonds in the form of investors which are not subject to federal income tax (such as pension funds).

We oppose this part of the administration's tax bill for the following reasons:

(1) The proposal would make state and local governments increasingly dependent on the federal government for financial support. In a few years, it is predictable that Congress will start using the subsidy as a tool for imposing its own social policies on state and local governments, much as it is currently doing with revenue sharing.

(2) The present system is simple and has worked well in practice. There is no evidence that solvent local governments have ever had any difficulty in marketing their bonds through existing channels. If there are abuses in the system by high-bracket taxpayers, these should be attacked directly.

(3) The scheme will result in a net revenue loss to the federal government. The subsidy will exceed the revenue gained from the tax on bond interest. The method proposed for solving the problem is inefficient.

H. Tuition tax credit

Senator Roth of Delaware has proposed a plan to give taxpayers a $250 credit for tuition paid to colleges by students or their parents. Senators Packwood and Moynihan propose to expand this to include primary and secondary education. The purpose of these proposals is to give some relief (primarily to middle-income taxpayers) from the crushing burden of educating their children.

The administration has proposed an alternative in the form of increasing grants and loans currently available and raising the income level for eligibility to include more middle-income taxpayers.

We have grave reservations about the advisability of either program. We believe there would be an almost irresistible temptation on the part of educational institutions to raise tuition levels by the amount of the tax credit so as either to relieve their own badly strained budgets or to expand desirable programs that otherwise would not be available. In other words, we fear that reducing market discipline in this area might result in an explosion of costs similar to that which has occurred in the medical field by the adoption of Medicare and Medicaid. The result would be no reduction at all in the burden on the middle-income taxpayer.

The present loan program has become so shot with default and fraud as to become a national scandal. Furthermore, it places a tremendous burden on those honest students who take advantage of it and must begin repaying almost immediately after graduation. We seriously question the wisdom of compounding these problems.

Because of these reservations, we take no position on either of these proposals at this time. We prefer to wait and see if some better alternatives present themselves.

I. Business travel and entertainment expenses

The administration has taken dead aim at business travel and entertainment expenses. The political code word is the "three-martini lunch". Among other things, the administration proposes to limit the deduction for business meals to one half of the amount expended. It also proposes to limit air travel deductions to the cost of a coach ticket; the extra cost of first class travel would be nondeductible. The apparent rationale for these proposals is that business entertainment and travel expenses are simply a cover for personal entertainment expenses. They should not be deductible because the businessman "enjoys what he is doing".

We believe that business meals should be fully deductible. Business entertainment is often essential to promotional and sales efforts. In the words of Senator Russell Long, Chairman of the Senate Finance Committee, "Entertain-

ment is to the selling business what fertilizer is to the farming business." Whether any particular expense is necessary for the business should be left to sound business judgment. There are undoubtedly some abuses, but the Internal Revenue Service has tools at its disposal right now that are capable of handling these situations.

We also believe that first class air travel should be fully deductible. Many businessmen must fly many thousands of miles in the course of their business. If he believes that first class accommodations allow him to arrive for business conferences relaxed and refreshed so that he can be most effective, the government should respect that judgment. The fact that both ends of the plane land at the same time is simply irrelevant to that decision.

The administration also proposed new rules relating to foreign conventions. At the present time, two foreign conventions per year are allowed, but allowable expenditures are limited and the bookkeeping requirements are onerous. The administration proposes limiting foreign conventions to those where there is a compelling reason for the sponsoring organization to hold the convention outside of the United States. The allowable expenses would be liberalized and the bookkeeping requirements relaxed. We feel that this is an improvement over the present system and that this portion of the administration bill should be adopted. However, we do feel that unlimited deductions should be allowed for foreign conventions held in Canada or Mexico, because many business organizations in those countries hold their conventions in the United States. The convention trade is good for business in both countries.

TRANSPORTATION ASSOCIATION OF AMERICA,
Washington, D.C., August 18, 1978.

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

DEAR CHAIRMAN LONG: Speaking on behalf of the Board of Directors of the Transportation Association of America (see current roster attached), I wish to express our full support of two specific provisions relating to the Investment Tax Credit included in the House-passed H.R. 13511 that is now under consideration by the Senate Finance Committee. These changes, if also approved by your Committee and passed into law, would be of tremendous assistance to the transportation industry in overcoming its inability to generate needed capital funds to meet both current and future public service demands.

One provision would make the ITC a permanent part of our tax system, thus increasing the opportunities for transport companies to make capital spending plans for the future. The other—a major and most needed change—would raise the present 50 percent income tax write-off limit for ITC's to 90 percent on a graduated basis.

TAA has long been a strong supporter of the ITC as a vital tool for the transportation industry in past investment programs—to the extent it could be utilized. Unfortunately, the tax laws as presently written and applied make it very difficult for high-investment and low-profit companies—such as is common in the transportation industry—to utilize their earned ITC's.

The problem of poor utilization of ITC's by the transportation industry has been studied in some detail by TAA. A position paper, which has been approved by the TAA Board, is attached. It contains a five-part program to stimulate the use of ITC's by the general public.

We hope that you and your staff will review this paper as part of your consideration of possible revisions to H.R. 13511. Of particular concern to TAA is the need to increase the use of ITC's by low- or no-income companies. This can be done in two ways: (1) To permit a one-time transfer of the ITC in whole or in part; and (2) To authorize refunds, in whole or in part for earned but unused ITC's.

We urge favorable consideration by your Committee of our recommendations. We also request that this letter and the enclosed position paper be included in the formal record of hearings on H.R. 13511.

Respectfully,

PAUL J. TIERNEY,
President.

Attachments.

The Investment Tax Credit—Its Importance to the Transportation Industry as a Generator of Vital Capital Funds

A Position Paper which:

Explains why the Investment Tax Credit is essential to the transportation industry, yet is of only limited benefit to it.

Proposes a five-part program to increase utilization of the Investment Tax Credit by the transportation industry; namely:

(1) Make the Investment Tax Credit permanent.

(2) Increase the Investment Tax Credit to 12% or more.

(3) Repeal, or sharply increase, the 50% income tax write-off limitation.

(4) Permit a one-time transfer of the Investment Tax Credit, in whole or in part.

(5) Authorize refunds, in whole or in part, for earned but unused Investment Tax Credits.

Summary and Recommendations

The Investment Tax Credit (ITC) is an effective, proven, and widely-endorsed mechanism for spurring capital formation and outlays. ITC legislation was recommended by President Kennedy and enacted by Congress in 1962 to promote economic expansion, productivity gains, and job creation in the private sector. Four Presidents and eight Congresses since have recognized its role in providing real economic growth.

Capital intensive industries such as transportation are major creators of ITC's and are thus potential major contributors to economic expansion through use of these tax credits. The transportation industry alone creates about 12% of all ITC's. Unfortunately, several "quirks" in the laws governing the use of ITC's prevent many companies from utilizing these legitimately earned credits to any appreciable extent. To illustrate, industry as a whole has been able to use only 75 percent of its earned ITC's; and far worse, the transportation industry has been able to use a mere 56 percent.

One of the major quirks is the "write-off limitation", which restricts the use of earned ITC's to 50 percent of a company's income tax liability. In other words, if a carrier earned $10 million in ITC's from a $100 million capital investment during a year, but had only $10 million in tax liability, it could charge off only $5 million, or 50 percent, plus $25,000. Since so many regulated transportation companies have heavy annual capital demands, yet small taxable incomes, their ITC's are earned faster than they can use them. Unprofitable carriers, of course, have no income taxes to write off. As a result, as of December 31, 1974 (latest year data available), earned but unused ITC's for the transportation industry totaled $1.3 billion—and this total unquestionably increased sharply during 1975 and 1976.

The Transportation Association of America, a national policy organization composed of transport users, suppliers, investors, and carriers of all modes (air, freight forwarder, highway, oil pipeline, railroad, and water), is very much concerned about the inability of the transport industry to fully utilize the ITC. Accordingly, it is proposing a five-part program to stimulate its use:

(1) *Make the ITC permanent.*—This would stimulate private-sector capital investment by allowing future planning because of assured ITC benefits.

(2) *Increase the ITC to 12 percent.*—This would increase the volume of ITC's that can be earned, thus stimulating investment to extent they can be used.

(3) *Repeal, or sharply increase, the 50 percent income tax write-off limitation.*—This would quickly and easily stimulate capital investment by doubling ITC's that can be used. Temporary tax losses would be more than offset by the multiplier effect on the economy and boost in private-sector jobs.

(4) *Permit a one-time transfer of earned ITC's.*—This would enable carriers with little or no income to more fully utilize ITC's by their sale to other companies, thus stimulating further investment. It would simplify and encourage such transfers, now done only through complex arrangements.

(5) *Authorize refunds for earned but unused credits.*—This would also stimulate capital investment by carriers with low or no income, as it would provide a refundable credit for that portion of their earned ITC's that cannot be used. This should help financially weak regulated carriers with heavy capital investment requirements to meet public obligations.

Lack of capital is weakening transport industry

What do you do when you can't raise enough money to cover your needs? For an individual, the answer is simple and inescapable—"Do without." But applying

this answer to a major sector of the economy, such as the transportation industry, may have far-reaching consequences. Our nation's economic welfare depends on the availability of adequate, efficient transportation service; and without sufficient capital funding, the transporation industry's ability to fulfill the need for that service is imperiled.

Thus, "doing without" for the transportation industry may in a very real sense mean "doing without" for the entire nation.

Last year the transportation industry estimated that it should have spent nearly $13 billion to replace outworn, outdated equipment and facilities and to expand its operations to meet the growing public demand for transport services. But it could raise only a little better than half that amount—just as was the case for every prior year of this decade. Estimates for 1978 present the same gloomy picture.

These figures illustrate a harsh truth that has beset the transportation industry for many years. Year after year the industry's ability to generate new investment capital has fallen far short of its needs. Year after year the industry has been compelled to re-evaluate those needs—to "do without"—long past its ability to absorb such capital shortfalls.

The results, as anyone familiar with the industry can attest, have been rising costs and, for a growing number of carriers, deteriorating service, despite the best efforts of the industry to overcome its problems.

When investment lags, transportation carriers must—just like an individual—take steps to live within the limits of their resources. Replacement cycles must be lengthened, expansion plans deferred, and plant maintenance programs delayed. Forced to rely on older, less dependable facilities and equipment, carriers find productivity and efficiency declining—and operating costs increasing. Faced with "catch-up" capital needs, little provision can be made for growth in transportation service demand, which has been rising at a compound rate of 3 percent a year for freight and over 4 percent for passenger services.

The railroads, which face perhaps the sharpest problems, most clearly show the corrosive effects of this capital squeeze. One-fourth of the trackage in the country is under "slow orders" because of poor physical condition. This tends to aggravate the size of freight-car shortages during peak-load periods. The railroad report that deferred maintenance and capital improvements now add up to a $4.2 billion backlog. Yet, this industry's averall rates of return for the last three years have been a lowly 1.20 percent, 1.64 percent, and 1.26 percent respectively.

Nor are the railroads alone in their travails. During the years of this decade no mode of transportation has been able to meet its capital needs. It is becoming increasingly clear that answers must be found—and found soon—the capital formation problems that are besetting transportation, if the nation expects to have an adequate, efficient national transportation system to support its future economic progress.

The investment tax credit represents a powerful tool to reverse this trend!

Need for capital formation and economic expansion

Capital Formation.—There is an unquestioned requirement for strong capital formation in the American economy. Qualified analysts have clearly documented this fact. According to the American Council for Capital Formation, "The U.S. will need the incredible sum of $4.5 trillion in new capital funds in the next ten years—three times the $1.5 trillion of the last decade." The New York Stock Exchange terms the capital shortage a "present fact"; and the Chase Manhattan Bank predicts a capital shortfall of $1.5 trillion during the next ten years, unless economic policies are altered. Widely reported economic studies and business forecasts echo this assessment.

Capital formation is a prime contributor to economic expansion. It reduces unemployment by providing jobs in the capital equipment industries. It expands the base of productive capital to provide more goods and services to consumers. It creates employment in the use of new equipment. It increases productivity. It enables recycling of the money supply through the various stages of manufacture and distribution. And since capital equipment order-through delivery time is often lengthy, it smooths economic cycles by counterbalancing government and consumer spending slowdowns.

Productivity.—Capital formation is closely linked to productivity. More and better capital equipment increases productivity per man-hour through use of ad-

vanced technology and materials of process controls. Productivity is the engine behind real economic expansion, real growth and inflation-free progress. The U.S. Bureau of Labor Statistics reports that productivity makes possible increases in real worker incomes—which have risen about the same rate as output per man-hour since World War II. It also increases the availability of goods and services to the population as a whole. Most researchers conclude that output per man-hour has increased in large part because the amount of capital supporting each worker has increased substantially.

Productivity also enables U.S. business to compete efficiently in the international market and against imports domestically. It also provides the margin of cost control for winding down inflation. The reverse also holds true; i.e., as capital formation lags, so does productivity. Former Treasury Secretary William Simon reported that productivity growth declined from 2.44% annually during the early 1950's to 1.33% per year for the period 1970–75. He compared this to a rate of productivity growth for our major trading partners, Japan and West Germany, that was more than double ours over the last 15 years.

Certain parts of American industry have noticeably suffered from the "productivity/relative prices gap." The steel, television, auto manufacturing, and shoe industries, among others, are experiencing reduced domestic manufacturing output because of imports. The result is the loss of many American jobs.

Economic Expansion.—Two other factors make economic expansion vital. First, the American population will continue to grow, albeit at a reduced rate. Zero population growth remains in the future, and current estimates call for the Americatn population to increase from 220 million in 1977 to 262 million by the year 2000. The need prevails for increased jobs.

Also, the current economic picture is far from ideal. Unemployment is much above desirable goals. College graduates face poor job prospects. Millions of people must work at jobs requiring lower skills and experience than they possess. Yet, programs to stimulate jobs must be long-lasting, not short-term inflationary measures. Job creation via capital outlays is the proper approach.

The investment tax credit is a proven tool to spur capital formation

Description.—The ITC is an economic benefit intended to stimulate investment, employment, output, and efficiency by reducing the cost of qualifying investments in capital equipment. The existing ITC generally allows a business enterprise to reduce (or credit) the amount of income tax otherwise due by an amount equal to 10 percent of the cost of the investment (up to $25,000 plus 50 percent of the tax liability). Unusable credits may be carried back three or forward seven years.

Philosophy.—The ITC was recommended by President Kennedy and enacted by Congress in 1962 to boost capital formation and economic expansion. At the time of its adoption, the nation was experiencing a period of high employment, economic recession, and idle industrial plant capacity. Secretary of Treasury Dillon called the ITC a key to "modernization and expansion of industry. . . which is essential to higher productivity. . . rising per capita income. . . rising real wages. . . rising investment incomes. . . and a help in holding prices down."

Support.—Support for the ITC transcends party lines and political philosophies. President Nixon asked Congress to reinstate the ITC in 1971 to "give the (economic) system a powerful new stimulus." President Ford asked for an ITC increase to 12 percent in 1975 to "put our people to work. . . and help shift the emphasis from inflation to jobs." The Senate Finance Committee that year praised the ITC for its "job creation both directly and through the multiplier effect . . . for its anti-inflationary nature . . . for its contribution to productvity." It also noted that "increased productivity has favorable implications for our balance of payments and exchange rate of the dollar . . . and that increasing the capital stock is essential to providing enough jobs for those entering the labor force."

The House Ways and Means Committee's "Tax Policy and Capital Formation Report" of 1977 surveyed research on the ITC and other tax incentives. Five of six major studies reported a 9 percent increase in capital equipment investment resulting from the ITC. The report stated that "tax incentives like the ITC increase the propensity to invest by somewhat more than the revenue loss (to the Treasury)." The Joint Committee on Internal Revenue Taxation Report of 1976 said: "During periods when the ITC was in effect (between 1962 and 1975), orders for general industrial machinery increased. At times this was quite dramatic. During the periods when the credit was not in effect, orders either declined or remained relatively constant."

Benefits.—As the ITC spurs capital investment, it generates orders for parts, row materials, supplies, and services. The multiplier effect of new wages translates to additional salaries, consumer purchases, jobs to supply added demand, new Federal, state, and local taxes, and the movement of some individuals from recipient to taxpayer status.

Alternatives.—Alternatives to private-sector stimulation may include public works projects, job-training programs, welfare programs, and recently-discussed full-employment strategies. Many have experienced high administrative costs, poor skill transfer, and limited success in reducing structural unemployment. Some programs are inflation-prone and most have demonstrated a poor record for providing permanent job skills and employment.

The evidence clearly supports the soundness of the ITC for both capital and economic expansion and its preference over other short-term measures that tend to feed inflation through creation of low- or no-productivity jobs.

The investment tax credit is especially productive in transportation sector

The transportatinon industry is a primary contributor to capital formation, although to a far less extent that it should be. It could be a major vehicle through which economic stimulus programs benefit the economy. To illustrate:

The transportation industry is capital intensive, as shown by the table below. With a net investment (investment less appreciation) of well over $60 billion, it obviously needs far more than that amount for replacement of equipment and facilities at current and future dollar values. Airlines, railroads, shipping, trucking, pipeline, and vehicle leasing concerns also require significant volumes of new equipment and facilities annually for expansion needs. One way to help generate this needed capital is to increase the availability and use of ITC's.

Net investment of ICC/CAB/FMC-regulated carriers in transportation property and equipment—December 31, 1975

	Millions
Air Carriers	$11,105
Motor Carriers	5,295
Oil Pipe Lines	7,678
Railroads-Car Lines	35,439
Water Carriers	1,850
Total	$61,367

There is a continuous need to purchase the most modern, efficient aircraft, rail cars, buses, trucks, barges, ships, and other equipment fleets. Domestic and international competition requires transportation companies to offer efficient, productive, up-to-date equipment. Transport equipment fleets must be constantly modernized.

Transportation equipment is expensive, with orders frequently amounting to millions of dollars for a single unit, and the volume of units needed each year is so high the total capital demand can rise to a billion or more dollars. This is shown by the figures below:

HIGH COST OF COMMERCIAL TRANSPORT EQUIPMENT

Type	Average cost	Number needed per year	Estimated annual cost
Air transport	$15,000,000–20,000,000	125	$1,900,000,000–$2,500,000,000
River barge	200,000	1,500	300,000,000
River towboat	1,500,000	140	210,000,000
Rail freight car	30,000	60,000	1,800,000,000
Intercity bus	100,000	1,200	120,000,000
Tractor-trailer	55,000	50,000	2,750,000,000

Transportation equipment is subject to heavy service and wear. This means a high equipment turnover rate in transport fields such as aviation, bus, and trucking. In other transport fields, such as rail and shipping, the equipment is long-life, yet requires heavy maintenance, repair, and overhaul—often to an extent requiring capital funding.

The complexity and scope of transportation equipment manufacture offers excellent employment opportunities for all types of worker skills.

Transportation industry's capital needs are expanding but are not being met

In 1974, the Transportation Association of America made an analysis of the capital needs of the various modes of carriers subject to the economic regulation of the Interstate Commerce Commission and the Civil Aeronautics Board. These estimates have been converted into constant 1977 dollar values, but they do not take into account the inflationary impact of future costs. To avoid charges of "blowing up" the estimates, TAA broke them down into "Replacement" and "Expansion", with the former category representing the cost of equipment and facilities simply to replace existing capacity. The later category represents the cost for expected expansion of capacity to meet future needs—but in constant dollar values.

ESTIMATED ANNUAL CAPITAL REQUIREMENTS OF PUBLIC INTERCITY CARRIERS, 1975-79

[Millions of constant 1977 dollars]

	Replacement	Expansion	Total	Annual outlays 1970-74
Railroads	$3,581	$1,394	$4,975	$2,693
Airlines	1,334	1,444	2,778	1,880
Motor carriers	2,044	756	2,800	1,409
Oil pipelines	174	1,574	1,748	610
Water carriers	270	265	535	411
Intercity bus	121	15	136	105
Total	7,524	5,448	12,972	7,108

It is obvious from the above table that the transportation industry is not meeting its capital needs—nor even its capacity replacement needs. Unfortunately, this "capital gap" is not a recent phenomenon, as illustrated by the table below, using data published by the U.S. Department of Commerce.

TRANSPORTATION INDUSTRY'S SHARE OF TOTAL INDUSTRY OUTLAYS FOR PLANT AND EQUIPMENT

[Billions of dollars]

	1950	1955	1960	1965	1970	1975	1977
All industries	20.21	29.53	36.75	54.42	79.71	112.78	137.02
Transportation	2.37	2.58	3.12	4.89	6.04	7.57	6.99
Percent transport	11.7	8.7	8.5	9.0	7.6	6.7	5.1

The regulated transporation industry, as indicated above, has been steadily losing out in the competitive market for capital funds. Investors understandably put their money where the return is the greatest, and many public carriers are poor risks compared to other investment markets.

These trends are unfortunate indeed, because the capital spending by the transporation industry decidedly benefits American society. Modern, efficient, high-quality transportation services provide better transporation for business and vacation travelers, faster and lower-cost transport for food and other business shipments, and more competitive transportation modes with lower rates and more productive services.

Investment tax credit has not worked as intended for transporation industry

For a number of reasons, the Investment Tax Credit has failed to work adequately for the transporation industry. While very helpful to the extent it has been used, various quirks in the laws and rules governing the use of the ITC have limited its use by the transporation industry.

Transporation Investment is High Relative to Profits.—As noted previously, overall transport investment is very sizeable, and the cost of equipment and facilities is very high—both in unit terms and in the large volume of units needed each year. Industry profits, on the other hand, are restrained because:

Large segments of the industry are government regulated, with rates and fares set by state and Federal agencies. Under regulation, the resulting rates of return on investment aften result in uneconomic profit levels. Rate levels are often held down because of strong resistance from users, consumer interests, and political groups. When increases are approved by regulators, their effect is often diminished by a lengthy hearing and appeal process.

Transportation companies have suffered from excessive cost increases. This is particularly true of carriers with sizeable fuel requirements. For example, the cost to the airlines for fuel increased from $1.3 billion in 1973 to $3 billion in 1976, and it now represents about 20 percent of total operating costs. Each cent-per-gallon increase in the price of jet fuel results in an additional $100 million in annual expenses for the U.S. scheduled airlines. In the railroad field, the average cost of equipment has risen 73 percent from 1973 to 1977. Similar increases could be cited for other modes.

Limited Income is Available to Use ITC's.—The constraints on the ceiling of rates and fares, because of regulation, make it very difficult for carriers to meet less-constrained increases in their costs of equipment, labor, fuel, etc. This obviously limits taxable incomes and the opportunity to utilize the Investment Eax Credit. As a result, many ITC's go unused.

The tax law quirk that restrains ITC use is the tax write-off limitation. Under the current law, companies may deduct credits up to a maximum of $25,000 plus 50 percent of tax liability above that amount. In an industry with high investment relative to profit (such as transporation), this limitation forces many credits to go unused. They cannot be claimed on a timely basis, and they are often permanently lost because of expired carryover periods.

This income tax write-off limit has created a backlog of earned but unused ITC's. and the size of this backlog has been dramatic for the transporation industry. For example, as of December 31, 1974, unused ITC's for this industry alone totaled $1.3 billion. This included $680 million for the airlines, $320 million for the railroads, and $300 million for other transport modes. Totals for the years 1975 and 1976 continued upward.

An analysis of the first 12 years of the Investment Tax Credit shows that the transporation industry was able to use only 56 percent of the ITC's it generated. For the respective modes of transport, the percentages of used ITC's were as follows: Airlines, 35 percent; Railroads, 55 percent; Water Carriers, 59 percent; Pipelines, 76 percent; and Trucking and Warehousing, 79 percent. The overall 56 percent utilization compares with a better, but still unsatisfactory, 75 percent for all U.S. industry.

Viewed another way, the capital-intensive transporation industry created 12 percent of all ITC's, but as a low-profit industry, it has 37 percent of all unused credits for this 12-year period. Thus, transporation has been especially affected by the 50 percent income tax write-off limitation.

Income Tax Write-off Limitation Creates a Disincentive for Transportation.—The 50 percent income tax write-off limitation, in application, tends to discourage investment, as explained below:

Companies with unused ITC's or marginal profits—such as much transportation companies—must effectively pay more for capital equipment than competitors able to use their ITC's. This discourages the former from making investments. According to Senators Long and Kennedy, "the current law is designed so that General Motors pays $90,000 for a $100,000 machine while American Motors pays the full $100,000." This amounts to a 10 percent surcharge for machinery and equipment for some companies, putting them at a competitive disadvantage.

Because marginally profitable and unprofitable carriers are forced to pay higher costs for productive equipment, compared to their competitors, they have less opportunity to improve operations and thus reverse their downward spiral.

With the 1976 rise in ITC's from 7 percent to 10 percent—a desirable change for companies able to fully utilize it—more low-income transporation companies "bumped" the 50 percent taxable income write-off limit. They were disinclined to invest above that limit because further capital purchases would be at a surcharge. Therefore, the raising of the ITC further without changing the tax write-off limitation will only magnify these problems.

When companies already have a backlog of past unused credits—as many transportation companies do—they are inclined to limit present and future investments until they have caught up.

In summary, tax experts report that tax write-off limitation rules hamper capital formation by penalizing: (1) companies whose investment is high relative to income, (2) marginally-profitable or unprofitable companies, (3) new companies, (4) small companies, and (5) venture capital firms.

Leverage Lease is a Poor Solution.—Some transporation companies have employed the "leveraged lease" technique to recycle earned ITC's. A company un-

able to use ITC's—because of the tax write-off limitation or because it has little or no taxable income—can lease the particular equipment from a third party who takes the ITC. The financing arrangement results in a slightly lower equipment lease rate to the original company, but at a cost higher than that if it could have used the ITC directly.

The device is widely used, but remains unpopular with most user parties. First farming out the ITC to a middleman involves the cost of relinquishing much of its value. It also poses complex legal and ownership problems that are not yet fully resolved. It is not practical for some major fixed (non-equipment) investments where the assets are not suitable collateral for third-party ownership. It finances existing transactions, but does not attract additional capital to industry. Because ownership rights accrue to the financier, it is more costly.

Ways to stimulate capital formation and outlays via greater use of the ITC

There are a number of constructive steps that can be taken to increase the use of the Investment Tax Credit, and thus stimulate both capital formation and spending. These are shown in the following five-part program being advocated by TAA. In some instances any one of the proposed changes would prove helpful, by TAA. In some instances any one of the proposed changes would prove helpful, but in most instances several of them should be put into effect to do the job.

While detailed comments on each are made below, these proposals are as follows:

(1) Make the Investment Tax Credit permanent.
(2) Increase the Investment Tax Credit to 12 percent or more.
(3) Repeal, or sharply increase, the 50 percent tax write-off limit.
(4) Permit a one-time transfer of the Tax Credit, in whole or in part.
(5) Authorize refunds, in whole or in part, for earned by unused ITC's.

1. Make the Investment Tax Credit Permanent

As urged by President Carter in his "Tax Proposals" to the House Ways and Means Committee on January 23, 1978, the Investment Tax Credit should be made permanent "so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures."

Uncertainty about the permanency of the ITC has undoubtedly had an adverse impact on its use since its introduction. As previously stated, the ITC was initially authorized by the Congress in 1962 at a 7 percent level. It was suspended in 1966, but brought back in 1967, only to be eliminated again in 1969. It was once again reinstated, at the 7 percent level, in 1971; and it was increased in 1975 to 10 percent for a two-year period. In 1976 it was extended through 1980 at the 10 percent level; and on January 1, 1981, it is scheduled to revert back to 7 percent.

TAA is in full accord with making the ITC permanent at least at the 10 percent level. The on-and-off and 7-or-10-percent history of the ITC certainly hasn't been conductive to sound financing of large—and often very long-term—capital obligations that are characteristic of the transportation industry.

2. Increase the Investment Tax Credit to 12 percent or More

Another way to stimulate capital investment—especially in capital-intensive industries such as transportation—is to increase the Investment Tax Credit to 12 percent or more. This would be of particular help to carriers with very heavy capital needs during the next decade, as is the case for airlines faced with replacement of very expensive new aircraft and costly noise reduction of much of their present fleets. Railroads must purchase many thousands of hopper cars to meet the growing demand for coal, which likewise calls for thousands of new barges—along with locomotives and towboats to propel them.

While such an increase in the ITC percentage would be of little direct financial assistance to companies with low or no taxable incomes, it should boost the supply of equipment that could be obtained by them through leasing. It represents a direct reduction in the cost of financing for carriers that can use it, which in turn should help them meet the capital outlays required for such things as rail track and right-of-way facilities that usually must be financed internally.

3. Repeal, or Sharply Increase, the 50 percent Income Tax Write-Off Limitation

As already explained in some detail, the present 50 percent income tax write-off limitation on use of the ITC has been perhaps the major reason why this in-

vestment incentive has been so poorly utilized. This is particularly true for the transport industry, with its very high capital needs and relatively low income levels.

Tax experts clearly recognize the inequities created by this limitation. In 1971, then Acting Associate Director Emil Sunley, Jr. of the Office of Tax Analysis, U.S. Treasury Department, outlined a "More Neutral Investment Tax Credit". Among seven proposals designed to "simplify the present credit and be equivalent to an across-the-board cut in the price of new machinery and equipment" was a call to repeal the tax write-off limit. He noted the limitation runs counter to Congress' wishes by "discriminating against rapidly-growing businesses, providing little benefit to certain industries threatened by foreign competition and as a side effect encouraging equipment leasing."

Frederick W. Hickman, as the Assistant Secretary of the Treasury for Tax Policy, spoke in 1974 of the counter-productive write-off limit. He said this policy "offers no assistance at all to companies in financial difficulty or with no taxable income . . . businesses for which increased productivity is most critical get nothing at all." He also noted that ITC write-off limitation discriminates against the innovative, growing firm, as well as small companies.

President Carter, in his latest "Tax Proposals", urges a boost in the income tax write-off limit from the present 50 percent to 90 percent, and "thereby increase the incentive for those businesses with relatively high investment needs and low taxable incomes." He also stated: "Developing businesses and firms suffering from temporary business reversals will be helped to compete more effectively with their larger or more stable competitiors." The President could have cited the transporation industry as an example in boh instances.

While TAA would prefer outright repeal of the 50 percent tax liability write-off limitation, it fully supports the President's proposal to increase it to 90 percent. Evidence to date shows that such a change will produce impressive results—particularly in the transportation industry. To illustrate, in 1976 Congress passed and the President signed into law Public Law 94-455, which included a provision allowing airlines and railroads to apply their ITC's to up to 100 percent of their taxable income for 1977-78, and 10 percent less each year thereafter until back to the standard 50 percent.

Did the change help? The answer is unquestionably "Yes", based on figures published by the U.S. Department of Commerce, as noted below:

EXPENDITURES FOR PLANT AND EQUIPMENT

[Billions of dollars]

	1976	1977	1978[1]
Air transport	1.30	1.68	2.17
Rail transport	2.52	2.90	3.34
Other transport	3.63	2.21	1.88

[1] Estimated.

It is unfortunate that the increase in the ITC write-off limit did not apply to the other modes of transport, because their capital needs and problems of financing are in many ways very similar to those of the air and rail carriers.

TAA supported this temporary change, and it was clearly justified when it is recognized that the airlines and railroads—as noted on page 7—had been able to use only 35 percent and 55 percent respectively of their earned ITC's during the first 12 years of the life of the credit. In dollar terms, the airlines had $680 million, and the railroads $320 million, in unused ITC's.

As shown by the airline and railroad experience, increasing the ITC write-off limitation can produce immediate results, and thus is perhaps the fastest way to stimulate capital formulation via the ITC. It would double the potential volume of ITC's, and the change is logical, easily understood, and adds no major complexities to the present tax system.

This change, however, cannot solve the problem by itself. While most desirable, it would not be of direct benefit to companies without any taxable income, and it represents no more than a partial solution in the transportation field, where more than one-third of the ITC's would still remain uncaptured. Because of the many marginally-profitable and unprofitable transport companies, carry-forward periods would expire before ITC's could be used. Also, the disincentive feature

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of the ITC would remain, with carriers unable to use their ITC's having to pay more for equipment and facilities than more profitable competitors.

Accordingly, this change should be made along with one or both of the following recommended changes, which are designed to help the capital formation problems of the unprofitable or marginally-profitable carriers which still must provide essential public transport services.

4. Permit One-Time Transfer of Investment Tax Credit, in Whole or in Part

Another solution is to permit firms which cannot themselves use the credit to transfer or sell their ITC rights to other companies. Such transferability would immediately compensate the capital investor. It would encourage investments by firms, including many in the transport industry, with large unused ITC's. This in turn should stimulate further investments.

The concept of transferability has basis in fact as well as law. A company purchasing new equipment today for the purpose of leasing it can elect to have the credit deduction pass to the user/lessee rather than keep it as owner/lessor.

A properly certified transferable credit could be sold close to its face value, because any taxpayer purchasing it would employ the ITC in lieu of cash in the payment of his taxes. Banks, investment bankers, or corporations per se would negotiate the transaction. Since the instrument would be backed by the full faith and credit of the Treasury, ITC Paper would be readily marketable.

Unrestricted transfer of unusable ITC's would eliminate the large volume of ITC's lost today by companies that must "sell" them in the form of leveraged leases, or forego the benefits entirely because of expired capture periods. The mechanism would eliminate the complex transactions and tax problems involved in leveraged leasing. Equipment users would not abandon the residuals or benefits of ownership.

Transferability is logical, straightforward, and simple to administer. It remains wholly within the business sector, which would obviate public and political concern over corporate subsidies. Also, it would directly benefit the many capital-intensive transport companies with little or no taxable income.

5. Authorize Refunds, in Whole or in Part, for Earned but Unused ITC's

The concept of refundability for application to the Investment Tax Credit is another way to stimulate capital formation, especially for unprofitable transport companies with heavy capital needs to meet their public obligations. The concept calls for removal of the requirement for tax liability to use ITC's, thus making the credit fair and equitable for all capital equipment investors.

Refundability calls for treating ITC's as credits against the firm's taxes to the extent taxes were due, with any excess credits refunded to the corporate taxpayer. The process is logical within the concept of having the Government support desirable private actions in the general public interest—as now done via subsidies, price supports, tax penalties, and other mechanisms. It is designed to correct an inequity in the present ITC program by allowing firms with heavy capital needs but no taxable incomes to share in the benefits.

The concept has gained impressive business and government support. For example, Senator Russell B. Long considered refundability initially in 1972 when studying revisions to the Social Security Law. He first proposed it in 1975 at the Senate Finance Committee's public hearings on the energy tax bill; and, in 1977, he offered a "Refund of Excess Investment Credit" amendment to the Internal Revenue Code and introduced the concept in S. 1270 as a "long overdue improvement of the investment tax credit".

In recognizing ITC's as tax subsidy incentive payments to stimulate investment by no-income companies, Senator Long said it is "time for us to urge the new Administration, our colleagues in the House and the public at large, to give serious consideration to the support of . . . eliminating this discrimination against the less fortunate in our economic society. The correction of this discrimination is long overdue."

Refundability of unused ITC's was endorsed by the Ford Administration in 1974, when it recommended full refundability after a three-year period. The White House Fact Sheet of October 8, 1975, said the proposal would:

> ". . . Help growing companies which have present investments which are large in comparison with their current incomes."
>
> ". . . . Help companies in financial difficulties, which get no benefit from the credit because they have little or no income tax liability against which to apply it."

". . . Help small businesses, which under present law are more severely affected by the restrictions and limitations."

Senator Stevenson introduced a bill in 1976 to treat expired unused investment credits as refundable overpayments of tax. S. 3080 was drafted, he said, "to make the investment credit more effective and fair by correcting a serious deficiency in its application." The Senator noted a precedent in the Senate Finance Committee's approval of refundable credits for expenditures for certain home insulation and solar and geothermal energy equipment, in July, 1975. He called the present ITC program "inequitable and counterproductive . . . when businesses make investments in reliance on the credit only to find that circumstances subsequently preclude its availability." He also said refundability would "make the credit a more effective device for stimulating investment in those sectors of the economy most seriously affected by the recession."

Another supporter of refundability and of Senator Long's amendment has been Senator Edward M. Kennedy. In a July 1, 1977, "Tax Reform Statement," Kennedy praised the ITC as "the most effective tool (of the last 15 years) to stimulate investment in productive capital assets." But he noted shortcomings in the credit's ineffectiveness and the exclusion of certain companies from ITC benefits. Endorsing refundability as a major improvement in that law, he said such a change would "structure the credit in a fairer manner and insure that many who could make significant investment are not discouraged from doing so by the artificial limits now contained in the credit mechanism."

The Senator cited a number of advantages of refundability, stressing that the primary advantage would be its effectiveness. These advantages include:

Effectiveness: "To be effective, an investment stimulus must be understandable by business and must have the confidence of business. I agree with the Treasury that our best economic stimulus is provided by a strengthened investment credit—but strengthened to help those businesses and institutions that will be most encouraged to increase investment and create new jobs. We should take advantage of our fifteen year experience with the investment credit, rather than spending time and effort to develop a new program as proposed by the House."

Simplicity: "The existing investment credit is already in place. It is well understood by business and the Internal Revenue Service. Adopting the proposal to make the credit refundable will not trigger another round of complex statutes and regulations, followed by more complex regulations in the never-ending chase between Congress, tax lawyers and the IRS."

"Ease of Administration: A refundable investment credit will also be much easier for the IRS to administer than either a new jobs tax credit in the House bill or the Administration's Social Security payroll tax credit. The government regulations that are required to implement a totally new program would be vastly reduced by simply modifying the existing investment credit. Moreover, the IRS personnel are already trained to audit and oversee the investment credit. The refundable investment credit is clearly superior to the House or Administration proposals in this respect."

"Equity: Finally, a refundable investment credit would significantly improve the equity of a major tax program already on the books. The House proposals for a new jobs tax credit and the Administration's Social Security payroll tax credit simply introduce new sets of inquiries into our tax system."

Senators Long and Kennedy called on President Carter in August, 1977, to include ITC refundability in the Administration's forthcoming tax program. They noted the "unfairness and potential discrimination to non-profit making concerns under the current law", who must pay a "surcharge" for capital equipment.

Opponents to refundability term it a drain on funds. But supporters note that present tax laws do not provide proper or fair allocation of benefits, and they say the burden should not fall upon an arbitrarily selected group, such as capital-intensive companies. In other words, transportation companies are among those most discriminated against by the present ITC system.

There are a number of ways to improve the investment tax credit program, but a combination of changes such as proposed above will be the best approach.

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William J. Quinn, Chairman and Chief Executive Officer, Chicago, Milwaukee, St. Paul & Pacific Railroad Company, Chicago, Ill.
C. B. Ramsdell, Vice President–Group Executive, Railway Products Group, Westinghouse Air Brake Company, Pittsburgh, Pa.
John S. Reed, Chairman and Chief Executive Officer, The Atchison, Topeka & Santa Fe Railway Company, Chicago, Ill.
James E. Reinke, Vice President–Government Affairs, Eastern Airlines, Inc., Washington, D.C.
W. Thomas Rice, Chairman of the Board, Seaboard Coast Line Industries, Inc., Richmond, Va.
Ronald G. Ross, Senior Vice President, Bank of America, N.T. & S.A., Los Angeles, Calif.
Paul Schuster, Chairman of the Board, Schuster Express, Inc., Colchester, Conn.
Henry E. Seyfarth, Seyfarth, Shaw, Fairweather & Geraldson, Chicago, Ill.
Richard F. Small, President, Union Mechling Corporation, Pittsburgh, Pa.
R. R. Smith, Chairman and Chief Executive, Smith's Transfer Corporation, Staunton, Va.
W. K. Smith, Vice President—Transportation, General Mills, Inc., Minneapolis, Minn.

Wilbur S. Smith, Chairman and Chief Executive Officer, Wilbur Smith and Associates, Columbia, S.C.
William I. Spencer, President, Citibank, New York, N.Y.
William F. Spitznagel, Chairman of the Board and President, Roadway Express, Inc., Akron, Ohio.
Edwin F. Stadelman, General Traffic Manager, J.C. Penney Company, Inc., New York, N.Y.
W. Stanhaus, Chairman and Chief Executive Officer, Spector Industries, Inc., Bensenville, Ill.
Stoney M. Stubbs, Chairman of the Board, Frozen Food Express, Inc., Dallas, Tex.
L. D. Thomas, Vice President—Operations, Planning & Transportation, Amoco Oil Company, Chicago, Ill.
Richard L. Thomas, President, The First National Bank of Chicago, Chicago, Ill.
Robert E. Thomas, Chairman of the Board, MAPCO, Inc., Tulsa, Okla.
George F. Tidmarsh, Vice President, Physical Distribution and Transportation, Sears Roebuck and Company, Chicago, Ill.
Kenneth L. Vore, Vice President—Traffic and Transportation, United States Steel Corporation, Pittsburgh, Pa.
Charles J. Waidelich, Cities Service Company, Tulsa, Okla.
Michael J. Walsh, Jr., Vice President—Transportation and Distribution, St. Regis Paper Company, New York, N.Y.
Hays T. Watkins, Chairman of the Board and President, The Chessie System, Cleveland, Ohio.
Bennett C. Whitlock, Jr., President, American Trucking Associations, Inc., Washington, D.C.
George K. Whitney, Partner, Massachusetts Financial Services Company, Boston, Mass.
H. Dillon Winship, Jr., President and Chairman of the Board, Georgia Highway Express, Inc., Atlanta, Ga.
Frederick C. Witsell, Jr., Vice President, Morgan Guaranty Trust Company, New York, N.Y.
Hugh E. Witt, Director—Government Liaison, United Technologies Corporation, Washington, D.C.

STATEMENT OF GERALD W. PADWE, ASSOCIATE NATIONAL DIRECTOR—TAX SERVICES, TOUCHE ROSS & CO.

To the Chairman and Members, Committee on Finance:

On behalf of Touche Ross & Co., a major international public accounting firm, I am privileged to present our views on the capital gains aspects of HR 13511, the 1978 Revenue Act, now under consideration by your Committee. We have reviewed the bill, as passed by the House of Representatives, both in a conceptual and technical framework; and would like to present comments in both areas.

As tax advisors and consultants, we wish to lend our strong support to the important steps which Congress is now taking to restore some of the entrepreneurial incentives in our tax system via the treatment of capital gains. In working with our clientele—which includes any number of small businesses and middle class individuals, as well as large corporations—we have become highly sensitive to the "lock-in" effect caused by the last ten years of increasing capital gain taxes at the same time that inflation has extracted an increasingly heavy toll on the purchasing power of the dollar. Financial and family planning decisions, which should go one way on a scale of human values, are forced in other directions because of unwillingness to incur substantial taxes on a lifetime accumulation of both real and inflationary "gains."

We are distressed at the unwillingness of the Administration to recognize the potential value to the economy of real capital gain reform. President Carter, commenting on the proposal by Representative Jones to scale back the top capital gains rate to 35%, stated at his Ju[illegible] 26 news conference that the proposal would result in "huge tax windfalls for millionaires and two bits for the average American." Secretary Blumenthal, appearing before this Committee's Subcommittee on Taxation and Debt Management two days later referred to S. 3065 (the Hansen-Steiger capital gain bill) as "a millionaire's relief bill, and I mean income millionaires". Such comments generate widespread media coverage,

insuring that they are likely to be heard and read, if misunderstood. It is less clear that they should be taken as accurate for purposes of dealing with the economic problems of the country.

We believe capital gain tax relief is important in our present economic posture, but we have in mind much more than just a short term impact on tax revenues. We think it would be most healthy to reverse the lock-in effect of our present capital gains structure, and we would particularly like to see entrepreneurial incentives revitalized in our capitalistic social structure. While we are not economists, and have no detailed tables or models to present, we feel it inevitable that the longer range effects of capital gain reductions must include the stimulation of new enterprise development, along with the additional jobs that such stimulus will produce.

Further, HR 13511 is not a "millionaires relief bill." We believe Mr. Blumenthal's testimony before this Committee on August 17, when he testified specifically with respect to HR 13511, was most persuasive on this point. He was discussing the graduated corporate rate structure and its impact on tax equity—but his written statement (page 14) contains some interesting lessons for us on the subject of capital gain reform: "The principal beneficiaries of the House provision [concerning graduated corporate tax rates] are individual owners of closely-held corporations—persons who are generally in higher income brackets than the owners of publicly-held companies. . . . In a group of tax returns studied by the Treasury Department, the average income of shareholders in closely-held corporations exceeded $50,000. By contrast, *the average income of all individual shareholders receiving corporate dividends was about $25,000.*" (Emphasis supplied.)

Thus, the average shareholder in a publicly-held company is what would be called, in our present inflationary economy, middle class. Many such taxpayers can wind up paying minimum tax on capital gains under today's rules. And, such taxpayers may be just as locked in to investments or businesses as the wealthiest taxpayer, due to the present structure of this aspect of our tax system.

Opponents of capital gain tax reduction point out—accurately—that there is no capital gain tax without some actual "gain," and they argue from there that the nature of the income calls for no distinction in our tax laws. We cannot agree. As illustration, Professor Martin David of the University of Wisconsin was quoted in the August 7, 1978 issue of Tax Notes (page 131) as having stated the following in "recent Senate testimony": "Much misplaced sympathy is bestowed on recipients of capital gains. Capital gains accrue on wealth. Recipients of such gains have wealth. . . . No crocodile tears need to be shed for the taxpayer who realizes the $40,000 gain on his residence, or his stock, or his small business. The fact is such gains represent success, and the accumulation of gain merely reflects the fact that the government is tardy in keeping its records straight with taxpayers who have wealth or property rights."

While individuals realizing capital gains may have "wealth" in a technical economic sense, statements such as the above fail to differentiate between economic wealth and financial wealth, and they certainly do not recognize taxpayer psychology. Regardless of the merits or demerits of indexing capital gains, the fact remains that a tax on capital gain is—in part at least—a tax on inflation, and the longer the holding period the larger the percentage of tax likely to be based on inflation. That is not "wealth" in the financial sense, nor is it a recognition of "success."

Further, we believe the argument is misplaced that the government is merely being "tardy" in maintaining its accounts with taxpayers, thus allowing an accumulation of wealth. It must be recognized that, given the complexity of our tax laws and—perhaps more important—the nature of human psychology, it would take a tremendous amount of training and discipline to persuade individual taxpayers to begin putting away money on accrued gains today for a tax that may have to be paid some years down the road when a business or a house is sold (particularly given the fact that the current accrual of "wealth" may be on paper only). We would discard this line of reasoning and argue instead that the capital gains tax is perceived, in good faith, by many who pay it as a penalty tax on inflation that actually may leave them in a worse position with respect to purchasing power than had been the cause before the gain was realized.

Attached, as Exhibit A, is a graphic representation of maximum marginal rates of tax on individuals deriving earned income, unearned income, and capital

gain income for the 25 years of the 1954 Internal Revenue Code. We believe it is instructive to note the manner in which the maximum capital gain rate has been approaching the maximum rate on both earned and unearned income since 1969; in fact, under the original Administration proposals (presented in January of this year), the maximum capital gain rate would have actually become higher than the maximum rate on earned income, while continuing to approach a further declining maximum rate on unearned income.

We believe that the combination of the effects of inflation (particularly for assets held over a period of years) and the rapid proportionate increase of maximum capital gain rates vis-a-vis maximum rates on earned or unearned income (Exhibit A) over the past decade, has played an important role in our recent history of inadequate capital formation. Accordingly, we strongly support congressional efforts to reverse this trend, and we urge this Committee to continue the steps begun by the House.

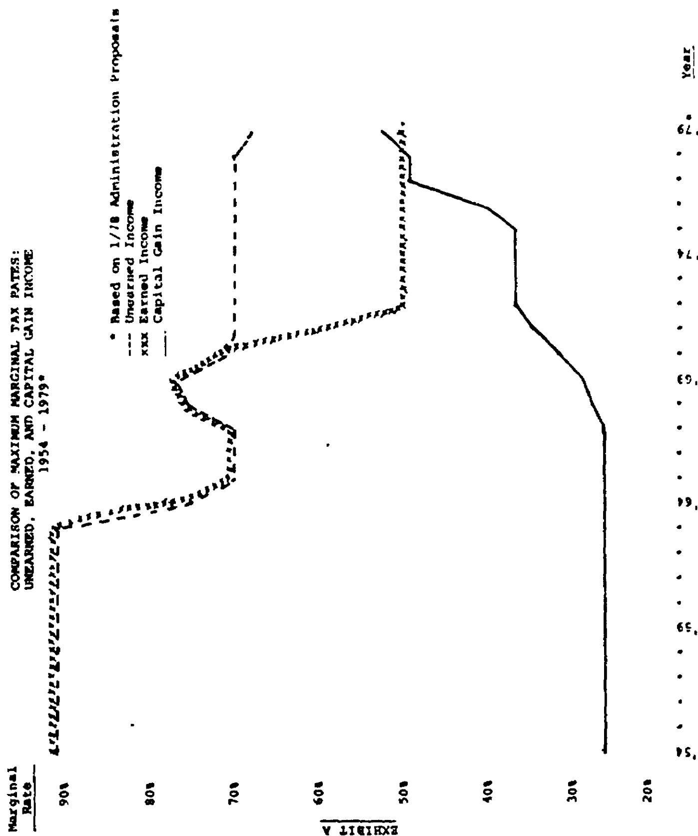

EXHIBIT A

We have some thoughts as to specific aspects of the House bill, which we would like to share with you.

Repeal of alternative tax

For all the reasons set forth above, it would be a mistake to repeal the alternative tax on the first $50,000 of long term capital gains. This alternative tax is one of the few capital formation incentives remaining in the tax law today; its repeal goes absolutely contra to the goals Congress seems to have in mind, and would create an additional disincentive to capital market investment and dynamics. In fact, even recognizing the difficulty of obtaining accommodation of many differing interests and viewpoints to put together a tax bill in the House; we are troubled that, at a time when lack of capital formation has been recognized as a major economic problem, the House would have taken such a step. We urge this Committee to undo it.

Alternative minimum tax

In view of our comments above, and with reference to Exhibit A showing how the so-called minimum tax has had the effect of doubling capital gains tax rates in the past decade, we believe the present economic needs of this country would be best served by not imposing a "minimum" tax on capital gains at all. Recognizing, however, the political perception that some tax should be paid by individuals who shelter even the 50% of net long-term capital gains that is subject to regular tax, our strong preference would be for the 10% alternative minimum tax on HR 13511 over the graduated rate approach recommended by the Administration on the House floor earlier in August and in Secretary Blumenthal's testimony to this Committee on August 17.

One problem with the alternative minimum tax concept is that it was developed to penalize taxpayers who "shelter" income through utilization of current deductions—normally of an investment type nature. What is often not recognized, however, is that tax shelters tend to accomplish tax deferral and not tax forgiveness; there is still no such thing as a free lunch. Further, in light of the 1976 Reform Act rules—particularly as those rules are proposed to bestrengthened in this 1978 bill—a taxpayer putting up the funds which will give rise to a current deduction, is very much at risk on those funds, with the potential of losing them all. We are not convinced that this is appropriately the basis for what can only be a penalty tax on the current recognition of capital gains. In addition, the way H.R. 13511 is worded (as well as under the Administration proposal), no deduction would be made as to the imposition of this penalty on an individual investor sheltering his income and an individual proprietor who may have suffered true business losses in the year while, at the same time, recognizing completely unrelated capital gains. Each is equally subject to the alternative minimum tax.

Secretary Blumenthal, in his August 17 testimony, used for illustration an individual with $2.2 million of capital gains, incurring $1.1 million of shelter losses to eliminate all regular tax liability. In arguing for the Administration approach of a graduated alternative minimum tax, he pointed out that under present law this individual would pay a minimum tax of $161,000; under H.R. 13511, the alternative minimum tax would be $108,000; but under the graduated approach proposed by the Administration, the "true alternative tax" would be $346,000. This, according to the Secretary, would "provide a much more reasonable minimum tax liability" for this individual.

We think not. While the Administration dwells on the fact that the individual has "sheltered" $1.1 million of gain and should therefore pay a penalty, we believe it should be recognized that he has taken $1.1 million of his money and put it at risk into the economic system. If, on the one hand, he loses that investment, he will not recover the $346,000 "true alternative tax" he paid, and this truly becomes a penalty against his capitalist efforts. On the other hand, if the investment proves to be a vood one, his recovery in the future will likely be at unearned income rates, subject to a 70 percent maximum tax (on top of the $346,000 he has already paid as a penalty). Under these circumstances, we see little basis for boasting that the approach recommended to you on August 17 would increase the alternative tax to 16 percent rather than 7.4 percent under current law or the 5 percent under H.R. 13511, merely because of the timing of taxpayer's deductions.

There is another reason we oppose the Administration approach to the alternative minimum tax. This tax is, in effect, a graduated one not because of the imposition of particular tax rates, but because part of the section 1202 deduction

for long-term capital gains becomes disallowed. In our judgment, the possible elimination of tax deductions should not be permitted without consideration of the state tax impact of such a decision—particularly where the real purpose behind eliminating the deduction is to avoid the complexity of setting up a graduated rate table on certain capital gains. At present, 28 states adopt federal taxable income as their tax base for individuals (subject to particular adjustments that a given state may have). Thus, adoption of the Administration approach to an alternative minimum tax would automatically result in increasing state taxable income in those 28 states for taxpayers subject to the tax.

This is not the place for an extended discussion of the combined federal-state-municipal tax burden borne by the American taxpayer. Volumes could (and perhaps should) be written on the subject, particularly given the apparent discontent in our country today with the level of taxation. Our position is that the federal government should not enact, without the most careful study, legislation that not only affects the federal tax burden of its citizens but automatically raises the states tax burden as well. This would certainly be the result of the Administration approach to the alternative minimum tax.

The same would not be true for the House-passed version of H.R. 13511. There, the alternative minimum tax is handled as a tax rate adjustment with no effect on taxable income. If it is appropriate to have an alternative minimum tax, we believe the House approach (using the rate structure) is far more appropriate than the Administration approach (adjusting taxable income).

Even in the House bill, we believe there is a technical flaw in the alternative minimum tax provisions which we would ask your Committee to correct. Under the House bill, the alternative minimum tax is imposed to the extent that it would be greater than the "regular" tax. Regular tax is computed before the 15 percent minimum tax on remaining tax preferences (no longer including capital gains) but after reduction for the amount of nonrefundable credits available, such as the investment tax credit, the foreign tax credit, etc. And, as pointed out by the Ways and Means Committee report on H.R. 13511 (House of Representatives Report 95–1445, August 4, 1978, p. 123), where the alternative minimum tax exceeds the regular tax, nonrefundable credits are not to be allowed to reduce this alternative tax. "This rule is designed to assure that each taxpayer, in fact, pays some minimum amount of tax with respect to capital gains", according to the Report.

Consider a taxpayer whose regular tax would be $5,000 and who has no investment credit or foreign tax credit in the current year. If he had incurred $130,000 of long-term capital gain during the year, his actual tax would be $5,500 under the House bill: [(One-half of $130,000)—$10,000]×10 percent.

Consider another taxpayer with the identical set of circumstances as the first, except that his operation also generated a $1,000 investment tax credit and $500 of foreign tax credit. Thus, his "regular tax" as defined by the House bill, would be $3,500. However, the 10 percent capital gain tax would still be $5,500, so the excess of the $5,500 over the $3,500 is taxed to him as an alternative minimum tax.

As we read HR 13511, the second taxpayer is paying an alternative minimum tax of $2,000 (the excess of the special tax on capital gains over his regular tax). The first taxpayer is paying an alternative minimum tax of $500. While each taxpayer has the same liability, the technical computation of the tax leads to the conclusion that the second taxpayer has utilized $1,500 of credits, even though he has received no benefit from them, and these credits are not available for carryback or carryover to another year. This strikes us as a highly unfair result, and one that should not be imposed.

The House Ways and Means Committee apparently agrees that the above result would occur. On page 123 of their Report, it is pointed out that credits may be carried back or carried over to other years if they are in excess of the regular tax limitations, thus inferentially recognizing that they may be lost where they are not in excess of these limitations and would be used in the current year but for the alternative minimum tax. Further, on the same page it is pointed out that "for alternative minimum tax purposes, there is no prerequisite that capital gains actually produce a tax benefit for the taxpayer." In the second illustration cited above, we believe it is wrong for the taxpayer to lose—purely through the mechanics of computation—benefits of credits that other taxpayers can carry back or carry forward, merely because the first taxpayer generated disproportionately high capital gains. This is no longer a matter of capital gains producing or not

producing a tax benefit, but of capital gains' existence denying taxpayer of other benefits to which he should be entitled.

We urge that this part of the House alternative minimum tax computation not be adopted.

$100,000 Exclusion on sale of residence

Few costs have risen as rapidly over the past number of years as those of housing—due both to inflation and real cost increases. We believe that the approach taken in the House bill, to significantly increase the amount of exclusion permitted once in a lifetime on the sale of a principal residence, and to remove the age restrictions of present law, is a most meaningful step and one which should be supported. There is, however, one aspect of the provision which warrants further attention by this Committee.

It is our conclusion that the present wording of this particular section is a triumph of form over substance. Thus, the exclusion can only be claimed on a single sale, and it is valid for up to $100,000 of gain if the residence sold was used as a principal residence in two of the prior three years. However, as a practical matter, much of the excluded gain may really be from the sale of prior homes regardless of for how long a period of time they were actually used as a principal residence. This result, of course, comes about because of the present rollover provisions in which a taxpayer defers gain on the sale of *any* principal residence at the expense of correspondingly reducing the basis of his next principal residence (assuming replacement within statutory time limits). Therefore, a 55-year-old taxpayer may purchase a home for $110,000, use it as his principal residence for three years, and sell it for $140,000. Despite the fact that his purchase price was $110,000, his tax basis in the home may well be only $40,000 because, on prior sales of homes during his lifetime, he has deferred $70,000 of gain on those sales by the application of present rollover provisions. Since he now literally meets the requirements of H.R. 13511 as to holding period and usage, he may exclude from income the entire $100,000 of tax profit on the sale of his present home despite the fact that $70,000 of the profit really arose from the sale of prior homes. (It might be noted here that Chairman Ullman of the Ways and Means Committee was queried specifically as to the "tacking on" of prior gains when he appeared before the House Rules Committee, and he assured the Rules Committee that the above result was exactly the intention of this legislative drafting.)

We are not quarreling with the inclusion of prior gains in applying the $100,000 exclusion rule; what we do find confusing is why, given this intended effect, the result should not be achieved by permitting the exclusion (rather than the deferral) of up to $100,000 cumulative lifetime gain on the sale of any principal residences. Such an approach should alleviate one problem we can foresee with the present House bill, and that is a concern with obtaining the $100,000 exclusion prior to death.

If this provision of H.R. 13511 is enacted as passed by the House, we anticipate that most taxpayers will avoid exercising their election to obtain the exclusion until their lifetime cumulative gains on sales of residences exceeds $100,000—there seems little point in making the election to cover a cumulative gain of $70,000, since only one election can be made in a lifetime and $30,000 of future exclusion would be lost. However, countering this line of reasoning is one that recognizes that the election is personal to a taxpayer and will be cut off by death. The competition between these two theories, we believe, will create unhealthy pressures aimed at tax minimization with, perhaps, some unfortunate financial or family planning decisions being made.

To illustrate, consider two taxpayers, both of whom contract on July 1, 1979 to sell their homes for tax gains of $100,000 each, and the closing takes place in each case on August 31. The first taxpayer dies on September 1: the sale occurred before his death, his executor can presumably elect the exclusion, and his heirs receive the proceeds of the sale free of tax. The second taxpayer is unfortunate enough to die August 29, before the closing: he has not made an election prior to death, it is lost and, thanks to the carryover basis rules, his executor will have to pay capital gain tax on the $100,000 gain before the proceeds are distributed to the heirs.

The above illustrates why we believe the House bill provision on this subject to be a triumph of form over substance. We see no social or economic value to the gambling that is likely to go on as taxpayers seek to maximize their prin-

cipal residence exclusions but to obtain them before death even to the point of intrafamily sales or sale-leasebacks by elderly homeowners seeking to avoid tax on $100,000 of capital gains. In fact, it is not beyond the realm of possibility that this Committee could be asked to consider—a few years from now—corrective legislation to negate the obtaining of $100,000 exclusions through "sales in contemplation of death."

To avoid these pressures, we would recommend two changes in HR 13511, concerning the lifetime exclusion. First, rather than a one-time exclusion, we recommend that taxpayers be permitted an unlimited number of exclusions until their cumulative excluded gain reaches $100,000. Having excluded the bulk of $100,000 over the course of a lifetime, there would be less pressure in later years for artificial transactions to obtain the benefit of a potentially lost, say, $20,000 remaining exclusion as opposed to a potentially lost $100,000 exclusion. This approach does cause some administrative difficulties; unlike the present rollover provisions, the exclusion accounting burden falls on owners of a residence (through their personal exclusions) rather than the residence itself (through adjustment of tax cost), and this means that adjustments have to be made with respect to an individual taxpayer's "exclusion account" where divorce occurs, where marital status goes from single to married, etc. We believe the Secretary could be required to provide regulations for these purposes, and that the increased administrative complexity is more than offset by the economic ends being served.

Second, we believe the holding period requirements are inappropriate. As discussed above, much of the gain eventually being excluded may come from sale of prior residences on which there is no holding period requirement at all. Since the gain "tacks on" under HR 13511, we feel that if a holding period requirement is considered important, the ownership period of each residence whose gain is eventually to be excluded should also tack on in meeting the holding period standard. It is completely inconsistent to impose a holding period requirement for only the last residence sold, while the excluded gain may pertain to homes that were owned over many years.

Accordingly, we recommend changing the House bill to permit the tacking on of holding periods from prior residences, if a holding period requirement is considered at all. We would further point out that this same inconsistency exists under present law, under which Code Section 121 requires use of the particular property as a principal residence for five out of eight years, even though the excluded gain may relate back to properties held many years before. Even were Congress to take no action this year on a $100,000 lifetime exclusion, it would be appropriate to amend the present Section 121 to remove this inconsistency.

TECHNICAL SYSTEMS INCORPORATED,
Pryor, Okla., August 17, 1978.

Mr. MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR MR. STERN: I wish to go on record in support of an increase in the tax exempt limits on Industrial Development Bonds.

Thank you,

GERRY K. BOYD, *President.*

FOREST CITY, IOWA, *August 21, 1978.*

MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SIR: I have learned that the Ways and Means Committee has okayed the Jones-Ullman compromise tax bill. Part of the provisions is the one shot exemption for sellers of any age of up to $100,000 of gain on the sale of the principle residence. The effective date of this one shot exemption would be to sales starting after July 27, 1978.

I feel that the effective date of this exemption should be January 1, 1978, as it penalizes those who sold prior to July 27, and it is a windfall to those who sell after that date.

Yours Very Truly,

JOHN C. THOMPSON.

STATEMENT OF WILLIAM J. NOLAN, JR., CHAIRMAN OF THE COMMITTEE ON TAXATION OF THE UNITED STATES COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE

This statement is being filed for the record on behalf of the United States Council of the International Chamber of Commerce by William J. Nolan, Jr., Chairman of the Committee on Taxation of the Council. The U.S. Council membership is comprised of most of the major business firms in the United States engaged in foreign trade and foreign operations. It represents American business interests within the International Chamber, which in turn represents the international business community in approximately 60 countries. Our Committee on Taxation has had the privilege of presenting its views on tax matters to the Committees of the Congress on many occasions.

Not long ago, the United States economy and American corporations were regarded by those outside the U.S. as the preeminent forces of the free world economy. The strength and confidence exhibited by and in the U.S. economy were crystallized by the role of the U.S. dollar in the international monetary system as the benchmark currency for all international trade and investment.

Similarly, the growth of U.S. corporations throughout the free world contributed to U.S. dominance in the international marketplace, prompting the publication of "The American Challenge" [1] in 1967.

Today, the atmosphere is much changed. The plummeting dollar reflects an international view that fundamental weaknesses are afflicting the U.S. economy, thus lowering the confidence in the worth of our currency. A recent survey [2] showed that even within the U.S. there is less business confidence than in almost all the other industrialized countries. "The European Revenge" [3] published in 1975 and the "Continental Challenge" [4] written in 1978 both indicate that U.S. corporations have suffered losses to foreign competitors in the international marketplace.

Although the U.S. economy is still the strongest and largest in absolute terms, its position relative to the rest of the world is declining. The free market ideology upon which its leadership was based is being questioned by calls for protection from not only producers in developed countries but less-developed countries as well. Impediments constraining the international free flow of trade and investment are being discussed and implemented despite the ultimate weaknesses inherent to such measures of inhibiting competition. In this environment, the impact of U.S. foreign direct investment on the U.S. economy has again entered the public light.

TERMINATION DEFERRAL

It has been often suggested that the Internal Revenue Code be amended to provide for the immediate U.S. taxation of all income earned by U.S. controlled foreign corporations (broadly as defined in the Subpart F provisions). Such a proposal would establish a new and unique principle which would in effect ignore the existence of separately incorporated entities. Consequently, the income of each foreign subsidiary would have to be recomputed in accordance with U.S. tax principles and subjected to U.S. tax with the foreign tax credit allowed broadly as heretofore.

This proposal will yield no discernable benefits to the U.S. Treasury and will generate conflicts with our trading partners. It will reduce tax neutrality by making U.S. business less competitive abroad (especially the small and medium sized firms) and will generate disproportionately large and unproductive compliance costs to all U.S. business operating abroad through foreign subsidiaries.

Such proposals are basically faulty for the following reasons:

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[1] Servan-Schreiber, J. J. "The American Challenge," New York: Atheneum, 1968.

[2] Silk, L., The New York Times, February 14, 1978, p. 51.

[3] Heller, R. and Willat, N. "The European Revenge," New York: Charles Scribner's Sons, 1975.

[4] Economist, "The Continental Challenge," pp. 78–79, February 4, 1978.

1. The revenue yields would be minimal estimated by the Treasury in connection with the President's proposal to the House of Representatives ($88 million in 1979, rising to $768 million in 1981, the first full impact year).

2. The principle of currently taxing the income of foreign subsidiaries of U.S. corporations could be viewed by some foreign governments as an improper intervention in the affairs of a local entity, thereby inviting possible retaliation of various kinds by foreign governments. That treatment would increase the cost of foreign withholding taxes to U.S. taxpayers and would require the U.S. Treasury to renegotiate virtually all our tax treaties. The renegotiation of our treaties would be time-consuming and costly.

3. Since no foreign country imposes its taxes on the undistributed earnings of foreign subsidiaries, subsidiaries of U.S. corporations would be at a disadvantage with their foreign competitors as regards the acceleration of U.S. taxes. This would impact the cash flow and competitiveness of smaller and new companies even more than existing established firms. Consideration also must be given to the cost of complying with a new law.

4. The additional tax burdens and compliance requirements would in effect be a penalty on U.S. business abroad, in conflict with existing U.S. tax policy that the U.S. tax system should be neutral.

5. There would result a great increase in the complexity of an already overly complex Internal Revenue Code, which is contrary to the often announced aim of simplifying the tax laws.

Overview

The proponents of terminating deferral refer to the deferral principle as though a foreign corporation is in substance taxed differently than is a U.S. corporation. The income of a foreign corporation is first taxed in the source country, and when that income is distributed as a dividend to its U.S. parent corporation, it is subject to U.S. corporate tax (with foreign tax credit relief). Similarly, the income of a U.S. corporation is subject to U.S. tax and that income is not taxed again while it remains within the corporate group. In both cases, corporate income is again taxed when it is distributed to the utlimate shareholders of the U.S. parent company. Under internationally accepted tax principles, income earned by a separate juridical entity is not taxed to its shareholders until received by them. This has been a basic underlying tenent of the U.S. tax system since inception and is reflected in the treatment of domestic shareholders of domestic corporation.

A foreign subsidiary of a U.S. corporation is legally a separate juridical person created under laws of another sovereign nation. Such a subsidiary is required to conform to the tax rules and regulations of the country under whose laws it was created and in which it conducts business activities. It has no responsibilities or obligations under the tax laws of the United States. In this connection, it is the foreign country in which the subsidiary is incorporated and operating, not the U.S., which provides the basic governmental services expected by the juridical persons of any sovereign state. Although the U.S. parent company of a foreign subsidiary has many obligations under our rules of law and customs, such obligations arise by reason of its separate existence as a U.S. corporation.

To the best of our knowledge, no country has ever instituted a policy which subjects to tax its resident taxpayers on the business operations of foreign subsidiaries. In fact, many major industrial countries (e.g., France and the Netherlands, Germany and Canada, in part) have territorial tax systems under which earnings of foreign subsidiaries are never subjected to home country taxation, in recognition of the principle that a host country should have the first and primary right to tax income earned within its boundaries.

Other countries of the world recognize and abide by the concept of separation of corporations and their shareholders. The recognition of legal forms and contracts is in the national interest of the U.S., as an exporter of goods, services and capital with substantial business investments located abroad. The extension of U.S. taxing jurisdiction to foreign income of foreign subsidiaries may well invite some form of retaliatory action by other foreign countries. For one thing, such unilateral action on the part of the U.S. would run counter to the philosophy embodied in our network of double taxation treaties. The renegotiation of these treaties would be a time-consuming and costly effort for our government, as our recent record in the treaty area shows. The U.S. has about half the number

of tax treaties as countries such as France. None were concluded in 1977. In 1975 and 1976 we concluded treaties with only four countries: Iceland, USSR, Poland and Romania. Thus, for the three years, 1975–77, we have not had a single treaty with any of our major trading partners become effective. What shape other retaliatory acts may take is speculative at best, but the seeds therefor will be sown if the U.S. proceeds to legislate in this direction. At the very least, it will result in increased foreign taxes to the extent additional foreign dividends are repatriated to meet additional U.S. tax costs. This will impact smaller and newer companies more severely because they are less likely to be able to offset the U.S. tax with foreign tax credits from other operations.

To restrain U.S. corporations or to place them at a disadvantage vis-a-vis their foreign competitors in the international market place would only add to their declining presence. An article in a recent international publication stated that "The Americans' international competitive position, as measured by their relative size in main industries, has been eroded in almost every sector. The rate, and, by some indicators, the volume of the expansion of European, especially continental European, firms into foreign manufacturing came to be higher than that of the American ones."[5] The U.S. decline has been experienced in thirteen major industrial sectors between 1959–1974 as non-U.S. multinational firms have conquered larger shares in these basic markets. Concurrent with the rise of non-U.S. firms' positions in the various sectors of the international market place was the increase in foreign direct investments made by these non-U.S. multinationals. Competitive factors and artificial barriers have prompted this type of investment by both U.S. and non-U.S. multinationals. Included among the causes are lower transportation costs, closeness to a market to assess its needs and to provide follow-up services, restrictive import duties, local content requirements, governmental procurement practices, on-site inspection requirements, lower production costs and proximity to needed raw materials.

Further weakening of the U.S. market-share in "thirteen basic industries" of the global economy, is in itself contrary to the health of the U.S. economy. For example it would result in the loss of benefits gained from the economies of scale in producing the capital equipment, complementary products and components which are now exported to U.S. foreign affiliates, the positive "trade balance" associated with foreign direct investment would be lost, and the benefits derived from corporate research and development effort would be diminished because the available returns from which to finance the effort and the expected returns from the effort would be smaller, given smaller markets and lower margins. These factors were important to the previous health and comparative advantage enjoyed by the United States in the eyes of the rest of the world.

To analyze the impact of U.S. foreign direct investment on the U.S. economy, it is necessary to look closely into to areas, employment and balance of payments, which are of acute concern to those attempting to solve the economic problems of the day. Many studies have been done highlighting these issues, however, none have empirically satisfied all parties. The preponderance of evidence resulting from this multitude of studies does support the position that U.S. foreign direct investment is beneficial to the U.S. economy. There exist government sources which clearly state this, e.g., the Tariff Commission's 1973 Report to the Senate Committee on Finance on Multinational Enterprises which found by using there sets of assumptions, ranging from "static" to "more realism," 1.3 million jobs lost to 500,000 jobs gained. The same study states that MNCs have had a net positive effect on the "basic balance" of the U.S. balance of payments, whereas "non-MNCs in the private sector, on the other hand, showed a deterioration. . . ."[6] Dr. Rolf Pickarz of the National Science Foundation summarized the findings of a NSF sponsored colloquim[7] on U.S. foreign direct investment in the following manner. "The available information, though incomplete, suggests that the United States, on net, benefits from [U.S.] foreign direct investment."

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[5] *Supra* note 4.

[6] The U.S. Tariff Commission, "Implications of Multinational Firms for World Trade and Investment and for U.S. Trade and Labor." Report to the U.S. Senate Committee on Finance, (Washington, D.C. 1973) vol. 1, pp. 6–8.

[7] National Science Foundation Colloquim on "The Effects of International Technology Transfers on the U.S. Economy," October 1973, p. 4.

With this type of evidence it is hard to understand the difficulty in reaching a consensus on the economic impact of foreign direct investment. The underlying problem with all the analyses is the set of assumptions upon which the studies are based. Even though the analytical framework is often similar, studies differ in the assumption that the world economy is either a static or dynamic environment. Usually, the "static' assumption leads to unfavorable results, whereas a "dynamic" assumption yields favorable results regarding the impact on the U.S. economy of U.S. foreign direct investments.

A "static" assumption is fairly easy to picture. In essence, it assumes that what is produced and sold abroad can be produced in the U.S. and exported, so that any foreign investment displaces jobs in the U.S. and lowers the pool of capital available to U.S. labor. The "dynamic" assumption is based on changes in the market place due to competitive forces. These changes are made to remain viable by not losing position in a market to a competitor and to gain a larger share of a market in order to increase viability. The latter assumption is akin to the principles of a market economy in which competition is the best method of allocating resources and creating improvements in the general welfare by the dynamic force of growth.

A dynamic economic environment impacts all elements of an economy, including the labor market. The labor market adjustments induced by U.S. foreign investments must be analyzed as occurring within a competitive environment. Thus, decisions made to invest abroad are prompted by competitive forces to maintain, expand, or penetrate a market. If these investments were not made, the market would be lost to a competitor, presumably foreign, which would result in domestic unemployment.

A second employment effect is the job created by foreign direct investment which does not occur when an inefficient firm is driven from a market altogether. Most studies indicate that by protecting or expanding investments abroad, more jobs are created than are lost in the U.S. economy. Generally, these jobs which are created require higher skilled labor and are better paying (estimates range from $900 to $4,000 more per year than the jobs displaced).[8] This point is important for it is often overlooked in the AFL-CIO arguments favoring the restraint of U.S. foreign direct investment because the jobs displaced are usually characterized by a high degree of unionization and those created are less unionized reflecting a broader spectrum of U.S. labor force.

The adjustment process experienced in equilibrating the labor market for any reason be it an increase in productivity, increased minimum wages, higher imports, higher levels of mechanization in an industry (e.g. agriculture), or foreign direct investment is a costly phenomena, particularly for the elderly or unskilled workers displaced. The best way to mitigate the adjustment cost in the U.S. is not to protect or subsidize inefficient producers by restraining the efficient ones from competing. Rather emphasis should be placed on creating growth in the economy by encouraging efficient producers to increase their competitive activities and handling the problems which cannot be resolved by more and higher paid productive jobs with a direct assistance program. According to several studies of firms with foreign direct investments and industries which account for the majority of foreign direct investment, these firms and industries were the more effective in creating employment. A 1973 study in the Survey of Current Business[9], demonstrates that during the period from 1966–1970 U.S. employment increased in 223 U.S. based multinational firms engaged in manufacturing by 7.6 percent, whereas employment in all other U.S. enterprises in manufacturing decreased by 2.4 percent. The argument that foreign direct investments are costly in terms of induced labor market adjustments appears to be fallacious if one views the growth in employment opportunities that occur within multinational firms and industries related to foreign direct investments in relation to other firms and industries. The former far exceeds the latter in offering all types of

[8] Webbink, Elizabeth, "U.S. Foreign Trade in Manufactured Goods, 1966–70, and the Structure of the Domestic Labor Market," unpublished doctoral dissertations, New York University, Graduate School of Business Administration, 1977. Stobaugh, Robert, "U.S. Taxation of United States Manufacturing Abroad: Likely Effects of Taxing Unremitted Profits," Financial Executives Research Foundation, 1976, pp. 17–23.

[9] Survey of Current Business, October 1973, p. 27 Samples of other studies which have shown a positive employment impact within U.S. firms investing abroad include: Business International, "The Effects of U.S. Corporate Foreign Investment, 1960–1970," New York 1972; and the Emergency Committee on American Trade The Role of Multinational Corporations in the U.S. and World Economics," Washington, D.C. 1972.

opportunities for employment. The underlying reason for this is that these firms and industries are in general more competitive in both the U.S. and world economy.

The impact of foreign direct investment on the U.S. economy can only be viewed in a dynamic, competitive international framework. Under these circumstances, U.S. firms investing abroad are acting in the face of foreign and domestic pressures to serve world markets in the most efficient way possible. To some degree U.S. firms have not been able to withstand foreign competitive pressures in retaining international market shares in thirteen basic industries. As long as foreign direct investment occurs under these foreign competitive pressures, domestic employment is not harmed at any level and is increased at the professional, skilled and clerical levels. The number of jobs created in multinational firms and industries related to foreign direct investment has significantly surpassed the number of jobs created in purely domestic firms and industries. To this extent the former can be said to facilitate labor market adjustments leading to better paid jobs. To discourage foreign direct investments by eliminating the deferral provision would be of little immediate benefit to the U.S. economy from either a balance of payments or employment point of view. The longer term impact of this attempt to restrain U.S. firms from competing in an efficient manner in the international economic arena would be a significant reduction in the national welfare for all the previously mentioned benefits would be foregone as would the U.S. forceful presence in the international market place.

The Low Priority of Tax Factors in Overseas Investment

It is often stated that deferral gives U.S. taxpayers a substantial incentive to invest overseas for purely tax reasons, presumably because income from foreign investment through foreign subsidiaries is taxed on a repatriation basis. Based upon our experience, this charge is not supported by the evidence.

For example, in a 1973 study, prepared by The Conference Board on behalf of the U.S. Department of Commerce for the purpose of eliciting reasons why U.S. businessmen invest abroad, the following results were noted:

Importance of Reasons for Foreign Investment

[Mentioned by number of companies]

Reason	Number
1. Maintain or increase market share locally	33
2. Unable to reach market from U.S. because of tariffs, transportation costs, or nationalistic purchasing policies	25
3. To meet competition	20
4. To meet local content requirements and host government pressure	18
5. Faster sales growth than in the United States	15
6. To obtain or use local raw materials or components	13
7. Low wage costs	13
8. Greater profit prospects abroad	11
9. To follow major customers	10
10. Inducements connected with host government investment promotion programs	8
Total	166

The above table summarizes responses of 76 companies included in the interview sample. The importance of each reason is measured by the frequency of mention by each executive (or group of executives from a respondent company). Just over 10 percent of the sample indicated that inducements offered by host country promotional programs are a factor in their decision to invest abroad, and such inducements include financial non-tax incentives. Moreover, judging by the total number of responses, it is not unreasonable to conclude that tax factors are rarely the sole reason for investing abroad.

Available statistics as to where U.S. investment abroad is located certainly support the thesis that taxation is a minor factor in overseas investment decisions. The following chart from the 1973 Tariff Commission study, referred to above, is quite revealing:

TABLE 2.—U.S. DIRECT INVESTMENT ABROAD: GEOGRAPHIC BREAKDOWN, 1929, 1950, 1960, AND 1970

[Billions of dollars]

Area	Book value at yearend			
	1929	1950	1960	1970
Canada	2.0	3.6	11.2	22.8
Europe	1.4	1.7	6.7	24.5
Japan	.3		.4	1.5
Other developed areas		.4	1.3	4.4
Latin America	3.5	4.4	8.4	14.7
Middle East			1.1	2.0
Other less-developed areas			1.4	4.6
Unallocated	.3	1.7	1.5	3.6
Total	7.5	11.8	32.0	78.1

Source: U.S. Department of Commerce. 1970 figures are partly estimated.

One has only to glance at this chart to discern that more than half of U.S. private sector investment abroad is in the developed countries, most of which are countries with corporate tax rates at least equal to the U.S. rates and can hardly be called tax havens.

It has been contended that tax incentives to invest abroad stand in conflict with the general policy of the United States to encourage investment of U.S. capital where it will be most productive, whether in the United States or overseas. One only has to look to the U.S. capital recovery provisions (i.e., the investment tax credit and the Asset Depreciation Range system), which are generally restricted to U.S. situs assets, to conclude that U.S. tax policy is slanted in the direction of encouraging U.S. investment over foreign investment. Accordingly, it can be concluded that U.S. business would prefer, if given a choice, to invest in the U.S., but as noted above, for reasons far beyond taxation impact, must invest abroad if it is to compete on an even footing with the MNCs of other nations. Termination of deferral can only serve to injure the competitiveness of U.S. business.

Ending Deferral Will Not Result in Simplification of the Rules Relating to Taxation of Foreign Income

General comments

It is difficult to conceive how it can be seriously argued that ending deferral will simplify the rules on taxation of foreign income. On the contrary, the use of this particular argument raises a question of the credibility on the part of its proponents. In fact, the additional complexity, together with the necessary compliance burden (on both taxpayers and revenue agents), is one of the most compelling arguments against eliminating deferral.

Under present law computing foreign income of subsidiaries for tax purposes, while not easy, can be done. Present income is in large part either dividend income which has been converted into U.S. dollars or inputed income which can be readily converted into U.S. dollars at exchange rates which are readily determinable. Ending deferral would bring into being issues as to realization of income, blocked income, translation of income and taxes, and proper exchange rates.

The practical effect of such proposals is that for each foreign subsidiary, the U.S. taxpayer must (after translating all foreign currency items into U.S. dollars, as discussed below), adjust foreign income and expenses to a U.S. taxable income base. The foreign subsidiary would normally maintain its income statements as required under foreign commercial law and compute its foreign taxable income as required by foreign tax laws. In addition, the U.S. Government would require each foreign subsidiary's income and expenses to be adjusted to U.S. tax accounting standards. The following are a few examples:

1. Many foreign subsidiaries determine inventories on a basis other than LIFO, since LIFO is not permitted under the laws and practices of many foreign countries. Terminating deferral, however, might make it more desirable for foreign subsidiaries to use LIFO, although the conformity requirement would be a

serious obstacle if the subsidiary reports under local rules in connection with local borrowings.

2. Foreign depreciation schedules would have to be recast in accordance with U.S. methods and useful life, a heavy detailed computational burden for foreign subsidiary accounting personnel.

3. Pension plan contributions would require some degree of conformity to U.S. requirements. Since U.S. tax rules are quite restrictive on the structuring of pension arrangements to obtain tax deductibilities, it is unlikely that contributions to any foreign pension plan would qualify as deductions. Although this leads to inequitable results, this is the position the IRS is already taking in its audits of tax returns of German subsidiaries of U.S. corporations, although the issue in these audits is the determination of foreign accumulated profits for foreign tax credit purposes.

No matter who undertakes the required accounting burdens, the compliance costs will probably be borne by the U.S. taxpayer, since certain foreign tax authorities would disallow deductions for compliance costs necessitated by a requirement of the U.S. Government imposed upon a U.S. parent company.

Reactions of Foreign Governments

The reactions of foreign governments could be expected to take three basic forms:

A. The developing countries in Latin America, South East Asia, Ireland, etc. would be afraid of losing capital investment needed to bootstrap their developing economies. They would try to replace tax inducements with non-tax grants and loans.

B. Certain developed countries with strong economies, e.g. Canada and Germany, would be pleased to see a greater tax burden placed on U.S. owned subsidiaries in their countries because it would weaken competition from the U.S. with their local companies.

C. Other developed countries that need and welcome U.S. investment (e.g., the U.K.) would consider the proposal disruptive to long-established trading relationships. Such a reaction could result (in the tax area) in less friendly negotiations of bilateral tax treaties.

The Treasury has summarily dismissed the prospect that foreign countries will attempt to retaliate against U.S. controlled subsidiaries if deferral were terminated as it has proposed. Such retaliation might take the form of revoking eligibility of U.S. controlled subsidiaries for tax holidays and other tax incentives (e.g., accelerated depreciation), accelerating dividend withholding taxes, etc. Although it is difficult to discern whether such retaliation would occur, the possibility should not be ignored, and perhaps should be aired through discussions with officials of the governments of our trading partners, particularly in view of the tide of nationalism around the world.

In a 1976 study, prepared by a team of economists headed by Robert Stobaugh, under the sponsorship of the Financial Executives Research Foundation, the question of foreign governments' reaction to the possible termination of deferral by the United States was considered. Professor Stobaugh and his associates conducted this portion of their study through interviews with the commercial attaches of 11 foreign nations, 6 developed and 5 developing nations.

The authors admitted that none of those interviewed would speak officially for their nations; however, they were all willing to provide their personal reactions. The study reads, in part, as follows:

"Their (the interviewees) position was that attempts to tax the undistributed earnings of foreign subsidiaries would be viewed as an infringement on their country's sovereignty. The tax proposal was viewed as a vehicle whereby foreign subsidiaries could be used to impose an American economic policy on a foreign country regardless of that country's needs or national objectives, for an American policy of taxing undistributed profits would defeat the purpose of tax incentives granted by host countries. In fact, we know from past history that the United States often has extended its reach into the domain of another government to affect the activities of affiliates controlled by U.S. parents. Sometimes the U.S. government has been successful, sometimes not.

"A number of attachés suggested that a reaction of some sort by their governments to such a tax policy would be in order. This was particularly true among those from less-developed countries. They thought it possible to increase their taxes in a way that would selectively tax U.S. affiliates in order to obtain most

of the increased tax revenues that would be paid by U.S. firms as a result of placing a U.S. tax on unremitted earnings." [10]

With respect to developing nations, a U.S. tax policy which results in diverting the benefits of a lower local tax rate or a special tax exemption (or other incentive) into the U.S. Treasury is likely to invite retaliation, without the threat of an assertion by the U.S. Government of discrimination, in the absence of tax treaties with these countries. For example, Argentina presently offers tax holidays to companies operating in the southern part of the country; however, such incentives (and any other incentives offered from time to time in other areas of the country) are subject to revocation if it can be demonstrated that the benefits of the incentive redound to the benefit of the home country treasury. The other developing countries, particularly our southern neighbors in Latin America, might take similar action. If such retaliatory actions were to discourage inflowing U.S. investment, the governments of the developing nations would take steps to attract investment from other developed nations, such as the European countries, Japan and the oil rich nations of the Middle East, or offer non-tax incentives.

With respect to developed countries, our treaty partners, it has been contended that retaliatory action may well be in contravention of the nondiscrimination clauses in the relevant tax treaties. It should, however, be noted that no study has been made as to the legal status of the nondiscrimination clauses in our tax treaties.

REPEAL OF DISC

It is an important goal of our country to provide tax and other incentives for U.S. firms to increase exports and, accordingly, we oppose the repeal of DISC. Increasing U.S. exports provides more employment in the United States which, in turn, increases personal purchasing power to buy a greater variety of goods and services, thereby providing a healthy stimulus to our national economy. Certainly no country in our world today can maintain employment and prosperity as well as a favorable balance of payments without fostering its export trade. However, to be competitive in foreign markets and at the same time fill this need through domestic exports, American firms are faced with the dilemma of incurring additional costs not faced by local manufacturers and producers in those foreign markets. These cost differentials take the following forms:

1. Labor costs are frequently cheaper in the foreign market than in the United States.
2. The U.S. exporter must incur freight and insurance costs substantially greater than local manufacturers whose proximity to the market is more advantageous. Certainly the delivery costs of computerized electrical equipment manufactured in the United States and sold in Europe through a distributing subsidiary 4,000 miles away are far greater than those of a manufacturer in Hamburg, West Germany dealing in the same market.
3. An adjunct of these transportation costs are the financial costs incurred during the delivery period to the foreign market.
4. Import duties are frequently an additional cost borne by the U.S. exporter which are not faced by manufacturers and producers in the host country.
5. Where value added taxes or multistage sales are used to any appreciable extent, the general practice is to refund the taxes paid by the foreign exporter at the time of export.
6. In the case of foreign income taxes, most of the major trading nations have features in their tax laws which tend to encourage exports.

Because of these discriminatory elements, it is essential that U.S. incentives to exports, such as the tax deferral feature of Domestic International Sales Corporations, be retained in view of the stated objective of the President and the present administration to foster U.S. employment and maintain a favorable balance of payments.

The U.S. Treasury has indicated that the revenue cost of the DISC program exceeds $1 billion per year. This alleged fact is based upon the premise that the deferral conferred by the DISC provisions is equivalent to an exemption. We disagree with this premise. The limitations placed upon the use of DISC funds and the conditions under which DISC benefits are terminated are so restrictive that a failure to continually increase exports not only results in a termination of DISC benefits but invariably triggers the taxation of accumulated DISC earnings. To claim that DISC deferreal is the equivalent of an exemption assumes

[10] *Supra* note 8, Stobaugh, p. 46.

that a given exporter will be able to increase exports forever. While a desirable goal, it is unrealistic to assume such an objective would be achieved. Furthermore, as exports decrease it becomes increasingly difficult to maintain investments in qualified export assets resulting in the elimination of deferral and a correspondng U.S. income tax. The deferred tax included in these earnings generates additional exports, earnings and employment which results in more U.S. tax to the U.S. producer. This factor should likewise be considered in any evaluation of the real economic cost of DISC tax deferral.

Therefore, it is clear distortion to claim that the loss of revenue is the tax on the earnings retained in the DISC. This so-called loss must be discounted by the above considerations.

The Treasury has contended that, because of the legal and accounitng costs of complying with the DISC legislation, larger corporations make more use of DISC than smaller corporations, based on a 1977 Treasury report that over 60 percent of DISC tax deferral benefits went to parent companies with more than $250 million in assets. This report fails to comment on the number of companies covered by 40 percent and 60 percent groupings. It stands to reason that a far larger number of companies with assets under $250 million would benefit from DISC than those exceeding that figure. The figures are misleading in that they fail to support the premise. Furthermore, since DISC is a paper corporation, the legal costs of organizing such entities is fairly normal. It is also our view that the use of outside professional legal and accounting advice in arranging for procedures to filter export transactions through DISC is not so expensive as to discourage the small and medium sized U.S. exporter from utilizing this vehicle.

The argument that the decline in value of the dollar is the reason for our increase in export levels does not take into account the subsidies made by foreign governments as to exports of their countries. If these subsidies reduce the export prices and affect the relative values of their currencies should not the U.S. consider the effect of the DISC provisions on the relative value of the U.S. dollar, and consider whether this is helping exports. The Treasury has apparently ignored this fact.

It is our further opinion that the Tax Reform Bill of 1976 adequately dealt with the objections to DISC. At that time it was felt that the provisions did not encourage additional U.S. exports since the deferral was based on total export sales including those developed in prior years. Accordingly, the DISC benefits were limited to the exent that a company increases it exports over a base amount and by excluding from DISC benefits certain products and commodities which Congress felt required no incentive for export sales. Thus, to accrue any tax deferral benefit a given U.S. taxpayer must increase his exports, a clearly desirable goal from an employment and balance of payment standpoint. The reasons for retaining the DISC provisions in 1976 are equally present today and, therefore, DISC should not be eliminated from the tax law.

With the advent of the incremental DISC provisions of the Tax Reform Act of 1976, the major value of the incentive no longer inures to the benefit of the large U.S. multinational enterprises, as asserted by the Treasury but now benefits primarily small companies and companies entering export activities *de novo*. Based on our recent experience, it is the smaller corporations embarking on export programs for the first time, that have availed themselves of the DISC incentive. To terminate the DISC at this point would be to undermine the plans and expectations of these companies formulated when decisions were taken to move into the export field.

Statement of U.S. League of Savings Associations

The U.S. League of Savings Associations[1] is pleased to have this opportunity to comment on the various provisions of the House-passed "Revenue Act of 1978", H.R. 13511.

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[1] 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 over 98 percent of the assets of the 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: Stuart Davis, President, Beverly Hills, Calif.; Joseph Benedict, Vice President, Worcester, Mass.; Lloyd Bowles, Legislative Chairman, Dallas, Texas; Norman Strunk, Executive Vice President, Chicago, Illinois; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Drive, Chicago, Ill. 60601; and the Washington Office is located at 1709 New York Ave., N.W., Wash., D.C.; Telephone (202) 785-9150.

1. CORPORATE RATE REDUCTIONS

The savings and loan business strongly supports the general corporate rate reductions contained in the Revenue Act of 1978. The five-step tax structure imposed by this legislation would reduce the corporate tax burden on the first $100,000 of taxable income while also granting tax relief to more profitable businesses by reducing to 46 percent the maximum corporate tax rate on income over $100,000.

A great deal of concern has been expressed by Congress over the decreasing investment by American business. The reduction of general corporate tax rates should stimulate this lagging business investment by providing a greater return on investment capital. In terms of the savings and loan business, this corporate tax relief will strengthen our declining reserves position—a situation which inhibits our ability to fully serve the savings and home borrowing public. For, under the banking laws, savings and loan associations must maintain specified reserve levels if they are to continue to seek the deposits of American savers. The deposits we attract enable our specialized institutions to maintain their extraordinary performance of recent years as the source of more than 60 percent of our nation's home mortgage credit. Thus, the ability to rebuild reserves through corporate tax relief directly benefits families wishing to buy a home.

2. TREATMENT OF CAPITAL GAINS ON SALE OF HOMES

The U.S. League applauds the House-passed provision excluding from gross income, on a one-time basis, $100,000 of capital gain realized on the sale of a principal residence. We believe that broadening the eligibility of this exclusion to include all individuals, regardless of age, is an important improvement in current law. With today's escalating inflation and rising property values the $100,000 exclusion will provide many homeowners with an opportunity for significant economic gain from homeownership. It will remove a barrier to family mobility and open up new opportunities for younger families purchasing existing homes.

We also fully support the provision of the House bill which permits non-recognition of gain on the sale of more than one principal residence within an 18-month period. If enacted, frequently-transferred families or individuals would now be allowed the benefit of non-recognition of gain if the sale and purchase of a principal residence is attributed to the individual's relocation for the convenience of his or her employer. In today's mobile economy, this is a needed improvement in the law.

3. MINIMUM TAX CONSIDERATIONS

Another area of the tax law which is of great concern to the savings and loan business is the special minimum tax on preference items. Savings and loan institutions under current law utilize a tax treatment based on allocations to reserves for bad debts. In 1969 this bad debt deduction was classified as one of the "preference" items and subject to the minimum tax. When the minimum tax was originally introduced it was primarily aimed at individuals with high gross income but low taxable income. We doubt whether Congress fully realized the significant additional tax liability (up to 15 percent of a savings and loan institution's total tax bill in some years) imposed on our institutions when in 1969 our bad debt deduction (IRC Sec. 593) was included as a minimum tax preference item. The minimum tax liability for our specialized home lending institutions has thus, perhaps unintentionally, amounted to a surtax on home mortgage credit. Furthermore, under the changes adopted in the minimum tax formula two years ago, the burden of this add-on minimum tax is scheduled to increase by more than 50 percent for tax years 1978 and thereafter for institutions utilizing Section 593.

The U.S. League requests Congress to either remove the bad debt reserve deduction from the list of tax code preference items (IRC Sec. 57(a)(7)), or, in the alternative to defer this scheduled 1978 minimum tax increase for savings and loan institutions.

4. INVESTMENT AND JOBS TAX CREDIT TREATMENT

Other anachronisms in the tax laws are the special limitations on the use of the investment and jobs tax credits by thrift institutions. When the investment credit was conceived by the Kennedy Administration, thrift institutions were

limited to 50 percent of the credit available to other corporations—reflecting, no doubt, their limited tax liabilities at that time (owing to their origins as generally mutual institutions). In the intervening years, savings and loan associations have become major corporate taxpayers; indeed, in recent years their effective tax rate approaches or exceeds that applicable to industrial and mining sector companies generally. In its original proposals last January, the Carter Administration recognized this unfairness in part by suggesting that the 50 percent limitation be adjusted to 70 percent.

Significantly, the investment credit limitation does not apply to other financial institutions—especially, the commercial banks which are direct competitors of savings and loan associations. If, for example, a bank opens a new branch office it may fully utilize the investment credit when it installs a vault while its S&L competitor across the street has only half of the credit available. (This discrimination is particularly pronounced since the effective tax rate of S&Ls is currently twice that paid by commercial banks.) The competitive problem is certain to become more acute as financial institutions make major equipment purchases associated with new developments in serving their customers through electronic banking.

Given the fundamental purpose of the investment credit—to stimulate the economy through business investment—it make no sense to artifically restrict in their participation one major category of corporate taxpayers, savings and loan associations. Thus, the U.S. League urges immediate repeal of the special 50 percent restriction in Section 46(e) of the Internal Revenue Code.

Similarly, the 1977 Tax Reduction and Simplification Act perpetuated this discrimination in the design of the jobs tax credit. It, too, limits thrift institutions to half of the credit available to other corporations. Since savings associations, because of the nature of their business, employ significant numbers of entry-level employees, it would seem particularly appropriate to encourage their full participation in the special employment programs such as the jobs credit. Thus, the U.S. League also asks for an immediate repeal of the special restriction on the use of the jobs credit by thrift institutions.

While we support the proposal in H.R. 13511 to make the investment credit permanent and increase the general limitation on its use from 50 percent to 90 percent of other tax liabilities we urge the quick elimination of the inequity which permits only the partial use of this credit for savings and loan associations.

As explained above, the successful jobs tax credit for hiring new workers is impaired for our institutions. Congress is now considering a more narrow job stimulus approach targetted to specific unemployed groups. If this plan were adopted, our members would rightfully be excluded. However, if a broader job stimulus is passed or an extension of present law is agreed upon, the U.S. League urges the Members of Congress not to deny savings and loan associations equal benefits under this law.

5. PUERTO RICAN S&L'S

We also feel that it is important to bring to the attention of the Senate Finance Committee at this time an existing tax inequity affecting our institutions located in the Commonwealth of Puerto Rico. At the present time, interest earned on savings deposits at Puerto Rican commercial banks is exempt from Federal tax as "Puerto Rican Source Income" (Sec. 861(a)(1)(F)). However, interest income generated at a nearby savings and loan association is not accorded similar Federal tax-exempt treatment. The only logical explanation for this disparity between Federal tax treatment of the various Puerto Rican-based financial institutions and their savings customers seems to be legislative oversight. Therefore, we appeal to the Committee to insure not only competitive equality but the very existence of the savings and loan alternative in Puerto Rico by granting equivalent Federal tax treatment to interest earned on deposits at our institutions located in Puerto Rico as is currently provided commercial banks under Section 861(a)(1)(F).

6. DEFERRED TAX TREATMENT FOR CERTAIN COMPENSATION PLANS

Finally, the U.S. League supports Section 121 of this bill which restores favorable deferred tax treatment to unfunded state and local government qualified compensation plans. Proposed regulations issued by the Internal Revenue Service on February 3, 1978, denied deferred tax treatment to plans already established by state and local governments. Section 121 resolves the uncertainty created by these proposed regulations by specifically authorizing that compensation

deferred by a participant in an eligible state compensation plan, plus any income attributable to the deferred amounts, is includible in the income of the participant or beneficiary only when paid or otherwise made available. However, we do suggest the adoption of one minor change in subsection b(4) of Section 121 of the bill which will make deferred compensation plans more easily administrable. The proposed change would allow deferral agreements to be made any time prior to performance of service by the participants, rather than restricting this election to the year in advance of the actual deferral.

Again, the U.S. League appreciates this opportunity to present its views on some of the important topics currently under consideration by the Senate Finance Committee.

STATEMENT OF AL POTEET, ASSISTANT DIRECTOR, NATIONAL LEGISLATIVE SERVICE, VETERANS OF FOREIGN WARS OF THE UNITED STATES

Mr. Chairman and members of the subcommittee:

Thank you for the opportunity to present to this distinguished Subcommittee the views of the Veterans of Foreign Wars of the United States with respect to pending legislation which is of great concern to our more than 1.85 million members of the V.F.W. and the 610,000 members of our Ladies Auxiliary.

My name is Al Poteet and I have the privilege of serving the Veterans of Foreign Wars as its Assistant Director, National Legislative Service.

There are a number of important bills being considered by this Subcommittee but one, S. 2771, is of particular importance to the Veterans of Foreign Wars, S. 2771, introduced by the Honorable William D. Hathaway, a member of the Committee on Finance would amend Section 513 of the Internal Revenue Code of 1954 by adding language specifying that the term "unrelated trade or business" does not include any trade or business which consists of conducting qualified games by tax-exempt organizations.

As I am sure you are aware, the Eighth Circuit Court of Appeals has handed down a ruling which would result in thousands of dollars in back tax liabilities for non-profit organizations. The ruling I refer to involved a V.F.W. Post in Minnesota which operated a regular bingo game utilizing paid workers. The V.F.W. qualifies for federal tax-exempt status as a "non-profit" organization under Section 501 of the Internal Revenue Code. Traditionally, the Veterans of Foreign wars has been granted a tax-exempt status by the Congress to further our organization's philanthropic goals and rendering service to veterans and their dependents.

The Tax Reform Act of 1969 was, to the best of our knowledge, the first law to impose broad tax liability on tax-exempt organizations as to their "unrelated business income." One of the basic reasons for that legislation was to remove the then existing inequity in taxing certain exempt organizations on such "unrelated business income" but not taxing others.

It is our contention that the congressional intent in regard to the "unrelated business income" provisions of said Act, was to impose tax liability on organizations such as veterans' organizations when they engaged in profit making activities which competed with commercial business. In the House Committee Report, House Report No. 94-413 (Part I), 91st Congress, First Session, which accompanied H.R. 13270 (enacted as the Tax Reform Act of 1969), on page 50, there is included the statement:

". . . Your Committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. . ."

Apparently the Internal Revenue Service and the federal courts do not agree with our interpretation, thus creating the need for S. 2771 or similar legislation. The aforementioned Circuit Court assessment against the V.F.W. Post was made notwithstanding the fact that the post's bingo activities did not compete with any commercial enterprise.

In Minnesota, the V.F.W., in conjunction with the American Legion, support youth activities in the Bloomington area with funding in excess of $120,000 which the city cannot provide. In addition, they financially support a baseball and junior hockey team which participate in state and local tournaments. Also, the V.F.W. in Minnesota donates televisions and wheelchairs to the local Veterans Administration hospital. Many of these activities that the V.F.W. participates in across the country are financed by the profits derived from licensed weekly bingo games.

In light of the foregoing, the Veterans of Foreign Wars of the United States, wholeheartedly supports the intent of S. 2771 to set aside the designation of bingos sponsored by the V.F.W. as an "unrelated trade or business" and recommends early passage thereof.

This concludes my testimony. Thank you.

WAYNE HUMMER & Co.,
Chicago, Ill., August 18, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Russell Senate Office Building 217,
Washington, D.C.

DEAR SENATOR LONG: You have often heard the expression that "it's worth its weight in gold". This applies to you, even though gold is selling at $200 per ounce, for your sound position on tax reform.

This will confirm the following telegram to you today:

"It is our request that letters to you dated June 13 and August 10, together with copy of telegram of latter date to Honorable Jimmy Carter be made a part of the records of the current Senate hearings pertaining to repeal 1976 capital gains tax on beneficiaries. Thank you".

Since this legislation is such a must, I would be only too glad to testify before your Committee on the repeal of these new taxes enacted in 1976 in the event you feel it would serve a purpose.

As you well know, we have on the statute books capital gains provisions on the sale of residences. Personally, I sold a large home in 1976 and with the reinvestment rights there were no burdens, except digging out old records covering a number of years to substantiate the cost. It is my opinion that it would be far better to provide for a specific capital gains exemption on all forms of property if we are to overcome the shortage of venture capital.

Cordially yours.

GEORGE E. BARNES,
Senior Partner.

WAYNE HUMMER & Co.,
Chicago, Ill., August 10, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate,
Russell Senate Office Building 217,
Washington, D.C.

DEAR MR. LONG: As you know, it is vital to repeal the new capital gains tax enacted in 1976 on our beneficiaries. In accordance with your Bill, we thought the enclosed telegram to President Carter would help our cause, a copy of which we are mailing to each member of Congress.

Inasmuch as a reduction in the capital gains rate to 35% will not help anyone except a few rich people, it is our hope that you will make every effort to reduce the rate to a level that would be helpful in relieving the long-standing shortage of venture capital.

With kindest personal regards, I am,

Cordially yours,

GEORGE E. BARNES, SR.

Enclosure.

WAYNE HUMMER & Co.,
Chicago, Ill., August 18, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Russell Senate Office Building 217,
Washington, D.C.

It is our request that letters to you dated June 13 and August 10 together with copy of telegram of latter date to honorable Jimmy Carter be made a part of the records of the current Senate hearings pertaining to repeal 1976 Capital Gains Tax on beneficiaries.

Thank you.

GEORGE E. BARNES,
Senior Partner.

[Telegram]

WAYNE HUMMER & CO.,
Chicago, Ill., July 31, 1978.

Hon. W. MICHAEL BLUMENTHAL,
Secretary of the Treasury,
Washington, D.C.

Cannot refrain from sending you another SOS to urge repeal of New Capital Gain Taxes enacted in 1976 on our beneficiaries after spending most of weekend helping elderly widow search attic for cost records of her old family residence. It is the rule rather than the exception that most taxpayers have not kept complete cost records over the years of all property and security holdings. Again, Senator Long's bill should receive prompt support from you and President Carter in order to restore order out of chaos by returning to date of death values. Lowering the capital gains tax rate to 35 percent would only benefit a comparatively few millionaries and provide no relief in correcting the longstanding venture capital shortage. May we hear from you.

GEORGE E. BARNES,
Senior Partner.

WAYNE HUMMER & CO.,
Chicago, Ill., August 4, 1978.

Hon. AL ULLMAN,
Chairman,
Ways and Means Committee,
House of Representatives,
Cannon House Office Building,
Washington, D.C.

DEAR MR. ULLMAN: Today, we are sending to each member of your Committee a copy of the enclosed telegram to Secretary Blumenthal, urging the passage of Senator Long's Bill on the repeal of the new 1976 capital gains taxes on our beneficiaries. This is a must inasmuch as it cannot be administered.

Also, I hope that your Committee understands that the lowering of the capital gains rate to only 35 percent will not relieve our nation's longstanding venture capital shortage.

Another important point which I have not mentioned to you heretofore in connection with a reduction in the capital gains rate; it is that such a cut should be made effective instantly in order to prevent wholesale establishment of losses in the current year at the higher rates to offset losses next year at the lower rates.

These views are based upon a lifetime of experience in the field of taxation. It is pertinent to remind you that the House Ways and Means Committee has more than once previously recognized and followed my considered views in the past for the best interests of the nation. As an example, Senator Dirksen had me come to Washington to stop withholding taxes on dividend and interest after both the House and Senate had passed such legislation and it had reached conference.

As I indicated to you in my previous letter, I will be glad to come to Washington now to help you formulate a capital gains tax program which will work effectively. Please let me hear from you.

Cordially yours,

GEORGE E. BARNES,
Senior Partner.

STATEMENT OF ALAN BERGSTEDT

I am a Certified Public Accountant. I am very interested in the activities of the voluntary non-profit charitable organizations of our country.

The trend toward a higher standard deduction on our tax returns has simplified tax returns for many middle and lower income taxpayers. The standard deduction now covers things which are both discretionary and non-controllable expenditures.

Discretionary deductions.—donations to charities.

Non-controllable deductions.—medical costs, real estate taxes, State and local income and sales taxes, union dues.

I feel that it would be more appropriate to permit donations to charities in addition to the standard deduction. This treatment has been allowed for alimony recently. Passage of S. 3111 would extend the privilege of deducting donations to charities to all taxpayers without consideration of whether or not their other deductions exceed the standard deduction. This would make the tax laws more fair and equal for the lower and middle income taxpayers.

Also, the increase of the standard deduction has decreased the incentive to make chaitable deductions for middle and lower income taxpayers. The wealthy still receive this tax benefit and have a high incentive to give to charities. I feel that the average citizen should not lose his influence over the activities of non-profit charities.

The tax deduction for donations is an impetus to consider giving. Without at least the psychological impetus to support and become involved in the programs of local and national charities, these groups may become more and more controlled by the wealthy. They will also become more dependent upon government support.

We want to reduce government involvement in our local affairs. The charities supported by voluntary gifts provide many effective low-cost benefits to our communities. Their gift income has suffered in recent years by up to $5 billion dollars according to some studies. S. 3111 would help maintain a strong private voluntary group of non-profit organizations by restoring the incentive to make donations to tax-exempt organizations.

Tax reform as suggested by President Carter should benefit the low and middle income citizens. This Senate bill (S.3111) would do that.

I hope that you will support this bill which will benefit a lot of taxpayers and the effective group of American charities.

APPENDIX C

STATEMENTS ON

ECONOMIC EFFECTS OF CHANGES

IN THE TAXATION OF CAPITAL GAINS

SUBMITTED IN RESPONSE TO

A REQUEST FOR VIEWS BY

RUSSELL B. LONG, CHAIRMAN,

COMMITTEE ON FINANCE

(Committee document released September 22, 1978)

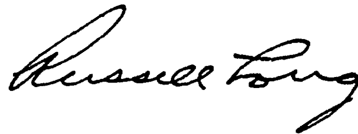
FOREWORD

One of the most important issues in the tax reduction bill now pending before the Senate is capital gains taxation. Many people believe that our existing high tax rates on capital gains reduce saving and investment and deter investors from selling assets which have appreciated in value. While it is generally agreed that a reduction in capital gains tax rates will cause changes in economic activity which will raise tax revenue (i.e., by inducing taxpayers to sell appreciated assets), the Treasury Department still estimates the revenue effects of capital gains tax changes without including these feedback effects. They agree in principle that one should take account of these feedback effects in making revenue estimates; however, because they are not certain about the magnitude of feedback effects, Treasury has not moved beyond static revenue estimates. By estimating revenue impact without including revenue gain due to these feedback effects, Treasury has not given us an accurate view of the results of a reduction in capital gains tax rates.

To get a broader range of views on this subject, I have written to 35 former high government officials and economic experts, including 8 former Secretaries of the Treasury, soliciting their views on the question of whether a capital gains tax reduction which increases the present 50 percent

exclusion for long-term gains to 70 percent or which sets a maximum rate on long-term gains of 25 percent, would increase or decrease Federal tax revenues. I am publishing these responses in their entirety, and I hope that they will be read and studied by everyone interested in the question of capital gains taxation.

The vast majority of the responses indicate that a cut in capital gains taxes will not reduce Federal revenues and may actually increase them. This would result from the unlocking of unrealized capital gains and from greater saving and investment, particularly in the sorts of risky enterprises which are the key to technical innovations in the economy. These analyses by these fiscal experts make a strong case for a capital gains tax reduction.



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Appendix--The materials presented to the Senate Finance Committee by former Treasury Secretary Henry H. Fowler and Dr. Martin Feldstein, National Bureau of Economic Research

RUSSELL B. LONG
LOUISIANA

United States Senate
WASHINGTON, D.C. 20510

August 28, 1978

The Honorable William Simon
Booz, Allen & Hamilton
245 Park Avenue
New York, New York 10017

Dear Bill:

As you know, the Senate Finance Committee has been holding hearings on H. R. 13511, The Revenue Act of 1978, and we plan to begin mark-up of this important legislation on September 7. As passed by the House of Representatives, the bill would cut individual and corporate income taxes by an estimated $16.3 billion on a calendar year basis, of which $1.0 billion reflects Treasury and Congressional staff estimates of a reduction in individuals' capital gains taxes to a maximum rate of 35 percent.

I am writing you today to request your judgment as to the official estimate of the impact of any cut in capital gains taxes on Treasury revenues. Witnesses before our Committee--particularly Dr. Martin Feldstein and financial experts such as former Treasury Secretary Henry Fowler--argued that a soundly structured reduction in tax rates on capital gains will unlock a significant volume of appreciated assets. They also believe that the increase in realizations will more than offset the decline in rate, thus initially raising rather than reducing Treasury receipts. Over the longer run, lower taxes on capital gains would be expected to foster capital formation and economic growth, thus increasing the size of the tax base. The testimony of Secretary Fowler and Dr. Feldstein along with the studies on which Feldstein's testimony is based, are enclosed.

What is your view, especially with respect to the unlocking impact on appreciated stocks, real estate, and other capital assets? If the percentage of capital gains included in taxable income were reduced from 50 percent to 30 percent or 40 percent, or if a 25 percent maximum tax rate were established for capital gains, would the impact on Treasury revenues be positive, negative, or neutral?

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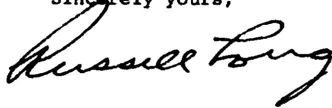
Page 2
August 28, 1978

I recognize fully that the payment of capital gains is voluntary in that the holder decides whether or not to liquidate an appreciated asset and the extent of unlocking cannot, therefore, be quantified. Nevertheless, the ultimate decision of the Congress with respect to this legislation will, as I noted, be of great significance to this country.

We, therefore, want to base our Committee recommendations on the best available advice. May I hear from you soon, preferably by September 6?

Sincerely yours,



(Identical letter sent to each of the individuals whose responses are reproduced on the following pages.)

The Honorable Russell Long
Chairman
Senate Finance Committee
217 Russell Senate Office Building
Washington, D.C. 20510

9.6.78

Dear Chairman Long:

I am delighted to respond to your request for my views regarding the impact of any cut in capital-gains taxes on Treasury revenues. You have requested my judgment as to the possibility of an "unlocking impact" on appreciated stocks, real estate and other capital assets, and you have sought my views as to what would be the impact on Treasury revenues as the maximum capital gains tax rate were reduced from 50% downward to 25%.

I am exceptionally pleased to respond to your letter on two counts. In the first place, I have always considered the Senate Finance Committee the premier committee in Congress. On every occasion I found the members of the committee receptive to the introduction of new ideas and willing to consider the abandonment of unworkable programs. Moreover, I can't ever recall an instance of lack of courtesy and patience.

Additionally, I'm especially glad to impart my views to you because I cannot overstate my belief that this nation faces a capital formation crisis whose possible effects and ramifications have not even begun to be understood, let alone appreciated. I can think of no more important aspect ot the tax legislation you are now considering than the measures which would stimulate capital investment.

You and your committee might be interested in knowing that this is not just a matter of recent concern with me. Alarmed at the prospect of diminishing

(2)

capital formation that loomed even then on the horizon, with its deleterious effect on the flow of investment funds in our economy, I had concluded in 1973 as Deputy Secretary of the Treasury that a major reduction in the tax rates on capital-gains was exactly what was called for. I had the agreement of the Secretary of the Treasury, my predecessor George Shultz, and also of President Richard Nixon to formulate and advocate such a program.

Knowing, of course, that the political temper of the times, born out of New Deal-Keynsian rhetoric, would not view such a cut for its salutary effect on the whole economy but simply as a tax break for the "fat cats", I was dispatched to sound out prospects with the then Chairman of the House Ways and Means Committee, Rep. Wilbur Mills. He was immediately receptive to the idea, quickly perceiving the benefits to both the short-term and long-term economic well-being of the country.

Mr. Mills, whose knowledge of tax laws, both as to their construction and effect, I have hardly seen equaled, was of the opinion that some 20 billion dollars might be unlocked. Additional revenues for the Treasury would be many billions of dollars.

You might be interested in knowing that Secretary Shultz and I found the work of the Treasury econometrics model in this exercise unsatisfactory. I am tempted to add here that in the course of my private career and my public roles in both the energy and traditional Treasury fields, I have almost always found such models to be grossly deficient in devining the future.

(3)

I am sorry to say that short-term considerations prompted the shelving of the capital-gains tax reduction plan at that time. I haven't the slightest doubt, Mr. Chairman, that some of the immense difficulties we have experienced in capital formation, deterioration in our financial markets, and the general lack of confidence in our economy both at home and abroad were in significant measure direct results of that decision.

It seems to me that the overriding consideration in this matter must be the now obvious lag in our real economic growth. The rate of real growth of our GNP sags significantly behind these nations whose currencies appreciate virtually every day against our own -- primarily West Germany and Japan. Our rate of productivity gains lags behind these nations as well. And by now economists of every persuasion concede that a large part, if not the major cause of this sorry state, is the fact that we continually devote a smaller percentage of our national output to fixed investments than do these other countries. Mr. Chairman, it is a sad thing for me to contemplate that the most powerful nation of the world is perhaps fatally compromising its future by having the lowest rate of capital investment in the last generation of any major nation in the free world.

It follows then that any move that would spur investment is the right one. And I think everyone has agreed that a cut in capital-gains taxes would do just that. But, it does seem to me that in the many ensuing discussions there are too many bookkeepers debiting and crediting a current account, with not enough emphasis given to the full economic effects -- especially over the longer-term.

First, there isn't the slightest doubt that reduced capital gains taxes will unlock a significant volume of appreciated assets. It is very difficult

to quantify the amount over a given period of time. Much depends on the value ascribed to these assets by their own particular market next year and the years just beyond. And I'm sure your experience and mine in predicting the course of equity markets, real estate and other commodity values over the shorter term are similar, and distressing.

Nevertheless, I have no reticence in saying that should tax cuts be enacted, the normal cycles prevailing in each of the many markets involving capital assets will initiate a tremendous unlocking that will result in substantial capital gains tax revenues for the Government. In this, I fully support the testimony given by former Secretary Fowler along with the results of the Feldstein study on the effects of taxation on the selling of corporate stock and the realization of capital gains.

But secondly, I find missing in all the studies an estimate of the impact of new investments that will undoubtedly come about as a result of the possibility of potentially higher after-tax profits from investments made in the reduced capital-gains tax environment. I believe you are aware Mr. Chairman, that several studies conducted by the New York Stock Exchange, the Securities Industry Association, and others have revealed two distressing facts. First, the number of shareholders investing in equities of publicly held corporations in the United States has been strongly curtailed. Although estimates vary it appears that there are about 10 million fewer investors in America than there were at the beginning of the decade. And secondly, it appears beyond dispute that the young adults of America have by-passed investing in our publicly held companies. They are doing this increasingly.

(5)

I would not be so rash as to say that the capital-gains tax structure is wholly responsible for these ominous developments. But, I think I am reinforced in my conclusion that the current excessive capital gains rates are a major factor when it is clear that these unfortunate trends set in after the hiking of the capital gains taxes in 1969, and have accelerated as new burdens have been placed on the investor and the potential investor (the lengthening of the holding period, etc.).

I hardly think I have to detail how ludicrous it is for government leaders to talk optimistically about the future, and this country's role in it, if Americans continue to foresake investment, the ultimate source of economic growth in a free society.

Putting together these two strains (that a cut in capital-gains taxes will both unlock currently held assets and stimulate new investments), I can only reiterate my view that _if_ there is any short-term loss on the revenue side for the Treasury it will be substantially made up in the few years just ahead by a) taxes derived from the sale of assets now held and investments to be made, and b) general income tax revenues that will be derived from a far healthier economy stimulated by increased capital investment.

In this regard I would argue that it would be foolish merely to look at short-term effects. I can recall that at the time the six month holding period for establishing long-term capital gains was lengthened in 1977 and 1978 to nine and twelve months respectively, it was estimated that there would be some 11 million dollars of increased revenues for the Treasury (a relatively

(6)

inconsequential number in a 400 billion dollar + budget). But no one estimated the revenue losses from the lack of capital-gains taken, and the lack of new investments with their taxable profits. And who is to say how much corporate and individual revenue (taxable) were lost as our economy stagnated in an under-invested slow-growth, high-inflation deficit-ridden environment.

I hope I have been persuasive in outlining reasons for a specific and substantial cut in the tax rates on capital assets. I am keenly aware that one effect of the reduction in the number of individuals investing in corporate shares has been a radical drop in public security issues valued at 1.5 billion dollars in 1969, to four new issues at the trough in 1975 with about 16 million dollars. Moreover, several studies have conclusively demonstrated that the rate of growth of research and development in our country has been significantly lagging behind other nations. And I note with particular interest that new high high technology firms have experienced a sharp decline from 1968 to 1976; 300 to virtually 0.

It is extraordinarily difficult to estimate the revenues that the Treasury should garner if capital-gains taxes are reduced. So much depends on the market environment which in turn is dependent on an economic outlook fraught with difficulties.

The Feldstein, Slemrod, Yitzhaki study indicates that in their sample year (1973), had the capital-gains tax rate been 25% rather than the current high rate, a three fold increase in total value of net gains would have been

realized. However, this study made no estimate of additional investments that might have been forthcoming as a result of the lower rates. It limited itself to corporate stock already held.

Additionally, it must be remembered that an increasing number of investors would permit corporations to avail themselves of external financing via the debt market to a far greater degree, with consequent economic gains that would reflect themselves in increased corporate and personal tax revenues.

All of these things lead me to believe that in lieu of massive overall tax reform of the type I proposed in my final days at the Treasury, that first a cut in long-term capital gains tax rates would not only be beneficial for the economy, but is virtually mandatory to avoid a crisis in capital formation and investments in the next few years.

Secondly, the lower the maximum rate on these gains, the greater the economic impact and the greater the revenues would be generated for the Treasury over a number of years. In specific answer to your question, the larger the cut in the rate, the more positive would be the impact on Treasury revenues.

Thirdly, I cannot say with any degree of certainty how much revenue would be gained by the Treasury in any one specific year, but I feel very certain that over the next few years, the revenue gain would probably exceed the upper estimates now being discussed, provided that the country addresses itself to its major problem -- inflation -- and reduces its massive operating

deficits and rein in its burgeoning money supply. It would not surprise me that under those circumstances, Chairman Mills' multi-billion dollar estimate might well be realized over a period of years.

I hope my support of a cut this year in the capital gains tax rate is not misread as in any way diminishing my intense advocacy of an overall tax reform/tax cut package along the lines I have previously espoused. Nevertheless, considering the bill before you, I believe a substantial cut in capital gains taxes would do more for the economy in tangible and intangible terms than is currently appreciated by most of our citizens. It is my conviction that the Treasury would gain substantially if national and fiscal and monetary policy is sound.

I thank you for the opportunity of allowing me to present my views.

With all good wishes.

William E. Simon

Bechtel Corporation
Engineers - Constructors
Fifty Beale Street
San Francisco, CA 94105

George P. Shultz
President

September 1, 1978

Dear Mr. Chairman:

Thank you for your letter inviting me to comment on the proposed reduction in individuals' capital gains taxes now before your Committee and also for the outstanding material prepared by Secretary Fowler and Dr. Feldstein which you enclosed. I am glad to comment since I believe this legislation to be about as important as anything your Committee has considered in a long time.

There is no question in my mind but that the effect on Treasury revenues from the type of capital gains reduction being proposed would be positive. The immediate "unlocking" would have a dramatic impact and the estimate provided by Dr. Feldstein on the basis of his careful research does not surprise me at all.

It therefore seems totally wrong, even ludicrous, to make a calculation on "revenue loss" on the basis that behavior does not change as a result of a change in tax rates. Behavior does change and will change in this case so that a revenue gain will clearly result. You remember that the same point emerged in our discussion of the taxation of the earnings of Americans working overseas.

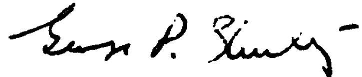
But I believe that the positive implications of your proposed changes go far beyond these effects of "unlocking". I happened to meet yesterday at Stanford University with a group of around one hundred entrepreneurs who have started and are managing small businesses. They see these possible changes in capital gains tax rates as being of tremendous importance to them. The changes would open up sources of risk capital not now available to them but that could be attracted to help their businesses. Everyone knows that investment in a new small business is risky.

All you have to do is look at the bankruptcy statistics to see this point. If the Government continues to insist on heavy taxation of any possible gains from such risk-taking, financing tends to dry up. On the other hand, if the taxation is reduced, then more capital would be available to these businesses and they will have much more chance to survive and prosper. In the process, jobs are created. In the process, new and creative ideas are brought to the American consumer. In the process, new competition is brought into the marketplace.

Mr. Chairman, you, your distinguished Committee and the Government of the United States generally can contribute tremendously to the vitality of our economy by acting boldly to reduce the rate of taxation on capital gains. By doing so, you will surely increase Treasury revenues not diminish them. But far more important, you will stimulate creativity and employment throughout our economy.

Thank you again for the opportunity to comment on this crucial piece of legislation.

Sincerely yours,



George P. Shultz

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

JOSEPH W. BARR

HOUYHNHNM FARM
HUME, VIRGINIA 22639
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734 FIFTEENTH STREET, N. W., SUITE 707
WASHINGTON, D. C. 20005
TELEPHONE 202/638-7676

August 29, 1978

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

Dear Russ:

I was most interested in your letter of August 28 and the attached testimony of Secretary Fowler and Dr. Martin Feldstein on the impact of lower tax rates on capital gains. You and your Committee will be facing some challenging decisions as you begin the mark up on H.R. 13511. It is at times like this that I sometimes wish that I were back in the Treasury wrestling with you or "agin you" on these tax issues.

You asked me

> "What is your view, especially with respect to the unlocking impact on appreciated stocks, real estate, and other capital assets? If the percentage of capital gains included in taxable income were reduced from 50 percent to 30 percent or 40 percent, or if a 25 percent maximum tax rate were established for capital gains, would the impact on Treasury revenues be positive, negative, or neutral?"

Russ, based on my experience in government and in business, I have a strong hunch that over time a lower rate on capital gains would tend to unlock the market on appreciated capital assets. I believe that lower rates would probably stimulate a much higher level of capital transactions. Thus, over time, the Treasury's revenue loss might be neutral and could be positive.

I earn my living as a director of several large multi-national corporations. While I do not have access to a large professional staff of statisticians and economists, I do have access to the

The Honorable
Russell B. Long -2- August 29, 1978

chief financial officers of the companies where I serve as a director. These companies in total have sales of about $10 billion world wide, profits of about $650 million, and pay U.S. income taxes of about $260 million. The capital gains tax is not a matter which is very important to these chief financial officers in their corporate capacity, so their opinion should be relatively unbiased. They do have a distinct corporate interest in seeing to it that the Treasury does not incur a significant revenue drop.

I was able to talk today with the chief financial officers of 3M, Burlington Industries, Control Data, and Commercial Credit. I am a director of other companies, but these were the men I could find today. To a man they agreed with my opinion, and some of them felt even more positive than I.

None of us felt smart enough to tell you where that rate should be. But we did agree on something that you did not ask me about. We believe that a reduction in the capital gains rate will have a significant and beneficial impact on the venture capital market. 3M, Burlington, Control Data and Commercial Credit can raise all the money we need. But we are all dismayed at the drying up of venture capital for new enterprises.

Thanks for asking my opinion. Knowing you and your Committee, I have attempted to confine myself to a position that I knew and could defend. I hope this opinion is helpful. Please give my best wishes to all my friends on your Committee.

Sincerely,

Joseph W. Barr

767 Fifth Avenue
New York, N.Y. 10022

September 5, 1978

Dear Russell:

In answer to your letter of August 28th I am glad to give you my views on the taxation of capital gains in connection with the Finance Committee's consideration of H.R. 13511, the Revenue Act of 1978.

For the record, I am presently one of the managing directors of Dillon, Read & Co., Inc., the investment bankers, and Chairman of the Board of United States and Foreign Securities Corp., a publicly traded investment company, listed on the New York Stock Exchange. My comments are strictly my own and do not purport to represent the views of any group or organization.

My experience in the field of taxation dates from my service as Secretary of the Treasury under Presidents Kennedy and Johnson from January 20, 1961 through the month of March, 1965. During that period I was personally responsible for the preparation and legislative presentation of two tax reform bills, the Revenue Acts of 1962 and 1964. These bills were designed to promote investment, stimulate the economy in a non-inflationary manner, promote greater tax equity through the closing of unjustified tax loopholes and to simplify the tax system. Both of these tax reform bills were prepared at the direction of President Kennedy and had his full support.

The bulk of President Kennedy's tax recommendations were enacted by the Congress including the adoption of the investment credit, across-the-board cut in tax rates, a minimum standard deduction and numerous loophole closings. Furthermore, in more recent Revenue bills, most of the important recommendations that were not accepted by the Congress in 1962 and 1964, have been enacted into law.

The one outstanding exception to this general acceptance of President Kennedy's tax proposals lies in the area of capital gains taxation.

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

The 1963 reform proposals, as recommended by the President, contained a carefully worked out package for the reform of the taxation of capital gains. This package contained three elements, an extension of the holding period to qualify for long term capital gain treatment from six to twelve months, an attack on the problem of the avoidance of all capital gains taxation at death, and a general, across-the-board reduction in capital gains taxation. The second and third elements of this package were designed to unlock capital gains and thus promote the flow of new capital for equity investment. In addition the second proposal was aimed at closing a major tax loophole and thus improving equity.

Unfortunately, the Ways and Means Committee in their consideration of the 1963 proposal, after initially approving a carryover of basis provision for the taxation of capital gains at death, decided against any change in this area in their final approval of the bill. As a result the entire capital gains package recommended by President Kennedy in 1963 was omitted from the Revenue Act of 1964.

Now, however, the situation is quite different. President Kennedy's first two recommendations in the capital gains area are now the law of the land. But instead of a reduction in capital gains rates there has been a substantial increase, with the rate going from 25% to 35% and with a minimum tax that can carry the top rate up to approximately 50%. The result has been the readily predictable locking in of capital gains and the creation of substantial barriers to equity investment. Since equity investment is the life blood of new and expanding small business, while large established concerns can prosper and grow on internally generated cash flows supplemented by the sale of debt securities, this increase in the rate of capital gains taxation has produced an unintended but nevertheless serious anticompetitive effect on our national economy. In effect, the Government through tax policy has created barriers to competition that it is trying to demolish with anti-trust policy. It is unfortunate but a classic case of the Government's left hand not knowing what its right hand was doing.

In order to free up our national, private, free enterprise economy so that we can continue to compete successfully in an increasingly competitive world, a substantial reduction in the rates of taxation applicable to capital gains is now necessary. The adoption of President Kennedy's third proposal, reducing the taxable percentage of capital gains from 50% to 30% would do

just that and would do it in a fair, across-the-board manner, with benefits available to all taxpayers from the smallest to the largest.

Unfortunately, H.R. 13511, as passed by the House, does not meet this need. The removal of capital gains from the current minimum tax with the substitution of an alternative minimum tax is a substantial improvement. However, the removal of the 25% alternative tax, while a most desirable simplification, has the effect of increasing capital gains taxation and hence increasing both the lock-in effect and the anti-competitive effect of our current capital gains tax structure. The figures presented by Dr. Feldstein, based on the 1973 Treasury tax sample, are compelling proof of this fact. H.R. 13511 should be amended to provide not only the elimination of the application of the current minimum tax to capital gains but a fair, across-the-board, reduction in rates.

The Steiger amendment, while useful in reducing the top rate to its former level of 25% and thus eliminating the need for the continuation of the alternative tax, is not equitable in that it provides no reduction of capital gains rates for smaller taxpayers. This problem would be entirely eliminated by the adoption of President Kennedy's proposal to reduce the inclusion of capital gains in taxable income from 50% to 30%. Under the current rate structure this would result in a rate of tax from 4.2% at the bottom to 21% at the top. In your letter of August 28th you mentioned the possibility of such a reduction to "30 percent or 40 percent". I would like to point out that there are strong arguments to favor an inclusion of no more than 35% of capital gains in taxable income. An inclusion of 35% of capital gains would mean a top rate of 24.5% which would permit the elimination of the 25% alternative tax, without raising capital gains taxes for any taxpayer. This would seem to be the most equitable way to accomplish the objective of freeing up capital for investment in new and small businesses, while at the same time obtaining a most desirable simplification of the tax code through the elimination of the 25% alternative tax. Any higher percentage of inclusion would either require the continuation of the complex 25% alternative tax or result in an undesirable increase in capital gains taxation for many taxpayers.

This brings me to the all important question of the revenue effect of a reduction in capital gains tax rates, which is the principal question raised in your letter of August 28th. In my opinion the adoption of the principle of President Kennedy's proposal, with a reduction of the percentage

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of capital gains to be included in taxable income to 30% or 35%, would result in an increase in Treasury revenues due to the induced effect of lower rates in unlocking capital gains. A similar result would flow from the establishment of a 25% maximum rate.

I base this opinion not only on the obvious fact that lower rates would induce more taxpayers to realize capital gains but also on the 1963 analysis of the problem by the Treasury tax staff under Assistant Secretary Stanley Surrey, and the more recent work of Dr. Martin Feldstein, using the 1973 Treasury sample. In preparing President Kennedy's 1963 tax proposals, the Treasury was naturally concerned with the revenue implications of the various proposals. In the area of capital gains the estimates of the Treasury's Office of Tax Analysis were contained in Table II of President Kennedy's 1963 tax message. A copy of this table was submitted by Secretary Fowler as an exhibit attached to his August 22, 1978 testimony before the Finance Committee.

This table shows a loss of revenue from the reduced inclusion percentage (from 50% to 30%) of $390 million. This figure also includes the effects of extending the holding period to twelve months. Presumably the $390 million revenue loss estimate would have been modestly higher if the effects of an extended holding period had not been included. On the other hand the table gives the estimate of the Treasury tax staff that the induced effects of lower effective rates would bring in $690 million in additional revenue from the increased realization of capital gains. The net result was an estimated increase in revenue of $300 million from the lower rates.

Since 1963, advances in computer technology have greatly improved the ability to estimate the effect of tax changes on revenue. The Treasury's 1973 tax sample used by Professor Feldstein in his analysis is an example of the type of detailed information that was not available in 1963. Using this data, Dr. Feldstein has shown that the 1963 conclusion of the Treasury tax staff regarding the increase in revenue that would flow from a reduction in capital gains rates was correct. Dr. Feldstein is recognized as one of the nation's outstanding economists, and I am unaware of any challenge to the technical competency of his analysis of the revenue effects of a reduction in capital gains rates. Indeed, should the Treasury Department now comply with your request for estimates of the revenue that would result from the

induced effect of lower rates of capital gains taxation, I see no way in which the Department could avoid the conclusion it reached 15 years ago when it examined the same problem, the conclusion which has been so ably reinforced by Dr. Feldstein's recent work.

One further comment on capital gains taxation is in order. The dramatic increase in the nation's inflation rate in recent years, and the prospect that higher rates will continue into the indefinite future have posed new problems in the taxation of capital gains. Because of the higher rate of inflation, an ever-increasing share of nominal capital gains is merely the result of inflation and does not in any way represent real gains. For this reason it seems only equitable that the Archer amendment or some variation of it be included in the final version of the Revenue Act of 1978.

I hope these thoughts may be helpful to you and your Committee during your further consideration of H.R. 13511.

With best wishes,

Sincerely,

Douglas Dillon

cc: Dr. Feldstein
Mr. Fowler

ROBERT B. ANDERSON
630 FIFTH AVENUE
NEW YORK, N.Y. 10020

August 30, 1978

Dear Russell:

I am responding to your letter of August 28 inquiring as to my views concerning H. R. 13511.

It is axiomatic in any tax legislation that the results of particular provisions are a matter of judgment until events prove the reality.

It is my judgment that a reduction of the capital gains tax from 50 percent to 30 percent would have a positive impact on Treasury revenues, and a reduction from 50 percent to 25 percent would have a substantial positive impact on Treasury revenues.

Without being simplistic, I believe that both economic statistics and a reasonable understanding of investor attitude support this view.

Even more fundamental than the immediate impact on Treasury revenues is the question of what such a reduction in capital gains tax would do for capital accumulation.

We must be constantly reminded that there are only two kinds of capital -- (1) capital that is saved and accumulated and (2) capital that is artificially generated or which is illusory. The latter sort of capital arises from excessive budget deficits, particularly when a large part of those deficits results in non-productive goods such as armaments where the best possible use is not to use

the armaments at all. Other illustrations would be unwarranted subsidies, whether direct or indirect.

True capital comes the hard way -- people save a part of their money, invest it in productive enterprise, and liquidate it when individual circumstances require.

Today we are constantly putting new impediments in the way of capital accumulation, and the most significant one is unwarranted rates of taxation and high inflation. Who wants to accumulate capital when the rate of inflation exceeds the interest rate. Who wants to accumulate and invest when upon liquidation of an investment half of one's appreciation in the capital investment goes for taxes.

One has only to look to the Republics of Central and South America where the flight of capital has been historical to see the devasting effect of any kind of legislation or inflation which impairs capital accumulation.

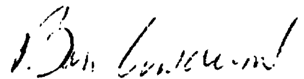
Labor would be well advised to remember that unless true capital is saved and accumulated to create new capital investments and to generate new productivity, there will be fewer jobs for those who want to work.

I know that my answers to your letter are primarily statements of opinion, but I cannot elaborate further and comply with your request to have a letter before your Committee by September 6. Unfortunately, I am leaving the country day after

tomorrow and my time is limited. When I return, if I can be of further assistance to you or your Committee, please advise me.

With every personal good wish, I am

Sincerely your friend,



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

JOHN W. SNYDER
2401 CALVERT STREET, N.W., SUITE 605
WASHINGTON, D. C. 20008

September 6, 1978

Honorable Russell B. Long
Chairman
Senate Finance Committee
217 Russell Senate Office Building
Washington, D. C. 20510

Mr. Chairman:

In response to your inquiry of August 28, 1978, which was not available for study until August 30th, and due to the fact that I have been making a change of command in the Harry S. Truman Scholarship Foundation (aggrevated further by three consecutive holidays), I regret that I have not had sufficient time to evaluate the pros and cons of the subject matter relative to the impact of a capital gains cut on the Treasury revenues.

It therefore appears to me that I can best serve you by being brief and simply expressing my views on the subject.

I agree that a likely effect in the short term would be some "unlocking" of appreciated assets. Undoubtedly, a substantial tax reduction would induce some persons to sell property that would otherwise be retained. As you suggest, this unlocking impact is difficult to quantify; increased Treasury revenues, generated by a high volume of sales, might be offset by lower sales prices caused by the selling surge. But, whatever the net effect on the Treasury, unlocking would be a temporary result of a tax cut.

Over the longer term, a reduction in the taxes on capital income would help to stimulate the productive business investment that our country so urgently needs. Such cuts could be in the form of reductions in the corporate tax rate, liberalization of the investment

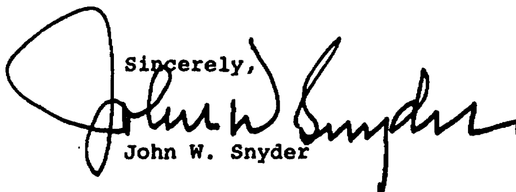
Honorable Russell B. Long
September 6, 1978
Page 2

credit, increases in depreciation allowances, or reductions in capital gains taxes. Any of these cuts could be expected to generate some "feedback" revenues to offset, partially, the initial loss of tax revenue, but I believe it unlikely that a net revenue gain would be produced by the tax cuts over the long term.

In considering the alternative forms of investment incentives, the Committee may wish to assess the efficiency and fairness of the options that are available. I am encouraged, in this regard, by your suggestions that a capital gains cut not be designed in a manner that destroys the minimum tax. Tax equity need not be sacrificed to adopt meaningful investment incentives.

I appreciate the opportunity to comment on the important tax legislation now before the Committee.

Sincerely,



John W. Snyder

C O P Y

Exxon Corporation
1251 Avenue of the Americas
New York, New York 10020
September 5, 1978

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

Dear Mr. Chairman:

I appreciate the invitation in your letter of August 28 to comment on the revenue effects of the capital gains tax proposals before your committee.

A number of my expert colleagues in Exxon's finance, tax, and economics departments have examined the studies prepared by Professor Feldstein and his associates at the National Bureau of Economic Research and find persuasive their indications of a probability that reducing gains taxation will increase the Treasury's revenue. Equally persuasive to me has been what I hear of the experiences of individual investors. Repeatedly I hear of new projects not undertaken because the investors feel "locked in" in their present holdings; apparently they feel the rewards of the new projects are too uncertain for them to begin the process with a certain high capital gains tax as they transfer their investments to the new projects. The result has been less productivity and less growth for our economy and less revenue for the Treasury.

With a lower gains tax, companies and individuals with attractive growth opportunities would be better able to attract equity investment, and the economy would benefit. In view of the low levels of investment the U.S. has experienced in the past decade in comparison with other advanced nations, I hope that your committee will accord high priority to the desirability of reducing the capital gains tax burdens which have played a large role in the decline of the equity markets of the United States.

There are also strong reasons of equity for reducing the gains tax. As an ex-Treasury official and as an economist I have strong feelings about the inequity which would be perpetuated in these inflationary times by continuation of present capital gains tax provisions. Capital gains realized today are taxed in a large proportion of cases at effective

rates higher than those applied to ordinary income when inflation corrections are made. In many cases the effective tax rates are above 100%, and in some cases there is taxation when there are no real gains at all. The prospect of such confiscatory tax rates cannot help but deter savings and investment. Employees' investment in the stock of their own companies is deterred as well as the investment of entrepreneurs taking risks on innovative long shots.

Under these circumstances it is clear to me that our present capital gains tax law should be amended even if it were certain that there would be a resulting revenue loss which would have to be made up by a more equitable distribution of that revenue burden elsewhere. The Senate now has an opportunity, however, to consider reform of the present capital gains tax provisions when those reforms would, at the most pessimistic extreme, allocate to capital gains recipients only a small portion of total tax reductions to be enacted. And far more likely is the prospect that capital gains tax reform will increase the Treasury's revenue! In this situation I believe the Senate would fail to meet its responsibilities if it did not enact this year significant legislation to reform the taxation of capital gains. For this reason I am grateful to you for focussing attention on proposals to go beyond the provisions of the current House bill, which would lower the gains tax for some but raise the tax for many.

Doing good at probably no cost is too good an opportunity for your committee to miss.

Sincerely yours,

(Signed)

Jack Bennett
Director and Senior Vice
President

STANFORD UNIVERSITY
STANFORD, CALIFORNIA 94305

DEPARTMENT OF ECONOMICS

September 5, 1978

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

Dear Senator Long:

Thank you for your letter of August 28 requesting my judgment as to the official estimate of the impact of any cut in capital gains taxes on Treasury revenues. I have reviewed H.R. 13511, the Revenue Act of 1978, as passed by the House of Representatives and also the testimony of both former Secretary of the Treasury Fowler and Professor Feldstein. Further, the study of the effects of government policy on capital formation and incorporation of such effects into an improved informational structure for evaluating tax policies have been one of my primary areas of research for the last two years.

Let me begin by stating the three pieces of information necessary to obtain an accurate estimate of the effect on tax revenues of reducing the percentage of capital gains included in taxable income from 50 percent to 30 percent or 40 percent or of adopting a 25 percent maximum tax rate on capital gains. I will then present my best judgment on each of these points and summarize, briefly, my opinions on this matter.

First, we would need to know the size and timing of the unlocking impact on appreciated assets, and the taxes which otherwise might have been paid on the accrued gains (e.g., eventual payment of estate taxes). Offsetting the tax collections on any increased realizations from the existing stock of accrued gains against the revenue losses on current realization levels at the lower rate gives us what we might call the very short term (perhaps the first couple of years) net revenue impact. This is the offsetting effect addressed by Fowler and Feldstein.

I believe that the essential point raised by Secretary Fowler and Professor Feldstein is correct: The official Treasury calculation can be extremely misleading since it fails to account for any induced behavioral responses (e.g., unlocking) of the rate reduction. The Treasury and the CBO continue to provide estimates of revenue effects of tax cuts, so-called "tax-expenditures," and the like which ignore induced incentives to save, invest and work. As a result, these estimates can only be interpreted as an upper bound on the revenue loss from rate reductions. If the induced behavioral response is negligible, the official estimates would be fairly accurate. In the case of capital gains taxes, however, the induced response is likely to be substantial and the official Treasury and Congressional staff estimates misleading.

The only serious study of unlocking is the one by Professor Feldstein and his colleagues. Working under rather severe data limitations (use of a sample of tax returns from a single year only, use of dividends as a proxy for wealth, etc.), they have been able to establish a substantial

sensitivity of realizations of capital gains to effective tax rates. The data limitations mentioned above as well as one or two other minor issues of interpretation would make me chary of using Feldstein's precise estimates. I do believe that a prudent interpretation is that his analysis demonstrates that the unlocking effect is non-trivial and would at the very least substantially offset the revenue loss from lower rates at current realization levels. A good working estimate is that within a year or two the unlocking effect would probably neutralize any capital gains revenue losses due to lower rates.

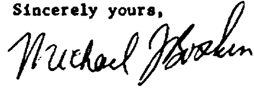
The second piece of information we would need is the effect of a decrease in effective capital gains tax rates on the accrual of capital gains. Will rate reductions induce an increase in the rate of accrual and, if so, from what source does the accrual derive: income that otherwise would have been taxed (or untaxed) or additional work effort? We have very little information upon which to base such an estimate. If little effect on accruals of capital gains occurs, the increased realization rate will have only a temporary revenue gain effect. On the other hand, if the rate reduction also affects the accrual rate, an increased realization rate due to unlocking would lead to a substantial permanent annual source of increased tax revenue. The best method of obtaining information on such effects is to follow a sample of taxpayers over a span of years to observe the forces affecting accruals as well as realizations of capital gains. Unfortunately, such data are unavailable at present. Hence, we have very little knowledge about the likely permanent annual effect on tax revenues of a capital gains tax cut. My opinion is that the accrual rate will be affected, but not so much, nor entirely from untaxed sources of income, so as to raise revenues substantially. I do believe that this induced accrual and subsequent realization effect would probably at least offset the revenue loss from rate reductions.

Finally, a capital gains effective tax rate reduction would tend to raise the overall net-of-tax-and-inflation rate of return to saving and investment. My own results (a copy of which is enclosed) suggests that this would lead to an increase in overall private capital formation (as opposed to merely transferring of assets from lower to higher productivity uses by reducing the lock-in effect) and hence future productivity, wages, income and tax revenues. This is a much longer term process relative to the unlocking discussed above and would take perhaps a decade to substantially increase tax revenues. But that is the nature of capital formation: increases in saving and investment accumulate over a span of years to increase future national income substantially.

In brief summary, I do believe that the official Treasury and Congressional staff estimates substantially overstate the revenue loss associated with the capital gains tax provisions contemplated in H.R. 13511. My opinion is that the unlocking effect of a rate reduction would in short order neutralize this revenue loss. I would need more evidence to claim that it would cause a permanent annual increase in capital gains tax revenues. However, in the long run, it would be likely to increase overall capital formation, productivity, income, and hence tax revenues.

If I may be of any further assistance, please do not hesitate to call upon me.

Sincerely yours,



Michael J. Boskin
Professor of Economics

MJB:cg

P.S. My paper is being sent under separate cover.

American Enterprise Institute for Public Policy Research
1150 Seventeenth Street, N.W., Washington, D.C. 20036
(202) 862-5800

Arthur F. Burns

September 5, 1978

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

Dear Senator Long

I am glad to respond to your recent inquiry about the capital gains tax.

In view of our persistent inflation, the present tax is frequently, if not typically, a tax on phantom profits. Venture capital investment is now virtually dead in our country. If investments of large risk are to be undertaken, there must be the promise of large rewards. Let us never forget that the big corporations of today were small a generation ago; their growth was made possible in large part by preferential treatment of capital gains.

Contrary to what the Treasury has been saying, experience indicates that, as a general rule, a reduction of the capital gains tax is no more likely to decrease than to increase tax revenues in the short run. I would add, however, that in view of recent extended discussions of capital gains, many investors have held off selling; hence a reduction of the capital gains tax may well result in larger tax revenues next year. In any event, if a lower capital gains tax stimulates investment, as is to be expected, tax revenues should rise over the long run.

Sincerely yours,

[signature]

COVINGTON & BURLING
888 SIXTEENTH STREET, N. W.
WASHINGTON, D. C. 20006

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September 6, 1978

Honorable Russell B. Long
217 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I write in reply to your letter of August 28, 1978, asking my judgment as to the revenue effect of certain pending proposals for lowering taxes on capital gains.

It is my judgment that, taking into account not only increased realization of capital gains but also the spur to risk-taking investment and the induced effects on the economy generally, enactment of the proposals would increase the federal revenues.

In arriving at this conclusion I would be hesitant to rely entirely on the anticipated increase in revenue flowing from increased realization of gains that could be expected from capital gains tax reduction. For example, the proposal to reduce the inclusion factor for capital gains from 50 percent to 30 percent would, broadly speaking, reduce revenues to three-fifths of their present amount except for induced effects; and if we were to rely solely on anticipated increases in realized gains to offset the revenue loss, realized gains would have to rise to five-thirds of their prior amounts, or to 167 percent. Thus, realization of gains would have to increase by 67 percent, or by two-thirds of their present total, to offset the "static" revenue loss.

I would have difficulty in concluding that realization of gains would suddenly increase by such a large amount. I have read the studies of Professor Feldstein, whom I hold in great esteem, concluding that realization of capital gains are highly sensitive to changes in capital gains taxes, and I was present when he testified before you. But based upon my

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Page Two

studies of capital gains data for the past fifteen years, I would be hesitant to say that a large immediate increase in realization of gains, standing alone, would fully offset a reduction in the inclusion factor from 50 percent to 30 percent. Obviously, there is a point of judgment that must be invoked, because a complete elimination of capital gains tax would result in a complete loss in capital gains tax revenue, although it would doubtless increase realizations substantially.

I have also studied the recent statement of Secretary Fowler, for whom I have the greatest admiration, and I was also present when he testified before you. I interpret his statement as relying, as I do, on other factors beyond increased realizations in concluding that there would be an actual increase in federal revenues from his proposal. He does refer in his statement to the Treasury's conclusion in 1963 that a reduction in the inclusion factor from 50 percent to 30 percent would increase revenues because of increased realizations. It is to be noted, however, that the 1963 proposal was coupled with a proposal to tax capital gains at death, which would, of course, force realizations because death is inevitable. I have consistently opposed all the proposals that I have seen to date to tax capital gains at death because of serious difficulties involved with respect to treatment of bequests to surviving spouses and charities; the sharply increased deathtime burdens, particularly on family-owned enterprises; the unreality of taxing a lifetime of unrealized gains in a single year, for which there seems to be no adequate answer in averaging techniques; and other technical and practical difficulties too numerous to mention here. The problems are greater, I believe, than those that have shown up with respect to carryover basis.

But while I hesitate to say that the revenues would be made up by increased realizations alone, I do believe that when that factor is combined with the substantial increase in equity and other risk-taking investment that would inevitably occur, and with the consequent benefit to employment and the entire economy, there would be a net overall increase in federal revenues.

I believe the House provision eliminating capital gains as preference items is quite desirable. I am convinced that the treatment of capital gains as preference items in the 1969 Act, and particularly in the 1976 Act, is complex,

confusing, difficult to explain and administer, and harmful to the economy. I think it acts as a significant deterrent to investment and to realization of capital gains, and its repeal would have a net effect of increasing revenues.

When I served at the Treasury during the consideration of the 1969 Act, the application of a minimum tax to capital gains was one of the few major changes made by that Act with which I disagreed and which, along with others at the Treasury, I opposed. I was particularly concerned with the very substantial increases in the taxes on capital gains as preference items contained in the 1976 Act. I think the 1976 changes had quite an adverse effect on the climate of investment by individuals, especially since they seemed to indicate that even further increases in the taxes on capital gains were in the offing. Indeed, scarcely was the ink dry on the 1976 Act when in early 1977 there was widespread discussion of taxing capital gains as ordinary income; and in January of this year the Administration proposed to eliminate entirely the regular income tax as a deduction in computing the minimum tax, a change which would have had the net effect of converting the minimum tax into an additional 7-1/2 percent tax on all capital gains exceeding $20,000 in any year.

I view it as an urgent priority to reverse this process and to reduce the tax burden on risk-taking investments by individuals in the interest of giving a clear signal that such investments are considered to be of prime importance to the economic well-being of the Nation.

I would note that while removing capital gains from the list of preference items, the House bill would eliminate the 25 percent ceiling tax on the first $50,000 of capital gains, thus raising an additional estimated $133 million in revenue. This would in fact represent a net increase in capital gains tax on a substantial number of individuals. At the Treasury in 1969 we strongly urged the retention of the 25 percent ceiling on the first $50,000 of capital gains and I would again urge its retention. I do not think the relatively small amount of additional revenue involved in this change warrants the imposition of higher capital gains taxes on these individuals.

With respect to Secretary Fowler's proposal to reduce the includible amount of long-term capital gains from 50 percent to 30 percent, I am inclined to think that changes along

those lines would be desirable. The strict limitations on deductions on capital losses, the effects of inflation, and the absence of adequate averaging devices to deal with gains accruing over long periods of time, make it necessary, I believe, to employ simplistic rules to make risk-taking investments more inviting in the interests of a dynamic economy. Secretary Fowler's proposal, moreover, has the advantage of being even-handed through all the income levels of taxpayers.

If I can be of any further assistance to you or to your staffs, I shall be pleased to do so.

Sincerely yours,

Edwin S. Cohen

NATIONAL CITY BANCORPORATION
TENTH FLOOR NATIONAL CITY BANK BUILDING
75 SOUTH FIFTH STREET
MINNEAPOLIS, MINNESOTA 55402
TELEPHONE: 612/340-3183

September 5, 1978

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

Dear Chairman Long:

This letter is in response to your letter of August 28, enclosing copies of statements by Mr. Henry H. Fowler and Professor Martin Feldstein before the Senate Finance Committee, requesting my judgment as to the impact of any cut in capital gains taxes on Treasury revenues.

As you know, I served with former Secretary Fowler in the U.S. Treasury Department for almost four years, 1965-68. While I was not at Treasury during the period when the Revenue Act of 1962 and the Tax Reduction of 1964 were enacted by the Congress, I became generally familiar with the background of that tax legislation and I was at Treasury when the Tax Reform Studies and Proposals of the U.S. Treasury Department were prepared at the close of 1968, although I did not participate in any significant degree in that effort.

Thus, it is not surprising that I am in virtually complete agreement with the points made by Mr. Fowler in his testimony on August 22 and in his letter to you of August 28, 1969. I should note also that the studies done by Professor Feldstein and his colleagues seem to me to be thorough and persuasive.

I am convinced that the level of taxation of capital gains in the United States tends to be counter productive in the

sense (a) that it leads to a "lock-in" effect that freezes funds invested in assets so that they cannot contribute further to help meet the needs for venture capital in an expanding economy, and (b) that it produces smaller revenues directly by holding back on the realization of such capital gains. I have made no systematic study so as to produce any concrete estimates of the revenue effects of lower taxes on capital gains, but on the basis of numerous conversations with people who have unrealized capital gains I am certain that reduction in the tax rate would produce substantially more sales and hence more realized gains and hence more tax revenues. In a broad sense, the lower the effective tax rate the more sales there would be. Obviously at some point of taxation the increase in sales would produce less revenue but that would not be the case were the tax structured as suggested by Mr. Fowler.

A second point is to me even more persuasive. Whether or not there now is or will be a "capital shortage" in a real sense, it seems to me evident that the rise in debt capital financing, the reduction in the number of equity owners and the sharp fall in the number of new ventures requiring equity capital all indicate that the present structure of capital gains taxation is not conducive to investment requiring equity for financing. As Mr. Fowler observes, other factors than the tax structure have contributed to this situation, but the tax structure is an important factor. If it can be corrected and at the same time produce greater revenues directly and even greater ones indirectly as investment sparks greater growth, it is highly desirable to correct it.

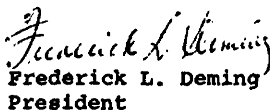
Finally, while you have not asked for comment on this point, I wish to say a word about "indexing" capital gains. It is, of course, true that after adjusting for price rises real capital gains become much smaller; Professor Feldstein's studies indicate they may even become negative. Nevertheless, it seems to me that it would be unduly complicated and probably unwise to "index".

The Honorable
Russell B. Long -2- September 5, 1978

I would prefer to scale the capital gains tax downward with the length of time the capital investment has been held which, in a sense, would partially accomplish the same objective.

I am pleased that you have asked for my comments on this important tax question; I hope that they will be useful to you and the Senate Finance Committee.

Sincerely,



Frederick L. Deming
President

FIRST BANK SYSTEM, INC.
MINNEAPOLIS, MINNESOTA 55480

GEORGE H. DIXON
PRESIDENT

September 1, 1978

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

Dear Senator Long:

Thank you for your August 28 letter inviting comment about the official estimate of the impact on Treasury Revenues of a cut in the capital gains tax (Title IV-Revenue Act of 1978-H.R. 13511).

As a former Treasury Department official, it is my recollection and present understanding that a flaw in the Treasury Revenue Estimating Model(s) is that it does not provide for a "feedback" effect--that is to say it assumes that the volume of capital transactions subject to a capital gains tax would remain essentially the same irrespective of the tax rate. While the assumptions underlying the construction of any Revenue Estimating Model may be challenged, I am far more comfortable with models which recognize that the volume of taxable transactions would indeed be different given different tax rates. I understand that the models used to support the testimony of Messrs. Feldstein and Fowler before your Committee recognized the importance of the "feedback" effect.

There is little doubt in my mind that the present system of taxing capital gains restrains the mobility of capital and encourages investment in relatively low risk activities and fosters direct consumption expenditures.

Like Feldstein and Fowler, I believe that a reduction in capital gains rates will unlock a very significant volume of appreciated assets; and within the rate reduction range you mention (50%-25%) the lower the rate the more positive the impact on Treasury Revenues, especially in the short run.

The Honorable Senator B. Long
September 1, 1978
Page 2

As your letter implies it probably is impossible to make a reliable prediction of the extent of unlocking, or of the point at which the effect of the reduction of the tax rate would exceed the revenue producing potential of the increased volume of transactions. Recognizing this uncertainty, I believe that fundamental Congressional objectives of stimulating the economy, employment and capital formation would be well served by a significant reduction in the rate of tax on long term capital gains, to say 25-30%. You will recall much better than I the recommendation President Kennedy made in his Tax Message in January 1963 in which he urged Congress to:

> " . . . . reduce the percentage of long term capital gains included in individual income subject to tax from the present 50 percent of the gain to 30 percent . . . ."

Sincerely yours,

George H. Dixon
President
First Bank System, Inc.

845 Third Avenue
New York, N.Y. 10022

THE CONFERENCE BOARD

September 1, 1978

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

Dear Mr. Chairman:

In response to your letter of August 28, I am glad to offer some comments on the revenue impact of cuts in capital gains taxes. In doing so, I speak only for myself, since The Conference Board does not take positions on public policy issues.

When I served in the Treasury Department from 1971-75, I had responsibility for tax revenue estimates, including receipts from the taxation of realized capital gains. From that experience I developed a deep skepticism of the accuracy of revenue estimates, and also of the perfectibility of the estimating process. I vividly remember spending a couple of days in 1972 with the staff of the Office of Tax Analysis reviewing their estimating procedures and exploring alternative procedures. Of all the categories, the biggest errors almost always showed up in capital gains. Further, the analytical methods for estimating the realization of capital gains seemed most stubbornly resistant to improvement. We tried everything we could think of, but nothing worked. Despite the sophistication and general competence of the professional staff (and I believe that's still true today), the empirical projections always proved to be unsatisfactory.

I outline this background to explain why I am unwilling to express a judgement on whether a reduction of capital gains taxes will have a negative, neutral or positive impact on tax receipts. I simply feel there is no sound basis for reaching a specific answer to this question.

I believe the official estimate (representing, as I understand it, taxes on assets sold by individuals, other than residences) of a $1.0 billion reduction in revenues for the next calendar year from the House bill is clearly wrong. Common sense tells us that in the first year or two there has to be some feedback on tax revenues from "unlocking" appreciated assets. (I can't believe the Treasury will not change their official view on this.)

The question is, how much? Again I have to say I don't know, and that I am highly skeptical of estimates made by others. In the short run the "unlocking" aspect might be significant, because there is undoubtedly an accumulation of "locked-in" appreciated assets from past years that will be affected by a reduction in the tax. While this transitory effect might be sizeable, the longer run impact of "unlocking" might be small.

THE CONFERENCE BOARD

The Honorable Russell B. Long - 2 - September 1, 1978

However, in the long run there is also the effect, mentioned in your letter, of enhanced capital formation and economic growth. It strikes me—and this is only impressionistic—that the proposed cuts in capital gains taxes are just not big enough to have a dramatic effect on economic growth. If so, the long-term impact on revenues would not be very great.

In this regard, however, I would conjecture that your idea of reducing the percentage of capital gains included in taxable income would have a somewhat more favorable effect than the House bill. But even so, I don't think we could expect more than a small increment to our long-term growth rate.

Let me not be misunderstood here. I fully support the cut in capital gains taxes, because I feel it is very important. It is important because even a small addition to growth is worthwhile. And it is important because a cut in capital gains taxes is a step in the right direction--the first forward step in perhaps a quarter of a century, after a lot of steps backward. Nevertheless, there are many unfinished items on the agenda, including replacement-cost depreciation, indexation of the tax system, etc.

I was particularly impressed by Henry Fowler's comments about the relationship of capital gains taxes to "the mobility and flow of risk capital from static to more dynamic situations," and especially the need for new ventures to have access to financing. I feel many of us underrate the importance of this aspect of economic growth.

In summary, then, I believe that a reduction of capital gains taxes will generate a significant feedback of tax revenues in the first year or two—possibly enough to "pay for" that part of the tax cut. But even though the net revenue effect must necessarily remain uncertain, a cut in capital gains taxes is a highly important objective for the nation.

I hope these thoughts are of some help to you and the Committee in your deliberations. Thank you for giving me the opportunity to comment.

Sincerely,

Edgar R. Fiedler
Vice President
Economic Research

ERF:bg

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

STEPHEN S. GARDNER
VICE CHAIRMAN

August 31, 1978

The Honorable Russell B. Long
United States Senate
Washington, D. C. 20515

Dear Senator Long:

This is in response to your request for an evaluation of the effects on Treasury revenues of various proposals for cutting the tax on capital gains.

The question you have raised is an extremely complex one. In such estimates, analysts must first make a number of key assumptions about such potential developments as the likely course of markets for stocks, real estate and other assets, and, more importantly perhaps, the extent to which a capital gains tax cut will "unlock" investment holdings. In forming judgments based on such assumptions, some guidance can be obtained from a review of the historical record. But there is nonetheless room for reasonable men to form quite different opinions in reading this record, as the wide disparity in the estimates that have been presented to you clearly attests.

As you know, Chairman Miller will be testifying before the Senate Finance Committee on September 6th. He plans to address the general issue of alternative tax strategies, with particular emphasis on tax changes designed to enhance capital formation.

Best wishes.

Sincerely,

Stephen S. Gardner

TOWNSEND-GREENSPAN AND COMPANY, INC.
ONE NEW YORK PLAZA
NEW YORK, N. Y. 10004

ECONOMIC CONSULTANTS (212) 943-9515

September 5, 1978

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

Dear Mr. Chairman:

There is no doubt that the so-called static estimates of revenue loss from capital gains tax cuts employed by the Treasury are misleading. Such estimates have a very limited purpose: that of determining where the initial tax cut falls. However, as an estimate of the expected change in federal revenues stemming from a capital gains tax rate cut, they are quite useless. The net revenue loss from virtually all of the capital gains proposals currently under consideration should be considered to be either negligible or nonexistent. There is even a reasonable probability that revenues could well increase as a consequence of a cut in rates at this time. (I am in agreement with Dr. Feldstein's findings in this regard.)

For budgetary purposes I would assume no revenue change for the capital gains proposals embodied in HR 13511. I would be inclined to make the same assumption with respect to your proposal of reducing the percentage of capital gains included in taxable income from 50% to 30%. This type of revenue feedback would be based on the "unlocking" effect only, and would not consider the additional tax receipts which would almost surely accrue as a result of enhanced capital formation. Over the long run, aggregate Treasury revenue would certainly rise as a consequence of a cut in the capital gains tax. The revenues would accrue not only from the unlocking effect, but also from the enhancement of economic activity and taxable incomes generally.

The capital gains tax is particularly important so far as risk taking is concerned. We have ample evidence that individuals are willing to take large risks for a low probability of obtaining a very large capital gain. We see it in the success of lotteries where individuals are all too willing to pay $1 for a lottery ticket which has the probability of one in 2 million of winning $1 million. We see similar attitudes among entrepreneurs who readily take large risks, provided the rewards can be substantial. The problem with the capital gains tax is that it chokes off the possibility of _very_ large returns and, hence, suppresses the so-called "lottery effect" of the capital investment process.

The Honorable Russell B. Long p. 2

This is one of the reasons why a major cut in capital gains tax rates should have a rather significant impact on long-term risk investment (clearly, something this country sorely needs at this stage).

I do not believe that should Treasury embody an "unlocking" revenue effect from capital gains rate cuts, that it need also make similar feedback adjustments for individual and corporate income tax cuts. It is important to distinguish between an unlocking effect generated by the voluntary creation of a liability by a person realizing capital gains, and the indirect feedback effect on the economy (and taxable incomes) from any cut in taxes. The latter are difficult to estimate and may, under certain conditions, be misleading. But this is not the case with an "unlocking" revenue impact. There is no comparable effect in the individual income and corporate tax rate structure and, hence, there is no necessity to make a revenue estimate which has an unlocking and feedback effect for all forms of tax cuts.

At some later date it may be desirable to include the different types of secondary and tertiary effects of a tax cut on Treasury revenues. But, in the interim, it would be desirable, as a first step, to assume zero revenue loss from the various types of capital gains tax cut proposals now being considered.

If I can be of any further assistance, please let me know. Best regards.

Cordially,

Alan Greenspan

AG:gc

COPY

September 12, 1978

MEMORANDUM

TO: Senator Russell B. Long, Chairman, Senate Finance Committee

FROM: Walter W. Heller, Regents Professor of Economics, University of Minnesota

RE: The Revenue Impact of Capital Gains Tax Cuts

The assessment of the revenue impact of capital gains tax cuts has to couple the effect on realizations (the "unlocking impact") with the effects on stock prices and capital formation.

It's a truism that people prefer lower to higher tax rates. And lower rates will reduce some of the lock-in effects of the capital gains tax. As a matter of fact, right now, capital gains are being "stockpiled" awaiting the promised land of lower rates after January 1. That would lead to a gush of realizations in 1979, with one known effect, that is, a one-time gush of revenues, and one unknown effect, a possible air pocket in the stock market if the recipients do not quickly reinvest the proceeds in other stocks.

In other words, I would expect revenues to take a one-time jump in the short run. But for the longer run, it is unlikely that the reduced lock-in effects will be great enough to compensate for the revenue loss from the rate reduction itself. Evidence to the contrary drawn from the post-1969 experience and from Secretary Dillon's testimony on President Kennedy's recommendations in 1963 is not persuasive.

In the Kennedy program, probably the most powerful force in unlocking unrealized gains would have been the provision for constructive realization of capital gains at death that was closely coupled with the 70% exclusion proposal. (Lengthening of the holding period to one year would also have added revenue.) The 1963 Treasury estimate of revenue gains is therefore not really applicable to the current case.

As to the impact of the 1969 tax increases, one should note that as the capital gains tax rose, stock prices and realizations also rose for several years. By January 1973, in fact, the stock price index was up by 46%. Then, under the impact of an explosion of oil prices and interest rates among other factors, stock prices were hammered down. So the post-1969 experience does not provide a clear-cut guide on how stock prices and capital gains revenues will respond to a change in capital gains rates.

On the question of the boost that capital gains tax cuts might give to stock prices, I have little doubt that such cuts would improve "market atmospherics" and increase the capitalized value or marketable assets. But extravagant claims of a 20% to 40% jump in stock prices are implausible to put it mildly. First, one should consider that the total value of U.S. common stocks today is about $1 trillion. Common sense suggests that a tax cut amounting to about $1 billion a year could not have anything like this kind of leverage on $1,000 billion of stock values. Second, as Treasury Assistant Secretary Daniel Brill brought out in his June 29 testimony before your Taxation and Debt Management Subcommittee, the results of several econometric studies on this point vary all over the lot because of (a) arbitrary assumptions about stock prices and (b) in one case, serious technical flaws.

The argument is also made that the induced effects of capital gains tax cuts--fostering of capital formation and growth--will broaden the tax base. But one should bear in mind (1) that well over half of capital gains have very little to do with business investment, stemming as they do from sales of land, private homes, cattle, art, antiques, precious metals, jewelry and the like; (2) that capital gains tax cuts give us a much smaller bang for the buck (and hence less feedback bucks for the bang) than tax cuts focused directly on business investment through accelerated depreciation, investment credits, and corporate rate cuts; and (3) that among the induced effects of capital gains tax cuts will be a magnified incentive to convert ordinary income into capital gains and thus lower ordinary income tax revenues.

I wish we had more solid ground on which to base estimates of the impact of capital gains tax cuts on realizations, on stock prices, on business investment, and hence on tax revenues. But we don't. In large part, we have to fall back on common sense and rules of reason. Under these circumstances, I would urge the Committee (1) to reject all extravagant claims about the revenue effects of capital gains changes; (2) to pursue the conservative course of projecting a moderate revenue loss from capital gains tax cuts; (3) to shape its capital gains tax reductions with an eye to the fundamentals of (a) improving the climate for business investment, and (b) promoting fairness in taxation; and (4) if results exceed expectations, declare tax cut dividends in future years when the facts are in.

HARVARD UNIVERSITY

HENDRIK S. HOUTHAKKER
HENRY LEE PROFESSOR OF ECONOMICS

218 LITTAUER CENTER
CAMBRIDGE, MASSACHUSETTS 02138

September 5, 1978

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

Dear Senator Long:

Thank you for your letter of August 28 asking for my views on capital gains taxation. As regards the specific question in your third paragraph I regret that I cannot be very helpful in the very short time available. There can be no doubt that some unlocking of capital gains will result from a lower tax rate, but without considerable research I cannot express any quantitative judgment on this effect. Moreover I do not feel that the impact on Treasury revenues is necessarily the decisive consideration in evaluating proposed tax reforms; the true touchstone should be the effect on the economy as a whole.

In this connection I may perhaps make the following more general observations.

1. The most important reform is indexing of the cost of capital assets, along the lines of the Archer amendment as I understand it. I can see no justification at all for taxing people on gains that are due entirely to change in the general price level.

2. As regards the encouragement of risk taking, the most significant reform that could be undertaken is a liberalization of the treatment of capital losses. The limitation of $1000 on losses that can be taken in one year has been in the tax laws for many years but should at least be raised in line with inflation. In fact, I could see a strong case for a higher limit, say, 10% of adjusted gross income.

3. I do not have strong feelings on the rate at which long term gains should be taxed. While it can be plausibly argued that capital gains are not income at all and therefore should not be taxed, it is also true that many possibilities of converting income into capital gains exist. Therefore taxation of capital gains is appropriate in practice. The present 50% rate appears to be a reasonable compromise and I would not give high priority to changing it.

I hope these observations will assist your Committee in its deliberation.

Yours sincerely,

HSH:js

September 1, 1978

Oral comments of Professor Burton G. Malkiel
Gordon S. Rentschler Memorial Professor of Economics
Princeton University, provided by telephone

There is no sound empirical work which could suggest the numerical impact on the Treasury created by capital gains tax cut. I am suspicious of the Treasury figures.

In theory, I believe that a capital gains tax cut does increase the reward for risk taking and may well do a lot of unlocking which would increase yields and the tax base to some extent.

A sensible way to achieve these results would be to use capital gains cuts that do not help people currently using real estate tax shelters. Indexing would skew the benefit to people who invest in small companies. I would favor this approach for that reason.

I disagree with the Steiger proposal because it gives the same break to everyone -- both entrepreneurs and those taking advantage of tax shelters -- rather than directing money to areas of the economy that need it.

WILLIAM McCHESNEY MARTIN
FLEMING BUILDING
800 SEVENTEENTH STREET, N. W.
WASHINGTON, D. C. 20006

By Hand

September 5, 1978.

Dear Senator:

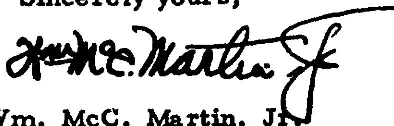
You have requested my judgment with respect to the impact on Treasury income of a change in the capital gains tax. You very properly note that this is a matter of judgment and not one that can be quantified specifically.

In my judgment, I would favor a 25 per cent maximum rate and believe this would unlock, over a reasonable period of time, a great deal of capital and thus would be constructive for the entire economy. At the same time it would be positive on Treasury revenues.

I am in full accord with the analysis of Professor Feldstein. I have followed this for many years and these are my conv' :tions for whatever they are worth.

With all good wishes,

Sincerely yours,



Wm. McC. Martin, Jr.

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

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Graduate School of Business Administration · The University of Michigan · Ann Arbor 48109

PAUL W. McCRACKEN
Edmund Ezra Day University Professor of Business Administration

September 7, 1978

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

Dear Russell:

This is in response to your letter of August 28 regarding the capital gains tax. While I do not consider myself to have any expertness in this field, I would make three general points.

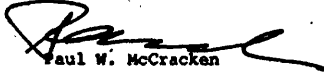
First, the capital gains tax clearly should not be applied to the part of the increase in an asset's nominal value which occurs because of a rise in the price level generally. To tax that part of the rise in its nominal price would be to convert the capital gains tax into a capital levy via inflation. If there is to be a capital levy, it should be the result of an explicit decision by government, with government's accepting political responsibility for the decision.

Second, I have read the statement by Secretary Fowler, am quite familiar with the basic research work by Professor Feldstein of Harvard, and I find their analyses of the "unlocking" effect to be achieved by a more reasonable capital gains tax to be persuasive. Estimates based <u>de jure</u> or <u>de facto</u> on the assumption that activity in markets for assets would not be responsive to more reasonable capital gains tax treatment do not appear solid. Here is one area where lower rates may actually produce more revenue.

Finally, the capital gains tax deals with what might be called the yeasting activity that generates economic progress -- namely, entrepreneurship. This country moved from an empty land to the world's largest economy, generating unmatched material levels of living for people generally, because it encouraged this economic creativity. We have been subjecting this activity to penalty tax status with our treatment of capital gains, treatment more severe than that accorded by many governments who consider themselves more socialist than ours.

If this imbalance is redressed, the major beneficiaries will not, of course, be "the rich." To suggest that is to indulge in the demagoguery of a bygone age that now sounds tired and stale. The major beneficiaries will be the added employment from the more vigorous job creation and the more rapid gains in real income for all that could be delivered by a re-energized economy.

Regards,



Paul W. McCracken

PWM:gb

The Brookings Institution

1775 MASSACHUSETTS AVENUE N.W. / WASHINGTON D.C. 20036 / CABLES: BROOKINST / TELEPHONE: (202) 797-6000

Economic Studies Program

September 6, 1978

The Honorable Russell B. Long
Chairman, Senate Finance Committee
217 Russell Senate Office Building
U.S. Senate
Washington, D.C. 20510

Dear Senator Long:

In response to your letter of August 28, I appreciate the opportunity to offer my judgments about the revenue effects of changes in capital gains taxation. My professional judgments in this area are intuitive, because I have not done independent research in it. But common-sense tests of plausibility and intuition are sorely needed as checks on empirical research findings. To state my conclusion at the outset, it is my considered opinion that any significant reduction in capital gains taxes would cost a substantial sum of federal revenues after allowing for any unlocking effect -- whether it is accomplished by reducing the inclusion ratio, by cutting the minimum tax, or broadening the alternative tax.

The changes in capital gains taxes legislated in 1969 added roughly a nickel on a dollar to the average effective tax rate on potentially realizable capital gains. It is utterly implausible to me that offering the taxpayer roughly seventy-five cents after-tax on the dollar -- rather than eighty cents -- could have reduced the realization of net gains by fully two-thirds, as Dr. Feldstein concludes from his study. Can anyone really believe that an extra nickel on the dollar would have made taxpayers volunteer for a significant reduction in their net worth and volunteer to pay about two and a half times as much in capital gains taxes?

The utter implausibility of that result points to the likelihood of a basic flaw in the methodology of the Feldstein study. Dr. Feldstein's work must be taken seriously; he is one of the most productive and ingenious members of my profession. But in this case the nature of the data forced an extreme degree of ingenuity that may have prevented valid inferences. Feldstein's findings tell us loud and clear that, in 1973 among people at the same level of adjusted gross income with the same level of dividends, those with higher marginal tax rates realized less capital gains on common stock than did those with lower marginal tax rates. But how can taxpayers with the <u>same</u> adjusted gross income in the <u>same</u> year have <u>different</u> marginal tax rates?

All American citizens are confronted with the same federal tax law. Differences in marginal tax rates at the same adjusted gross income must result mainly from differences in itemized deductions. (Differences in the applicability of averaging, alternative tax, and minimum tax may also create different marginal tax rates.) Apparently, Feldstein has really found that people with large amounts of itemized deductions in relation to income also tend to have large amounts of realized net capital gains in relation to their dividends. The relationship between high itemized deductions and high realized capital gains could emerge in many ways. Implicitly, Feldstein is assuming a causal chain of the following sort: some people have especially large itemized deductions for reasons that are unrelated to capital gains; those large deductions lower their marginal tax rate; the lower tax rate then encourages larger realization of capital gains. In that event, anything that lowers tax rates (like a change in the law) will swell realizations. But let me offer three hypothetical examples of different causal chains. First, people who held growth stocks (rather than dividend-oriented stocks) that had large potentially realizable gains in 1973 may have tended to borrow heavily on their stocks and thus to have had large deductions for interest payments. Second, people who realized especially large capital gains may have tended to make unusually large charitable contributions in that year. Third, people with unusually large medical expenses or casualty losses may have realized a large volume of capital gains to raise cash. Any of these would create a spurious, misleading negative relationship between realized gains and tax rates. These are all only possibilities, but I strongly suspect that such processes must be operative to produce the implausible overall result.

Let me suggest one type of empirical cross check that could be performed on Feldstein's findings. His equation has implications for the realization of net gains on corporate stock that should be taken by nontaxable investors. Some small pension funds and small endowments of private universities and nonprofit organizations are comparable to very high income individuals in their portfolio choices, except that their tax rate is zero. Do they realize as much as Feldstein would predict for a taxpayer with a zero tax rate on capital gains?

I would like to add several further comments that are relevant to this discussion. If I believed that lower tax rates would triple realized capital gains as Feldstein implies, I would be seriously concerned that such a tax cut would lower stock prices. If people voluntarily would pay much more in taxes, they would obviously have much less to reinvest and could not be expected to put all of that back into stocks. This adverse effect of a wave of realization might easily outweigh the favorable effect of increased after-tax returns. Presumably, the purpose of lowering tax rates on capital gains is to improve the climate for investment, not simply to raise funds for the Treasury. To the extent that the Treasury really

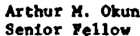
gained, the equity market may well lose!

Turning to another issue, I would stress that any discussion of unlocking effects should recognize that the extent to which the taxpayer volunteers for capital gains taxes depends not only on his current tax rate but also on his options for the future. If unlocking capital gains was the only objective, the most effective measure would be the imposition of constructive realization on gains at gift or death. Indeed, that was a key feature of the 1963 Kennedy program which also proposed to lower the inclusion ratio to 30 percent. And, as you will recall, the House bill which called for a lower inclusion ratio without constructive realization was strongly opposed by the Administration.

In terms of promoting business investment in plant and equipment, what the Congress does to cut the corporate tax rate is far more important than what it does to cut capital gains taxes. The President's original proposal for a phased cut in the basic corporate rate from 48 percent to 44 percent is the optimal investment incentive, working directly at the point of capital budgeting decisions. Whatever revenues you are willing to forgo as a stimulus to capital formation should be concentrated in that direction; that will serve the nation far better than any search for a free lunch on capital gains relief. If we could only run a controlled experiment, I would love to bet that a reduction in the corporate tax rate of an extra point would do more to stimulate business investment than any equivalent tax relief on capital gains.

Thank you for the opportunity to express these views.

Sincerely,



Arthur M. Okun
Senior Fellow

AMO:mw

C O P Y

CITIBANK

LEIF H. OLSEN
Chairman Economic Policy Committee

September 7, 1978

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

Dear Chairman Long:

I have read the analysis prepared by Martin Feldstein and Joel Slemrod, both of Harvard University, on the effects of taxation on the realization of capital gains. I would concur with their conclusion that a reduction in the capital gains tax to 25% would encourage taxpayers to realize capital gains in sufficient amount to produce more revenues for the U.S. Treasury rather than less.

I would particularly encourage your Committee to reduce the capital gains tax to 25%. One reason is that an added element in discouraging the realization of capital gains by investors is the sharp increase in inflation over the past decade. Since the capital gains tax is levied on nominal gains, the taxpayer often faces a real loss if he elects to tax himself by transferring from one capital asset to another. That is, the gain remaining after the tax is paid will often be less than the increase in the price level over the time the asset was held. Even if the capital gain is indexed so as to eliminate the tax on the part which represents inflation, I would still recommend the lower rate. The reason is that a substantial proportion of what constitutes realized capital gains is reinvested in another capital asset. In other words it simply represents a portfolio transfer. When the government taxes such a transfer it levies a sales tax on capital transfers which has an adverse effect on private capital formation. While it is not currently under consideration, I strongly favor the treatment of all capital gains as we now treat the sale and repurchase of primary residences. We should only tax capital gains when they are withdrawn for consumption purposes.

The Honorable Russell B. Long
Page 2
September 7, 1978

The Committee should carefully consider the cost to the country and the capital markets of levying a tax which discourages both the efficient allocation of capital and the amount of capital formation. Proponents of high capital gains taxes insist that capital gains are simply another form of income. However, in the opinion of a number of economists, this is incorrect. For the record, I would like to include an article which was published in Citibank's Monthly Economic Letter for June 1978. Since capital investments generate a flow of income, as pointed out in the article, then taxing in a way that reduces the potential supply of capital adversely affects potential income flows from which the government derives its basic revenues. It also has negative effects on job creation and ultimately on our standard of living. In short, the capital gains tax is a perverse tax.

I want to thank you very much for this opportunity to comment on H.R. 13511.

Sincerely yours,

(Signed)

Leif H. Olsen

Capital-gains tax: an idea whose time has gone

Inflation has illuminated the flaws of the capital-gains tax for all to see. It has heightened the tax's bias against saving, and this in turn acts as a brake on long-term growth.

In matters of taxation — no less than in war — it's dangerous to make assumptions about the outcome of a battle until the last shot has been fired. Only a few months ago, it seemed that the Administration would persuade Congress — acting in the name of "reform" — to further discourage private investment by raising the tax on capital gains. But now opinion is turning in a more rational direction.

Signs of a turnabout on Capitol Hill came when Rep. William Steiger of the Ways and Means Committee proposed that the capital-gains tax be restored to where it was in 1969, before President Nixon allowed it to be hiked and tightened. No one expected that the young Republican from Wisconsin would succeed in making more than a futile gesture. But cynics

underrated the power of reason — and the anti-tax mood in the nation.

Steiger strongly argued that a lower tax on capital gains would raise more revenues for the Treasury than a higher one. And 19 members, a majority of the heavily Democratic Ways and Means Committee, went along with him. The fight isn't yet over, but Steiger's success — his amendment has more than 60 sponsors in the Senate — has cleared the way for a consideration of his and other proposals for changes in capital-gains taxation.

One of them is a proposal by Dan Throop Smith of the Hoover Institution for a tax-free rollover of reinvested capital gains. Under the Smith plan, for which there are already a number of precedents, capital gains on all assets would be treated the way gains on the sale of houses are treated now. That is, no tax would be levied as long as the full proceeds of the sale were reinvested in other assets. Only those gains used for consumption purchases would be taxed.

The other dramatic change came in California, where the electorate voted heavily to pass Proposition 13, which limits annual property taxes to 1% of market value and places a 2% ceiling on increases in assessments so long as a property isn't sold. What the proposition does is limit the extent to which the state can tax the unrealized capital gains of California property owners.

Common link

Each proposal aims at solving a specific problem: the Steiger amendment at encouraging more investment and Proposition 13 at lowering the burden of property taxation at a time when the California state coffers are overflowing. But there's a common element that links the events on both coasts — and that is inflation. Even with stable prices the case for taxing capital gains is dubious. Six other advanced industrial countries — Australia, Belgium, Germany, Italy, Japan and the Netherlands — most of them to our political "left," don't tax capital gains. And in a climate of high and fluctuating inflation the argument for taxing capital gains collapses.

Last September, this *Letter* explained why most people suffer when progressively higher taxes are levied on inflated capital values. Nothing that's happened since alters the validity of that analysis, and therefore much of it is repeated in what follows.

The tax consequences of inflation on capital are far-reaching. What were originally designed as levies on the income from capital become taxes on wealth. This is so because of: 1) the inflation premium that gets built into interest rates; 2) the underdepreciation of business assets; and 3) the capital-gains tax.

If the real yield on a bond is 3%, and people in the market expect that prices will go on rising at a 6% annual rate until the bond matures, then the market or nominal rate on that bond will be 9% — a 3% return to capital plus a 6% inflation premium. The 6% premium must be added to the bond-buyer's original investment to keep its purchasing power unchanged — $1.06 is needed next year to buy the same goods and services that a dollar buys today. But under current tax laws, the price premium is taxed along with the 3% return to capital. Assuming a 30% marginal tax rate, the after-tax return to capital falls from 2.1% in the absence of inflation to 0.3% in the case of 6% inflation. Any higher tax or inflation rate actually turns the real rate of return on the bond negative.

Inflation imposes another tax on capital through the overstatement of profits. It happens whenever the purchase price or book value of capital equipment is lower than its replacement cost. This can be illustrated in the following example: A manufacturer buys a stamping press for widgets that costs $1,000 and wears out in 10 years. If he earns 10% on the machine after depreciation, and if the corporate tax rate is 50%, his net after-tax profit or return on capital is $50 a year. He also sets aside $100 a year for depreciation.

Assume now a 5% rate of inflation. If widget prices and the cost of replacing the machine go up by 5% each year for five years, yearly replacement-cost depreciation rises to $125 in the fifth year, ignoring compounding, not the $100 allowed. Although after-tax profits

rise to $75, the real after-tax return on capital falls. This is because of the $12.50 tax on income—50% of the additional $25—that should, in fact, have gone to depreciation. The result is a rate of return 20% less than had obtained before the onset of inflation. So whether it's interest income or profits from a machine, the inability of the present tax system to distinguish between capital and income causes taxes to be levied on wealth.

And to add insult to injury, inflation strikes again if the stamping machine is sold. Capital-gains taxes are levied on the difference between the current-dollar sale price and the historical cost, not on the difference as expressed in dollars of constant purchasing power. Assume that after five years the owner sells the half-used machine at a price of $1,250, 25% higher than its original cost of $1,000. Under current law the owner has a capital gain of $250 and a tax liability of $62.50, assuming a 50% tax on half of the gain. And yet the seller couldn't purchase any more services with the $1,250 than he could have bought with his $1,000 five years earlier. (The original cost less the depreciated tax basis is ordinary income.)

Stocks and homes

The process by which phantom windfalls transform the capital-gains tax into a wealth tax is even more strikingly apparent in the case of houses and common stock.

Assume that a family buys a home in 1966 for $24,000 and sells it 10 years later for $46,000. These are actual average sales prices of a standard house in both years. There is a capital gain of $22,000 and if taxed at one-half the 30% marginal rate drawn from our earlier example, that family would owe $3,300 in taxes. But inflation accounted for $17,600 of the gain. The house they bought in 1966 would cost $41,600 in 1976 prices. So the real capital gain was only $4,400. The capital-gains tax, excluding the effects of inflation, should be $660, one-fifth of the liability under current law. The family can defer its tax liability by buying another home. But the potential tax liability remains, nonetheless.

The same problem arises when an individual sells a share of common stock, except that the tax can't be deferred by reinvestment. For example, back in 1967, an individual could have gone to his broker and bought the equivalent of a current share each of three widely held stocks—AT&T, Exxon and General Motors—for a total of $86.36 plus commissions. By 1976, his investment would have grown to $196.62. Had he sold those shares, his capital gains would have been $109.26.

Under present laws, his taxes would be $16.39 assuming a 30% marginal tax bracket. But when an adjustment is made for inflation, the story is radically changed. As measured in 1976 dollars, the investor paid $177.98 for his three shares, not $86.36. So the actual gain in real wealth or purchasing power was $17.66, one-sixth the nominal gain and only $1.28 more than the capital-gains tax.

At the heart of the argument for capital-gains taxation is a concept of taxable income. Developed more than 40 years ago by Robert Murray Haig and Henry C. Simons, it defines annual income—the ability to pay taxes—as consumption, plus or minus any change in the market value of a person's "property rights." And since capital gains are increases in the value of property, the definition says they should be taxed in the same manner as income.

But despite the widespread acceptance of the Haig-Simons definition, the case for treating long-term capital gains as ordinary income isn't convincing. In fact, a stronger case can be made for abolishing the capital-gains tax altogether than for increasing it.

What the argument comes down to is that the very existence of an income tax affects capital values, since potential buyers will look to returns after tax, not before tax. The reduction in capital values that occurs when the tax is imposed is a tax on capital—as effective as any collected by government. What it does is discourage investment. When investment slows in the face of expanding demand for the product of that investment, the price of that product rises, and eventually before-tax returns and after-tax returns also rise. But there

is less investment than there would have been. A capital-gains levy is still another tax on capital and thus an added deterrent to investment. And since the stock of capital is a vital determinant of productivity, labor produces less output and the level of real wages is lower than it might be. Thus the tax burden in the final analysis falls most heavily on labor.

Capital-gains taxes discourage investment in another way. Because the tax is most often levied at the time an asset is sold, it locks in holders of assets with large capital gains. The higher the severance tax becomes, the less likely the holder is to realize his gains. With a 100% capital-gains tax rate this becomes painfully clear. If you sell, you realize nothing; if you hold, you have something and something is better than nothing. The upshot is a marked reduction in the mobility of capital that is hardly conducive to the financing of new ventures or the rapid growth of investment.

The final and in many ways most damning indictment of the current tax system is that it is implicitly but massively discriminatory. Tax laws are drawn in such a way that they severely penalize the individual accumulation of certain types of wealth. Collective saving — private pension plans and profit-sharing plans, for example — is not taxed when the income is first set aside or when dividends and interest are received or when capital gains are realized. But the individual saver, with few exceptions, is taxed at each and every turn. The major offset to this bias is the treatment of home ownership. To be sure, savings invested in a home are still taxed, but the federal government does not require the payment of a capital-gains tax when the house is sold if another home at least as expensive is purchased.

Waiving taxes on pension and profit-sharing plans and deferring capital-gains taxes on home sales is good policy. It eliminates — or at least reduces — the bias against saving. But the same treatment ought to be accorded other forms of private saving by individuals.

The current bias against saving must be reduced if a satisfactory rate of long-term growth is to be sustained. A good beginning can be made with a sharp reduction — or, better, the elimination — of taxes on capital gains.

Telegram

IPMPOMU HSB
1-0183064248 09/05/78
TLX BROWNHAR NYK
01 PD NEW YORK NEW YORK 9/5/1978
PMS SENATOR RUSSELL B. LONG PLEASE DONT PHONE

UNITED STATES SENATE
WASHINGTON, D.C. 20510

FOR SENATOR RUSSELL B, LONG
RESPONDING TO YOUR LETTER OF AUGUST 28 WHICH I HAVE JUST RETURNED TO FIND, I FULLY AGREE WITH THE POSITIONS EXPRESSED BY PROFESSOR FELDSTEIN AND SECRETARY FOWLER, IN MY OPINION A REDUCTION OF THE TAXABLE INCOME SUBJECT TO CAPITAL GAINS TAXATION TO 30 PERCENT WOULD AT LEASE PRODUCE NO NET REDUCTION IN TREASURY REVENUE AND WOULD PROBABLY PRODUCE AN INCREASE,

REGARDS
BOB ROOSA
BROWN BROTHERS HARRIMAN AND CO

15:34 EST

IPMPOMU HSB

RAYMOND J. SAULNIER

LEHMAN HALL
BARNARD COLLEGE, COLUMBIA UNIVERSITY
NEW YORK, NEW YORK 10027

September 1 1978

Senator Russell B Long
Chairman, Senate Finance Committee
217 Russell Senate Office Building
Washington DC 20510

Dear Senator Long:

Responding to your letter of August 28, I have no basis in systematic empirical studies I have made myself to answer the question whether a reduction of capital gains taxation would be positive, negative, or neutral in its effect on Treasury revenues, but on the basis of studies by others and from impressions I have formed from personal and professional involvement in the securities business over a long period, I believe it would be positive.

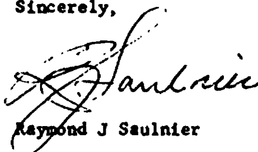
I would expect the immediate effect, say in the first year or two, to be a considerable increase in sales of securities for realization of gains, and that these sales would suffice to yield a larger volume of tax revenues at a lower tax rate than could be expected at present rates. And I would expect a deep cut to be more certain to have this effect than a small cut.

Moreover, in any year, not just in the next year or two, a reduced rate of capital gains taxation should produce more revenue than the present rate.

It is also a virtual certainty that a lower capital gains tax would be positive in its effect on capital formation and, by promoting a higher level of economic activity than would otherwise prevail, would produce a higher volume of revenue from other tax sources than would be produced if capital gains taxes were to continue at their present level.

In short, whether we look at the immediate or longer-term effect of a capital gains tax rate reduction, the case for reduction - and for a deep reduction - is a strong one.

Sincerely,



Raymond J Saulnier

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Gary L. Seevers
Commissioner

(202) 254-6268

September 5, 1978

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

Dear Mr. Chairman:

Thank you for inviting me to comment on the likely impact of a reduction in capital gains taxes on Treasury revenues.

I assume you asked me as a former Member of the President's Council of Economic Advisers. In light of my current position as a Presidential appointee to an independent regulatory commission, I believe it would not be appropriate for me to express a judgement on this particular analytical question. For one reason, the taxation of capital gains has an important influence on some types of futures trading which I am responsible for regulating along with the other members of the Commission. Moreover, I do not claim any special expertise on the unlocking impact of lower capital gains taxes. My work as an economist has not, to date, ventured into the specialized area.

I hope that in the future, however, when I have a status which would make it appropriate for me to comment, you will ask for my views again.

Sincerely,

Gary L. Seevers

HERBERT STEIN
2500 VIRGINIA AVENUE, N.W.
WASHINGTON, D.C. 20037

September 3, 1978

Senator Russell B. Long
United States Senate
Washington, D.C. 20510

Dear Senator Long:

This is in reply to your letter of August 28, 1978 asking about the revenue effects of reducing rates of tax on capital gains.

Let me say at the outset that I am not a student of this very complicated question and I can only give you some observations based on general considerations.

It seems clear to me that reduction of the capital gains rates will increase the amount of realizations. If the Treasury's estimates of revenue loss are based on the assumption that realizations are unaffected, the estimates almost certainly overstate the revenue loss. I am impressed by the Feldstein study which concludes that reduction of capital gains tax rates now under consideration would increase the revenue by increasing realizations. However, past experience prompts me to say that until such studies have been examined by experts for some time, and compared with the results of other studies using other data, we don't really know how much confidence to place in them. I would especially call attention to the qualification noted by Feldstein that his study related to a period when gains unrealized at death were wiped out for tax purposes.

In your letter you refer to the effect of reduced taxes on capital gains in stimulating economic growth and thus raising the tax base. I believe that there would be such an effect, but I would not count on it making a significant contribution to revenue for a long time.

If I had to make a guess, I would put the net revenue effect of the kinds of capital gains revisions now under consideration at zero.

Sincerely yours,

Herbert Stein

Yale University New Haven, Connecticut 06520

DEPARTMENT OF ECONOMICS
Cowles Foundation for Research in Economics
Box 2125, Yale Station

September 12, 1978

The Hon. Russell B. Long
United States Senate
Washington, D. C. 20510

Dear Senator Long:

I have your letter of August 28th requesting comment on cutting the capital gains tax rate.

In view of your request for an early reply, the best I can do is to send you some comments originally prepared for Senator Muskie and Representative Giaimo. These are enclosed.

I cannot answer your question whether revenues would increase or decrease in response to reductions of capital gains tax rates. I doubt that anyone can. The effect will be different in short run and long run, and will depend on many things, among them whether investors think Congress will make further concessions in future. Fortunately the revenue at stake is small. There are other considerations of greater moment, some of which I discuss in the enclosure.

Sincerely,

James Tobin

JT:lh
Enclosure

(Dictated from Wisconsin, not read)

Our present system of capital gains taxation is both inefficient and inequitable. But the needed reforms cannot be accomplished by a simple reduction of rates. They require careful thought and integration with other aspects of the federal tax system.

The most obvious purpose of capital gains taxation is to prevent evasion of tax on earnings from assets by conversion of taxable income into capital appreciation. Many such conversions are feasible under existing tax law, and some which are counter to the law are hard to detect. Examples of conversions are: capital assets are over-depreciated to avoid income tax but the gains in their value are considered capital gains for tax purposes on realization or transfer; corporate earnings retained instead of disbursed as dividends never appear as individual taxable incomes but only as capital gains. The present tax code provides incentives for such conversions, since realized capital gains are taxed at lower rates than income and gains on assets transferred at death or by charitable gift are taxed even less or not at all. An incidental corollary is that the revenue effect of setting capital gains tax rates higher or lower cannot be judged by looking at the yield of the capital gains tax alone; to the extent that less preferential rates deter conversions, the revenues will appear as income taxes.

The principal moral is that reduction of capital gains tax rates should be accompanied by measures to limit conversions. For example, retained corporate earnings could be imputed to shareowners as taxable income; the tax basis of their shares would rise correspondingly. Likewise, the gain on depreciated assets sold or transferred could be considered ordinary taxable income up to the cumulative amount of depreciation previously claimed for tax purposes. Provisions of this kind would greatly mitigate the inequity and the revenue loss of lowering, even eliminating, capital gains taxation. They would also greatly diminish the lock-in effects of the present tax on realized gains.

The lock-in effect of present capital gains taxation is, contrary to popular belief, not due solely to the rates of taxation on realized gains. It is also due to the fact that taxation of gains can be largely or wholly escaped by holding assets until death or gift. The incentive to hold is all the greater because charitable donations of assets are deductible from ordinary income at market value even though no tax is levied on the excess of market value over tax basis. Since so many investors are, for these or other reasons, able to avoid taxation of gains at anything close to the explicit maximum rates, it is not clear that the system on balance depresses asset prices or deters investment. However, the lock-in may well place new issues and new ventures at a disadvantage relative to old established issues and enterprises. The capital markets would be more efficient and flexible in allocating funds if the lock-in incentives were reduced. One suggestion to that end was made in the preceding paragraph.

A less radical proposal is the following: Allow an investor the option of establishing a securities portfolio within which realizations of gain or loss on individual securities would be free of capital gains tax, on the condition that net withdrawals from the portfolio for any purpose -- including gifts and bequests -- would be subject to capital gains tax. The gain or loss involved in such withdrawals would be reckoned as if the portfolio were a mutual fund, comparing the net asset value on withdrawal with the average net asset value of past acquisitions. The same option would be available to investors in regular mutual funds: they would not have to pay tax on reinvested capital gains distributions if they agreed to pay it later on any liquidation or transfer.

Similar provisions already apply to sales and purchases of homes. In view of the subsidies and tax concessions already provided for owner-occupied homes, I do not see the equity of further preferential treatment of capital gains on residences. These are, after all, assets on which current income -- the rent in kind received by the owner-occupier -- is untaxed. The multiplication of preferences and incentives for housing investment deprives business investment of needed funds, and the privileges offered owner-occupiers burden rental housing relative to owner-occupied housing.

In considering the merits of capital gains taxation, it is important to distinguish reproducible productive assets, and claims on them, from

The Hon. Robert N. Giamo
and The Hon. Edmund S. Muskie

August 3, 1978

non-reproducible assets. The case for preferential tax treatment is much weaker for the second category. It includes unimproved real estate, whose value depends on nature and site, and collectors' items.

Symmetry is a desirable feature of capital taxes. The government should, by loss offsets, share in risk as well as in gain.

The issue of inflation accounting is certainly important for capital gains taxation, as for many other aspects of the tax system -- depreciation, taxation of interest, dividends, and rents; tax rate brackets. It is true that many capital gains currently realized represent purely monetary appreciation rather than gains of purchasing power. Relief is appropriate, but there are numerous pitfalls in a piecemeal approach to the problem of adjusting tax liabilities to inflation. Some of the income from nominally denominated assets -- savings accounts, bonds, etc. -- is compensation for inflation anticipated and realized. Holders of currency and interest-free demand deposits suffer capital losses in purchasing power. Debtors make real capital gains from unexpected inflation just as creditors suffer losses. Partial ad hoc correction of tax liabilities for inflation will create new inequities, loopholes, inefficiencies, and revenue losses. If the Congress wishes to adopt a new unit of account for taxation, it should do so thoroughly and systematically.

Caution is also wise in choosing the price index number for such a unit of account. None of the present indexes is really appropriate. The CPI, for example, does not apply to a representative sample of investors; counts indirect taxes, from which it would be foolish automatically to excuse income taxpayers; counts interest and capital costs, as well as consumption costs, of homes and other consumer durable goods; reflects changes in dollar prices of imported goods even though the government is intrinsically incapable of insuring the whole country against adverse changes in our international terms of trade. It would be wise to create a new index specifically designed for use in the indexing of taxes, social insurance benefits and other transfers, and private labor contracts. Moreover, the federal government should issue some marketable obligations so indexed. The market price of those obligations would then provide a yardstick which could be used in tax calculations that require separating real from nominal returns and gains.

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PAUL A. VOLCKER
PRESIDENT

September 6, 1978

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

Dear Mr. Chairman:

I am pleased to respond to your request for comments on H.R. 13511, the 1978 House tax revenue proposals. I have been concerned with the sluggishness of business capital formation for some time, and I believe that reductions in the tax on income from capital are critically important to improve incentives to invest and benefit the U.S. economy. The proposed corporate income tax cuts, the extension of the investment tax credit, and a capital gains tax cut would all help accomplish this. I am particularly pleased by the proposed extension of the investment tax credit to the rehabilitation of industrial and commercial premises, a feature that should contribute to the redevelopment of the older urban areas of the country.

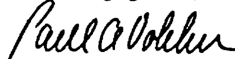
As to specific effects of a capital gains tax cut, I find it difficult to make quantitative judgments for the reasons you suggest. In qualitative terms, I would agree with the testimony of others that the short-run impact on Treasury revenues might well be positive, if asset prices increase significantly and/or lower tax rates induce investors to realize substantial capital gains that have been deferred in realization. Over the longer run, however, I suspect the direct effects of the tax cut will cost the Treasury revenues. For one thing, under the 1976 tax law, it is mainly the timing of capital gains realizations, not the cumulative dollar amount that the investor can choose. This means that a lower tax rate can only accelerate realizations, and this seems to me unlikely to offset the negative effect of a lower tax rate on total capital gains revenues over a period of time. Second, the dividend payout rate of corporations may be reduced in response to a reduction in the tax rate on capital gains relative to the tax rate on ordinary

income. Because the tax rate on dividends is higher than the tax rate on capital gains, a lower dividend payout will cause Federal personal tax revenues to decline even if investors realize their gains immediately. Thus, the increase in revenues from more frequent stock sales might be offset by the reduction in dividend payout.

Potentially, the negative effect on revenues over a longer period of time could be offset should capital formation and economic growth be adequately stimulated. The main question here, in my mind, is whether a capital gains tax cut is the most effective and equitable way to achieve this desirable result, or whether more emphasis on other actions, such as more liberal depreciation allowances for business capital, is a better way to stimulate business capital formation and growth. This is, of course, a matter the Congress will ultimately have to decide on the basis of evidence that is not entirely clear, and a combination of approaches, as already provided in the House Bill, is not unreasonable.

There is one provision of the House Bill about which I have great reservations: singling out in the capital gains area a tax exemption for gains that reflect inflation. I recognize the real problem--that of taxing "fictitious" gains--at which the proposal is directed. But inflation has capricious tax effects in other areas as well, and I hate to see our energies and ingenuity directed toward selective efforts to shield one form of income or another from the effect of inflation, possibly leading to the delusion that somehow we can live comfortably with inflation. Let's keep our emphasis on the need to combat inflation--not adjust to it!

Sincerely yours,



Paul A. Volcker

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1730 PENNSYLVANIA AVENUE, N.W.
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September 6, 1978

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

Dear Mr. Chairman:

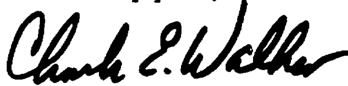
Thank you very much for your letter of August 28 relating to the impact on Treasury revenues of a significant reduction in tax rates on capital gains.

I agree fully with Professor Feldstein and former Treasury Secretary Henry Fowler that the short-run impact (i.e., from the "unlocking effect") will be so large that the revenue impact is almost certain to be positive. This view is supported by common sense; by statements made to me by investors as well as my own inclinations and intentions; and by the scholarly analyses prepared by Dr. Feldstein.

As to the longer-run impact, current techniques of economic forecasting do not permit a precise answer. We can be certain that lower capital gains taxes will promote capital formation -- which in turn fosters growth and creates jobs -- with a strongly positive impact on the tax base. My judgment is that the econometric studies presented to your Committee are substantially correct, and that the increase in the size of the tax base would more than offset the reduction in rates. Treasury revenues would therefore rise instead of decline.

For these and other reasons, I strongly support a significant reduction in taxes on capital gains, preferably through the decrease in the percentage of gains subject to tax, as you have proposed.

Sincerely yours,



Charls E. Walker
President

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

HENRY C. WALLICH
MEMBER OF THE BOARD

September 5, 1978

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

Dear Chairman Long:

I appreciate this opportunity to provide my personal views on the magnitude of the unlocking effect on appreciated assets for a given reduction in the tax on capital gains and its impact on tax revenues.

In an article written for the National Tax Journal in 1965, I summarized two studies that had opposing estimates of what would be the results of a higher or lower capital gains tax rate on Treasury tax revenues. One was that of the Treasury which estimated that the reduction in capital gains tax rates, proposed in the President's 1963 Tax Message, would produce an increase in realizations of 25 per cent and a loss of revenue of $310 million.

A contrary estimate was that made by Lou Harris and Associates, Inc., for the New York Stock Exchange in 1960. On the basis of a detailed investor survey, it was concluded that a 20 per cent cut in capital gains taxes would approximately double the Treasury's revenue from realized capital gains, while a 50 per cent cut would produce a further small gain.

The studies cited above are also relevant to the lock-in effect. Those who conclude that a cut in tax rates would increase revenue, as do Lou Harris and Associates, Inc., argue implicitly that the lock-in is strong. Lower taxes would greatly increase the volume of realizations. The other side, in this case the Treasury, implies the opposite.

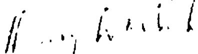
The conflicting estimates noted above suggest to me that one cannot speak with assurance about the revenue effects of

different capital gains tax rates. It is obvious, however, that at a tax rate of zero, or very close to it, there would be no revenue or only very little. My basic conclusion is, therefore, that the tax does reduce the supply of savings by something not far from the amount of tax revenue produced.

Moreover, my personal view of rational investor behavior would tend to support the position of a generally strong lock-in effect. This is because a rational investor is likely to hold a random walk philosophy of the stock market. That philosophy would cause him to conclude that he cannot expect to improve his investment results by frequent switching and would lead him to a "buy and hold" strategy.

Hence, I conclude that the reduction in the lock-in effect resulting from a cut in the tax rate would be substantial, even though I cannot be more specific about the revenue effect than my above statement. I also believe that a reduction in the rate would raise the value of equities and homes generally. This would lower the cost of capital to business and encourage investment.

Sincerely yours,



Henry C. Wallich

C O P Y

THE FIRST NATIONAL BANK OF CHICAGO

EDWIN H. YEO III/CHAIRMAN
ASSET AND LIABILITY MANAGEMENT COMMITTEE

September 6, 1978

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

Dear Chairman Long:

It is clear that high marginal tax rates on realized capital gains discourage people from investing in assets which have a low current yield but the promise of possible appreciation in the future. This disincentive weakens personal investment and diverts what investment there is into relatively less productive channels. Venture capital for new enterprises is certainly adversely affected.

It is also clear that high capital gains tax-rates deter people from realizing capital gains by selling the assets they own. This disincentive impairs the efficiency of capital markets, because it keeps funds locked into uses that are not as productive as others. People hold shares in declining firms for example, rather than selling those shares and reinvesting in growing enterprises. Since capital gains are taxed only when realized, the continual disincentive to realize gains depresses the potential revenue of the tax. This is not a one-time effect, but one that continues year after year.

These twin effects of the capital gains tax, (in discouraging risk investments and capital gains realization) can be expected to be most pronounced where the tax rate is highest. This is, in part, offset by volume effects, that is, a reduction in areas where rates are already low could affect a much larger number of transactions than where rates are high. Nonetheless, revenue effects will most likely be positive from reducing the highest capital gains tax rates. It is my judgement that reducing the portion of capital gains included in income from 50 percent to 30 percent would entail a net revenue loss. This proposal concentrates most of the rate reduction where rates are already relatively low.

The effect of inflation needs to be dealt with. Even a 25 percent tax rate on capital gains may be confiscatory if the gains are not real -- that is, if they provide little or no increase in real purchasing power. Professor Feldstein's

COPY

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Continuing Our Letter of September 6, 1978

Sheet No. Two

research indicates that it is the effect of inflation, rather than the tax rates per se, that is most injurious to those of medium income who realize capital gains.

If capital gains tax rates where reduced to a maximum of 25 percent, it is not unreasonable to suppose that there would be a sufficient increase in turnover and volume of investing to generate more tax revenues, particularly in the longer run. Increased realization would not depress asset prices because most capital gains are reinvested, and because the prospect of higher after-tax returns would increase the demand for assets subject to capital gains taxation.

I would also suggest that some speculative investment in various things, artifacts and the like may be motivated by the relative ease of concealing the related capital gains and thus evading the tax. Reduced capital gains tax rates on more visible transactions (such as the sale of stock) would result in a change in investment strategies. The consequences of such a shift would be to direct funds to more productive uses.

Sincerely,

(Signed)
Edwin H. Yeo III

1972

APPENDIX

Hold for release
Tuesday, August 22, 1978
10 a.m.

Statement of Henry H. Fowler
Before the Senate Finance Committee
August 22, 1978

My name is Henry H. Fowler.

I am a General Partner in Goldman, Sachs & Co., an investment banking and securities brokerage firm at 55 Broad Street, New York City. I appear here speaking only for myself and not as a representative of any organization.

May I express my appreciation for the opportunity to present a statement to this Committee during its consideration of the pending tax bill.

By way of background for the newer members of the Committee, the record should show that I served as Undersecretary of the Treasury from January 1961 to May 1964, by appointment of President Kennedy and as Secretary from April 1, 1965 to December 20, 1968, by appointment of President Johnson.

My service as the Undersecretary and general deputy to Treasury Secretary Douglas Dillon included a very major involvement in working within the Treasury and the Administration and with the Congress and its Committees on the formulation and enactment of the tax programs of the early Sixties. These included President Kennedy's Tax Messages of April 1961 and January 1963 and the enactment by Congress of the Revenue Act of 1962 and the Tax Reduction Act of 1964.

You will recall that, in addition to many detailed changes in the tax code that are generally regarded as "tax reforms", these measures included the initial passage of the investment tax credit and the largest reduction in history of the rates of taxation on personal and corporate income taxes.

Despite the successful enactment, with some minor modification, of President Kennedy's recommendation for reduction in personal and corporate income tax rates, we failed to secure the passage of one of his key recommendations for a substantial reduction in the taxation of capital gains. That brings me to the thrust of my statement which deals with that piece of "unfinished business."

My views as a private citizen on the subject to be discussed are parallel to the views I expressed and espoused as Undersecretary and Secretary of the Treasury. A review of my public statements during that period will attest to that fact.

Nor is my conviction that the increase in taxation of long term capital gains in the 1969 Tax Act was a mistake a recent or belated one. On August 28, 1969, I sent a letter to the Senate Finance Committee during its hearings on the bill that became the 1969 Act, opposing the increase in the rate of capital gains taxation by removing the maximum or alternative rate. I attach a copy of that letter as an exhibit to this statement. (See Exhibit I.) Its reasoning is in full accord with this statement.

The main purpose of this statement is to urge that the Congress, in its attempt to rectify the proven damage done to our system of capital gains taxation in the Tax Act of 1969, amend the House bill to include the adoption of the proposal for the reduction in taxation of long term capital gains, advanced by President John F. Kennedy in his Tax Message of January 24, 1963, which was not adopted.

He recommended that, in addition to enacting major reductions in the rates of taxation on personal and corporate income, the Congress should:

> "Reduce the percentage of long term capital gains included in individual income subject to tax from the present 50 per cent of the gain to 30 per cent." (See H.R. Document No. 43, 88th Congress 1st Sess. p. 23.)

As he noted in his Message, this proposal along with his recommended reduction of the personal income tax rate schedule from a 20 to 91 per cent range to a 14 to 65 per cent range, would have produced capital gains rates on long term gains that would start at 4.2 per cent and progress to a maximum of 19.5 per cent instead of the then existing 10 to 25 per cent range.

Today, as in 1963, as President Kennedy observed in his Tax Message supporting this recommendation:

> "The tax on capital gains directly affects invest-

> ment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy. The provisions for taxation of capital gains are in need of essential changes designed to facilitate the attainment of our economic objectives."

Unfortunately, and I believe unwisely, some of the changes in the revenue laws affecting capital gains in the 1969 Tax Act and subsequent acts have moved in the opposite direction to that recommended by President Kennedy. They have placed heavier rather than reduced tax burdens on capital gains. They have adversely affected the investment decisions of individual taxpayers in the directions he espoused.

These additional taxes on capital gains have tended to immobilize risk capital in static situations rather than increasing its mobility to more dynamic situations.

They have directed savings by individuals into consumption or relatively risk free debt instruments rather than into risk capital for new ventures or small and medium size businesses, with their vast potential for job creation, new products and services, increased competition, and growth of the tax paying revenue producing private sector.

They have been conducive to a trend by major, well established

companies to use debt rather than equity investment for the financing of the expansion of business or the acquisition of new plant and equipment to increase productivity and capacity.

They have tended to reduce substantially the number of individual Americans who have direct ownership positions in private enterprise and, hence, a stake in the preservation of its dynamic role in our society.

These are not merely my conjectures.

They are supported by a wealth of evidentiary and statistical fact assembled and presented before subcommittees of this Committee in Hearings several years ago chaired by Senator Bentsen and, more recently, on June 28 and 29 of this year before the Subcommittee on Taxation and Debt Management, chaired by Senator Harry Byrd.

Many Senators, most notably Senator Hansen of this Committee, have hammered home these and related observations and organized sentiment to take remedial action for which I, for one, am grateful.

Alarm bells have been ringing in the oft quoted statistics on:

- the decline in the number of individuals investing in corporate shares from 31 million in 1970 to 25 million in 1975;
- the drop in new public security issues for small firms from about 548 issues valued at $1.5 billion in 1969 to 4 new issues worth $16million in 1975, with averages

of $100 million per year in the 1970-77 period;

- the fall off in the formation of new high technology firms from 300 in 1968 to nearly zero in 1976.

Undoubtedly, other factors have conjoined with the heightened tax barriers to investing risk capital raised by the 1969 Tax Act to bring about these trends. But it is the generally held opinion in business and financial circles that the increases in capital gains taxes have been an important contributing factor.

Both present law and the House bill leave unchanged the provision for the inclusion of 50 per cent of long term capital gains taxable as personal income that President Kennedy would have reduced to 30 per cent.

It is my conviction that an amendment incorporating his proposal is sorely needed along with other measures included inthe House bill modifying the tax treatment of long term capital gains.

It is needed as a clear and unequivocal signal to every taxpaying American from the lowest to the highest bracket that his national government encourages him or her to save and invest in an ownership share in private productive enterprise.

Your Chairman, Senator Long, has been zealous to reward the worker, to use his words in a recent notable address to the National Press Club, with "a piece of the action in the company for which he worked".

I would hope that in the legislation before this Committee, the Senate, the Conference and the President, to use Senator Long's words again, will

"help the rank and file of Americans to own a stake in our free enterprise system."

By adding the proposal of President Kennedy to the House bill the Congress will provide a system of capital gains taxation appropriate to the times and to a better functioning national economy. It is needed to provide a dynamic element in that economy, dependent as it is on private investment in the private sector for increasing growth, jobs and productivity.

The alternatives are to do nothing more or to merely restore the alternative ceiling rate of 25 per cent on long term capital gains which was the law prior to the 1969 Tax Act.

To leave the top rate on long term capital gains at 35 per cent, as the House bill does, would not provide a meaningful reduction for taxpayers in the tax brackets from the bottom to the top of the income scale whose capital gains are <u>not</u> substantially affected by the minimum tax and the maximum tax. This would be true of the overwhelming majority of individual taxpayers. The House bill would fail to provide the incentive necessary to encourage taxpayers up and down the income scale to save and invest their savings as risk capital. It would retain the most retrogressive feature of the 1969 Act, the provision that directly lifted the top rates on long term capital gains from 25 per cent to 35 per cent.

To increase the reduction only by restoring the alternative tax provision that placed a ceiling of 25 per cent on the taxation of long term capital gains, which is <u>one</u> of the effects of the Steiger-Hansen bill (S. 3065), commendable

as it is, would provide additional incentive to save and invest risk capital only for a relatively small minority of relatively high income taxpayers who are in the income brackets above 50 per cent. (For example, married couples filing jointly with incomes of $53,000 or over.)

The Kennedy proposal added to the House bill would provide more meaningful tax reduction on capital gains for all individual taxpayers regardless of their bracket with the tax range being from 4.2% to 21%.

Moreover, the Kennedy proposal does equity in the sense of taxing only 30 per cent of the capital gain of any taxpayer, but maintains the relative progressivity in taxing capital gains as the tax rates on ordinary income.

In speaking of this aspect of the Kennedy proposal, Secretary of the Treasury Douglas Dillon, in testimony before the House Ways and Means Committee in 1963, said:

> "It will result in more equal treatment of individuals in various income groups. Unlike the present arrangement, the relative difference between capital gains tax rates and ordinary income tax rates would be the same at all levels of income."
>
> (See H.R. Document 43, 88th Cong. 1st Sess. page 53).

The following table illustrates these points by comparing the taxation on a $5,000 capital gain accruing to a married couple filing jointly, without reference to the minimum and maximum tax provisions, under:

9

A. Existing law

B. The House Bill

C. The restoration of the alternative tax fixing a 25 per cent ceiling on the capital gains tax.

D. The Kennedy proposal reducing the inclusion of the long term capital gain taxable as ordinary income from the present 50 per cent to 30 per cent.

Taxation of Long Term Capital Gains Under Various Alternatives
(Without Reference To Minimum and Maximum Tax Provisions)
On A $5000 Capital Gain Of A Married Couple Filing Jointly.

Taxable income bracket (thousand dollars)	A. Existing Law (not incl. Minimum and Maximum Tax			B. House Bill				C. Addition of Alternative 25% Ceiling to House Bill			D. Kennedy Proposal For 30% Inclusion				
	tax rate present law	present tax on 50% inclusion (in dollars)	per cent of gain collected as tax	tax rate in House Bill	tax on 50% inclusion (in $)	per cent of gain collect. as tax	savings in dollars over present law	per cent of gain collected as tax with 25% ceiling	tax on 50% inclusion with 25% ceiling	savings in $ over House Bill	tax using House Bill and Kennedy inclusion rate (30%) (in $)	% of gain collected as tax	savings in dollars over present law	savings in dollars over House Bill	savings in dollars over House Bill and 25% ceiling
Column 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10	Col. 11	Col. 12	Col. 13	Col. 14	Col. 15	Col. 16
4000	14%	350	7	14%	350	7	0	7	350	0	210	4.2	140	140	140
8000	19%	475	9.5	18%	450	9	25	9	450	0	270	5.4	205	180	180
12000	22%	550	11	21%	525	10.5	25	10.5	525	0	315	6.3	235	210	210
16000	25%	625	12.5	21%	525	10.5	100	10.5	525	0	315	6.3	310	210	210
20000	28%	700	14	24%	600	12	100	12	600	0	360	7.2	340	240	240
24000	32%	800	16	28%	700	14	100	14	700	0	420	8.4	380	280	280
28000	36%	900	18	32%	800	16	100	16	800	0	480	9.6	420	320	320
32000	39%	975	19.5	36%	900	18	75	18	900	0	540	10.8	435	360	360
36000	42%	1050	21	39%	975	19.5	75	19.5	975	0	585	11.7	465	390	390
40000	45%	1125	22.5	42%	1050	21	75	21	1050	0	630	12.6	495	420	420
44000	48%	1200	24	45%	1125	22.5	75	22.5	1125	0	675	13.5	525	450	450
52000	50%	1250	25	50%	1250	25	0	25	1250	0	750	15	500	500	500
64000	53%	1325	26.5	53%	1325	26.5	0	25	1250	75	795	15.9	530	530	455
76000	55%	1375	27.5	55%	1375	27.5	0	25	1250	125	825	16.5	550	550	425
88000	58%	1450	29	58%	1450	29	0	25	1250	200	870	17.4	580	580	380
100000	60%	1500	30	60%	1500	30	0	25	1250	250	900	18	600	600	350
140000	64%	1600	32	64%	1600	32	0	25	1250	350	960	19.2	640	640	290
180000	68%	1700	34	68%	1700	34	0	25	1250	450	1020	20.4	680	680	230
300000	70%	1750	35	70%	1750	35	0	25	1250	500	1050	21	700	700	200
400000	70%	1750	35	70%	1750	35	0	25	1250	500	1050	21	700	700	200

Note: This table was subsequently revised, see last page of this appendix.

I would not wish to be misunderstood on several scores.

First, my advocacy here, limited to the field of capital gains taxation, should not be confused as an expression of belief that the measures advanced, standing alone, are a cure-all for our tax and fiscal problems or our broader economic ills. I, for one, would not wish to make exaggerated claims for a substantial reduction in capital gains taxes.

Other features of the House bill, for example, those dealing with the investment tax credit and the reduction in personal and corporate income tax rates are commendable. But, to play them off against a reduction in capital gains taxes for revenue consideration is to miss a vital point I will come to later. The nation needs those measures and a meaningful capital gains tax reduction as well to help overcome the investment lethargy that has overtaken it.

After this bill is enacted, much will lie ahead for future Congresses to do in adapting our tax system to changing times and in dealing with the problems of inflation, jobs, inadequate capital formation, low levels of productivity increase, imbalances in our international payments and internal budgets, and the declining dollar, in a manner consistent with our national security and national welfare.

The point is that in any mosaic of measures designed to treat these problems the nation needs, as an essential element, a system for taxing capital gains that provides an incentive to save and invest risk capital in private enterprise.

Second, you will note that my specific proposal is in addition to and not a substitute for other provisions of the House bill affecting capital gains, such as, for example, the one exempting the one time tax-free sale of a residence where the capital gain does not exceed $100,000. More specifically, the adoption of President Kennedy's formula should be combined with the modification of the minimum tax and the maximum tax provision, which were added in the 1969 Tax Act and subsequent acts. Their present application to capital gains should be removed while substituting the so-called alternative minimum tax on those taxpayers who otherwise would avoid paying any appreciable income tax by combining capital gains with tax shelters.

Also in the present highly inflationary climate these changes should be supplemented by a provision tempering the taxation of capital gains on such assets as securities, real estate, and plant and equipment held for long periods when increased values reflect inflation rather than increases in real realizable values.

This combination of measures, together with the existing provisions in the 1976 Revenue Act for "carryover" of basis for taxation to heirs at time of transfer at death, would provide the kind of tax system of capital gains envisaged by President Kennedy's 1963 program. It would couple the "liberalization of treatment with more sensible and equitable limitations" that he sought.

Third, in advancing the addition of President Kennedy's formula as an amendment to the House bill, I have given careful consideration to the revenue effects, particularly in view of the large budget deficit which is and

should be a matter of deep concern to the Congress.

Since only 30 per cent of long term gains would be subject to taxation under the proposed amendment, instead of 50 per cent, some seem to assume that there would be an equivalent decline in revenues.

It is true that the amendment would reduce the amount of tax paid per dollar of capital gains realized.

But that method of calculation of revenue effect assumes that the same number of transactions involving the same amount of capital gains would occur with the law providing for 30 per cent inclusion as with the present 50 per cent inclusion.

That was not the assumption used by the 1963 Treasury Department in estimating the revenue effects of the capital gains package recommended by President Kennedy. Indeed, the Treasury Department then, speaking through Secretary Douglas Dillon, presented to the Committee a tabular estimate of revenue effects showing that the "induced effects" of the package of changes in the taxation of individual capital gains would increase revenue by $690 million, substantially exceeding estimated revenue losses from the proposed changes. (See Table 11 attached to the Statement of Secretary Dillon, H. R. Document No. 43, 88th Cong. 1st Sess. p. 71) A copy of that table is attached as Exhibit II.

As Secretary Dillon explained in his statement to the House Ways and Means Committee in 1963, a substantial increase in revenue "will be realized as a consequence of the unlocking effects of the proposals and the greater

volume of capital transactions that can be confidently anticipated." (See H.R. Document No. 43, 88th Cong. 1st Sess. p. 59)

Somewhat earlier in discussing specifically the recommendation for the reduction in the inclusion as taxable income from 50 per cent to 30 per cent, the Secretary noted that:

> "Independent outside surveys, our own studies, and letters and comments which are received daily from taxpayers throughout the country indicate clearly that these substantial reductions will increase taxpayers' willingness to realize capital gains and stimulate a larger turnover in capital assets."
>
> (See Document No. 43, p. 53.)

I share the view of the old Treasury and Secretary Dillon, particularly since, as noted before, the Congress has enacted in the 1976 law a provision for carryover of a decedent's basis at death, with the consequence that hereafter the capital gains tax on before death appreciation that accrues after the year of 1976 law will be paid when the property is sold by the heir.

The "lock-in" of unrealized capital gains will be diminished substantially by meaningful reductions in taxes on capital gains just as they were increased by their increased taxation in the Tax Act of 1969, as the able study of Professors Feldstein and Siemrod of the National Bureau of Economic Research entitled "The Lock-in Effect of the Capital Gains Tax" has persuasively demonstrated.

I do not present any precise estimate of the revenue effect of the addition of the suggested amendment. But I believe in the concept of "induced effects" - that the conduct of individual taxpayers will change with regard to saving, investment in risk capital, and the realization of capital gains, as the taxation of capital gains are increased or diminished.

Moreover, there will be more indirect economic consequences of an increased flow of risk capital into the economy, which, in turn, will produce additional taxable personal and corporate income yielding additional revenue that would not exist if the capital gains taxes were not reduced. These favorable economic consequences in terms of additional jobs and growth in the private sector with additional revenue to the Treasury are the subject of several scholarly detailed economic and statistical analyses already available to the Committee or forthcoming from later witnesses.

Rather than duplicate this testimony and information let me state a conclusion based on experience and judgment.

That conclusion is that the increase in the number of taxable transactions involving long term capital gains and the volume of those realized gains plus the more indirect but highly desirable economic consequences of a substantial reduction in capital gains taxes referred to above will more than compensate the Treasury for the reduced amount of tax paid per dollar of gains realized.

In so concluding, let me thank the Chairman and members of the Committee for permitting me to bring a nostalgic note from past history to bear upon a vital issue of the present. I hope it will be of some value to you in your important deliberations.

EXHIBIT I

HENRY H. FOWLER
55 Broad Street
New York, N.Y. 10004

August 28th, 1969.

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

Dear Chairman Long,

I am submitting this letter as a Statement for inclusion in the record of the deliberations of the Senate Finance Committee on the proposed Tax Reform Act of 1969.

You and your colleagues have the highly important responsibility of reviewing and revising this bill as it passed the House of Representatives and working out any differences in Conference.

I have assessed my own responsibilities to comment as a private citizen (now a General Partner in the investment banking firm of Goldman, Sachs & Co.) and as the Under Secretary and Secretary of the Treasury from early 1961 through December 20th, 1968.

This letter is the result. My views as a private citizen on the subjects to be discussed are parallel to the views on these subjects I expressed as Under Secretary and Secretary of the Treasury as a review of my public statements during that period will attest.

There are a large number of provisions in the bill. Many of them reflect in whole or in part the Tax Reform Studies and Proposals of the U.S. Treasury Department, prepared during my tenure as Secretary by the Treasury Tax Policy Staff under the direction of Assistant Secretary Stanley Surrey, and published earlier this year (February 5th) for information only as a Joint Publication of the House Ways and Means Committee and the Senate Finance Committee. Other provisions have been added on the recommendation of the new Administration or on the initiative of the House Ways and Means Committee.

On all save <u>three</u> specific provisions I shall follow the course I did in the House proceedings; namely, refrain from comment, technical and otherwise, preferring to stand on my general Statement on the Tax Reform Program of the Treasury Department, dated December 11th, 1968, which appears in full on pages 3 through 9 of Part 1 of the published report referred to.

But I do feel impelled to speak out on three specific provisions of the proposed bill which

(a) were not included as needed reforms in the old Treasury report referred to and
(b) taken together, would reverse and undo salient features of a tax policy of vital importance to a viable economic system based on free private enterprise which tax policy was confirmed in the early sixties by the Congress on the recommendations of President Kennedy and President Johnson.

That policy, developed by the Treasury Department of those years in association with other parts of the Executive and Congress, was designed to safeguard and promote adequate private investment - as an essential ingredient in sustaining economic growth, increasing job opportunities in private enterprise in sufficient number and ever improving quality, providing a steadily rising standard of living, and keeping the U.S. economy competitive.

The three provisions referred to should be deleted because they are incompatible with the maintenance of a dynamic private sector in a free enterprise economy so long as the present and projected high tax rates on individual and corporate income persist. Moreover, they undo recently won advances toward a tax policy geared to sustained and non-inflationary economic growth and reasonably full employment in the private sector.

They would reverse a national policy as old as the nation and the federal tax system and as recent as the last major revision of our permanent tax structure in the 1960s - the placing of a high tax premium on the risk investment of savings or borrowed capital.

I refer to the provisions of the proposed bill which would (a) repeal the investment tax credit, (b) increase the rate of capital gains taxation by removing the maximum or alternative rate and (c) extend the period in which any investment must be held to qualify profits or losses therefrom as capital gains or losses.

In most of the advanced industrial countries in the Free World capital gains are not taxed. In these countries investment tax credits and

and special allowances are established features of their tax systems. They are considered fundamental to the national pursuit of non-inflationary growth and progress via increased production and productivity.

These policies, contrary to the proposed changes above, are supported in economies far more mixed than our own and far less dependent on private enterprise and investment. It would be ironic to downgrade or give a low order of priority to policies specifically designed to preserve the role of free private enterprise in a nation that has hitherto been an example of the success of that system.

Past Congresses have sought by these very features of the tax law now under attack to make our tax system compatible with a high rate of private investment. They should be preserved as long as that system is characterized by high tax rates on individual and corporate income.

The underlying policy common to these provisions under attack is simple - to maintain the vitality of a free private enterprise system dependent on large and continuing outlays of private capital.

Our national concern with the economy and the tax system - except in periods of war - and as recently as the early sixties - has been the inadequacy of the tax system in preserving the opportunity and incentive for private investment.

A re-reading of the Tax and Economic Messages of the late President Kennedy in 1961-3 would raise seriously doubts concerning the wisdom of tax proposals admittedly designed to diminish the premium and pace of risk investment.

A primary thrust of these Messages, confirmed as national policy in the Revenue Acts of 1962 and 1964, was the promotion of adequate private investment - the freer and fuller flow of capital into productive effort.

In his last Tax Message of January 24th, 1963, President Kennedy provided the policy basis for the Tax Reduction Act of 1964 in these words:

> "Despite the improvements resulting from last year's depreciation reform and investment credit - which I pledged two years ago would be only a first step - our tax system still siphons out of the private economy too large a share of personal and business purchasing power and reduces the incentive for risk, investment and effort - thereby aborting our recoveries and stifling our national growth rate."

It seems unlikely that developments in the last few years of war, inflation, and rapidly expanding public expenditures have changed the truth and relevance of these words in his accompanying Economic Message of 1963:

"To raise the nation's capacity to produce - to expand the quantity, quality and variety of our output - we must not merely replace but continually expand, improve, modernize and rebuild our productive capital. That is, we must invest, and we must grow."

The meaning of these words is clear and unequivocal.

The nation does not need less capital and less private risk investment - it needs more.

It needs more private risk investment to provide more and better jobs which, in turn, increase total production and productivity, new products and services.

It needs more private risk investment to provide opportunities for all our citizens and to increase the standard of living for all.

What is the applicability of President Kennedy's pronouncement to the three provisions of the present bill?

Simply, that it would be a serious mistake to change our tax laws so as to discourage individual savers and corporations from investing for profit in private enterprise. By putting their savings and capital to work through risk investment, these individuals and corporations make our system a viable one.

We should never, in logic or by inference, subscribe to the proposition that a substantial tax premium for risking hard earned savings or borrowed capital in useful enterprise is a tax loophole or inequity.

This discussion is not addressed to policies that were formulated decades ago and have outlived their usefulness.

In 1962 Congress solemnly adopted as a permanent structural change in our economic and tax system a principle that was the investment tax credit. It provided that all those who invested earnings, borrowed money or equity capital in new machinery and equipment for business use should receive an investment tax credit for a percentage of that investment.

A vast majority of the members of the U.S. Senate voted for that proposal in late 1962.

Were they wrong?

They did not think so in 1964 when they voted to strengthen and

improve the original provision.

They did not think so in 1967 when another overwhelming majority voted to restore the investment credit which had been temporarily suspended to cool down an excessive capital goods boom.

Why did these Senators, most of whom are still members of the body, vote for the investment tax credit?

It was designed, adopted and has proven effective:

- for encouraging the development of new and better quality job opportunities, new products, new services, and new processes for improving old ones,

- for promoting competitive efficiency in our productive machinery on a scale practiced by the nations competing in our markets at home and abroad,

- for increasing national productivity,

- for enabling business to offset, in some measure, the rising costs that would otherwise engulf the economy in a more serious cost push inflation than the one we now have.

An examination of the reasoning advanced for repealing the investment tax credit reveals only considerations of short term expediency. The rationale for the change is that the purposes the investment tax credit has served and is serving so well are not very important now and are not likely to become so again. So it is to be permanently revoked.

The role that the investment tax credit and a vigorous capital formation played in the U.S. economy the last six years and its potential for the long term future should not be so lightly dismissed.

Sober second thoughts should lead to a better answer to any of our current fiscal and monetary dilemmas than the permanent revocation of a device that has served the nation so well in the past and is sure to be needed more often than not in the future.

Now, to add a few comments on the other two proposals affecting capital gains directly.

The nation and the Congress have long recognized that realized increases in capital risked for at least six months should be taxed at only one half the rate on ordinary income, and, in no event, should exceed 25 percent for any taxpayer (except in wartime).

Can anyone doubt that the end result of combining in one bill provisions eliminating this ceiling on capital gains and doubling the holding period will be less private capital put at risk and less mobility of risk capital and its unrealized gains from relatively safe untaxed shelters to the new or dynamic enterprises that do not have established credit or earnings?

Are new and small businesses more or less likely to find equity financing that provides an opportunity for growth with these changes in the law?

Could so-called black capitalism thrive or flourish in the environment these new provisions would create except on the basis of government hand-out?

It is a striking paradox that the House bill puts a ceiling of 50 percent on the top marginal rate on earned income (a commendable action), while eliminating the ceiling on capital gains.

The two actions taken together are said to reduce the pressure to use tax shelters to convert ordinary income to capital gains from a 45 percent differential to 17 1/2 percent.

Is it necessary to "throw out the baby with the bath"?

The way to prevent ordinary income from being converted to capital gains is to resist changes in law that have this effect. The other stated reason for eliminating the present ceiling on the taxation of capital gains is the variance with the progressive tax rate structure on ordinary income, permitting taxpayers with top marginal rates in excess of 50 percent in effect to include less than 50 percent of their capital gains into ordinary income.

In 1963 when President Kennedy sought to remedy this situation he sought a structural change that would do so but would also facilitate "our economic objectives". He recommended as the right approach to both objectives a decrease in the percentage of capital gains taxable for all taxpayers. The effect of this approach is to give the same character of progressivity to the taxation of capital gains as to ordinary income by increasing rather than decreasing the premium for risk investment.

President Kennedy recommended that the inclusion rate of capital gains into ordinary income be reduced from 50 percent to 30 percent which would have more than accomplished the restoration of progressivity to the taxation of capital gains.

In so doing he noted that:

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital and thereby the strength and potential for growth of the economy."

It should be observed that at the same time President Kennedy sought a significant reduction in the tax rate on capital gains he also recommended extending the holding period to one year, some definitional changes to minimize the treatment of ordinary income as capital gains and the taxation of capital gains accruing at the time of gift or death.

But the important fact that he stressed was the interrelationship of liberalization of the tax treatment of true capital gains with equitable adjustments, saying:

"I, therefore, recommend the following changes, the nature of which require their consideration as a unified package, coupling liberalization of treatment with more sensible and equitable limitations." (Underlining ours.)

A bill which includes only a harsher treatment of capital gains in both the rate of taxation and the holding period is neither consonant with our "economic objectives" nor adequate as a tax reform measure in the capital gains area.

The wise course is to remove those provisions from the House bill unless and until a formula can be devised that "couples liberalization of treatment" of capital gains "with more sensible and equitable limitations."

In closing, may I stress the fact that the responsibility of the United States Senate and its Finance Committee to review and revise the bill before it is far greater than that which attended its deliberations on the Revenue Acts of 1962 and 1964. In those bills the objective was structural change to provide both a sound but dynamic long term growth economy and equity between taxpayers. In its generally commendable, indeed necessary, effort to make our tax system more equitable, the House bill, at least in the three particular sections noted, seems to sacrifice tax policies established to provide a sound but dynamic growth economy to considerations of equity which are non-existent or marginal.

The issue is simple.

Is the Senate and its Finance Committee sure that the policies these three provisions would destroy, so painfully forged in the past, have outlived their usefulness for the 1970s?

Has some miracle been forged in the fires of war in South Vietnam that has so altered our economic system as to solve permanently the problem diagnosed by President Kennedy as recently as 1963?

Are the words he uttered then already obsolete - not only for the years of war and its accompanying inflation but for the years of peace ahead?

> "The chief problem confronting the economy in 1963 is its unrealized potential - slow growth, underinvestment, unused capacity and persistent unemployment. The result is lagging wage, salary and profit income, smaller take-home pay, insufficient productivity gains, inadequate federal revenues and persistent budget deficits."

Are all those risks so far behind us that we can jettison the tools and techniques we used to overcome them?

It would seem the better part of wisdom to answer these questions in the context of a more normal peacetime economy than at present.

Long range tax policies designed to safeguard long term private investment in a tax structure still characterized by high rates on income should be maintained unless the most compelling reasons of equity require that they be abandoned.

To determine now that they are no longer useful or desirable - at a time of oncoming reconversion from a siseable military effort when a rigorous program of fiscal and monetary restraint has already lowered the trajectory of real growth from excess demand half-way to a recession is to compound cyclical with structural risks.

It is for these reasons and against this background I would hope that the Committee and the Senate will insist upon the deletion from the Tax Reform bill of the three provisions singled out for this discussion.

Respectfully yours,

Henry H. Fowler

President's 1963 Tax Message

EXHIBIT II

Table 11

Tax Program - Capital Gains and Losses
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(in millions of dollars)

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Total, before induced effects	- 40	+140	+100
Induced effects	+690	- 40	+650
Total..	+650	+100	+750

Office of the Secretary of the Treasury

Office of Tax Analysis

February 6, 1963

EXHIBIT 1

HENRY H. FOWLER
55 Broad Street
New York, N.Y. 10004

August 28th, 1969.

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

Dear Chairman Long,

I am submitting this letter as a Statement for inclusion in the record of the deliberations of the Senate Finance Committee on the proposed Tax Reform Act of 1969.

You and your colleagues have the highly important responsibility of reviewing and revising this bill as it passed the House of Representatives and working out any differences in Conference.

I have assessed my own responsibilities to comment as a private citizen (now a General Partner in the investment banking firm of Goldman, Sachs & Co.) and as the Under Secretary and Secretary of the Treasury from early 1961 through December 20th, 1968.

This letter is the result. My views as a private citizen on the subjects to be discussed are parallel to the views on these subjects I expressed as Under Secretary and Secretary of the Treasury as a review of my public statements during that period will attest.

There are a large number of provisions in the bill. Many of them reflect in whole or in part the Tax Reform Studies and Proposals of the U.S. Treasury Department, prepared during my tenure as Secretary by the Treasury Tax Policy Staff under the direction of Assistant Secretary Stanley Surrey, and published earlier this year (February 5th) for information only as a Joint Publication of the House Ways and Means Committee and the Senate Finance Committee. Other provisions have been added on the recommendation of the new Administration or on the initiative of the House Ways and Means Committee.

On all save three specific provisions I shall follow the course I did in the House proceedings; namely, refrain from comment, technical and otherwise, preferring to stand on my general Statement on the Tax Reform Program of the Treasury Department, dated December 11th, 1968, which appears in full on pages 3 through 9 of Part 1 of the published report referred to.

But I do feel impelled to speak out on three specific provisions of the proposed bill which

(a) were not included as needed reforms in the old Treasury report referred to and
(b) taken together, would reverse and undo salient features of a tax policy of vital importance to a viable economic system based on free private enterprise which tax policy was confirmed in the early sixties by the Congress on the recommendations of President Kennedy and President Johnson.

That policy, developed by the Treasury Department of those years in association with other parts of the Executive and Congress, was designed to safeguard and promote adequate private investment - as an essential ingredient in sustaining economic growth, increasing job opportunities in private enterprise in sufficient number and ever improving quality, providing a steadily rising standard of living, and keeping the U.S. economy competitive.

The three provisions referred to should be deleted because they are incompatible with the maintenance of a dynamic private sector in a free enterprise economy so long as the present and projected high tax rates on individual and corporate income persist. Moreover, they undo recently won advances toward a tax policy geared to sustained and non-inflationary economic growth and reasonably full employment in the private sector.

They would reverse a national policy as old as the nation and the federal tax system and as recent as the last major revision of our permanent tax structure in the 1960s - the placing of a high tax premium on the risk investment of savings or borrowed capital.

I refer to the provisions of the proposed bill which would (a) repeal the investment tax credit, (b) increase the rate of capital gains taxation by removing the maximum or alternative rate and (c) extend the period in which any investment must be held to qualify profits or losses therefrom as capital gains or losses.

In most of the advanced industrial countries in the Free World capital gains are not taxed. In these countries investment tax credits and

and special allowances are established features of their tax systems. They are considered fundamental to the national pursuit of non-inflationary growth and progress via increased production and productivity.

These policies, contrary to the proposed changes above, are supported in economies far more mixed than our own and far less dependent on private enterprise and investment. It would be ironic to downgrade or give a low order of priority to policies specifically designed to preserve the role of free private enterprise in a nation that has hitherto been an example of the success of that system.

Past Congresses have sought by these very features of the tax law now under attack to make our tax system compatible with a high rate of private investment. They should be preserved as long as that system is characterized by high tax rates on individual and corporate income.

The underlying policy common to these provisions under attack is simple - to maintain the vitality of a free private enterprise system dependent on large and continuing outlays of private capital.

Our national concern with the economy and the tax system - except in periods of war - and as recently as the early sixties - has been the inadequacy of the tax system in preserving the opportunity and incentive for private investment.

A re-reading of the Tax and Economic Messages of the late President Kennedy in 1961-3 would raise seriously doubts concerning the wisdom of tax proposals admittedly designed to diminish the premium and pace of risk investment.

A primary thrust of these Messages, confirmed as national policy in the Revenue Acts of 1962 and 1964, was the promotion of adequate private investment - the freer and fuller flow of capital into productive effort.

In his last Tax Message of January 24th, 1963, President Kennedy provided the policy basis for the Tax Reduction Act of 1964 in these words:

> "Despite the improvements resulting from last year's depreciation reform and investment credit - which I pledged two years ago would be only a first step - our tax system still siphons out of the private economy too large a share of personal and business purchasing power and reduces the incentive for risk, investment and effort - thereby aborting our recoveries and stifling our national growth rate."

It seems unlikely that developments in the last few years of war, inflation, and rapidly expanding public expenditures have changed the truth and relevance of these words in his accompanying Economic Message of 1963:

"To raise the nation's capacity to produce - to expand the quantity, quality and variety of our output - we must not merely replace but continually expand, improve, modernize and rebuild our productive capital. That is, we must invest, and we must grow."

The meaning of these words is clear and unequivocal.

The nation does not need less capital and less private risk investment - it needs more.

It needs more private risk investment to provide more and better jobs which, in turn, increase total production and productivity, new products and services.

It needs more private risk investment to provide opportunities for all our citizens and to increase the standard of living for all.

What is the applicability of President Kennedy's pronouncement to the three provisions of the present bill?

Simply, that it would be a serious mistake to change our tax laws so as to discourage individual savers and corporations from investing for profit in private enterprise. By putting their savings and capital to work through risk investment, these individuals and corporations make our system a viable one.

We should never, in logic or by inference, subscribe to the proposition that a substantial tax premium for risking hard earned savings or borrowed capital in useful enterprise is a tax loophole or inequity.

This discussion is not addressed to policies that were formulated decades ago and have outlived their usefulness.

In 1962 Congress solemnly adopted as a permanent structural change in our economic and tax system a principle that was the investment tax credit. It provided that all those who invested earnings, borrowed money or equity capital in new machinery and equipment for business use should receive an investment tax credit for a percentage of that investment.

A vast majority of the members of the U.S. Senate voted for that proposal in late 1962.

Were they wrong?

They did not think so in 1964 when they voted to strengthen and

improve the original provision.

They did not think so in 1967 when another overwhelming majority voted to restore the investment credit which had been temporarily suspended to cool down an excessive capital goods boom.

Why did these Senators, most of whom are still members of the body, vote for the investment tax credit?

It was designed, adopted and has proven effective:

- for encouraging the development of new and better quality job opportunities, new products, new services, and new processes for improving old ones.

- for promoting competitive efficiency in our productive machinery on a scale practiced by the nations competing in our markets at home and abroad,

- for increasing national productivity,

- for enabling business to offset, in some measure, the rising costs that would otherwise engulf the economy in a more serious cost push inflation than the one we now have.

An examination of the reasoning advanced for repealing the investment tax credit reveals only considerations of short term expediency. The rationale for the change is that the purposes the investment tax credit has served and is serving so well are not very important now and are not likely to become so again. So it is to be permanently revoked.

The role that the investment tax credit and a vigorous capital formation played in the U.S. economy the last six years and its potential for the long term future should not be so lightly dismissed.

Sober second thoughts should lead to a better answer to any of our current fiscal and monetary dilemmas than the permanent revocation of a device that has served the nation so well in the past and is sure to be needed more often than not in the future.

Now, to add a few comments on the other two proposals affecting capital gains directly.

The nation and the Congress have long recognized that realized increases in capital risked for at least six months should be taxed at only one half the rate on ordinary income, and, in no event, should exceed 25 percent for any taxpayer (except in wartime).

Can anyone doubt that the end result of combining in one bill provisions eliminating this ceiling on capital gains and doubling the holding period will be less private capital put at risk and less mobility of risk capital and its unrealized gains from relatively safe untaxed shelters to the new or dynamic enterprises that do not have established credit or earnings?

Are new and small businesses more or less likely to find equity financing that provides an opportunity for growth with these changes in the law?

Could so-called black capitalism thrive or flourish in the environment these new provisions would create except on the basis of government hand-out?

It is a striking paradox that the House bill puts a ceiling of 50 percent on the top marginal rate on earned income (a commendable action), while eliminating the ceiling on capital gains.

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In 1963 when President Kennedy sought to remedy this situation he sought a structural change that would do so but would also facilitate "our economic objectives". He recommended as the right approach to both objectives a decrease in the percentage of capital gains taxable for all taxpayers. The effect of this approach is to give the same character of progressivity to the taxation of capital gains as to ordinary income by increasing rather than decreasing the premium for risk investment.

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"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital and thereby the strength and potential for growth of the economy."

It should be observed that at the same time President Kennedy sought a significant reduction in the tax rate on capital gains he also recommended extending the holding period to one year, some definitional changes to minimize the treatment of ordinary income as capital gains and the taxation of capital gains accruing at the time of gift or death.

But the important fact that he stressed was the interrelationship of liberalization of the tax treatment of true capital gains with equitable adjustments, saying:

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-6-

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> "The chief problem confronting the economy in 1963 is its unrealized potential - slow growth, underinvestment, unused capacity and persistent unemployment. The result is lagging wage, salary and profit income, smaller take-home pay, insufficient productivity gains, inadequate federal revenues and persistent budget deficits."

Are all those risks so far behind us that we can jettison the tools and techniques we used to overcome them?

It would seem the better part of wisdom to answer these questions in the context of a more normal peacetime economy than at present.

Long range tax policies designed to safeguard long term private investment in a tax structure still characterized by high rates on income should be maintained unless the most compelling reasons of equity require that they be abandoned.

To determine now that they are no longer useful or desirable - at a time of oncoming reconversion from a sizeable military effort when a rigorous program of fiscal and monetary restraint has already lowered the trajectory of real growth from excess demand half-way to a recession is to compound cyclical with structural risks.

It is for these reasons and against this background I would hope that the Committee and the Senate will insist upon the deletion from the Tax Reform bill of the three provisions singled out for this discussion.

Respectfully yours,

Henry H. Fowler

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Office of the Secretary of the Treasury

Office of Tax Analysis

February 6, 1963

For Release on Delivery
Wednesday, August 23, 1978
10 A.M. E.S.T.

TESTIMONY TO THE
SENATE FINANCE COMMITTEE

by

MARTIN FELDSTEIN
PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH
and
PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

WEDNESDAY, AUGUST 23, 1978

August 23, 1978

Key Points

Testimony of Martin Feldstein

The Taxation of Capital Gains

(1) The realization of capital gains is so sensitive to tax rates that reducing the tax rate on capital gains would actually increase tax revenues from this source.

(2) An analysis of corporate stock capital gains in 1973 shows that inflation doubled the overall tax rate on such gains. Taxpayers with incomes below $100,000 suffered real capital losses on average but were taxed on real gains. The Archer Amendment should therefore be retained.

(3) The plan passed by the House to eliminate the alternative tax method and take capital gains out of preference income would actually cause more tax rate increases than tax rate decreases among taxpayer with 1978 adjusted gross incomes over $100,000. The decision to eliminate the alternative tax should be reversed.

Corporate Tax Reduction

(4) The sluggish performance of the economy over the past decade is due in significant measure to the low rate of capital formation. This in turn reflects the sharp increase in the effective tax rate on corporate profits.

(5) Depreciation rules should be based on inflation-adjusted costs.

(6) A cut in the corporate tax rate to 40 percent, voted now but becoming effective only in 1981, would stimulate capital formation now without any concurrent increase in the deficit.

activity would, of course, increase revenue further. But even without such stimulating effects, the evidence indicates that reducing the tax rate on capital gains would increase both total tax revenue and the taxes paid by high income individuals.

The key evidence in this study[1] is an analysis of the Treasury Department's sample of individual tax returns for 1973. The sample consists of over 30,000 individuals with more than 230,000 stock sales. Although the individuals are not identified, the sampling rates are known; the sample can therefore be used to construct accurate estimates of totals for all taxpayers. With this data, we found that the realization of capital gains on corporate stock is extremely sensitive to the tax rate. We calculated that limiting the top capital gains rate to 25 percent would have caused an almost three-fold increase in the total value of net gains realized in 1973. Because of this great increase in the realization of gains, the reduction in tax rates would have substantially increased capital gains tax revenues. Our calculation indicates that the tax revenues on corporate stock capital gains would have more than doubled if the tax rate had been limited to 25 percent.

This study was restricted to gains on corporate stock. To study the tax sensitivity of all types of capital gains, we examined the Treasury's published data on capital gains before and since the 1969 Tax Reform Act.[2] The historic record shows that all gains as a whole are sensitive to higher tax rates. We have compared the two

[1]This study is reported in M. Feldstein, J. Slemrod and S. Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," National Bureau of Economic Research Working Paper No. 250, 1978.

[2]This study is reported in J. Slemrod and M. Feldstein, "The Lock-in Effect of the Capital Gains Tax: Some Time Series Evidence", National Bureau of Economic Research Working Paper No. 257, 1978.

years before the 1969 Tax Reform Act with the two most recent years for which data are available. Over this period, taxpayers with adjusted gross incomes below $100,000 increased their realized gains by 18 percent. In contrast, realized gains fell by 35 percent for the very high income taxpayers (with AGI over $500,000) who were most effected by the 1969 changes. These data indicate that the gains of this high income group would have been about twice as high today if they had not been depressed by the 1969 tax changes.

In short, the Treasury's calculation that cutting the top capital gains tax rate to 25 percent would cost $2 billion is totally misleading. They arrive at this figure because they ignore the unlocking of gains that would result from the lower tax rate. Reducing the top tax rates on capital gains would actually increase tax revenues. A capital gains tax cut should therefore not be evaluated as an alternative to other ways of stimulating capital formation because a capital gains tax cut has no real revenue cost.

With this as background, I want to talk briefly about two aspects of the bill recently passed by the House: the Archer Amendment to adjust capital gains for inflation and the elimination of the alternative tax.

Inflation and the Taxation of Capital Gains

I think the Archer amendment is a very desirable feature of the bill and should be retained. As you know, when corporate stock or any other asset is sold, current law requires that a capital gains tax be paid on the entire difference between the selling price and the original cost even though much of the nominal gain only offsets

a general rise in the prices of consumer goods and services. Taxing nominal gains in this way very substantially increases the effective taxrate on real price-adjusted gains. Indeed, many individuals pay a substantial capital gains tax even though, when adjustment is made for the change in the price level, they actually receive less from their sale than they had originally paid.

In a recent study at the National Bureau of Economic Research[1], we measured the total excess taxation of corporate stock capital gains caused by inflation and the extent to which this distortion differs capriciously among individuals. For this study we used the Treasury Department's sample of 30,000 individual tax returns for 1973 that I mentioned a few minutes ago.

We found that in 1973 individuals paid capital gains tax on $4.5 billion of nominal capital gains on corporate stock. When the costs of these shares are adjusted for the increase in the consumer price level since they were purchased, this gain becomes a loss of nearly $1 billion.

The $4.6 billion of nominal capital gains resulted in a tax liability of $1.1 billion. The tax liability on the real capital gains would have been only $661 million. Inflation thus raised tax liabilities by nearly $500 million, approximately doubling the overall effective tax rate on corporate stock capital gains.

[1] This study is reported in M. Feldstein and J. Slemrod, "Inflation and the Excess Taxation of Capital Gains", NBER Working Paper No. 234, 1978 (published in The National Tax Journal, June 1978).

Although adjusting for the price change reduces the gain at every income level, the effect of the price level correction is far from uniform. In particular, the mismeasurement of capital gains is most severe for taxpayers with incomes under $100,000. In the highest income class, there is little difference between nominal and real capital gains; in contrast, taxpayers with incomes below $100,000 suffered real capital losses even though they were taxed on positive nominal gains. (The nominal and real gains and corresponding tax liabilities are compared in Exhibit 1; I will not comment further on these figures now.)

The proposal in the House passed bill to adjust taxable gains for the effects of inflation would eliminate this unfair treatment and would provide a more equitable and predictable taxation of capital gains. It is important to realize that, based on the 1973 experience, two-thirds of the tax reduction on corporate stock gains that would result from this inflation correction would go to taxpayers with AGI's below $100,000 even though they only paid less than one-fourth of the capital gains tax on corporate stock. The inflation correction would thus be a major benefit to middle income investors.

The Alternative Tax

Let me turn now to the proposal to eliminate the alternative tax that is contained in the bill passed by the House. I think this would be a very serious mistake. For many individuals, the adverse effect of eliminating the alternative tax would outweigh the favorable

effect of taking the untaxed half of capital gains out of preference income.

It is easy to see how this can happen. A high income executive or professional with little or no so-called preference income would not benefit from the provision that takes capital gains out of preference income. He would however find that eliminating the alternative tax would raise his tax rate on capital gains.

This type of situation should not be considered a rare anomaly. It is actually the typical result of the House-passed bill. Among taxpayers with 1978 adjusted gross incomes over $100,000, the combination of eliminating the alternative tax method and taking capital gains out of preference income would actually cause more tax rate increases than tax rate decreases.

More specifically, to study this question I used the 1973 Treasury data on individual sales and gains projected to 1978 levels. I found that, with these sales and gains, eliminating the alternative tax and taking capital gains out of preference income would raise the capital gains tax for 99,000 individuals with AGI's over $100,000. Only 79,000 such individuals would pay lower capital gains taxes. Of course, since the taxpayers with reduced tax rates are also the investors with the largest gains, this combination of policies results in a net reduction in the total tax liability on the initial level of gains. But this does not change the fact that (aside from

the indexing proposal) the plan passed by the House would actually cause more capital gains tax increases than decreases.

The effect of this would be to discourage investment by the very individuals whom the current tax reform sought to bring back into greater equity investment. I am confident that the magnitude of this perverse effect was not anticipated by those who drafted the House bill. I hope that in light of this new evidence you will reconsider and reverse the decision to eliminate the alternative tax. Let me remind you that doing so would not only stimulate personal investment but would also increase Treasury revenue.

Corporate Tax Reduction

For the very brief time that remains, let me turn to the corporate income tax. The sluggish performance of the economy over the past decade is due in significant measure to our low rate of capital formation. Moreover, if investment were stronger, it would be possible to reduce the government deficit without fear of inadequate demand. And the added investment would increase capacity and thereby avoid the potential bottlenecks that threaten to increase the rate of inflation.

A key reason for the low rate of corporate investment has been the sharp fall in the after-tax profitability of investment. The primary cause of this low profitability has been the great increase in the effective rate of corporate income tax. Because inflation causes taxable profits to overstate real profits, the true corporate tax rate on real profits has increased from 41 percent

in 1967 to 52 percent in 1977 despite the changes in statutory rules intended to stimulate investment.

Two remedies are called for. First, depreciation rules should be based on inflation-adjusted costs not the original "historic" costs used in the current tax law. This would not only reduce the total tax rate but would eliminate a major and unecessary source of uncertainty that hangs over current investment decisions.

The second change is to reduce the statutory corporate tax rate itself from the current 48 percent level. The House bill makes a small step in this direction with a two percent cut. I want to conclude my remarks this morning by suggesting a more dramatic change.

Consider the idea of a substantial cut in the corporate tax rate - to 40 percent, for example - voted now but becoming effective only in 1981. If such a tax cut were irrevocably promised, it would cause a significant increase in investment even before the lower tax rate takes effect. The prospect of a lower tax rate on future profits would stimulate investment even before the tax rate fell. Indeed, firms would rush to make the investments in order to get the depreciation at the higher tax rate. A substantial tax cut explicitly legislated for the future would thus stimulate capital formation now without any concurrent increase in the deficit. I hope that you will give this simple idea your serious consideration.

Exhibit 1

Capital Gains and Associated Tax Liabilities

Adjusted Gross Income Class

	Less than zero	Zero to $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	All
				(Millions of Dollars)					
1. Nominal capital gains	86	77	21	369	719	942	1135	1280	4629
2. Real capital gains	-15	-726	-895	-1420	-255	437	839	1125	-910
3. Tax on nominal capital gains	1	-5	23	80	159	215	291	374	1138
4. Tax on real capital gains	0	-25	-34	-52	58	141	235	337	661

2016

THE EFFECTS OF TAXATION ON THE SELLING OF CORPORATE STOCK AND THE REALIZATION OF CAPITAL GAINS

Martin Feldstein
NBER and Harvard University

Joel Slemrod
NBER and Harvard University

Shlomo Yitzhaki
Rehovath University and the Falk Institute, Jerusalem

NBER Working Paper No. 250

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, Massachusetts 02138

June 1978

SUMMARY

This study provides the first econometric analysis of the effect of taxation on the realization of capital gains. The analysis thus extends and complements the earlier study by Feldstein and Yitzhaki (1978) of the effect of taxation on the selling of corporate stock. The present analysis, using a large, new body of data obtained from individual tax returns, supports the earlier finding that corporate stock sales are quite sensitive to tax rates and then shows that the effect on the realization of capital gains is even stronger.

More specifically, the estimated tax sensitivity implies that limiting the capital gains tax rate to 25 percent would have caused an almost three-fold increase in the total value of the net gains realized in the 1973 sample year. As a result, the reduction in tax rates would have substantially increased the revenue produced by the capital gains tax rate.

THE EFFECTS OF TAXATION ON THE SELLING OF CORPORATE STOCK AND THE REALIZATION OF CAPITAL GAINS

Martin Feldstein*
Joel Slemrod*
Shlomo Yitzhaki**

The effective rates at which capital gains are taxed have increased very substantially in recent years. Debate continues on proposals to change the tax law in ways that would further increase these tax rates as well as on proposals to reduce the effective tax on capital gains. The present paper uses a new, rich body of microeconomic data to estimate how taxation affects the selling of corporate stock and the realizing of capital gains. The results indicate that the current high rates of tax on capital gains substantially reduce the selling of corporate stock, particularly sales that would involve recognizing net capital gains.

Until 1969, the tax rate on long-term capital gains[1] was limited by a ceiling of 25 percent. Individuals whose marginal tax rates were below 50 percent could exclude half of their gains, thereby paying a tax rate of less than 25 percent. Higher income individuals could use the "alternative tax"

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[1]At this time, the long-term capital gain rate applied to assets held for at least 6 months.

method that subjected the entire gain to a 25 percent tax. Since then, several statutory changes have combined to raise the tax on capital gains. The alternative tax method is now limited to the first $50,000 of capital gains per taxpayer; since 50 percent of the gains in excess of this amount are excluded from taxable income, the personal tax rate on marginal capital gains can now be as high as 35 percent. A "minimum tax," originally introduced in the Tax Reform Act of 1969, now subjects the excluded half of capital gains for some taxpayers to an additional tax of 15 percent. In 1969, the tax on capital gains was effectively raised further for some high income individuals by a provision which made the tax rate that such individuals must pay on wage and salary income depend on the amount of capital gains that they realize.[1] The combination of these tax changes makes the current marginal capital gains tax rate exceed 40 percent for many individuals, substantially more than the previous 25 percent maximum.[2]

In addition to these statutory tax changes, the effective tax on real capital gains has been raised substantially by inflation. Under current law, the capital gains tax is levied on nominal capital gains with no adjustment

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[1]Under the "maximum tax" provisions, the marginal tax rate on wages, salaries and other personal services income is limited to 50 percent. The 1969 change provides that, for each two dollars of capital gain, the individual must reduce the income that he subjects to the 50 percent "maximum tax" by one dollar and subject that dollar to his ordinary tax. This reclassified dollar may then be taxed at a personal rate of up to 70 percent. For an individual with a 70 percent marginal tax rate, this reclassification adds 20 cents per two dollars of capital gain.

[2]Several other statutory changes have also raised the tax on capital gains: the holding period required to qualify as long-term capital gains has increased; the basis of capital assets transferred at death is no longer increased to market value; the ability to donate capital gain property to charities has been limited; etc. In addition, state income tax on capital gains have become increasingly important.

for changes in the price level since the stock was acquired. This not only overstates the value of real capital gains but, by converting real losses to nominal gains, reduces investors' opportunities to offset capital losses against capital gains. Feldstein and Slemrod (1978) analyzed the corporate stock sold by individuals in 1973; they found that adjusting the costs of these stocks for the increase in consumer prices since they were acquired would change the $4.6 billion gain on which taxes were paid to a loss of nearly $1 billion and would cut the corresponding tax liability in half.

A wide range of proposals to change the taxation of capital gains is being actively discussed.[1] The Treasury has proposed eliminating the alternative tax completely. Other proposals to increase the tax on capital gains include raising the minimum tax or even eliminating the 50 percent exclusion. The effective tax rate would be lowered by proposals to tax only real gains or to decrease the tax rate with the length of the holding period, or to repeal the minimum and maximum tax rules related to capital gains. More radical proposals include extending the "rollover" provision (in which capital gains are not taxed if the proceeds are reinvested) to corporate stock or a more general substitution of an expenditure tax for the current income.

A prerequisite for sound policy decisions is an understanding of how alternative tax rules would affect investor behavior. It is particularly important to know whether high tax rates "lock investors in" existing stocks, thereby reducing the efficiency of the capital market. Similarly, it is important to know whether increasing the tax rate on capital gains would

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[1]See, among others, Break and Pechman (1975), Brinner (1973) and David (1968).

actually increase revenue or, by substantially reducing the realization of gains, would decrease revenue.

This study provides the first econometric analysis of the effect of taxation on the realization of capital gains. The analysis thus extends and complements the earlier study by Feldstein and Yitzhaki (1978) of the effect of taxation on the selling of corporate stock. The present analysis, using a large, new body of data obtained from individual tax returns, supports the earlier finding that corporate stock sales are quite sensitive to tax rates and then shows that the effect on the realization of capital gains is even stronger.

The first section of the paper discusses the data used in this analysis. Section 2 presents estimates of the effect of the tax on common stock sales and compares these results with those of the earlier Feldstein-Yitzhaki study. The third section discusses the corresponding estimates of the response of realized capital gains. Simulations of the effects of several alternative policies are presented in section 4. There is a brief concluding section.

1. Data and Definitions

Each year the Internal Revenue Service and the Treasury select a stratified random sample of approximately 100,000 individual tax returns with which to study income sources, deductions and tax liabilities. The information for each taxpayer consists of the major items on the individual's tax return (form 1040). The sample is drawn so that the sampling fraction increases to 100 percent for taxpayers with adjusted gross incomes over $200,000. As a result, the sample can be used to make accurate estimates even for the high income groups which consist of relatively small numbers of people. Moreover, because the sampling probabilities are known, unbiased estimates for all taxpayers or for any subgroup can be constructed.

In 1973, the Treasury collected more detailed information on the capital gains and losses reported on these tax returns. In addition to the usual information on each tax return, this special study recorded for each sale of a capital asset (as reported on schedule D of form 1040) the nature of the asset (stock, real estate, etc.), the purchase price, date acquired, sale price, and date sold. Our analysis focuses exclusively on the sale of corporate stock.

In order to study the effect of tax rates on the selling of corporate stock, we require a probability sample of all the taxpayers who own stock and not just those who sold stock in 1973. Although the tax returns provide no direct information about the ownership of corporate stock, we can use the receipt of dividends to identify stockholders. Our sample consists of 53,523 taxpayers who received dividends in 1973; the sample weights imply that this group represents a population of 11.5 million taxpaying units which owned

stock in 1973. All taxpayers without dividend income are eliminated from the sample.

The analysis that we present in the following sections of this paper relates the value of the stock sold and of the net capital gain realized by each stockowner in the sample to his "capital gains tax rate" and to other determinants of sales and gains. To calculate each individual's "capital gains tax rate" we use a sophisticated computer program (TAXSIM) that embodies the basic features of the tax law as of 1973. This program calculates the effect on the individual's total tax liability of another dollar of capital gains, including such calculations as the use of the alternative tax, the extra "minimum tax," and the change in the standard deduction for those who do not itemize their deductions. The "capital gains tax rate" is a marginal tax rate defined as the extra tax liability due on an additional dollar of capital gain.

Since the capital gains tax rate of an individual can vary with the amount of capital gain that he realizes, there are several possible ways of calculating our capital gains tax rate variable.[1] The simplest procedure is to use the capital gains tax rate that would apply to the first dollar of corporate stock capital gain that the individual realizes, i.e., the extra tax liability that would be due on a dollar of capital gain if the individual had no other sales of corporate stock. This "first dollar capital gains tax

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[1] In effect, the individual faces a schedule of capital gain tax rates rather than a single rate.

rate" has the statistical advantage of being exogenous in the sense that it is independent of the individual's decision about how much gain to realize.[1]

However, for very wealthy individuals who typically realize large gains, these "first dollar" rates could differ substantially from the tax rates at which marginal decisions were actually made in 1973. The most appropriate rate to use for each individual is the "last dollar capital gains rate," i.e., the additional tax liability that would be incurred if the individual increased his capital gain in 1973 by one dollar. Because this tax rate is endogenous to the individual's decision, an equation using this rate cannot be estimated by ordinary least squares. We therefore use a consistent instrumental variable estimation procedure.[2] Fortunately, both definitions of the tax rate yield quite similar results.

The specification of the equations that we have estimated and the precise definitions of the other variables will be discussed in the following section where the estimates of selling behavior are presented. Before turning to this, it is useful to comment briefly on the difference between the data used in the current study and the data used in the earlier Feldstein-Yitzhaki analysis. That study was based on the 1963-64 Federal Reserve Board survey of 646 households that owned common stock at the end of 1962. The information collected for each household included the value of common stock owned at the

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[1]There is, of course, the possibility that the individual adjusts his other taxable income during the year to the amount of gain that he realizes, thus making even this "first dollar" tax rate endogenous. To reflect this would require a much more elaborate behavioral model than we have.

[2]The instrumental variables are the exogenous "first dollar capital gains tax rate" and a "predicted last dollar capital gains tax rate" based on the average capital gains of individuals with that income and dividends.

end of 1962 and the amounts sold and purchased during 1963. This permitted studying "stock switching" and "net selling" separately. There was no reliable information on the amount of gain realized and tax rates had to be estimated on the basis of income data reported in the survey. Despite these problems and the relatively small sample, the Feldstein-Yitzhaki analysis found clear evidence that the sale of corporate stock is very sensitive to individual differences in capital gain tax rates.

2. The Selling of Corporate Stock

Our analysis of the selling of corporate stock focuses on the value of corporate stock sales per dollar of dividends received during 1973. We use dividends in this way to represent the value of the stock in each individual's portfolio since the tax returns contain no direct measure of the portfolio value. There is some evidence that the ratio of dividends to portfolio value varies inversely with the adjusted gross income (Blume, Crockett, and Friend; 1974); this suggests that the tax rate appears to have a smaller effect on the sale-dividend ratio than it actually does on the sales-value ratio and therefore that our parameter estimates understate the effect of the tax on the selling of corporate stock.

In 1973, the average dividend yield on corporate stock was approximately three percent.[1] By restricting our sample to taxpayers with at least $3,000 of dividends, we limit our attention to individuals with portfolio of approximately $100,000 or more. Such taxpayers accounted for 79 percent of all dividends reported by individuals for 1973. Restricting the sample in this way eliminates the implausibly high ratios of sales to dividends that occur in smaller portfolios because of chance fluctuations and measurement errors. Taxpayers with larger portfolios are also less likely to distort the estimates by altering the timing of capital gains and losses to take advantage of the very small opportunities to offset long-term losses against short-term gains, etc.

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[1]The yield on the Standard and Poors 500 stocks was 0.031.

The age of the taxpayer affects the selling decisions in a number of ways. The tax rules that prevailed in 1973 provided that the basis (or "cost") of assets transferred at death would be revalued to the current market value. This implies that the tax deterrent to selling should increase with the taxpayer's age and should be particularly strong for older taxpayers. Older taxpayers are also likely to have held their stock for a longer time, thus increasing the ratio of gain to total share value and increasing the incentive not to sell. These considerations apply to selling in order to reinvest the proceeds in other assets. Feldstein and Yitzhaki (1978) contrasted this "switch selling" with the "net selling" used to finance consumption. Older individuals are more likely to be net sellers in order to finance consumption. Although the tax return data does not include an exact age, we can distinguish taxpayers who are age 65 or older; we include a dummy variable wherever at least one individual is at least age 65. Since our data do not allow us to distinguish switch selling from net selling, the overall effect of age is ambiguous.

Two other variables are likely to affect the individual's decision to sell common stock: the value of the stock in his portfolio and the level of the individual's income. Although the probability of selling at least some stock is likely to increase with portfolio size, the ratio of sales to dividends is likely for two reasons to vary inversely with the size of the portfolio. First, any net sale of stock to finance a major consumption expenditure or nonportfolio investment could more easily represent a large fraction of a small portfolio. In addition, switching two or three securities in a small portfolio could involve selling a very large fraction of the total

value of the portfolio. Although we do not have a direct measure of the value of stock to include in the equation, we can again use the value of dividends to represent the value of the stock. We include the logarithm of dividends so that the variable will not be dominated by the largest portfolios.

Individuals with lower money incomes are more likely to be retired (or below their permanent income for other reasons) and are therefore more likely to want the proceeds of the net sales of common stock. Again, switch sales are not likely to follow the same pattern as net sales. Higher income individuals are more likely to switch stocks because they can better afford the risks of speculation and are more likely to have access to relevant investment information. We include the logarithm of adjusted gross income in our equation without any a priori theory about its sign.[1]

Equation 1 of Table 1 presents the estimated coefficients for this equation. The coefficient of the tax variable (-67.9 with a standard error of 4.05) indicates that the taxation of capital gains has a very powerful effect on the selling of corporate tax. For example, a ten percentage point increase in the tax rate on capital gains reduces the sale-to-dividends ratio by 6.8.

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[1]To eliminate the simultaneity of adjusted gross income and sales, we exclude the actual capital gains included in AGI from AGI but add back in a predicted value of "included" capital gains based on a tabulation by income and dividends.

The negative coefficient on the age variable indicates that older taxpayers are less likely to sell than younger taxpayers. The tax incentives to postpone switch selling thus dominate the need to finance retirement consumption. The sales-to-dividend ratio also varies inversely with portfolio size and income.

Several variants of equation 1 which have been estimated (but are not presented) deserve comment. Using the "first dollar" marginal tax rate, i.e., the marginal tax rate on capital gains that the individual would face before he realized any capital gains, reduces the coefficient of the tax variable only slightly (from -67.9 to -55.7) and leaves the other coefficients essentially unchanged.[1] Extending the sample to all shareholders (and not just those with more than $3,000 of dividends) eliminates the estimated effect of the tax; the coefficient of the tax variable is very small and less than its standard error. As we noted above, we believe that this reflects the problems of measuring behavior of investors with small portfolios but it may also indicate that such investors are less sensitive to tax considerations.

In 1973, 50 percent of shareholders with more than $3,000 in dividends sold some corporate stock. Equation 2 of Table 1 shows that the decision to sell anything, as well as the amount of selling, is sensitive to the individual's tax rate. The tax coefficient of -0.906 (with a standard error of .0393) implies that a 10 percentage point increase in the marginal tax rate reduces the probability of selling something by 9.1 percentage points. The other

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[1]Using a marginal tax rate based on "predicted capital gains" introduces substantial random error and results in a substantially reduced tax coefficient.

estimated coefficients show that older people are less likely to sell, that investors with larger portfolios are more likely to sell something, and that higher income individuals are also more likely to sell.

Equations 3 and 4 describe the selling behavior of taxpayers age 65 and over.[1] The tax coefficient in equation 3 is lower than in equation 1 but is still substantial. The probability of selling (equation 4) shows an even greater sensitivity for older taxpayers than for the population as a whole.

The evidence in this section confirms the earlier findings of Feldstein and Yitzhaki (1978) that current tax laws have a very substantial effect on the selling of corporate stock. Indeed, the basic tax coefficient estimate of -67.9 in our sales-to-dividend equation is quite similar to the earlier estimate that the sales-to-market value responds to the marginal tax rate with a coefficient of -3.20 (standard error = 1.04). Since the dividend-to-market value ratio is approximately 0.03, the current estimate of -67.9 is equivalent to -2.04 in the units of the earlier study.

Two problems should be borne in mind in interpreting the current estimates and the results presented in the next section. First, we have information on the individual's tax rate only for 1973. An individual whose tax rate varies substantially from year to year will tend to sell more when his rate is low. To the extent that low rates in 1973 are only temporarily low, our estimates will overstate the sensitivity of selling to the tax rate. We have no way of knowing how important this is. Second, our analysis is based on the 1973 experience and therefore on the bequest rules that applied then. In 1973, the

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[1] More precisely, at least one "age exemption" was claimed by these taxpaying units.

tax rules provided for a full revaluation of assets transferred at death. Current law provides only for a carry-forward of the basis of assets that are bequeathed. Since this change reduces the advantage of not selling, investor behavior may be somewhat less sensitive to tax rates now than in 1973.

3. The Realizing of Capital Gains

A unique advantage of our current set of data is that it contains accurate information on capital gains and losses. We are therefore able to make the first estimates of the effects of the tax law on the realizing of net capital gains. This section follows the structure of the previous one and focuses on the net capital gains (positive or negative) realized in 1973 per dollar of dividends. We again examine the effect of the marginal tax rate and the taxpayer's age, portfolio size and income.

Equation 5 of Table 1 shows that the realizing of capital gains is very sensitive to the marginal tax rate. The coefficient of -35.6 (with a standard error of 2.16) implies that a ten percentage point change in the marginal tax rate changes the gain-to-dividend ratio by 3.56. An important implication of this high coefficient is that a reduction in the tax rate on capital gains would actually increase the total revenue collected.[1]

The realization of capital gains varies with portfolio size and income in the same way that selling does. The effect of age is more difficult to interpret. Equation 5 indicates that age does not have a statistically significant effect when the tax rate, income and portfolio size are taken into account. Comparing equations 1 and 5 thus suggests that the ratio of capital gains to sales rises with age, a quite plausible implication since older taxpayers are likely to have held their assets longer. Limiting the sample to older taxpayers (equation 6) indicates that they are less responsive to the tax rate.

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[1]When this equation is re-estimated for the "first dollar" marginal tax rate, the coefficient estimates are very similar: the tax coefficient is -30.3 (standard error 1.84). When the sample is extended to all dividend recipients, the standard errors are large and the parameter estimates are unstable.

This lower sensitivity to the tax suggests that age per se may be more important than equation 5 indicates since older taxpayers generally have lower marginal tax rates.

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4. Simulating Alternative Tax Rules

The estimated coefficients imply that corporate stock sales and the recognition of capital gains are both very sensitive to marginal tax rates. In this section, we use the estimated parameter values to calculate the impact of alternative tax rules on the aggregate volume of selling and the aggregate value of capital gains. For this purpose, we contrast the observed behavior under the 1973 law with two alternatives: Option 1 limits the rate of tax on long-term capital gains to 0.25 (and eliminates the minimum tax) while Option 2 taxes all capital gains as short-term gains, thus eliminating both the alternative tax and the exclusion.[1]

Our simulation of the effect of tax changes on selling uses the tax coefficient in equation 1 of Table 1, -67.9. For each individual, we calculate the tax rate change implied by going from the 1973 law to the option being studied.[2] We then multiply this difference between marginal tax rates by -67.9. This yields the predicted change in the individual's ratio of sales-to-dividends. This is added to his actual 1973 sales-to-dividend ratio to get a new predicted value. This new predicted value is multiplied by the individual's actual 1973 dividends to get a predicted sales for the individual. This predicted value (or zero if the predicted value is negative) is aggregated over all individuals using the appropriate sampling weights.

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[1]For both options, net capital losses are constrained to be less than $3,000, the value anticipated in the current (1978) tax rules. For the sake of comparison, this constraint has been imposed on the 1973 "current law" simulations as well.

[2]More specifically, we use the marginal tax rate on the last dollar of actual capital gain under the two alternatives.

This gives the total predicted sales for the particular option. A similar calculation is done for capital gains using the coefficient of -35.6 from equation 4. In both cases, the caluclation is limited to individuals with dividends of at least $3,000; this causes our calculations to understate the effect of tax changes, but the understatement is small since these individuals represent 79 percent of the dividends and, having generally higher incomes, are more sensitive to changes in the tax rules.[1]

The results of our simulation are presented in Table 2, for seven adjusted gross income classes as well as for all taxpayers together.

Consider first the impact of the tax options on the value of corporate stock sales. Limiting the long-term capital gains tax rate to 0.25 (option 1) nearly doubles corporate stock sales to $49.5 billion from the $29.2 billion under the 1973 law. In contrast, treating all capital gains like short-term gains (option 2) reduces selling to $16.6 billion, nearly one-half its 1973 level. Not surprisingly, the relative changes are greatest for the higher-income taxpayers.

The changes in realized gains are even more dramatic than the changes in sales. Limiting the tax rate to 25 percent causes a nearly three-fold increase in realized gains, from $5.4 billion to $15.8 billion. The higher tax rates under option 2 would substantially contract the value of realized gains.

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[1]Note that we do not use all of the estimated coefficients of equations 1 and 5 to predict selling and gains under alternative tax rules. The very low explanatory power of the equations would make such predictions very inaccurate We use instead the quite precisely estimated tax coefficient to calculate changes in selling and gains. An alternative way of describing our procedure is to say that we add the calculated residual for each individual to the predicted value based on all the coefficients.

Predicted capital gains are constrained to be zero whenever predicted sales are zero.

SIMULATIONS OF ALTERNATIVE TAX POLICIES

	Adjusted Gross Income Class							
	Less than $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	Total
	- Millions of dollars -							
1973 law								
Sales	1652	2149	7337	6677	4654	3730	3050	29249
Net gains	153	277	1111	801	904	1016	1152	5416
Tax liability	6	29	162	177	245	324	406	1349
Option 1								
Sales	1652	2232	7733	9576	9601	10319	8390	49503
Net gains	153	321	1317	2270	3426	4406	3908	15801
Tax liability	6	40	214	540	840	1093	971	3704
Option 2								
Sales	1466	1148	3051	3786	2591	2418	2128	16594
Net gains	158	120	258	356	484	660	829	2869
Tax liability	-6	7	40	84	150	254	369	899

Option 1 limits the rate of tax on long-term corporate stock capital gains to 0.25.
Option 2 taxes all corporate stock capital gains as short-term gains.
All figures refer to population with dividends greater than $3000.
For both options, net gains are constrained to be greater than $-3000 for each return. For the sake of comparison, this constraint has been imposed on the 1973 law estimates as well.

It is interesting to note the revenue effects of the tax changes. A decrease in the tax rate causes a substantial increase in tax revenue while a rise in the tax rate causes tax revenue to fall sharply.[1]

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[1]Note that this calculation, like all the analysis in this paper, refers only to corporate stock. The total revenue effect for all capital gains cannot be determined without further analysis of other asset types.

The revenue estimates that are presented in Table 2 use the following approximations. For the 1973 law and option 1, the actual last dollar marginal tax rate on short-term capital gains is applied to all gains. More detailed simulations of the tax revenue effects of alternative tax laws are to be the subject of future research.

5. Conclusion

The estimates presented in this paper confirm the earlier finding of Feldstein and Yitzhaki (1978) that the selling of corporate stock is sensitive to the tax rates and show that the realizing of capital gains is even more responsive. More generally, this study provides further evidence of the powerful effects that our tax system has on the process of capital formation.

The results indicate that reducing the tax on capital gains would not only encourage a more active market in corporate stock but would also increase tax revenue. There are a number of other proposals to alter the taxation of capital gains that would also increase selling: adjusting the cost of assets for the general rise in the consumer price level; constructive realization of gains at death; taxing accrued gains directly or retroactively with interest; or allowing tax-free rollovers. Analyzing the effects of such proposals requires a more complete model of the decision to sell corporate stock. The development of such a model would be an important extension of the current analysis.

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The Lock-in Effect of the Capital Gains Tax: Some Time-Series Evidence

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The Lock-in Effect of the Capital Gains Tax: Some Time-Series Evidence

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One issue in the current debate about lowering capital gains tax rates is the revenue cost of such a reduction. Much of the controversy has centered around the increased tax revenue that would result if the tax reduction stimulated the economy to a higher level of national income. Another, more direct, possibility is that the tax revenue loss would be mitigated by an increased volume of capital gains realizations coming at any given level of national income. Investors holding appreciated assets will be less "locked in" to their current portfolio when faced with a lower tax penalty to selling assets.

Some work we have done recently at the National Bureau of Economic Research[1] suggests that the positive response of corporate stock capital gains realizations to reduction in the capital gains tax rate is quite substantial. In fact, it may be so large that a cut in the capital gains tax would actually increase revenue from this type of capital gain. These studies used two different cross-sectional data sets to investigate the response of individual transactions behavior to the taxation of gains.

Our purpose in this note is to present some new evidence that a lock-in of capital gains can also be detected by looking at the aggregate data on all capital gains before and after the changes in the taxation of capital gains. The lock-in effect is evident once we divide individuals into categories on the basis of how much the tax changes have affected them.

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We divide individuals into three categories - (i) those with adjusted gross income (AGI) less than $100,000, (ii) those with AGI between $100,000 and $500,000, and (iii) those with more than $500,000 in AGI. Our reasoning is that the limitation on the alternative tax, the introduction of the tax on preference income, and the "poisoning" of earned income would primarily affect only those in the latter two categories, and affect the highest-income group more intensively than the middle group. This is illustrated by the following evidence. In 1974, (the latest year for which such information is available), 57% of the income in the highest class came from returns subject to the additional "minimum" tax on preferences, 14% of the income from the middle group was from additionally taxed returns, while less than a quarter of one percent of the income from the under $100,000 group was subject to the minimum tax. The cutoff of the alternative tax similarly impacted largely the upper two groups, where the greatest concentration of returns with long-term capital gains exceeding $50,000 occurs. In 1974, 98% of all the net capital gains of the highest group were made by returns with at least $25,000 net gain (Note that $50,000 of long-term capital gain is equal to $25,000 of net gain as defined by the IRS). Eighty-eight percent of the net capital gain of the middle group was so concentrated, while only 22% of net capital gain of the lowest income group had at least $25,000 net gain per return. Clearly the limitation of the alternative tax affects the highest income asset sellers much more often than the lowest.

Table I presents the recent history of the net gain from the sale of capital assets by income class.

Table 1

Net Gain from Sales of Capital Assets, 1967-1976 ($ billions)

Adjusted gross income	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
Less than $100,000	10.3	12.7	10.3	7.7	10.4	12.9	13.5	11.8	11.9	15.2
$100,000 to $500,000	2.6	3.6	3.1	1.9	2.6	3.4	3.2	2.4	2.4	3.2
More than $500,000	1.7	2.6	2.7	1.1	1.6	2.1	1.5	1.2	1.2	1.5
Total	14.6	18.9	16.1	10.7	14.6	18.4	18.2	15.4	15.5	19.9

Source: Statistics of Income: Individual Tax Returns, 1972 to 1976 (1975 and 1976 data is preliminary). Figures for 1971 and before are taken from the historical summary presented in the 1972 volume.

The first thing we notice is that the total net gain bounces around substantially from year to year, even when the tax law is unchanged. Obviously there are factors other than taxes that influence realization of gains.

The most important law changes increasing the capital gains tax were contained in the Tax Reform Act of 1969, the relevant provisions of which took effect in the succeeding three years. In order to discern a lock-in effect, we ought to compare 1969 and before with 1970 and after. In addition we might expect increased gains realized in 1969 in anticipation of higher taxes starting in 1970.

The simplest comparison, between 1969 and 1970, provides the most striking evidence of a lock-in effect. While net gains of the presumably unaffected under $100,000 class were 34% higher in 1969 than in 1970, they

were 63% higher for the $100,000 to $500,000 class, while the over $500,000 class had 145% more gains in 1969. If we adjust the trend in gains by the change in the lowest-income class, the gains of the highest-income class were 111% higher in 1969 than in 1970.

Comparing these two years may be unfair if 1969 included anticipatory selling by the higher income classes, and there is some evidence that it did: while net gains of the lowest income class fell 19% from 1968 to 1969, net gain of the highest income class actually increased 4%.

A fairer and more relevant comparison would be an average of 1967 and 1968 net gains on the one hand and an average of 1975 and 1976 on the other, the two most recent years for which data is available. Table 2 makes this comparison. Note first that in 1975-6 the net gains of the lowest income class were somewhat higher than in 1967-8, so if anything the trend since then has been upward. Nevertheless, we see that the net gains of the middle group were about 12 percent lower in 1975-6 than they were in 1967-8, and that the net gain of the highest income class were 35 percent lower in 1975-6 than in 1967-8. This is an indication that the highest income individuals were much less likely to realize gains after the Tax Reform Act of 1969 than before.

Table 2

Comparison of Net Capital Gains for 1967-68 and 1975-76 ($billions)

Adjusted Gross Income	1967-68	1975-76	% Change
Less than $100,000	11.47	13.52	+17.9
$100,000 - $500,000	3.14	2.76	-12.1
More than $500,000	2.12	1.38	-34.9

The evidence does not depend on the assumption that the relative respective income classes has remained constant over the past decade. If we normalize the net gains in each class by some measure of total income in the group, a similar (and more powerful) relationship holds. Table 3 specifically shows net capital gains as a percentage of adjusted gross income (not including the net capital gains) for our three groups.

Table 3

Net Capital Gains as a Percentage of Adjusted Gross Income
Net of Gains 1967-68 and 1975-76

Adjusted Gross Income	1967-68	1975-76	% Change
Less than $100,000	2.36	1.42	-39.8
$100,000 - $500,000	37.4	9.72	-74.0
More than $500,000	154.7	36.3	-76.5

While there has been a large decrease in the gain percentage for all groups, the upper two groups' decline was far more extreme than the lowest income group.

In sum, we can detect evidence of a lock-in effect in the aggregate data on net gains from capital assets. This, in addition to evidence from cross-sectional research, indicates that estimates of the revenue change resulting from a change in capital gains taxation based on the assumption of unchanged net realized gains may be misleading.

Footnote

1 M. Feldstein and S. Yitzhaki, "The Effects of the Capital Gains Tax on the Selling and Switching of Common Stock", Journal of Public Economics, 1978; M. Feldstein, J. Slemrod, and S. Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains, National Bureau of Economic Research, 1978.

Goldman Sachs

August 24th, 1978.

Dear Chairman Long,

You will recall that in my testimony last Tuesday, August 22nd, on the Tax Bill, I made the comment that the Table on page 10 of my statement did not reflect the House action in repealing the special 25% ceiling on taxes on capital gains up to the first $50,000. At that time I asked for permission to submit a revised Table which would reflect that change.

Enclosed please find a copy of the revised Table, which I would appreciate being placed in the Record.

Thanking you again for your courtesies in connection with my appearance before the Committee on this important matter, I am with best wishes,

Sincerely yours,

Henry H. Fowler

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

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TAXATION OF LONG TERM CAPITAL GAINS UNDER VARIOUS ALTERNATIVES (WITHOUT REFERENCE TO MINIMUM AND MAXIMUM TAX PROVISIONS) ON A $5,000 CAPITAL GAIN[1] OF A MARRIED COUPLE FILING JOINTLY

	Existing law (not including minimum and maximum tax)			House bill					Addition of alternative 25 percent ceiling to House bill			Kennedy proposal for 30 percent inclusion				
Taxable income bracket (thousands)	Tax rate, present law (percent)	Present tax on 50 percent inclusion	Percent of gain collected as tax	Tax rate in House bill	Tax on 50 percent inclusion	Percent of gain collected as tax	Savings in dollars over present law	Tax increase	Percent of gain collected as tax with 25 percent ceiling	Tax on 50 percent inclusion with 25 percent ceiling	Savings over House bill	Tax using House bill and Kennedy inclusion rate (30 percent)	Percent of gain collected as tax	Savings over present law	Savings over House bill	Savings over House bill and 25 percent ceiling
(Col. 1)	(Col. 2)	(Col. 3)	(Col. 4)	(Col. 5)	(Col. 6)	(Col. 7)	(Col. 8)	(Col. 8a)	(Col. 9)	(Col. 10)	(Col. 11)	(Col. 12)	(Col. 13)	(Col. 14)	(Col. 15)	(Col. 16)
$4,000	14	$350	7.0	14	$350	7.0	0	0	7.0	$350	0	$210	4.2	$140	$140	$140
$8,000	19	475	9.5	18	450	9.0	$25	0	9.0	450	0	270	5.4	205	180	180
$12,000	22	550	11.0	21	525	10.5	25	0	10.5	525	0	315	6.3	235	210	210
$16,000	25	625	12.5	21	525	10.5	100	0	10.5	525	0	315	6.3	310	210	210
$20,000	28	700	14.0	24	600	12.0	100	0	12.0	600	0	360	7.2	340	240	240
$24,000	32	800	16.0	28	700	14.0	100	0	14.0	700	0	420	8.4	380	280	280
$28,000	36	900	18.0	32	800	16.0	100	0	16.0	800	0	480	9.6	420	320	320
$32,000	39	975	19.5	36	900	18.0	75	0	18.0	900	0	540	10.8	435	360	360
$36,000	42	1,050	21.0	39	975	19.5	75	0	19.5	975	0	585	11.7	465	390	390
$40,000	45	1,125	22.5	42	1,050	21.0	75	0	21.0	1,050	0	630	12.6	495	420	420
$44,000	48	1,200	24.0	45	1,125	22.5	75	0	22.5	1,125	0	675	13.5	525	450	450
$52,000	50	1,250	25.0	50	1,250	25.0	0	0	25.0	1,250	0	750	15.0	500	500	500
$64,000	53	1,250	25.0	53	1,325	26.5	0	$75	25.0	1,250	$75	795	15.9	455	530	455
$76,000	55	1,250	25.0	55	1,375	27.5	0	125	25.0	1,250	125	825	16.5	425	550	425
$88,000	58	1,250	25.0	58	1,450	29.0	0	200	25.0	1,250	200	870	17.4	380	580	380
$100,000	60	1,250	25.0	60	1,500	30.0	0	250	25.0	1,250	250	900	18.0	350	600	350
$140,000	64	1,250	25.0	64	1,600	32.0	0	350	25.0	1,250	350	960	19.2	290	640	290
$180,000	68	1,250	25.0	68	1,700	34.0	0	450	25.0	1,250	450	1,020	20.4	230	680	230
$300,000	70	1,250	25.0	70	1,750	35.0	0	500	25.0	1,250	500	1,050	21.0	200	700	200
$400,000	70	1,250	25.0	70	1,750	35.0	0	500	25.0	1,250	500	1,050	21.0	200	700	200

[1] Note: Since the present law applies a special 25 percent ceiling on taxes on capital gains under $50,000 for the taxable year, which provision would be repealed by the House bill, a similar table for a capital gain well above the $50,000 level would show increased percentages of gain collected as tax in col. 4 for the brackets above 50 percent and additional proportioned savings over present law in col. 14.