THE INTERNAL REVENUE CODE OF 1954

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-THIRD CONGRESS

SECOND SESSION

ON

H. R. 8300

AN ACT TO REVISE THE INTERNAL REVENUE LAWS
OF THE UNITED STATES

PART 2

APRIL 9, 12, 13, 14, AND 15, 1954

Printed for the use of the Committee on Finance

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1954

45994

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THE INTERNAL REVENUE CODE OF 1954

FRIDAY, APRIL 9, 1954

United States Senate,
Committee on Finance,
Washington, D. C.

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10:10 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Martin, Williams, Flanders, Carlson, Bennett, Byrd, and Long.

The Chairman. The meeting will come to order.

Mr. Arthur Elder of the American Federation of Labor. Is Mr. Elder here? Is anyone else representing the federation?

All right, Mr. Russ Nixon. Make yourself comfortable, Mr. Nixon, and identify yourself for the reporter.

STATEMENT OF RUSS NIXON, WASHINGTON REPRESENTATIVE, UNITED ELECTRICAL, RADIO, AND MACHINE WORKERS OF AMERICA (UE)

Mr. Nixon. I am Russ Nixon, the Washington representative of the United Electrical, Radio, and Machine Workers of America.

Senator, I want to first express appreciation for the opportunity to appear before you.

The Chairman. We are glad to have you, Mr. Nixon.

Mr. Nixon. The position I want to take with you is presented on behalf of 800,000 members in our union, in the electrical, radio, machine, and farm-equipment industries.

In a very major way, what we want to present is a similar position to that that we presented to you in 1951, Senator Millikin, if you may recall. Our position is based upon two very fundamental principles: First, our conviction that no taxes should be levied on an American family whose income is not large enough to maintain living standards at officially determined minimum adequacy levels of health and efficiency.

Second, that the revenue lost by not taxing family incomes below minimum adequacy levels can be replaced to the extent necessary without causing real hardship by closing loopholes and raising taxes on large incomes and wealth now escaping adequate taxation.

In line with your injunction about the time situation, Senator Millikin——

The Chairman. How much time have you been given?

Mr. Nixon. Fifteen minutes.

The CHAIRMAN. You will have more time than that.

Mr. NIXON. Thank you.

I would like to introduce the full statement into the record and to summarize it.

The CHAIRMAN. That will be done, and it will be included in the record.

(The prepared statement of Mr. Nixon follows:)

STATEMENT OF RUSS NIXON, WASHINGTON REPRESENTATIVE, UNITED ELECTRICAL, RADIO, AND MACHINE WORKERS OF AMERICA (UE), BEFORE THE SENATE FINANCE COMMITTEE ON 1954 TAX PROPOSALS, APRIL 9, 1954

This statement is presented on behalf of the 300,000 workers represented by the U. E. R. and M. W. A. in 1,000 electrical, radio, machine, and farm-equipment plants where UE is the bargaining agent. This UE position on tax policy reflects widespread discussion and deliberation among our members, in annual UE national conventions, UE district conferences, and UE local union meetings.

The basic UE tax principles are simply stated:

1. No taxes should be levied on an American family whose income is not large enough to maintain living standards at minimum adequancy levels of health and efficiency.

2. The revenue lost by not taxing family incomes below minimum adequacy levels can be replaced to the extent necessary without causing real hardship by closing loopholes and raising taxes on large incomes and wealth now escaping adequate taxation.

On the basis of these principles, the UE is in general opposition to the main content of H. R. 8300 because it revises the internal-revenue system for the benefit of those already wealthy instead of for the relief of the millions of low-income families now paying poverty-inducing taxes. This UE statement considers primarily the question of income-tax-exemption levels. The UE favors the general purpose of the George-Frear-Kerr bill, S. 2983, while suggesting certain detailed exemption proposals which would even more adequately meet the test of removing taxes on substandard-income families.

The UE presented these same proposals to the Senate Finance Committee in 1951. The arguments for elimination of poverty-creating taxes presented at that time must now be augmented to include the great urgency to eliminate such taxes from millions of American families in order to combat the growing stagnation of our economy. The root cause of the serious depression threatening us today is the inability of the great mass of the American people to buy back the tremendous quantity of goods and services that it is in our national capacity to produce. This basic lack of purchasing power rises from the inadequate income of the majority of our population and the heavy burden of taxation borne by these families whose income is inadequate for maintenance of minimum decency levels of living.

If Congress is to avoid aggravating the present depression trends and is to take effective action to maintain full employment, it must reject the self-seeking propaganda of big financial and industrial interests of the country which insist upon the suicidal courses of continuing heavy taxation on below adequacy income families.

The basic tax issue confronted by the Congress is simply, whose taxes will be cut? H. R. 8300 primarily cuts taxes for the wealthy and economically powerful interests of our country. This is the road to deeper depression and greater unemployment. The George-Frear-Kerr bill and the proposals of the UE to raise income-tax exemptions would eliminate poverty-creating taxes on the millions of American families whose lack of purchasing power today is causing unemployment and threatening depression.

What is a livirng wage?

In spelling out the UE tax proposals, the first consideration is: What is a living wage; how much does a family need to have a minimum adequate living standard? This is the question of what level of family income should be exempt from taxation.

Fortunately, we have an objective yardstick by which to measure what a "minimum adequate standard of living" amounts to. The Bureau of Labor Statistics' City Worker's Family Budget gives this "minimum adequate standard" for a family of four. For families of other sizes, the Treasury Department in 1947 assembled the basic information necessary to adjust the BLS budget.

The BLS minimum adequate budget is by no means a luxury budget. It is far below what we consider the American standard of living. It was, in January 1954, $433 (for a 4-person family) less than the budget estimated by the Heller Committee for Research in Social Economics, University of California, as necessary for a "healthful and reasonably comfortable living."

In important respects, it is even lower than average consumption in the depression, especially of foods, and considerably lower than actual per capita consumption in 1953.

BLS food budget compared to United States per capita consumption

	BLS budget allowance per person	Actual United States consumption per capita [1]	
		1935-39	1953
Meat, poultry, fish……pounds..	116	157	166
Eggs……number..	256	298	389
Fluid milk and cream……pounds..	320	340	352
Fresh vegetables……do….	121	235	218

[1] U. S. Department of Agriculture, Agricultural Marketing Service, Apr. 8, 1954.

There is nothing luxurious about the clothing budget. The man of the house could buy 1 overocat every 6¼ years, 1 topcoat every 10 years. He could buy 5 shirts a year, and 2 pairs of shoes. His wife could buy 1 cotton street dress a year; her wool dress would have to last her 5 years.

In the medical care department, the family could each go 3 times a year to the doctor, and each could receive 1 visit from the doctor at home.

The family could buy 1 low-priced car every 15 or 16 years. In this car, they could drive to 19 movies during the year and to 4 baseball games (or other sports events, plays, or concerts).

This family would be allowed 1 newspaper a day. It could buy a magazine once a week for 32 weeks of the year. For serious reading, it would have to go to the public library; the budget allows only 1 book per year. It would have to get along with the same radio for 9 years.

This family could have a telephone in its home, but would be allowed to make 3 local phone calls a week; it could write 1 letter a week. It could have such standard appliances as a cookstove, refrigerator, washing machine, iron, sewing machine, vacuum cleaner, etc., if it could find a way to finance them on terms extending to 17 years for the stove, refrigerator, and vacuum cleaner, and up to 100 years for the iron and sewing machine. The alternative is to share such items with other families, where possible.

In spite of the obviously inadequate standard of living permitted by this BLS budget, we can use it as a measure of the minimum standard to determine below what income level taxes should not reach.

How much income was necessary, in January 1954, to attain this minimum adequate budget?

Table II

	Amount needed
Single person	$2,103
Family of 2	2,881
Family of 3	3,656
Family of 4	4,294
Family of 5	4,834
Family of 6	5,371
Family of 7	5,855

Source: BLS City Worker's Family Budget, October 1951, adjusted to January 1954 prices, and adjusted for different family sizes by means of Treasury Department study, Individual Income Tax Exemptions, 1947, p. 6. The budget includes an allowance for Federal personal income tax.

How many American families get a living wage?

The shocking fact is that a majority of American families do not today receive incomes sufficient to attain this quite meager minimum adequate standard of living. The latest detailed income data we have are for 1951, but there is no reason to believe that conditions have changed for the better since then.

In 1951, we find that there were 26,140,000 American families who could not reach this modest standard of living. These were 53 percent of all American families. Thus, a majority of our families are now living at substandard levels.

Table III

Single person needed $2,032 but	5, 860, 000	persons got less
Family of 2 needed $2,772 but	6, 160, 000	families got less
Family of 3 needed $3,530 but	4, 310, 000	families got less
Family of 4 needed $4,138 but	4, 100, 000	families got less
Family of 5 needed $4,637 but	2, 600, 000	families got less
Family of 6 needed $5,170 but	1, 530, 000	families got less
Family of 7 needed $5,620 but	1, 580, 000	families got less
Total persons	26, 140, 000	

Sources: Budget data: BLS City Worker's Family Budget, October 1951, adjusted for different family sizes by same method as in table II. Income data: Family Income in the United States, Series P-60, No. 12, June 1953, table 4. Budget includes an allowance for Federal personal income tax.

If we do not accept this very minimum BLS budget as an adequate measure of what we consider the American standards of living, but use rather, the more adequate budget necessary for a healthful and reasonably comfortable living estimated by the Heller committee for research in social economics, University of California, we find that in 1949 almost two-thirds, or 62 percent, of all American families could not reach an American standard of living.

That these substandard families should have to bear the burden of income taxation is a monstrous distortion of the aims of democratic government. Our country is weakened both morally and physically, and the danger of depression is greatly enhanced, by the poverty-creating effects of taxation on this majority of our families who do not have the income required to purchase the simplest necessaries of life.

The Nation's depression base

The UE's basic tax proposal is that no family already living at a substandard level, as measured by the above BLS budget and income requirements, should be subjected to income taxation. The majority of our families who do live under such conditions form the core of the shortage of purchasing power threatening the economic health of the country. The most cursory examination of available data show beyond a doubt that the great mass of our people do not have the income and assets to buy the great outpouring of goods from our productive system. Freeing these people from income taxation would release large amounts of purchasing power to buy up these goods.

Who gets the bulk of the Nation's income?

The facts, as indicated by the Federal Reserve Board's 1953 Survey of Consumer Finances, are that in 1952 the total of those families with incomes less than $4,000 a year—constituting 59 percent of all families in the United States—received only 31 percent of the total money income.

TABLE IV.—*Distribution of income, 1952*

Money income before taxes [1]	Percent of all spending units [1]	Percent of total money income—	
		Before taxes [1]	After taxes [2]
Less than $4,000	59	31	34
$4,000 and over	41	69	66
$7,500 and over	9	28	25

[1] Table 1, pt. I.
[2] Supplementary table II, pt. II.

Source: Federal Reserve Board, 1953 Survey of Consumer Finances, Federal Reserve Bulletin, June 1953.

We have chosen the income level of $4,000 as a rough indication of the average requirements of the Bureau of Labor Statistics' minimum adequate budget for 1951. Thus, we are talking here in a general way of the same majority of American families which we indicated above are living under substandard conditions. This majority of our families receives only 31 percent of total money income. This is the weakness of our great mass market. These families do not have the income to satisfy their many needs and to buy the mountains of goods our economy puts out. They are the ones who need tax relief to help make ends meet.

In contrast, families with incomes of $4,000 and over annually—only 41 percent of all families in the United States—received 69 percent of total money income in 1952. The concentration of income is seen to be even greater when we note that the small portion (9 percent) of our families making more than $7,500 get over one-quarter—28 percent—of all money income.

This minority of families with the bulk of income cannot possibly consume the great quantities of goods which we have the capacity to produce.

Who has the liquid assets?

Liquid asset holdings are even more concentrated than income, and thus contribute to the weakness of the mass market for goods and services. The claim is often advanced that the American people have a vast store of liquid assets which are available for purchases. The facts show, however, that the low-income majority of our families have a very small portion of these assets, and that the relatively few upper income families hold the bulk of the assets. Thus, where the wants and needs for goods are there are few assets available to turn needs into actual purchases.

TABLE V.—*Proportion of liquid assets held by income groups, early 1953*

Money income before taxes (1952)	Percent of spending units	Percent of liquid assets held
Less than $4,000	59	36
$4,000 and over	41	64
$7,500 and over	9	34

Source: 1953 Survey of Consumer Finances, Federal Reserve Bulletin, June 1953, pt. I, supplementary table II.

Thus, in early 1953, 59 percent of all spending units, those with incomes less than $4,000 annually, held only 36 percent of liquid assets, while the remaining 41 percent of spending units, those with incomes greater than $4,000, held the great bulk—64 percent—of liquid assets. Concentration of holdings in the high-income groups was even greater, since units with incomes in excess of $7,500, only 9 percent of all units, held 34 percent of all liquid assets.

Actually, the Nation's liquid assets are even more concentrated than the above income class data reveal, since on January 1, 1952, 50 percent of all spending units had only 1 percent of all liquid assets, while the top 10 percent held 66 percent of all such assets.

Who does the spending?

Government statistics detailing the actual purchases of the American people bear out the contention that our country is plagued by a shortage of purchasing power based on the inadequate incomes of the great mass of our people.

The facts show that the low-income majority of our people, because they do not have the total income, are actually able to do only a small portion of total spending in the country.

TABLE VI.—*Distribution of income and expenditures by spending units, by size of income 1949*

Spending units ranked by size of income (before taxes)	Percent of total money income (after taxes)	Percent of total expenditures
Top 40 percent (income of about $3,500 and over)	67	63
Bottom 60 percent (incomes less than about $3,500)	33	37

Source: Federal Reserve Bulletin, November 1950, table 19, p. 1451.

With spending units ranked by size of income, we find that in 1949 the bottom 60 percent of spending units, those with incomes less than about $3,500 annually, while representing the majority of all units, were able to do only 37 percent of spending because they received only 33 percent of total money income. These are essentially the families forced to live at substandard levels. Their endless needs remain unsatisfied, while the goods they produce in such vast quantities pile up on retailers' and wholesalers' shelves and in Government and private warehouses.

On the other hand, the minority of spending units, those whose incomes in 1949 were greater than $3,500, while constituting only the top 40 percent of spending units, received 67 percent of total money income and consequently did 63 percent of total spending.

These 1949 data are unfortunately the latest available, but later data on income distribution give sufficient reason to believe that the relationships for that year still hold true today.

This distortion of income distribution and expenditures is an amazing revelation for those of us who in the past have found it easy to accept the reasonable sounding proposition that the majority of our families do the majority of the spending. The proposition is contradicted by the facts. This becomes even more clear when we look behind the overall figures at the spending patterns for particular kinds of consumer goods.

As incredible as it may seem, the bottom 60 percent of our spending units account for a minor portion of spending even for the necessaries of life. In 1949, this majority of units (60 percent) bought only 38 percent of a group of consumer goods and services consisting primarily of food, housing, clothing, medical care, transportation, recreation, education, and State and local taxes (Federal Reserve Bulletin, November 1950, table 19, p. 1451). Is it any wonder that the Federal Government has piled up huge quantities of unsold farm products? Are these unsold products seriously to be considered as surplus?

Let us look now at the data for purchases of various consumer durable goods. What sections of the population buy the majority of these goods?

TABLE VII.—*Income distribution of purchasers of various consumer durables and homes, 1953*

Money income before taxes	Percent of all spending units	New autos	Furniture and major household appliances	Television sets	Homes (nonfarm)[1]
Under $4,000	59	19	47	41	29
$4,000 and over	41	81	53	59	71

[1] The income distribution of nonfarm spending units is approximately the same as that of all units: Under $4,000, 57 percent of all nonfarm units; $4,000 and over, 43 percent.

Source: 1953 Survey of Consumer Finances, Federal Reserve Bulletin, pt. II, supplementary table 3; pt. III, supplementary table II.

It is immediately apparent that the low-income spending units, those with annual incomes less than $4,000, while representing not much less than two-thirds of all spending units—59 percent to be precise—accounted for only a minor portion of purchases of a number of important durable goods. Thus, in 1952 the low-income 59 percent of units bought only 19 percent of all new autos sold, only 29 percent of new homes, only 41 percent of television sets sold, and only 47 percent of the furniture and major household appliances. On the other hand, the 41 percent minority of our spending units accounted for the greater part by far of these purchases: 81 percent of all new autos, 71 percent of new homes, 59 percent of television sets and 53 percent of furniture and household appliances.

That these spending patterns were not peculiar to the year 1952, but have been continuing trends, is indicated by the pattern of ownership distribution by the same income classes. Ownership data for certain goods are available for early 1952 and early 1953.

TABLE VIII.—*Ownership of consumer durable goods and homes, by income groups*

Money income before taxes [1]	Percent of all spending units	Percent of each income group owning			
		Auto	TV set	Refrigerator	Homes (nonfarm)[2]
Early 1952:					
Under $4,000	64	46	16	57	46
$4,000 and over	36	81	53	86	62
Early 1953:					
Under $4,000	59	46	([3])	([3])	45
$4,000 and over	41	82	([3])	([3])	61

[1] In year prior to year specified.

[2] The income distribution of nonfarm spending units is approximately the same as that of all units: Early 1953 (1952 income), under $4,000, 57 percent of all nonfarm units; $4,000 and over, 43 percent; early 1952 (1951 income), 62 percent for under $4,000; 38 percent for $4,000 and over.

[3] Not available.

Sources: Federal Reserve Bulletins 1952 and 1953, Survey of Consumer Finances. Early 1952, FRB August 1952, table 8, p. 866; table 15, p. 870, table 16, p. 871; September 1952, table 1, p. 975; for homes, 1953 Survey, pt. III, supplementary table I. Early 1953, 1953 Survey, pt. IV, supplementary table 7; pt. III, supplementary table 1.

With distorted purchase patterns of this kind, it is no surprise that unsold goods have piled up, such as the 650,000 unsold new autos in early 1954, and that layoffs and unemployment have been rising rapidly. A majority of our working-class families do not have these durable goods and homes which they need and want. Because of their inadequate purchasing power, the mass market our productive system needs is undermined.

As a matter of fact, preliminary findings of the most recent Federal Reserve 1954 Survey of Consumer Finances has disclosed that consumers generally plan to buy in 1954 even fewer of these items than they planned to buy in 1953. Only 6.8 percent of nonfarm spending units plan to buy homes in 1954, compared to 8.8 percent in 1953. Only 7.8 percent plan to buy new autos, compared to 9.0 percent—in the face of tremendous inventories of unsold new cars. And only 26.8 percent plan to buy furniture and major household appliances, compared to 31.9 percent who planned such purchases in early 1953.

In this kind of a threatening situation, it is important that Congress revise our tax structure so as to put added income into the hands of those low-income families who must spend to live. Present congressional tax proposals for relief to the wealthy and the corporations is courting economic disaster for the entire country.

Present tax setup is poverty- and depression-creating

Our present tax system bears relatively most heavily on the majority of our families already living at substandard levels. Thus, the impact is to add poverty where there already is plenty of it, and to add to the threat of depression by depriving of sorely needed purchasing power, families who would spend it to buy the necessaries of life.

The argument is often advanced that this situation is unavoidable. Low-income families, it is said, constitute the bulk of the Nation's population. By virtue of their numbers, they are said to receive the bulk of the Nation's income, and hence must bear a large part of the tax burden in times of great need of Federal revenue.

We have already given the data proving this argument to be false. In actual fact, the lower end of the income scale, those spending units with incomes less than $4,000 annually, who are below the level of the minimum adequate standard of living, received only 31 percent of total money income in 1952 even though they made up 59 percent of all spending units.

Even if we stretch the lower end of the income scale up to $5,000, to include the middle spending units just managing to keep their heads above water, we find still a minor part of total income. These spending units received in 1952 only 47 percent of total money income even though they were three-quarters (74 percent) of all units. The bulk of the income (53 percent) is received by the 26 percent of units who have annual incomes greater than $5,000 annually.

The poverty-creating effects of our present Federal personal income tax are quite clear. Let us take a very representative case: A manufacturing worker with wife and 2 children, who is earning the officially reported average weekly wage of $70.92 (as of January 1954). His annual income at this rate is $3,688—if he works 52 full weeks in the year. To achieve the minimum living standard provided by the BLS budget, however, he needs $4,294, including allowance for Federal income taxes. His income, therefore, is $606 short. This means he and his family must do without some of the meager supply of items listed in the BLS budget—some of the food, or the clothing, or the medical care. Certainly he is unable to purchase the durable goods—such as washing machines, refrigerators, autos—which he needs.

This very typical worker pays $298 in Federal personal income tax. If Congress were to exempt him from this taxation, he would still be $308 short of the minimum adequate budget (Federal income taxes excluded). But Congress would have provided his family with a considerable measure of relief, and would at the same time have guaranteed that much more spending power to help ward off the threatening depression.

We have already shown earlier that this typical worker is not alone in his unfortunate position. The latest overall income data available show that in 1951 there were 20,140,000 American families, 53 percent of all families, in this same situation. As a matter of fact, these same data show that 2,200,000 families whose incomes in 1951 would have just allowed them to keep their heads above water by reaching the minimum budget, were forced below the level of minimum adequacy and decency by the necessity of paying Federal personal income taxes.

These are the stark poverty-creating aspects of our Federal personal income tax which Congress must correct if it is to have any claim to following the precepts of democratic government.

The total tax burden on working people is well known, of course, to be much greater than that of Federal personal income taxes alone. The impact of all taxes, Federal, State, and local, direct and indirect, is such that workers bear by far the heaviest relative burden. This impact has been measured for the year 1948. There is every reason to believe that it is just as heavy today.

TABLE IX.—*Impact of Federal, State, and local taxes on various income groups*

Income group	Tax payment as percent of income	
	1938-39	1948
Under $1,000	18.0	22.6
$1,000 to $2,000	17.5	21.3
$2,000 to $3,000	17.4	21.6
$3,000 to $4,000	17.7	21.8
$4,000 to $5,000	18.9	21.7
$5,000 to $7,500	18.7	22.1
$7,500 and up	24.7	31.7
All groups	20.9	24.7

Sources: 1938-39: TNEC Monograph No. 3, Who Pays the Taxes? (1940); revised figures cited in Fiscal Policies and the American Economy, Editor K. E. Poole, Prentice-Hall (1951), p. 302. 1948: Estimates of R. A. Musgrave et al. in The Distribution of Tax Payments by Income Groups in 1948, in National Tax Journal, March 1951.

The table shows that the proportions of income going for taxes at lowest income levels is very high, equals that for much higher incomes covering up to 95 percent of all taxpayers, and only in the top 5-percent class is there even a limited application of the ability to pay principle.

UE tax proposals

The basic UE tax proposal is to raise personal and dependents' exemptions to the level required to eliminate all income taxes on families whose incomes are less than that required to attain a minimum adequate standard of living.

Adoption of this proposal would return our Federal income tax to a basic principle written into the law at its very inception, and maintained throughout most of our history. According to the Treasury Department's 1947 study, Individual Income-Tax Exemptions:

"This viewpoint appears as far back as the beginning of the Federal income tax during the Civil War period. The then Commissioner of Internal Revenue stated with reference to the $600 personal exemption provided under the 1864 law: 'It was, of course, the purpose of the law to exempt so much of one's income as was demanded by his actual necessities' " (report of Commissioner of Internal Revenue, 1866, p. XXIII, p. 3).

The argument for increasing exemptions is unanswerable from an economic, social and humanitarian point of view. The 1947 Treasury Department study on Individual Income-Tax Exemptions cites this argument:

"For the long run, it is regarded as essential to exempt amounts required to maintain the individual and his family in health and efficiency. Apart from humanitarian aspects, this view is based on certain practical social and economic consderations. Thus, it is held that taxing substandard living will result in lowered economic vitality in the community, lower revenues, and possibly result in higher Government expenditures for social repairs."

The study notes further: "In this view, ability to pay does not commence until a point is reached in the income scale where the minimum needs of life have been obtained."

Anticipating the argument that exemption of low incomes puts more taxes on the rich, and that this reduces "incentive," the Treasury study notes that "the sacrifice involved in going without certain necessities is not susceptible of measurement or comparison." In other words, the sacrifice involved in cutting family consumption down from a Cadillac scale of living to a Buick scale, or even to a Chevrolet scale, is not to be compared with the sacrifice involved in giving up a quart of milk a day or new shoes for the children, or a much-needed visit to the doctor. Yet that is precisely the kind of sacrifice which is imposed daily on low-income families by the present tax burden.

As late as 1939, personal and dependents' exemptions eliminated taxation on incomes already below an acceptable standard of living. Since then, however, exemptions have been continually lowered while the cost of a minimum adequate budget has been continually rising. The result has been that present exemptions are grossly inadequate, and the present Federal personal income tax is a poverty-creating tax.

TABLE X.—*Individual income-tax exemptions: 1939 and now*

Size of family	Exemptions		Amount needed to restore purchasing power of 1939 exemptions
	1939	January 1954	
Single person	$1,000	$600	$1,942
Married couple	2,500	1,200	4,850
Family of 4	3,300	2,400	6,410

Source: 1947 Treasury study, Individual Income-Tax Exemptions, chart 3, adjusted to January 1954 prices by BLS consumer price index.

Thus, for a family of 4, the 1939 exemption of $3,300 would be equaled by an exemption of $6,410. The present exemption of $2,400 is exactly $4,000 short of this.

Above all, however, present exemptions are grossly inadequate compared with the budget requirements of a minimum adequate standard of living today.

TABLE XI.—*Present individual income-tax exemptions and minimum budget requirements*

Size of family	Present gross exemptions	Cost of budgets, January 1954 [1]	
		BLS "minimum adequate"	Heller committee "health and decency" [2]
Single person	$675	$1,838	$2,000
Married couple	1,325	2,597	2,835
Family of 4	2,675	3,996	4,357

[1] Excluding Federal personal income tax.

[2] Budget of the Heller Committee for Research in Social Economics, University of California, for September 1949, corrected to January 1954: Consumption items corrected by BLS Consumer Price Index; social-security tax increased to $72.

Thus, a family of 4 is today allowed an exemption $1,321 short of the basic requirements of the BLS "minimum adequate" budget, and $1,682 short of the more acceptable American standard of the Heller "health and decency" budget.

In line with the minimum BLS budget requirements, the UE proposes that exemptions should be set at the following amounts:

Single person	$1,800
Married couple	2,600
Dependent	700

Thus, a family of 4 would be allowed an exemption of $4,000, just sufficient to cover the minimum BLS budget requirements.

The UE supports the George bill (S. 2983), which increases personal and dependents' exemptions to $800 in 1954 and to $1,000 thereafter. In sharp contrast, the whole of the long and complex H. R. 8300 in almost every way is truly a rich man's tax "relief" bill. The George bill, on the other hand, with one simple proposal, would be infinitely more conducive to the Nation's economic health and to democratic principles of government, by giving real relief to low-income families in need of additional purchasing power to reach an acceptable standard of living.

Nevertheless, the UE believes that its personal-exemption proposals more adequately realize a return to the basic principle of income taxation laid down in the original law of 1864—the principle that it is "essential to exempt amounts required to maintain the individual and his family in health and efficiency" (Treasury Department).

TABLE XII.—*Minimum budget requirements compared to exemptions under the UE proposals, the George bill (S. 2983), and the present law*

Size of family	BLS minimum budget requirements, January 1954 [1]	UE proposal	George bill, 1955	Present law
1	$1,838	$1,800	$1,000	$600
2	2,597	2,600	2,000	1,200
3	3,355	3,300	3,000	1,800
4	3,996	4,000	4,000	2,400
5	4,555	4,700	5,000	3,000
6	5,115	5,400	6,000	3,600
7	5,635	6,100	7,000	4,200

[1] Excluding Federal personal income tax.

Thus, the proposed UE exemptions of $1,800 for an individual, $2,600 for a married couple, and $700 for each dependent—are sufficient all down the line, allowing something extra for very large families. The straight $1,000 exemption proposed by the George bill is sufficient only for families of 4 or larger, with a very sizable excess for the largest families. But the George bill exemption for the single individual is $838 short of the minimum budget, $597 short for a married couple, and $355 short for a family of 3.

The UE very strongly urges that the George bill is a very long step in the right direction, and hence should be adopted. Nevertheless, Congress should adopt the UE proposals as the major element in a general tax revision aimed at democratizing our tax system and at using tax policy as a genuine anti-depression weapon.

Reduce excise taxes on consumption

A second long-overdue and major element of the proper tax revision is reduction and removal of excise taxes on consumption. These are the most regressive taxes, and completely contrary to democratic principles of taxation. It is unnecessary to go into details on this subject, but the UE proposes that Congress must certainly remove Federal excises on such common consumption items as beer, cigarettes, transportation, and household appliances. Above all, under no circumstances should any new sales taxes, general or specific, be levied on consumption goods.

Taxes for revenue should be levied on profits and wealth

At this point it would be well to debunk a false argument often advanced in opposition to the kinds of tax proposals made by the UE. The revenue losses incumbent upon such proposals, it is said, could not be replaced. Even if the entire income of the upper brackets were confiscated, the argument goes, the revenue obtained would not come near that lost. In times of great need of revenue, the Federal Government must reach into every section of the population, no matter what its conditions, it is argued.

This argument is easily laid to rest. The UE proposals flow directly from the democratic principle that taxes should be based on ability to pay, and should be progressive. "Ability to pay does not commence until a point is reached in the income scale where the minimum means of life have been obtained" (1947, Treasury Department). In a democratic system of taxation, the main burden should be placed upon profits and wealth, and not upon substandard and barely standard levels of living.

These principles for the elimination of poverty-creating taxes do not necessarily mean reducing actual tax revenue. There are more than sufficient alternative sources of revenue. And, in a democratic society such as ours, any alternative source of tax revenue is more desirable than taxes which force families not to eat enough, to be ill-clad and ill-housed, and not to see the doctor when need be. These are the fundamental factors which must determine the kind of tax revision this Congress adopts.

Alternative sources of tax revenue

It has been estimated that the UE tax proposals for raising exemptions and removing excises, would cause the Federal Government a $11 billion annual loss of revenue—$8 billion for the $1,000 exemption, and about $3 billion for excises. This $11 billion could be replaced, without undue hardship, and without touching the income-tax rates on upper individual income brackets. The $11 billion could be replaced by restoring the excess-profits tax and by closing loopholes in the present tax laws, which permit corporations and wealthy families to evade great amounts of their just tax liabilities.

Alternative sources of tax revenue (estimated)

Restoration of excess profits tax	$2,500,000,000
Elimination of accelerated amortization program	1,500,000,000
Closing loopholes	7,100,000,000
Total	11,100,000,000

Restore the excess-profits tax

The excess-profits tax is estimated to have yielded about $2½ billion in 1952. In spite of this, corporations in that year made the fabulous sum of $18.6 billion after all taxes. In 1953 total corporate profits after taxes were $19.6 billion, almost double the $10.6 billion profits of the most lush year (1943) of World War II. If this most prosperous World War II year were taken as a standard—and surely $10.6 billion in corporate profits after taxes is hardly unsatisfactory—1953 corporate profits would leave a pool of $9.6 billion for tax revenue.

But in any case, simple restoration of the excess-profits tax which expired just a few months ago, would yield the Government $2,500,000,000.

Eliminate the accelerated amortization tax bonanza

The program for accelerated amortization of "defense" facilities was enacted in 1950. The House Committee on Expenditures in the Executive Departments has called this program the biggest bonanza that ever came down the Government pike, and declared its administration was unsound and detrimental to the public interest (H. Rept. 504, May 28, 1951).

The cost of this bonanza in tax revenue lost to the Government has been estimated by former Interior Secretary Oscar Chapman. According to the latest release of the Office of Defense Mobilization (April 5, 1954), $30 billion worth of facilities have been certified as of March 24, 1954. In 1951 Mr. Chapman said, "If the total investment in facilities certified over the next few years amounted, say, to $30 billion, which is not considered at all unlikely, the short-term loss of tax revenues could therefore approximate $13 billion" (hearings before the House Committee on Expenditures in the Executive Departments, March and April 1951, pp. 394–400).

Taking into account the long-term effects of taxes repaid after the facilities involved have been written off, Mr. Chapman had this to say: "If the total investment involved in facilities certified over the next few years amounted to $30 billion, the total long-term cost would be almost $9 billion (at a low assumed effective tax rate) and more than $6.5 billion (at a high assumed effective tax rate)" (p. 396). Thus, we can estimate roughly that the magnitude of the long-term revenue loss to the Federal Government resulting from the accelerated amortization program, when spread over a period of 5 years will average from $1.3 to $1.8 billion per year.

Mr. Chapman noted further an extremely important point, "* * * the short-term cost should not be minimized by undue emphasis on the lesser, long-term cost. Under a pay-as-we-go tax policy, the short-term loss of revenue must, of necessity, be compensated for by increasing the already heavy tax burden of the people as a whole; i. e., by shifting the tax burden of a relatively few corporations to other taxpaying segments of the public" (p. 396).

Close tax loopholes for corporations and wealthy

By far the largest source of alternative tax revenue available to the Federal Government is that which could be tapped if gaping holes in the present tax laws were closed. Estimates made of the magnitude of the annual revenue available from this source are:

Elimination of wealthy family income splitting	$3, 000, 000, 000
Tightening estate and gift taxes	1, 000, 000, 000
Reduction of oil and mineral depletion allowances	750, 000, 000
Reduction of preferential treatment of capital gains	500, 000, 000
Withholding tax on dividends and interest	300, 000, 000
Elimination of tax-exempt securities	350, 000, 000
Elimination of phony family partnerships	200, 000, 000
Stricter enforcement of laws	1, 000, 000, 000
Total	7, 100, 000, 000

Conclusion

In conclusion, it must be stated emphatically that the UE does not consider its tax proposals by any means as being in the nature of punitive tax legislation. On the contrary, legislation of the sort proposed is clearly in the best interests of the Nation. No doubts whatsoever can be entertained on this score with respect to the proposal that taxation be based strictly on ability to pay, and that ability to pay commences only when sufficient income has been exempted to permit a family to attain a reasonable American standard of living on a healthful and efficient basis. In our democratic society, this has been a long-standing principle which has been violated only in recent years.

Furthermore, from the standpoint of the economic welfare of the entire Nation, a tax policy such as that proposed by the UE will militate against the development of the serious depression which we are threatened with today. A general tax revision of the type proposed in H. R. 8300 would not only violate further our democratic principles, but would also aggravate the economic threat and court national disaster.

On the contrary, the UE tax proposals would put great sums of additional purchasing power into hands which would spend it immediately so as to lessen the tragedy of want amidst plenty, which lies at the heart of the trend to economic depression and deterioration.

The CHAIRMAN. I want to say to you that by putting something in the record it goes to the staff and they digest it, and it will be presented to the full committee.

Go ahead, Mr. Nixon.

Mr. NIXON. I appreciate that.

I am going to direct my attention primarily to the question of individual income-tax exemption levels, although of course we are interested in the general tax situation.

In general, our union is in opposition to the main content of H. R. 8300, because, in our opinion, it revises the internal revenue system for the benefit of those already wealthy, instead of for the relief of the millions of low-income families now paying poverty-inducing taxes. We in general favor the purposes of the George-Frear-Kerr bill, but we have certain suggestions of detailed exemption proposals which, in our opinion, more adequately meet the test of removing taxes on substandard income families.

When we testified here in 1951, we urged the removal of taxes on families whose incomes are less than enough for minimum budgets, on the basis of humanity, on the basis of the welfare of individual people involved, the millions of families that are in that category. Now, in 1954, we add to this argument, in our opinion, the great urgency of eliminating such taxes from millions of American families in order to combat the growing stagnation of our economy. The root cause of the serious depression which threatens us today is the inability of the great mass of the American people to buy back the tremendous quantity of goods and services that it is in our national capacity to produce. This basic lack of purchasing power arises from the inadequate income of the majority of our population and the heavy burden of taxation borne by these families whose income is inadequate to maintain adequate levels of living.

Now, in our opinion, the basic issue confronted by the Congress is simply whose taxes will be cut? In our opinion, H. R. 8300 primarily cuts taxes for the wealthy and economically powerful interests of our country. This is the road to deeper depression and greater unemployment. The George-Frear-Kerr bill and the proposals of our union to raise income-tax exemptions would eliminate poverty-creating taxes on the millions of American families whose lack of purchasing power today is causing unemployment and threatening depression.

What we are setting out here is that we propose a return to the original principles which underlay the setting of exemptions and income taxation. When income taxation was first introduced in this country in 1864 the principle was stated that a minimum level of existence, income sufficient for necessity, should be the consideration in determining the minimum level of income-tax exemption. This principle followed through 1939 until it was abandoned with necessary reason after 1939, as exemptions were lowered and a concept of an officially determined minimum level of living was more or less forgotten in the necessity for the financing of the military effort of that period.

We are now suggesting, as a matter of national interest, the reestablishment of the concept of a minimum standard of living below which we shall not apply taxes inasmuch as such taxes bite into the basic necessities of American families, and in that sense have a different significance than any other taxes we can levy.

Now, this raises the question at the outset: What is a living wage? How much does a family need to have a minimum adequate living standard? Fortunately, this is not a question where you need merely to take the opinion of a union or of outside individuals. The Government itself has been defining what is the minimum level of living: what is the minimum budget.

We have an objective yardstick by which to measure the minimum adequate standard of living. It is prepared by the Bureau of Labor Statistics' City Worker's Family Budget. It is kept up to date and it is constantly being reviewed and revised.

As I said, Senators, in 1951, it seems to me that not enough attention has been paid to these data in the tax consideration of the Congress. Very frankly, it seems to me that the Congress knows a great deal more about oil depletion and machinery depreciation than it knows about stomach depletion and standard of living depreciation, which follows from income taxes levied on families whose incomes are already inadequate to maintain minimum standards of living.

Now, I am sure that this committee is well aware that the Bureau of Labor Statistics' minimum adequate budget is by no means a luxury budget. I urge you to inspect this budget very carefully and see what its implications are, as you consider what to do with income-tax exemptions. If you look at it, you will find that it is a most modest kind of standard of living. As a matter of fact, it is $433 less than the budget estimated by the Heller Committee, the University of California budget that they say is necessary for healthful and reasonably comfortable living.

The budget includes in it a most modest consumption pattern. It includes in it a food-budget pattern, which is less than the actual United States per capita consumption at the present time. It includes in it most modest and, in my opinion, actually inadequate provisions for medical care, for the basic necessities of living. And certainly it has a most modest provision for something that goes beyond the elementary necessities.

This you can verify by simple attention to the content of that budget, and yet, in spite of the obviously inadequate standard of living permitted by this Bureau of Labor Statistics' budget, we can use it as a minimum standard to determine below what income taxes should not reach.

The Treasury Department in 1947 prepared a very significant study of the budget pattern, as it related to exemptions. I am sure you have that report and are well acquainted with it. They adjusted the budget data for various sizes of families in the country, and they made an indication of what actual income was required for a single person, for two persons, three persons, four persons, and so on, to maintain this minimum adequate budget.

We have brought this adjustment up to date, on the basis of changes in the cost of living, according to these officially determined standards—and I emphasize "these officially determined standards"—they are your standards, they are Government standards, set up and supervised by the Government.

In January 1954, to attain this minimum adequate budget, a single person needed $2,103 in income. A family of 2 needed $2,881. A married couple with two children needed $4,294. This includes the requirement for current taxation.

Now, given that standard, the minimum standard officially designated by the Government, we can then ask the question: How many American families get income adequate to cover this standard of living? A shocking fact is that a majority of American families do not today receive income sufficient to attain this quite meager minimum adequate standard of living. I have a feeling that Congress sort of likes to look the other way when confronted with this irrefutable fact.

In 1951, we find that there were 26,140,000 American families who could not reach this modest standard of living from their income. These were 53 percent of all American families. This means that, according to the officially designated budget, a majority of our families do not have incomes sufficient to maintain them at officially designated minimum standards of living.

These substandard families, having to bear the burden of income taxation, seems to us to weaken the economic base of our prosperity and to underlie the danger of depression. The poverty-creating effects of taxation on this majority of our families who do not have the income required to purchase adequately the simplest necessities of life, is a major root cause of our current economic difficulty.

If you will take a look at the question of income in this country, you will find that there is an unquestioned picture of inadequacy of mass purchasing power, characterizing the majority of our families. This also is to be shown by reference to income distribution data, again prepared by the Federal Government.

In 1952, the total families in our country who had incomes less than $4,000 a year constituted 59 percent of all families in the country. Yet, they received only 31 percent of the total money income—59 percent of our families received 31 percent of the total money income.

In our opinion, it is in the inadequacy of purchasing power of these families that we find the basic cause for our problem of consuming the potential capacity of our productive machinery, and it is our point, of course, that tax revision should direct itself at this basic difficulty. That means that taxes should be eliminated from those families whose income is inadequate to meet these minimum levels.

This point, it seems to me, is further verified by reference to the question of who has the liquid assets of our country. We kind of like to think that we have a certain equality of leveling wealth in this country. The facts, of course, do not bear this out, because the possession of liquid assets indicate that they are even more concentrated than the income distribution.

On January 1, 1952, 50 percent of all the spending units in our country had only 1 percent of all the liquid assets possessed in our country. The top 10 percent of the spending units in America held 66 percent of all such assets.

If you look at the question of who does the spending, again you will find that there is a distortion here whereby the low-income majority of the people, because they do not have the adequate total income, are actually able to do only a small portion of the total spending of our country.

For example, we find that a majority of the spending units, 60 percent of all units, bought only 38 percent of the consumer goods and services, consisting primarily of food, housing, clothing, medical care, transportation, recreation, education, and State and local taxes.

This is, it seems to me, verified by reference to the people who buy our products. Families below $4,000 in 1953 made up 59 percent of all our families, but in 1953 they bought only 19 percent of all the automobiles purchased in our country. We wonder why there is a problem in the automobile factories. This is the place to look for the answer.

The same thing is reflected in the area of ownership. It is a commonplace saying that "everybody has an automobile" in America. The fact is that only 46 percent of the family units with incomes under $4,000 own automobiles, regardless of age or condition. Only 46 percent of all the families with incomes under $4,000 own automobiles, and yet they made up 64 percent of all the spending units in our country.

What is the point of this? The point of this is to show that the basic difficulty of finding adequate mass-purchasing power in sufficient volume to keep the wheels of our factories turning, rests in the simple fact that the majority of our population, the majority of our families, given the inadequacy of their income and given the added burden of income taxation, find it difficult to carry their purchasing burden.

I noticed a statement by the chairman, quoted in Business Week magazine, to the effect that activity amongst consumers would trickle up to investors and to producers. I think that is a very apt observation, and the point I am making is that there is a grave limitation on the trickle-up, because of the inadequacies of income and the heavy burden of taxation in these low-income levels.

Now, what we are proposing, then, is that these income levels having inadequate incomes to maintain an officially determined standard of living, should as a matter of humanity and as a matter of combating the danger of depression, be the prime target of tax revision.

Let me give you one specific example to show you what this situation is, to show the poverty-creating effects of our present personal-income taxation. Take a representative case: A manufacturing worker with a wife and two children, who is today earning the officially reported average weekly wage of $70.92. His annual income at this rate is $3,688. That is the national average for factory workers. He gets that $3,688 if he works 52 full weeks of work. That is a heroic assumption, but let's make it for the purpose of illustration. To achieve the minimum living standard provided by the Bureau of Labor Statistics' budget, however, he needs $4,294, including provision for Federal taxes. His income is $606 short. This means that he and his family must do without some of the meager supply of items listed in the Bureau of Labor Statistics' budget, some of the food or the clothing or the medical care.

Certainly he is unable to purchase, if he is unable to pay for it, the durable goods, such as washing machines, refrigerators, automobiles, and the things he needs which are in our capacity to produce.

This very typical worker pays $201 in Federal personal-income tax. If Congress were to exempt him from this taxation, he would still be $308 short of the minimum-adequate budget. But Congress would have provided his family with a considerable measure of relief, and would at the same time have guaranteed that more spending power would have been created to help ward off the threatening depression.

To repeat again, our basic proposal is that we must take a new look at the minimum levels of existence. This is a very precise measure. It is something that you can put your hand to; you can check it. If you decide to, you can look at the budget and say, "This is a false study. There are errors in it. It isn't true that this is the amount of money that workers need." Or, you can come up with the conclusion that, "Yes, it is a good, reliable measure of a minimum standard of living." If you draw that conclusion—and it seems to me that you must make some conclusion about the legitimacy of this budget—then it seems to me that you are faced with a very serious implication, if we continue taxes that cut below that minimum-budget level.

I know that the decision with regard to taxes and, of course, the decision with regard to cut taxes, presents the Congress with a very difficult problem of choice. And there are arguments for all kinds of tax cuts, and there are logical arguments that can be made. But what I am trying to say, what my union is trying to say to the Congress, is that, in our opinion, you must start as a matter of priority with the proposition that the first tax cuts you impose are those directed to relieve families from poverty-creating effects of taxation; that if we have taxes now which without any question reduce the standard of living of people below what we, the Government, you, the Government, officially says is the minimum level, then this should be the first target of our tax revision.

It is one thing to say, for example, that you are going to impose on certain levels of income by taxes the obligation to sell a Cadillac and drive a Buick, or even to sell a Buick and drive a Chevrolet, and that might be unfortunate and people might not like it, but that is quite a different thing than to say to the majority of American families that you have to decide not to go to the dentist even if you need to. Or, that you have to decide not to have quite as much milk as you really ought to have. Or, that you have to live in an inadequate house. That is quite a different proposition.

And, very humbly, I want to say that in our experience this issue has not been adequately faced by the Government since, I would say, the end of the war. The necessity of reducing incomes during World War II, I think, is not seriously to be debated. But the situation is different now. What we are urging is that you take a most serious look and that you know what you are doing, what the human consequences are, what the welfare consequences are, as well as what the economic consequences are, of imposing $200 taxation on a man and his wife and two children, whose income is only $3,600, which we say officially, as a Government, is already $600 below a minimum adequate level.

We are convinced if you do this you will come to the conclusion that this is damaging to us as a country, because it fastens poverty onto many people, and it is damaging to us as a country because it aggravates the inadequacy of purchasing power which is such a serious problem for all of us.

Now, as I said at the outset, we support the general intention and direction of the George proposals for raising exemptions. We have a suggestion with regard to that which, if you are seriously going to decide to do something about exemptions, we think should be considered. And our suggestion is that there is something better to be done than a straight across-the-board exemption change. The change that we propose, we think very logically follows from our argument, is related to the minimum budget needs for different sizes of families. And this follows from the data that are readily available to you from the budget estimates of the Bureau of Labor Statistics.

We propose, in line with this, that the exemption for a single person should be $1,800; that the exemption for a married couple should be $2,600; and that the exemption for dependents should be $700. This, we say, as you can see from the material that is in front of you, is related to the fact that for a single person the BLS says he has to have $1,800 to maintain the minimum existence, not $1,000. We suggest $1,800 as the first exemption. For a married couple the exemption that we propose is $2,600. The BLS minimum budget figure is $2,597.

Likewise, the adding of dependents to a family does not add the equal of the expense of the first member of the family or the second member of the family. It does not add a thousand dollars to the minimum expense of a family. It adds approximately $700 per person. And we suggest that in place of an across-the-board exemption, which is very commonly proposed and is of course specifically proposed in the George bill, that a more realistic exemption schedule would differentiate between the first member of the family, between the second member of the family, and the other dependents. This we say, of course, with full support of the general principles and purposes and general reasoning that we think lies behind the introduction of Senator George's bill.

As I said before, all of this presents the Congress with a very difficult question of choice, because if you leave aside the question of cutting the budget, which is not really the proper discussion for me at this point, you have the question of alternatives, in that what you give up in an area, you must gain in another area.

We are deeply disturbed at the evidence so far that, in making the choice of these alternatives, Congress is turning its back on the majority of the families who are faced with the poverty-inducing taxes, and is finding it possible to rationalize putting the main burden of its tax reduction on corporate income and on wealthy families. We urge that this is the wrong choice. Our opinion is that the revenue lost by exemptions, raising exemptions, either in terms of the George bill or as we have proposed, can be made up from alternative sources which would not create undue hardship for human beings, if creating any hardship at all, and which would be in line with the national necessities of meeting the problem of threatening depression.

We have outlined these various alternative tax-income sources. They rest on increased taxation in the corporate area. They rest a great deal upon handling the question of loopholes, and they rest a great deal on the question of increasing and making more strict the enforcement of the existing tax provisions.

Now, I know, and do not propose here, that the alternative source of taxes lies in raising the rates above a certain level, say, $10,000. This is a very popular debating point. I heard Senator Williams make it over the television sets last week, or a week or so ago, that if you cut exemptions for the people that you could have a confiscatory tax above $10,000, and still not equal the loss in income. This is a question of mathematical correctness, and it is correct. But the point needs to be made that the reference there is to the net surtax income; that if you were to make reference to adjusted gross income, which is the figure that has some correspondence to economic net income, you would find that in income sources over $10,000, over $10,000 adjusted gross income, there is still $30 billion of such income left, even after paying about $13 million or $14 million of Federal tax. There is certainly not much revenue to be gained by raising the rates in the upper bracket incomes, as they are now defined, but there is a large revenue potential in redefining split income, in closing loopholes, and in having strict enforcement of laws, not only in the corporate income area but in the individual tax area.

The point I want to make again with regard to these alternatives— and it seems to me they cannot be handled by jumping in immediately and saying that this is wrong with this, or that this is the difficulty with this alternative. Alternatives must be weighed, and when you pose the argument for not doing anything about what we think is the excess depletion allowances in the oil area, or when you pose the argument for splitting the incomes which affect only the families above average incomes, you must realize that you are posing this as an alternative to eliminating poverty-inducing taxes on the majority of the American families. Obviously, in our opinion, the choice for the welfare of the people and the choice for the welfare of the country, demands that in this situation it is urgently required to lay the burden of taxes not on those people to whom it must necessarily mean poverty living, but instead today, as we revise our tax schedule in the face of economic difficulties, which everybody recognizes regardless of how they debate the extent, what is needed is action to stimulate the purchasing power of the great mass of people and to give this stimulus to economic activity in our country.

In our opinion, this requires priority of attention to the substantial increase in exemptions to remove taxes from those families, the majority of those families in our country whose income is already inadequate to meet officially determined minimum levels of adequate living.

That concludes the summary of my statement, sir.

The CHAIRMAN. Thank you very much. Do you want your whole statement in the record?

Mr. NIXON. Yes, sir. I understand that is in the record.

Thank you very much.

The CHAIRMAN. Mr. Elder, of the American Federation of Labor. Mr. Elder, sit down and be comfortable, and identify yourself for the reporter.

STATEMENT OF ARTHUR A. ELDER, TAX CONSULTANT, AMERICAN FEDERATION OF LABOR COMMITTEE ON TAXATION, ACCOMPANIED BY BORIS SHISKIN, DIRECTOR OF RESEARCH; AND PETER HENLE, ASSISTANT DIRECTOR OF RESEARCH, AMERICAN FEDERATION OF LABOR

Mr. ELDER. Senator Millikin, members of the committee, my name is Arthur A. Elder. I am tax consultant for the American Federation of Labor, with office in New York City.

I want to assure you, Senator, and members of the committee, that members of our organization appreciate the tremendous problem and challenge that is presented to your committee in the bill that you have under consideration. We recognize that it is a virtual impossibility for your committee to approve or fashion a bill that will satisfy everybody.

As a representative of the American Federation of Labor, I wish to assure you that members of our organization recognize the need for a balanced tax program, a program that will take into account the needs of all segments of the economy; that is, the producing segment, investment, the producer, the farmer, and all other segments of the economy. With that in mind, I would like to present to your committee a statement.

We outline at the outset certain basic considerations which we believe should be paramount in our thinking at this time. Throughout the period of the defense emergency, and until very recently, the

American Federation of Labor has urged that Federal taxes be maintained at relatively high levels in the interest of maintaining a sound economy. We have opposed tax reductions which would impair the Nation's ability to meet defense and foreign-aid needs. We have opposed chronic deficits in a period of prosperity and high employment. We have warned against tax cuts that would contribute to inflation. Above all, we have urged that fiscal and tax policies be determined by considerations of equity and by the economic requirements of the Nation.

In keeping with these principles, the American Federation of Labor now urges that tax policies be adopted which will best maintain the economic health of the Nation. We are no longer in a period of high production; we fear deflation, rather than inflation, at the present time. Production is off 11 percent from the high of 1953, and the Census Bureau reports that during the week of March 7–13 unemployment reached 3,725,000, a figure which does not include workers temporarily laid off.

During a period when important segments of industry are not operating at capacity, we cannot see that tax cuts giving preferential tax treatment to investors and corporations will increase the demand for goods and services. We believe that experience has demonstrated that an increase in purchasing power is in itself the best assurance of an economic climate conducive to maximum investment and necessary plant expansion. Under present circumstances, the American Federation of Labor believes that sound tax policy demands that major emphasis be placed on adoption of those measures directed at increasing purchasing power.

I would like to discuss briefly the tax reductions that have been approved up to this point, which have been sanctioned by Congress and are pending at the present time.

During recent months a number of proposals calling for tax reductions of various amounts have been publicized. The American Federation of Labor has not proposed nor does it now suggest any program calling for tax changes that might embarrass the administration. However, the administration itself has proposed and Congress has approved several tax reductions which have already gone into effect or are scheduled to go into effect in the near future. We are concerned with these changes, as well as with those embodied in H. R. 8300. We propose to address ourselves specifically to comment on such changes. Of the total of $6 billion annually in tax reductions which have gone into effect since January 1, $2 billion will accrue to corporations through expiration of the excess-profits tax. An additional $3 billion will go to individuals through the 10 percent reduction in personal income tax. Reductions in excise-tax rates will presumably result in $1 billion in savings to consumers. Another $1 billion in excise-tax reductions is scheduled for April 1, 1955. In addition, if the Senate approves action taken by the House, a 5-point reduction in corporate income-tax rates should result in annual tax savings to corporations of approximately $2 billion, also effective on April 1, 1955.

The excise-tax reductions already approved and in effect should bring relief to all consumers. We believe these reductions in rates were long overdue, since they were scheduled by Congress during World War II to take place at the conclusion of hostilities. Further, we would point out that the present rates on tobacco, liquor, gasoline, automobiles, trucks, buses, and parts, which it is proposed to continue until April 1, 1955, are still at levels considerably in excess of those prevailing during World War II.

Incidentally, these rates too, presumably should have been restored to their prewar level, at the conclusion of hostilities, and yet we actually have them in 1954 at considerably above the rates that were effective during the war. That is the so-called war emergency rates.

There has been frequent reference to current high taxes on corporation profits. By all past standards, corporation taxes are high. However, the record shows that after taxes most corporations have continued to enjoy net profits which have enabled them to make liberal provision for dividends and to accumulate substantial reserves. In our opinion, provision already made for downward adjustment in corporation taxes, coupled with the further reductions being considered by your committee, is excessive. I would say excessive, relative to the cuts that already have gone into effect or are being proposed at this time in other fields.

Much has been said of the stimulus to spending that would result from the $3 billion reduction in personal income taxes. Up to this point, spendings have actually declined subsequent to the tax reduction during the first quarter of 1954, as compared with the same period of 1953. The U. S. News & World Report has estimated that $924 million—31 percent—of the $3 billion in tax savings will accrue to taxpayers earning less than $5,000 yearly, while $2.063 billion would go to taxpayers with annual incomes of above $5,000. It seems to me that that is important, when we refer to the possible benefit that is presumed to have accrued from the cut in income taxes effective January 1.

This would seem to confirm our contention that the cut in personal income tax provided inadequate relief to those in the lower-income brackets.

Senator WILLIAMS. Mr. Elder, may I interrupt: Assuming those figures are correct—and I don't question them—that completely excludes the enunciation that was made on that tax bill at the time it was passed in 1950, as being a tax bill which opposed such a large part of the increased taxes on the low-income groups, because it was an automatic suspension of the law which was passed at that time. So, if only 31 percent of the benefits go to those below $5,000, then that was an error at that time.

Mr. ELDER. That may have been true. Yet, I think it still could be said that at that particular time, taking into account the very heavy tax burden that the low-income groups were paying—and later on I will develop that that is in proportion to the burden that was being borne by people in the upper income brackets—that that $924 million figure, assuming it is correct, did constitute a rather excessive heavy additional burden on those people in the low-income groups.

We believe it did not take sufficiently into account the fact that the high first-bracket tax, coupled with the extremely low exemption, constituted a disproportionately heavy tax burden on millions of taxpayers in the income groups below $5,000. Substantial tax relief for these taxpayers is urgently needed.

Although the income tax is based upon the principle of ability to pay, increasingly, over the years, tax rates have been raised and exemptions lowered to the point where the income tax works unnecessary hardship on low-income taxpayers.

The 40-cent minimum wage in 1939 meant an income of $832 to a single worker, for the year. That is assuming full-time employment. This income was not subject to Federal income tax. Today a single worker earning the 75-cent minimum hourly wage and steadily employed earns $1,560, which nets him $1,382 after Federal taxes, the equivalent of $723 in terms of 1939 purchasing power. There are millions of workers employed at the 75-cent minimum wage, and it is clear that higher prices and Federal taxes have cut their standard of living approximately 13 percent below what it was in 1939.

There has been no comparable sacrifice on the part of taxpayers whose incomes are $5,000 or more, as can be seen from the following table published in U. S. News & World Report for March 12, 1954:

[In percent]

	Average tax rate for those earning—			Average tax rate for those earnng—	
	Less than $5,000	$5,000 or more		Less than $5,000	$5,000 or more
1929	0.1	6.1	1949	7.8	15.9
1939	1.2	10.5	1950	7.8	17.0
1942	8.1	32.5	1953	9.4	20.3
1945	9.8	29.0	1954	8.5	18.9

In this table, in the first column you have listed the average effective tax rate applying to taxpayers with incomes of less than $5,000.

In the second column, you have the same average effective tax rate, as it affects taxpayers at different years, with incomes over $5,000.

From these figures it can be seen that taxpayers with less than $5,000 income are paying an average effective tax rate of 87 percent of that which they paid in 1945. That is, in 1954, as the tax law now stands, according to these figures, people in the low-income group below $5,000 are paying approximately 87 percent of what they did in the last wartime year.

But taxpayers with more than $5,000 income are paying an average effective tax rate of 65 percent of that which they paid in 1945. Between 1945 and 1949 there was a tax-rate decline of 20 percent for taxpayers with less than $5,000 income, a decline of nearly 50 percent for those with more than $5,000 income.

Now, referring particularly to the year 1945, you will note that the effective tax rate, as estimated to apply to the below-$5,000-income taxpayer, is 9.8 percent. Contrast that with the 29 percent as applied to the income above $5,000. Skipping over to 1954, you see that the same effective rate as applied to the below-$5,000 taxpayer has declined to 8.5 percent, whereas, in the case of the upper income taxpayer, it has declined from 29 percent to 18.9 percent.

Now, there are many factors, of course, that are responsible for this situation. Taxwise we believe that it reflects the fact that there have been many changes made in the tax laws that have operated to the particular advantage of the upper income group of taxpayers.

In short, the income tax has become a much less effective instrument of tax policy because of its increasingly less progressive character.

It strikes harder than it did in the past at those taxpayers who are least able to pay, largely because of various tax-escape provisions which Congress has permitted to continue or has legalized during the past 10 years.

I believe, Mr. Chairman, at this point I would like to make one thing clear: It sometimes is assumed that labor organizations more or less traditionally feel it an obligation to subscribe 100 percent, or more than 100 percent, to the theory that the only equitable type of tax change is a tax change that will benefit the lower income groups. Now, if that ever was the case, as far as the American Federation of Labor is concerned, I don't believe it is true today. The fact is that we have in our membership a very large proportion of people who are in the income group above $5,000. Perhaps it is not as large a proportion as some other groups in our society have, but it is a very substantial proportion. And we feel a responsibility to them, just as we feel a responsibility to all of our members, regardless of their income. So, that I would merely like to emphasize at this point that we believe that this tendency toward less progressivity of the tax structure is bad. It is bad for the whole economy and it is bad, we believe, for all of our people, whether they are in the low-income groups or whether they are in the upper income groups. And we sincerely believe that it is bad for all other groups in the economy, regardless of what their income level may be.

Now, in the next section we discuss the bill that is directly before this committee for consideration.

We believe that this bill is faulty, in that it combines tax reduction with technical revision. As we see it, that is perhaps its most objectionable feature. This is entirely without regard to the merits of any of the particular proposals, whether they involve revenue losses or not.

The American Federation of Labor is aware of the need for a revision of the Revenue Code. Early last summer we expressed our approval and support of the proposed revision to eliminate obscurities, remove inconsistencies, and eliminate manifest inequities that have become apparent through the administration of existing laws. In expressing our approval, we said we believed that simplicity and equity could be attained by eliminating existing loopholes and the preferential tax treatment enjoyed by particular groups of taxpayers at the expense of taxpayers generally. In our statement to the House Ways and Means Committee, we said, "We are convinced that your committee can make a signal contribution to achieving equity and a sounder economic basis for our tax structure by rejecting any and all suggestions to create new tax loopholes and recommending only those changes that are dictated by broad public policy."

We believe that H. R. 8300 goes far beyond providing for technical changes. Far from eliminating preferential treatment for certain classes of taxpayers, the bill contains provisions which in the main will benefit certain corporations and a few selected groups of individual taxpayers. The American Federation of Labor believes it unfortunate that these provisions, involving basic changes in tax policy, and costing, initially, $1.4 billion in revenue loss annually, with a probable ultimate loss of 3.5 to 4 billion dollars, should have been included in an omnibus bill designed, presumably, to simplify the administration of tax laws.

On the matter of possible revenue loss, the committee report on H. R. 8300—House Report 1337, page 4—states: "On balance, the total of the changes for which no specific revenue effect is given is as likely to result in a net gain as in a net loss of revenue." It is exceedingly difficult to reconcile this statement with the facts. Gains in tax receipts are not anticipated from even 1 of the 19 new measures proposed in H. R. 8300. I might qualify that to say that there are no gains in the new measures proposed in the bill for which anticipated revenue changes are listed in the schedule.

Every one of the proposed changes anticipates losses during fiscal 1955, ranging from a low of $3 million in the case of amendments governing personal exemptions for trusts, to a high of $300 million through the proposed changes governing depreciation. These facts make it difficult to believe that changes for which no specific gain or loss of revenue are listed will cancel out.

In sanctioning an initial reduction of $1.4 billion for fiscal 1955, Congress would be committing itself to additional reductions which, when fully operative, would involve revenue loss estimated to run between 3.5 and 4 billion dollars. Further, to the extent that entirely new areas of tax escape are opened up, new vested interests will be established. Already it has been pointed out that a number of the proposed changes calling for revenue reductions discriminate against specific groups within certain categories. These groups, on the basis of all past experience, will immediately proceed to build up pressures either during this or the next session of Congress to extend and enlarge the particular tax escape device in which they have an interest.

I would like to discuss briefly dividend exclusion and credit. Since this is a point that has been given widespread attention in the press and also in the debate in the House, I am reducing my comments to a minimum. Not because I don't think it is important, but because I believe most of the arguments, pro and con, have been brought to the attention of your committee.

We believe the dividend exclusion and credit provision would establish an entirely new principle which can be justified neither in equity nor in terms of economic needs at this time. When fully effective, the provision would involve annual revenue loss of $814 million. Of this tax saving, approximately $600 million would accrue to taxpayers with annual incomes exceeding $10,000. These constitute 4 percent of all income taxpayers—1,600,000. By contrast, stockholders in the below-$5,000-income group, who constitute 80 percent of all taxpayers, would secure tax savings of $90 million through the proposed dividend credit.

On this point, I don't have sufficient copies for all members of the committee, I am sorry, but we have a table prepared, which is printed from a study that was made for the Brookings Institution by Lewis H. Kimmel, entitled "Share Ownership in the United States."

(The table referred to follows:)

Family units holding publicly owned stocks distributed by combined family income

Reported combined family income [1]	Total family population		Share-owning family units		
	Percent	Number	Percent of group population	Estimated number	Percent of total
Less than $2,000	19.8	9,910,000	2.2	220,000	4.6
$2,000 to $3,000	17.1	8,560,000	3.6	310,000	6.5
$3,000 to $4,000	22.0	10,990,000	4.6	510,000	10.7
$4,000 to $5,000	16.4	8,210,000	7.4	610,000	12.9
$5,000 to $10,000	21.0	10,480,000	19.8	2,080,000	43.8
$10,000 and over	3.7	1,850,000	55.1	1,020,000	21.5
Total families	100.0	50,000,000	9.5	4,750,000	100.0

[1] Based on anticipated 1952 income before taxes as reported by a reprcsentative family member, usually the head.

Source: Share Ownership in the United States, by Lewis H. Kimmel, the Brookings Institution, Washington, D. C.

This table is headed "Family units holding publicly owned stocks distributed by combined family income." Now, we have listed various income categories, with the heading "Reported combined family income." And then, under this heading, we have listed families with income of less than $2,000; families with income between $2,000 and $3,000; $3,000 and $4,000; $4,000 and $5,000; $5,000 and $10,000; and then $10,000 and over. Now, I think these figures are significant. In the next column we have a listing of the number of families, both on a percentage basis and in terms of actual number, in the various income classifications.

Now, of those families with income below $2,000, we have listed 19.8 percent, constituting 9,910,000.

From $2,000 to $3,000, we have listed 17.1 percent, and that number is 8,560,000.

From $3,000 to $4,000, 22 percent of the families, and 10,990,000.

From $4,000 to $5,000, 16.4 percent; 8,210,000.

From $5,000 to $10,000, 21 percent of the families, numbering 10,480,000.

And, finally, in the income group of $10,000 and above, you have 3.7 percent of the families, numbering 1,850,000.

In the next column is listed the percentage of the families in these various income groups that own stock. There has been much reference to the large number of individuals and groups, and some little dispute as to the income classification in which they happen to be. So I think these figures are very significant.

You have 2.2 percent of the families in the groups with income below $2,000, who own stock. That is 220,000 families, which constitute 4.6 percent of the total number of families that own any stock.

In the next group, $2,000 to $3,000, in which you have 17.1 percent of the families, you have only 3.6 percent of those families owning stock, numbering 310,000.

In the next income group, $3,000 to $4,000, you have 4.6 percent of the families, of the total of 22 percent of the families, numbering 510,000 families who own stock, constituting 10.7 percent of the total.

Then, from $4,000 to $5,000, you have 7.4 percent of 16.4 percent, or 610,000, owning 12.9 percent of the stock.

Now, at that point I think if we stop and we add these percentages that apply to families in the income group below $5,000, we find that that comes to 34.7 percent of the families in the income groups below $5,000, according to these figures, who own stock.

The CHAIRMAN. What kind of stock are we talking about?

Mr. ELDER. Family units owning publicly owned stock.

The CHAIRMAN. Do you mean, listed securities?

Mr. ELDER. I don't know that. Mr. Henle, do you know?

Mr. HENLE. The definition was carefully drawn, and we could get it for you. But it is certainly all listed corporations, and it may have included some others.

The CHAIRMAN. That would be very interesting to know.

Senator MARTIN. That is very important, whether or not that includes these small corporations we have out over the country, whether it includes the banks—there are very few banks where their stocks are listed on the stock exchange. That would be very interesting information to have.

Senator CARLSON. I would be interested to know if it includes stock from cooperative organizations.

Mr. ELDER. Will you supply that information, Mr. Henle?

The CHAIRMAN. Send us a memo on that.

Mr. ELDER. We will do that.

Mr. SHISKIN. The stock included in the Brookings study referred to shares which are available to the public. In other words, those which may be in the closely held corporations or family-owned corporations that are not available to the public, are not included in these figures.

Senator BENNETT. These people who owned these closely held stocks would benefit, so it isn't reasonable to assume that the figures you are quoting us represent the actual condition for the stock-owning situation in the whole United States.

Mr. SHISKIN. The only distortion it would have would be in favor of the higher income families.

Senator BENNETT. Do your figures reflect the percentage of the stocks that are held by funds and trusts and insurance companies?

Mr. ELDER. These do not.

Senator BENNETT. So that again distorts your figures, and they do not accurately reflect the actual effect of stockownership in the United States. They actually reflect a limited segment of the picture.

Mr. ELDER. But isn't it true, Senator, that it is this prticular segment that has occasioned the most controversy, if you will, pro and con? That is, the individual holdings.

Senator BENNETT. Your argument of total effect is on the basis of a limited situation. The stock held in insurance companies, pension trusts, including union pension trusts, certainly benefits the people or has a substantial benefit for people in the class below $5,000, about which you have been talking today.

So, the only point I wish to make—and I think you will agree with me—is that this table is not finally conclusive. The proportions you suggest do not accurately reflect the total situation in the United States.

Mr. ELDER. I would agree to that. It reflects merely what we intended it to reflect, and that is the effect of the enactment of this particular provision on individuals to the extent that we could obtain the most applicable information.

And it is true that there are indirect effects which would benefit these various groups that you referred, through trusts and so on. But essentially this, I believe, is the point on which there has been the bulk of the discussion, pro and con.

The CHAIRMAN. Mr. Elder, I am informed by the staff that the Brookings Institute study refers only to listed securities?

Mr. ELDER. Thank you.

The CHAIRMAN. And there is a vast amount of securities outside of listed securities.

Mr. SHISKIN. That study was made by the Institute itself for developing a policy in which stocks could be more widely distributed, and that was the purpose.

The CHAIRMAN. Yes, that was the purpose of those who got up the figures. But that does not conclude the point of how many others owned stocks that are not listed.

Mr. ELDER. To conclude then, Mr. Chairman, if I may, in the groups above $5,000, 19.8 percent of the 21 percent of the families in that particular group, constituting 43.8 percent of the families that owned stock. And in the group of $10,000 and above, where you have 3.7 percent of the families, we find that over half of them, 55.1 percent, own stock and that they own 21.5 percent of the total.

The CHAIRMAN. Do I understand that 3.7 percent of the total family population with incomes over $10,000, with listed securities, number 1,850,000? Is that right?

Mr. ELDER. The total number of families was 1,850,000, and of that, 1,020,000 owned shares.

The CHAIRMAN. Now, can you tell us what percentage of the total tax revenue was contributed by that 3.7 percent?

Mr. ELDER. Well, I imagine Mr. Stam has that at his fingertips. I have that in my briefcase.

The CHAIRMAN. I will ask Mr. Stam, but I am asking you if you have that figure. It would be interesting to know what part of the tax burden is carried by that 3.7 percent.

Mr. ELDER. On the percentage basis, I think I gave it to you, roughly, Mr. Chairman, in the figures that I quoted previously, in terms of the effective rate.

Now, with regard to the current year, or last year, I don't have those figures. It may be that Mr. Stam has those figures. I do know this, though, that as far as effective rate is concerned, in the statistics of income for 1950, for example, the effective rate that is listed for the various income classifications is very uneven. That is, you might find at the top, in the highest income category, that actually they are paying an effective rate of 60 percent of their income. And you might find in the category below that, that it is 62 percent. Then you have a drop to 55 percent, and then you have an increase. So, it is uneven in the upper income levels.

The CHAIRMAN. Yes. I am merely interested in the point of what percentage of the total revenue is contributed by this $10,000 and over bracket.

I may say there was introduced in the record yesterday some statistics that bear on the progressivity, if that is what you call it, of our income-tax structure. And you get figures that are fantastic in the relation between what the higher brackets pay to what the lower brackets pay.

Mr. ELDER. One final point I would like to make——

Senator LONG. May I ask this question of the witness: Do you have any statistics on who holds the most corporate stock? Now, I put a memorandum in the record yesterday that indicated that 80 percent of all corporate stock is held by six-tenths of 1 percent of American families. Do you have any information to indicate whether those statistics are in line, or whether the stockownership is more broadly spread than that?

Mr. ELDER. No, sir. On the basis of the figures I have, and the rough check I made, and the statistics of income for 1950, I find that that is approximately correct. And it is in accord with the statement that I made earlier here.

Senator LONG. I further understand that 90 percent of Americans don't own any corporation stock.

Mr. ELDER. That is my understanding.

The CHAIRMAN. I think you will find that about 75 percent of our Federal revenue is derived from people with $5,000 or over in income. But, if we can have some figures on that, I think it would be interesting.

Mr. ELDER. I would like in conclusion on this particular topic, to point to the fact that there are many arguments that have been advanced for the enactment of this particular program. We have heard in the past reference to double taxation. We hear much less of that recently.

A good many people who formerly used that argument in justification of the enactment of this particular proposal, now rest their argument principally on the contention that this is a measure designed to stimulate holdings of shares.

In that connection, I had the privilege several years back to be a member of a committee of the National Tax Association, of which Harold Groves of the University of Wisconsin was chairman. Now, at that time it was my impression that the chairman of the committee, as well as the members of the committee, were very much interested in this subject. Dr. Groves, I felt, was interested not in terms of relieving investment income, but rather in terms of integration of the corporate and the personal tax structure, and his feeling was that one of the principal difficulties of the present situation was that it had a tendency to operate in favor of the very large corporation. But I did not gather that it was his opinion—certainly it was not the conclusion of the members of the committee at the meetings that I attended—that the answer was the relief of dividend income from taxation.

Now, I would like to read—this is not the final report; this is a reference to the discussion——

The CHAIRMAN. I do not understand the proposal to relieve dividends from taxation.

Mr. ELDER. Partial relief.

The CHAIRMAN. When the same revenue is taxed at some other level?

Mr. ELDER. That is right.

The CHAIRMAN. So that is vastly different from a complete relief of dividend income.

Mr. ELDER. That is right.

I think it can be said, of course, that there is a question of degree; that at this particular point the suggestion is that the limit be 10 percent. Initially, the suggestion made in the House committee, I believe, was that the limit should be 15 percent. Now many people have referred to this as a beginning, and entirely apart from all the other considerations, it would seem to me that that is a very relevant question: How far is it going? It is an entirely new principle, as far as our tax structure is concerned.

The CHAIRMAN. I wouldn't say how far it is going, but the fundamental point is, it is an objection to double taxation. The fellow who owns the stock also owns the corporation. If the corporation is taxed, he should not be taxed twice on something that has already been taxed.

Mr. ELDER. All I would say to that, Senator, is that as far as the law is concerned, the corporation is one individual and the stockholder is another.

The CHAIRMAN. That overlooks the ownership of the corporation.

Mr. ELDER. Under the law, the corporation enjoys certain advantages which accrues to it by virtue of its being a corporation. And it would seem to me that a stockholder can't expect to have his cake and eat it too.

The CHAIRMAN. There is no sense in having a cake, if you don't eat it.

Mr. ELDER. Well, as a matter of fact, you are raising another problem. A good many of them are quite content to let their cake remain in the corporation. Now, whether or not this proposal would result in a distribution or more cake is problematical. I am not persuaded that it would.

I merely want to conclude, if I may, Mr. Chairman——

The CHAIRMAN. We will let you conclude, but take all the time you want.

Mr. ELDER. Thank you.

Senator BENNETT. Mr. Chairman, I want to ask the witness if he could tell us in what year dividends were taxed for the first time.

Mr. ELDER. Untaxed?

Senator BENNETT. They were untaxed between. the beginning and——

Mr. ELDER. Yes; they were taxed in the thirties.

Senator BENNETT. That is right. So, for approximately 20 years there were no taxes on dividends.

Mr. ELDER. Now, wasn't there normal tax? There was a normal tax.

Senator BENNETT. Mr. Stam tells me they were exempt from the normal tax.

Mr. ELDER. And they were subject to the surtax, that is right. But they were taxed.

Senator BENNETT. But the purpose in making them subject to all taxation was to force the program of retiring distribution of corporate profits.

Mr. ELDER. All I would say to that is this: What we are really discussing here is the whole question of whether or not income, any type of income, should enjoy preferred status.

Now, I would say that the organization on behalf of which I am speaking believes that we shouldn't talk in terms of preferred classes of income. But if we do talk of preferred classes of income, then earned income definitely should be given preference in the matter of consideration to dividend or investment income. Now, that is our position.

Senator BENNETT. The point I want to make is that the position of the Government for 20 years was that there should be no normal double taxation on income. And this isn't a new principle we are proposing. It is a first step to the principle on which the income-tax law was originally set up.

Mr. ELDER. Excuse me, Senator. This goes far beyond anything that we ever had, because it does precisely what wasn't done earlier. It relieves dividend income from the surtax, which, in the case of the upper-income people, is very substantial. You reach a point where, if you are in the very high income group, if you have a matter of $5,000 that is tax exempt, under this provision, that $5,000 at the 80-percent rate will mean a saving of $4,000. Now, that is something entirely different from what we had in the thirties.

Senator BENNETT. You and I are talking in technicalities, but the fact is that when the income-tax law was passed, it was assumed—at least with respect to normal taxes—that taxation on dividends was a double taxation. It was not justified, and therefore it was not imposed.

Mr. ELDER. Mr. Senator, I would just say to that, that up until the early forties it was also assumed that earned income should have a preferred status, and it had a preferred status under the law.

By the same token, it would seem to me that if you are now considering whether this type of income, that type of income, or the other type of income should have a preferred status, then certainly I think that we would be very definitely for giving earned income a priority to dividend income.

Senator BENNETT. Is there any other type of income that is taxed twice?

Mr. ELDER. Yes. Practically every individual every day is taxed twice, or 3 or 4 or 5 times. And he is taxed in his own person, not in the same way that you have in the case of the shareholder, because the shareholder is not taxed twice. It is the income that is taxed twice, not the shareholder. And if the shareholders were sincere about this, they would go for a proposition under which they would be taxed exactly as partners are taxed. But you talk to them about that, and they run for cover, because the great majority of upper-bracket stockholders would lose a whole lot more under that proposition than they lose under the existing tax situation.

Senator BENNETT. Do you have any figures to bear out that statement?

Mr. ELDER. Well, it is obvious, Senator.

Senator BENNETT. It is hardly obvious to me; if an upper-bracket stockholder is in a 90 percent bracket, and he gets 50 percent of the income of the corporation taken out before his 90 percent is applied, he hasn't got much left.

Mr. ELDER. Well, of course on that I think we could carry this on through the lunch hour.

Senator BENNETT. That is right.

Mr. ELDER. Because there are ways of escaping, and you know that, Senator, and I know that.

Senator BENNETT. I think I have made my point.

Senator LONG. May I ask the witness this question: Do you think there is any merit to the statement President Eisenhower made during the last campaign, that the average American citizen pays 100 hidden taxes when he buys an egg, 150 hidden taxes when he buys a loaf of bread, and over 200 when he buys an automobile?

Mr. ELDER. I think perhaps the President was right. You carry these things to their logical conclusion, and that might be your conclusion. But I don't know to what purpose. The Government needs money. The people turn to the Government in times of stringency. The Government must have revenue, and we get it from taxation, and until we have a single tax we must go along with the system we have.

The point I am making is merely this, that if you talk in terms of double taxation, the stockholders have much less of a claim to any relief on the score of double taxation than John Q. Citizen that you meet on the street when you leave this building.

Senator LONG. Actually, doesn't John Q. Citizen pay tax when he buys gas, and doesn't he pay tax when he buys electrical appliances, and tax on his income, and social-security tax—there are a great number of taxes that he pays, as well as the hidden taxes. But no one seems to be too concerned about the fact that he pays a lot of taxes on those things, do they? I would like to relieve him of some of those, if we could.

Mr. ELDER. That has been my feeling, Senator. We recognize, of course, that the backbone of the tax system really was supplied with the inauguration of the withholding principle during the early 1940's. We know that. But we also know that under the withholding principle, very close to 100 percent of our members pay their tax on a 100 percent basis. And, on the basis of all our experience, we are not satisfied that that is equally true of people who are depended on as patriotic citizens to submit their income tax declaration, and so on.

If I may conclude this, then, I wish merely——

The CHAIRMAN. I just want to say if you have any evidence that anyone has not paid the taxes he should pay, for goodness sakes, submit it.

Mr. ELDER. Well, Senator, if I may, I would feel that certainly as a citizen that would be my obligation. I am at all times prepared to assume my responsibiliy as a citizen.

But I would also go further than what I have said: I am afraid some of these things are excursions, but since these questions are put to me, I feel it is my obligation to answer them.

I must also say that it is my belief—and this is not the statement of the American Federation of Labor; I am expressing this as my personal opinion—that the tax measures that have been approved within the last 10 or 15 years, and supported by Democrats as well as Republicans, unfortunately—at least a majority of Democrats and a majority of Republicans, too, have by and large operated to enable the people in the income groups who are not subject to the withholding tax, to avoid, taxation which it is not possible for people in the lower income groups, who are subject to the withholding tax, to avoid.

Seantor FLANDERS. I would like to make an inquiry as to your belief, or feeling, or whatever it is. Is it that these people are disobeying the law, or that the laws are so drawn?

Mr. ELDER. The laws are so drawn.

Senator FLANDERS. You are not imputing any criminal——

Mr. ELDER. And the other, too.

Senator FLANDERS. You are imputing criminal, as well as legal?

Mr. ELDER. If I follow that first point too far, I will become an assistant to the FBI and, Senator, I don't care to do that. I have trouble enough as it is.

Senator FLANDERS. It is interesting, Mr. Chairman, to find a witnes in this position, because generally it is the public which says that congressional committees impute various infractions of the law to citizens. Now, here we have the citizens doing the same thing. And maybe this thing is an epidemic, and it is going to run through both committees and citizens and everybody else.

The CHAIRMAN. Mr. Elder, I would just like to suggest——

Mr. ELDER. Mr. Chairman, may I make this comment?

The CHAIRMAN. Yes, you may, but let me make this comment first: I repeat again, if you have any evidence where anyone is cheating on his taxes, for goodness sakes, submit it.

Mr. ELDER. Thank you. And I think the comment I have to make is relevant to that, too. Certainly, if I have any evidence, I will be happy to submit it; I would submit it. But I also believe, in that connection, Senator, that to the extent that either you or I have any questions as to the amount of, well, tax evasion that may be going on, that question may be minimized by effective work on the part of our Internal Revenue Department.

I know, personally, 3 or 4 years ago—in 1950 I believe it was—I was very much pleased when it developed that my own income-tax form was among the—I don't know how many—extra forms that were examined and taxpayers called in. And I happened to be one of those people, and I feel that is one of the best ways to minimize the thing that we are concerned about.

Senator FLANDERS. I might say that I am specially favored in that every one of my income-tax returns was.

Also, Mr. Chairman, I would like to introduce to the witness the one man of all the men in the United States who has made a contribution toward the honesty of the enforcement of the tax laws, and that is Senator John Williams, of Delaware. He is my favorite investigator. He never puts a finger on his man but what that man gets fired or takes sick, or resigns, or something. That is my impression.

And I will wind up, Mr. Chairman, with just one other statement, that I am very much puzzled at the suggestion that dividend receivers get preferential treatment. They don't. They are the only bunch in the lot that is soaked twice. So, why call it preferential treatment?

The CHAIRMAN. Of course, if you say no preferential treatment for anyone, you would strike out the whole progressive nature of our income taxes.

Senator FLANDERS. Yes. You do anyway.

Senator WILLIAMS. Mr. Chairman, if I might make a comment, I think it would be a shame to let this hearing go, that so many people may be questioning the honesty and integrity of the American people. I want to say this, as one who has worked in this field in the last couple of years and had occasion to be in it, that it is my experience, and I am more convinced today than when I started, that the overwhelming majority of the American people, as taxpayers, whether they be public officials or not, are honest and are trying to do the job as they see it.

Now, unfortunately, there are a very small minority who forget that a public office is a public trust, or forget that they do have a responsibility as citizens to pay taxes, and that small minority makes the front pages, and it sometimes is distorted all out of proportion.

But I think we should always remember that the American people are honest, and our whole tax system is based upon voluntary payment of taxes on the part of the American people, and if that ever fails, our country is gone. I think that as a Government we have to have confidence in the people, and I think the people likewise have to have confidence in the Government.

Senator LONG. Mr. Chairman, inasmuch as this subject came up, I would hope that the committee would obtain the results that the collector of internal revenue obtained when he undertook to send people into some of the major American cities and simply go from door to door, checking on income-tax returns to see how he made out. I think there is a high percentage of Americans who do overlook paying taxes on one item or another, and who pay less than they might otherwise pay, and I assume that is what the witness had in mind.

I regret to say that sometime back the collector was courteous enough to check with me on a report I had sent in, and I was pleased to find an item I had overlooked. And I was glad to make up the difference to the Government, because I wouldn't want to pay less than I owed.

I think that the same experience has been found in many instances, where the collector goes around from place to place and simply takes your report without any suspicion at all that the taxpayer might have underpaid, and examines it.

Senator FLANDERS. I want to beg your pardon for slowing up the proceedings, and I won't do it again.

The CHAIRMAN. Do you want to make a comment?

Senator FLANDERS. No.

Senator MARTIN. Mr. Chairman, I agree with Senator Williams. Of course, where a man does something improper, he ought to be punished, and of course he gets large publicity.

At one time I had the privilege of collecting the taxes for the great Commonwealth of Pennsylvania, and I feel, like Senator Williams, that the great, great percentage of the people are entirely honest and are trying to pay the amount of tax that they feel is due the various branches of Government.

I have also found that many people, in their great desires to be honest with the Government, pay more than they should pay, and as a result you will notice that every once in a while there are refunds, and that shows that they were trying to do the right thing. Of course, every man ought to pay his full amount of tax, and the man ought to consider it a privilege to pay tax to a Government like ours.

I sometimes think that we ought to do a little educating along that line, and that we ought to have the tax men at the courthouses in various places, as we now do, where people could go in and consult with the tax collectors, as to just what they ought to pay and just what they shouldn't pay.

Now, I am on this committee, but in my own case I just hate to file my own return without the help of someone, because this thing has gotten to be terribly complicated. And one of the things we are trying to do in this bill is to make it less complicated, so that it is easier for the taxpayer to pay what he actually owes his Government.

The CHAIRMAN. I also want to add that I am a virtuous man also. Senator Byrd is the only one who has not made a self-serving declaration.

Let's proceed with the hearing.

Mr. ELDER. Senator, I certainly appreciate that this point has been established, because if it has been established, it has been established to my satisfaction. If we assume that most taxpayers are paying what they should pay, that leaves me only with the conclusion that to the extent that the lower-income groups, to which I referred earlier, are paying a disproportionately heavy percentage of their total income in income taxes and other taxes to the Government, as compared with the people in the upper-income groups, that is the result of laws that have been enacted by Congress in past years. Certainly not this Congress yet, because this Congress has time to go, and I am assuming it will do the right thing as far as this measure that is before it is concerned.

The CHAIRMAN. Let's assume that, and go ahead.

Mr. ELDER. All right. We are still on dividend exclusion and credit. And the one point I want to make—and this is with regard to this committee of which Dr. Groves was chairman, and that was this: That the concern of most members of that committee was with some type of integrating of corporate and personal income tax. And the one statement that I would like to read here on that is this:

> In reserving the right to change its mind, the committee has expressed preference for the dividend deduction at the corporate level.

Now, unless you gentlemen have questions on that, I am not going to go into any discussion, but I would say that that proposal would involve revenue loss possibly. Undoubtedly it was suggested in terms of an integration, not in terms of tax relief for any particular group, because it was not the feeling, as I recollect the discussion, that tax relief for dividends was necessary. A great many people do not agree that it constitutes double taxation. A corporation is one entity and the individual stockholder is another.

The CHAIRMAN. I don't want to prolong the discussion, but, of course, the corporation is an entity. But it is owned by somebody, and it is owned by the stockholder. So, he gets nicked at the corporate level, and he also gets nicked at the personal level. And that is the point.

I don't think you can build up a fiction that the corporation is entirely separated from people, that it is a villainous institution that roosts down in the alleys of the financial district of New York, and is working all sorts of sinister designs against the citizen of the United States. I think it used to be maybe that they controlled or had a greater measure of control over the economy of this country than they now have, but I think if you are looking for fellows hiding and conspiring behind the ashcans in the alleys leading into Wall Street, conspiring, I think you will find the United States Government itself, as it used to be, is a better place to look.

Mr. ELDER. I am not suggesting that, Senator. I am merely suggesting, to the extent that the shareholders believe, that under the present dispensation they are subject to double taxation, and they have recourse under the law. That is, they can set up business on a partnership basis and be taxed directly once.

The CHAIRMAN. They can do that, whether a corporation or not, on a partnership basis.

Mr. ELDER. That is correct.

Considerable publicity was given to the initial action of the House Ways and Means Committee in approving a dividend credit provision that would have resulted in the eventual loss of considerably in excess of $1 billion yearly. This fact would seem to argue that proponents of tax savings for stockholder taxpayers, who least require tax relief, regard the present proposal as an initial step in the elimination of taxation of corporate dividends. We strongly urge your committee to delete this section of H. R. 8300.

Now, I would like briefly to comment on depreciation.

The report of the Committee on Ways and Means lists the revenue loss anticipated through the operation of the proposed amendments liberalizing depreciation at $375 million for fiscal 1955. Regarding probable future losses, the report, page 25, states:

> In the second and immediately subsequent years, there would be greater losses if the effect on investment were ignored, but it is highly likely that by that time the stimulus which the new formula brings will have produced a volume of additional investment and taxable income which will result in there being no net revenue loss under this provision.

In contrast, the minority group of the Ways and Means Committee quotes estimates of the Joint Committee on Internal Revenue to the effect that the shifting over to the new methods of depreciation will involve revenue loss of $375 million in the first year, $1,040 million in the second year, and $1,550 million in the third year. The minority statement further estimates that before annual average depreciation under the new method is at a level approximately that under present law, the sum of $19 billion in tax revenue will have been irretrievably lost.

Now, I am not commenting upon the accuracy of these figures. I am merely pointing out that these figures are referred to, are given as estimates of people whom I assume have looked into the situation thoroughly, and have information much later than that which is available to me.

Senator BENNETT. At this point, Mr. Chairman, I am interested in the word "irretrievably." Can you point out to the committee how it is possible to so manipulate depreciation so that a businessman can take it twice on the same article?

Mr. ELDER. No, there is no suggestion that that is the case. The statement of the minority committee merely is to the effect that in a shift from this present system to a new system, a certain amount of revenue will be lost, in gradually increasing amounts, until it reaches a certain point, after which it will decline. And, that at the end of a certain period—18 years, I believe it is—we will have reached a level, and from that point on there will be no revenue lost. That is, we can anticipate that the revenue loss will have ceased and that the amount of taxation will be at the level that it is now, approximately, assuming no expansion. If there is an expansion, naturally whatever the system, you are going to have an increase.

Senator BENNETT. That would assume that for the next 18 years we would have a disproportionately high depreciation rate.

Mr. ELDER. No.

Senator BENNETT. How else could you assume there could be a revenue loss during these 18 years?

Mr. ELDER. Yes, it assumes that in the shift there will be a greater revenue loss.

Senator BENNETT. I have before me, and you may not have seen this, so that I am talking perhaps without your having the figures to check, as you talked without our having figures to check, a minute ago——

Mr. ELDER. Yes.

Senator BENNETT. The proposal of the Treasury is to permit depreciation on the basis of a declining balance.

Mr. ELDER. That is right.

Senator BENNETT. And their forms shows that, taking a 10-year-life basis, on a straight-line basis of a 10-percent depreciation per year, at the end of 10 years there would be no value left.

But, on their declining balance, at the end of 10 years there would be approximately 11 percent of the value left. So that over the years the actual depreciation that could be claimed and deducted would be 10 percent less on the declining-balance basis than it would be on the straight-line basis.

And, on that basis, it is hard for me to see how you can claim that for 18 years there is going to be a revenue loss, when actually the man whose chooses the declining-balance basis has an advantage for 4 years, for the first 4 years. Taking our 10-percent basis again as an example, taking the example in the table, with $100,000 investment on a straight 10-year declining basis, it is $10,000 a year that he deducts for depreciation. On the declining basis he deducts $20,000 the first year, $16,000 the second, $12,000 the third, $10,200 the fourth, and from then on, for the rest of the 10 years, he is depreciating at a rate less than $10,000. Until the last year he is only taking off $2,684. And, since you are working toward infinity on this declining-balance basis, there will always be a balance, no matter how far you go.

So, as a matter of fact, it seems to me that it is contrary to the facts to claim that there will be for 18 years an irretrievable loss of revenue, because you choose this rather than the straight-line basis of depreciation. After all, you can only depreciate an article once, no matter which basis you use.

And, while I will agree that the adoption of this basis—and which, by the way, as you remember, in the bill only refers to new purchases; you can't go back and adjust your existing investment—while this will represent an adjustment, while it may represent a variation in the pattern, actually under it I can't see how anybody will eventually be permitted to charge off more depreciation than 100 percent. And if he can't do that, how can he get a depreciation advantage and make a great saving in taxes and reduce the tax revenue over the period of the depreciable life of his investment.

Mr. ELDER. Senator, I would like to say this with regard to that point, and then I have one other point on this.

No. 1, with regard to the estimates of revenue loss, I read the report of the committee and I see the statement on this matter that in effect there will be no revenue loss; that because of an anticipated expansion in capital expenditures, due to the stimulation that will be provided by this, plus the normal anticipated expansion, whatever revenue loss there is immediately or in the near future will be made up.

Now, if that is so, taken together with what you have added, the assumption would be that in the ordinary course of events we actually will be receiving more revenue as a result of this provision, than otherwise. But I can't accept that, in view of the fact that I believe the minority statement, which is in this same volume, develops this thesis that there will be an irretrievable loss of the amount that I stated. And I don't believe it is a matter for me to decide. It is a matter for your committee to determine. I raise this as a question.

Now, one thing more I think should be said, and then I have one or two short points further on this particular topic. On the matter of revenue loss I think we recognize that taxes now are at an abnormally high level. There is an added advantage taxwise to those corporations that are in this fortunate position of taking advantage of this particular provision at this time. And there are many corporations that do not gain through this because they do not employ a large amount of capital in capital goods, or capital equipment.

That being the case, I think you can see that they can anticipate a preferential—or that I believe they are given preferential treatment.

Senator BENNETT. I would just like to remind you that we had accelerated depreciation in World War II, and fellows who took that paid more taxes than the men who took the normal rate of depreciation, because the tax rates went up after World War II.

We had accelerated depreciation again during the Korean war, and we are still postponing the day when corporate tax rates will be reduced.

Mr. ELDER. For a year.

Senator BENNETT. Well, we are postponing it. And, one of the things you learn in this business is that postponement of dates like that goes on, or tends to go on and on. We are not deciding today that corporate rates will be reduced next April. We are deciding that they won't be reduced before next April, with the possibility that the committee, meeting next spring, will continue them, if the situation makes it necessary.

You and I are in complete disagreement on this basis. We are entitled to our own opinion. I have operated a business for 30 years, and I have never been able to figure out a way to get a tax advantage through an attempt to manipulate depreciation. You have the opportunity to depreciate your asset once, no more than that, and on that basis it is impossible for me to accept the word "irretrievably," no matter who says it.

Senator LONG. Might I just ask the witness this question with regard to that point: As long as a person continues to expand his operation, isn't there a possibility that he can stay ahead of the Government ever getting the money back. In other words, if you buy equipment and you depreciate it 20 percent the first year, when you ordinarily would have depreciated it 10 percent on the straight-line basis and, let us say, by having a larger deduction for the first 2 or 3 years with that equipment, about the time when you would no longer be depreciating that equipment, if you buy more equipment you can continue to hold down the amount that you would pay by means of depreciation. And, as long as you continue to expand your operation to the extent that you expand it, that indicates that there is a tax loss as far as the Government is concerned.

Mr. ELDER. That is true, Senator. And I think, of course, in that connection the fact that this defense emergency setup, under which war contractors, defense production contractors, were allowed accelerated depreciation privileges, is a particular case in point. I mean it would seem to me to argue that there is validity in the contention that this need for depreciation allowance should be taken into account. I feel that would emphasize the need for approaching it rather on a short-run basis than suggesting the inauguration of an entirely new policy.

I note, for example, in the Wall Street Journal of Wednesday, a reference to the fact that—

> fast writeoffs of protective construction for defense plants have been extended to additional areas by the Office of Defense Mobilization. Previously, only plants in 70 critical target areas were eligible for 100 percent accelerated amortization of funds spent for protective construction. This treatment has been extended to defense supporting plants in all of the 193 target areas designed by the Federal Civil Defense Administration.

Senator BENNETT. Do you think that was in order to give them tax advantage?

Mr. ELDER. No.

Senator BENNETT. Actually, the purpose of that, the value of accelerated depreciation, is to facilitate the financing of a wartime program, because with accelerated depreciation the banker sees a better opportunity for his borrower to earn enough money to pay his principal back. There is that advantage.

But, so far as the effect on depreciation itself, I have never been able to figure out a way by which it would have any ultimate effect.

The CHAIRMAN. We have to hear one more witness. Unless there is some burning question a member of the committee wants to ask, I suggest that you bring your talk to the best possible conclusion.

Senator FLANDERS. I would like to raise a question very briefly.

The CHAIRMAN. All right, let's have the burning question.

Senator FLANDERS. When neither the witness nor my colleague from Louisiana raises the question of what harmful results would obtain if a company continued to expand its operations, which means its production, which means its employment, isn't that just exactly what we are aiming for? Are we not trying to do that? That is the question I raise with regard to that.

Senator LONG. The point I want to make, Mr. Chairman, and the point I have been trying to make in this connection, is that I would completely agree that there is merit to accelerated depreciation, and I wouldn't question that for a moment. But I don't want to be misled about this matter. It is going to cost revenue to the Government. It is just that simple, as far as I am concerned. You are not going to collect as much money when you collect accelerated depreciation if you didn't get it.

Senator BENNETT. You are not going to collect it in 5 years, but over the life of the plant you are going to collect exactly the same, the tax rate being identical.

The CHAIRMAN. Proceed, please, Mr. Elder.

Mr. Elder. I have more on this topic, but I will omit it. It will be in the record.

The Chairman. Yes; it will be in the record.

Mr. Elder. We do wish to call to your attention several new provisions in H. R. 8300 governing deferred compensation, pension and profit sharing trusts. These provisions may not involve substantial revenue loss; however, they do propose the legalization of discrimination which we believe should not be sanctioned by your committee.

Section 165 (a) of the Revenue Code stipulates the requirements that must be met by pension and profit-sharing trusts to be exempt from taxation. To qualify under 165 (a) a plan must be classified as nondiscriminatory or alternately it must meet the percentage rules set forth in section 165 (a) (3) (A). It may be noted that the percentage classification is almost never applied, so that almost any plan which qualifies today must qualify under the nondiscriminatory provision. The existing law also requires that benefits be nondiscriminatory except that recognition may be given to benefits available under the social-security and/or railroad-retirement programs.

Section 501 (e) (3) of the bill is to replace section 165 (a). Instead of the nondiscrimination rule, it sets forth a new set of arbitrary rules. The test for discrimination becomes if (*a*) more than 30 percent of the contributions under the plan are used to provide benefits for shareholders; or (*b*) more than 10 percent of the participants are key employees. Further, the plan will qualify only if the appropriate percentage of regular employees are covered where the appropriate percentage is 50 percent if there are less than 20 employees (but not less than 10) and 25 percent if there are more than 20 employees (but not more than a total of 100). (Key employees are defined as the highest paid 10 percent of the employees.)

Thus an employer with one employee can provide a plan for himself. This is not possible under the present law.

An employer who sets up a plan for 40 employees under the present law must provide nondiscriminatory treatment as to coverage and benefits. Under the bill he is permitted to cover any 10 employees on any basis he may desire.

An employer with 50,000 employees must under the present law provide nondiscriminatory coverage and benefits. Under the bill he may cover any 1,000 employees without any question as to discrimination because he will not violate the 30-percent rule and he cannot violate the key-employee rule since by definition he cannot have more than 100 key employees regardless of the number of employees.

Section 501 (e) (4) (A) permits discrimination in pension benefits. The plan will cover employees making over $4,000 only and provide for benefits based on the first dollar of income. If such a plan provides for benefits of 40 percent of pay, the excluded employee earning $4,000 gets nothing; the covered employee earning $4,001 will get 40 percent of $4,001 or $1,600.40 in addition to whatever social security may provide.

Under present law, if employees earning less than any particular salary level are excluded from the plan, you cannot provide covered employees with benefits on the excluded amounts. For example, in the above case no benefits are allowable on the first $4,000 income of covered employees if employees earning $4,001 are not similarly treated.

Section 501 (e) (4) (B): Under this provision an employer with 50 employees covered by a profit-sharing plan may provide 10 percent of compensation out of profits to all employees covered by provide 20 percent to 1 or 2 individuals who incidentally may be major stockholders earning far in excess of other employees.

The last paragraph of section 501 (e) (4) permits one shot profit-sharing trusts under which the employer would not be required to continue the plan beyond one single payment. At the present time a profit-sharing plan must be a permanent program in order to qualify. The tax loss from this seemingly minor proposed change could be extremely large.

Section 501 (e) does not specifically cover industrywide pension plans established as a result of collective bargaining. We believe that the law should make specific provision for such plans so that there is no question as to their eligibility.

Mr. ELDER. We do not propose any tax-reduction plan which would imperil the financial security of the Government. We have already noted, however, that H. R. 8300 will result in initial revenue loss of $1.4 billion and ultimately $3.5 to $4.5 billion yearly loss in revenue. We urge your committee to give serious consideration to replacing the reductions proposed in H. R. 8300 by reductions that would be more equitable and more nearly in accord with current and future economic needs.

To achieve these ends, we propose that tax relief be concentrated on two major points: Reducing the rates from 20 percent to 10 percent on the first $500 of net taxable income, and raising exemptions by $100. If it should be proved that it is not feasible at the present time to do both of these things, then we believe priority should be given to the reduction in rates.

This program would help those people who need the help the most. A single person, for example, earning $1,600 would find his taxes reduced through the rate reduction from $168 to $118. A $100 increase in the exemption would further cut his tax bill to $98.

A married couple with an income of $3,000 would have their tax bill reduced from $300 to $200 by the reduction in rate, and the exemption increase would further cut their taxes to $160.

As between rate reduction and an increase in exemptions, if a choice must be made, we believe it should be made in favor of the reduction of the rate to 10 percent on the first $500 of net taxable income. This rate reduction would cost less, and it would do more to aid those who need aid than would the increase in the exemption. The total cost of the rate reduction would be $2 billion a year, as opposed to $2.5 billion which raising the exemptions would involve.

The single taxpayer earning $1,600 would save $50 a year through the rate reduction proposed, as against a $20 saving through the exemption increase. The married couple with an income of $3,000 would save $100 by rate reduction, as against $40 through the increased exemption.

Reduction of the tax rate to 10 percent on the first $500 of net taxable income would yield the greatest benefits to taxpayers most in need; it would distribute those benefits most equitably; and it would do it at a minimum cost to the Federal Government.

If I might comment just briefly on this point, I would like to refer to the fact that in Canada you have a $1,000 exemption for adult taxpayers. That is for the husband and wife. And you have a 15 percent beginning tax rate, as against a 20 percent beginning tax rate here, with like exemption of only $600 for adult taxpayers.

INTEGRATED PROGRAM NECESSARY

No tax policy can in itself create a prosperous economy. If they are to be really effective, tax reductions should be an integrated part of a whole economic program. There is no assurance that any kind of tax reductions will automatically bring about necessary increases in spending or the fullest possible level of employment. These results will be brought about only if tax cuts are combined with other measures designed to insure the economic health of the Nation.

Most important of those other economic measures which should go hand in hand with tax reductions is the development of an urgently needed program of public works, carried on by the Federal Government in cooperation with the States and the local governments.

In his January 1954 Economic Report, President Eisenhower indicated something of the tremendous need for public works. Our roads, he warns, will wear out faster than they can be rebuilt unless we invest an estimated $8 billion a year for the next decade to work down the tremendous backlog of needed highways and to keep those already built in usuable condition.

The President further indicated in his report the need for an annual expenditure of $5.5 billion to meet the needs of 10 million elementary and high school pupils who do not have adequate school facilities. Even at that rate, it will be at least 5 years before we have worked down the existing backlog. Another $1¼ billion a year is needed, the President estimates, to bring American colleges and universities up to standard within the next 10 years. This adds up to a total of $6¾ billion a year needed for school construction, compared to the $2.5 billion yearly currently being spent.

Other needs for public construction cited in the President's report include more than doubling the rate of construction of hospitals and of water and sewerage facilities.

All in all the President outlines a need for an annual expenditure for public works of $19¼ billion, an increase of more than $8 billion over the $11.2 billion spent in 1953. Failure to meet these needs can mean continued human and economic loss to our Nation.

Yet, in the face of this need for stepped up public construction, reports from the Departments of Labor and Commerce for the first quarter of 1954 indicate that Federal spending for new public construction was down 17 percent over the corresponding period of one year ago, more than offsetting an 8 percent rise in State and local expenditures.

Tax cuts cannot compensate for shortsighted policy. But a sound tax program combined with an accelerated program of public investment in roads, schools, housing, hospitals, water and sewerage facilities, and other construction can do much to promote increased buying power, full employment, and a healthy American economy.

Unfortunately, the President's report proposes no specific program to finance the additional public works. In our opinion such a long-range program is needed. Experience has shown that neither the States nor the local communities are in a position to finance these needed public works out of existing sources of revenue. Many State governmental units are hampered by archaic tax laws and constitutional restrictions on their taxing power; competition between taxing units has led to adoption of regressive tax laws based on the taxpayers' "inability to resist" rather than on their "ability to pay." In spite of increasing recourse to sales taxes, payroll taxes and nuisance taxes of various kinds, tax revenue of States and large cities in many instances is inadequate to meet current needs and make sufficient provision for expansion of services and public works. During the 5-year period from 1948 to 1952, State and local indebtedness increased from $18.7 billion to $29.6 billion, an average increase of over $2 billion a year. During this 5-year period, State and local debt increased by 58 percent, whereas the Federal Government debt increased less than 3 percent. But even with mounting debts, State and local governments are unable to meet the need for public works which was outlined in the President's Economic Report.

FEDERAL, STATE, LOCAL SHARING

We believe a practical answer to this problem so directly related to the economic health of the Nation is greater use of the Federal taxing power to enable States and local governmental units to provide necessary public works. A program of sharing of tax revenue under Federal auspices should be inaugurated to supplement existing programs of grants-in-aid to the States. The taxing power of the Dominion Government in Canada is being used in the income-tax field for the benefit of the provinces.

Our Federal Government could use its taxing power with no less effect for the benefit of our States and local governments.

Here we are, in a period in which it is essential that the State and local expenditures should be increased for very much needed public works.

President Eisenhower has referred to the fact that we would need at least $8 billion or more a year to take care of much needed additional public works. And I think he made this statement in the Economic Report, where at some length is set forth the need for public works in various categories.

Now, we know that the present situation is such that the State governments and local governments are going into debt at the rate of $2 billion a year, and still they are not taking care of these needed additional public works. In many cases they are not keeping up with the current needs for services, and we know the reason. We know that the reason is archaic constitutional restrictions, limitations on local taxing power, competition between States, competition between municipalities and, finally, lack of tax resources in certain instances.

We feel that the answer to that is a closer integration between the Federal tax program and that of the States and the localities. It is our considered opinion that talking about throwing more responsibility on the State and local governments is whistling in the wind, because experience has shown that up to a certain point they will, but beyond that point, they won't, and in many cases they can't.

And that suggests to us the need for integrating the Federal tax program much more closely with the State and local programs than has been done up to this time. I say that principally because, on the basis of observation, we believe that increasingly State and local governments are trying to finance themselves, trying to lift themselves up by their bootstraps, and they just can't do it. They can't finance these needs out of nuisance taxes, excise taxes, sales taxes, payroll taxes—they just don't produce the revenue. Besides that, they are inequitable, they are uneconomic, they cost entirely too much for administration. And there is the answer.

In a way, I believe that answer has been suggested in Canada, where they have a system of sharing, under which the Dominion Government collects the income tax, and the revenue up to a certain point is shared with the provinces.

I believe that is an area which should be thoroughly explored, and if it is explored, I am persuaded that it would be possible to integrate the tax programs at the various levels much more closely with the economic needs of the entire Nation.

Mr. Chairman, I am very sorry that I have taken up as much of the lunch hour as it appears that I have. I appreciate your courtesy and the courtesy of all the members of the committee. Thank you very much.

The CHAIRMAN. We thank you very much for your testimony. It has been interesting. A lot of your time has been occupied by members of the committee, so no harm done. Thank you very much.

Mr. ELDER. Thank you.

(The following supplementary statement was subsequently supplied for the record:)

SUPPLEMENTARY STATEMENT OF ARTHUR A. ELDER

1. Dividend exclusion and credit

The attached tables amplify my comments regarding the proposed change in tax status for dividend income.

These tables represent summaries of data included in the 1950 Statistics of Income issued last fall by the Bureau of Internal Revenue. The tables indicate the distribution of dividend income among individuals who filed taxable income-tax returns.

Table I compares for different classes of adjusted income the total number of taxable returns and the number of returns reporting dividend income. As you can see, the percentage of returns with dividend income rises sharply in the higher income groups.

Table II shows the distribution of taxable returns, adjusted gross income, and dividend income. The table brings out closely the fact that dividend income is highly concentrated among the upper-income groups. In fact, the distribution of dividend income is far more highly concentrated at the upper end of the income scale than is the distribution of gross income itself.

It should be noted that these tables include dividends from both publicly owned and privately held corporations. They do not, of course, include dividends which were received by tax-exempt institutions or dividends received as fiduciary income. We have investigated this issue and according to the most reliable estimates dividends paid to trusts, tax-exempt institutions and similar groups, accounted for not more than 15 to 20 percent of total corporate dividends.

2. A. F. of L. proposal

Additional calculations have been made to estimate more accurately the revenue loss in the A. F. of L. proposal to reduce from 20 percent to 10 percent the tax rate on the first $500 of net taxable income. We now find that this proposal would involve a revenue loss of $2.9 billion.

TABLE I.—*United States individual income tax returns, 1950, with number of returns reporting dividend income*

Adjusted gross income class	Total number of taxable returns	Number of taxable returns with dividends	Percent of returns with dividend income
Under $1,000	1, 570, 113	27, 385	1. 7
$1,000 to $2,000	5, 996, 778	198, 338	3. 3
$2,000 to $3,000	8, 717, 908	335, 006	3. 8
$3,000 to $4,000	8, 668, 606	418, 587	4. 8
$4,000 to $5,000	5, 740, 400	415, 065	7. 2
$5,000 to $10,000	6, 114, 699	1, 023, 149	16. 7
$10,000 to $50,000	1, 295, 077	684, 884	52. 9
$50,000 to $100,000	62, 689	51, 312	81. 9
Over $100,000	20, 412	18, 388	90. 1
Total	38, 186, 682	3, 172, 114	8. 3

Source: Statistics of Income for 1950, pt. 1, preliminary report, Bureau of Internal Revenue, U. S. Treasury Department, 1953.

TABLE II.—*United States individual income tax returns, 1950, with data for taxable returns giving adjusted gross income and dividend income*

Adjusted gross income class	Total number of taxable returns	Percent of total returns	Adjusted gross income	Percent of gross income	Dividend income	Percent of dividend income
Under $1,000	1, 570, 113	4. 1	$1, 310, 810	0. 8	$19, 641	0. 3
$1,000 to $2,000	5, 996, 778	15. 7	9, 200, 478	5. 8	66, 816	1. 1
$2,000 to $3,000	8, 717, 908	22. 8	21, 943, 283	13. 8	159, 956	2. 7
$3,000 to $4,000	8, 668, 606	22. 7	30, 154, 986	19. 0	297, 477	5. 0
$4,000 to $5,000	5, 740, 400	15. 0	25, 557, 691	16. 2	299, 312	5. 1
$5,000 to $10,000	6, 114, 699	16. 0	39, 046, 068	24. 6	583, 456	9. 9
$10,000 to $50,000	1, 295, 077	3. 4	23, 081, 874	14. 6	2, 285, 455	38. 6
$50,000 to $100,000	62, 689	. 2	5, 579, 036	3. 5	866, 875	14. 7
$100,000 and over	20, 412	. 1	2, 670, 895	1. 7	1, 338, 931	22. 6
Total	38, 186, 682	100. 0	158, 545, 122	100. 0	5, 917, 919	100. 0

Source: Statistics of Income for 1950, pt. 1, preliminary report, Bureau of Internal Revenue, U. S. Treasury Department, 1953.

The CHAIRMAN. Senator Kem, we are very glad to have you with us.

This is Mr. James Kem, who was formerly a Senator from Missouri and a very highly respected member of this body.

STATEMENT OF HON. JAMES P. KEM, A FORMER UNITED STATES SENATOR FROM THE STATE OF MISSOURI, ON BEHALF OF FIELD FOUNDATION, INC.

Senator KEM. Thank you very much, Mr. Chairman and gentlemen of the committee. I am appearing on behalf of the Field Foundation, Inc., which is a charitable trust.

The CHAIRMAN. Excuse me. I will be back in a moment. We will have a 2-minute recess.

(A short recess was taken.)

The CHAIRMAN. The meeting will come to order. Proceed, Senator Kem.

Senator KEM. Mr. Chairman, my name is James P. Kem, and I am appearing here on behalf of the Field Foundation, Inc., which is a charitable organization.

My reason for appearing before this committee is to propose an amendment to section 514 of H. R. 8300. This amendment is intended to clarify a provision relating to the rental income of charitable organizations, such as the Field Foundation.

The Field Foundation authorized philanthropic grants totaling $715,866.85 in the fiscal year ended September 30, 1953. Net appropriations for exclusively charitable, scientific, and educational purposes total $4,429,992.72 since the foundation's first award in 1941. Typical grants have been made to the Child Research Council of the University of Colorado, at Denver, to explore personality development of infants and preschool children; Haverford College in Haverford, Pa., for a graduate program in assistance of undeveloped regions; and the United States Children's Bureau, Washington, D. C., to develop action against rising juvenile delinquency.

Similar grants have been made to study the value of the adviser in teacher training; to improve day camps and afterschool play groups; and to study the problems of mental health, with particular emphasis on the problems of maladjusted children.

The principal asset of the Field Foundation is a large office building in Chicago, known as the Field Building. By its charter, the funds of the foundation are confined exclusively to charitable, scientific, and educational fields.

As this committee of course knows, the Revenue Act of 1950 for the first time imposed a tax on certain income of charitable and other tax-exempt organizations. Among other things, Congress taxed the rents which a charity derives from a so-called supplement U lease. Generally speaking, section 423 of the present code defines a "supplement U lease" as a lease of real estate for more than 5 years where the lessor is a charity which acquired the real estate on borrowed funds. Congress enacted the special provisions on supplement U leases in order to deal with what had come to be known as the leaseback.

This committee, as well as the Ways and Means Committee, felt that in some instances charities were trading on their tax exemption. In other words, they were functioning as conduits for privately owned business. Instead of buying real estate directly, the business would have a charity buy the property and then rent the property from the charity on a long-term lease. Since the charity would be receiving tax-exempt income, it could borrow the necessary funds on more favorable terms to the lender than the privately owned business could afford. For example, it could more rapidly amortize the debt, using the money which a private business would have to pay in tax. At the same time, the tax exemption enabled the charity to lease the property on generous terms to the privately owned enterprise. Moreover, under this arrangement the private lessee could write off each year its entire rent instead of the much lower depreciation deductions to which it would have been entitled as the direct purchaser of the property.

Since leaseback arrangements depended on the use of long-term leases, the Congress carefully distinguished between long-term leases and short-term leases. Needless to say, the Congress was well aware that many charitable organizations traditionally invest in real estate, and it had no desire to disturb these routine investments. Therefore, the line was painstakingly drawn at 5 years. In short, rents derived from a lease of property for more than 5 years are now subjected to tax, and rents from a lease for 5 years or less are not.

In the case of large commercial property, such as an office building, some of the available space may be occupied for more than 5 years and some for shorter terms. In order to cover such cases, the code contains detailed rules for determining whether all or any part of the rents from the long-term leases is to be taxed. If, for example, 50 percent or more of the total area is leased for more than 5 years, or if 50 percent or more of the total rents are earned on such leases, all the rents from such leases are taxable under the formula contained in the statute. But, in any event—and Mr. Chairman and members of the committee, this is an important point—the rentals from short-term leases, defined in terms of 5 years or less, are not subject to tax.

Although the policy of the Congress is quite clear, the language of the statute inadvertently raises a disturbing problem. For example, a tenant may be in possession of a loft under a 5-year lease. At the end of the 4th year, negotiations are begun for the execution of a new lease. When the old lease still has 1 year to run, a new 5-year lease is executed.

The problem which seriously concerns my client, and I believe other similar foundations, is that some revenue agent may say that the remaining 1 year of the old lease should be tacked on to the term of the new lease, and then argue that the outstanding leasehold is for 6 years.

If that argument is sound, a new lease could never be executed until the stroke of midnight of the day on which the old lease expired. I am sure that the Congress never intended so incongruous a result. Certainly, it would impose an impossible burden, for as a practical matter a 5-year lease could not be extended without subjecting the lessor to tax. The problem, then, is particularly acute where the tenant contemplates making leasehold improvements in the expectation of renewing its present lease.

Since it is perfectly clear under present law that 5-year leases are not objectionable, there must, from a practical standpoint, come a time when the landlord and tenant can negotiate a new lease for a new 5-year term. Obviously, they should be able to do so without incurring a discriminatory heavy tax burden designed by the Congress for an entirely different sort of case.

On the other hand, we recognize that if there is to be no tacking of successive leases, tax avoidance schemes might undermine the whole purpose of the law. A lessor and lessee could, in effect, create a long-term lease by rapidly executing a series of separate leases, each for 5 years. Perhaps the courts would look through this kind of scheme and treat the successive leases as one continuous lease. However, this possibility of avoidance, of determining whether or not such an integrated scheme existed, does present serious difficulties at the administrative level.

It seems obvious that some specific rule should be devised to clarify the methods which may be employed in negotiating new leases. At the same time, the rule should be so drawn as to preclude abuses of the type just mentioned.

It is suggested that provision be made in H. R. 8300 for a definite period during which the landlord and tenant may execute a new lease, without raising any doubt as to whether the new lease will be treated as an independent transaction.

In the practical operation of real estate, renewals are ordinarily made during the last half of the current term. It is therefore suggested that H. R. 8300 be amended so as to permit a new short-term lease to be executed during the last half of the current term without the unexpired portion of the old lease being tacked on to the new lease for the purpose of determining the length of the new lease.

My purpose in appearing here is not to raise any question as to the policy of the legislation that is now generally known as supplement U. I recognize that it is intended to correct an abuse which disturbed the Congress. My only purpose here is to invite the attention of the committee to a situation which, in my judgment, needs clarification. In order to accomplish this clarification, we are proposing an amendment to the present law. I won't take the time to read that now.

The CHAIRMAN. Did you discuss that with the director of our staff, Mr. Stam?

Senator KEM. I haven't had the opportunity to do so, but I will. I won't take up the time now to discuss the verbiage of the amendment.

The CHAIRMAN. The best way to get that settled is to talk with the director.

(The proposed amendment referred to, of sec. 514 (b) (2) (A), of H. R. 8300, follows:)

That section 514 (b) (2) (A) of H. R. 8300 be amended to read as follows:

"(A) In computing the term of a lease which contains an option for renewal or extension, the term of such lease shall be considered as including any period for which such option may be exercised; and the term of any lease made pursuant to an exercise of such option shall include the period during which the prior lease was in effect. *In computing the term of a new lease which is executed before the date of termination of an existing lease held by the same tenant with whom such new lease is made, the term of such new lease shall be considered as including the unexpired portion of such existing lease for the purpose of determining the term of such new lease unless such new lease (if for a term of not more than 5 years) shall be executed during the second half of the term of such existing lease (but in no event prior to 2½ years from the date of expiration of such existing lease).* If real property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition." [Italics indicate material inserted.]

The CHAIRMAN. Thank you very much, Senator Kem. We appreciate seeing you here.

Senator KEM. Thank you very much, Mr. Chairman, for your usual courtesy.

The CHAIRMAN. We will meet again Monday morning at 10 o'clock.

(By direction of the chairman, the following is made a part of the record:)

WASHINGTON, D. C., *April 9, 1954.*

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I am informed that the Senate Finance Committee, in its consideration of the revision of the Internal Revenue Code, does not have sufficient time to hear testimony on proposed changes which have already been heard by the House Ways and Means Committee.

I am writing to you in support of an amendment to section 213 (e) (1) (A) of the proposed Internal Revenue Code of 1954. The amendment would add the phrase "including amounts paid for antiseptic diaper service."

Testimony in support of such an amendment was presented before the House Ways and Means Committee on June 17, 1953, by Mr. Harper L. Schimpff. His statement is contained in the report of that committee.

The substance of this amendment was covered by H. R. 5502 introduced by Representative Clifford Davis of Tennessee. Regrettably, Representative Davis was wounded by one of the Puerto Rican Nationalists and was unable to take a vigorous role in support of his bill. He did, however, return to the floor of Congress on the day when a final vote was taken in order to make a last plea for his amendment. A copy of his statement is enclosed.

In this communication I shall not attempt to repeat the detailed information presented by Mr. Schimpff to the House Ways and Means Committee. I realize how pressing your committee is with the many major issues contained in the bill, and unfortunately this often results in bypassing lesser issues, no matter how meritorious. For this reason I have condensed to less than 1 page the reasons which I believe justify your committee's favorable action on this amendment.

Very sincerely yours,

STANLEY I. POSNER.

[From the Congressional Record of Thursday, March 18, 1954, p. 3338]

Mr. DAVIS of Tennessee. Mr. Chairman, on June 2 of last year at the request of one of my constituents, I introduced H. R. 5502 which provides in effect that expenditures made for an antiseptic diaper service shall be considered a medical expense under the internal-revenue law. This bill is intended to give some modest assistance to parents of newborn infants during the year when they face their highest expenditures for the child, his hospital bills and fees to the doctors, as well as all of the other expenses which a new child brings to an American family.

Here in this country we give no bonuses or subsidies to the Americans who have sufficient faith in the future to bring new Americans into the world. Other countries, whose philosophies and ambitions require manpower for the battlefield, frequently give cash prizes to encourage large families.

Although we do not encourage population increase for the battlefield, the annual addition to our population is one of the greatest stimulating factors which exist for the American economic progress and we should not overlook the stimulus which these new children bring to our economy.

American babies are among the healthiest in the world. Nevertheless, each year more than 25 of each 1,000 livebirths die within the first year. Recent medical investigation discloses that a significant number of these deaths have their origin in the common skin irritation known generally as "diaper rash." It has been medically demonstrated that the use of antiseptic diaper service will prevent this common disease and thereby avoid the necessity for the suffering and medical expense and even deaths which may otherwise occur. In my opinion, and I am joined by many others in that opinion, payments for this preventive measure are entirely justified expenses to prevent or cure disease. However, under the existing regulations there may be some doubt as to the availability of the deduction in some cases or others. My bill is intended to clarify the situation and I earnestly urge the Ways and Means Committee to accept an amendment to this effect.

BRIEF SUMMARY OF REASONS FOR TAX DEDUCTIBILITY OF ANTISEPTIC DIAPER SERVICE

1. Diaper rash is a skin infection so common among infants that prevention is a necessary part of baby care. Antiseptic diaper service not only prevents, but cures. In 1 medical study of 50 diaper-rash cases, 49 were cured in a week after impregnated diapers were used. (Journal of Pediatrics, 1947; Current Medical Digest, January 1948.)

2. Complications from diaper rash may be serious or fatal. Boric-acid poisoning, for example, can enter the skin. A recent study of 109 cases of such poisoning shows more than 70 percent mortality for babies under a year old. It is believed that many unreported cases have occurred in addition to those diagnosed. (Journal of Pediatrics, December 1953.)

3. Infectious diarrhea may also be transmitted through diapers if not made bacteriostatic as antiseptic service does.

Worse than polio? If all the facts were known, it is likely that diaper rash leads to more infant deaths than infantile paralysis.

The infant mortality rate has declined through the years. In 1930, when diaper services began, more than 64 babies, out of 1,000 born alive, died before they were a year old. By 1952, the rate had been cut below 29, or less than half.

Many advances in medicine and infant care were responsible. Among them, antiseptic diaper service was by no means the least.

The antiseptic process is not exclusive: Any diaper service can use it at extra cost.

Tax deductibility will help bring such service within the reach of families heavily burdened by the high costs of modern baby care, especially those in the middle-income brackets.

It is only fair that the Congress adopt this amendment to the pending general tax-revision bill.

NATIONAL INSTITUTE OF DIAPER SERVICES, INC.
By STANLEY I. POSNER, *General Counsel.*

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D. C., April 9, 1954.

Hon. EUGENE D. MILLIKEN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR MR. CHAIRMAN: I am in receipt of a letter from Miss Marion P. Lang who is the sole support of her mother who is totally blind. Miss Lang's situation is one which I sincerely feel should be given consideration by your committee when making changes in the present tax bill.

Her father died 5 years ago and she is now the head of the family which consists of her mother who, as I mentioned before, is totally blind, and entirely dependent upon Miss Lang for support. There is also the added expense of a seeing-eye dog for her mother. As the law now reads, Miss Lang cannot take two deductions for a blind person unless that person be either husband or wife. There are many other cases in our country of a son or daughter being the sole support of an elderly mother or father and actually being the head of that family, yet they cannot take the deductions accorded a husband or wife who is the head of a family.

These two inequities are worthy of serious consideration, and I would appreciate having your ideas on this important subject.

Thanking you for your interest in this problem, and with very best wishes, I am,

Sincerely yours,

WILLIAM B. WIDNALL.

HAVERHILL, N. H., *April 9, 1954.*

Senator EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee, Washington, D. C.

DEAR SENATOR MILLIKIN: As a shareholder who is dependent upon a meager amount of dividends for his livelihood I am taking the liberty of presenting to the committee at its public hearings on the House version of the Revenue Act of 1954 my opinion of the cure for double taxation of corporate profits incorporated therein. I presume that written opinions will be brought to the attention of the committee members just the same as the opinions of those who can afford to journey to Washington to deliver theirs in person.

For 10 years prior to retiring in 1946 on account of my health I was assistant director of General Motors Corp.'s tax section during which period Federal income taxes were my chief responsibility, so I have some knowledge of the matter.

If the Senate permits the President's dividend-tax proposals to be enacted the GOP will be putting itself into a pit from which it can't extricate itself in a hurry.

Yours very truly,

KENNETH JOHN MACDONALD.

TAXATION OF SHAREHOLDERS' INCOMES

(By Kenneth John MacDonald, Haverhill, N. H.)

Eighty-four years ago the Supreme Court ruled that the proportional interest of a shareholder in the profit of a corporation was income to him whether distributed or otherwise (*Collector* v. *Hubbard*, 1870). As the relationship of shareholder to corporation is exactly the same now as it was then it follows that the corporation tax and the dividend tax are both levied on the same income and from the same individuals.

Everyone agrees that it is wrong to tax the same income twice and that double taxation is unjust wherever it occurs. The House bill purports to remedy the situation, but it is quite plain that it would only aggravate it. A toothache will not be cured if the dentist extracts a perfectly sound tooth instead of the rotten one adjacent to it; yet that is exactly parallel to the measures proposed by the administration to cure the evil of double taxation.

Both the corporation tax and the dividend tax must be examined very closely before the cause of the injustice can be determined. Each must be made to pass muster standing upon its own feet and its merits or faults appraised independently of those of the other. A great degree of laxity in the taxation of profits remaining after payment of the corporation tax cannot be regarded as compensating for a greater degree of severity in the corporation tax itself.

The measures advocated by the President and adopted by the House are based upon the assumption that the injustice is caused by a fault in the dividend tax; an assumption which, although altogether false, has been built up and fostered by the greatest flood of propaganda ever brought to bear upon any subject in the realm of taxation. Powerful interests stand to gain much if they are enacted into law, but there are equally powerful reasons why they should be discarded not only for now but forever.

In the year 1952 corporations as a whole paid 54 percent of their so-called after-tax profits in dividends. While that was the highest percentage paid in any year since the war, it still left approximately $8 billion with the corporations to be added to the fund from which tax-free stock dividends and tax-free stock splits are made.

Assuming that the percentage paid in 1954 will be the same as in 1952 and (for the sake of simplicity) that the corporation tax will be 50 percent; then of every $2,000 earned the Government will take $1,000; the shareholders will receive $540; and the corporations will keep $460.

That means that each individual shareholder will pay tax at the rate of 100 percent on 50 percent of his proportional share of the earnings; that he will pay tax under the graduated rates on 27 percent of such share, and that he will pay no tax at all on the remaining 23 percent.

Now, each shareholder is in a position to figure out for himself whether he made a good or a bad bargain in paying tax at the rate of 100 percent on one-half of his income for the privilege of escaping tax on 23 percent of it. If his net income is below a certain point in the graduated-income scale, he will find that he is a loser; if it reaches but does not pass that point he will find that he is fully compensated; but if his income is above that point he will be pleased to learn that he is not only fully compensated, but is paid a bonus to boot. The lesser his income the greater his degree of loss, and the greater his income the greater his degree of gain.

Obviously, the injustice about which so much clamor has been raised cannot be corrected by paying a still greater bonus to the gainers before all the losers are at least made whole. Yet that is what the scheme sold to the House would do. Nobody can deny that.

From one point of view much could be said in favor of the proposition that the steeply graduated scale of tax rates should be abolished and that the Government should raise whatever revenue it needs by laying tax at a flat rate on all incomes regardless of size and without benefit of exemptions or deductions; everyone from the richest to the poorest would be taxed at the same rate and on his entire income. It is not difficult to determine who would find the most merit in that scheme. But, what is not generally recognized is that the corporation tax is that scheme enacted into law, or, that about 40 percent of all revenue raised by taxing incomes is raised by laying tax at a flat rate upon all shareholders.

Consider for example the situation of an aged blind person under its provisions. Such a person having an income of $2,000 from any source other than corporation profit will be allowed 3 exemptions of $600 each and $200 of deductions. Consequently he will pay no tax. But if his income is derived from corporation profit his exemptions and deductions will go by the board, and (as if that were not enough) he will be taxed at the same rate as a person earning upwards of $44,000; he will be deprived of $1,000 to support the Government while he will be lucky to get $540 to support himself.

As to the laxity and inadequacy of the dividend tax there is this to be said: If the 16th amendment gave Congress power to confiscate 50 percent (or any other percent) of the proportional interest of each shareholder in the profits of corporations for public use, one-half of such profits belongs to the Government as a matter of right and the other half belongs to the shareholder. Therefore nobody can dispute the fact that the shareholder is enriched by the half belonging to him to the same degree that one of partners who operate a corner grocery or an alley garage is enriched by his share of the partnership profit. Yet the latter is required to pay tax on every dollar he makes regardless of how little he draws for his personal use while the shareholder is taxed only for what he draws for his personal use regaradless of how much he makes.

Shareholders are the only taxpayers who are privileged to determine for themselves the extent to which their incomes shall be exposed to taxation. Nobody could imagine Congress even considering a proposal that the workmen in the factories be permitted to invest a portion of their wages in the companies which employ them without paying tax on the portion so invested. Yet the cases are exactly parallel. In 1952 alone shareholders invested $8 billion of their incomes without paying a nicket of tax. As Justice Brandeis once said in this connection: "Shareholders will pay taxes not upon their incomes, but only on the income of their income." "And," he might well have added, "not even on the whole of that."

The laxity and inadequacy of the dividend tax cannot be corrected by measures which were designed to make it still more lax and inadequate. A majority of the House were sold the idea that it is wrong to bring even as little as 27 percent of the incomes derived from corporation profits—the source of the very highest incomes—under the graduated rates and it accepted as a much-needed reform a scheme that is nothing more or less than an entering wedge designed to remove all corporation profits from tax under those high rates in the course of time.

Instead of paying still greater bonuses to those who are the gainers under the present tax laws Congress should do the exact opposite; it should deprive them of the privileges which they have hitherto enjoyed. Therefore its attention is directed to the 1954 counterpart of the $8 billion that escaped taxation in 1952. If just and equitable treatment of shareholders is the objective then the very first step taken should be toward bringing the profits retained by the corporations under the graduated rates by requiring each shareholder to report his proportional share of the earnings whether distributed or otherwise in the same manner as partners are required to report their incomes.

Then as much of the new revenue obtained from this hitherto untapped source as the Nation can afford to devote to the removal of injustice should be applied toward moderating the severity of the flat-rate tax that is collected through the corporations. With such a large sum of new revenue in sight, it might even be possible to limit application of the 100-percent tax to not more than 47 percent of each shareholder's income instead of increasing the portion so taxed to 52 percent as the President demands.

Once the profits retained by the corporations are brought to tax the payment of tax bonuses would cease; the interests of all shareholders would then lie in the same direction; even the richest would feel that in the absence of compensating privileges he should not be taxed at the rate of 100 percent on any part of his income. That in the end would mean that all corporation profits would be routed through the tax returns of the individual shareholders and thus brought under the graduated rates where exemptions and deductions are not treated as a mockery and a sham and where ability to pay is recognized as a just principle in spreading the tax burden over the people.

All shareholders are not rich. Just the other day the United States Steel Co. reported that 56 percent of the 280,000 individuals who own its stock had incomes of less than $5,000, and that the average income for that group was a little less than $2,800.

Justice to all shareholders, to all other taxpayers, and to the Public Treasury does not lie in the direction the House was induced to take. It lies in the exact opposite direction. Congress should constantly aim at bringing, not less and less, but more and more of shareholders' incomes under the graduated rates where they belong and where no person is cheated out of the exemptions applicable to his age and condition.

NATIONAL FARMERS' UNION,
Washington, D. C., April 5, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: National Farmers' Union is opposed to the "trickle down" program of tax cuts in the tax bill passed by the House of Representatives. As one means of increasing the purchasing power of these low- and middle-income bracket families, we urge the amending of the Internal Revenue Code to increase personal exemptions to $1,000.

Such a measure would leave more take-home pay in the pockets of these segments of the population, and the increased purchasing power would be reflected immediately in greater consumption of farm products and increased purchases of the products of industry.

Pertinent statements from the program for 1954–55, adopted by the delegates to recent Farmers' Union convention at Denver, Colo., are as follows:

"When, for whatever reason, the economic machinery of the Nation begins to slow down and fails to expand at the rate of 5 to 10 percent per year the economic repercussions are almost invariably felt first on the farms of the Nation. Farm costs remain high and inflexible. Prices received by farmers for the goods they sell drop, returning to farmers a smaller gross income from which to pay the high fixed costs. This means smaller income available for family living; less dollars to buy goods and services that have remained high in price. Farm purchasing power goes down, reducing the sales and jobs of those who produce industrial goods and provide services to farm people. Main street businessmen in the towns and cities of the farm areas feel the pinch and reduce orders; factories reduce production schedules and lay off workers; unemployment increases and consumer demand drops. The best way to prevent the development of a recession or depression is to follow policies that will maintain an expanding full employment economy. However, when a depression threatens special measures should be available for immediate use. We support the following:

"*Farm price supports.*—The first place to prevent a depression is on the farms through an adequate farm price-support program as outlined earlier in this statement.

"*Unemployment insurance.*—We are convinced that unemployment insurance should be made more universally applicable for all hired workers and the rate of payment should be constantly modernized to keep up with average increases in wage rates and costs of living. We endorse the idea of putting large corporations on the same footing with family farms with respect to overhead fixed costs of labor.

"*Public works shelf.*—We are convinced that the Federal and State Governments should have standby depression-control powers just as they have standby inflation-control powers. Both State and Federal Governments should have already prepared a full shelf of public works plans and blueprints ready for use to put people to work building schools, hospitals, highways, dams, soil, forest and water conservation works and other public projects at the first indication of growing unemployment.

"*Monetary and fiscal policy.*—Just as monetary and fiscal policy should be used to help curb inflationary developments so should it also be used to encourage the development of an expanding economy and to prevent the beginning or worsening of a depression condition.

"Federal tax legislation should be revised to raise personal exemptions up to $1,000, eliminate excise and sales taxes on the necessities of life, and reduce business taxes on small business. We are opposed to the imposition of a national general sales tax, manufacturer's tax, and other similar tax, by whatever name it may be advanced.

"Federal tax loopholes should be closed and sufficient tax rate increases for corporations and for those groups best able to pay should be levied to balance the Federal budget."

"We oppose the shifting of income taxes from high income brackets to low and middle income brackets and any limitation on the maximum percentage which may be levied."

The statement regarding taxes, minimum wages, and social security which was adopted by the National Dairy Producers Conference at Madison, Wis., on January 22 and 23, 1954, is as follows:

"Inasmuch is it is clearly demonstrated that increasing the purchasing power of lower-income families results in their increased consumption of dairy products, while equal increases in incomes of higher-income groups do not, we recommen: That any tax reduction made by Federal or State Governments should be tailored to benefit low-income families, preferably by raising the personal exemption; that the legal minimum wage should be raised and extended to additional workers, including agricultural workers; that benefits should be increased, and coverage extended to additional workers, including agricultural workers, of unemployment insurance workmen's disability programs; that social security benefits be increased and extended to additional workers, including agricultural workers and family-farm operators."

A statement adopted by the Montana Farmers Union convention, Great Falls, Mont., October 21 through 24, 1953, is as follows:

"Taxation should be considered a means of furthering the aims of our democracy. Meeting the constantly increasing costs of national defense and of administering our broadening domestic program presents a problem of tax distribution which calls for an honest tax program.

"Inequitable tax distribution has placed a burden upon low incomes. Inequitable taxes along with rising costs operate against a high standard of living which has become an American ideal.

"Plugging tax evasion loopholes would free large sums of money for tax purposes. Records reveal that life insurance companies have escaped paying taxes through weak and unworkable legislation. Oil companies evade paying millions of dollars of tax money through a favored depletion allowance tax clause and a reduction on oil royalties. Lack of adequate excess profits tax and income splitting constitute other methods of tax avoidance.

"We ask that farmers be permitted to adjust their net income over a period of years for taxing purposes.

"We hereby go on record as unalterably opposed to a Federal sales tax. We also are opposed to a new hidden sales tax on manufactured articles, a tax that would be added to retail selling price."

The North Dakota Farmers Union program for 1954 contains a statement on taxes as follows:

"All taxes for the purpose of raising revenue should be levied according to ability to pay. This principle rules out general taxes from high income brackets to low and middle income brackets, and any limitation on the maximum percentage which may be levied. This principle requires drastic steeply graduated gifts and inheritance taxes, and effective limits on individual net income.

Federal taxes

"Cooperative tax structure should be revised to prevent tax evasion and tax avoidance, to eliminate loopholes, provide tax levies which will stimulate production at capacity, particularly by small business, and deter monopolistic practices. This should include tax policies to encourage the distribution of income by requiring annual allocation of earnings to stockholders.

"We oppose the proposed imposition of a general Federal sales tax of manufacturers sales tax.

"To partially offset the increased and continually rising cost of living we recommend that personal exemptions be raised from the present $600 to at least $1,000.

"We abhor an economic or fiscal and monetary policy that condones and abets profiteering in time of war. Therefore, we favor continuance and improvement of the excess-profits tax that will effectively curb and prevent undue profits created by pressure from war or the defense program.

"We oppose the so-called millionaire constitutional amendment to limit income-tax rates to only 25 percent."

A statement from the Wisconsin Farmers Union program for 1953–54 is as follows:

"We believe that taxes should be levied according to ability to pay. We are opposed to any proposals for either a State or Federal sales tax.

"We reiterate our former statement that we are opposed to the principal of taxing cooperative savings. We shall continue to oppose double taxation of patronage refunds. We also oppose the program advocated by the National Tax Equality Association to remove the income-tax exemption provision for qualified agricultural cooperatives.

"We favor a continuation of the excess-profits tax after December 1953. In the light of corporation earnings, we favor an increase in the excess-profits-tax rate.

"We favor the elimination or plugging of all loopholes so as to tax income derived from present tax-exempt Federal, State, or local securities.

"We are opposed to the repeal of the State tax on oleomargarine.

"We favor enactment of a State graduated land tax to prevent the growth of corporation farming.

"We favor restoration of the State surtax on incomes to provide additional funds for State aid to rural schools.

"We take the position that tax money levied for the building of highways and roads should be used for this purpose; therefore, we are opposed to any plan which would destroy the segregation of highway tax income.

"We also believe that the income exemptions for personal incomes under Federal taxes should be increased in line with increased living costs."

The chain reaction of consumer buying that will be set off by an increase in personal income-tax exemptions will forestall to a great degree the further deterioration to the national economy. It will enable wage earners and farmers to increase standards of living and create additional jobs. The trickle-down theory is, we believe, wrong in concept, wrong in equity, and incapable of curing our economic ills.

I shall appreciate your including this letter in the record of your committee.

Sincerely,

James G. Patton, *President.*

Samuel N. Ain & Associates,
New York 5, N. Y., April 9, 1954.

Hon. Eugene D. Millikin,
Chairman, Finance Committee,
Senate Office Building, Washington 25, D. C.

Dear Senator: At a recent meeting of a large organization of technical people devoted to the problems of pension and profit-sharing plans, a panel discussed the effect of the H. R. 8300 on our field. The purpose of this organization is to serve as a forum for the dissemination of information on matters affecting this field. Its bylaws provide that it shall not take any position on legislative matters. Therefore, I am writing as an individual, an actuary specializing in such plans for 18 years, transmitting the views I expressed as a member of the panel.

In preparing to serve on the panel, I made a detailed study of three of the sections of the bill, sections 403, 501 (e), and 505. The possible effects of these provisions of the bill, particularly section 501 (e), were so horrifying to me that I feel the urgent necessity of bringing these consequences to your attention.

I traced, by example, the effect of the sections on a number of realistic situations. While I am confident that my analysis is correct, it is suggested that you have these examples (exhibit A) submitted to the Treasury Department for its interpretation of the effect of section 501 (e) on the situations presented. Alternately, you may wish to send all of my statement (exhibit B) to the Treasury for its comments. Your attention is particularly invited to pages 5 to 13 of this exhibit where marginal references are made to the examples in exhibit A. It is my opinion that you will find the results and consequences as alarming as I did.

It should be noted that the examples and views enclosed do not by any means call attention to all the anomalies, eccentricities, and undesirable results which will be produced. The full effect of this legislation on a technical, dynamic, and growing field, such as that of pension and profit-sharing plans, will not be known for some years to come. However, it is very clear to me now that the bill in its present form, particularly section 501 (e), opens the way to consequences most certainly not in the public interest. I am sure that you will agree with me after you have had an opportunity of studying the material submitted, and that you and the other members of your committee will want to take steps to avoid this unhappy result.

If I can be of any help to any of the members of your committee on the technical matters involved, please feel free to call upon me.

I am sending a copy of this letter to the other members of your committee.

Respectfully yours,

Samuel N. Ain, *Actuary.*

Exhibit A

Examples Relating to the Application of Section 501 (e)—501 (e) (3) Nondiscriminatory Classifications

Example I.—An employer with 40 regular employees seeks to adopt a pension plan covering only the 10 highest paid employees who would all be eligible to receive full benefits.

Question. Would the plan not be deemed discriminatory under the key-employees test because more than 10 percent of the participants are key employees?

Question. If so, would the plan nevertheless qualify under the exception to the key-employees test because of the percentage of regular employees covered?

Example II.—An employer with a large number of employees seeks to adopt a plan providing full benefits to the 1,000 highest paid employees none of whom own as much as 10 percent of the company's stock.

Question. Wouldn't this plan be nondiscriminatory because under the key-employees test the total number of key employees is limited to 100, a result which cannot exceed 10 percent of the total group of participants?

Question. Is it not true that so long as the plan covered at least 1,000 employees, the result of applying the key-employees test to this plan cannot be affected by the number of individuals employed, even if the plan covered as few as 1,000 of 200,000 employees?

Example III.—An employer has 40 regular salaried employees and 200 regular wage employees. He wishes to put in a plan covering all salaried employees, but excluding wage employees. The salaried group includes the highest five paid employees.

Question. Is it not impossible for the employer to cover all salaried employees in a plan without having the plan deemed discriminatory under the key-employees test?

Question. Is it not true that the employer cannot have recourse to the coverage exception to the key-employees test, since 40 salaried employees represent less than 25 percent of the total of all regular employees?

Question. If the wage employees were covered under a separate plan with benefits that are not strictly comparable, would the discrimination tests apply any differently to the salaried group?

Example IV.—An employer considers as regular employees persons with 5 or more years of service. He has 14 such employees, 8 of whom earn in excess of $3,600 a year. He has other employees with less than 5 years of service. He puts in a plan covering regular employees earning in excess of $3,600.

Question. Will this plan be deemed nondiscriminatory under the coverage principle even though violating the key-employees test?

After 1 year of the plan's existence 3 more employees become regular employees by attaining 5 years of service. None of them earn in excess of $3,600. The plan then covers 8 employees out of 17 regular employees.

Question. Does the plan then become discriminatory because the coverage principle can no longer be applied (less than 50 percent of the regular employees are now participants)?

Example V.—An employer has 800 employees with more than 5 years of service, 200 of whom earn over $3,600, and 300 employees with 1 to 4 years of service, 50 of whom earn over $3,600. The employer wishes to put in a plan covering regular employees earning in excess of $3,600.

Question. Will the plan be considered discriminatory if it were to cover:

(*a*) Employees with 5 or more years of service?

(*b*) Employees with 1 or more years of service?

Example VI.—A company employs 4 persons with 5 or more years of service including the principal stockholder and his wife. A plan is instituted covering only these latter two persons.

Question. Will the plan be considered discriminatory?

Question. If the only employees with more than 5 years of service were the principal stockholder and 1 other person, would it be discriminatory to cover just the principal stockholder?

Question. In the above 2 cases if the benefit is as high as, say, 75 percent of salary, will it alter the answers?

Example VII.—A company employes 40 persons including 10 salaried employees, 1 of whom is the principal stockholder. Assume that all the key employees are in the salaried group and that a plan is put into effect covering only salaried employees.

Question. Would the plan be discriminatory if all salaried employees were included?

Question. Would the plan be discriminatory if all salaried employees except the principal stockholder were included?

501 (E) (4) RATIO OF CONTRIBUTION AND BENEFITS

Example VIII.—An employer wishes to set up a plan covering all employees and providing 25 percent of final pay less primary social security. This plan, in effect, would provide no benefit on the first $4,080 of compensation but it would provide a benefit of 25 percent of any excess.

Question. Would these benefits be acceptable under present law?

Question. Would these benefits be acceptable under this section?

Question. If such a plan, qualified under the existing law, is amended to increase the rate of benefit from 25 percent to 30 percent, will the new benefits be acceptable?

Example IX.—An employer wishes to set up a plan covering only employees earning in excess of $6,000 a year. The coverage is acceptable under paragraph (3) and no other plan exists.

Question. Are benefits acceptable if the plan provides benefits of:

(*a*) 50 percent of that part of compensation in excess of $6,000?

(*b*) 50 percent of all compensation?

Example X.—A single profit-sharing trust qualifies under paragraph (3). The plan includes several employees who own 10 percent or more of the stock of the corporation.

Question. Could the contribution during any year be allocated so that the employee-shareholders each receive twice the percentage of his salary as any other covered employee, i. e., if each employee-stockholder receives 20 percent of his salary, each other employee will receive 10 percent of his own salary; if each employee-stockholder receives 29 percent of his salary, each other employee will receive 14½ percent of his own salary?

Example XI.—A large employer sets up several profit-sharing trusts each of which covers the president of the corporation. Each trust qualifies separately under paragraph (3). Contributions to each of the trusts are to be allocated in a manner satisfying the 75- to 25-percent limitation of paragraph (4) (B). The overall contribution to all of the trusts does not exceed 15 percent of the aggregate compensation of all the participants.

Question. Is it possible to allocate to the president in each trust twice the percentage of salary allocated to any other employee in that trust?

Question. By extension of this device would not the percentage credited to the president be limited only by the number of trusts established?

EXHIBIT B

Deductions for employer contributions to a pension, profit-sharing, annuity, or stock-bonus plan are now controlled by section 23 (p) of the code. It would be replaced by section 403 of the bill. The language of the general rule of 403 (a) is undoubtedly a tremendous improvement over the tortuous language of the general rule of section 23 (p) which became notoriously symbolic of governmental gobbledegook in a presidential campaign.

The limitation on deductions for contributions to a pension or annuity plan, now controlled by clauses (i), (ii), (iii), and (iv) of section 23 (p) (1) (A), would be controlled by subparagraphs (A), (B), (C), and (D) of section 403 (a) (1). The 5-percent limitation in clause (i) of the present code would be changed to 10 percent. The reference to periodic examinations by the Commissioner at not less than 5-year intervals would be removed. A provision has been added that where the past service cost with respect to the benefits of some employees has been fully funded and deducted, the limitation with respect to these employees, is the normal cost of their benefits. In order to determine when past service has been fully funded, separate calculations will have to be made with respect to individual or groups of employees only where different rates or types of benefits apply or where the nominal rates of benefits are subject to being offset by benefits under some other plan or program. The committee report tries to explain this with the example of a plan involving social-security offsets under which some employees' benefits will be completely wiped out by the offset, in which case, it says, no deduction will be allowable with respect to these employees. The reference to special calculations must go far beyond this rather obvious example. Suppose the past-service liability with respect to some employees is very small but in excess of zero, and 10 percent of their compensation will completely wipe out their past service liability in 1 year. On the other hand the past-service liability with respect to other employees remains substantial. It would seem to me that the language referred to contemplates the elimination, at least in subsequent years, of the compensation of the employees with respect to whom the past service has been wiped out. This provision is open to such strict interpretation that it could require almost individual calculations in some instances.

Let us consider the possible interpretation of this provision in a case where benefits are 1 percent of the first $3,600 and 2 percent on the excess. The Commissioner could say that the actual contributions with respect to those employees earning $3,600 or less and those employees who are earning in excess of $3,600 are to be determined separately each year, and that the earnings on the assets with respect to each of these groups of employees are to be maintained separately so that a computation can be made to determine whether there is any unfunded past service cost with respect to the lower paid employees who receive 1 percent benefits only. When an unfunded past service cost no longer exists, their compensation must be eliminated in determining the 10-percent limitation on contributions under paragraph (A). I do not think that the reference in this subparagraph to separate computations would give the taxpayer the opportunity of determining how the contributions are to be allocated for the purpose of making the determinations as to when the past-service cost of individual groups has been fully funded. Think of the case where an employer with a group annuity plan of an offset type or a group annuity plan with different rates or types of benefits wishes to claim his contributions under paragraph (A). The insurance company generally funds the past-service cost of those closest to retirement first. The insurance company will need to make additional calculations with respect to different groups of employees, or even individual employees, in order to determine when the past service cost for these groups has been fully funded. Only then can the employer fix his limitation on contributions by adding the normal cost for benefits for these groups to 10 percent of the compensation of the remaining participants. In such instances the record work and the computations might very well become quite detailed and cumbersome. In other instances it will be very simple.

Why has this complication been added? When the deductions under clause (i) are liberalized from 5 percent of compensation to 10 percent of compensation, the door is opened to much tax abuse. If the abuse is to be limited in extreme cases, such a compensating provision is necessary. The writing of suitable regulations for this subparagraph will take much patience, forbearance, and wisdom over a period of several years.

What is the purpose of increasing the limitations on deductions to pension plans? Is it to correct an inequity existing among employees who have pension plans? If this were the case. or if it is believed that the employers need a greater leeway in what they can contribute to bring the plan up to a fully funded basis as early as possible, then, as all of you who are familiar with the technicalities of costs and funding know, the logical place to permit greater deductions would be in the existing clause (iii) of section 23 (p) (1) (A) which it is proposed to replace with subparagraph (C). This could readily be done there by increasing the limitation on contributions toward past service from 10 percent of the past service base to some higher percentage.

Perhaps the purpose of increasing the limitation is to encourage the establishment of more pension plans. This, to my mind, is not the way for the Federal Government to encourage the establishment of sound pension plans. If this proposal is effective in encouraging the establishment of pension plans it is more likely to foster the establishment of unsound pension plans because the employer who looks for a method of funding unrelated to actual cost, which is the principle of paragraph (A), is more apt to adopt a plan which he cannot reasonably support over a long period of time.

Subparagraph (B) is the same as present clause (ii).

Subparagraph (C) is substantially the same as the present clause (iii) and establishes a limitation of the normal cost of the plan plus 10 percent of the unfunded cost. However, in lieu of the use of the unfunded cost as of the establishment of the plan as the base, this paragraph provides for the use of the unfunded cost as of the beginning of the current year plus all payments in prior years in excess of the total normal costs for those years. It thus is very similar to the use of the special 10 percent base as described in the bulletin on section 23 (p) (1) (A) and (B), except that it includes interest on unfunded portions of the past service cost. I cannot support this change from the special 10 percent base on theoretical grounds. It is interesting to note that it will have the effect of granting a larger 10-percent base to taxpayers whose liquidation of the past service is spread out over a longer period of time. Also, depending upon the regulations there authorized, it could mathematically result in a smaller contribution than under clause (iii).

Subparagraph (C) does not explicitly state that the part of the limitation due to contributions toward past service will be eliminated when the past service cost has been fully funded. Perhaps support can be found for this in the general rule that the deductions must satisfy the expense provisions of sections 212 or 162. Perhaps support could also be found in the last sentence of (C) which reads "Any increase in costs resulting from an amendment to the plan made after the year of its establishment must be treated as though provided under a distinct supplemental plan, except that all increases resulting from amendments made in 1 taxable year of the employer may be treated collectively as though resulting from one amendment." If the Commissioner cannot eliminate the 10 percent after the prior service cost has been fully funded this last sentence means nothing. In any event it would certainly be better to have this point clearly explained.

Subparagraph (D) of section 403 is the same as clause (iv) of the code and leaves any questions with regard to the operation of that provision unanswered.

Paragraph (2) introduces no change.

Paragraph (3) is to replace the existing subparagraph (c) with respect to the limit on deductions on account of contributions to a profit-sharing plan. Under (3) (A) it now becomes possible for an employer with a profit-sharing plan to buy retirement annuities directly without going through a trust. I must admit that I cannot see that this would be a particularly practical device.

Paragraph (3) (B) introduces a new concept which applies to a corporation which is a member of a group eligible to file a consolidated tax return. The group has a common profit-sharing plan. If the corporation has neither profits nor surplus but another member of the group has, these profits or surplus may be used for the benefit of the employees of the first corporation. Members with profits will then contribute (and take deductions for their contributions) in the proportion that their profits and surplus bear to the profits and surplus of the combined group. I think this is a desirable provision although the language reminds one of the present general rule in section 23 (p) (1).

Section 403 (a) (3) (C) starts off with "the term 'stock bonus or profit-sharing plan,' 'profit-sharing plan,' and 'plan,' as used in this paragraph, shall not include any plan or part thereof under which contributions are not paid into a trust or toward the purchase of retirement annuities * * *." The rest of the subparagraph is in the present code. It seems to me that the purpose of the quoted provision is to prevent the contribution into a trust from being based upon the compensation of employees who are considered part of a profit-sharing plan under 501 (e) but whose benefit is paid in cash.

Section 23 (p) (1) (E) of the code gives an accrual-basis taxpayer 60 days after the close of the taxable year in which payment must be made in order to be deemed made in the year of accrual. Section 403 (a) (6) extends the 60 days to the time prescribed by law for filing the tax return, including extensions allowed. This should be particularly helpful to a taxpayer who can have a qualified profit-sharing plan without a definite formula.

Subparagraph (7) is intended to replace 23 (p) (1) (F) and contains the same anomaly, namely, that you can have a greater deduction under a pension plan alone than under a pension plan and profit-sharing plan combined.

In summary, then, how does section 403 (a) of the bill, excluding paragraph (5), compare with section 23 (p) (1) of the code? It adds some flexibility in the case of a profit-sharing plan of an affiliated group. Otherwise, it complicates the provisions and makes them a little less logical with no overall beneficial effect.

Section 501 (e) of the bill describes the characteristics required of pension, profit-sharing, or stock-bonus trusts organized in the United States in order that they be exempt under 501 (a). The characteristics are described in four paragraphs. The first two paragraphs can be considered to be the same as the first two paragraphs in the existing section 165 (a). They require that there be a plan providing for the distribution of the corpus and income of the trust and that there be a statement that the assets cannot be diverted to purposes other than for the exclusive benefit of employees or beneficiaries. Paragraph (3) says that the classification of covered employees must be nondiscriminatory and sets forth the rules for determining whether they are nondiscriminatory. Paragraph .(4) sets forth the permissible allocation of contributions or crediting of benefits among participants.

The rules set forth in paragraph (3) may be summarized as follows: The plan will be considered discriminatory only if:

(a) More than 30 percent of the contributions under the plan are used to provide benefits for shareholders who own directly or indirectly 10 percent of voting stock; or

(b) More than 10 percent of the participants are key employees. Key employees are defined as the employees who are within the highest paid 10 percent of all regular employees, but not more than a total of 100.

Except, that even if the classification falls into one of these two categories of discriminatory plans, it is deemed nondiscriminatory if a sufficiently high percentage of regular employees participate in the plan. These percentages work out so that if there are:

Less than 20 regular employees, 50 percent will have to participate; 20 to 40 regular employees, 10 employees will have to participate; more than 40 regular employees, 25 percent will have to participate.

Regular employees are all employees of the employer excluding those not employed for the minimum period prescribed in the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in 1 week or not more than 5 months in any calendar year.

Participants are those employees included in the classification of participants who, if they remained employees at their current rate of compensation until normal retirement age, would be entitled to full benefits under the plan.

If you have read paragraph 3 rather hurriedly you may feel that I have omitted a very important part, namely the 6 enumerated classes of employees which may be covered. If you read it more closely, you will see that nothing follows from the enumeration and whether your group is one that falls within or without the enumerated classes, it will be acceptable, provided it complies with the rules.

I would like to illustrate the rules with some examples.

Example 1: Employer A has 40 regular employees. He adopts a plan to cover the 10 highest paid of the 40. The group has 4 key employees (10 percent of 40) and all 4 are in the plan. Regardless of how the plan works out on the 30 percent rule, it discriminates according to the 10 percent key employee rule, because more than 10 percent of the participants are key employees. However, it complies with the percentage of covered employees rule and is therefore deemed nondiscriminatory as to coverage.

Example 2: Employer B has 10,000 regular employees. He adopts a plan providing full benefits to the 1,000 highest paid employees. This plan will almost certainly not discriminate under the 30 percent rule and cannot discriminate under the key employee rule because there cannot be more than 100 key employees so that not more than 10 percent of participants will be key employees. The plan therefore is deemed nondiscriminatory as to coverage, without any necessity of applying the coverage rule to determine that at least 25 percent of the regular employees are participants. Similarly, any group as large as 1,000 will qualify.

Example 3: Employer C has 20 salaried employees and 100 wage employees. He wants a plan for all the wage employees. This plan will be nondiscriminatory under the 30 percent rule as well as under the 10 percent rule. It will also qualify under the percentage of coverage rule.

As example 4, let us use the same hypothetical situation as in example 1 under which an employer had 40 regular salaried employees, 10 of whom were covered in a plan which is nondiscriminatory under the rules, but, add the fact that the employer has 200 regular wage employees—a total of 240 regular employees of whom 24 are key employees. Here he cannot set up a plan to cover the 10 top employees. In fact he cannot set up a plan to cover all salaried employees because he will come up against the key employee rule since now more than 10 percent of the participants will be key employees, and he will come up against the percentage of coverage rule since 40 is less than 25 percent of 240. Suppose the wage employees are unionized and do not wish to come into the plan. This employer is in a straitjacket and cannot adopt any plan for his salaried employees. Thus we see that under example 1, an employer can pick and choose one-fourth of all his employees—by name if you wish—whereas in example 4, a very reasonable employer cannot adopt any plan.

Example 5: Is that of an employer who has 14 regular employees (with more than 5 years of service), 8 of whom earn in excess of $3,600. He also has employees with less than 5 years of service. He adopts a plan covering employees with 5 or more years of service who earn over $3,600. This plan would qualify under the percentage of coverage rule. After the plan is in existence for 1 year, 3 additional employees complete 5 years of service and are therefore regular employees under the rules but are not participants because they earn less than $3,600. The plan now covers 8 regular employees out of 17 and ceases to qualify. (The tests for discrimination thus go into the fourth dimension with time as the additional variable and what qualifies today may not qualify tomorrow.)

Consider example 6, a modification of 5: An employer has 800 employees with more than 5 years of service, 200 of whom earn over $3,600 and 300 employees with 1 to 4 years of service, 50 of whom earn over $3,600. He wants to adopt a plan providing uniform benefits on compensation over $3,600. If he covers employees with 5 or more years of service, he will have 200 out of 800 and therefore it will be deemed to be nondiscriminatory, but if he wishes to cover employees with 1 or more years of service he will be covering 250 out of 1,100 regular employees and it will discriminate. (Bear in mind that regular employees in this case would include all employees with more than 1 year of service if the plan covers some employees with 1 or more years of service.) Thus we see by making the plan broader in a manner most people would consider nondiscriminatory, a nondiscriminatory plan becomes discriminatory.

Perhaps more in line with what the bill was intended to cover, is example 7. that of an employer with four employees including the principal stockholder and his wife. A plan covering just these two top employees will qualify as a nondiscriminatory plan from the standpoint of coverage because 50 percent of the regular employees are participants.

Example 8: Let us consider the case of a corporation which employs 40 persons including 10 salaried employees 1 of whom is the principal stockholder. If the corporation wishes to set up a plan covering all 10 salaried employees the plan will be nondiscriminatory as to coverage, even though violating the key-man rule, since it just satisfies the requirement that 25 percent of the employees be participants. However, if it is desired to cover only salaried employees under the plan but exclude the principal stockholder, the plan will be discriminatory because it still violates the key-man rule and can no longer avail itself of the 25 percent participation exception from that rule. Thus we see that the effect of removing the principal stockholder from a plan is to convert it from an acceptable one to one which will be deemed discriminatory.

At this point I would like to refer you once more to the definition of participants as those employees included in the classification of participants who, if they remained employees at their current rate of compensation until normal retirement age, would be entitled to full benefits under the plan. Note the word "full." It would thus seem that if you are using a step-rate plan, like 1 percent on the first $X, plus 2 percent on the excess, you cannot include in your participants, for testing nondiscrimination of coverage, those employees making $X or less. I have not attempted to explore the ramifications introduced by this word, but it is worthy of careful consideration, inasmuch as it seems likely that an effort will be made to qualify many plans under the coverage exclusion principle rather than under the dual tests laid down by the 30 percent stockholder and 10 percent key-man rules.

By the way, two employers in the same industry competing in the same labor market could not necessarily adopt the same plan because what under the rules is nondiscriminatory for one may be discriminatory for the other.

Paragraph (4) sets forth the measure of acceptability in benefits. In a pension plan the benefits are acceptable if the contributions or benefits of or on behalf of employees under the plan do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower, except that the first $4,000 of annual compensation may be disregarded.

Assuming, then, that you have a suitable coverage classification, you can provide benefits in any amount on compensation in excess of $4,000 a year. For example, you can provide nothing on the first $4,000 and 75 percent of compensation in excess of $4,000. Similarly you could provide nothing on the first $3,000 and anything at all on the excess, or 1 percent per year of service on compensation between $3,000 and $4,000, and 2 percent per year of service on compensation in excess of $4,000.

You could not eliminate benefits on the first $4,500 and provide 24 percent on compensation in excess of $4,500 as you probably could under existing integration rules. On the other hand, if you have a suitable coverage classification, you could cover only employees earning over $5,000 and give them full benefits starting at $4,000, or even starting at $1, so that an employee earning $5,000 will get no benefit and an employee earning $5,001 will get substantial benefits, e. g., $3,000 a year. Such a classification would be acceptable under the bill.

The $4,000 exclusion provision would introduce no problem into many of the popular type plans but will introduce serious problems as well as encourage discrimination in others.

As example 9, consider a plan providing benefits of 25 percent of final pay less primary social security. At $4,000 the social security amounts to $1,020 a year, which is more than 25 percent of pay, so that a $4,000 man would get no benefit under the plan. This plan would not be acceptable because it provides less under the plan at $4,080 on the $80 in excess of $4,000 than at $4,100 on the $100 in excess of $4,000. As you know, under the existing rules the plan would be considered nondiscriminatory. On the other hand, the plan that provided nothing to employees earning less than $6,000 and 50 percent, starting at the first dollar of income, to employees earning in excess of $6,000 would be definitely discriminatory under the existing rules. Until 1941 the most discriminatory plan I saw was of this type, but not so flagrant. It provided nothing to employees earning less than $3,000, but employees who earned $3,000 immediately started off with very substantial benefits. And it was plans of this latter type which brought about, in my opinion, the limitations of section 165 (a).

If the proposed social security bill becomes law, benefits and contributions under social security would be based on the first $4,200 of income. However, under the bill you could not provide for benefits on compensation in excess of $4,200 only.

Under the bill there would be no means of taking employee contributions into account in testing acceptability. A plan providing for no contributions on compensation under $5,000 and 5 percent on compensation in excess of $5,000 with benefits of 1 percent per year of service on compensation between $4,000 and $5,000 and 1½ percent per year of service on compensation in excess of $5,000 would not be acceptable because you look at benefits only and at the $5,000 level the ratio of benefits to compensation in excess of $4,000 is greater than at $4,500. Under the present law this plan could be considered nondiscriminatory. On the other hand in example 10 where benefits are 1 percent per year of service on all compensation in excess of $4,000 and contributions 5 percent on compensation between $4,000 and $20,000 with no contributions on compensation in excess of $20,000, the benefits would be deemed acceptable under the bill but discriminatory under the present law because higher paid employees get the same benefits for smaller contributions. It may be noted that this latter situation is not likely to be found in undisguised form but methods of disguising it can readily be suggested.

I indicated before that a plan providing for no benefit on the first $4,200 or $5,000 and a benefit on the excess would not be acceptable. This may be a general rule but there are exceptions. Consider as example 11 an employer who has 4 employees, 2 of whom earn $12,000 and 2 earn $8,000. He wants a plan providing for 20 percent on compensation between $4,000 and $8,000 and 40 percent of the excess. This would appear not to be acceptable under paragraph (4). On the other hand, the employer could establish 2 plans, 1 covering the 2 top people and the other covering the other 2. Each of the plans would qualify separately under paragraphs (3) and (4), and paragraph (4) says "Any classification which meets the requirements of paragraph (3) of this subsection shall be considered separately in the application of this paragraph." Under the bill this plan would therefore be acceptable.

Before we leave subparagraph (A) I would like to mention another type of plan which would be deemed acceptable as to benefits, i. e. zero percent on first $3,000, 1 percent per year of service on the next $2,000, and 2 percent per year of service on compensation in excess of $5,000. First we can disregard compensation under $4,000. An employee earning between $4,000 and $5,000 will get at least 2 percent on his compensation in excess of $4,000 because he gets the 1 percent on the compensation between $3,000 and $4,000 as well as 1 percent on the compensation in excess of $4,000. Participants therefore can be said to get at least 2 percent on the compensation between $4,000 and $5,000 and 2 percent on the excess. The plan would therefore qualify.

I would like to spend another minute on the type of plan permitted by the bill providing for coverage of all employees earning in excess of $5,000 a year in which employees making $5,000 a year or less receive no benefits under the plan, but employees earning a cent more will get benefits of 50 percent of pay or $2,500 a year. The present law prohibits this sort of thing on the grounds that discrimination exists as between the $5,000-a-year employee and the employee making $5,000.01. In my opinion this plan is undesirable. It tends to create deep and wide cleavages between groups of employees. You might say it is the employer's money and therefore up to the employer to determine the pattern that his plan is to take. We don't want Government interference and while this may be an unwise thing to do you can't distribute wisdom by legislation. Perhaps so, but the Government does grant tax advantages and it seems to me that those advantages should be limited to desirable plans. Moreover, the proponents of the bill cannot escape the criticism with such a disclaimer because if we look at the profit-sharing provisions we see not only that this thing is permitted, but there is no alternative. If you cover employees earning in excess of $5,000 a year in a profit-sharing plan and the plan provides for contributions of 15 percent of compensation, in a year that profits are available the $5,000-a-year employee will of course get nothing while the employee earning $5,000.01 a year will get $750. Paragraph 4 (B) of the section 501 (e) is very clear on this point. Profit-sharing distributions must be based on compensation starting at the first dollar for covered employees regardless of who is excluded.

The rule for allocations under a profit-sharing plan is described in subparagraph (B) or paragraph (4). This rule provides that at least three-quarters of each year's contribution (as well as all forfeitures) must be allocated so that the raito of allocations to compensation be no greater for any covered employee than for a lower-paid covered employee. The balance (which would be no more than one-quarter of each year's contribution) can be allocated in any manner at all, on a pick and choose basis if you wish, so long as the radio of total allocation to compensation for any covered employee be no more than two times the ratio for any lower paid covered employee.

A profit-sharing plan that allocates contributions on the basis of compensation only would, of course, qualify. As for the three-fourths of the total contribution there does not seem to be any room for an allocation formula involving years of service. Similarly, as for the three-fourths of contribution there does not seem to be any room for an allocation based on the amount of employees' contributions as under a thrift plan. Of course, the one-quarter can be allocated in any way as long as no employee gets a percentage allocation more than twice any other participant. This one-fourth may or may not give you the necessary elbow room to adopt the type of plan you could at present. Also, at present you can integrate a profit-sharing plan with social security so that if you have no other qualified deferred compensation plan you could adopt a profit-sharing plan which would provide no allocations on the first $3,600 of compensation and up to 9⅜ percent on compensation in excess of $3,600. Under the proposed rule this would not be possible.

Because one-quarter of the pie can be divided any way the employer chooses (with the limitation factor of 2) there is very substantial room for discrimination, in the old-fashioned sense, in favor of shareholders and highly paid. There is, of course, no reason why the shareholders cannot each get 29 percent of pay and all other employees 14½ percent of pay. It cannot be denied that there are advantages in giving the employer an opportunity of rewarding individual accomplishment by higher deferred profit-sharing distributions. But also consider the opportunities it affords for discriminatory practices.

It seems to me that under the bill there is room for almost unlimited discrimination in this area, i. e., not even limited to a factor of 2. This could be done by a large employer who sets up a series of trusts. For example, trust 1 would cover all employees in division 1, plus the president; trust 2 would cover all employees in division 2, plus the president; trust 3 would cover all employees in division 3, plus the president. In this way, with 3 trusts, the president would get a total annual allocation of 6 times the percentage of anyone else, i. e., he could get 87 percent of his salary, against 14½ percent for anyone else. The bill says that the 15-percent limitation on contributions also applies to the compensation of all covered employees in all plans but does not seem to prevent this abuse as to benefits.

On the use of compensations other than basic or regular compensation as a basis for benefits, the bill would allow less leeway than is currently permitted. It would permit total compensation only if the total compensation is determined under a definite formula. Total compensation has, to my knowledge, always been permitted if it is determined under a formula, and frequently a much more liberal policy has been permitted, depending upon individual circumstances.

I would like to refer briefly to the problem of the union-sponsored multiemployer plan for the benefit of workers represented by the union. As you know, hundreds of such plans have been adopted, and an increasing number of workers are relying on such plans to fill out their retirement programs. The Internal Revenue Service has in the past read into section 165 (a) the authorization for qualification of such plans. Certainly section 165 (a) does not lend itself readily to this interpretation. Many attorneys feel that it cannot ever be strained to give the necessary interpretation in certain instances. Thus, in rewriting the code there is the opportunity of adequately taking care of this problem. The drafters of the bill referred to the problem in the committee report but did not deal with it in the bill itself. The report states that such plans will continue to qualify as employee plans. There may be serious questions whether the opinions expressed in a committee report are to be deemed as approved by all the Members of Congress who vote for the bill and by the President who signs it. Would it not be better to give adequate consideration to this important problem in the bill itself.

What is the effect of the proposed changes to the requirement of qualification of pensions and profit-sharing plans? The prohibition against discrimination, which is the keystone of 165 (a), has been eliminated. The adjective "discriminatory" can still be found in the bill and the report, but it has acquired new meaning. As a result of the arbitrary rules there set forth, a plan established unilaterally by an employer to cover all employees whom he can legally cover (namely those employees not represented by a collective-bargaining agent) is deemed discriminatory even when no stockholders are to be covered; a plan intended to provide nominal benefits (perhaps less than under social security) to persons earning in excess of $3,600 is deemed discriminatory; a plan which does not discriminate today may automatically be discriminatory tomorrow because of normal happenings which do not remotely affect discrimination. The addition of relatively low-paid employees on a uniform basis to a nondiscriminatory plan will make it discriminatory, while the addition of a high-paid employee who is a sole stockholder will make a discriminatory plan nondiscriminatory. A plan whose participants have been selected on a name basis is automatically approved and a bona fide plan covering all the employees that the employer can cover is discriminatory. A plan providing no benefits to some employees and providing disproportionate benefits to others is approved. * * * What can we expect if these provisions should become law? The extreme cases which will be established under the encouragement of these provisions will become national scandals which might very well engulf the entire field of pensions and profit-sharing and bring it into disrepute. As a result some later Congress will be forced into a position of adopting legislation much more stringent than that existing today.

STATEMENT SUBMITTED BY A. E. SHARPE, VICE PRESIDENT CALIFORNIA TEXAS OIL CO., LTD., NEW YORK 17, N. Y., ON RECOMMENDED AMENDMENT OF SECTION 402 (a) (3) (ii) AND SECTION 505 (b) (1) OF H. R. 8300

For the reasons set forth below, we respectfully recommend the following two technical amendments to H. R. 8300:

(1) In section 402 (a) (3) (ii) change the parenthetical reference from section 421 to section 505; and

(2) In section 505 (b) (1) change the phrase "more than 50 percent" to "50 percent or more."

California Texas Oil Co., Ltd. (hereinafter referred to as Caltex) is a corporation the beneficial ownership of which rests equally with Standard Oil Co. of California and the Texas Co. The practice under which two corporations hold equal half interests in a subsidiary so as to operate as genuine partners rather than with one having greater control and power than the other is becoming increasingly widespread. The practice has many desirable business advantages.

Caltex has an employees savings plan and an incentive compensation plan each of which is qualified under section 165 (a) of the Internal Revenue Code as a nondiscriminatory profit-sharing or stock-bonus plan. Pursuant to these plans, contributions are made to a trustee and are invested in the common stock of the parents.

Although such plans qualify under section 165 (a), the provisions of section 165 (b), which defer the taxation of the unrealized appreciation on the distribution of the securities of the employer corporation, are not applicable because of the reference in section 165 (b) to section 130A. This latter section, which deals with so-called restricted stock options, defines the term "parent corporation" as one owning "more than 50 percent of the * * * stock" of the employer corporation. As a result of this definition, the employees participating in the Caltex plans and their beneficiaries are taxable in the year of distribution on the unrealized appreciation in the securities of the two parent companies received under the plans solely because each of the parents owns exactly 50 percent of the stock of Caltex rather than either one of the parents owning "more than" 50 percent.

H. R. 8300 as passed by the House of Representatives would not only perpetuate this discrimination, but would actually compound it by disqualifying a trust in which the assets are invested in securities of the parent corporations no one of which owns "more than" 50 percent of the stock of the employer.

Section 402 (a) of H. R. 8300, like section 165 (b) of the code, proposes to defer the taxation of the unrealized appreciation in securities of the employer corporation distributed by qualified pension, profit-sharing and stock-bonus plans. Like its predecessor, section 402 (a) (3) defines securities of the employer corporation by reference to section 421, which deals with restricted stock options. Unlike the existing code, however, H. R. 8300 contains an entirely new section (sec. 505) dealing with allowable investments for employees' trusts. This section, which would be specifically applicable only to such trusts, includes a definition of securities of the employer and securities of a parent corporation or a subsidiary corporation of such employer. We submit that the definition by reference in section 402 (a) (3) (ii), dealing with qualified employees trusts, should be to section 505, which likewise deals with such trusts, and not to section 421, which deals with stock options. This is desirable not only in the interests of clear draftsmanship but also because policy consideration affecting employees' trusts may, either now or later, be quite different from those affecting restricted stock options.

Assuming that the reference in section 402 (a) (3) (ii) will be changed from section 421 to section 505, we further recommend that the definition of parent corporation in section 505 (b) (1) be changed to cover the situation where an employer corporation is owned 50 percent by each of 2 parent corporations. This would merely require changing the phrase "more than 50 percent" to "50 percent or more."

This change is necessary in order to permit the continued operation of plans such as our employees savings plan and our incentive compensation plan. We understand that Caltex is by no means the only company that is owned equally by 2 parent corporations and that our plans are not the only qualified pension, profit-sharing or stock-bonus plans in which the trustee is required or permitted to invest equally in the securities of the 2 parent companies.

We know of no reason why an employer corporation owned equally by 2 parents should be denied the right to continue qualified employees' plans and why the employees participating in such plans should continue to be denied the right to defer the tax on the unrealized appreciation in the securities of such parents distributed by the trust when an identical plan of an employer owned by 1 parent would receive this preferred tax treatment. The changes in H. R. 8300 recommended herein would remove an existing unreasonable discrimination and would prevent a further extension of such discriminatory treatment without adversely affecting the revenues.

It may be noted that the "50 percent or more" stock-ownership principle is recognized in section 131 (f) (2) of the present Internal Revenue Code and section 902 (b) of H. R. 8300 relating to foreign tax credits for corporate stockholders in foreign corporations. The changes recommended herein would follow this precedent.

Statement by Cyril J. C. Quinn, Chairman of Tax Committee, in Behalf of National Association of Investment Companies Before the Senate Finance Committee

The National Association of Investment Companies respectfully proposes to the committee a technical amendment to Internal Revenue Code section 362 (b) (7) (sec. 852 (b) (3) (C) of H. R. 8300) concerning the method of distribution of capital gain dividends by regulated investment companies to their shareholders.

The proposed amendment would involve no loss of revenue to the Treasury, but is one of great importance in the administration of the companies.

Regulated investment companies obtain funds from the public sale of their shares and then invest these funds in a diversified list of stocks and bonds of corporate enterprises. They are designed to afford to a large number of individuals of moderate means an opportunity to pool their investment funds so as to secure diversification of risk and experienced investment management. The companies now have total assets of about $5 billion, but the average value of each stockholder's investment is only about $3,000. The companies are subject to regulation by the Securities and Exchange Commission under the Investment Company Act of 1940.

Because regulated investment companies represent an intermediate corporate layer betwen the investor and the operating business corporation and thus involve the possibility of triple (rather than the usual double) taxation of corporate income, the code for many years has contained special provisions relating to the taxation of these companies and their shareholders. Briefly summarized, it provides that if the regulated investment company distributes to its shareholders at least 90 percent of its ordinary net income the company then is not taxed on the income so distributed, but it is taxed currently to the shareholders. In practice the companies have distributed 100 percent of their ordinary income.

The statute does not require that the companies distribute their long-term capital gains. It provides that if such gains are not distributed, the company must pay capital gains tax of 25 percent on them; but if the gains are distributed the company pays no capital gains tax and the shareholders include the distributions in their individual returns as long-term capital gains. Since the large majority of shareholders pay an effective rate of tax on capital gains much lower than 25 percent, the result is that because of the need to offer the shareholder so far as possible a tax position similar to that which he would have if he invested directly, the companies have generally distributed to shareholders all their net realized long-term capital gains. This is done for the further reason that if the gains are retained by the investment company they may be reflected in the market value of the investment company's shares and produce a second capital gains tax whenever the shareholder sells his investment company stock.

Since these provisions of the statute took their present form in 1942, the level of stock-market prices has more than doubled, with the result that a large part of the current value of many of the companies is represented by appreciation in securities which if sold by them will result in capital gains. Under the present provisions of the code a major turnover in the investment company portfolio could create a need for distributing to shareholders in the form of a capital gain dividend a large proportion of the company's assets. While in certain companies and in certain situations the distribution of capital gains in cash dividends to shareholders may be appropriate, particularly where they are not large in amount, nonetheless in other companies and in other situations it may be quite inadvisable and inappropriate for the following reasons, among others:

(1) There is a tendency among stockholders to assume erroneously that capital gain dividends represent recurring spendable income like ordinary dividends, rather than a part of their capital fund at work as would be the case with capital gains if the stockholders invested directly in the operating business corporations.

(2) Misapprehension as to the nature of a cash capital gain dividend may produce a false stimulus to market demand for the investment company stock. This has already lead the National Association of Securities Dealers to warn against investment company stock salesmen placing improper reliance upon capital gain dividends in soliciting purchasers for the stock. Actually distribution of realized gains will lead to a reduction in future dividends from the investment company because there will be a smaller fund at work in the investment company.

(3) Capital gains should be retained to offset the inevitable capital losses of subsequent years. To disburse all gains without reserving for losses which may occur in later years is obviously unsound.

(4) A number of investment companies have outstanding debentures and preferred stock. These companies should not distribute to shareholders large amounts of capital gains and thus weaken the position of the senior securities.

(5) In the only court decisions to date capital gain dividends paid to estates and trusts have been held to be income, distributable by the executor or trustee

to the income beneficiary, rather than principal to be held for remaindermen. Since capital gains realized by an executor or trustee on direct investments of the trust funds would normally be held in principal, the need for distributing to income beneficiaries capital gain dividends received on investment company shares creates an obstacle to the investment of fiduciary funds in investment companies since it makes the investment company shares a wasting asset for the estate or trust.

(6) Since the problems attendant upon capital gain dividends do not exist if the investment company leaves the gains in unrealized form, the current situation may tend to discourage management from making substantial changes in the investment portfolio and thus the interest of the shareholders may be adversely affected.

Some of the open-end investment companies—i. e., those companies which are under a legal obligation to buy back from the shareholders their stock at any time at approximately the current asset value—have endeavored to meet these troublesome problems in part by paying capital gains dividends either in stock of the company or in cash, whichever the stockholder selects. This at least gives the stockholder the option to leave his share of the realized gains in the company if he so desires. But this procedure has proved to be cumbersome, expensive, and difficult to explain adequately to the vast number of small investors who are stockholders of the companies. It has failed to meet the principal problems mentioned above for so long as cash is offered as a dividend, the distribution takes on both legally (in the case of shareholders who are executors or trustees) and practically in the market place the earmarks of a distribution of ordinary income. Furthermore, for various technical reasons it is not feasible to use the optional stock dividend procedure in the case of the so-called closed-end investment companies—i. e., those which are not legally bound to buy in their outstanding shares.

To remedy the situation it is proposed to amend section 362 (b) (7) of the code (sec. 852 (b) (3) (C) of H. R. 8300) so as to permit capital gain dividends to be paid in stock of the issuing corporation. In the case of the open-end companies the payment of capital gain dividends in stock will for practical purposes of the shareholder be the same as paying them optionally in stock or cash since the shareholder is entitled at any time on demand to turn in any of his stock to the company for the cash equivalent. In the case of the closed-end companies the shareholder would have a ready market in which to sell his stock dividend shares and thus promptly convert them to cash if he so desires; but, in addition, in order to provide him with cash sufficient to pay the maximum capital gains tax to which he would be subject without selling any shares, the proposed amendment would require, in the case of the closed-end companies, that the capital gain dividend consist of no more than 75 percent stock and no less than 25 percent cash.

Thus while the shareholder's personal position would be no different under the proposed amendment than at present, the character of the capital-gain dividend would be made clear both from a legal and a market standpoint. As a stock distribution rather than a cash distribution, it would be clear that it represented capital funds and would not be confused with ordinary income. If the shareholder sold the newly distributed stock back to the company or on the market, he would know that he was liquidating part of his investment funds and not deriving cash dividend income. The companies would not automatically deplete their investment funds upon realizing gains and could manage their portfolios without the problem which capital-gain dividends now entail.

There would be no revenue loss to the Treasury involved in this proposal since it involves only the method of distributing capital gains. Indeed, because of the elimination of many problems now involved in changing the investment portfolio, it is quite likely that there would be a substantial increase in the realization of capital gains by the companies and a resultant increase in revenue to the Treasury.

There is no constitutional problem involved in permitting the distribution of currrent capital gains in stock since Congress can tax these gains of the company directly to the shareholder whether distributed or not. (Cf. I. R. C. secs. 331–340, relating to foreign personal holding companies; I. R. C. secs. 391–396, relating to personal service corporations; I. R. C. sec. 169, relating to common trust funds, etc.) Furthermore, the entire provisions of Internal Revenue Code, sections 361 and 362 [Secs. 851–855 of H. R. 8300], relating to regulated investment companies are elective with the companies; and if desired as a protection against any possibility of constitutional challenge, a new election by the company to have the new provision applicable in its case could be provided in the enacting statute.

It is, therefore, respectfully proposed that section 362 (b) (7) of the Internal Revenue Code [sec. 852 (b) (3) (C) of H. R. 8300] be amended so that capital-gain dividends could be paid not only in cash, or optionally in cash or stock, but could also be distributed in stock of the company if the stock is redeemable at the election of the shareholder or if it is accompanied by a distribution of cash amounting to at least 25 percent of the total capital-gain dividend. The amendment could be made in simple form by adding at the end of Internal Revenue Code, section 362 (b) (7) [sec. 852 (b) (3) (C) of H. R. 8300] a sentence reading as follows:

"As used in this paragraph the term 'dividend' shall include a distribution payable in the company's stock which the recipient is entitled to redeem for approximately his proportionate share of the company's net assets or the cash equivalent thereof, or which is accompanied by a capital-gain dividend in cash equal in amount to at least 25 percent of the sum of such cash and the fair-market value of such stock at the time of the declaration of the dividend."

ABSTRACT AND TITLE GUARANTY CO.,
Detroit 26, Mich., April 9, 1954.

Re H. R. 8300, Revised Internal Revenue Act of 1954

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: This company is an insurance company organized under the insurance code of the State of Michigan and under the supervision of the commissioner of insurance. Its corporate powers are to examine titles to real and personal property, furnish information relative thereof, and insure owners and others interested therein against loss by reason of encumbrances or defective title.

Our income taxes are computed at the usual corporate rate. We receive no favored treatment. On the contrary, even the reserves set aside for the payment of losses under our policies are computed as earnings for the purpose of taxation, although such funds while held in reserve for losses are not available to stockholders for dividend purposes.

Our income and excess profits taxes for the year 1953 amounted to approximately 71 percent of our net earnings before taxes, as computed on the report required by the commissioner of insurance.

Under sections 34 and 246 of House Resolution 8300 now before your committee, the individual and corporate stockholders of this company would be denied the credits against dividends provided for other classes of corporations. The greater part of the capital stock of this company is held by a private corporation which now receives an 85 percent credit against dividends paid. If this credit is to be removed and a 52 percent tax is to be assessed against our dividends after we have already paid a full tax on our own earnings, the amount of those earnings which will eventually trickle down to the private stockholder of the parent corporation will be very small.

It is respectfully suggested that the provisions of sections 34 and 246 of H. R. 8300 should be amended to void the discrimination which would be imposed upon this and similar insurance corporations as the sections are now drafted.

Sincerely yours,

FRANK I. KENNEDY, *President.*

(Whereupon, at 12:30 p. m., the committee recessed, to reconvene at 10 a. m., Monday, April 12, 1954.)

THE INTERNAL REVENUE CODE OF 1954

MONDAY, APRIL 12, 1954

United States Senate,
Committee on Finance,
Washington, D. C.

The committee met, pursuant to call, at 10:30 a. m., in room 312, Senate Office Building, Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Martin, Williams, Malone, Carlson, Bennett, Byrd, Hoey, Frear, and Long.

The Chairman. The committee will come to order.

Mr. Edward T. McCormick, president of the American Stock Exchange, has very kindly agreed to submit a written statement of his position, which will be put in the record.

(Mr. McCormick's statement follows:)

Statement of the American Stock Exchange on H. R. 8300

I am Edward T. McCormick, president of the American Stock Exchange, 86 Trinity Place, New York City.

My exchange is the second largest securities exchange in the United States, and is comprised of 802 regular and associate members doing business in approximately 1,700 offices in more than 400 cities throughout the country.

I appreciate the strict time limitations under which the committee is operating, so I have made this statement as brief as possible, knowing that my prior comments on the vital subjects of double taxation of dividends and the capital-gains tax, addressed to the House Ways and Means Committee on July 16 and 28, 1953, will be brought to your attention and, consequently, need not be repeated here.

So far as section 34 and 116 of the bill are concerned, referring respectively to the proposed dividend credit and the partial exclusion from gross income of dividends received, this exchange respectfully urges their adoption as proposed in the bill.

While the alleviation from the existing inequitable double taxation provided for in these sections is not as great as we would wish, nor nearly as extensive as our neighboring nation Canada has granted for the purpose of stimulating equity financing, nonetheless, realizing the need of the Nation for as much revenue as possible, under existing circumstances, we feel constrained not to ask that more be done by the Senate than to join with the House in this initial, though small step toward the ultimate elimination of this admittedly inequitable tax.

As for the capital-gains tax provisions in subchapter P of chapter 1 of the bill, we strongly but respectfully suggest that you adopt an amendment at least reducing the capital-gains period from 6 to 3 months. We firmly believe that such an amendment, by inducing a multiplication of long-term capital-gains transactions, will result in greater revenue to the Treasury, providing an offset, in large measure, to such revenue loss as can be expected from adoption of the double taxation relief provisions. Our own tax history is evidence of the truth of this assertion. Moreover, reduction of the period, by stimulating the liquidity of equity markets, will redound not only to the benefit of investors but to the economic health of our domestic corporations as well.

I am grateful for this opportunity to express the views of the exchange in the record of your hearings.

The CHAIRMAN. We have with us this morning former Senator Scott Lucas, who was a very valued member of this committee. We are very glad to have you here again, Senator.

Senator CARLSON. Mr. Chairman, I wonder if you would yield to me for a moment to submit a letter for the record. I have a letter from Frank Bane, executive director of the Council of State Governments, in which he submits a memo on an investment "which makes an interesting suggestion which might be of benefit to the States and their localities in offering their bonds for sale."

He says this proposition has not been acted upon by any of their organizations, but he wanted to submit it to the Senate committee for consideration, and I would suggest that Mr. Stam look this over.

The CHAIRMAN. We will put it in the record and let Mr. Stam have it.

(The letter referred to follows:)

THE COUNCIL OF STATE GOVERNMENTS,
Chicago 37, Ill., April 5, 1954.

Hon. FRANK CARLSON,
United States Senate,
Washington, D. C.

MY DEAR GOVERNOR: It is not necessary to tell you that I am not a tax expert. Attached, however, is a brief memorandum which makes an interesting suggestion which might be of benefit generally and to the States and their localities.

The proposal seems to follow the general plan of the so-called mutual or investment fund. In such mutual funds, there are many shareholders who pool their holdings in a diverse and large group of securities. Income is paid both from the earnings of the securities and the profits on sales. The attached proposal, it would seem, would do the same thing for tax-exempt securities of States and localities and special public districts. The key to the proposal is a requirement that the Internal Revenue Act be amended so that the interest paid to the holders of the shares in this type of investment or mutual fund would be tax exempt just as it would be if the shareholder owned the individual municipal bonds himself.

It would seem further that such an amendment would expand the market for bond issues of the smaller local units of government; would enable these smaller units to market their bonds to greater advantage; and would perhaps encourage these smaller units to move ahead with their planning and programing of necessary public works. It might also help some of the special districts and toll road and bridge authorities sell their bonds at better interest rates.

This proposal has not been acted upon by any of our organizations, but since the tax bill is now pending in the Senate, I would greatly appreciate your opinion as to whether such an amendment to the bill would be feasible and desirable. Many thanks.

With kindest personal regards, I am

Very sincerely,

FRANK BANE,
Executive Director.

PROPOSAL FOR INVESTMENT FUNDS OF TAX-EXEMPT SECURITIES

It is proposed that a change be made in the taxation of income received by the holders of investment company shares, which would permit tax-exempt income received by the investment company to be passed on as dividends tax exempt to the shareholders.

Such a change would make it possible for an individual to hold through his investment company shares a diversified list of tax-exempt securities and to receive his income in the same tax-exempt status as though he had only a single tax-exempt security.

The effect of this change would be twofold. First, to broaden the market for tax-exempt securities, particularly of smaller and less known municipalities, school districts, etc., and second, to permit the investor of moderate income to hold as an investment a diversified and supervised list of tax-exempt securities.

We know of no such investment company specializing in tax-exempt securities and if there be any they are of inconsequential size. Accordingly, there is no consideration of loss of revenue in correcting an illogical and obstructive feature of the present tax structure.

The following memorandum discusses in more detail the desirability of making this change.

Attached to the memorandum is a suggested text of an amendment to the revenue act which would accomplish the purpose which is herein described.

1. During the next few years, State and local governments will be compelled to undertake a tremendous volume of public works and construction activities. The totals each year are likely to be larger than the annual amounts that have been recorded since the end of the war. The need for better roads and bridges and more schools and hospitals has become intensified as our population has continued to grow and to shift its geographic location.

2. The public-works construction program that will be demanded by our people will be handicapped as it gathers momentum by inadequate pools of financial capital. Schools and classrooms, to take one example, will be needed in hundreds of areas where the governmental units are not well known, or where there are unknown credit ratings as far as the regular investors in municipal bonds are concerned. The big cities and the State governments can tap pools of financial capital which are adequate. The situation is different, however, when it comes to smaller school disrticts in Texas or Colorado, for example, or irrigation districts in Arizona or New Mexico. Most investors in municipal bonds are unfamiliar with many of these governmental units—there are more than 100,000 of them—and they cannot be expected to take the time and the trouble to become acquainted and to invest with confidence even if the financial return is higher than in the case of well-known names.

3. The solution of a similar problem in the thirties was worked out through the use of Federal Government capital. Hundreds of small municipal government units and instrumentalities were able to build irrigation systems, bridges, and other revenue-producing improvements through the use of funds derived from the sale of their obligations to the RFC—which in turn derived its funds from the Treasury. The need today is for a solution which will attract private capital to these State and local government needs; a solution which will make it unnecessary to depend so much on the Federal Government, to tap the Federal budget or to utilize the Treasury's borrowing power.

4. Such a solution could be worked out by the utilization of a financial instrument which is currently successful in other fields, the specialized investment fund. A change in the revenue laws, which would permit tax-exempt bond interest to be passed through a regulated investment fund to the shareholder in the tax-exempt status in which the fund receives it, is required in a manner similar to that now followed by regulated investment funds with respect to the passing through of capital gains to their shareholders.

5. The specialized investment fund: The idea would be to establish investment funds specializing in municipal bonds—particularly those of the small and medium size school districts, road authorities, irrigation districts, as well as the general obligations of the smaller cities and towns issued for such purposes as hospitals, etc. The obligations of these governmental units carry a substantially higher rate of interest than is carried by the best known credits and names. The quality in most cases is extremely good. The wide geographic distribution obtainable in these issues, plus their great variety and good quality should permit adequate diversification and safety of investment, and the cost of supervision would be low relative to the higher yields that would be obtained.

6. Changing the tax laws: Investment funds of the type suggested require a change in the Federal income-tax laws, because at the present time tax-exempt municipal interest received by a corporation becomes taxable dividends when passed on to its shareholders. The change that is suggested would extend to such tax-exempt interest the Federal income-tax treatment accorded individuals holding nontaxable securities. That is, if the amounts involved are passed on by an investment company holding only tax-exempt securities, they would then be nontaxable to the shareholders.

7. It was recognized a decade and a half ago that (*a*) the accumulation of pools of capital from large numbers of people having small amounts to put into equities and (*b*) the investment of these aggregations in a diversified security portfolio managed by a professional financial organization, could be achieved only if special provisions were made for the taxation of the income earned and the capital gains enjoyed. The soundness of the analysis at that time is testified to by the rapid

growth of mutual investment funds in the past 10 years. The new developments in the municipal field are providing a situation which, in many respects, is similar to that which existed with respect to equities before the war. A new financal problem is arising, and the financial community, given appropriate legislation, can be expected to work out methods by which it may be handled.

The Chairman. Please start your statement, Senator.

STATEMENT OF HON. SCOTT W. LUCAS, ON BEHALF OF AMERICAN FINANCE CONFERENCE

Mr. Lucas. Mr. Chairman, I wish to thank you for the kind words you said about me in the beginning.

My name is Scott W. Lucas. I am appearing on behalf of the American Finance Conference, a national association of independent finance companies, a sizable number of whom own all or a considerable portion of the stock of affiliated insurance companies. In addition, many insurance companies are associate members of the American Finance Conference.

Our especial concern is with section 246 (a) (1) H. R. 8300. The effect of that section is to make the deduction of 85 percent of the amount received as dividends by corporations—a general rule set out in section 243 (a) of H. R. 8300—inapplicable in the case of dividends received by corporations as a result of their ownership of stock in any insurance company.

The very first section of the House Ways and Means Committee Report No. 1337, on H. R. 8300, refers to the fact that the purpose of "these changes has been to remove inequities," that the bill will "create an environment in which normal incentives can operate to maintain normal economic growth," that the bill was developed through lengthy study of means of "removing tax inequities," and that among provisions of the bill important to the growth and survival of small business are those which provide a "stimulus to equity financing through dividend relief."

Mr. Chairman, I can conceive of nothing more commendable in a comprehensive revision of the internal-revenue laws than the removal of inequities and the provision of stimulation for our economic growth. Yet section 246 (a) (1) creates an inequity and effectively retards the development of an important phase of our economy. Briefly, this is why:

Under present law—section 26 (b) (1) of the Internal Revenue Code—a corporation is entitled to a credit against net income of 85 percent of the amount it receives as dividends from other corporations which are subject to tax. But section 246 (a) (1) of H. R. 8300, while purporting to carry over this existing credit as a deduction, for some reason for which I am frank to say I can see no logic, disallows the deduction in the case of dividends received from all insurance companies, despite the fact that certain types of those disallowed companies pay the full 30-percent normal tax and the full 22-percent surtax on their entire net income.

For example, under the present law, if corporation A owns the stock of the B casualty insurance corporation, C dry goods corporation, and D manufacturing corporation, then corporation A would be entitled to a credit against its net income of 85 percent of the dividends received from the B corporation, C corporation, and D corporation.

But under H. R. 8300, shareholder corporation A would be entitled to a deduction of 85 percent of the dividends it received from C corporation and D corporation, and no deduction at all with respect to dividends it received from B casualty insurance corporation—and this despite the fact that B, C, and D corporations are treated alike under the present law and, in other respects, under H. R. 8300; and pay under the present law and will pay under H. R. 8300, Federal income taxes at precisely the same rates.

Is this the removal of inequities, or is it the creation of discrimination? In the light of the foregoing, the answer is obvious.

Now, as to the environment which the House committee report claims is made healthier as a result of H. R. 8300. So far as the affected insurance companies are concerned, just the opposite results, for the effect of section 246 (a) (1) will be to retard the growth of the companies, since the bill, by making corporate ownership of such insurance company stock less attractive, would add obstacles to the acquisition of additional capital.

Obviously, so far from stimulating investment in insurance companies, H. R. 8300 would cause present corporate shareholders to suffer substantial loss, would depress the value of insurance company stock, and would tend to make future investors either to remain indifferent to insurance company stock, or to demand excessive or prohibitive terms as a condition of investing.

Mr. Chairman, and gentlemen of the committee, the discrimination I have described above relates to corporate owners of insurance corporation stock. May I add that the same type of inequity prevails in section 34 (c) (1) and section 116 (b) of H. R. 8300, which deny to individual stockholders of such insurance companies the new relief from double taxation of dividends, in section 923 (d) (2) which denies to such insurance companies the section 37 credit dealing with business income from foreign sources; and in the section 951 (c) (4) election as to treatment of deferred income from sources within foreign countries.

Mr. Chairman, I would not presume to suggest the exact language to effectuate the correction of the inequitable and discriminatory treatment accorded insurance companies. Having served on this committee, I have a sufficiently high regard for its staff to be certain that the technical changes to accommodate the necessary adjustments will be carefully and skillfully made, providing the committee goes along with my theory.

The CHAIRMAN. We miss you around here, Senator.

Mr. LUCAS. Thank you very much. I miss you fellows, too.

The CHAIRMAN. Have you been in touch with Mr. Stam, Senator?

Mr. LUCAS. I talked with Mr. Stam on the phone one day.

The CHAIRMAN. I hope you will get together with him and have a good talk with him about what you have recommended.

Mr. LUCAS. I certainly will be glad to do that at Mr. Stam's convenience. I shall also submit additional statements on other questions which I ask to be made part of the printed record.

(The following statements were subsequently submitted for the record:)

Statement by Scott W. Lucas on Behalf of American Finance Conference Submitted to Senate Finance Committee on H. R. 8300

I. Sections 246 (a) (1), 243 (a), 84 (c) (1), 116 (b), 923 (d) (2), 951 (c) (4), dealing with taxation of insurance corporation dividends

On April 12, 1954, I testified before the Senate Finance Committee on this point. For the committee's convenience, I am setting forth below my statement on this subject.

I am appearing on behalf of the American Finance Conference, a national association of independent finance companies, a sizable number of whom own all or a considerable portion of the stock of the affiliated insurance companies. In addition, many insurance companies are associate members of the American Finance Conference.

Our especial concern is with section 246 (a) (1) of H. R. 8300. The effect of that section is to make the deduction of 85 percent of the amount received as dividends by corporations (a general rule set out in sec. 243 (a) of H. R. 8300) inapplicable in the case of dividends received by corporations as a result of their ownership of stock in any insurance company.

The very first section of the House Ways and Means Committee report (No. 1337) on H. R. 8300 refers to the facts that the purpose of "these changes has been to remove inequities," that the bill will "create an environment in which normal incentives can operate to maintain normal economic growth," that the bill was developed through lengthy study of means of "removing tax inequities," and that among provisions of the bill important to the growth and survival of small business are those which provide a "stimulus to equity financing, through dividend relief."

Mr. Chairman, I can conceive of nothing more commendable in a comprehensive revision of the internal revenue laws than the removal of inequities and the provision of stimulation for our economic growth. Yet section 246 (a) (1) creates an inequity and effectively retards the development of an important phase of our economy. Briefly, this is why:

Under present law (sec. 26 (b) (1) of the Internal Revenue Code), a corporation is entitled to a credit against net income of 85 percent of the amount it receives as dividends from other corporations which are subject to tax. But section 246 (a) (1) of H. R. 8300, while purporting to carry over this existing credit as a deduction, for some reason for which I am frank to say I can see no logic, disallows the deduction in the case of dividends received from all insurance companies, despite the fact that certain types of those disallowed companies pay the full 30 percent normal tax and the full 22 percent surtax on their entire net income.

For example, under the present law, if corporation A owns the stock of the B casualty insurance corporation, C dry goods corporation, and D manufacturing corporation, then corporation A would be entitled to a credit against its net income of 85 percent of the dividends received from the B corporation, C corporation, and D corporation. But under H. R. 8300, shareholder corporation A would be entitled to a deduction of 85 percent of the dividends it received from C corporation, and D corporation, and no deduction at all with respect to dividends it received from B casualty insurance corporation—and this despite the fact that B, C, and D corporations are treated alike under the present law and, in other respects, under H. R. 8300; and pay under the present law, and will pay under H. R. 8300, Federal income taxes at precisely the same rates.

Is this the removal of inequities, or is it the creation of discrimination? In the light of the foregoing, the answer is obvious.

Now as to the environment which the House committee report claims is made healthier as a result of H. R. 8300. So far as the affected insurance companies are concerned, just the opposite results. For the effect of section 246 (a) (1) will be to retard the growth of the companies, since the bill, by making corporate ownership of such insurance company stock less attractive, would add obstacles to the acquisition of additional capital. Obviously, so far from stimulating investment in insurance companies, H. R. 8300 would cause present corporate shareholders to suffer substantial loss, would depress the value of insurance company stock, and would tend to make future investors either to remain indifferent to insurance company stock or to demand excessive or prohibitive terms as a condition of investing.

Mr. Chairman, the distrimination I have described above relates to corporate owners of insurance corporation stock. May I add that the same type of inequity prevails in section 34 (c) (1) and section 116 (b) of H. R. 8300, which deny to individual stockholders of such insurance companies the new relief from double taxation of dividends; in section 923 (d) (2) which denies to such insurance companies the section 37 credit dealing with business income from foreign sources; and in the section 951 (c) (4) election as to treatment of deferred income from sources within foreign countries.

I would not presume to suggest the exact language to effectuate the correction of the inequitable and discriminatory treatment accorded insurance companies. Having served on this committee, I have a sufficiently high regard for its staff to be certain that the technical changes to accommodate the necessary adjustments will be carefully and skillfully made.

II. SECTIONS 275 AND 312 (C), BARRING DEDUCTIONS OF INTEREST ON CERTAIN SUBORDINATED BONDS

The effect of these two sections is to prohibit the deduction for income tax purposes of interest on corporate notes and bonds, if these obligations are held by persons who together own (directly or indirectly) 25 percent or more of the corporation's common stock and if the obligation is subordinated to claims of other creditors.

1. Although the House Ways and Means Committee report recites that the bill contains "many provisions which are important to the growth and survival of small business," the subject provision works a real hardship on many small corporations which are owned by a small group of persons, such as family-owned corporations whose stockholders must lend money to their firms under subordination agreements so that the company may borrow money and obtain credit from lenders who are not stockholders.

2. There is no real distinction between a second mortgageholder and a subordinated noteholder, except that the latter is not secured by a lien. In both cases, the lender understands that his obligation is junior to a superior indebtedness. The subject provision of H. R. 8300 injects a concept entirely foreign to the field of corporate finance when, in effect, it abandons all the traditional attributes of an indebtedness and substitutes a formula related to whether the holder of the obligation is also a stockholder.

3. The holder of a subordinated obligation is a creditor and not a stockholder as long as the obligation has all the attributes of an indebtedness: (1) a fixed maturity date; (2) a promise to pay a sum certain in money on that date; (3) a definite obligor; and (4) a definite obligee. If an instrument meets these traditional tests of an indebtedness then interest should be allowed as a deduction—and it should be no less allowed if it is a subordinated debt and if it happens that the holder owns more or less than 25 percent of the common stock of the issuer. Sheer logic would dictate that if the instrument evidences a valid indebtedness, a deduction should be allowed for the interest paid thereon regardless of who owns the security.

4. The subject provision, so far from removing inequities which the House Ways and Means Committee report claims H. R. 8300 does, adds a discriminatory feature which does not exist in the present law. The United States Tax Court, United States district courts, United States courts of appeals, and the United States Supreme Court have consistently held that interest is deductible on subordinated notes if they have all the characteristics of a debt, even though such notes are held by stockholders. It is obvious that many small family-owned corporations would, if the subject provisions became law, suddenly have imposed on them a very heavy tax burden and in many cases the consequences would bring chaos to their financial structure. Long-range financial planning, reflected in the issuance of subordinated obligations, would be penalized because the planners relied on the law and court decisions.

5. A glance at a set of hypothetical figures will show the ruinous effect of the subject provision. If a corporation now has 5 percent subordinated bonds outstanding held by stockholders, it must earn at least 5 percent on the borrowed money in order to pay what has always been called interest thereon. If the corporation earns 7 percent from the use of this money, it has a profit of 2 percent. But what happens if the interest paid on these obligations is not deductible? Since the corporation would pay a 52-percent income tax, it must

earn 10½ percent in order to pay the 5-percent rate on the bonds. In other words, with the same 7-percent earnings the corporation will suffer a loss of 3½ percent under the subject provision instead of the 2-percent profit which it has been earning.

6. Questions are certain to arise if the subject provision became law. For example:

(1) Since the income from such bonds will be taxed to the holder who owns 25 percent or more of the common stock, does that make such income a dividend?

(2) If it is a dividend, does it qualify for the dividend credit under section 34 of the proposed law?

(3) Would the interest paid on such subordinated obligations give rise to the 85 percent dividend credit in those cases where a corporation owned the subordinated obligation and also owned 25 percent or more of the stock of the company that issued the note?

(4) Suppose a subordinated bond was originally issued to a nonstockholder in good faith who later sold it to a person or a group who together owned 25 percent or more of the common stock of the company. Would this give rise to tax deficiencies?

It appears that the purpose of this provision is to disallow the deductions in the cases of undercapitalized corporations whose balance sheet would show an abnormal amount of debt and an extremely nominal amount of capital. (We say "it appears," because this provision was not included in the House Ways and Means Committee's published announcement of substantive changes in existing law nor is there any explanation of the reason for this provision in the House Ways and Means Committee report on H. R. 8300.) Surely, this committee can correct the provision's obvious deficiencies and still reach the vice sought to be eliminated.

III. SECTION 163, AUTHORIZING A DEDUCTION FOR FINANCE CHARGES PAID NOT TO EXCEED 6 PERCENT OF THE AVERAGE UNPAID BALANCE UNDER THE CONTRACT

This section of H. R. 8300 continues the deduction for interest presently contained in section 23 (b) of the Internal Revenue Code. In addition, however, the section provides for the deduction of certain carrying charges as interest where the interest charged cannot be ascertained.

It is no exaggeration to say that the mass distribution and marketing of cars, appliances, and many other commodities usually sold on time, is made possible by the existence of the time-price doctrine. In brief, this doctrine is that the difference between a cash price and a time price on the time sale of any commodity is not interest and therefore is not subject to the limitation of conventional interest statutes. This is a principle which has been enunciated as far back as 1861 by the Supreme Court of the United States (*Hogg* v. *Ruffner*, 66 U. S. 115), and is simply another way of saying that for automobiles and other commodities sold on time, there are two prices available to the purchaser: One price if he pays cash and another price if he pays on time.

This principle is so well established in law, and is so embedded in the pattern of the financial fraternity engaged in financing mass production and distribution, that it is a fair statement that if this doctrine is overturned through infelicitous language in a tax bill there would be serious adverse economic consequences to the Nation as a whole.

Under the present law, interest payments made by borrowers are deductible, but neither the present law nor the Internal Revenue Service has permitted a similar deduction for finance charges. This denial of a deduction has been consistent with the time-price doctrine, for the denial does nothing more than confirm what is a fact in any event: That a time-price differential is not interest.

We do not quarrel with that portion of section 163 which continues to allow a deduction for interest paid. Nor do we quarrel with the principle of that portion of section 163 which accords to a time buyer a deduction. What we do urge is that the liberalizing feature of section 163 be articulated in such a way that, while the deduction authorized by section 163 (b) would not be disturbed, the language of the section would not and could not be construed as doing violence to the time-price differential doctrine. The deficiencies in section 163 can be easily corrected without disturbing in the slightest the intention of the drafters.

It is suggested that the section be changed to read as follows, the matter to be deleted from section 163 being enclosed in brackets and the new matter being in italics:

"(a) GENERAL RULE. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

"(b) INSTALLMENT PURCHASES WHERE NO SEPARATE INTEREST CHARGED IS [NOT SEPARATELY STATED] INDICATED

"(1) GENERAL RULE. If personal property is purchased under a contract—

"(A) which provides that payment of part or all of the purchase price is to be made in installments, and

"(B) in which carrying charges are [separately stated] *included* but [the] *no* interest charge [cannot be ascertained] *is separately indicated,* then the payments made during the taxable year under the contract shall be treated [as including] *for the purposes of this section as if they included* interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balances outstanding on the first day of each month beginning during the taxable year, divided by 12.

"(2) LIMITATION. In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

"(c) CROSS REFERENCES

"(1) for disallowance of deduction for interest relating to tax-exempt income, see section 265 (2).

"(2)For disallowance of deduction for carrying charges chargeable to capital account, see section 266."

IV. SECTION 6323, AFFECTING FEDERAL TAX LIENS

Under sections 3640 and 3641 of the Internal Revenue Code the Commissioner is authorized to make assessments and certify such assessments to collectors for collection. Under' section 3671, Internal Revenue Code, a tax lien arises in favor of the Government for unpaid taxes when the assessment list is received by the collector, and this lien continues as a secret lien, without the necessity of any public filing or notice, until it is satisfied or otherwise discharged in accordance with particular circumstances specified by statute. However, under section 3672, Internal Revenue Code, the lien is invalid as against any "mortgagee, pledgee, purchaser, or judgment creditor" until a notice of lien has been filed by the collector in specified offices, and this filing is in the nature of a public notice, just as is the filing or recording of a chattel mortgage or other security device.

It has been held that the classes of persons protected under section 3672 are only those "specifically included in the statute and no others." For illustration, see *United States* v. *Eisinger Mill and Lumber Company* (Md.) (98 Atl. (2) 81)); *United States* v. *Security Trust and Savings Bank* (340 U. S. 47). Section 3672 was originally enacted to overcome the effect of *United States* v. *Snyder* (149 U. S. 210), and was subsequently amended to extend its protection to pledgees to overcome the effect of *United States* v. *Rosenfield* (26 Fed. Sup. 433).

Recently, to our knowledge, the Government has contended in pending cases that the assignee of accounts receivable was not a conventional "pledgee" within the meaning of section 3672, and, therefore, did not have the benefit of the protection afforded by that section, and that an entruster under the Uniform Trust Receipts Act, enacted in 31 States and 2 Territories, is likewise not within the classes of persons protected by section 3672. We do not believe such an interpretation was within the congressional intent.

It has also been held that a reservation of title by a conditional seller is valid as against an unfiled tax lien asserted against the conditional buyer, since the property involved was not that of the taxpayer. See *United States* v. *Anders Contracting Company* (111 Fed. Supp. 700).

The Uniform Commercial Code has been enacted in Pennsylvania, may shortly be enacted in Massachusetts, and is under serious consideration by public or semipublic bodies in about another dozen States. As this committee knows, this commercial code abolishes distinctions between chattel mortgages, pledges, trust receipts, factors liens, etc., and substitutes in their place a single lien concept known as a security interest held by a creditor called a secured party. We feel reasonably sure that if the code became widely enacted, as is hoped, the Government would contend that a secured party holding a security interest is not within the class of persons protected by the language of the present section 3672 of the Internal Revenue Code.

Another feature of our present law that we endorse is that actual notice of the existence of a secret tax lien by a secured creditor is not a substitute for the required filing in order to give the Government priority as against a mortgagee, pledgee, purchaser, or judgment creditor. See *United States* v. *Beaver Run Coal Company* ((CCA 3d, 1938) 99 Fed. (2) 610). In order for the Government's lien to be valid against such classes of persons there must be the definite prescribed public act of a filing which affords certainty and definiteness as to the date as of which rights of parties are fixed.

Under H. R. 8300, section 6203 is new, takes the place of section 3640 and section 3641 of the Internal Revenue Code and the date of the making of the assessment as authorized thereby becomes important because under section 6322 which takes the place of section 3671 of the Internal Revenue Code the Government's tax lien arises when the assessment is made and not when the assessment list is received by the collector.

Section 6323 of H. R. 8300, comparable to section 3672 of the Internal Revenue Code, continues to protect only mortgagees, pledgees, purchasers, and judgment creditors, as to which we definitely feel some changes should be made, and in addition contains a new provision substituting notice which can be charged to a secured creditor, instead of the present required filing, to give the Government priority over a secured creditor.

To restore the protection to the classes of persons entitled to that protection, as the foregoing demonstrates, it is suggested that section 6323 (a) be amended to read as follows:

"INVALIDITY OF LIEN WITHOUT NOTICE. Except as otherwise provided in subsections (c) and (d) the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, judgment creditor, or holder of a perfected lien or security interest until notice thereof has been filed by the Secretary or his delegate."

At present the effectiveness of the Government's lien is determined by a definite prescribed act of filing a public notice. Under the bill, an assessment against a taxpayer, not even in default, may be made upon the recording of the taxpayer's return since the taxpayer by his return in effect assesses the liability against himself in favor of the Government. We understand the liability of taxpayers will be recorded by mechanical process, and we would imagine that the recording would be made at the latest by the due date of the tax. This undoubtedly will be prescribed by regulation which will put the world on notice of the fact that every taxpayer who has filed a return and not paid a tax may have a lien existing against him, or at least every taxpayer who has not paid his tax by due date, even though there is pending a disputed question of liability with reference to the tax, has a tax lien against him, and this notice may be sufficient to put any secured financing institution behind the Government's claim and lien for taxes, even though no notice has been filed.

It is obvious that such a situation can generate considerable difficulty and may result in drying up the extension of secured credit to any person who even for a good reason is delinquent in the payment of any tax.

For this reason, it is suggested that section 6323 (c) be changed to read as follows:

"LIEN VALID WITHOUT NOTICE IN CERTAIN CASES. The lien imposed by section 6321 shall be valid without the filing of notice thereof as against any judgment creditor if—

"(1) the judgment creditor has not obtained a valid judgment in a court of record or of competent jurisdiction for the recovery of specifically designated property or for a certain sum of money, or

"(2) the judgment creditor has a valid judgment of a court of record and of competent jurisdiction for the recovery of a certain sum of money but has not perfected a lien under such judgment with respect to the property involved."

APPENDIX

SECTIONS OF H. R. 8300 REFERRED TO IN FOREGOING STATEMENT

PART I

Section 246 (a) (1)

"SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

"(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS. The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following);".

Section 243 (a)

"SEC. 243. DIVIDENDS RECEIVED BY CORPORATIONS.

"(a) General Rule. In the case of a corporation, there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends (other than dividends described in paragraph (1) of section 244, relating to dividends on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter."

Section 34 (c) (1)

"SEC. 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

"(a) * * *

"(b) * * *

"(c) No Credit Allowed for Dividends From Certain Corporations. Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following) ;".

Section 116 (b)

"SEC. 116. PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS.

"(a) * * *

"(b) Dividend to Which Subsection (a) Applies. Subsection (a) applies only to dividends received from domestic corporations other than corporations described in section 34 (c) (relating to denial of credit for dividends received). In determining, for purposes of this section, the amount of any dividend, the rules of section 34 (d) (relating to special rules for certain distributions) shall apply."

Section 923 (d) (2)

"SEC. 923. BUSINESS INCOME FROM FOREIGN SOURCES.

"(a) * * *

"(b) * * *

"(c) * * *

"(d) Certain Corporations Ineligible for Credit. The credit provided in section 37 shall not be allowed in the case of a corporation, which for the taxable year—

"(1) * * *

"(2) is subject to the tax imposed by subchapter L (sec. 801 and following relating to insurance companies) ;".

Section 951 (c) (4)

"SEC. 951. INCOME WHICH MAY BE DEFERRED.

"(a) * * *

"(b) * * *

"(c) Certain Corporations Ineligible. No election under this part may be made by a corporation, which, for the taxable year—

"(1) * * *

"(2) * * *

"(3) * * *

"(4) is subject to the tax imposed by subchapter L (sec. 801 and following, relating to insurance companies) ;".

PART II

Section 275

SEC. 275. NONPARTICIPATING STOCK.

"No deduction shall be allowed for any amounts paid with respect to nonparticipating stock (as defined in sec. 312 (d)) which, but for this section, would have been deductible from gross income."

Section 312 (c)

"SEC. 312. DEFINITIONS RELATING TO CORPORATE DISTRIBUTIONS.

"(a) * * *

"(b) * * *

"(c) Securities. The term "securities" means an instrument representing an unconditional obligation (or obligations) of a corporation to pay a sum certain in money other than open account indebtedness.

"(1) which in the case of obligations held by persons who together own 25 percent or more of the participating stock is not subordinated to the claims of trade creditors generally;

(2) payments, if any, for the use of the principal amount of which are not dependent in amount upon the earnings of the corporation and are unconditionally payable not later than the maturity date of the principal amount;

"(3) For the purpose of (1), above, in determining the ownership of stock and debt, section 311 shall be applicable. Except as used in this subsection, the term "securities" means only securities representing indebtedness of the distributing corporation."

PART III

Section 163

"SEC. 163. INTEREST.

"(a) GENERAL RULE. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

"(b) INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.

"(1) GENERAL RULE. If personal property is purchased under a contract—

"(A) which provides that payment of part or all of the purchase price is to be made in installments, and

"(B) in which carrying charges are separately stated but the interest charge cannot be ascertained, then the payments made during the taxable year under the contract shall be treated as including interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

"(2) LIMITATION. In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

"(c) CROSS REFERENCES.

"(1) For disallowance of deduction for interest relating to tax-exempt income, see section 265 (2).

"(2) For disallowance of deduction for carrying charges chargeable to capital account, see section 266."

PART IV

Section 6323

"SEC. 6323. VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS.

"(a) INVALIDITY OF LIEN WITHOUT NOTICE. Except as otherwise provided in subsections (c) and (d), the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the Secretary or his delegate—

"(1) UNDER STATE OR TERRITORIAL LAWS. In the office designated by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law designated an office within the State or Territory for the filing of such notice; or

"(2) WITH CLERK OF DISTRICT COURT. In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law designated an office within the State or Territory for the filing of such notice; or

"(3) WITH CLERK OF DISTRICT COURT FOR DISTRICT OF COLUMBIA. In the office of the clerk of the United States District Court for the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

"(b) FORM OF NOTICE. If the notice filed pursuant to subsection (a) (1) is in such form as would be valid if filed with the clerk of the United States district court pursuant to subsection (a) (2), such notice shall be valid notwithstanding any law of the State or Territory regarding the form or content of a notice of lien.

"(c) LIEN VALID WITHOUT NOTICE IN CERTAIN CASES. The lien imposed by section 6321 shall be valid, without the filing of notice thereof, as against any mortgagee, pledgee, purchaser, or judgment creditor, if—

"(1) in the case of a mortgage, pledge, or purchase, such mortgagee, pledgee, or purchaser had notice or knowledge of the existence of such lien at the time the mortgage, pledge, or purchase, was made, or

"(2) in the case of a judgment creditor, the creditor has not obtained a valid judgment in a court of record and of competent jurisdiction for the recovery of specifically designated property or for a certain sum of money, or

"(3) in the case of a judgment creditor who has a valid judgment of a court of record and of competent jurisdiction for the recovery of a certain sum of money, no lien with respect to the property involved has been perfected under such judgment.

"(d) EXCEPTION IN CASE OF SECURITIES

"(1) EXCEPTION. Even though notice of a lien provided in section 6321 has been filed in the manner prescribed in subsection (a) of this section, the lien shall not be valid with respect to a security, as defined in paragraph (2) of this subsection, as against any mortgagee, pledgee, or purchaser of such security, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien.

"(2) DEFINITION OF SECURITY. As used in this subsection, the term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, share of stock, voting-trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

"(e) DISCLOSURE OF AMOUNT OF OUTSTANDING LIEN. If a notice of lien has been filed under subsection (a), the Secretary or his delegate is authorized to provide by rules or regulations the extent to which, and the conditions under which, information as to the amount of the outstanding obligation secured by the lien may be disclosed."

The CHAIRMAN. Mr. Stam, will you plan to have a talk with the Senator?

Mr. STAM. I will be glad to.

The CHAIRMAN. Mr. Eric Johnston. It is good to see you Mr. Johnston. Will you please identify yourself to the reporter.

STATEMENT OF ERIC JOHNSTON, PRESIDENT, MOTION PICTURE EXPORT ASSOCIATION, INC.

Mr. JOHNSTON. Thank you. My name is Eric Johnston. I am president of the Motion Picture Export Association, representing 10 leading American motion-picture companies in their operations abroad We have our head offices in New York and Washington. We are here to testify on amendments to section 923 of H. R. 8300. I have a prepared statement, and with your permission, Mr. Chairman, I would like to file this prepared statement for reference, and merely talk to you for about 4 minutes on our position on H. R. 8300.

The CHAIRMAN. That will be fine. Will you put it in the record, please?

(Mr. Johnston's prepared statement follows:)

STATEMENT BY ERIC JOHNSTON, PRESIDENT, MOTION PICTURE EXPORT ASSOCIATION, INC.

Mr. Chairman, my name is Eric Johnston. I am president of the Motion Picture Export Association, 1600 I Street NW., Washington. The association represents the following 10 American film companies in their operations abroad:

Allied Artists International Corp., Columbia Pictures International Corp., Loew's International Corp., Paramount International Films, Inc., RKO Radio Pictures, Inc., Republic Pictures International Corp., Twentieth Century-Fox

International Corp., United Artists Corp., Universal International Films, Inc., and Warner Bros. Pictures International Corp.

I am here to present the views of the association and its member companies on section 923 of H. R. 8300, which your committee has under consideration.

I would like to express appreciation for the tremendous work of Congress in revising our tax structures and in correcting its inequities. The recodification and overhauling of our tax statutes are long overdue and the taxwriting committee of Congress are deserving of the warmest commendation for undertaking this difficult, laborious, and essential task.

As one who has had an extensive interest in international trade, I would like also to state my gratification over the steps that Congress is taking to stimulate the flow of American venture capital abroad.

As you may know, this is not the first time I have appeared before a congressional committee in support of legislation designed to promote foreign trade, and through it, to encourage the growth of competitive capital throughout the world.

Specifically, the proposal incorporated in section 923 is one of a group designed to provide foreign investment incentives, which were originally recommended to the President by the International Development Advisory Board, of which I have the honor to be chairman.

The basic intent of section 923 is to provide incentives to American enterprises that make substantial investments and engage in active business operation in foreign countries. Clearly the motion-picture industry qualifies for the 14-point tax credit on the income derived abroad from the operation of its theaters and from the business of distributing its films.

Ours is a worldwide business. Our companies have establishments in more than 40 countries and they service exhibitors in every country of the free world. These exhibitors largely depend upon our product and services for their existence.

On our payroll abroad we carry approximately 30,000 employees, consisting both of Americans and of foreigners. Our foreign property holdings are extensive. They include centers for the distribution of films, storage facilities, offices, theaters, laboratories, and film-printing plants. This represents a substantial proportion of our total investments.

These investments in other lands are not static. Our companies are not coupon clippers. They engage actively in operations to develop and expand their trade, business, and investments abroad.

Now I want to turn specifically to the provisions of section 923.

Most of our earnings abroad are derived from film rentals. Under section 923 it appears doubtful whether such form of income qualifies for the proposed tax credit.

The possible failure of the present draft of the section to qualify film rentals for the tax credit may have been either inadvertent or due to a misunderstanding of the extensive scope of the business activities that must be carried on abroad in distributing films to theaters.

The distribution of films in foreign countries is a major business activity, usually handled through wholly owned subsidiaries, both domestic and foreign.

The business activities carried on abroad include such complicated and costly operations and services as the printing, dubbing, titling, synchronization, scoring, shipping, maintenance, distribution, and the exhibition of films.

All these involve large and continually recurring financial risks and outlays, and all of which inure to the benefit of foreign countries. For example, printing costs alone amount to $5 million annually.

In an undertaking such as ours, it is not realistic to segregate our operations abroad for business or tax purposes. There is an interrelationship among our various operations that cannot be avoided.

In view of these evident facts, I submit that the motion-picture industry is justly entitled to the tax incentive provided in section 923.

The expansion that has occurred in motion-picture operations overseas has been undertaken purely on our own initiative. And this has come about in spite of the discrimination to which our industry has been subjected in foreign countries, discrimination ranging all the way from import quotas to arbitrary taxation—taxation directed exclusively at our industry.

The American film industry is the only one in the world that does not receive Government support in one form or another. I mention this simply to emphasize my earnest hope that, in considering this legislation, you will recognize that the

American motion-picture industry in its operations abroad should be assured of equal treatment with other enterprises investing and doing business in foreign countries.

With the incentive provided in section 923, our industry will be able to increase its investments abroad—particularly in underdeveloped countries. The American film industry would furnish additional employment and would make sizable contributions to the economic progress of the free world.

The necessary clarifying amendments to section 923, identified as 4-8-54-E, are pending before the committee, having been introduced by Senator Johnson of Colorado. As part of my testimony, I am filing with the clerk of the committee a supplemental statement explaining the proposed amendments.

Mr. Chairman, I deeply appreciate the time the committee has given me to present our views to you.

AMENDMENTS PROPOSED BY THE MOTION PICTURE EXPORT ASSOCIATION TO SECTION 923 OF H. R. 8300

The following two amendments to section 923 are needed to clarify the application of the proposed 14-percentage-point foreign income tax differential to income from motion picture film rentals:

First, on page 222 of the bill, add at the end of section 923 (a) the following new paragraph:

"(5) as rentals in respect of motion-picture films."

Second, on page 223 of the bill, add at the end of section 923 (b) the following new paragraph:

"(3) rentals received by a foreign corporation in respect of motion-picture films shall be deemed to be derived from the active conduct of a trade or business described in paragraph (3) (A) (ii) of subsection (a)."

The first amendment makes section 923 (a) clearly applicable to income from film rentals received by domestic corporations whenever such income is from foreign sources. The second amendment makes section 923 (a) clearly applicable to dividends and interest from foreign subsidiary corporations which derive their income from foreign film rentals.

Earnings and profits of foreign subsidiary corporations derived partially from film rentals and partially from the operation of theaters will be covered by section 923 after the addition of the second proposed amendment, since theater operation is already adequately described by the reference, in section 923 (a) (3) (A) (ii), to the active conduct of a trade or business through a retail establishment or other like place of business.

Domestic corporations operating theaters abroad may qualify income from such operations under section 923 (a) (1), as the bill is now written, by treating their theater operations as separate branches and electing the deferral provisions of part IV.

Mr. JOHNSTON. In the first place, Mr. Chairman and gentlemen, may I express to you our great appreciation for the tremendous task which has been undertaken by the Congress of the United States in revising and rewriting our tax laws. The recodification and the reworking of our tax structure have been long overdue. I think that the Congress of the United States deserves the greatest credit for undertaking this laborious, painstaking, but very essential task.

May I also express our appreciation for including in the bill an incentive for the flow of American private capital abroad. As chairman of the International Development Advisory Board, which advises the President of the United States on technical assistance problems overseas, I assure you we have long recognized, as has the Congress which wrote this legislation, that, if we could get an adequate amount of private American capital flowing overseas, many of our economic problems around the world would be solved. Then, much of the necessity for foreign aids and grants would be removed.

I want to compliment the Congress for including in the bill a provision as an incentive for the flow of American capital overseas. Section 923 encourages private capital to go overseas by its provision to extend the 14-percentage-point tax credit for the Western Hemisphere to the whole world. The committee report on this section specifically excludes royalties and license fees earned abroad. We can thoroughly understand that and think it is a wise provision, because normally, royalties and license fees do not create any business or stimulate the flow of private capital abroad, and, therefore, would not be included in this tax incentive feature. Unfortunately, this hits the motion picture pretty hard, because our film rentals abroad have been classified as royalties, and as such, would not be entitled to the 14-percentage-point tax credit from overseas. Yet, we think this is entirely unfair to the motion picture industry for two reasons. In the first place, we are a big business abroad, operating establishments in more than 40 countries in the free world, employing more than 30,000 persons in our business operations and in theaters. Our investment is more than $100 million in these countries.

Senator BENNETT. Mr. Johnston, may I interrupt at this point? When you say you are operating establishments, are you referring to physical operations in which American capital has been invested? Do you own the buildings; do you own the facilities?

Mr. JOHNSTON. Yes, Senator, we operate not only offices, but we operate laboratories, printing plants, studios, theaters, entire business operations, in these areas abroad.

Senator WILLIAMS. Does this estimate of employment include the theaters?

Mr. JOHNSTON. Yes, the persons that we employ directly in the theaters and in other operations abroad as well. The theater employment amounts perhaps to a little more than a third. We, therefore, do business abroad, qualifying, we feel, under section 923, as to investments abroad. Furthermore, these investments can be stimulated and expanded greatly with the proper incentives. That is what we want to do, and we think that is what the Congress of the United States intends us to do.

Senator CARLSON. Mr. Chairman, do I understand, then, that you are operating businesses in the foreign countries, and yet your income is not classed as income but classed as royalties?

Mr. JOHNSTON. That is right.

The CHAIRMAN. Give us a little information on the exact nature of the operation.

Mr. JOHNSTON. Mr. Chairman, we not only have offices abroad from which we distribute films, but we actually operate laboratories where we make prints of the films that are shown in the theaters. You understand, many prints of a film have to be made for showings in theaters. So we operate film printing plants and we produce advertising materials and things of that kind. We also operate studios in which we make pictures. All of these are business operations in the accepted sense of the term.

They are as much as other business—they are our factories abroad, which we operate.

Senator WILLIAMS. Would they be distinguished differently from oil companies and other royalty types?

Mr. JOHNSTON. They wouldn't be distinguished from any other manufacturing concern, because we are manufacturing firms abroad.

The second point, Mr. Chairman, in which we are unique is that the motion picture is the best means of comunication and information.

A picture can always be understood better by people than can anything else. Therefore, our Government has urged us to go abroad. After the World War, we went abroad in certain countries of the world where we got no revenue. We received nothing; we even paid our own out-of-pocket expense. The Government still wants us to show our films abroad. We are the only film industry, gentlemen, that is not subsidized, the only major film industry in the world that is not subsidized by its Government.

We receive no subsidy from the American Government, nor do we want any. We merely want to operate as free, competitive, private enterprise abroad. And that is how we are operating. Yet, these other governments which subsidize their films, frequently, also, subsidize their foreign operations. Take Russia as an illustration. The Russian film industry is owned by the Russian Government. It also subsidizes its films abroad and has purchased interests in theaters abroad and it engages in coproduction abroad in order to get its films scattered throughout the world.

Our Government wants us to expand our operations abroad. We ourselves want to expand, and with the proper tax incentive, as given to other business, we think we can expand our operations abroad.

Gentlemen, briefly, that is our position. In order to bring that about, an amendment to section 923 has been introduced by Senator Johnson of Colorado. It is identified as 4-8-54-E, and this amendment is now pending before your committee. I have attached to my prepared statement and filed with the clerk a supplemental statement explaining this proposed amendment.

Gentlemen, I want to thank you very much for your courtesy in giving me this brief opportunity to explain in our position. Thank you very much.

The CHAIRMAN. Have you been in touch with our staff, Mr. Johnson?

Mr. JOHNSON. I have not been in touch with Mr. Stam. We have tried to reach him, but he is a very busy man. We would like to talk to him at our earliest opportunity.

The CHAIRMAN. I am sure he will be glad to talk with you.

Is Mr. McDermott in the room? If not, is Mr. Funston present?

Will you be seated, please, and identify yourself to the reporter?

STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE

Mr. FUNSTON. Mr. Chairman, my name is Keith Funston. I live in Greenwich, Conn., and I am president of the New York Stock Exchange. I deeply appreciate the opportunity to present our views on the tax revision program under consideration. My remarks will be confined to 2 sections of H. R. 8300: (1) sections 35 and 116, which provide limited relief from double taxation of dividends; and (2) subchapter P of chapter 1, relating to the taxation of capital transactions.

In addition to representing the New York Stock Exchange, I have the honor to speak today also for the Investment Bankers Association, the National Association of Securities Dealers, the American Stock Exchange, and the regional stock exchanges throughout the country, organizations which represent the securities industry of our Nation.

The CHAIRMAN. What is the American Stock Exchange?

Mr. FUNSTON. That is the second largest exchange in the United States. It is located in New York City.

Senator BENNETT. It used to be known as the Curb.

Mr. FUNSTON. I am speaking, also, for Mr. McCormick, who is the president of that exchange. The recommendations being made in the complete statement being filed with your committee, and in the summary which I will now present, are those of the entire group.

The financial community is vitally interested in having tax revisions made which would encourage the spread of share ownership, strengthen our corporate democracy, and assist American corporations in obtaining adequate equity financing.

There are, today, 6,500,000 to 7,000,000 holders of publicly owned American corporations, and an additional 1,500,000 holders of stock of smaller private corporations—a total of about 8,500,000. This is a large number, but it is not enough. There has been a definite trend in recent years toward increased ownership of shares by people of modest means. This trend should be encouraged. There is no better way of preserving our American competitive private enterprise system than by making the great mass of our people patrners in that capitalistic system—giving them a direct ownership stake in its prosperity and growth.

Double taxation of dividends and taxation of capital gains discourage share ownership. They also are barriers to the raising of sufficient equity capital—or risk capital—for the continued expansion of American business. I am sure we all want to see this essential expansion accomplished by private initiative and private capital, rather than by Government sponsorship and Government financing.

Another reason for adding to the incentives for equity investment by individuals is to reverse the trend toward debt financing of industry. In recent years, new debt has been incurred by our American corporations at more than three times the rate at which new equity capital was obtained.

The CHAIRMAN. What did it used to be? What was the old ratio?

Mr. FUNSTON. I don't have the exact figures before me. I would say it was about 1½ to 2 times in the period 20 to 25 years ago.

The CHAIRMAN. In equity finance?

Mr. FUNSTON. Yes, new equity capital as related to debt. In recent years, the greatest portion of equity capital has been provided through the retention of earnings and, if you will, the utilization of depreciation funds that have been accumulated, but the debt part has been about 3 times larger than the equity part, which has represented, maybe, about 8 percent of the total funds required for expansion.

The CHAIRMAN. About 8 percent?

Mr. FUNSTON. Yes, sir. I am sure that is substantially correct.

I strongly endorse the provisions of sections 34 and 116 which provide partial relief from the present double taxation of dividends. Even though the relief is limited—except to the smaller shareholders—the incentive for additional equity investment by individuals will, I believe, be significant.

Now, just who are the people who would immediately benefit from the proposed change?

According to the Brookings Institution, about 1 family out of 10 owns corporate shares. Thirty-four percent of these families have incomes of less than $5,000, and 78 percent have incomes under $10,000. It is obvious that the beneficiaries of this change are a substantial proportion of our population.

There has been considerable debate about the amount of stock owned by shareowners in various income groups. The United States Steel Corp. recently made a survey of its 286,000 shareowners. I believe their figures give an unusually revealing picture of the distribution of the ownership of a typical American corporation. Here are some of the facts disclosed:

United States Steel Corp. has about the same number of shareowners—286,000—as employees—300,000.

More than three-quarters of the shareowners own less than 100 shares each, representing investments, at today's prices, of less than $4,500.

Fifty-three percent of the individual shareowners have incomes less than the average basic wages paid the company's steelworkers—about $4,500 a year.

Of the 20,500,000 shares held by individuals, 53 percent—about 10,800,000 shares—is held by persons with incomes of under $10,000. In addition, several million shares are held by insurance companies, pension trusts, banks, mutual funds, colleges, and charitable organizations—which are in turn owned by and serve virtually all Americans.

The principal advantage of this proposal, however, is not that present shareowners will pay a somewhat smaller tax. The principal benefits will come from the encouragement of more widespread share ownership. People of modest means will be given special incentive to purchase up to $2,000 of equity securities, because up to this point no double taxation will apply.

The Government also will benefit by the additional corporate tax on the earnings of new investments. And, inasmuch as dividends are not deductible in determining taxable income, whereas bond interest is deductible, the immediate revenue loss may very well turn out to be a revenue gain, as equity capital replaces corporate debt. In the process, a much healthier corporate structure will be created.

There is another area of our tax laws, that relating to the taxation of capital transactions, in which improvements should be made in the interest of encouraging equity investment. Unfortunately, subchapter P of chapter I does not now provide for such improvements.

The capital-gains tax has robbed capital of its most precious asset—its mobility. And, inasmuch as capital is taxed only when it moves, the Government also is deprived of revenues that would be obtained if we encouraged, rather than discouraged, capital transactions.

The present long holding period requires an investor to substitute a calendar for investment judgment. We believe that the purposes of the holding period would be just as well met if it were established at 3 months, instead of 6.

This change would restore freedom of action to investors. It would be of immeasurable help in achieving the goal we, in the exchange, have set for ourselves, that of making this country a Nation of shareowners.

Not the least important effect of reducing the holding period, from the Government's point of view, would be an actual and almost immediate increase in tax revenues. Previous experience in shortening the holding period seems to me to demonstrate conclusively that a further reduction would benefit the Government as much as it would the investor and our capital markets.

I refer to the reduction in the holding period in 1942, when revenues from the capital-gains tax jumped almost immediately from a net loss to several hundred million dollars of gain, reaching $721 million in 1945. In each year since then, the revenue from the capital-gains tax—after allowance for deduction of capital losses—has been more than 2½ times the highest yield of this tax during any of the 10 years prior to shortening of the holding period.

In the detailed statement I am submitting, there are recommendations also for reducing the rate of tax and for increasing the amount of losses that can be offset against other income. Also included are the reasons for such changes, why they would have a favorable effect on our economy.

Our specific recommendations are: First, that the holding period be set at 3 months; second, that the rate of tax be cut in half; and third, that the annual allowance for the offset of capital losses be increased to $5,000.

We understand that it may not be possible at this session of Congress to do all of these things. However, we strongly recommend that the cut in the required holding period to 3 months be made at this time.

We feel particularly justified in asking that this change be made now, because it would substantially increase governmental revenues and reduce the overall cost of the tax bill before you. My estimate of the amount of immediate additional revenues that would result from this change is $200 million per annum—and this, I believe, is a conservative figure.

Thank you, gentlemen, for the privilege of appearing.

The CHAIRMAN. Are there any questions? If not, thank you very much, Mr. Funston.

(Mr. Funston's material follows:)

STATEMENT BY G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE

I deeply appreciate the opportunity to present, on behalf of the New York Stock Exchange, our views on the tax-revision program under consideration. I have the honor of representing also other segments of the financial community, including the Investment Bankers Association of America, the National Association of Securities Dealers, the American Stock Exchange and other stock exchanges throughout the country. The recommendations presented are those of the group.

My comments will be confined to two sections of the bill: (1) Sections 34 and 116 which provide limited relief from double taxation of dividends; and (2) subchapter P of chapter 1 relating to the taxation of capital transactions.

Double taxation of dividends and taxation of capital gains both have tremendous bearing on the problem of providing sufficient equity capital—or risk capital—for the continued expansion of American business. This is an expansion that I am sure we all want to see accomplished by private initiative and private capital, rather than by Government sponsorship and Government financing.

As the principal marketplace for the securities of our publicly owned American corporations, the stock exchange has a deep concern in giving our corporate enterprises more incentive to finance their expansion through equity rather than debt securities. Our interest, and that of our members and investors throughout the country, is not confined to the larger corporations. As undewriters, our members aid in financing the growth of thousands of smaller businesses.

As dealers they provide markets for the ownership shares of many businesses which have not yet reached national stature. As brokers they serve the small investor as well as the large. As an exchange, we seek our future listings among today's smaller, growing enterprises. The several regional exchanges, and the over-the-counter market, devote a major portion of their efforts to working directly with small businesses all over the Nation.

THE EQUITY CAPITAL PROBLEM

The American economy has an insatiable need for new capital— $6 billion to $8 billion annually, just to provide the tools and equipment necessary to put to work productively the 700,000 people who join the Nation's labor force each year. The total spent by corporations for new plant and equipment, and for replacement of existing facilities, is currently at the rate of over $25 billion a year. Huge as this sum is, it will have to be increased if we are to continue to provide new and better paying jobs, to create new and improved products, and to replace outmoded equipment.

Since World War II, we have financed the greatest capital expansion in the history of American industry. But just how this capital was obtained is often overlooked.

For every dollar raised in the postwar period by new stock issues, industry raised about $3.20 by debt financing and supplied $9 from retained earnings and depreciation reserves. To provide these capital funds, industry found it necessary to double its debt and to reduce the percentage of earnings paid out in dividends from about 75 percent before the war to less than 50 percent in recent years.

It should be pointed out, also, that it is only established enterprises which have been able to finance expansion through increased retention of earnings and greater debt financing. New and growing businesses have found it extremely difficult, if not impossible, to obtain new equity capital necessary for a start or for growth.

The result has been that total corporate debt at the end of 1953 was more than $190 billion—double what it was at the end of World War II. New debt was being incurred by our corporations last year at almost three times the rate at which new equity capital was obtained in our capital markets.

The inability of American corporations to finance their capital needs soundly and prudently has been the direct result of tax policies—high rates of tax on individual and corporate incomes, double taxation of corporate dividends and the throttling capital-gains tax.

DIVIDEND PROPOSAL

The importance of strengthening and encouraging incentives for risk taking is recognized in the provisions of H. R. 8300 which would lessen the present double taxation of dividend income.

Even though the relief from double taxation of dividends provided by sections 34 and 116 is very limited—except to the smaller shareholders—the incentive for additional equity investment by individuals will, I believe, be significant. I urge this committee's approval of these provisions.

Now, just who are the people who would immediately benefit from the proposed change? Until very recently no statistically reliable figures of share ownership have been available. Based on a Brookings Institution study made in 1952, we now know that there are between 6¼ million and 7 million holders of publicly owned American corporations and another 1½ million holders of stock of smaller private corporations, a total of about 8½ million shareholders. About 1 family out of 10 own corporate shares. Thirty-four percent of these families have incomes of less than $5,000 and 78 percent have incomes under $10,000. It is obvious therefore that the beneficiaries of this change are a substantial proportion of our population.

About 24 percent of all corporate stock, it should be noted, is held by insurance companies, pension trusts, banks, mutual funds, colleges, charitable organizations, which are, in turn, owned by and serve virtually all Americans.

There has been considerable debate about the amount of stock owned by shareowners in various income groups. The United States Steel Corp. recently made a survey of its 286,000 shareholders. I believe their figures give an unusually revealing picture of the distribution of the ownership of a typical American corporation. Here are some of the facts disclosed:

United States Steel Corp. has about the same number of shareholders (286,000) as employees (300,000).

More than three-quarters of the shareholders own less than 100 shares each, representing investments, at today's prices, of less than $4,500.

Only 10 percent of the shareholders have incomes greater than $25,000.

No individual owns as much as three-tenths of 1 percent of either the common or preferred stock.

Fifty-three percent of the shareholders have incomes less than the average wages paid United States Steel's steelworkers, about $4,500 a year.

Almost one-third of the shareholders (31 percent) have annual incomes of less than $3,000 a year.

Of the 20½ million shares held by individuals, 53 percent—more than 10.8 million shares—is held by persons with incomes of under $10,000.

A copy of the complete report of the survey, which was contained in the corporation's annual report for 1953, follows:

Number of stockholders and shares held, Dec. 31, 1953

	Preferred		Common		Total	
	Holders	Shares	Holders	Shares	Holders[1]	Shares
Individuals:						
Women	36,732	1,073,596	97,215	7,918,578	126,258	8,992,174
Men	18,246	592,056	88,444	8,410,493	102,067	9,002,549
Joint accounts	5,899	130,041	35,511	2,363,224	40,166	2,493,265
Total	60,877	1,795,693	221,170	18,692,295	268,491	20,487,988
Charitable and educational[2]	1,397	119,975	608	159,976	1,899	279,951
Insurance companies	163	389,948	96	124,013	243	513,961
Industrial and other companies	558	89,551	1,422	610,320	1,856	699,871
Trustees, guardians, and estates	7,329	360,472	5,353	1,064,948	11,962	1,425,420
Brokers, nominees, and others	916	847,172	1,399	5,458,204	1,789	6,305,376
Total	71,240	3,602,811	230,048	26,109,756	286,240	29,712,567

[1] 15,048 are holders of both preferred and common shares.

[2] Includes medical and religious organizations, foundations, hospitals, libraries.

for the western and southwestern areas of the country, a model that received enthusiastic public acceptance. During 1954 it is expected that steel panel houses and commercial structures will be introduced by this subsidiary.

"In January 1954, a new subsidiary, United States Steel Homes Credit Corp., was organized to assist the dealer-builders of United States Steel Homes, Inc., in their financing.

"For many years United States Steel has contributed to community funds, hospitals, educational, and other activities, in which it had an interest. In 1953, United States Steel Foundations, Inc., a nonprofit corporation, was formed to aid charitable, educational, and scientific organizations and activities. Its members and governing board of trustees are all directors of United States Steel Corp. A contribution of $12 million was made by United States Steel to the foundation in 1953 as an original grant. Such contributions are deductible by corporations in computing Federal taxes on income. The foundation has made and will make, from income and principal, contributions to community funds, hospitals, and other charitable, educational, and scientific organizations and activities. The grants by the foundation can be taken into consideration by United States Steel in connection with the needs of the many communities and areas in which it has an interest.

"*Stock option incentive plan*

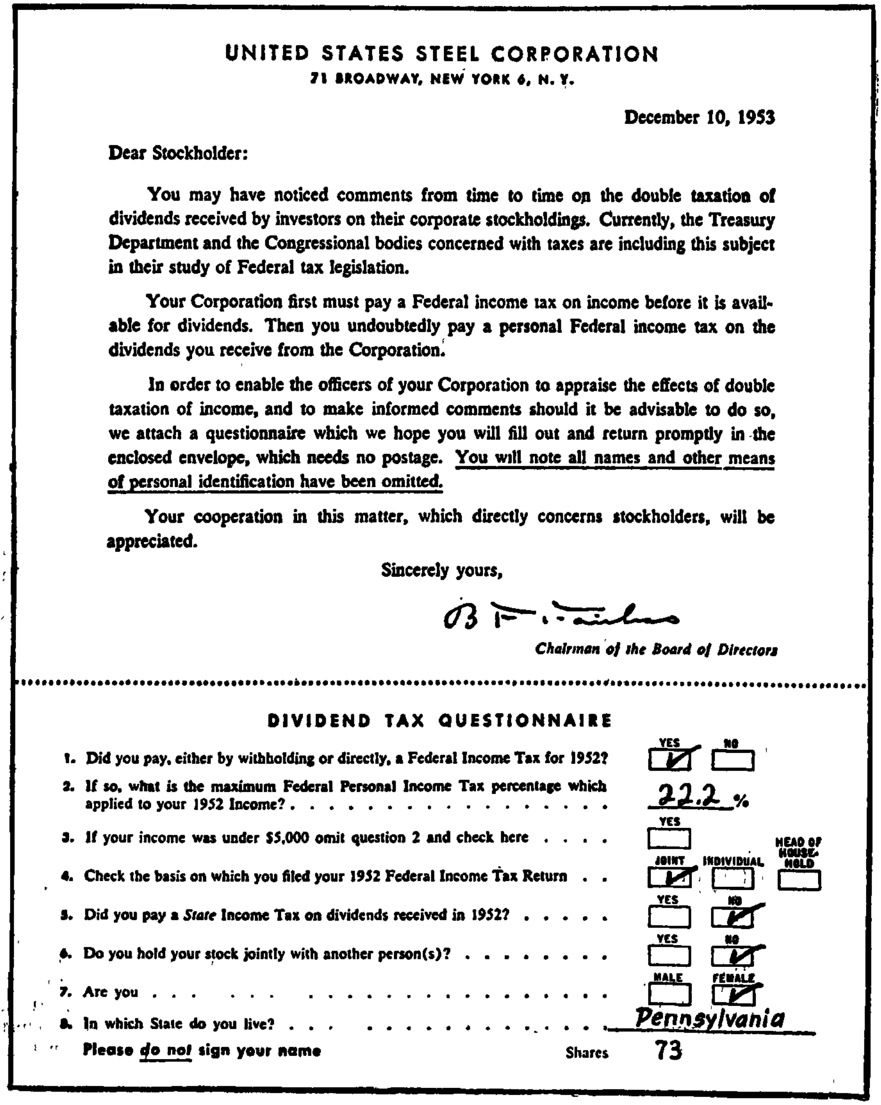
"The courts have disposed of both lawsuits which were instituted by two stockholders in 1951 in the State and Federal courts in New Jersey, to enjoin the carrying out of United States Steel's stock option incentive plan. The two stockholders owned together 320 shares of common stock. On October 29, 1953, the superior court of New Jersey granted summary judgment dismissing the complaint on the merits, and on November 5, 1953, the United States District Court for the District of New Jersey dismissed the suit pending in that court. This action followed a decision by the Supreme Court of New Jersey upholding a somewhat similar stock option plan of the Standard Oil Co. of New Jersey in litigation involving one of the plaintiffs bringing the actions against United States Steel. Following that decision by the highest New Jersey court, the plantiffs consented to the above disposition of the litigation that had been brought by them against United States Steel.

"Under the plan, which was approved by an overwhelming vote of the stockholders at the annual meeting in 1951, options were granted for 384,000 shares of common stock in 1951 and for 393,700 shares in 1953, or a total of 777,700 shares. In each case, the option price was the market price at the time the options were granted. Through December 31, 1953, no options had been exercised, and 15 options for a total of 14,300 shares had terminated.

"Stockholders

"There are now more owners of stock of United States Steel than at any time in the past. At December 31, 1953, there were 286,240 holders of record, an increase during the year of 5,906. A large majority of these holders are individuals—average citizens in all walks of life. More than three-quarters of the stockholders own less than 100 shares each, and no individual stockholder holds as much as three-tenths of 1 percent of either the preferred or common stock.

* * * * * * *



UNITED STATES STEEL CORPORATION
71 BROADWAY, NEW YORK 6, N. Y.

December 10, 1953

Dear Stockholder:

You may have noticed comments from time to time on the double taxation of dividends received by investors on their corporate stockholdings. Currently, the Treasury Department and the Congressional bodies concerned with taxes are including this subject in their study of Federal tax legislation.

Your Corporation first must pay a Federal income tax on income before it is available for dividends. Then you undoubtedly pay a personal Federal income tax on the dividends you receive from the Corporation.

In order to enable the officers of your Corporation to appraise the effects of double taxation of income, and to make informed comments should it be advisable to do so, we attach a questionnaire which we hope you will fill out and return promptly in the enclosed envelope, which needs no postage. You will note all names and other means of personal identification have been omitted.

Your cooperation in this matter, which directly concerns stockholders, will be appreciated.

Sincerely yours,

Chairman of the Board of Directors

DIVIDEND TAX QUESTIONNAIRE

1. Did you pay, either by withholding or directly, a Federal Income Tax for 1952? YES ☑ NO □
2. If so, what is the maximum Federal Personal Income Tax percentage which applied to your 1952 Income? . . . . 22.2 %
3. If your income was under $5,000 omit question 2 and check here . . . . YES □
4. Check the basis on which you filed your 1952 Federal Income Tax Return . . JOINT ☑ INDIVIDUAL □ HEAD OF HOUSEHOLD □
5. Did you pay a *State* Income Tax on dividends received in 1952? . . . . . YES □ NO ☑
6. Do you hold your stock jointly with another person(s)? . . . . YES □ NO ☑
7. Are you . . . . MALE □ FEMALE ☑
8. In which State do you live? . . . . Pennsylvania

Please do not sign your name Shares 73

"FINANCIAL SUMMARY—STOCKHOLDERS REPORT THE FACTS

"United States Steel, like other corporations, is essentially a voluntary undertaking by a great many people to produce the abundant goods and services wanted in an expanding economy. The first requirement is to supply the tools of production. The money to do this represents savings of one large group of people—the stockholders. Once the tools are provided the jobs of operating them are thereby created and the undertaking expands to include another large group of individuals—the employees.

"United States Steel's records tell a great deal—but not all—about how the cooperative undertaking as a whole may be faring. Those records report the sales to customers, the purchases made, the taxes paid; they report the wearing out of the tools of production supplied by stockholders; they report the hours and earnings of employees. They tell very little, however, about the stockholders beyond the savings supplied by them and the amounts paid to them in dividends.

"Realizing this, United States Steel recently communicated with each of its approximately 280,000 individual stockholders (including those whose stock is in their brokers' names) requesting that they disclose, without identifying themselves individually, information permitting a grouped analysis of their income status in 1952 and of Federal taxes they paid on income received in dividends from United States Steel. About 140,000 of the stockholders—an astonishingly large proportion—supplied the information requested. What they reported proved equally astonishing.

"*Small owners*

"The notion that United States Steel's typical stockholders are in any sense people of great wealth is statistically exploded by the information received. Most of them are of modest means. Only 10 percent of them had incomes greater than $25,000. Only 26 percent of them had incomes of more than $10,000 a year. Nearly three-fifths of them—56 percent—had incomes that were less than $5,000 a year. The incomes of more stockholders—17 percent of all stockholders—fell within the $2,000 to $3,000 a year income range than into any other $1,000 range. There were as many stockholders with incomes of less than $4,300 as there were with incomes of more than that amount. Eight percent of the stockholders had incomes so small that they were not subject to any Federal income taxation at all.

"*Compared with steelworkers*

"Fifty-three percent of the stockholders had incomes that were less than the average wages paid to United States Steel's steelworkers; an annual rate of about $4,500 in the latter part of 1952 when operations were free of strikes. More than one-third—36 percent—of the stockholders had annual incomes that were less than the average wages paid to steelworkers in the lowest wage bracket, about $3,000. These wage amounts do not include the pay increase in June 1953, averaging over $200, nor do they include those employment costs borne by United States Steel to provide pensions, insurance, and other employee benefits, averaging over $400.

"The 47 percent of the stockholders whose incomes were more than $4,500 brought the average income for all stockholders to about $11,000.

"*Personal taxation of dividends*

"The average proportion of dividends paid to stockholders that was taken from them by Federal income taxes was 21 percent. The average top-bracket taxation of dividends was 37 percent, assuming that United States Steel's dividends were the last dollars of income stockholders received.

"*Importance of dividend income*

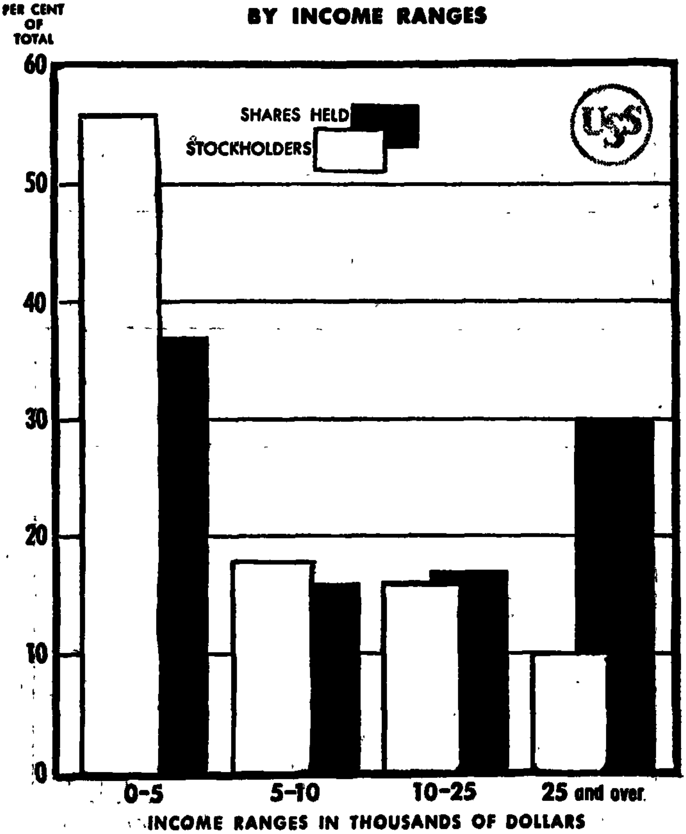
"The distribution of income among stockholders and the distribution of shares among them differ sharply and surprisingly. The 56 percent of the stockholders whose incomes were less than $5,000 each had in the aggregate only 14 percent of the aggregate income of all stockholders. Yet this 56 percent of the stockholders, whose average income was a little less than $2,800, owned 37 percent of the shares. United States Steel common and preferred dividends paid to them represented nearly 8 percent of their income, which is almost 4 times as great as the corresponding 2 percent for stockholders having incomes greater than $5,000. In this respect the income taxes paid by United States Steel bear four times as heavily on its stockholders of lesser incomes.

"Double taxation

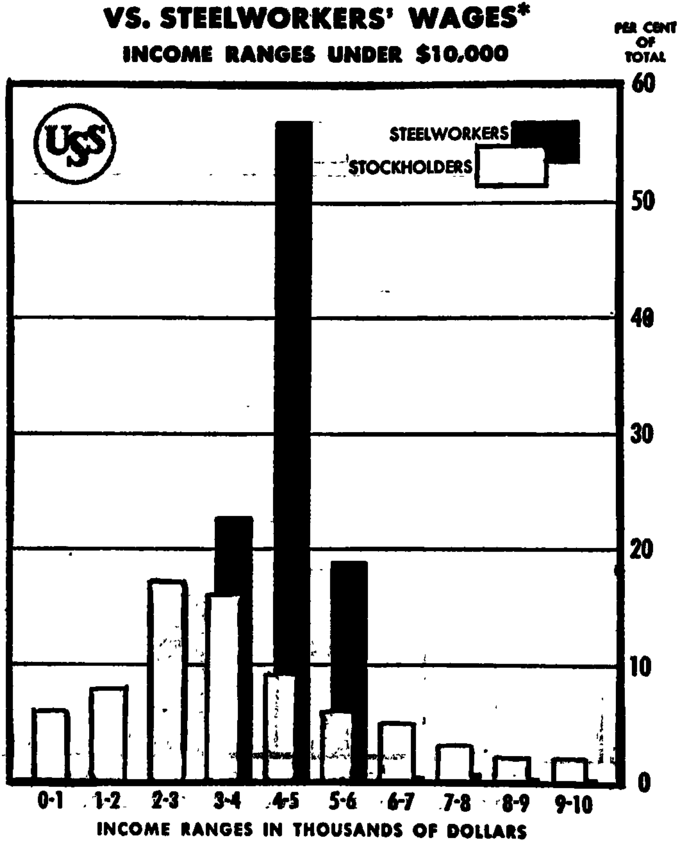
"In 1953 United States Steel, in order to have 41 cents of income, had to pay 59 cents in Federal income taxes. In other words, out of each dollar potentially available for dividends, 59 cents went for income taxes. The remaining 41 cents, when paid out in dividends, was then subjected on the average, as previously noted, to a personal income tax diminution of 21 percent, equivalent to 9 cents. This left a net of 32 cents out of the original dollar. By this process of double taxation the Government, therefore, claimed 68 cents of the potential dividend dollar.

STOCKHOLDERS AND SHARES HELD

BY INCOME RANGES



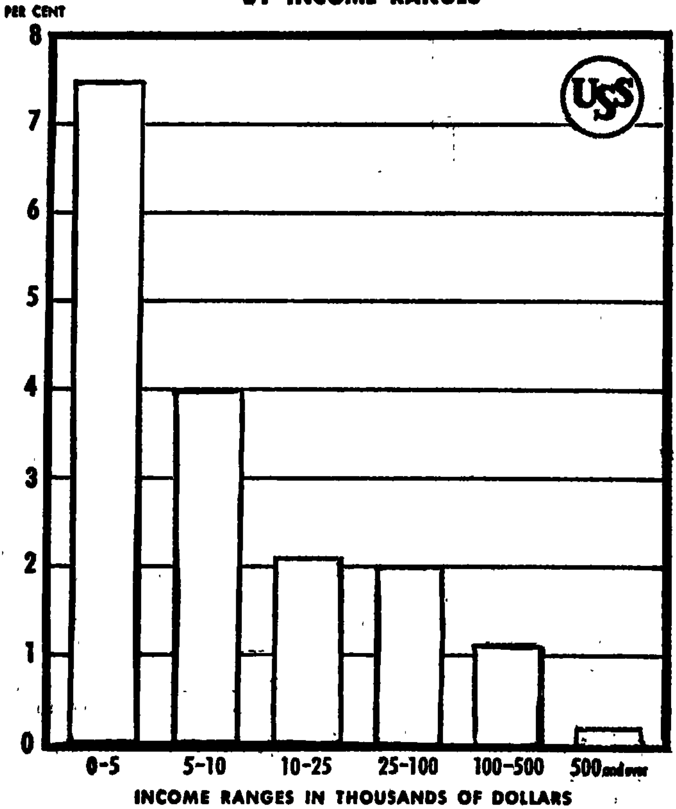
STOCKHOLDERS' INCOMES
VS. STEELWORKERS' WAGES*
INCOME RANGES UNDER $10,000



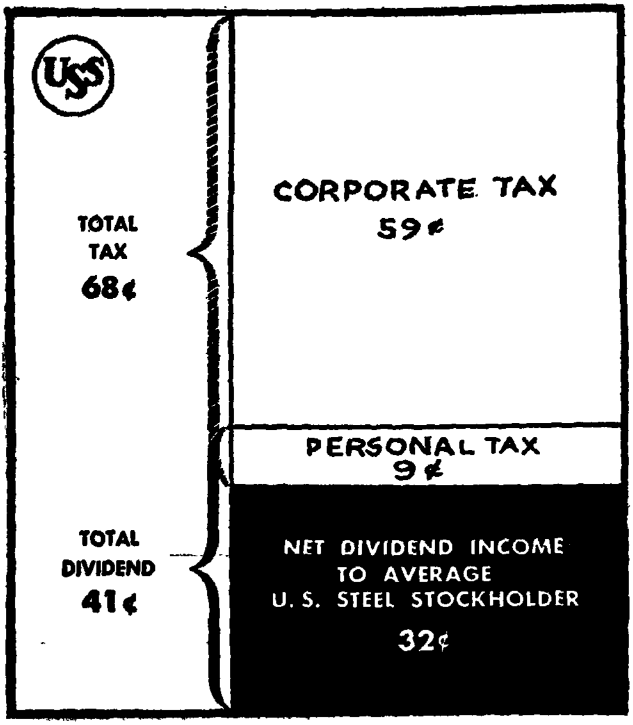
*Wages based on hourly earnings times annual hours worked

U. S. STEEL DIVIDENDS AS A PER CENT OF STOCKHOLDERS' GROSS INCOMES

BY INCOME RANGES



DOUBLE TAXATION



"The public interest

"The income and income tax facts about United States Steel's stockholders when added to those of United States Steel are relevant to a public interest that transcends the interest of any single company and its particular stockholders and employees. The American people have, over the years, found a way voluntarily to cooperate with each other to produce an abundance of goods and services beyond the dreams of other times and places. The core of that cooperation is corporate America.

"Over recent years taxation has come to be concentrated at the very point where it could most threaten the operation of these cooperative undertakings. Thus no one questions that 100 percent taxation of the potential dividend dollar would destroy all incentive of one great group involved—the stockholders—to supply savings to expand existing or start new enterprises. Yet the facts show—if United States Steel and its stockholders can be considered representative—that the incentive by 1953 was two-thirds destroyed by taxation.

"In United States Steel approximately 300,000 individual and institutional stockholders have an invested average of about $8,000 each for the tools of production which provide jobs for approximately 300,000 employees. Such investment in tools must continue if existing businesses are to expand and be kept modern and new businesses are to be created. Investment in new tools of production is the only way that new self-sustaining productive jobs can come into existence. The large-scale creation of such new jobs is required if an expanding labor force is to be fully employed. It cannot long be done without stockholder participation and will not be done if the incentive for so doing is destroyed by taxation.

"The alternative to private cooperative creation of new jobs is an increased burden upon Government to support or subsidize otherwise jobless people. It is significant that a mounting public concern about unemployment and inflation has paralleled the mounting tax impairment of incentives to large-scale job creation. It is of equal—but hopeful—significance that the American people through their Government are now considering the diminution of the tax deterrents to such large-scale development of new jobs and abundant production of the good things of life.

"*Note on statistical methods*

"The questionnaire sent to stockholders is shown on page 22. It was sent only to individuals, not to institutions, trustees, etc. To insure representativeness of the sample, questionnaires were eliminated therefrom by use of random numbers so that the following known characteristics of all individually recorded stockholders were proportionately represented in the sample: Geographical distribution; men, women, joint accounts; common and preferred shares; number of shares held. Weighting each top-bracket tax rate the stockholders reported in their replies by the dividends paid on the shares they respectively held yielded an average top-bracket rate of taxation of 37 percent.

"Classification of stockholders by size of income was determined as follows: By type of return each top-bracket rate indicated the range within which each stockholder's taxable income fell. Adding typical exemption and deduction amounts, as determined from Statistics of Income for 1950, part I (Treasury Department release, October 8, 1953), gave the control range within which the income fell. Income in this study means 'adjusted gross income,' as defined in Individual Income Tax Return, Form 1040. Incomes within the control ranges, including those reported as under $5,000 were allocated to narrower income brackets in conformity with the patterns recorded in the cited document. Graphic smoothing of the allocations served to conform them to the general pattern of income distribution known to exist.

"Shares of common and preferred stock held by stockholders within the control income ranges were allocated to stockholders in narrower income ranges by graphic and numerical interpolation. Percentage distributions of stockholders and shares by income ranges are on page 22.

"For the midpoint of each narrow range the typical tax liability was calculated and expressed as a percentage of the income. Weighting these percentages by the dividends paid on the shares held by stockholders within each income range indicated that 21 percent of the dividends was, on the average, taken in personal income taxes.

"Fifty-six percent at the stockholders filed joint income-tax returns. In such instances the income attributed to the stockholder was actually all the combined income of husband and wife, exclusive, of course, of any nontaxable income. Stockholders' incomes are thus overstated in comparison with steelworkers' incomes, because in the latter instance only the wage income of one spouse—the wages paid by United States Steel—was recorded, and no allowance was made for income received from any other source."

It is the small investor, and only the small investor, who would receive complete relief from double dividend taxation. Even when the provisions are fully effective, complete exemption from double taxation would be afforded only to the first $100 of dividends—the return on about $2,000 of stock.

Let's consider 5 shareholders in different income brackets, all with dividend income amounting to 5 percent of their total income. Here is what their percentage reluction in total taxes would amount to:

Gross income	Percentage reduction in total tax, based on secs. 34 and 116		
	1954	1955	1956
Joint return 2 dependents, optional deduction, 5 percent of gross income from dividends:			
$4,000	9.2	16.7	16.7
$10,000	2.2	4.7	5.6
$20,000	1.3	3.0	3.6
$50,000	0.6	1.5	1.9
$100,000	0.3	0.9	1.2

These examples all assume that 5 percent of total income comes from dividends.

The principal advantage of this proposal, however, will not be that those who now own stock will pay a somewhat smaller tax. The principal advantage will be the encouragement of more widespread share ownership. There has been a definite trend in recent years toward increased ownership of shares by people of modest means. This trend should be encouraged. There is no better way of preserving our American competitive system than by making the great mass of our people partners in our capitalistic system—giving them a direct ownership stake in its prosperity and growth.

Under section 116, people of modest means will be given special incentive to purchase up to $2,000 of equity securities—because up to this point no double taxation will apply. Our corporate democracy will be strengthened as more Americans own their share of American business.

The Government will benefit also by the additional corporate tax on the earnings of new investments. And, inasmuch as dividends are not deductible in determining taxable income, whereas bond interest is deductible, the immediate revenue loss may very well turn out to be a revenue gain as equity capital replaces corporate debt. In the process a much healthier corporate structure will be created.

Double taxation of dividends has not always been part of our tax structure—it came into our tax laws at the time of the undistributed profits tax of 1936. Prior to then, dividends had always been totally or partially exempt from individual tax.

Canada, whose economic progress has been especially noteworthy in the last several years, adopted a 10-percent dividend tax credit in 1949, and, in view of its success in attracting large amounts of domestic and foreign equity capital, doubled it a year ago.

I'd like to quote to you briefly from a statement made by the Honorable D. C. Abbott, Minister of Finance for Canada, when he announced plans in February 1953 for the doubling of their dividend credit:

"Canada is fortunate these days," he said, "in being able to attract enterprising foreign capital. This is desirable and we welcome it. At the same time it would seem to be a good thing if Canadians were encouraged, where they can safely do so, to join in a wider participation of equity ownership in the expanding industrial wealth of our country. This dividend credit of 20 percent should, I think, be of considerable assistance in encouraging our people to increase their stake in Canada's future."

The 20-percent credit allowed Canadian investors is twice that contemplated as a maximum under H. R. 8300.

CAPITAL-GAINS PROVISIONS

There is another area of our tax laws—that relating to the taxation of capital transactions—in which improvements should be made in the interest of encouraging equity investment. Unfortunately subchapter P of chapter 1 does not now provide for such improvements.

Objectives of capital-gains revision should be:

First: Minimum interference with normal capital transactions. The present law erects unnecessary roadblocks to the free flow of capital.

Second: Within the limitations of fairness and overall benefit to our economy, our tax laws should be designed to produce maximum revenues for the Government. The capital-gains tax is one area where tax revision does not have to mean tax reduction. Our present laws have had the effect of sterilizing, from a tax viewpoint, large portions of our capital and tax revenues have suffered accordingly.

The capital-gains tax is a unique tax in that it is self-imposed. Because the tax reduces his capital available for reinvestment, only as a last resort will an investor voluntarily impose the tax upon himself. Instead of encouraging the successful investor to seek new risk ventures, our tax laws force him by the threat of heavy taxation to immobilize his capital.

The capital-gains tax has robbed capital of its most precious asset—its mobility. And, inasmuch as capital can be taxed only when it moves, the Government also is deprived of revenues that could be obtained if we encouraged rather than discouraged capital transactions.

What are these deterrents to normal capital transactions?

First, there is the arbitrarily long holding period, which requires an investor to substitute a calendar for investment judgment. Now it is true that most investors do hold securities for more than 6 months. But the requirement that they must hold them for at least 6 months in order to qualify the transaction for capital-gains treatment, not only places a severe limitation on an investor's freedom but, even more important, deters him, in many cases, from entering into the transaction at all.

The present tax, in short, freezes present investors into existing investments and shuts out of the market entirely many potential investors.

We believe that the purposes of the holding period would be just as well met if it were established at 3 months.

I would like to point out that the dealer and the professional trader in securities would not benefit from such a reduction. In-and-out transactions, in most cases, are concluded in a matter of days or; at most, of weeks. The capital gains of this group are a negligible part of the whole. According to Treasury Department figures, less than 4 percent of total capital gains are short-term gains.

The restoration of freedom of action to investors would be of immeasurable help in achieving the goal we in the exchange have set for ourselves—that of making this country a nation of shareowners.

Not the least important effect of reducing the holding period, from the Government's point of view, would be an actual and almost immediate increase in tax revenues.

Previous experience in shortening the holding period seems to demonstrate conclusively that a further reduction would benefit the Government as much as it would the investor and our capital markets.

When the law provided a minimum holding period of 18 months from 1938 to 1941, it is a matter of record that revenues from capital gains of individuals dropped from $12 million in 1938 to the point that, in 1940 and 1941, capital losses offset capital gains.

In the tax bill of 1942, which was passed in October of that year, the holding period was reduced from 18 to 6 months. Despite the limited time the shorter period was in effect, capital gains tax receipts expanded to $68 million in 1942. In 1943 returns from the capital-gains tax increased to $266 million, in 1944 to $354 million and in 1945 to $721 million. In each year since then the revenue from the capital-gains tax, after allowance for deduction of capital losses, has been more than 2½ times the highest yield of this tax during any of the 10 years prior to the shortening of the holding period.

A second change that I would like to urge is a substantial reduction in the rate of tax. I recommend that this be done by requiring only 25 percent of the gain, instead of 50 percent as at present, to be included as taxable income. The Government could benefit by taking a smaller tax from a greater number of transactions, thereby substantially increasing the total tax yield.

Many investors with long-term unrealized gains regard themselves as frozen into existing investments. They understandably refuse to impose this tax on themselves because they regard it as too punishing.

This immobilizing effect of the capital-gains tax is particularly severe at the present time because so many unrealized gains are entirely illusory. They are due mainly to the general rise in price levels which has resulted from governmental fiscal and monetary policies and which represents little or no gain in purchasing power.

A third change we recommend is an increase in the allowable capital-loss offset against other income from $1,000 to $5,000 a year. The present limitation is particularly harsh on the growing class of small investors who frequently do not have other gains against which to offset possible losses. About 46 percent of all shareholders hold only a single issue. To such shareholders, particularly, the present basis of tax is a "heads you win, tails I lose" proposition.

To summarize our position on this tax, we believe that the capital-gains tax—

1. Impairs the liquidity of the securities markets by freezing present investors into existing investments and by discouraging new risk taking, thus keeping our free markets from making their maximum contribution to the flow of capital into industry.

2. Makes it difficult for new and growing companies to obtain adequate equity funds because risk taking is penalized.

3. Distorts the value of securities by discouraging the realization of gains and encouraging the realization of losses.

4. Deprives the Government of hundreds of millions of dollars of revenue, because both the holding period and rate of tax are far beyond the levels which would be most productive for the Government.

We recommend that, as soon as possible, the holding period be set at 3 months, that the rate of tax be cut in half, and the provisions for the offset of capital losses be increased to $5,000, retaining the present carryover provisions.

We understand that it may not be possible at this session of Congress to do all of these things. However, we strongly recommend that the cut in the required holding period to 3 months be made at this time. We feel particularly justified in asking that this change be made now, because it would substantially increase governmental revenues and reduce the overall cost of the tax bill before you. My estimate of the amount of immediate additional revenues that would result from this change is $200 million per annum, and this, I believe, is a conservative figure.

The CHAIRMAN. Mr. Walter Maynard, Association of Stock Exchange Firms.

STATEMENT OF WALTER MAYNARD, CHAIRMAN, TAX COMMITTEE, ASSOCIATION OF STOCK EXCHANGE FIRMS

The CHAIRMAN. Make yourself comfortable and introduce yourself for the purposes of the record.

Mr. MAYNARD. Mr. Chairman, my name is Walter Maynard. I am chairman of the tax committee of the Association of Stock Exchange Firms. I am also a partner in Shearson, Hammill & Co., a medium-sized securities firm with headquarters in New York and 16 branches in this country and abroad.

I am confining this statement to the subject of the taxation of capital gains.

What I have to say here today is based on 25 years of experience in the investment field. I have found, as has everyone else who has had similar experience, that the actual working and practical effect of the capital-gains tax is very different from theory concerning it.

I am going to discuss only two of the modifications of the present tax treatment of capital gains which our industry would like to see. The first of these modifications is a much lower effective rate of capital-gains tax. I avoid the word "relief" in asking for a lower rate of capital-gains taxation because tax "relief" usually means less revenue for the Treasury. I earnestly believe that lowering of capital-gains tax rates would increase revenues, and I know that many reputable economists also hold this view. As a basis for this belief, I will give you an example of an actual recent transaction.

Conversations similar to the one I'm about to describe are enacted hundreds of times every day in connection with sales of every kind of property—not only securities, but also farms, stores, and businesses.

A client who had over a period of years accumulated moderate-sized holdings of a number of good stocks, came in and told me that he wanted to help his daughter and son-in-law build a house, that to raise the money he had to sell $10,000 worth of stocks, and asked which of his holdings he should sell. Among other things, he had 100 shares of Du Pont stock and 250 shares of United States Steel. I pointed out that Du Pont had gone up a good deal; that the present price was fairly high in relation to underlying values and earnings, and that the yield was low; I suggested that he sell it and keep his United States Steel, which was down a good deal from the high of recent years, was now relatively depressed by a low rate of steel-making operations which I believed to be temporary, and in addition paid an excellent return. His answer to this suggestion was: "My Du Pont cost me only $50 when I bought it in 1949. If I were to sell it at today's price of $110, it would cost me a tax of $1,500—13 percent of my money. I think your advice is all right from an investment point of view, but let's sell the United States Steel—I paid $42 for it last year and the little loss I'll have to take will help me with my income tax."

The result was that we sold the United States Steel and the Treasury got no revenues. This little story illustrates the actual economics of the tax. When the potential tax liability exceeds a fairly low percentage of the value of the property to be sold, the effect of the tax is to lock that particular property up tightly. My observation is that when the tax cost of making a sale exceeds 2 or 3 percent of the value of the assets being sold—which is equal to about half a year's income—it pretty effectively inhibits selling. In other words, the tax really acts as a transfer tax, and when the rate of this transfer tax gets too high, its effect is simply to cause investors to refrain from incurring liability for it.

At the present time this locking-up process caused by the tax is already beginning to have a marked, and, I believe, potentially dangerous, effect on the market itself by distorting supply-demand relationships. When the price of any stock in an advancing phase reaches a level at which every holder has a gain, the transfer tax effect of the capital-gains tax begins to operate at an increasing rate, the supply of stock promptly begins to dry up, and the upward price movement becomes accelerated.

It seems reasonable to expect, human nature being what it is, that some of these powerful upward moves will be carried to excess, with a consequent risk of an eventual decline of comparable scope.

It also seems reasonable to expect that in the next upward phase in general business activity, the soaring prices that now characterize tax-locked markets in a relatively small number of stocks will spread to a much larger area. It may be that for this reason alone you will be asked to eliminate the tax. If you were to cut it in half now, you would certainly increase the Treasury's revenues and at the same time diminish the risk of the development of an unsound and dangerous boom-and-bust situation in the Nation's security markets.

In connection with the foregoing line of reasoning, I must also urge that you consider shortening the present 6-month holding period required to qualify property for capital-gains-tax treatment. It has been the experience of all of us in the securities business that investors almost always hold their assets for as long as is needful to obtain the certainty of minimum tax liability; therefore, the holding period might as well be short as long. If the holding period is short, the economy would get the advantage of more active security markets, more revenues from transfer taxes, and better availability of equity capital to industry. Broader markets would also produce somewhat greater revenues from the capital-gains tax itself because of lessened liquidation costs on large blocks of securities. To shorten the holding period to 3 months would be a constructive step from every point of view.

I appreciate this opportunity of being heard.

The CHAIRMAN. We are very glad to have you here. Are there any questions?

Thank you very much. I neglected to ask you to explain the nature of your organization.

Mr. MAYNARD. Sir, the Association of Stock Exchange Firms is a trade body of member firms of the New York Stock Exchange that do business with the general public. It has 441 member firms, comprising virtually all the firms doing business with the public.

The CHAIRMAN. Over the whole United States?

Mr. MAYNARD. Over the whole United States.

The CHAIRMAN. Thank you very much.

Mr. J. Raymond Berry. Make yourself comfortable, Mr. Berry, and identify yourself for the record.

STATEMENT OF J. RAYMOND BERRY, NATIONAL BOARD OF FIRE UNDERWRITERS

Mr. BERRY. My name is Raymond Berry, and I am appearing for some 220 stock insurance companies which write the major portion of all fire and allied lines of insurance written in the United States. These companies are presently subject to taxation at the full 30-percent normal tax rate and the full 22-percent surtax rate on their entire net income, under section 204 of the Internal Revenue Code. They receive no special tax treatment and have borne their full share of the tax load at all times.

These insurance companies would continue to be subject to full corporate tax rates on their entire net income under the provisions of section 831 of the bill which provides, in part, as follows:

> (a) Imposition of tax: Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company) * * *.

Section 11 provides for the imposition of the 30-percent normal tax and the 22-percent surtax on the taxable income of a corporation.

Although this bill continues to tax these insurance companies at full corporate rates on their entire taxable income, under sections 34 (c) (1), 116 (b), and 246 (a) (1), such companies would be discriminated against by a complete denial of (1) the newly established relief to individuals from double taxation of dividends, and (2) the existing 85-percent-dividends-received credit which is presently granted to all corporate stockholders.

As to the dividend treatment, that has already been treated so admirably by Senator Lucas that unless you want me to go into it again I will pass that part of my statement. We have been in touch with Mr. Stam and with the Treasury staff. We have submitted to them our proposed amendment on that. We think that is clear. We expect to keep our liaison with them open, so I think that can be passed and will save some time. But we are concerned about our treatment under 923 (d) (2) and 952 (c) (4). Here these companies are discriminated against in that their income is not given the benefits which the incomes of other corporations receive. The former section 923 (d) (2) allows a 14-percent credit against United States tax for business income from foreign sources and the latter permits the deferment of foreign income under certain circumstances.

It is submitted there is no logical reason for excluding these stock fire insurance companies from the benefits of the above sections. Heretofore Congress has never discriminated against these companies. Their foreign income presently is subject to taxation at full normal and surtax rates, less credits or deductions for foreign income taxes, in the same manner as other corporate taxpayers.

When these companies write business in foreign countries as a general rule, they do so either on a branch-office basis or through an association such as the American Foreign Insurance Association, AFIA, or American International Underwriters, AIU.

Some companies write on a branch-office basis in all countries; others combine the two methods, a common procedure being to write on a branch-office basis in Canada and Cuba, and through an association in the rest of the world.

An association consists of a group of insurance companies which have pooled their resources to write business in foreign countries under the supervision of trained experts in the foreign field. Because of the risk involved, a better distribution of the hazard is obtained where companies operate in a pool or association on a percentage basis.

The CHAIRMAN. Is it a direct insurance or an underwriting insurance or what kind of insurance?

Mr. BERRY. It is all kinds of property insurance and it is written through agencies and branch offices in these foreign countries.

The CHAIRMAN. Does a citizen of France get a policy from this, or do you simply underwrite the risk?

Mr. BERRY. Do we reinsure something?

The CHAIRMAN. Yes.

Mr. BERRY. We write direct to the fellow who wants to buy insurance.

The CHAIRMAN. Mr. Stam, what is the reason why these gentlemen have not had the suggested benefits?

Mr. STAM. We have had some meetings with these gentlemen, and we are trying to look into their problem and see what investments they have abroad. The way the bill is framed, it gives no relief to the people who merely manufacture goods in this country and sell them abroad. That is the whole exporting problem, the theory being that they should have a substantial investment abroad before they get relief because they are risking their capital. We are looking into this problem. We had a meeting with these gentlemen the other day and are trying to see what their situation is. We are working on it now.

The CHAIRMAN. Go ahead, Mr. Berry.

Mr. BERRY. I should confirm Mr. Stam's statement. We are endeavoring to get him the figures he wishes. Some of them are in this memorandum.

Most countries require such companies to make substantial qualifying deposits on entry and additional deposits to cover their unearned premium and loss reserves. As these reserves increase in size the deposit requirements also increase. It is estimated that in Canada alone these companies have at least $200 million invested—the major part of which is deposited with the Dominion authorities for the protection of policyholders.

The CHAIRMAN. In what kinds of securities?

Mr. BERRY. Mostly Dominion securities.

The CHAIRMAN. Is that the same situation abroad?

Mr. BERRY. Yes; largely in the securities of those countries.

There is no business which by its very nature becomes a more integral part of the economic structure of a country than the business of insurance. It is the vehicle for the credit required by other businesses and it constitutes the vital protection of the investment of those businesses in their physical assets. No other business places more capital at risk than do these insurers. Protection is afforded against the hazards of fire, explosion, windstorm, ocean and inland transportation, liability, theft, surety, and allied lines.

While the foreign figures for the entire business are not available, association figures can be used to show a pattern of operation. The figures of one of the associations, AFIA, show premium writings in foreign countries for 1953—excluding Canada—of approximately $30 million. On that volume of premiums there was an estimated amount at risk of $6 billion. This association has some 1,500 employees engaged abroad, and in its thirty-odd years of existence has incurred approximately $165 million losses in these foreign countries. In addition, all of the assets of its member companies wherever located are exposed to the risks of the business.

The insurance companies' investment in any foreign country consists of real estate, either owned or leased; deposits, payment of salaries to its essential staff of employees; the payment of other operating expenses, including taxes; the payment of insurance losses; and funds and profits which are subject to withdrawal restrictions by blocking of currency by foreign governments.

It would indeed be ironic to allow the benefits in question to the ordinary commercial enterprises and to deny those benefits to the insurers who make possible the establishment, growth, and development of those commercial enterprises.

It is respectfully requested that these particular subsections be amended by adding before subchapter L the words "part I or part II of" so as to read as follows:

> Is subject to the tax imposed by part I or part II of subchapter L (sec. 801 and following relating to insurance companies).

Mr. Chairman, I want to thank you on behalf of our companies. We do hope to continue our negotiations with Mr. Stam and his staff.

The CHAIRMAN. Fine.

Senator BENNETT. Mr. Chairman, may I ask one question?

The CHAIRMAN. Certainly.

Senator BENNETT. Are you required in many countries to make substantial investments in the assets of those countries, or is the limit of your requirement the deposits with the Government?

Mr. BERRY. No; we will make investments in Government securities and make deposits of whatever nature they may require. Largely, they require securities of the country in which we are doing business.

Senator BENNETT. May I ask my question another way. Do you make any substantial investments in the securities or Government securities of the country beyond the amount required for your deposit?

Mr. BERRY. We have to. Taking Canada, as we write more business we are required to increase our reserves and we are required to increase our amount of securities which we invest in, in Dominion securities. Then, too, we will buy real estate in certain parts of the globe for the operation of these companies. Are you thinking in terms of a company, let's say, in South Africa that has gone in the manufacturing business and we buy the stock of that company?

Senator BENNETT. Insurance companies in this country make their investments in private stocks and bonds as well as in Government stocks and bonds. I wondered to what extent you share in this transfer of American capital abroad by investing your assets in privately owned securities, or securities representing privately owned businesses.

Mr. BERRY. Of course, every time we make a loss good, we are making an investment. Can I call on a representative of the Great American Insurance Co. who is here, which company is a member of AFIA, and can probably answer your question direct? May I introduce Mr. Niederlitz, who I think can answer that question?

Mr. NIEDERLITZ. Mr. Chairman, as a rule we do not make investments in foreign corporate stocks except where it is necessary to do so in order to operate in certain countries. In those cases it is necessary, sometimes, to have your own insurance company in that country.

The CHAIRMAN. By requirement of law?

Mr. NIEDERLITZ. Well, it is not always a requirement of law, but in order to meet the competition in those countries. However, to get back to the investment in other corporate stocks, that is not usually done because of the restriction that we have in our own tax bill here in the United States. As you know, any dividends from foreign stocks do not have the 85-percent credit, so that limits the investments in corporate securities.

Senator BENNETT. What about foreign corporate bonds?

Mr. NIEDERLITZ. We do have in a limited way foreign corporate bonds. It is mostly in the government bonds of the countries where they are doing business.

Senator BENNETT. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. BERRY. Thank you, Senator.

The CHAIRMAN. Mr. Robert Wyatt. Sit down and make yourself comfortable, Mr. Wyatt, and identify yourself to the reporter.

STATEMENT OF ROBERT H. WYATT, THE NATIONAL EDUCATION ASSOCIATION, ACCOMPANIED BY LEONARD CALHOUN, COUNSEL, THE NATIONAL EDUCATION ASSOCIATION

Mr. WYATT. Mr. Chairman, and members of the committee, I am Robert H. Wyatt, executive secretary of the Indiana State Teachers Association. My testimony today deals with section 38 of H. R. 8300. It is a privilege for me to appear here today as spokesman for the National Education Association of the United States. The NEA represents more than 550,000 voluntary members of the teaching profession, and, through affiliated State and local organizations, enrolls a total of nearly a million teachers, superintendents, and other school officials.

Teachers as a group have been foremost in the struggle to secure equal tax treatment for all retired people. Since the introduction of the Mason bill, H. R. 5180, in the House of Representatives last May, we have cooperated with a number of other organizations in studying the desirability and justice of the retirement-income-exemption provisions put forth by Representative Mason.

Many national and State organizations join the NEA in applauding the acceptance by the House of Representatives of the basic philosophy of exempting from taxation the retirement income of those persons not now protected by previous legislation or Treasury rulings.

However, we do feel that certain basic differences between the original Mason bill and section 38 of H. R. 8300 should be rectified by your committee Attached to my statement is a copy of section 38 containing 4 underlined revisions which I will discuss.

The first and most important of these deals with the omission of persons retired under pension plans prior to attaining age 65. This omission could be corrected by inserting in section 38 (a) the words "or who has been retired under a retirement system."

In our opinion, the failure to include this provision would definitely unbalance the legislation and leave unremedied the plight of all those persons who must retire before reaching age 65.

Let me elaborate on this briefly. Most persons who retire before 65 must take a reduced pension, and therefore may be in particular need of the exemption. People in certain occupations such as firemen and policemen are frequently required to retire at an earlier age than most other occupations, and this fact is reflected in their retirement systems.

I do not need to stress for you the rigorous and hazardous nature of the daily lives led by our police and firemen. While the teaching profession may not be physically as dangerous as these jobs, it has its wearing effects, and many teachers who have served 20, 25, or 30 years in their school systems retire for long service, though they have not reached age 65. Some teachers, for example, reach a state of health which may disqualify them for efficient service as teachers, but which does not qualify them as disabled persons. Surely these prematurely aged people should not be discriminated against.

The CHAIRMAN. What are the usual retirement causes in the usual retirement system, as it affects schoolteachers? How many years of service? At what age is retirement compulsory and at what age is it optional and so forth?

Mr. WYATT. Compulsory ages of retirement range from around 65 to 75, where there are any compulsory ages. Minimum service ordinarily is 20 years or more; very few systems require less than 20 years.

The CHAIRMAN. What is the average age when a schoolteacher commences to teach?

Mr. WYATT. For the great bulk of the teachers now teaching, their ages were possibly in the neighborhood of 19, 20, or 21. But educational requirements have increased in the past 20 years so that the teachers beginning in the last 10 or 15 years have been older, 22 or 23 being about the spot, I believe, where they would begin.

Many teachers, firemen, policemen, and other workers are required by Federal and State law and municipal ordinances to retire at a specified age, or after a specified number of years of service. Our best estimates show that about 1 teacher in 5 is retired before age 65. As a superintendent said to me recently, "Few of our teachers quit voluntarily before reaching age 65. Most of them are either compelled by law to retire, or they are just worn out."

For firemen and police, the percentage of retirements under age 65 is much higher, running well over 60 percent.

Under civil-service law, workers may retire at age 60 after 30 years' service. Particularly in hazardous jobs under civil service we find a large number of such retirements. In fact, approximately one-third of all civil-service workers are retired before reaching age 65.

Mr. Chairman, my answers to your question might have been slightly misleading when I stated that 20 was a minimum. Retirement after 20 years' service would place the teacher on a very low retirement income and is the exception. Thirty years is a fairly standard period for retirement. Those who retire earlier than that because of actuarial situations receive much smaller pensions, almost negligible.

Senator FREAR. Mr. Chairman, does he mean that they retire after 30 years of service or are eligible for retirement?

Mr. WYATT. They are eligible for retirement.

Senator FREAR. If they start teaching at the age of 23, they are then 53. What do they do between the ages of 53 and 65?

Mr. WYATT. As I stated a moment ago, about one-fifth of the teachers retire before 65. The number is small.

Senator FREAR. You mean about one-fifth of those eligible for retirement?

Mr. WYATT. I mean about one-fifth of those who retire are below age 65.

Senator FREAR. That are members of some type of retirement system?

Mr. WYATT. Yes; that are covered by a retirement system. Your question probably is pointed toward what they do and whether they are earners in that period. Some of them would be earners. The provisions of this bill, of course, would exclude them from the exemption provided they earned——

Senator FREAR. But is it not true that after having taught 30 years and they are eligible for retirement and they begin teaching at an early age and have some years between the 30-year expiration of their time or their requirements for retirement and age 65, that they have to continue to teach to make a living?

Mr. WYATT. Yes; that is correct. That is why I was saying their annuity would be so substantially reduced by actuarial factors that they either must teach or they don't have much of a living; that is true.

The CHAIRMAN. Does that condition continue until they are 65?

In other words, do they come into an enhanced benefit when they are 65?

Mr. WYATT. In practically no case is their annuity increased at age 65. I think there might be a few exceptions in which social security at age 65 might enter in a small measure. Otherwise, they do not change.

Senator HOEY. Do most of the State systems permit retirement at 60?

Mr. WYATT. Yes; that would be a very accurate statement, Senator. We feel, Mr. Chairman, that conforming section 38 to the Mason bill provisions relating to the persons I have just described is desirable and defensible in all justice.

I request the permission of the committee to include in the record a detailed cost estimate just completed by the NEA Research Division. This estimate breaks down the costs for retired persons over age 65, the costs for those between 55 and 65, and gives the total for both groups.

We placed the minimum figure at 55 because those under that point are so negligible as hardly to be found.

You will note that if the exemption proposed in section 38 were also made available to persons between 55 and 65, it would result in a tax reduction of about $17,500,000.

The CHAIRMAN. Is that in the teaching business or the whole range of that problem?

Mr. WYATT. That is the teaching business or the whole range of that problem?

Mr. WYATT. That is the whole range, all of the persons affected in the United tSates in all occupations, policemen, firemen, civil-service workers, or any others The attached statement breaks that down to a very detailed extent showing various income groups and age groups.

There are three further adjustments which we believe should be made in section 38. They are these:

(1) In section 38 (d), restore the original $1,500 exemption figure in lieu of $1,200. Since the total pension under the Railroad Retirement Act is exempt from taxation, we believe that the committee would want to consider more nearly equalizing the taxation procedures for all retired persons by raising to $1,500 the limitation adopted by the House of Representatives.

Senator BENNETT. Mr. Wyatt, do your yellow sheets show the estimated loss to the Government if this figure is raised from $1,200 to $1,500? I understand the figures you quoted us are based on $1,200.

Mr. WYATT. That is correct, and the attached statement does not indicate the tax reduction brought about. We will be very happy to make a study of that point and file it with the committee.

Senator BENNETT. Does the committee have that figure, Mr. Stam?

Mr. STAM. We did make some estimates on that. I don't recall what they are. I think the loss was much more substantial.

Senator BENNETT. Since the recommendation has been made for a $300 overall increase in exemptions regardless of the age pattern, I think we should try to have that figure.

Mr. WYATT. The estimate in the statement is that about 1,100,000 persons would be affected by the first proposal. Of course, after the $1,200 exemption, the income would drop off materially since annuities are not large. We will be very happy to file a statement on that.

(2) In section 38 (d) (2), remove the $900 ceiling on earned income for retired individuals age 75 or over by adding the phrase "unless such individual has attained age 75." This would give all retired persons age 75 or over the same unlimited earning privileges as those not afforded persons covered by social security.

(3) In section 38 (b), after the words "in excess of $600" insert the phrase "or has been retired under a retirement system." This would avoid discrimination against those persons who must retire from active work before they have been able to fulfill the 10-year rule.

In conclusion, I would like to point out that a number of other national organizations have joined the NEA in studying the desirability of the proposed changes.

I have a statement, Mr. Chairman, that I would like to file for John A. Wood, secretary of the National Council on Teacher Retirement.

The CHAIRMAN. I will be put in the record.

(The statement referred to follows:)

STATEMENT BY JOHN A. WOOD III, SECRETARY, NATIONAL COUNCIL ON TEACHER RETIREMENT, TRENTON, N. J.

The National Council on Teacher Retirement of the National Education Association, through its executive and legislative committees has instructed me to file a brief statement stating their views with respect to section 38 of H. R. 8300.

The council includes in its membership 48 States and local teacher retirement systems. Being identified with the National Education Association it works closely with the departments and commissions of the NEA in matters affecting the retirement of our public schoolteachers and the welfare of our retired teachers. With other national organizations of public employees, we have followed closely the progress of the Mason bill, H. R. 5180, now embodied with modifications in section 38 of H. R. 8300.

We wish to emphasize the need of the proposed exemptions of retirement income not only for those who have attained age 65 but also for those persons under age 65 who have been retired under a retirement system. Staff pension funds for private and public employees are tailored to fit the needs of the profession, business, or vocation in which a career of service has been rendered.

Some of these services are so hazardous in nature that they cannot be adequately performed by any person after attaining middle fifties or early sixties. Other services are so exhausting that 30 or 35 years of employment is all that some people can render.

Most of these staff pension funds make adequate provision for retirement if disability is incurred before age 65 or a specified number of years of service have been attained. These are real retirements. Persons so retired must live and meet their obligations on reduced income with no opportunity or ability to supplement retirement income by earnings.

We beg the Finance Committee to restore the exemptions for persons retired under a retirement system or pension fund, and to not limit the credits to those who have attained age 65.

Both the NEA in convention at Miami Beach in July 1953 and the National Council on Teacher Retirement in convention at Atlantic City in February 1954 passed resolutions advocating that $1,500 of retirement income be exempt from Federal tax.

With the bill containing an adequate work clause as proposed, much of the needed relief is lost if the exemptions are not allowed until retired persons attain age 65. We therefore ask that $1,500 not $1,200 of retirement income be exempt from tax and that the exemptions be not limited to retirement income earned after age 65.

Following are the NEA and the National Council on Teacher Retirement official resolutions on exemption of retirement income as adopted in annual convention in July 1953.

NEA RESOLUTION, ANNUAL CONVENTION, JULY 1953

The National Education Association advocates an amendment of the Federal tax laws so as to permit up to a total of $1,500 in addition to the regular exemptions of the retirement income of all retired persons to be exempt from the Federal income tax.

RESOLUTION NO. 6 OF THE NATIONAL COUNCIL OF TEACHER RETIREMENT INCOME-TAX EXEMPTIONS

"Whereas certain large groups of retired persons are now granted income-tax exemptions not allowed to other retired persons; and

"Whereas many retired persons living on fixed dollar benefits are in dire circumstances because of heavy Federal taxes and decreased purchasing power; and

"Whereas President Eisenhower has called for the removal of inequities in the Federal tax structure in order to make tax burdens fairer for millions of taxpayers; and

"Whereas passage of H. R. 5180 now before Congress would do much toward eliminating this tax inequity and would give fair and equal tax treatment to all groups of retired persons: Be it

"*Resolved,* That the National Council on Teacher Retirement in convention assembled February 15, 1954, continuing its efforts to obtain equal tax exemption, heartily endorses H. R. 5180 and vigorously supports its passage."

Mr. WYATT. The following organizations have directed me to say that they concur in the recommendations which I have made: National Retired Teachers Association, National Council on Teacher Retirement. National Conference on Public Employee Retirement Systems, Fraternal Order of Police, International Association of Fire

Fighters, National Conference of Police Associations, American Library Association, National Association of Retired Civil Employees.

Senator Carlson. Mr. Chairman, I wonder if Mr. Wyatt has any figures as to the number of people who would be affected if we reduced the age limit from 65 to 55. How many people in the teaching profession or of all of these professions on whose behalf you are appearing would be affected?

Mr. Wyatt. The statement indicates 1,100,000 persons. I would like to call on Miss Bradley of our research division.

Miss Bradley. I think that is contained in section 3 of the statements.

Senator Carlson. Mr. Wyatt, I understand you are submitting this statement for the record and it will be available in the record?

Mr. Wyatt. That is right.

Senator Carlson. That is all, Mr. Chairman.

The Chairman. Thank you very much, Mr. Wyatt.

(The attachments to Mr. Wyatt's statement follow:)

Section 38 of H. R. 8300—Internal Revenue Code of 1954

(The italicized portions indicate the changes recommended by the National Educational Association and by a number of other national organizations.)

SEC. 38. RETIREMENT INCOME

(a) General Rule. In the case of an individual who has received earned income before the beginning of the taxable year and who has attained the age of 65 before the end of the taxable year, *or who has been retired under a retirement system*, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the amount received by such individual as retirement income (as defined in subsection (c) and as limited by subsection (d), multiplied by the rate provided in section I for the first $2,000 of taxable income; but this credit shall not exceed such tax reduced by the credits allowed by section 33 (relating to foreign tax credit), section 34 (relating to credit for dividends received by individuals), and section 35 (relating to partially tax-exempt interest).

(b) Individual Who Has Received Earned Income. For purposes of subsection (a), an individual shall be considered to have received earned income if he has received, in each of any 10 calendar years before the taxable year, earned income (as defined in section 911 (b)) in excess of $600, *or has been retired under a retirement system.* A widow or widower whose spouse had received such earned income shall be considered to have received earned income.

(c) Retirement Income. For purposes of subsection (a), retirement income means income from—

(1) pensions and annuities,
(2) interest,
(3) rents, and
(4) dividends,

to the extent included in gross income without reference to this section, but only to the extent such income does not represent compensation for personal services rendered during the taxable year.

(d) Limitation of Retirement Income. For purposes of subsection (a), the amount of retirement income shall not exceed *$1,500* less—

(1) any amount received by the individual as a pension or annuity—
(A) under title II of the Social Security Act,
(B) under the Railroad Retirement Acts of 1935 or 1937, or
(C) otherwise excluded from gross income, and

(2) any amount of earned income (as defined in section 911 (b)) in excess of $900 received by the individual in the taxable year *unless such individual has attained age 75.*

(e) Rule for Application of Subsection (d) (1). Subsection (d) (1) shall not apply to any amount excluded from gross income under section 72 (relating to annuities), 101 (relating to life insurance proceeds), 104 (relating to compensation for injuries or sickness), 105 (relating to qualified employers' accident and health plans), 401 (relating to certain employee annuities and insurance contracts), 402 (relating to employees' trusts), or 1241 (relating to private annuities).

Estimates of Tax Loss to the Federal Government of the Proposal To Exempt up to $1,200 of the Income of Retired Persons

(Prepared by the Research Division of the National Education Association of the United States)

H. R. 5180, sponsored by a number of public employee groups, proposed to remove certain inequities by allowing a $1,500 exemption from Federal income taxes of the income of retired persons. The general idea was incorporated into the House revenue bill (H. R. 8300) but with certain changes: (*a*) The amount was reduced to $1,200; (*b*) the maximum exemption which any taxpayer might have at present tax rates was limited to $240, and the exemption was limited to persons 65 years of age and over (H. R. 5180 applied also to persons 55 to 64 years of age who were retired under a public or private retirement plan).

Part I of this memorandum summarizes the main conclusions of the estimates. Part II consists of a summary statement and statistical tables when the $1,200 is applied to those 65 years of age and over. Part III shows the tax loss to the Government if the exemption were applied to those 55 to 64 years of age.

The present memorandum is a series of careful estimates based upon published data of the Bureau of the Census and the Social Security Administration. Because of the limitations of the basic statistics it has been necessary to make a number of assumptions so as to complete the calculations. These assumptions are included in each part of the present memorandum.

PART I. SUMMARY OF THE ESTIMATES

If the $1,200 exemption is made available to retired persons 65 years of age and over, the Federal Government would not receive approximately $64 million in income taxes.

The same exemption applied to those retired under retirement systems who are between the ages of 55 and 64 years would result in a tax loss of approximately $17,500,000.

The total tax loss for the 2 age groups is estimated as $81,500,000; it might be as low as $75 million and it might be as high as $90 million.

PART II. ESTIMATED TAX LOSS ON PERSONS 65 YEARS OF AGE AND OVER

Of the 13 million population 65 years and over, one-fourth (25.4 percent) have no income and presumably are supported by other individuals. Approximately 17.9 percent are living on current earnings only rather than retirement income.[1] Twenty percent are on public assistance[2] and presumably pay no income taxes.

All of the above groups (63.3 percent of all persons in this age bracket) would constitute no loss in tax to the Federal Government under the provisions of H. R. 5180.

An additional one-third (33.7 percent) of all persons 65 years and over are receiving OASI, railroad retirement, or veterans' benefits which are tax exempt. Persons' retired under these plans at the lower income levels pay no income tax, while it is reasonable to assume that most of those at the upper income levels already are receiving tax-exempt income up to, or in excess of, the $1,200 limit. (See assumptions 4 through 8.) The loss in tax to the Federal Government from these groups, therefore, would be slight.

The remaining 3 percent of persons 65 years and over would be the group receiving the most benefits under H. R. 5180 and would represent the bulk of the loss in taxes.

Of the 13 million persons 65 years and over, the research division of the National Education Association estimates that approximately 1,100,000 would

[1] Income distribution, number of persons 65 and over with and without incomes, and number with earnings only, from U. S. Department of Commerce, Bureau of Census Series P-60, Nos. 11 and 14, Income of Persons in the United States: 1951 and 1952.

[2] Number of persons receiving income from the various social insurances, etc., estimated mainly from Federal Security Agency, Social Security Administration, Social Security Bulletin, June 1953, vol. 16, No. 12, p. 23.

benefit under H. R. 5180. On the average these would save about $60 annually in Federal income taxes. The total tax loss to the Federal Government would be about $64 million; the range of this estimate may be from $60 million to $70 million.

Tables 1 through 4 present detailed figures on which these estimates are based.

Assumptions used for persons 65 years of age and over

1. That the distribution of income for retired persons over 65 is the same as for all persons over 65.

2. That all women over 65 reported as having incomes were single, widowed, or divorced.

3. That all persons receiving OAA only and OASI plus OAA would have no taxable incomes.

4. That single persons, both men and women, and married men with wives under 65 receiving OASI only having the various total incomes would be receiving the following amounts from OASI which would be exempted from tax:

Total incomes:	*Income from OASI*
Below $1,500	Less than $500.
$1,500 to $1,999	$500.
$2,000 to $2,499	$650.
$2,500 to $2,999	$890.
$3,000 and over	$1,020.

5. That for these same marital groups covered by OASI plus other plans, the exempted amounts would be increased 10 percent. This assumes that 10 percent of the other plans would be of the tax-exempt type and that the benefits received would be the same as those from OASI. Persons with the following total incomes would be receiving the various amounts which would be exempted from tax.

Total incomes:	*Tax-exempted income*
Below $1,500	Less than $550.
$1,500 to $1,999	$550.
$2,000 to $2,499	$715.
$2,500 to $2,999	$979.
$3,000 and over	$1,122.

6. That married men with wives over 65, whose income is high enough to pay tax, would be receiving at least $1,500 exempted income from OASI, veterans' compensation or pension, and railroad retirement. Therefore, there would be no loss in tax from these groups.

7. That single persons and married men with wives under 65, covered by railroad retirement only or veterans' compensation or pensions only, would be receiving the following total incomes of which certain amounts would be exempted from tax.

Total incomes:	*Tax-exempted income*
Below $1,500	Less than $500.
$1,500 to $1,999	$500.
$2,000 to $2,499	$650.
$2,500 to $2,999	$1,020.
$3,000 to $3,499	$1,260.
$3,500 to $3,999	$1,380.
$4,000 and over	$1,500 and over.

8. That for these same marital groups, covered by railroad retirement plus other plans and veterans' compensation and pension plus other plans, the exempted tax would be increased 10 percent. (Use same assumptions as given in 5 above.) Persons receiving the following total incomes would have the various amounts listed below exempt from tax:

Total incomes:	*Tax-exempted income*
Below $1,500	Less than $550.
$1,500 to $1,999	$550.
$2,000 to $2,499	$715.
$2,500 to $2,999	$1,122.
$3,000 to $3,499	$1,386.
$3,500 and over	$1,500 and over.

9. In calculating the tax the following were used:

(*a*) A standard 10-percent (not to exceed $1,000) deduction.

(*b*) The following dependency exemptions:

Single persons	$1,200
Married men with wives under 65	1,800
Married men with wives over 65	2,400

(*c*) That single persons, which included widowed and divorced persons, had no other dependents and that married men had no dependents other than wives.

(*d*) That all married men filed joint returns.

10. The effect of the so-called 3-percent annuity rule was omitted in all calculations. Had this ruling been applied, the tax loss would be somewhat reduced.

TABLE 1.—*Estimated total number, income status, and source of income for population 65 years of age and over by sex*

Item	All persons		Number of men		Number of women	
	Number	Percent	Number	Percent	Number	Percent
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. Estimated total persons 65 and over	12,986,000	100.0	6,080,000	100.0	6,906,000	100.0
(*a*) Persons without income (supported by others)	3,301,000	25.4	481,000	7.9	2,820,000	40.8
(*b*) Persons with incomes of all types	9,685,000	74.6	5,599,000	92.1	4,086,000	59.2
2. Source of income:						
(*a*) Persons with income from earnings only	2,328,300	17.9	1,842,100	30.3	486,200	7.1
(*b*) Retired persons with incomes	7,356,700	56.7	3,756,900	61.8	3,599,800	52.1
OAA only; OAA plus OASI	2,600,100	20.0	1,100,100	18.1	1,500,000	21.7
OASI only; OASI plus other plans (excluding OAA)	3,814,800	29.4	2,125,000	34.9	1,689,800	24.5
Railroad retirement only; veterans' compensation only; railroad retirement plus other plans; veterans' compensation plus other plans	560,000	4.3	350,000	5.8	210,000	3.0
All others	381,800	3.0	181,800	3.0	200,000	2.9

TABLE 2.—*Distribution of retired persons 65 years and over by income level, type of retirement plan, sex, and marital status*

Income level	OAA and OAA plus OASI		OASI only and OASI plus other types (excluding OAA)				Railroad retirement and/or veterans' compensation (only or with other types)				All others				Tota
	Men	Women	Single men	Married men		Women	Single men	Married men		Women	Single men	Married men		Women	
				Wife under 65	Wife 65 or over			Wife under 65	Wife 65 or over			Wife under 65	Wife 65 or over		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Below $1,000	1,100,100	1,500,000	137,900	91,900	188,000	1,076,000	21,400	14,300	29,300	88,000	8,300	5,500	11,200	79,000	4,350,900
$1,000 to $1,499	--------	--------	150,900	100,700	205,900	209,800	25,700	17,100	35,000	33,000	5,600	3,700	7,700	38,000	833,100
$1,500 to $1,999	--------	--------	85,000	56,700	116,000	130,300	15,200	10,200	20,700	22,500	5,100	3,400	7,000	20,000	492,100
$2,000 to $2,499	--------	--------	71,400	47,500	97,300	91,800	11,900	7,800	16,100	15,000	3,600	2,400	5,000	12,000	381,800
$2,500 to $2,999	--------	--------	63,100	42,000	86,100	42,000	10,200	6,700	13,800	12,800	3,300	2,200	4,500	10,000	296,700
$3,000 to $3,499	--------	--------	69,000	46,000	94,000	77,600	10,600	7,100	14,500	12,200	3,100	2,100	4,300	11,000	351,500
$3,500 to $3,999	--------	--------	25,400	16,900	34,600	15,200	7,600	5,000	10,200	9,000	3,600	2,400	5,000	4,600	139,500
$4,000 to $4,499	--------	--------	20,600	13,800	28,200	19,750	4,700	3,100	6,500	11,250	4,400	2,900	6,000	5,000	126,200
$4,500 to $4,999	--------	--------	15,200	10,200	20,800	5,000	2,700	1,800	3,700	2,800	4,500	3,000	6,000	3,000	78,700
$5,000 to $5,999	--------	--------	27,800	18,500	37,800	13,000	2,500	1,700	3,400	2,200	8,200	5,500	11,100	6,400	138,100
$6,000 to $6,999	--------	--------	8,900	6,000	12,200	5,000	800	500	1,200	800	2,700	1,700	3,600	5,000	48,400
$7,000 to $9,999	--------	--------	11,600	7,800	15,900	1,200	1,000	700	1,400	125	3,400	2,300	4,700	1,675	51,800
$10,000 to $14,999	--------	--------	5,300	3,600	7,300	1,150	500	300	700	100	1,600	1,100	2,100	1,550	25,300
$15,000 to $24,999	--------	--------	4,500	3,000	6,100	800	400	300	500	100	1,300	900	1,800	1,100	20,800
$25,000 and over	--------	--------	4,500	3,000	6,100	1,200	400	300	500	125	1,300	900	1,800	1,675	21,800
Total	1,100,100	1,500,000	701,100	467,600	956,300	1,689,800	115,600	76,900	157,500	210,000	60,000	40,000	81,800	200,000	7,356,700

TABLE 3.—*Distribution of tax loss to Federal Government under proposal to exclude $1,200 from taxation deductible at the bottom tax rate for retired persons 65 years and over (by income level, type of retirement plan, sex, and marital status)*

Income level	OAA and OAA plus OASI		OASI only and OASI plus other types (excluding OAA)				Railroad retirement and/or veterans' compensation (only or with other types)				All others				Total
	Men	Women	Single men	Married men		Women	Single men	Married men		Women	Single men	Married men		Women	
				Wife under 65	Wife 65 or over			Wife under 65	Wife 65 or over			Wife under 65	Wife 65 or over		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Below $1,000	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
$1,000 to $1,499	--------	--------	0	0	0	0	0	0	0	0	28,560	0	0	193,800	222,360
$1,500 to $1,999	--------	--------	341,535	0	0	337,950	60,705	0	0	82,200	390,150	0	0	1,530,000	2,742,540
$2,000 to $2,499	--------	--------	3,176,705	0	0	3,318,760	526,515	0	0	633,500	605,880	110,400	0	2,019,600	10,391,360
$2,500 to $2,999	--------	--------	3,353,520	43,420	0	1,842,300	294,720	0	0	326,560	733,425	302,720	90,900	2,222,500	9,210,065
$3,000 to $3,499	--------	--------	2,028,840	986,680	0	1,257,020	0	0	0	0	697,190	447,300	460,100	2,473,900	8,351,030
$3,500 to $3,999	--------	--------	610,890	403,540	0	273,140	0	0	0	0	821,880	528,960	980,000	1,050,181	4,668,591
$4,000 to $4,499	--------	--------	383,860	256,120	0	352,175	0	0	0	0	1,044,560	638,580	1,321,200	1,187,000	5,183,495
$4,500 to $4,999	--------	--------	226,480	146,880	0	74,500	0	0	0	0	1,080,000	661,200	1,322,400	720,000	4,231,480
$5,000 to $5,999	--------	--------	417,000	262,700	0	195,000	0	0	0	0	1,968,000	1,211,650	2,445,330	1,536,000	8,035,680
$6,000 to $6,999	--------	--------	133,500	85,800	0	75,000	0	0	0	0	648,000	379,270	793,080	1,200,000	3,314,650
$7,000 to $9,999	--------	--------	174,000	117,000	0	18,000	0	0	0	0	816,000	552,000	1,108,400	402,000	3,187,400
$10,000 to $14,999	--------	--------	79,500	54,000	0	17,250	0	0	0	0	384,000	264,000	504,000	372,000	1,674,750
$15,000 to $24,999	--------	--------	67,500	45,000	0	12,000	0	0	0	0	312,000	216,000	432,000	264,000	1,348,500
$25,000 and over	--------	--------	67,500	45,000	0	18,000	0	0	0	0	312,000	216,000	432,000	402,000	1,492,500
Total	0	0	11,060,830	2,446,140	0	7,791,095	881,940	0	0	1,042,260	9,841,645	5,528,080	9,889,410	15,572,981	64,054,381

TABLE 4.—*Estimated number of retired persons 65 years and over who would benefit, average amount of benefit, and tax loss to Federal Government under the proposal to exclude $1,200 from taxation deductible at the bottom tax rate*

Type of retirement plan	Sex and marital status	Number of persons benefiting	Average amount of benefit	Tax loss to Federal Government
(1)	(2)	(3)	(4)	(5)
OASI (tax exempt)	Single men	351,810	$32	$11,100,000
	Married men with wife under 65	133,720	18	2,400,000
	Married men with wife 65 or over	0	0	0
	Women	315,560	25	7,800,000
Railroad retirement and/or veterans' compensation (tax exempt)	Single men	26,470	34	900,000
	Married men with wife under 65	0	0	0
	Married men with wife 65 or over	0	0	0
	Women	34,000	29	1,000,000
All others (not tax exempt)	Single men	48,060	204	9,800,000
	Married men with wife under 65	27,400	201	5,500,000
	Married men with wife 65 or over	49,100	202	9,900,000
	Women	96,300	162	15,600,000
Total		1,082,420	59	64,000,000

Estimate of tax loss on persons aged 55 to 64

On the basis of information obtained mainly from the Social Security Administration, the NEA research division estimates that there are 675,000 persons aged 55 to 64 receiving benefits under public and private retirement plans. It further estimates that 200,000 of these persons have income from earnings in excess of the limitations provided in the revenue bill and, therefore, would not benefit if the provisions were extended to include persons aged 55 to 64 retired from public and private retirement plans.

Of the remaining 475,000 persons, it is estimated that 50,000 are widows with minor children receiving tax-exempt benefits under OASI, and 200,000 are receiving tax-exempt benefits under railroad retirement and veterans' compensation. If the proposed $1,200 exemption were extended to include the 250,000 persons in these groups, only about 30,520 would benefit and the amounts saved by these individuals, on the average, would be small. The estimated tax loss to the Federal Government would be less than $2 million ($1,815,775).

The remaining 225,000 persons aged 55 to 64 are believed to be receiving benefits under public and private plans which are not tax exempt. If the proposed exemption were extended to include this group they would receive the most benefits and would represent the major part of the loss in taxes.

In brief, the extension of the exemption to persons aged 55 to 64 would benefit an estimated 138,580 persons. On the average these would save about $126 annually in Federal income taxes. The total tax loss to the Federal Government would be about $17½ million ($17,443,750) ; the range of this estimate is believed to be between $15 million and $20 million.

Tables A through D present detailed figures on which these estimates are based.

Assumptions used for persons aged 55 to 64

1. Most men in this age group are married men and heads of families. We assumed that all retired men are married men with dependent wives, but no other dependents, and that they all filed jointly with wives.

2. Most women in this age group with incomes are single, widowed, or divorced. We assumed that all retired women fall into these categories for our calculations. These women had no dependents.

3. We assumed that 50,000 women are widows with minor children and receiving income from OASI. However, we figured no loss on this group, as income is too small.

4. We assumed that the distribution of income for retired men and for retired women 55 to 64 is the same as for all men and for all women 65 years and over in age.

5. The persons covered by railroad retirement and veterans' compensation receiving the following total incomes would have the various amounts listed below exempt from tax:

Total income:	*Tax-exempted income*
Below $1,500	Less than $500.
$1,500 to $1,999	$500.
$2,000 to $2,499	$650.
$2,500 to $2,999	$1,020.
$3,000 to $3,499	$1,260.
$3,500 to $3,999	$1,380.
$4,000 and over	$1,500 and over.

6. In calculating taxes the following were used:

(*a*) A standard 10-percent (not to exceed $1,000) deduction.

(*b*) Personal exemption of $600 for women, $1,200 for men.

7. The effect of the so-called 3-percent annuity rule was omitted in all calculations. Had this ruling been applied, the tax loss would be considerably reduced.

TABLE A.—*Estimated number of persons aged 55 to 64 retired under public or private retirement plans, and estimated number of such persons whose income from earnings exceed the statutory limitations (by sex and type of retirement plan)*

Type of retirement	Total number of persons receiving incomes from retirement plans			Persons receiving retirement incomes with earnings in excess of limitations			Retired persons aged 55 to 64 with no earnings or earnings not in excess of limitations		
	Total	Men	Women	Total	Men	Women	Total	Men	Women
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
OASI (tax exempt)	[1] 50,000	0	[1] 50,000	0	0	0	[1] 50,000	0	[1] 50,000
Railroad retirement and/or veterans' compensation (tax exempt)	250,000	100,000	150,000	50,000	25,000	25,000	200,000	75,000	125,000
All plans not tax exempt	375,000	225,000	150,000	150,000	100,000	50,000	225,000	125,000	100,000
Total	675,000	325,000	350,000	200,000	125,000	75,000	475,000	200,000	275,000

[1] Widows with minor children.

TABLE B.—*Distribution of persons aged 55 to 64 retired from public and private retirement plans by income level, sex, and type of retirement plan*

Income level	Men		Women			Total
	Railroad retirement and/or veterans' compensation (tax exempt)	All plans not tax exempt	OASI widows with minor children (tax exempt)	Railroad retirement and/or veterans' compensation (tax exempt)	All plans not tax exempt	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Below $500	32,100	53,500	50,000	47,750	38,200	307,050
$500 to $999				47,500	38,000	
$1,000 to $1,499	11,025	18,375		9,750	7,800	46,950
$1,500 to $1,999	6,375	10,625		6,000	4,800	27,800
$2,000 to $2,499	5,250	8,750		4,125	3,300	21,425
$2,500 to $2,999	4,650	7,750		2,250	1,800	16,450
$3,000 to $3,499	5,025	8,375		3,500	2,800	19,700
$3,500 to $3,999	2,250	3,750		1,000	800	7,800
$4,000 to $4,499	1,800	3,000		1,250	1,000	7,050
$4,500 to $4,999	1,275	2,125		375	300	4,075
$5,000 and over	5,250	8,750		1,500	1,200	16,700
Total	75,000	125,000	50,000	125,000	100,000	475,000

TABLE C.—*Distribution of tax loss to Federal Government under H. R. 5180 excluding $1,200 from taxation deductible at the bottom tax rate for persons aged 55 to 64 retired from public and private retirement plans (by income level, sex, and type of retirement plan)*

Income level	Men		Women			Total
	Railroad retirement and/or veterans' compensation (tax exempt	All plans not tax exempt	OASI widows with minor children (tax exempt)	Railroad retirement and/or veterans' compensation (tax exempt)	All plans not tax exempt	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Below $500	0	0	0	0	0	0
$500 to $999	0	0	0	0	$839,800	$839,800
$1,000 to $1,499	0	$93,738	0	$215,696	908,700	1,218,134
$1,500 to $1,999	$27,753	812,430	0	683,400	1,026,720	2,550,303
$2,000 to $2,499	245,905	1,470,942	0	416,625	2,688,000	12,835,510
$2,500 to $2,999	151,916	1,724,660	0	74,475		
$3,000 to $3,499	0	1,884,662	0	0		
$3,500 to $3,999	0	856,125	0	0		
$4,000 to $4,499	0	712,200	0	0		
$4,500 to $4,999	0	2,610,000	0	0		
$5,000 and over	0		0	0		
Total	425,574	10,164,757	0	1,390,196	5,463,220	17,443,747

TABLE D.—*Estimated number of persons aged 55 to 64 retired from public and private retirement plans who would benefit*

Type of retirement plan	Sex	Number of persons benefiting	Average amount of benefit	Tax loss to Federal Government
(1)	(2)	(3)	(4)	(5)
OASI (tax exempt)	Widows with minor children.	0	0	0
Railroad retirement and/or veterans' compensation (tax exempt)	Men	11,800	$36	$425,575
	Women	18,720	74	1,390,200
All plans not tax exempt	Men	59,560	171	10,164,750
	Women	48,500	113	5,463,225
Total		138,580	126	17,443,750

(Supplement to April 12 testimony on sec. 38 of H. R. 8300 (Robert H. Wyatt):)

NATIONAL EDUCATION ASSOCIATION OF THE UNITED STATES,
Washington, D. C., April 21, 1954.

Memorandum to James L. McCaskill, director,
NEA legislative and Federal relations division.
From: Frank W. Hubbard, director, NEA research division.

On Monday, April 12, during the hearings on the revenue bill, Senator Bennett asked Robert Wyatt for an estimate of the revenue losses if the $1,200 exemption on the income of retired persons were raised to $1,500. Mr. Wyatt said that the NEA research division would supply such an estimate at an early date. That is the purpose of the present memo.

This memorandum has been prepared as a supplement to the memorandum issued under date of March 1954, copies of which were filed with the Senate Finance Committee. The earlier memorandum contained 4 numbered tables and 4 tables designated A, B, C, and D; hence, the current statement includes tables 5 and 6 and E and F.

It will be noted: that an exemption of $1,500 would:

1. Produce a tax loss of about $122,500,000 for all age groups; the true amount might fall between $115 million and $130 million.

The estimated tax loss for those 65 and over is estimated as about $101,650,000; for those under 65 years of age the amount is estimated at about $20,775,000.

2. Increase the number of taxpayers affected, who were 65 and over, from 1,100,000 (under the $1,200 exemption) to 1,122,000 persons; increase the number of taxpayers affected, who were under 65 years of age, from 138,580 (under the $1,200 exemption) to 150,370.

I believe that the present supplementary statement is best read in connection with the earlier statement because we used the same assumptions, income distributions, and explanations.

FRANK W. HUBBARD.

FWH: kh

TABLE 5.—*Distribution of tax loss to Federal Government under proposal to exclude $1,500 from taxation deductible at the bottom tax rate for retired persons 65 years and over (by income level, type of retirement plan, sex, and marital status)*

Income level	OAA and OAA plus OASI		OASI only and OASI plus other types (excluding OAA)				Railroad retirement and/or veterans' compensation (only or with other types)				All others				Total
	Men	Women	Single men	Married men		Women	Single men	Married men		Women	Single men	Married men		Women	
				Wife under 65	Wife 65 or over			Wife under 65	Wife 65 or over			Wife under 65	Wife 65 or over		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
Below $1,000	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
$1,000 to $1,499	0	0	0	0	0	0	0	0	0	0	$28, 560	0	0	$193, 800	$222, 360
$1,500 to $1,999	0	0	$341, 535	0	0	$337, 950	$60, 705	0	0	$82, 200	390, 150	0	0	1, 530, 000	2, 742, 540
$2,000 to $2,499	0	0	3, 176, 705	0	0	3, 318, 760	526, 515	0	0	633, 500	605, 880	$110, 400	0	2, 019, 600	10, 391, 360
$2,500 to $2,999	0	0	5, 450, 600	$43, 420	0	3, 207, 700	633, 820	0	0	749, 120	843, 810	302, 720	$90, 900	2, 601, 000	13, 923, 090
$3,000 to $3,499	0	0	5, 818, 260	1, 646, 120	0	5, 524, 195	427, 300	$53, 030	0	421, 800	860, 870	482, 160	460, 100	3, 054, 700	18, 748, 535
$3,500 to $3,999	0	0	2, 007, 810	1, 334, 780	0	1, 110, 060	130, 390	86, 190	0	99, 450	1, 011, 960	660, 960	995, 000	1, 293, 060	8, 729, 660
$4,000 to $4,499	0	0	1, 521, 460	1, 017, 560	0	1, 442, 750	0	0	0	0	1, 276, 880	798, 660	1. 622, 400	1, 451, 000	9, 130, 710
$4,500 to $4,999	0	0	1, 080, 720	707, 880	0	355, 500	0	0	0	0	1, 336, 500	826, 200	1, 653, 600	891, 000	6, 851, 400
$5,000 to $5,999	0	0	2, 110, 020	1, 282, 050	0	986, 700	0	0	0	0	2, 460, 000	1, 514, 700	3, 056, 940	1, 920, 000	13, 330, 410
$6,000 to $6,999	0	0	676, 400	416, 400	0	380, 000	0	0	0	0	810, 000	472, 940	991, 080	1, 500; 000	5, 246, 820
$7,000 to $9,999	0	0	881, 600	581, 100	0	91, 200	0	0	0	0	1, 020, 000	685, 392	1, 379, 428	502, 500	5, 141, 220
$10,000 to $14,999	0	0	402, 800	273, 600	0	87, 400	0	0	0	0	480, 000	330, 000	630, 000	465, 000	2, 668, 800
$15,000 to $24,999	0	0	342, 000	228, 000	0	60, 800	0	0	0	0	390, 000	270, 000	540, 000	330, 000	2, 160, 800
$25,000 and over	0	0	342, 000	228, 000	0	91, 200	0	0	0	0	390, 000	270, 000	540, 000	502, 500	2, 363, 700
Total	0	0	24, 151, 910	7, 758, 910	0	16, 994, 215	1, 778, 730	139, 220	0	1, 986, 070	11, 904, 610	6, 724, 132	11, 959, 448	18, 254, 160	101, 651, 405

TABLE 6.—*Estimated number of retired persons 65 years and over who would benefit, average amount of benefit, and tax loss to Federal Government under the proposal to exclude $1,500 from taxation deductible at the bottom tax rate*

Type of retirement plan	Sex and marital status	Number of persons benefiting	Average amount of benefit	Tax loss to Federal Government
(1)	(2)	(3)	(4)	(5)
OASI (tax exempt)	Single men	351,810	$69	$24,150,000
	Married men with wife under 65	133,720	58	7,760,000
	Married men with wife 65 or over.	0	0	0
	Women	315,560	54	17,000,000
Railroad retirement and/or veterans' compensation (tax exempt).	Single men	42,700	42	1,780,000
	Married men with wife under 65	7,090	20	140,000
	Married men with wife 65 or over.	0	0	0
	Women	50,700	39	1,990,000
All others (not tax exempt)	Single men	48,060	248	11,900,000
	Married men with wife under 65	27,400	245	6,720,000
	Married men with wife 65 or over.	49,100	244	11,960,000
	Women	96,300	190	18,250,000
Total		1,122,440	91	101,650,000

TABLE E.—*Distribution of tax loss to Federal Government under proposal to exclude $1,500 from taxation deductible at the bottom tax rate for persons aged 55–64 retired from public and private retirement plans (by income level, sex, and type of retirement plan)*

Income level	Men		Women			Total
	Railroad retirement and/or veterans' compensation (tax exempt)	All plans not tax exempt	OASI widows with minor children (tax exempt)	Railroad retirement and/or veterans' compensation (tax exempt)	All plans not tax exempt	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Below $500	0	0	0	0	0	0
$500 to $999	0	0	0	0	$839,800	$839,800
$1,000 to $1,499	0	$93,738	0	$215,696	908,700	1,218,134
$1,500 to $1,999	$27,753	812,430	0	699,000	1,039,200	2,578,383
$2,000 to $2,499	245,905	1,470,942	0	616,241	968,880	3,301,968
$2,500 to $2,999	319,909	1,984,232	0	198,450	2,370,000	12,834,337
$3,000 to $3,499	221,320	2,327,126	0	154,350		
$3,500 to $3,999	49,725	1,054,125	0	22,000		
$4,000 to $4,499	0	870,600	0	0		
$4,500 to $4,999	0	3,262,500	0	0		
$5,000 and over	0		0	0		
Total	864,612	11,875,693	0	1,905,737	6,126,580	20,772,622

TABLE F.—*Estimated number of persons aged 55 to 64 retired from public and private retirement plans who would benefit, and tax loss to Federal Government under the proposal to exclude $1,500 from taxation deductible at the bottom tax rate*

Type of retirement plan	Sex	Number of persons benefiting	Average amount of benefit	Tax loss to Federal Government
(1)	(2)	(3)	(4)	(5)
OASI (tax exempt)	Widows with minor children	0	0	0
Railroad retirement and/or veterans' compensation (tax exempt).	Men	19,090	$45	$865,000
	Women	23,220	82	1,905,000
All plans not tax exempt	Men	59,560	199	11,875,000
	Women	48,500	126	6,130,000
Total		150,370	138	20,775,000

The CHAIRMAN. Mr. Givens. Sit down and be comfortable and identify yourself to the reporter.

STATEMENT OF ROYCE L. GIVENS, SECRETARY-TREASURER, NATIONAL CONFERENCE OF POLICE ASSOCIATIONS

Mr. GIVENS. My name is Royce L. Givens. I am secretary-treasurer of the National Conference of Police Associations, representing approximately 100,000 policemen from coast to coast and as far south as the Panama Canal. I am an active member of the uniformed forces of the Metropolitan Police Department of the District of Columbia, representing the National Conference of Police Associations with specific reference to section 38 of H. R. 8300.

We respectfully urge that section 38 (a) be amended as follows:

Line 3 of subsection (a) of section 38, after the words "taxable year," insert the following "or who has been retired under a retirement system,"

This same language to be inserted in subsection (b) line 5 after the words "excess of $600."

These amendments will give policemen the same relief granted to others.

The hazards in police work necessitate early retirement on disabilities that make them unfit to protect the lives and property of citizens. Few can serve as a policeman past middle age and there are not enough limited duty assignments in the police departments for those who are no longer able to serve actively on the street. Therefore, State and local governments have provided retirement systems for policemen at an earlier age than those in other professions or vocations.

May we further point out that this type of retirement has been provided specifically for policemen and firemen due to the very nature of their duties, which sets them apart from other professions or vocations, in order to attract and hold qualified personnel to the end that we can render prompt and efficient service to the public. We are firm in the conviction that our retirement program is one of the very bases upon which the recruitment and moral aspect of our profession is based.

The police service is one that has long been recognized as one that is best staffed with relatively young men. The very nature of police duty requires the services of one who is physically fit and mentally alert. All present police retirement programs of any recognized merit provide for retirement of the members of our profession several years in advance of persons engaged in other professions or vocations.

The CHAIRMAN. Give us an average picture. When does a policeman usually start and finish?

Mr. GIVENS. The majority of them, Senator, start at around 23. Some of them come in at 21. The average retirement is based on 25 years' service at approximately 55 years of age. Some can go out at 52 years of age.

The service of a policeman beyond that which is currently accepted as the prime of his active years would result in hidden costs to the local or State government.

On March 15, 1954, the President of the United States, made a speech relative to this bill and he stated among other things "Now here are some of the ways in which you will benefit: * * * Fairer tax treatment for the widows of policemen and firemen and others who have fraternal or private pension plans." H. R. 8300 as passed by the House does not live up to what the President said.

Unless this amendment is adopted policemen will not benefit under this program, because, the greater majority of policemen retire many years before they reach 65. As a matter of fact practically all police departments have compulsory retirement before 65.

The CHAIRMAN. How many years of service are usually required prior to retirement?

Mr. GIVENS. 25, sir.

Mr. Chairman, with the permission of the committee I would like to file as part of this statement copies of letters I have received from a number of police associations on this subject.

The CHAIRMAN. We will put them in the record.

(The information referred to follows:)

SAN DIEGO POLICE ASSOCIATION, INC.,
San Diego, Calif., March 24, 1954.

Regarding H. R. 5180
HON. WILLIAM F. KNOWLAND,
Senate Office Building,
Washington 25, D. C.

DEAR SIR: Since this bill was first introduced, police associations all over this country have supported and urged passage of this bill. However, the changes that have been made in H. R. 5180, from its original form, do not seem wholly justified. The reduction from $1,500 tax-free pension to $1,200 would work a hardship on all persons tentatively covered by this bill. Certainly there is no justification for considering an age limit of 65 before being entitled to this exemption.

We implore you to return the $1,500 exemption to the bill, and if an age limit is necessary, you must, in all fairness, exclude police officers from the age limit. No other group of public employees is required to make the sacrifices that are expected of police officers, and in those cases where necessary, their very lives are the price of fulfilling their jobs.

This association urges passage of this bill, but sincerely believe that the recommended changes would better serve the intent and purpose of the bill. There is not doubt that in its original form, H. R. 5180 would be more equitable treatment for America's first line of defense on the home front, the police officers.

Sincerely,

L. E. THRALL, *President.*

PEACE OFFICERS RESEARCH ASSOCIATION OF CALIFORNIA, INC.,
San Diego, Calif., March 24, 1954.

Re H. R. 5180

Hon. JAMES B. UTT,
Room 322, House Office Building,
Washington, D. C.

DEAR SIR: Since this bill was first introduced, police associations all over this country have supported and urged passage of this bill. However, the changes that have been made in H. R. 5180, from its original form, do not seem wholly justified. The reduction from $1,500 tax-free pension to $1,200 would work a hardship on all persons tentatively covered by this bill. Certainly there is no justification for considering an age limit of 65 before being entitled to this exemption.

We implore you to return the $1,500 exemption to the bill, and if an age limit is necessary, you must, in all fairness, exclude police officers from the age limit. No other group of public employees is required to make the sacrifices that are expected of police officers, and in those cases where necessary, their very lives are the price of fulfilling their jobs.

This association urges passage of this bill, but sincerely believes that the recommended changes would better serve the intent and purpose of the bill. There is no doubt that in its original form, H. R. 5180 would be more equitable treatment for America's first line of defense on the home front, the police officers.

Sincerely,

ATHOS SADA, *President.*

PEACE OFFICERS RESEARCH ASSOCIATION OF CALIFORNIA, INC.,
SAN DIEGO COUNTY CHAPTER,
March 29, 1954.

H. R. 5180, the Mason bill

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SIR: This organization represents all the law-enforcement officers in the county of San Diego, and we would like to give you our feelings on H. R. 5180 (exempting retirements from taxation).

Since the Mason bill was first introduced, we as police officers have supported passage of this bill which we believed would partially carry out President Eisenhower's desire to make the tax burdens more evenly and more equitably proportioned. The $1,500 exemption in the original version of the bill was just about the figure that would have helped the bulk of retired police officers, the patrolmen. Those in higher pension brackets could afford to pay on the amount of pension above this figure. Originally there was no age limit, which meant coverage for police officers who, on the average, retire at age 45 to 50. With the bill in its present form of $1,200 exemption after age 65, there is no just coverage for police officers.

Police work is a young man's game: Hire them early, burn them out, and then retire them. Certainly this country does not have any room for 65-year-old policemen, for obvious reasons. These retiring officers receive pensions granted them by local authorities and pay the regular tax rates on their salaries. Why, then, can't they be granted tax relief on their pensions like railroad retirements and social security benefits which are supported by Federal funds? We do believe that after you weigh the facts as presented, you will see your way clear to restore the original benefits of the Mason bill, $1,500 tax exemption on pensions, and without the age restriction in the case of police officers.

We are not asking for special favors, but rather just treatment which we believe our years of unselfish service to the public has entitled us to receive. The recommended changes in this bill, if you restore them, would also act as a job inducement to assist the recruitment of high caliber men to the police service, and certainly you are well aware of the need for the highest caliber men in police service.

With this letter goes the hope of some 700 peace officers and their families in this county, who sincerely trust that this time the long-forgotten and mistreated "men in blue" will receive their just due.

Sincerely,

ATHOS SADA, *Captain, President.*

MARCH 30, 1954.

HON. WILLIAM F. KNOWLAND,
Senate Office Building,
Washington, D. C.

DEAR SIR: I am writing to you at the direction of the executive board of the Welfare Association, Oakland Police Department. We are vitally interested in the Mason bill, H. R. 5180, which is now in the Finance Committee of the United States Senate.

In its original form the Mason bill gave some tax relief to retired police, fire, school teachers, and similar groups of public employees. However, H. R. 8300, which is what is left of the Mason bill, increases age for qualification to 65 years. It also includes a 10-year work clause, which was also added to the original bill.

The members of the Oakland Police Department are very interested in having the original sections of the Mason bill restored, in order to give some relief to our retired members. It wil be greatly appreciated by all concerned in Oakland if you could support this legislation to correct any inequities, as now proposed.

Inspector Don Rodman, of the Oakland Police Department will be in Washington within the next 2 weeks to attend the National Conference of Police Associations. He would consider it a privilege to see you personally while there, if only to bring you greetings from the Oakland Police Department.

We are all naturally very proud of your outstanding record while in the United States Senate, and wish you continued success in the future.

Respectfully yours,

JOHN H. STURM,
Secretary-Treasurer, Welfare Association, Oakland Police Department.

POLICEMEN'S ASSOCIATION OF THE
DISTRICT OF COLUMBIA,
February 15, 1954.

(The following letter was sent to all members of the House Ways and Means Committee):

MY DEAR CONGRESSMAN: Enclosed herewith is a copy of a letter written to the President by our association. We are sending a copy of this letter to you and to each member of the Ways and Means Committee.

By no means should this letter be considered or construed as a criticism of your committee or any of its actions. We fully realize the ned for and the magnitude of the task in revising the Revenue Act. We well know that the changes recommended thus far have been carefully considered and the relief granted entirely justified. Equally well we know that the national economy cannot afford at this time to grant relief to every deserving group.

We do feel, however, that no portion of our population is more deserving or needful of relief than our retired people, yet we fear we have not presented their case to your committee as fully or as well as other groups have done.

The letter to the President and this letter to you have been written in the hope that your considered attention may be directed to the problems of our retired people and that they may be granted the tax relief they so much need and deserve.

Very sincerely yours,

FRANCIS H. DUNN, *President.*

POLICEMEN'S ASSOCIATION OF THE DISTRICT OF COLUMBIA,
February 13, 1954.

PRESIDENT OF THE UNITED STATES,
White House, Washington, D. C.

DEAR MR. PRESIDENT: In your message to Congress on January 21, 1954, you said, "Revision of the tax system is needed to make tax burdens fairer for millions of individual taxpayers."

The segment of our population that most needs tax relief is our retired people who must live on pensions—fixed incomes that will not now provide the necessities much less the comfort and ease it was intended they should have when these pensions were being earned.

We, the members of the Policemen's Association of the District of Columbia, and acting in accord with the National Conference of Police Associations, representing over 100,000 active law-enforcement officers, seek nothing for ourselves as active present-day workers whose salaries are more or less geared to current living conditions, but we do ask consideration for our retired members and for all retired persons. We ask no special benefits for our retired members over any other group; we do ask equal treatment for all people who have retired under either public or private systems.

The Mason bill, H. R. 5180, now under consideration by the House Ways and Means Committee, would provide equal tax treatment for all retired people. This bill corrects the inequities that now exist, not by increasing the tax load on some retired people but by providing for all the benefits now enjoyed by some.

Almost 9 million Americans now receive retirement payments exempt in part from Federal taxation—for example, somewhat more than 2 million persons receiving benefits under the Railroad Retirement Act already have the exemption we seek for all retired workers under the Mason bill.

The cost—the loss of revenue to the Government—of the Mason bill is not excessive. Exhaustive research by the National Education Association shows that the top cost will be about $85.8 million.

Frankly, this is a small sum compared to the tax relief the House Ways and Means Committee has already approved for corporation and dividend receivers, yet this committee has delayed the consideration of the Mason bill.

Mr. President, we earnestly urge you to use your influence to get the Mason bill, H. R. 5180, into the general revision of the Revenue Act. This bill is in accord with your stated policy and will provide relief to the people who need it most.

Very truly yours,

Francis H. Dunn, *President.*

Mr. Givens. Mr. Chairman, I am honored to have the privilege to say these few words to your committee relative to a subject that is very vital to policemen. We sincerely trust that you will give our suggestions favorable consideration.

Thank you.

The Chairman. What relation does your organization have with Colorado?

Mr. Givens. At the present time we are not honored by the membership of anyone in Colorado. We are trying to make a contact with them and with your help we will do so.

The Chairman. Thank you, sir.

Senator Malone. Senator Millikin, I have Earl Wooster who is superintendent of public schools in Reno. He is not going to appear before the committee but may we have him stand up.

The Chairman. Will you stand up, please. We are very glad to have you.

Senator Martin. Mr. Chairman, I have Mr. Norman Ablehart and Miss Goodwin, whom I would like to stand up, from the Commonwealth of Pennsylvania.

The Chairman. Will you people stand up, please?

Senator Carlson. Mr. Chairman, if that is in order we have the superintendent of schools from Leavenworth, Kans., Mr. Bryan.

The Chairman. Let him stand up.

Senator Frear. There certainly must be somebody in the audience from Delaware, Mr. Chairman. There they are.

The Chairman. There must be someone here from Louisiana. There is a gentleman. How about Utah? There is a gentleman from Utah. How about Virginia?

Mr. Givens. Mr. Chairman, I am a resident of the county of Fairfax but a member of the Metropolitan Police Force. I would like to remind the Senator from Delaware that the Delaware Association of Police is a member of the National Conference.

Senator Frear. Thank you very kindly.

The Chairman. Proceed, Mr. Bare.

STATEMENT OF CARL C. BARE, CHAIRMAN OF THE NATIONAL LEGISLATIVE COMMITTEE, FRATERNAL ORDER OF POLICE

Mr. BARE. Mr. Chairman and members of the committee, I am Carl C. Bare, deputy inspector of police in the city of Cleveland and chairman of the national legislative committee of the Fraternal Order of Police.

This is a national organization representing more than 36,000 active policemen from departments of all sizes, ranging from those with 1 or 2 men to large metropolitan cities such as Cleveland, Philadelphia, New Orleans, Birmingham, Miami, and many others. We also represent the retired people from these departments.

I am also vice chairman of the National Conference on Public Employee Retirement Systems representing more than a million and a half public employees throughout the United States.

I speak to you today in behalf of these organizations and also for the Joint Committee on Public Employee Organizations which includes representatives of: the Municipal Finance Officers' Association; the National Council on Teacher Retirement; the National Conference of Public Employee Retirement Systems; the Fraternal Order of Police; the National Conference of Police Associations; and the International Association of Fire Fighters.

We are very appreciative of the consideration given us by the House of Representatives in section 38 of H. R. 8300 in providing income tax exclusion for retirement income. However, a large number of our members were, we believe, unintentionally, discriminated against by limiting the exclusion to persons over 65. This is particularly true in the case of policemen and firemen.

Due to the physical requirements of the police profession it is necessary that we be able to retire these men at an age much younger than 65. As an administrative officer in a large police department, I dread to think what would happen to law enforcement and the protection of our citizens if all our men were required to work to that advanced age.

I would like to emphasize that a bit if I may, Mr. Chairman. We find in our police department that after a man reaches 50 years of age almost without exception we have to find a so-called light-duty job for him. He is no longer able to go out in our zone cars, on our beats, and in our mobile patrols and do the work that is expected of him. So we have to find a light-duty job and we don't have enough to go around if we carry them much beyond that age.

To meet these circumstances our police retirement systems necessarily provide for retirement at a much earlier age, usually about 52 years. Consequently, by far the greater number of our retired people are under age 65. For example, in the city of Cleveland only 32 percent of our retired people are over 65. In Philadelphia the figure is 35 percent. Practically all of these people were retired before reaching 65.

In Cleveland only 4 percent of those on retirement had retired after reaching the age of 65.

These people have had fewer working years to accumulate savings and must spread these savings over a greater number of years, hence, any supplementation of retirement income from this source is limited. It also requires more money to live in our younger years so the need for income tax relief is even greater. Most of our retired people do not enjoy the additional $600 exemption granted persons over 65. Therefore their need for income tax relief is probably even greater than the need of those over 65.

If the exclusion benefits are limited to persons over 65, thousands of retired policemen and firemen throughout the country, who are no longer able to continue in their profession and must depend on retirement income to live, will continue to be discriminated against. This is also true with other public employees except to a lesser degree.

We do not feel that the Members of the House intended to do this. They did not fully understand the situation. We ask that you members of this committee correct this by amending section 38 to extend the exclusion benefits to persons who have been retired under a retirement system.

We also feel that the $1,500 exclusion originally provided in H. R. 5180 was a reasonable figure and urge you to increase the $1,200 exemption provided by H. R. 8300 to $1,500.

We urge you to give these suggestions serious consideration.

Thank you for permitting me to express our views.

Mr. Chairman, with your permission, I have a statement from the Minnesota Police and Peace Officers Association that I would like to have made a part of the record.

The CHAIRMAN. We will put it in the record.

Mr. BARE. Thank you for the opportunity to appear.

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

(The statement referred to follows:)

MEMORANDUM

To: The Senate Finance Committee.
Filed by: Minnesota Police and Peace Officers Association.
Subject: Proposed tax exemption under the Federal income-tax law of the retirement income of police officers and all other individuals who do not already have special exclusions and exemptions of retirement income of as much or more than the proposed floor.

STATEMENT OF WILLIAM H. JOYCE, PRESIDENT, MINNESOTA POLICE AND PEACE OFFICERS ASSOCIATION

Mr. Chairman and members of the committee, my name is William H. Joyce. I am a lieutenant of police in the city of Minneapolis, and president of the Minnesota Police and Peace Officers Association. We are appearing before your committee in behalf of both the active and retired police officers of the State of Minnesota to respectfully request that in your consideration of section 38 of H. R. 8300, you may see fit to recommend to the Congress that the language originally contained in this section when a part of H. R. 5180 be reinserted, more specifically, that language known as paragraph (17) (B) defining a retired individual.

For approximately 10 years, the National Conference of Public Employee Retirement Systems, and the National Education Association, as well as other organizations, have labored for recognition of the inequity which exists relative to the treatment of retirement income for tax purposes. What the Congress, or the States which ratified the 16th amendment, considered income in the year 1913 when the Federal income tax became law, we do not presume to know, but it is a fair assumption to conclude that they never intended the pensions of public employees to form a part of the tax base.

The fact that benefits of the Social Security Act, and pensions payable under the Railway Retirement Act, are not computable for income-tax purposes indicates that this thinking has been prevalent in more recent years. The provision of section 38 of the bill under discussion which provides that exclusion shall be made available only to persons 65 or older, nullifies almost completely any tax relief to retired employees of the public safety divisions. At age 65, there is now available an additional exemption of $600 to husband and wife. The salary of a police officer is not in sufficient amount that he can acquire property or investments which will yield an income placing him in a tax bracket where he would benefit from this delayed exemption. He normally has only his retirement income, and since, for the good of the service as well as physical reasons, he must retire prior to age 65, he will be deprived of the tax relief proposed.

These pensions or annuities, small enough at best, are further decreased by the present provisions of the tax law relative to retirement income. Due to inflationary prices since 1941, it has become necessary for the annuitant to supplement his income with part-time employment. The amount of his pension subject to taxation is thereby greatly increased, although his total purchasing power has remained even or decreased. This creates hardship cases at a period in their lives when they should be entitled to peace and tranquillity. We submit that retirement benefits were intended to furnish the bare necessities of life for faithful employees in their declining years, and not to form a part of the tax base for budget purposes.

We are not unmindful of the privilege it is to be here and present our petition before your committee. It is our sincere hope that in your deliberations on this measure, you will see fit to propose that section 38 be so amended as to define a retired individual as one who "has attained the age of 65, or who has retired prior to attaining age 65, under a public or private retirement plan providing him a pension or annuity, and who thereafter has 1 or more months of retirement."

I wish to thank the chairman and members of the committee for the privilege of making this presentation, and for your kindness in affording us this opportunity.

The CHAIRMAN. Capt. Franz Willenbucher. I am glad to see you, Captain. Make yourself comfortable and identify yourself for the reporter.

STATEMENT OF CAPT. FRANZ O. WILLENBUCHER, USN (RETIRED), EXECUTIVE VICE PRESIDENT AND LEGAL COUNSEL, RETIRED OFFICERS ASSOCIATION AND NATIONAL COUNSEL, COMMISSIONED OFFICERS ASSOCIATION, PUBLIC HEALTH SERVICE

Captain WILLENBUCHER. I am Capt. Franz O. Willenbucher, USN, retired, executive vice president and legal counsel of the Retired Officers Association and national counsel of the Commissioned Officers Association of the Public Health Service. I am accompanied by Rear Adm. Allen P. Mullinnix, USN, retired, assistant legislative counsel of the Retired Officers Association. I shall read a short statement on behalf of both organizations in view of the committee's desire that presentations of more than one organization on the same matter be consolidated into a single statement.

The Retired Officers Association and the Commissioned Officers Association of the Public Health Service both appear here this morning to make one suggestion for an amendment to the proposed new Internal Revenue Code which is under consideration before this committee.

Section 104 of H. R. 8300 will, if enacted, replace section 22 (b) (5) of the present code and contains substantially the same language. We shall address our remarks to proposed section 104 (a) (4), which now appears in section 22 (b) (5) of the present code as the last complete clause.

Under section 22 (b) (5) of the present Internal Revenue Code, members of the Armed Forces, retired for physical disability, are now entitled to exclude from gross income for income-tax purposes so much of their retired pay as is attributable to the percentage of physical disability under the provisions of the Career Compensation Act.

The language upon which this exclusion will be based, if the pending legislation is enacted, is found in section 104 (a) (4) as quoted herewith:

SEC. 104. COMPENSATION FOR INJURIES OR SICKNESS.

(a) IN GENERAL * * * gross income does not include * * *.

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces of any country.

This provision has been interpreted to include an officer of the Coast and Geodetic Survey or of the Public Health Service only when he is retired by reason of a disability which was incurred while serving with the Armed Forces.

Many officers of the Coast and Geodetic Survey and the Public Health Service are receiving this benefit by virtue of service in World War II. However, an officer of either of these services who incurs a disease or injury today which results in his enforced retirement for physical disability is not entitled to this benefit. Thus, the denial of this benefit to members of such services creates an inequity between them and members of other uniformed services, and it also creates an inequality of benefits accorded to members within these two services who are retired for physical disability under identical circumstances of grade, length of service, and percentage of disability, between members now retired and some formerly retired.

Prior to the enactment of the Career Compensation Act, officers of the Coast and Geodetic Survey and the Public Health Service were retired for disability and received disability retired pay on a basis comparable to that of the other uniformed services.

In other words, the standards were similar.

Upon the enactment of the Career Compensation Act, all the uniformed services were brought under the same disability-retirement provisions. That is, all of the armed services plus the Coast and Geodetic Survey and the Public Health Service.

In other words, an officer of the Coast and Geodetic Survey or the Public Health Service must meet the same requirements as an officer of the Armed Forces in order to qualify for physical disability retirement, and upon such retirement his retired pay is computed under the same formula as is applicable to such an officer.

Therefore, it is discriminatory that an officer of either of these two services who is in an identical active duty-pay status as an officer in one of the other uniformed services should, because of the lack of the exclusion benefit, receive in effect less disability retired pay, even though retired for the same disability.

Generally speaking, disability compensation payable under any system, public or private, including the Federal Employees' Compensation Act, is tax exempt. Therefore, it appears that officers of these services who are retired for physical disability are the only people not included for participation in this benefit.

Thus, the members of these services, retired for physical disability during peacetime, appear to be discriminated against not only between themselves and other officers of their services who incurred their disabilities in time of war and those of the armed services during peacetime, but also between themselves and other groups of individuals who are receiving disability compensation.

Section 402 (h) of the Career Compensation Act limited the tax exemption to that part of retired pay which a member would receive if his retired pay were computed on the basis of percentage of disability. Since this provision appears in a statute which is applicable to commissioned officers of the Coast and Geodetic Survey and the Public Health Service, it indicates a congressional intent to authorize tax exemption on an equal basis to all members of the uniformed services.

Physical disability retirement is awarded an officer only when his physical qualifications have been impaired to a point where he is not as able as before the impairment occurred to engage in gainful employment in civilian pursuits, and in some cases is entirely unable to do so. Consequently, in individual cases the matter of exclusion of part or all of physical retirement pay for tax purposes is of great economic benefit.

From all these considerations, it appears that had the Public Health Service and the Coast and Geodetic Survey been in mind when section 22 (b) (5) was drafted, the members of those services, retired for physical disability, would have been included for similar treatment with reference to exclusion of retired pay they receive on the basis of physical disability retirement.

In addition to the inherent justice of this proposal, the following information shows the small impact of the suggested amendment on the total income-tax receipts of the United States: In the Coast and Geodetic Survey there are 18 officers who were retired for physical disability and only 12 would be affected if this amendment were adopted. In the Public Health Service, there are 135 officers retired for physical disability, of whom all but 22 now enjoy some exclusion of retired pay from gross income for income-tax purposes. Thus, at the present time, the overall total who would be benefited by this amendment is only 34 officers.

Each officer of the Coast and Geodetic Survey and the Public Health Service could become retired for physical disability, although actually only a very small percentage so retire. Consequently all these officers, faced during their active-duty careers with the possibility of retirement for physical disability from physical deterioration in service to their country, often in remote places, would be greatly benefited in morale if they knew that they would receive this benefit should their health become broken.

The Retired Officers Association and the Commissioned Officers Association of the Public Health Service recommend that section 104 (a) (4) be amended to extend the same tax benefits to this small group of retired personnel on a basis of equality with those retired for physical disability from the other branches of the uniformed services.

Proposed language which would accomplish this result is as follows: In section 104 (a) (4) of the proposed Internal Revenue Code change the period at the end of the paragraph to a comma, and add:

and the disability retired pay of members of the uniformed services, as defined in section 102 (a) of the Career Compensation Act of 1949 (63 Stat. 802), subject to the limitations contained in section 402 (h) of said Act.

That is the language, Mr. Chairman, we think would accomplish it. We thank you very much for this opportunity and certainly hope the committee can act favorably on the proposal.

The CHAIRMAN. We are glad to have had you here. Thank you very much.

Because of the death of a Senator last night, we have to be on the floor at 12 o'clock. We will resume this hearing and the rest of the witnesses at 3 o'clock this afternoon in this room.

(Whereupon, at 12 noon the committee recessed to reconvene at 3 p. m. the same day.)

AFTERNOON SESSION

The CHAIRMAN. Mr. Sheild, please.

STATEMENT OF MARCELLUS C. SHEILD, CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES

Mr. SHEILD. Mr. Chairman and Senators, my name is Marcellus C. Sheild. I am a retired employee of the Federal Government. My appearance is in behalf of the National Association of Retired Civil Employees of the United States, an organization of more than 70,000 members with over 400 chapters in the United States, Hawaii, Panama, and the Philippines. We believe our membership to be typically representative of the opinions and desires of the approximately 200,000 retired Federal civil employees.

I shall not attempt to read all of this statement, Mr. Chairman. I will leave out those parts that have been covered by others who testified preceding me in connection with this same subject matter.

The CHAIRMAN. Thank you very much.

Mr. SHEILD. Our organization is interested in section 38, retirement income, and also section 871, which relates to the tax on nonresident alien individuals. We heartily and with gratitude approve section 38 as far as it goes. We would like to point out, however, some features which we feel should be changed to make the justice of the section more nearly complete. It leaves out those persons in retirement under age 65 and we believe they should be included.

I should like to point out one feature of this situation and that is that section 38 is comprehensive in that it covers those in retirement over 65 retired from specific organizations or a municipality or a State or the Federal Government and also those persons over 65 who have retired from business or professions who have income from annuities, interest, dividends, rents, or other sources, and are bona fide in retirement.

Retirement systems differ as to the age for retirement. There are many systems that permit retirement before age 65 and some that compel it. The civil-service system, the TVA, railroad retirement, and some other plans permit retirement at age 60, after specified periods of long service, usually 30 years.

Federal systems having compulsory retirement from 60 to 65 include the Foreign Service; the Army and the Air Force; the Navy; Marine Corps; commissioned personnel of the Public Health Service, Coast and Geodetic Survey, and the Coast Guard; and under the civil-service system, those civil employees of the Canal Zone government, the Panama Canal Company, and the Alaska Railroad. District of Columbia police and firemen, under Federal law, are retired before 65 unless there is special provision for their retention. Almost all public and private retirement systems have adequate provision for retirement for persons irrespective of age, on account of disability arising during this employment.

The roll of civil-service retirees of the United States as of June 30, 1953, was approximately 190,000, of whom one-third was under age 65. No perpendicular line can be drawn with a certain statement that all on one side over 65 are ready for retirement and those on the other side are not. Individuals differ. Our years of useful life are dependent upon heredity, environment, health, extraversion, type of life employment, and other factors. The studies of geriatrics and gerontology are making rapid strides in the analysis of why some people age more rapidly than others. There is no present answer that supplies a general rule to indicate that all over 65 are ready for retirement and none under 65 meets the test.

We feel there is another significant factor to be borne in mind. Persons in retirement over or under 65 are living on their life savings. Most annuities are very small. The average annuity of civil-service retirees as of June 30, last, for those retired for age or service, was $1,482, and for those retired for disability was $1,122. They contributed to the retirement fund and were taxed on that part of their pay as it went into the fund. It is true that under the tax laws they were entitled, under the 3-percent rule, to recover their cost of the annuity tax free before the full amount of annuity became taxable. There is, however, no escape from the fact that a tax on an annuity or pension of an individual in retirement is a more severe burden, relatively, at the same rate than the tax on an individual with earned income. Earned income is subject to upward adjustment to meet increased living costs. Annuities are fixed and their purchasing power decreases with every upward move of the cost of living.

We feel that those under 65 in retirement are entitled to the same consideration as those 65 and over. 2. We appeal to you on behalf of those in retirement because of disability and their unfitness to continue longer in the employment for which they are qualified. Of the 190,000 retired Federal civil employees on June 30, last, 27 percent were retired for disability. More of these are under 65 than over that age. Persons retired under other systems, public or private, are similarly situated. Under section 38, those individuals under 65 retired for disability are automatically eliminated, with all others of that age group. We submit there can be no more deserving individual to come under the provisions of section 38 than the person retired for disability.

Section 38 also contains a "10 years of earned income" provision, which also militates against those disabled retirees. These are the individuals both over and under 65 who have been retired with less than 10 years of previously earned income. A man may have worked for 9 years, 11 months and 29 days, and been retired for disability on account of serious accident or illness unfitting him for further employment, and yet be barred from the benefits of the section by this 10-year clause. We wish to see it eliminated or modified so as not to bar those disabled retirees, no matter what their age may be.

We would request you to increase the exemption of $1,200 to $1,500 of the original Mason bill.

At present a married person retired under maximum benefits of old-age and survivor insurance receives tax-exempt payments for himself and wife at the rate of $1,530. A single person similarly entitled to the maximum, receives $1,020 a year, tax-exempt. Both of these amounts are recommended to be increased by the President's message to Congress of January 14. The maximum payment to an individual under the Railroad Retirement Act, electing to retire at 60, after 30 years, is $1,320, tax-exempt, and the maximum for a husband and wife under the same act, retired at age 65, is $2,480, tax-exempt.

We feel that the amount of $1,500 is more realistic and just in the light of the discrimination that exists and is likely to exist, as between the tax-exempt groups and the non-tax-exempt groups of individuals on retirement income. This disparity will be further accentuated in relation to social-security payments if the projected increases in those benefits are enacted by the Congress.

To recapitulate, Mr. Chairman, under section 38 we request your honorable committee to consider these 4 matters: (1) The inclusion of those under age 65; (2) the inclusion of those retired for disability, irrespective of age and the "10 years of earned income" provision; (3) the increase of the exemption from $1,200 to $1,500; and (4) provision for those age 75 and over to benefit irrespective of the amount of their earned income.

Senator BENNETT. Mr. Chairman, may I ask Mr. Sheild a question?

The CHAIRMAN. Certainly.

Senator BENNETT. Do you recommend the same amendment to permit exemptions for retired persons under 65 which was recommended this morning by the representative of the NEA, which would limit that benefit only to those who retire under a retirement system and would deny it to people who retire on their own savings?

Mr. SHEILD. Well, we have approved the language which the NEA submitted to you. It would bar persons under 65 who might have their own individual retirement plan or are with an insurance company.

Senator BENNETT. Also you have made the point about the problem of the disabled person. Under this language recommended, they would get no assistance if they were disabled and dependent upon their own annuities to take care of them.

Mr. SHEILD. I think if this is to be a general plan, that those persons under 65 who are retired under a plan of their own for disability, or not for disability, should benefit under this section if they are bona fide retirees just as the persons over 65.

Senator BENNETT. The discussions this morning referred to the period between 55 and 65. Do you think 55 should be substituted for 65 as the minimum limit at which a person can take advantage of this exemption?

Mr. SHEILD. I think it is not necessary to place any difference in age. I think there is one subsection which has generally been overlooked in connection with this, and that is subsection (d) (2) which provides that the amount of the exempt retirement income shall not exceed $1,200, less any amount of earned income in excess of $900, so that no matter what the person's age might be, the retiree is to be restricted by that provision, relating to the earned income. And there is also subsection (b), a 10-year provision of earned income, by which a person who retires under a private annuity, if that annuity was furnished to them, they couldn't benefit by this section because they have not had 10 years of earned income, and subdivision (b) of section 38 said the person must have 10 years of earned income and in each of those years, not less than $600 of earned income a year.

Senator BENNETT. Are you saying to us that no person can qualify under a private annuity system because they haven't had 10 years of earned income?

Mr. SHEILD. Those under 65 would not as I read it. If a man bought an annuity for his wife and she were to enjoy that annuity during his lifetime, as I read this section, she wouldn't have had 10 years of earned income and couldn't enjoy the exemption, but if that annuity ran after his death she could have the exemption after his death because there is a provision which says, "a widow or widower whose spouse has received such earned income shall be considered to have received earned income."

Senator BENNETT. That takes us down a slightly different path but you feel, as I understand it, that if we drop the age limit for people who earn their annuities under a formal retirement system, we should consider some means by which we could give the same privilege to people who retire on private annuities?

Mr. SHEILD. I would think that would be fair and there is also a limitation in the section to the effect that the tax credit shall not exceed $240 in the case of any individual. This was designed to prevent those in the higher income brackets from receiving any greater tax credit under this section than the 20 percent of the $1,200 exemption which is provided, so that everybody, irrespective of the size of their income, would share alike in the credit.

Senator BENNETT. That has already been covered.

Mr. SHEILD. Yes, sir.

Senator BENNETT. Thank you, Mr. Chairman.

Mr. SHEILD. There is one other matter we would like briefly to call to your attention. There are approximately 3,000 nonresident alien employees of the United States, and 600 survivors of deceased employees and deceased annuitants receiving annuities from this under the Civil Service Retirement Act. These annuities are held subject to the 30 percent income tax on nonresident alien individuals under section 871. The larger percentage of these persons are citizens of the Philippine Republic who gained an alien status by the independence of the Philippines on July 4, 1946. We ask you to consider and relieve the injustice of the 30 percent tax on these former retired employees. The whole subject matter is fully set forth in a letter to the chairman of the committee dated March 30, which I should like permission to insert at this point and not read unless you desire it.

The CHAIRMAN. It will be included in the record.

(The letter referred to follows:)

MARCH 30, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance, United States Senate.

DEAR MR. CHAIRMAN: May I call your attention to a tax situation relating to a group of nonresident aliens who are receiving annuities as retired civil employees of the United States Government under the Civil Service Retirement Act.

Information received by us from the Civil Service Commission, at our request, shows that based on checks issued by the Retirement Division dated February 1, 1954, payments of such annuities were being made as follows:

	Number	Average monthly annuity payment due before tax	Average monthly annuity payment after tax withheld
Retired employees	3,052	$51.29	$46.56
Survivor annuitants	586	21.70	19.57

We are further advised that of the 3,052 checks issued to retired employees, 2,020 went to residents of the Philippine Islands, and of the 586 checks issued to survivor annuitants, 333 went to such residents. The remainder were scattered in other countries. It is our belief that a large part of this remainder is located in Panama and the West Indies.

Prior to 1952 the nonresident alien tax of 30 percent was not applied to these annuitants. Early in that year the Internal Revenue Service advised the Civil Service Commission that the annuities were subject to the 30 percent tax. The method of application was designed to ease the impact of the 30 percent tax on these very small pensions, and the 3 percent rule relating to recovery of cost tax free was applied so that the 30 percent would apply to the 3 percent increment of cost until it was recovered tax free. That is the present situation with respect to these annuitants as the Retirement Division advises that approximately 4 percent of them are at present subject to the 30 percent tax on the full annuity.

However, under the provisions of section 72—Annuities of the pending revision of the Internal Revenue Code, H. R. 8300, the recovery of cost on the 3 percent basis is changed, and these alien retirees will recover their cost more rapidly and be sooner subject to the 30 percent tax.

We are advised that the total amount of tax withheld during the calendar year 1953 was $182,074.75.

It will be noted that the average annuity of a retired employee is a little over $600 a year before tax, and the average for the survivors is $250. The imposition of the 30 percent tax to these small amounts will be catastrophic to these former employees of the United States. They know nothing about our tax laws, and are unable to understand why their former just employer and protector of their land, has imposed such a drastic and incomprehensible cut in their pensions.

Most of this situation arose from Philippine independence in 1946, when these retirees in that country acquired status of citizens of a foreign country. Many of them were employed during the period when we had large military and civil establishments there. Before independence there was no thought of them as aliens and subject to the 30 percent tax. That status was not raised by the Internal Revenue Service until about 1952. The average amount of tax now being withheld per month is $5 from retired employees, and $2 in the case of survivors, or approximately 10 percent average tax.

Relief to them could be accomplished by amendment of section 871—tax on Nonresident Alien Individuals by exempting them from the section. They make no returns, and to require them to do so would be almost an administrative impossibility.

The exemption would have the effect of a just solution of a vexing matter that will be accentuated by the provisions of section 72, which will speed up the time when the 4 percent now paying the full 30 percent tax will be greatly enlarged. Such exemption has a sound basis in the retirement income principle as found in section 38—Retirement Income for persons residing in the United States.

Your sympathetic consideration will be greatly appreciated. A copy of this letter is being transmitted for information purposes to the Secretary of State, the Secretary of the Treasury, the chairman of the Ways and Means Committee, and the Ambassador from the Philippines.

With assurance of my esteem and bespeaking your interest in this matter, I am,

Respectfully yours,

FRANK J. WILSON, *President.*

(See supplemental letter on p. 1144.)

Mr. SHEILD. Mr. Chairman, we very much appreciate the privilege of appearing here and stating our case to the members of the committee.

The CHAIRMAN. Thank you very much.

(The unread portion of Mr. Sheild's statement follows:)

STATEMENT BY MARCELLUS C. SHEILD, CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES, ACCOMPANIED BY MR. FRANK J. WILSON, PRESIDENT, AND HON. ADDISON T. SMITH AND MR. THOMAS J. FITZGERALD, MEMBERS OF THE EXECUTIVE COMMITTEE ON SECTION 38, H. R. 8300, RETIREMENT INCOME

Mr. Chairman and Senators, my name is Marcellus C. Sheild, a retired employee of the Federal Government. I would like to introduce my associates, Hon. Addison T. Smith, a former Representative in Congress from Idaho, Mr. Frank J. Wilson, president, and Mr. Thomas J. Fitzgerald.

Our appearance is in behalf of the National Association of Retired Civil Employees of the United States, an organization of more than 70,000 members, with over 400 chapters in the United States, Hawaii, Panama, and the Philippines, to promote the welfare of annuitants and potential annuitants of the civilian public service. We believe our membership to be typically representative of the opinions and desires of the approximately 200,000 retired Federal civil employees.

Section 38 is an admirable step forward in recognition of the principle of tax exemption for those in retirement, which our association has consistently advocated for many years. The House of Representatives in the 80th Congress recognized this principle by passing a bill to exempt the first $1,440 of annuity of retired Federal employees from income tax, but the measure failed of Senate action.

Section 38 embodies in limited form the principles of H. R. 5180, known as the Mason bill, which has been endorsed by many national organizations in behalf of those in retirement. Its purpose was to eliminate the discrimination that exists between those groups in retirement whose entire pension or annuity under certain retirement plans is exempt from income tax, and those similarly situated under other plans who must include annuity or pension in gross income for tax purposes. Persons in retirement under the Social Security Act, the Railroad Retirement Act and some other plans, receive such benefits tax free. They constitute a majority of the persons in retirement under retirement plans.

We heartily and with gratitude approve section 38 as far as it goes. We would like to point out, however, some features which we feel should be changed to make the justice of the section more nearly complete.

1. The section leaves out those persons in retirement under age 65, and we believe they should be included.

This omission is a great disappointment to a very large number of retired persons. The Mason bill, which served as a pattern and the stimulus for section 38, contains no age limitation. No question, to our knowledge, was raised at the hearings before the Ways and Means Committee on this phase of the legislation. That committee on February 17 last, first adopted the section, with no age limit, but with a reduction from $1,500 to $1,200 in the exemption.

The Treasury Department evidently approved inclusion of those under 65, for on that same day, February 17, the Secretary issued the following press statement:

"The Treasury actively supported the principle of giving tax relief to retired workers. We feel, however, it should be limited to those who live principally on small pensions or other small incomes, and not extended to those receiving relative large pensions or other large income. We agree with Chairman Reed that the real hardship area involves retired people who are dependent upon modest pensions for their livelihood."

On February 25 the Ways and Means Committee revised its previous action on section 38, and issued a press statement outlining the changes, as follows:

"The committee revised somewhat the $1,200 retirement income exclusion previously agreed to. The exclusion is not to be availble to those under age 65, nor to those who have not in prior years earned at least $600 in each of 10 years. Moreover, the tax benefit to be derived is to be limited to the bottom tax rate (presently 20 percent) multiplied by the exclusion. In addition, the work test previously provided with respect to the exclusion, is to be modified somewhat, to make the reductions in the exclusion more gradual."

This release gave no explanation as to why these changes were made, particularly in eliminating the under 65 group. However, Chairman Reed, on that same day, issued a press statement, in which he said in part:

"The amended provision will cost $125 million, thus saving about $115 million a year. This saving is due to the fact that today's action will keep this relief from being a windfall to wealthy taxpayers. Under the change, individuals with small incomes will get the same amount of relief as under the original committee action."

We draw the conclusion from this statement that the reduction in loss of revenue by the committee's action on February 17 ($240 million) to the loss by the committee's revised action on February 25 ($125 million) was primarily due to the insertion on the latter date of the tax benefit limitation of $240, and not the elimination of those with small incomes under age 65.

Nowhere along the line of the public history of this section—in the hearings or report of the committee; the press releases of the committee or chairman, or the public statements of the Treasury Department—is there indication that those under age 65 were considered an important revenue loss factor.

Most persons now in retirement, over or under 65, are those who, in their years of earned income, have helped to bear the heavy tax burdens of an exceptional era in the history of our Nation. They have helped to pay the heavy cost of World War I, the depression years, and World War II and its aftermath. To pursue them into their sunset years and extract the maximum margin of tax from their small devalued pensions and meager savings constitutes at least a semblance of double taxation.

It should be borne in mind that under section 38 those persons under social security, railroad retirement, and other tax-exempt systems with retired pay less than the exemption specified in section 38, will benefit by this new exemption to the extent they are otherwise able to qualify under it with other retirement income.

We request that an exception be made in the case of those retired persons over age 75 so that their earned income in any amount does not operate to bar them from benefiting, if otherwise qualified under the section.

An individual receiving social-security benefits who has attained age 75 is entitled to have any amount of earned income and continue to receive his tax-exempt social-security benefits. It would be justice to accord the same treatment under this section to persons in retirement under other systems who may be 75 or over. Such a person is now limited under the section by the limitation on earned income over $900 in the taxable year.

We believe that the loss of revenue factor to be incurred by including those in retirement under 65 is not serious. More of them are likely to have earned income than those over 65, and consequently he barred from participation by the general limitations of the section. An independent study made by the research division of the National Education Association indicates that the loss of revenue involved by including those under 65 in retirement who could qualify for the benefits of the section would not exceed $17.5 million with the exemption at $1,200 and $22 million with the exemption at $1,500.

The Chairman. Mr. Malcolm Johnson.

Will you make yourself comfortable and identify yourself for the record?

STATEMENT OF MALCOLM JOHNSON, ATTORNEY, NEW YORK CITY

Mr. Johnson. I am Malcolm Johnson, a lawyer in New York City. My firm represents a number of fire and marine stock insurance companies. These companies are taxable under sections 831 and 832 of H. R. 8300, on their entire net income, at regular rates of 30 and 22½ percent, respectively. Under the bill as now drafted, they would not be entitled to the 85-percent special deduction allowed corporations for dividends received, and the new credit allowed to individuals. In order to conserve the committee's time, I am not going to review all of the grounds for suggested amendments. Mr. Berry of the National Board of Fire Underwriters has covered these quite adequately, as has Senator Lucas.

I would like, however, permission to file a detailed, technical statement.

The CHAIRMAN. We will be very glad to have it. I can only speak as of this moment, but I think that will be fixed up. There seems to be an injustice about that that everyone seems to recognize. I think that will be fixed up.

Mr. JOHNSON. Thank you, sir.

(The prepared statement referred to follows:)

STATEMENT OF MALCOLM JOHNSON, ATTORNEY, NEW YORK CITY, REGARDING DIVIDENDS ON STOCK OF FIRE, CASUALTY, AND MARINE INSURANCE COMPANIES, AND REGARDING CERTAIN BUSINESS INCOME OF SUCH COMPANIES FROM FOREIGN SOURCES

I am an attorney, practicing in New York City. My firm represents a number of stock fire, casualty, and marine insurance companies. I would like to call to your attention a serious discrimination and oversight in H. R. 8300 as presently drafted with respect to the 85 percent special deduction allowed by section 243 to corporations for dividends received from such insurance companies, with respect to the credit allowed to individuals under section 34 for such dividends, with respect to the partial exclusion from gross income of such dividends received by individuals under section 116, and with respect to the treatment of certain foreign income of such insurance companies.

I. TREATMENT OF DIVIDENDS FROM STOCK FIRE, MARINE, AND CASUALTY INSURANCE COMPANIES

Under section 831, part III, of subchapter L of H. R. 8300, a stock fire, casualty, or marine insurance corporation is subject to tax at the full, normal tax rate of 30 percent and the surtax of 22 percent on its entire "taxable income." Section 832, defining the "taxable income" of such an insurance company, is taken almost bodily from section 204 of the Internal Revenue Code of 1939. As such, it has been in the law since 1921.

Under section 832 of the Internal Revenue Code of 1954 the "taxable income" of such a stock insurance company includes its investment income, its underwriting income, its gain from sale or disposition of property, and "all other items constituting gross income under subchapter B." There is, therefore, no item of income which is not taxed at full corporate rates. Its principal deductions are for "expenses incurred" and "losses incurred." "Unpaid losses," as used in determining "losses incurred," must, under valid Treasury regulations (118, sec. 39.204-2), be limited to "actual unpaid losses" which represent a "fair and reasonable estimate of the amount the company will be required to pay." The reasonableness of every individual company's unpaid losses must be substantiated in the light of such announced principles. The other deductions are of the same general type as are allowable to any corporation, appropriately defined in insurance terminology.

The concept of "taxable income" of such a company is therefore identical with that of any other corporation subject to the regular tax and such "taxable income" is taxed at full normal and surtax rates of 30 percent and 22 percent, respectively. Therefore, the profits out of which the dividends are paid by such a company have borne a full tax at regular rates. Even though the corporate profits have borne a full tax, by reason of a defect or discrimination contained in section 246 (a) (1) as presently drafted, a corporate stockholder which receives a dividend from such corporation would be denied the 85 percent special dividends received deduction under section 243. Section 246 (a) (1), as presently drafted, excludes from the 85 percent special dividends deduction and dividend from "an insurance company subject to a tax imposed by subchapter L (sec. 801, and following)." Part III of such subchapter deals primarily with stock fire, casualty, and marine insurance companies. Parts I and II deal with life-insurance companies and mutual insurance companies. The reference in section 246 (a) (1) to the entire subchapter L therefore operates to exclude dividends from stock companies from the 85 percent special dividends received deduction, even though the profits of such companies have been fully taxed. Section 246 (a) (1) would change section 26 (b) of the present law, which clearly allows the 85 percent dividends received credit to corporations receiving dividends from stock fire, casualty, and marine insurance companies. There is no expressed intention in the Ways and Means

Committee report on the bill to change in any way the 85 percent dividends received credit with respect to dividends from such stock fire, casualty, and marine insurance companies.

In much the same fashion, an individual stockholder receiving a dividend from a stock fire, marine, or casualty insurance company would be denied the new credit provided by section 34 and the exclusion provided by section 116 of the Internal Revenue Code of 1954. The exception contained in section 34 (c) (1) and incorporated in section 116 (b) is similar to that contained in section 246 (a) (1). The denial of such special deduction to the corporate shareholder and the exclusion and credit to the individual shareholder was obviously not intended where the dividend-paying corporation was subject to an income tax on its entire net income. Any such denial was intended to be limited to situations where the dividend paying corporation had not borne a full tax on its net income.

The purpose of the special deduction to corporations for dividends received and the new exclusion and credit to individuals for dividends is to mitigate the effect of double taxation of corporate profits (see p. 6, Report of the Committee on Ways and Means, House of Representatives, to accompany H. R. 8300). Sections 34 (c), 116 (b), and 246 (a) provide limitations with respect to the exclusion, credit, and the deduction provided in sections 34, 116, and 243, respectively. The limitations in these sections have as their sole purpose the elimination of the credit and exclusion and the special deduction in situations in which no double taxation in fact occurs. Thus, on page 6 of the foregoing report, it is stated:

"The relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations."

We respectfully submit that these limitations were not intended to apply to dividends received on the stock of a fire, casualty, or marine insurance corporation taxable under section 831. Rather, the limitations with respect to such dividends appear to have been included in the above sections either through a technical oversight which upsets the expressed intent of the Committee on Ways and Means or through a failure to understand that such companies are taxed on their full profits with no special advantages not afforded to corporations in general. The limitation provision does not correctly reflect the manner in which stock fire, casualty, and marine insurance corporations are taxed or the nature of the dividends paid to its stockholders.

For the purposes of sections 34, 116, and 243, a clear distinction should be made between so-called dividends to policyholders as defined in section 312 (a) (2), and dividends to stockholders as defined in section 312 (a) (1). There is, of course, no double taxation on so-called dividends to policyholders on participating policies issued by a stock fire, casualty, or marine insurance corporation or by a mutual insurance company since such dividends are not dividends at all but are considered a return of premium to the policyholder as evidenced by the deduction allowed for such return of premiums by section 832 (c) (11). No similar deduction is allowed a stock fire, casualty, or marine insurance corporation for dividends paid to its stockholders, and, of course, such dividends are includible in the gross income of the recipient. As stated above, there is, therefore, double taxation with respect to dividends to stockholders on their stock investment. The so-called dividend to a policyholder of either a mutual insurance company or on a participating policy of a stock company is merely a rebate or adjustment of the premium. It has always been treated as such by the law, regulations, and courts, and is so recognized by H. R. 8300 in section 312 (a) (2). In connection with the so-called dividends to policyholders or rebate, double taxation of corporate profits could never be involved and no special dividends-received deduction or credit should be allowed. On the other hand, the distributions to stockholders on their stock are dividends in the true sense of the word as defined in section 312 (a) (1). In such case, there is double taxation of corporate profits and the special 85-percent dividends-received deduction and the credit and exclusion provided for individuals should be allowed. This memorandum is addressed solely to distributions on the stock of the stock insurance companies taxable under part III of subchapter L. No special dividends-received deduction or credit or exclusion is requested in connection with the so-called dividends or rebates to policyholders. The effect of the amendment proposed herein would be to allow such deduction and such credit and exclusion with respect to dividends on stock but to deny the same for so-called dividends to a policyholder paid by either a mutual company or by a stock company on a participating policy.

It should further be pointed out that under section 26 (b) of the Internal Revenue Code of 1939, dividends to corporate stockholders paid by fire, casualty or marine insurance corporations subject to tax under section 204 of the 1939 code, are eligible for the credit provided in section 26 (b). This provision recognizes that stock fire, casualty or marine insurance corporations are subject to tax on their full gross income less allowable deductions in the same manner as corporations subject to tax under sections 13 and 15 of the 1939 code.

If the bill contained in H. R. 8300 is enacted in its present form, the economic consequences to the insurance industry will be exceedingly drastic. The stock of fire, casualty and marine insurance corporations is widely held by corporate investors who at present receive the 85 percent credit allowable under section 26 (b) with respect to dividends on such stock. This benefit is removed in the proposed Internal Revenue Code of 1954. The removal of the benefit would, of course, drastically depress the market value of the stocks of fire, casualty and marine insurance corporations and place present corporate investors in such stocks at a decided disadvantage. It would also hamper efforts of existing companies to acquire additional capital and make more difficult the formation of new stock fire, casualty and marine insurance corporations.

In addition, existing companies having subsidiaries would be adversely affected. In order to prevent a confiscatory tax on the income from their investments in subsidiaries, they would be required to file consolidated returns and suffer the 2 percent addition to tax imposed as a privilege for filing such return. Moreover, by virtue of the definition of affiliated groups, not all closely allied corporate groups are eligible to file consolidated returns.

II. BUSINESS INCOME OF STOCK FIRE AND CASUALTY INSURANCE COMPANIES FROM FOREIGN SOURCES

Under section 923 there is allowed a credit equal to 14 percent of the amount of the taxable income with respect to certain defined business income from foreign sources. Under section 923 (d) (2) this credit is not allowed in the case of a corporation which "is subject to the tax imposed by subchapter L (sec. 801 and following relating to insurance companies)." There would seem to be no reasonable basis for discriminating against insurance companies in this connection. The competition in procuring insurance business in foreign countries is considerable. It is usually necessary for the insurance companies to employ agents or employees in the foreign countries, to expend funds therein, to tie up large amounts of capital in the form of deposits in such foreign countries required by insurance laws or regulations, and otherwise to employ considerable capital, time, and energy abroad in the development of this business. There would seem to be no particular reason to discourage the procuring of insurance in foreign countries by denying an advantage allowed to other forms of business. It is therefore requested that this section be redrafted so as to eliminate this discrimination.

III. PROPOSED AMENDMENTS

In place of the present language, the following language is proposed:

"SEC. 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

"(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS. Subsection (a) shall not apply to any dividend from—

"(1) An insurance company, other than a stock insurance company taxable under section 831, subject to a tax imposed by subchapter L." (Sec. 801 and following.)

"SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED

"(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS. The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company, other than a stock insurance company taxable under section 831, subject to a tax imposed by subchapter L (sec. 801 and following).

"SEC. 923. BUSINESS INCOME FROM FOREIGN SOURCES

"(d) CERTAIN CORPORATIONS INELIGIBLE FOR CREDIT. The credit provided by section 37 shall not be allowed in the case of a corporation which for the taxable year—

* * * * * * *

"(2) is subject to the tax imposed by part I or part II of subchapter L (sec. 801 and following relating to insurance companies)."

It is respectfully submitted that sections 34 (c) (1), 246 (a) (1), and 923 (d) (2) should be amended as above to remove this unjust discrimination against the fire, casualty, and marine stock insurance companies and their stockholders and so as to remedy the obvious oversight contained in these sections.

Senator BENNETT. Since we met this morning I have had a call from the Title Insurance Co., and they feel they face the same problem and at this point in the record I would like to indicate that whatever relief is given should be considered also for title insurance companies.

The CHAIRMAN. That will be noted in the record.

Mr. JOHNSON. The amendments being offered by the national board and myself cover all insurance companies taxable under part III which would include the title insurance companies.

Senator BENNETT. Thank you.

The CHAIRMAN. Mr. Brenner, please.

STATEMENT OF DAVID S. BRENNER, CERTIFIED PUBLIC ACCOUNTANT OF NEW YORK

Mr. BRENNER. Mr. Chairman, and members of the committee, my name is David S. Brenner. I am a certified public accountant practicing in New York City. This statement is made on my own behalf, although the subject is of great importance to many of my clients. I have submitted my complete statement for the record. I shall now address the committee with a short résumé of this statement.

(The statement referred to follows:)

STATEMENT OF DAVID S. BRENNER, CERTIFIED PUBLIC ACCOUNTANT OF NEW YORK, BEFORE THE SENATE FINANCE COMMITTEE'S HEARINGS ON THE REVENUE REVISION BILL OF 1954 (H. R. 8300), APRIL 12, 1954

My name is David S. Brenner. I am a certified public accountant practicing in New York City. This statement is made on my own behalf, although the subject to which I wish to address myself is of great importance to many of my clients.

I am here to call this committee's attention to a certain inequity in the tax law, as it affects people engaged in the field of professional entertainment—that is, the stage, screen, radio, television, and variety performers, singers, dancers, producers, directors, musicians, and others similarly situated—and to ask this committee to consider certain remedial legislation. This inequity is the inability of these individuals to deduct their ordinary and necessary business expenses in arriving at adjusted gross income.

TREATMENT OF ORDINARY AND NECESSARY BUSINESS DEDUCTIONS

It has been contended on behalf of various groups of employees that all of their ordinary and necessary business expenses should be allowed as deductions in arriving at adjusted gross income. This method of deducting expenses would put employees on an equal footing with independent contractors in that it would allow them these business deductions and in addition permit them to make use of the standard deduction. I believe that such treatment should be afforded the expenses of the people engaged in professional entertainment.

The House of Representatives, in section 62 (2) (D) of H. R. 8300, proposes to extend just such treatment to outside salesmen. I find no fault with that provision. My only criticism is that the provision does not go far enough. The very reasons given as the basis for inserting section 62 (2) (D) in the bill apply with equal force to those engaged in professional entertainment. On page 9 of the House Ways and Means Committee's report which accompanies H. R. 8300, there is this statement:

"If these salesmen were independent contractors they would be permitted to take business expense deductions in computing adjusted gross income and still use the standard deduction. Moreover, the business expenses incurred by outside salesmen usually are substantial relative to their incomes."

I submit that those engaged in professional entertainment should be allowed to deduct their ordinary and necessary business expenses in arriving at adjusted gross income for two reasons:

(1) These expenses are very substantial in relation to their total incomes.

(2) The line between employee and independent contractor in the case of many people engaged in the field of professional entertainment is difficult to draw. Because of the uncertainty of classification, different individuals somewhat similarly employed may have different size tax bills although having similar size incomes.

THE SUBSTANTIAL NATURE OF THE EXPENSES

I can testify from many years of personal experience with the tax and related problems of people in the entertainment field, that the business expenses incurred by them are very substantial relative to their incomes. I can think of no other profession or occupation where business expenses are so substantial relative to income.

People in the entertainment field have very substantial business expenses because of the nature of their profession. Not only do they have many of the business expenses that taxpayers otherwise employed may have, they have many expenses unique to their calling. (Even where their expenses are similar in nature to expenses usually incurred in other professions or occupations, show people's expenses are apt to consume a greater portion of income that these same types of expenses consume of the incomes of people in other professions or occupations. This is especially true of entertainment expenses.) In addition, many expenses that are similar to nondeductible expenses outside the entertainment business are legitimately deductible by people in the entertainment field.

All of these facts add up to a large business expense deduction for those engaged in the field of professional entertainment. Items like agents' and managers' fees, entertainment expenses, wardrobe costs, telephone answering service, trade publications, costumes, gifts, tips, and other gratuities are incurred regularly by show people and they add up to very substantial reductions of these taxpayers' spendable incomes.

To further illustrate just how substantial the business expenses of show people can get, I would like to discuss in a little detail just two of the many expenses they incur and show just how these two items alone consume a very substantial part of their incomes. These two items are agents' and managers' fees and entertainment expenses.

I would like to bring up the problem of agents' and managers' fees for two reasons. First, because they are so substantial and are incurred by just about every individual who earns a living in the entertainment field. Rarely are these fees less than 10 percent of gross earnings. Often, combined agents' and managers' fees can go as high as 30 percent. There is hardly any question about the fact that these fees are substantial.

Secondly, the present tax treatment of these fees is just another reason for extending section 62 (2) (D) of H. R. 8300 to cover show people. Realistically an entertainer's true earnings are the net amounts of compensation remaining after agents' and managers' fees are deducted. However, at present, these fees are treated as employment-agency fees and may be deducted on the tax return only among the itemized miscellaneous deductions. A more equitable treatment would require the recognition of the realities of the situation and would permit such expenses to be deducted in arriving at adjusted gross income.

As for show people's entertainment expenses, here, again, we have a clear example of substantial expenses. These expenses are generally high for two reasons. The first stems from the fact that few people in show business ever have long-term engagements. Even while an individual is working, he must constantly seek his next engagement. To do that, he must entertain potential employers and others in a position to help advance his professional career. The second reason is the professional entertainer's dependence for his financial success on his popularity with the public. Here, entertainment of those who help keep him in the public eye is an essential expense of the professional entertainer. The courts have long recognized that amounts spent by show people for theater tickets, dinners, and entertainment for authors, critics, directors, newspapermen, potential show backers, and others are legitimately deductible. (See, e. g., *Blackmer* v. *Commissioner* (70 F. 2d 255 (2d Cir. 1934)); *Lenore Ulric* (27 B. T. A. 666, reversed, 2d Cir., Feb. 14, 1935).)

As I have said, agents' fees and entertainment expenses are but two of the many deductible expenses incurred by people in show business. They are large items, for which most professional entertainers spend heavily. Add to these two all the other expenses I have previously mentioned, plus the many, many more I have not mentioned, and you can easily see just how substantial an ordinary and necessary business expense outlay is reqnired of those who are engaged in the field of professional entertainment.

Thus, if (as it would appear from the Ways and Means Committee report) the basis for the inclusion of section 62 (2) (D) in H. R. 8300 is the substantial nature of the expenses involved, it would seem that in all equity the provisions of that section should be extended to all employees whose business expenses are substantial relative to their incomes. And, as I believe my foregoing testimony clearly demonstrates, the ordinary and necessary business expenses of individuals engaged in the field of professional entertainment are unquestionably very substantial.

EMPLOYMENT STATUS: EMPLOYEE OR INDEPENDENT CONTRACTOR

In the paragraph I previously quoted from the House Ways and Means Committee's report accompanying H. R. 8300, it is stated that if these outside salesmen (to whom relief is proposed to be offered under section 62 (2) (D)) were independent contractors they could deduct their business expenses and in addition use the standard deduction. From this statement, I infer that the committee was convinced that these salesmen should be treated as if they were independent contractors without formally defining their status as such. I presume that this approach was taken because in that area it was difficult, if not impossible, to draw a pricise line and that the committee felt that these people so closely approached the status of independent contractor that they should, for business expense purposes, be treated as such. Again, I have no quarrel with the committee. And again, I am moved to say that for those very same reasons the provisions of section 62 (2) (D) should be extended to cover individuals engaged in the field of professional entertainment.

There is a considerable amount of uncertainty as to the true employment status of many individuals in the field of professional entertainment. Although they are often treated as employees, a good argument can be made in very many instances for considering these individuals to be independent contractors.

Consider a television actor, for example. He might act in one television play one week, in another play the next week. In each case, he is engaged for that one performance, perhaps by a different television station or advertising agency. This individual, it can be argued, is not really an employee. Holding himself out to various employers as he does, he is really an independent contractor. Another television actor may be engaged to appear in a series of telecasts, week after week. His position is more nearly an employee than the first. Yet both are probably treated as employees by the television stations or agencies. Furthermore, during the year the status of both may change, so the first actor is now acting in a series and the second is free-lancing. Or each may be doing a combination of both during one period of time.

This example is not too uncommon and helps point up the difficulty of determining the true nature of the employment status of professional entertainers. It is my contention that inasmuch as it is usually so difficult to determine these people's true status, they should not be limited by the niceties of legal interpretation in determining how they are to deduct their ordinary and necessary business expenses. Since their expenses are so substantial, and since they are usually close to being independent contractors, if not technically so, they should be allowed to treat their business expenses as do independent contractors. This laudable result can be accomplished (without the necessity of having to define or redefine terms like "independent contractor") by extending the provisions of section 62 (2) (D) of H. R. 8300 to cover individuals engaged in the field of professional entertainment.

I would also like to point out that by eliminating the distinction between an employee and an independent contractor in the entertainment field—through the extension of the coverage of section 62 (2) (D)—a serious disparity in the treatment by the Internal Revenue Service of similar types of expenses on different types of returns would be obviated. I have found that the manner in which show people are able to deduct their expenses on their tax returns affects the degree to which these expenses are later questioned by the Internal Revenue Service. (I am not talking here of the nature of the expenses; I am only concerned with how they are deducted on the tax return.) I find that where an individual in show business has to list himself as an employee on his tax return, his professional expenses become natural targets for examiners. These expenses, when listed under "miscellaneous expenses" on the tax return, generally elicit investigation and questioning because they differ sharply from the usual deductions claimed by other salaried employees. (On examination, of course, these expenses generally stand up. But they elicit many an unnecessary examination.) Yet, when another individual in show business, perhaps in a somewhat similar position to the first individual, is able to list himself as an independent contractor, not only is he able to deduct his professional expenses from his gross income to arrive at adjusted gross income, but his business deductions (generally of the same type as claimed by the first individual under "miscellaneous deductions") are rarely challenged by the Internal Revenue Service. I submit that such a disparity of treatment of similar expenses by the tax examiners should not exist. Amending section 62 (2) (D), as proposed, would eliminate this disparity.

Mr. BRENNER. I am here to call the attention of this committee to certain inequities in the tax law as it affects people engaged in the field of professional entertainment—that is, the stage, screen, radio, and television—and to ask this committee to consider certain remedial legislation. This inequity is the inability of these people to deduct their ordinary and necessary business expenses in arriving at their adjusted gross income, in addition to their statutory deductions.

The House of Representatives, in section 62 (2) (D) of H. R. 8300, proposes to extend just such treatment to outside salesmen. I find no fault with that provision. My only criticism is that the provision does not go far enough. The very reasons given as the basis for inserting section 62 (2) (D) in the bill apply with equal force to those engaged in professional entertainment. On page 9 of the House Ways and Means Committee's report which accompanies H. R. 8300, there is this statement:

> If these salesmen were independent contractors they would be permitted to take business expense deductions in computing adjusted gross income and still use the standard deduction. Moreover, the business expenses incurred by outside salesmen usually are substantial relative to their incomes.

I submit that those engaged in professional entertainment should be allowed to deduct their ordinary and necessary business expenses in arriving at adjusted gross income for two reasons: (1) These expenses are very substantial in relation to their total incomes, (2) the line between employee and independent contractor in the case of many people engaged in the field of professional entertainment is difficult to draw.

Referring to expenses, among the most substantial of these expenses are agents' and management fees and entertainment expenses. Agents' and management fees are important for two reasons. First, because they are so substantial and are incurred by just about every individual who earns a living in the entertainment field. Rarely are these fees less than 10 percent of gross earnings. Often combined agents' and management fees can go as high as 30 percent. There is hardly any question about the fact that these fees alone are substantial.

Second, the present tax treatment of these fees is just another reason for extending section 62 (d) of H. R. 8300, to cover show people.

Realistically, an entertainer's true earnings are the net amounts of compensation remaining after agents' and management fees are deducted. However, at present the fees are treated as employment agency fees and may be deducted on the tax return only among the itemized miscellaneous deductions. A more equitable treatment would require the recognition of the realities of the situation and would permit such expenses to be deducted in arriving at an adjusted gross income.

With regard to——

The CHAIRMAN. Are you going to give us some concrete cases before you finish, illustrating your points, where expenses have been denied?

Mr. BRENNER. No expenses have been denied, sir. The facts I am presenting to you are based upon my 12 years of experience preparing income-tax returns for just these individuals, sir, and what happens at the time we appear in front of the revenue agents. Once it is shown that they are employees, we must take into consideration the total of their expenses, those which are allowed as personal expenses, such as contributions, interest, and taxes and in addition we must show their professional expenses as miscellaneous deductions. They are in that case always denied the use of the standard deduction. The professional expenses of these people are so great compared to their income—I'm talking about the smaller earnings; I'm not talking about the glamorous star, sir—that they have very little left over after their living expenses and professional expenses, to take off those amounts which are usually shown under these other deductible expenses, like charitable contributions, taxes, interest, and so forth. And, in that case, because they cannot take their professional expenses off the top, off the gross, they are denied the ability to use the standard deduction.

The CHAIRMAN. They cannot deduct an agent's expense, for example.

Mr. BRENNER. Only under miscellaneous. My findings are such, sir, that once they deduct the amounts under the miscellaneous section of the long-form return, they have very little to take off at the top of the long-form return.

The CHAIRMAN. How about costumes and that sort of thing?

Mr. BRENNER. Sir, they are allowed all these expenses, but they lose out on the standard deduction.

If I can refer back to the salesman, the salesmen were given this relief because salesmen found, that although they were employees, they were not treated equitably as compared to those salesmen who held themselves out as independent contractors. I will try to prove to you, sir, that the same situation exists and even more so, with professional entertainers.

I have prepared returns for many, many people in the theater. That is my specialty. I was happy to see what is being done for salesmen, but I immediately got in touch with the various organizations representing show people to show them that the same sort of treatment should be accorded to them. I have met with them. I have worked at this thing very hard, and very conscientiously. However, time would not allow me to wait any longer for these organizations, and I took it upon myself, again very conscientiously, to come here and present the views as I see them.

The CHAIRMAN. We are very glad to have your views.

Mr. BRENNER. Thank you, sir. I do represent about eight members of the Council of Equity who have shown their confidence in me by coming back to me repeatedly for the preparation of their tax returns. If I may continue, I think I can prove my point.

The CHAIRMAN. Go ahead.

Mr. BRENNER. I have tried to prove that it is unfair not to show agents' and managers' fees, which can go as high as 30 percent, and take that off the top before figuring the statutory deduction. Another very large amount of expense is entertainment. Entertainment of those who help advance the professional career and help keep the professional entertainer in the public eye is an essential expense of the professional entertainer.

The courts have long recognized that amounts spent by show people for theater tickets, dinners, and entertainment for authors, critics, directors, newspapermen, potential show backers and others are legitimately deductible.

I refer to *Blackmer* v. *Commissioner* (70 F. 2d 255 (2d Cir. 1934)): *Lenore Ulric* (27 B. T. A. 666, reversed, 2d Cir., Feb. 14, 1935).

Thus, if, as it would appear from the Ways and Means Committee report, the basis for the inclusion of section 62 (2) (D) in H. R. 8300 is the substantial nature of the expenses involved, it would seem that in all equity the provisions of that section should be extended to all employees whose business expenses are substantial relative to their incomes. And, as I believe my foregoing material clearly demonstrates, the ordinary and necessary business expenses of the individuals engaged in the field of professional entertainment are unquestionably very substantial.

Mr. BRENNER. In the paragraph previously quoted from, the House Ways and Means Committee report accompanying H. R. 8300, it is stated that if these outside salesmen, to whom relief is proposed to be offered under section 62 (2) (d) were independent contractors they could deduct their business expenses and in addition use the standard deduction. From this statement, I infer that the committee was convinced that these salesmen should be treated as if they were independent contractors without formally defining their status as such.

There is a certain amount of uncertainty as to the true employment status of many individuals in the field of professional entertainment. Although they are often treated as employees, a good argument can be made in very many instances for considering these individuals to be independent contractors.

Consider a television actor, for example. He might act in 1 television play 1 week, in another play the next week. In each case, he is engaged for that one performance, perhaps by a different television station or advertising agency, or I might add, sponsor, package show, or almost anybody. He very rarely knows who the organization is who will submit his W-2 form.

This individual, it can be argued, is not really an employee. Holding himself out to various employers as he does, he is really an independent contractor. Another television actor may be engaged to appear in a series of telecasts, week after week. His position is more nearly an employee than the first. Yet, both are probably treated as employees by the television stations or agencies.

I hope that is the case you are looking for, sir.

The CHAIRMAN. That gives me some idea. Now, let's take an assumed case: How do they get their jobs? Are they on a list?

Mr. BRENNER. Two ways, sir. Through an agent and through their own efforts. That is where the entertainment expense comes, and they are continuously, and while engaged on one engagement, they are continuously seeking new engagements and they must keep themselves in front of the people.

The CHAIRMAN. Do they circulate around and find out where the shows are coming in and bring themselves to the attention of whoever hires the people?

Mr. BRENNER. Absolutely.

The CHAIRMAN. Or, they have an agent to do that for them?

Mr. BRENNER. They do that themselves in addition to the agents. They must continuously keep themselves before the eyes of the people who are looking for their type of character or star.

The CHAIRMAN. Is that where the expense of entertainment comes in?

Mr. BRENNER. Yes, sir.

The CHAIRMAN. How do they do that, do they invite someone to lunch?

Mr. BRENNER. They invite people to lunch, they invite people to their homes. When they are opening the shows, the agents and themselves hand out tickets to all the people who can come to the show tc see how they perform.

The CHAIRMAN. That is how they get a good hand?

Mr. BRENNER. I know that that sometimes happens. On opening night they have all their friends in the audience.

The CHAIRMAN. Supposing someone has a bit part in television, how much does he get for making this appearance?

Mr. BRENNER. Well, the minimum is less than $100, sir. The average for a pretty good character actor is about $250. There is another inequity which I won't bring up at this time, but I will just pass it in mentioning, though I had compared with that, but I decided to drop it at the last moment and that is the amount of withholding on these people. The amount of withholding, withheld on the television actor who appears, once a week, we'll say, is the equivalent, if he was appearing 5 days a week, we'll say, and the amount of refund they receive at the end of the year is quite substantial as a result of all that.

The CHAIRMAN. How many weeks a year are those people employed?

Mr. BRENNER. The average, as shown by the statistics prepared by the various organizations, are so low I would hate to mention is, even if I knew. It is very, very low, sir.

How they live is a very moot question, and we have to answer it before the very competent agents employed by Commissioner Andrews. They must not only live, but they have the overhead expenses of keeping themselves circulated and well dressed, et cetera and et cetera.

May I go on, sir?

The CHAIRMAN. Please do.

Mr. BRENNER. Another television actor may be engaged to appear in a series of telecasts week after week. His position is more nearly an employee. Yet, both are probably treated as employees by the television agency or station.

During the year the status of both may change so that the one actor is working in a series and the second is free-lancing. Or each may be doing a combination of both during one period of time.

This example is not too uncommon and helps point up the difficulty of determining the true nature of the employment status of professional entertainers. It is my contention that inasmuch as it is usually so difficult to determine these people's true status, they should not be limited by the niceties of legal interpretation in determining how they are to deduct their ordinary and necessary business expenses. Since their expenses are so substantial, and since they are usually close to being independent contractors, if not technically so, they should be allowed to treat their business expenses as do independent contractors. This laudable result can be accomplished, without the necessity of having to define or redefine terms like "independent contractor," by extending the provisions of Section 62 (2) (D) of H. R. 8300 to cover individuals engaged in the field of professional entertainment.

Gentlemen of the committee, I thank you for the opportunity given me to address your committee. I hope you will see fit to make the changes.

Senator BENNETT. Mr. Brenner, I have just one question. You suggest this group of people should be given the same consideration as salesmen. That is the purpose of your testimony. Do you know of any other group that falls inside of the same general pattern?

Mr. BRENNER. No, sir. Those are the two groups as I have mentioned, in my experience of preparing tax returns for so many individuals, where I felt very strongly about that one point, that they could not take their statutory deductions in addition to their business and professional expenses. The salesman, the outside salesman, and also these entertainers, and especially the entertainers, who I have a great love for, because they are such a hard-working group. Their time and their talent is not limited to a certain few hours. They work continuously and they are very conscientious and hard working people.

The CHAIRMAN. For an average television show, how much preliminary do they go through to learn their parts?

Mr. BRENNER. They must spend about a week in rehearsal. It is pretty hard, sir.

The CHAIRMAN. It is pretty hard.

Mr. BRENNER. When you take into consideration that for the average Broadway show, they have to spend quite a bit of time rehearsing, and then they are expected to do as good a job on much shorter notice, on a television performance.

This does not only apply, sir, to television, this applies to a singer. He may be on a concert tour and in that case be an independent contractor. He may sing in a church in a choir and in that case be an independent contractor. Another time you will find him singing on the Broadway stage, and so forth.

The CHAIRMAN. What is the distinction in this particular line between an independent contractor and an employee?

Mr. BRENNER. That is exactly why I am here. It is very, very difficult and it takes an awful lot of talking. The distinction as far as the entertainers are concerned—and I agree with them—is that wherever a W–2 form is submitted by an employer—in other words, wherever the employer—usually a very big organization—having been told by their attorneys to take no chances but to consider these people employees, they do so. You see, we are not trying to change their status, sir. There is no change intended in this bill that I have reference to, as far as salesmen are concerned. We are trying to get them the same relief as is being accorded these outside salesmen.

The CHAIRMAN. These very humble people in the entertainment field who go around and play for lodges and night shows and that kind of business? Are they employees or independent contractors?

Mr. BRENNER. I have made a study of that. I have here "Status of theater people as independent contractors." These people you refer to are known as variety entertainers. Insofar as they appear with their own act—at lodges, vaudeville stages, et cetera, they are independent contractors, but in the cases quoted here, if they were to appear as one act in a circus, they immediately become employees, but they do the very same thing, sir.

The CHAIRMAN. We are very much obliged to you.

Mr. BRENNER. Thank you.

The CHAIRMAN. Mr. Mertz, please.

STATEMENT OF ARTHUR C. MERTZ, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. MERTZ. My name is Arthur C. Mertz, and I am appearing for the National Association of Independent Insurers.

The CHAIRMAN. Tell us something about the nature of that organization. What it does.

Mr. MERTZ. First, may I explain that I have filed with the clerk a detailed memorandum on this subject, and some of the material in that memorandum has already been covered by earlier witnesses. I shall dispense with reading it, with your permission, and shall make my remarks very brief.

The CHAIRMAN. We will put your statement in the record.

(The memorandum referred to follows:)

MEMORANDUM SUBMITTED BY NATIONAL ASSOCIATION OF INDEPENDENT INSURERS IN PROTEST AGAINST THE DISCRIMINATORY TREATMENT OF STOCK INSURANCE COMPANIES AND THEIR SHAREHOLDERS UNDER H. R. 8300

This memorandum is submitted by the National Association of Independent Insurers, an association whose membership includes 103 capital stock casualty and fire insurance companies doing business in every State and Territory of the United States, with aggregate assets in excess of $600 million, and with aggregate premium volume which exceeded $500 million in 1953. A list of the member stock companies is attached to this memorandum.

The association wishes to register a vehement protest against those provisions in H. R. 8300 (secs. 34 (c) (1), 116 (b), 246 (a) (1), 923 (d) (2), and 951 (c) (4)) that would impose drastic and discriminatory burdens upon the entire stock-casualty and fire-insurance industry, and that would result in severe loss to its many thousands of shareholders. The discriminatory impact of the provisions in question seriously affects such insurance companies and their individual and corporate shareholders.

1. INDIVIDUAL SHAREHOLDERS

Sections 34 and 116 of H. R. 8300, as passed by the House of Representatives on March 19, 1954, provide for certain credits and exclusions from income in regard to cash dividends received by individuals from domestic corporations;

consisting in general of the exclusion from income of $50 per year in the first year (increased to $100 in the following year)[1] plus a credit against income tax of 5 percent (increased to 10 percent in the following year) of the remaining dividend income.[2] It is provided, however, in section 34 (c) (1) and section 116 (b) that the dividend exclusion and dividend credit afforded by sections 34 and 116 shall not be allowed with respect to dividends received by individuals from "an insurance company subject to a tax imposed by subchapter L." Sections 831 and 832 of subchapter L embody, without change of substance, section 204 of the 1939 code which imposes upon the net income of every insurance company (other than a life or mutual insurance company) taxes computed as provided in the code sections relating to business corporations generally.

Thus, the cash dividends received by individuals from stock-insurance companies would be excluded from the benefits extended by sections 34 and 116 to all business corporations, even though section 831 of subchapter L specifically provides that taxes assessed against such corporations shall be computed on the same basis as those assessed against business corporations generally.

2. CORPORATE SHAREHOLDERS

Domestic corporate shareholders receiving dividends from a domestic corporation (including dividends from domestic stock-insurance companies) are under present law, entitled to a credit of 85 percent thereof in computing their net income subject to corporate income taxes. Section 243 of H. R. 8300 continues this treatment but provides that the shareholder corporation will be allowed a deduction instead of a credit. However, section 246 (a) (1) makes the deduction allowed by section 243 inapplicable to dividends received from "an insurance company subject to a tax imposed by subchapter L." Hence, corporate shareholders would not be allowed a deduction with respect to dividends received from stock-insurance companies.

For the reasons set forth below, we submit that no valid grounds exist for treating dividends received by individual and corporate shareholders from stock-insurance companies any differently from dividends received by such shareholders from business corporations in general and that sections 34 (c) (1), 116 (b) and 246 (a) (1) should be revised to eliminate the unfair and serious discrimination which they would inflict upon such insurance companies and their shareholders:

I. The exclusion from the relief provisions of sections 34 and 116 of dividends paid to individual shareholders by stock-insurance companies is contrary to the expressed purpose of the legislation, namely, to afford relief "in situations in which double taxation actually occurs" (H. Rept. No. 1337, pp. 5, 6). The House report points out that under present law the earnings of a corporation are taxed twice, once as corporate income and again as individual income when paid out as dividends to shareholders (p. 5). It declares that this results in a higher tax burden on distributed corporate earnings than on other forms of income and has contributed to the impairment of investment incentives (p. 5). It points out also that capital which otherwise would be invested in stock is driven into channels which involve less risk in order to escape the penalty of double taxation and that this has restricted the ability of companies to raise equity capital through stock issues (p. 6).

All the above considerations apply with equal force in the case of stock-casualty and fire-insurance companies as in the case of business corporations generally. Sections 34 and 116, in their present form, would result in a higher tax burden on distributed corporate earnings of such stock-insurance companies than on distributed corporate earnings of corporations generally as well as in a higher tax burden than on other forms of income. Thus, with respect to such stock insurance companies, sections 34 (c) (1) and 116 (b) would accentuate rather than alleviate the inequalities and unfair conditions which sections 34 and 116 are designed to eliminate.

II. Section 246 (a) (1) of H. R. 8300 places an additional tax burden on distributed corporate earnings of stock-insurance companies—a tax burden which does not exist under present law and one which is not placed on business corporations generally either under present law or under H. R. 8300. As previously noted, section 243 allows corporate shareholders as a deduction an amount equal to 85 percent of the dividends received from domestic corpora-

[1] Sec. 116.

[2] Sec. 34.

tions. By virtue of section 246 (a) (1), this deduction does not apply to dividends received from a stock-insurance company. Thus, the difficult position in which stock-insurance companies are put by sections 34 (c) (1), and 116 (b) is made even more critical by section 246 (a) (1), and a serious penalty would be imposed upon corporate ownership of insurance stocks.

III. The House report contains no explanation whatever as to why dividends received by individual and corporate shareholders from stock-insurance companies are dealt with under H. R. 8300 differently than dividends received from any commercial or manufacturing company. The statement in the report that the relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs, does not explain the discrimination, for earnings of the stock-insurance companies in question are in fact taxed twice, once as corporate income and again as dividend income when paid out to shareholders. The report cites examples of companies whose stockholders are denied the benefit of the dividend credits because the companies are not subject to double taxation, but these examples do not include stock-insurance companies—and, as noted above, could not properly do so. Thus, the express objective of the relief provision—to eliminate or reduce double taxation of dividends—is directly frustrated in an important segment of American business investment by denying the dividend benefits to insurance-company stocks.

IV. There exists, in fact, no valid basis for differentiating between dividends received from stock-casualty and fire-insurance companies, on the one hand, and dividends received from commercial and manufacturing companies, on the other. Under H. R. 8300, as under present law, the taxes imposed upon the net income of every such stock insurance company are computed in the same manner and at the same rates as are the taxes of corporations in general. All such stock insurance companies are subject to a 30-percent normal tax rate and the full 22-percent surtax rate on their entire net income, in the same way as manufacturing and mercantile companies. The net income of such insurance companies differs in no respect here material from the net income of other corporations. It consists of gross income less deductions—the gross income consisting of (*a*) the amount earned from investment income and from underwriting income, (*b*) gain from the sale or other disposition of property, and (*c*) all other items constituting gross income under the code sections defining gross income (sections equally applicable to business corporations in general); and the deductions being essentially the same as in the case of other corporations.[3] In short, it can fairly be stated that such stock-insurance companies pay taxes at the same rates and upon net income determined in substantially the same manner as that of any commercial or manufacturing company. This is true under existing law and remains unchanged under the proposed Internal Revenue Code of 1954.

V. In discussions with representatives of the Internal Revenue Service, in an attempt to ascertain the reasons for the discriminations which H. R. 8300 would impose upon stock-insurance companies, interest was expressed in the matter of loss reserves and whether insurance companies might obtain a tax advantage over other corporations by maintaining loss reserves in excess of their actual losses. As will be shown below, no possible tax advantage could be derived in any such manner.

In determining their underwriting income for a taxable year, insurance companies are entitled to subtract "losses incurred" from their earned premiums. The regulations of the Internal Revenue Service expressly provide that—

"Every insurance company to which this section applies must be prepared to establish to the satisfaction of the Commissioner of Internal Revenue that the part of the deduction for 'losses incurred' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such lcsses which, in the opinion of the Commissioner, are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The Commissioner may require any such insurance company to submit such detailed information with respect to its actual

[3] Dividends paid to policyholders as such are allowed as a deduction in computing net income. But such dividends, or return of premiums, must not be confused of course with dividends to stockholders as such.

experience as is deemed necessary to establish the reasonableness of the deduction for 'losses incurred' " (Reg. 118, sec. 39.204-2 (b).)

In short, a stock insurance company may not under law maintain excessive loss reserves and the Internal Revenue Service has full authority to require stock-insurance companies to maintain only such loss reserves as are reasonable. If a stock-insurance company maintains excessive loss reserves, it is subject to the usual sanctions. Surely, discriminatory legislation is not to be based upon a concept that a tax advantage might be obtained through unlawful action.

VI. There is no analogy between stock-casualty and fire-insurance companies and the other corporations which are denied the benefits of sections 34, 116, and 243 of H. R. 8300. Aside from insurance companies, the provisions of these sections are made inapplicable only to dividends received from corporations with respect to which there is not double taxation of corporate earnings. These corporations consist principally of corporations of the type mentioned in the House report, namely foreign corporations or tax-exempt domestic corporations (p. 5). We see no reason in logic or policy for extracting stock-casualty and fire-insurance companies from the general class of business and financial corporations with which they have traditionally been grouped for tax purposes, and throwing them in with such disparate and dissimilar entities as foreign corporations and tax-exempt organizations.

The serious consequences of the discriminatory treatment of stock-insurance companies by H. R. 8300 can readily be anticipated:

1. The capital stock of such companies would immediately suffer a substantial decline in market value as a result of the more favorable tax treatment of dividends paid on other corporate stocks, causing substantial capital loss to present investors.

2. The present corporate shareholders would suffer a substantial loss with respect to net investment income, since for the first time they would be denied a credit or deduction of 85 percent on dividends received from such insurance companies in computing their net income subject to corporate income taxes. All present shareholders would suffer a comparative net investment loss in relation to present shareholders of corporations in general in view of the discriminatory tax burden on dividends received from stock insurance companies.

3. Investors would tend either to reject future offerings of capital stock by such insurance companies or to exact more attractive terms as to dividends and security, thereby inhibiting expansion of this important segment of the insurance industry through capital-stock offerings.

4. The stock-insurance companies may be forced to finance expansion by capitalizing earned surplus through payment of stock dividends rather than through new stock offerings, with a consequent reduction in cash dividend payments. In such event, the discriminatory provisions may well result in a decrease in the Federal revenue derived from the earnings of stock-insurance companies.

In any event, no conceivable benefit to the Federal revenue could justify the discriminatory treatment of such insurance-company dividends and the imposition of such sweeping damage upon an important domestic industry and its many thousands of shareholders.

Additional discriminations against stock-insurance companies would be imposed by sections 923 (d) (2) and 951 (c) (4) of H. R. 8300. Section 923 (d) (2) denies to stock-insurance companies the credit allowed under section 37 of H. R. 8300 to business corporations generally with respect to business income from foreign sources. Section 951 (c) (4) denies to stock-insurance companies an election granted to business corporations generally as to the treatment of deferred income from foreign sources. No explanation is to be found in the House report for such discrimination against the stock-insurance companies, and there is no justification for treating such insurance companies differently in these respects from business corporations generally.

We respectfully submit, therefore, that sections 34 (c) (1), 116 (b), 246 (a) (1), 923 (d) (2) and 951 (c) (4) of H. R. 8300 should be amended to eliminate the unfair and completely unjustified discriminations which they would impose upon the insurance companies in question and their shareholders.

National Association of Independent Insurers,
By Vestal Lemmon, *General Manager.*
Arthur C. Mertz, *General Attorney.*

STOCK COMPANY MEMBERS OF NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Aegis Casualty Insurance Co., Denver, Colo.
Allstate Fire Insurance Co., Skokie, Ill.
Allstate Insurance Co., Skokie, Ill.
American Bankers Insurance Company of Florida, Miami, Fla.
American Fire & Casualty Co., Orlando, Fla.
American General Insurance Co. of Minneapolis, Minneapolis, Minn.
American Guarantee & Liability Insurance Co., Chicago, Ill.
American Mercury Insurance Co., Washington, D. C.
American Title & Insurance Co., Miami, la.
American Universal Insurance Co., Providence, R. I.
Atlantic Casualty Insurance Co., Newark, N. J.
Atlantic & Gulf States Insurance Co., Easley, S. C.
Audubon Insurance Co., Baton Rouge, La.
Auto Insurance Co., Covington, Ky.
Automobile Club Insurance Co., Columbus, Ohio.
Baloise Fire Insurance Co., Ltd., Miami, Fla.
Bankers Insurance Co., Conway, Ark.
Cal-Farm Insurance Co., Berkeley, Calif.
Casualty Underwriters, Inc., St. Paul, Minn.
Central National Insurance Co., The, Omaha, Nebr.
Citizens United Insurance Co., Indianapolis, Ind.
Commercial Insurance Co., Amarillo, Tex.
Continental Union Insurance Co., Birmingham, Ala.
Delta Fire & Casualty Co., Baton Rouge, La.
Dubuque Fire & Marine Insurance Co., Chicago, Ill.
Economy Auto Insurance Co., Freeport, Ill.
Educators Automobile Insurance Co., Fort Worth, Tex.
Employers Insurance Co. of Alabama, Inc., Birmingham, Ala.
Equity General Insurance Co., Miami, Fla.
Fire & Casualty Insurance Co. of Connecticut, The, Hartford, Conn.
Firemen & Mechanics' Insurance Co., Inc., Fort Wayne, Ind.
Freeport Motor Casualty Co., Freeport, Ill.
General American Casualty Co., San Antonio, Tex.
General Bonding & Insurance Co., Oklahoma City, Okla.
General Casualty Co. of Wisconsin, Madison, Wis.
Government Employees Insurance Co., Washington, D. C.
Great Central Insurance Co., Peoria, Ill.
Great National Fire & Casualty Co., Waco, Tex.
Great Northern Insurance Co., Minneapolis, Minn.
Guaranty Fire & Marine Insurance Co., Columbia, S. C.
Hawkeye-Security Insurance Co., Des Moines, Iowa
Highway Casualty Co., Chicago, Ill.
Home Service Lloyds, Dallas, Tex.
Houston American Insurance Co., Houston, Tex.
Inland Empire Insurance Co., Salt Lake City, Utah
Insurance Co. of St. Louis, St. Louis, Mo.
Insurance Co. of the South, Jacksonville, Fla.
Insurance Co. of Texas, The, Dallas, Tex.
Inter-Ocean Reinsurance Co., Cedar Rapids, Iowa
La Salle Casualty Co., Chicago, Ill.
Liberty National Insurance Co., Coeur D'Alene, Idaho
Louisville Fire & Marine Insurance Co., Louisville, Ky.
Michigan Surety Co., Lansing, Mich.
Mid-Continent Casualty Co., Kansas City, Mo.
Mid-South Insurance Co., Jonesboro, Ark.
Mid-State Insurance Co., Chicago, Ill.
Midwestern Fire & Marine Insurance Co., St. Louis, Mo.
Minnehoma Insurance Co., Tulsa, Okla.
Motor Vehicle Casualty Co., Elmhurst, Ill.
Mountain Standard Insurance Co., Denver, Colo.
National Farmers Union Property & Casualty Co., Denver, Colo.
National Fidelity Insurance Co., Spartanburg, S. C.
National Fire & Marine Insurance Co., Omaha, Nebr.
National Indemnity Co., Omaha, Nebr.
National Service Fire Insurance Co., Memphis, Tenn.

Oregon Automobile Insurance Co., Portland, Oreg.
Permanent Insurance Co., Columbus, Ohio
Pioneer Casualty Insurance Co., San Antonio, Tex.
Preferred Fire Insurance Co., Topeka, Kans.
Preferred Insurance Co., Grand Rapids, Mich.
Premier Insurance Co., Rochester, Minn.
Public National Insurance Co., Miami, Fla.
Republic Indemnity Co., The, Columbus, Ohio.
Republic Indemnity Co. of America, Los Angeles, Calif.
Riverside Insurance Co. of America, Little Rock, Ark.
St. Louis Fire & Marine Insurance Co., St. Louis, Mo.
Secured Fire & Marine Insurance Co., Indianapolis, Ind.
Security General Insurance Co., Sioux Falls, S. Dak.
Southern Farm Bureau Casualty Insurance Co., Jackson, Miss.
Southern Fire & Casualty Co., Knoxville, Tenn.
Southern General Insurance Co., Atlanta, Ga.
Southwest American Investment Co., Houston, Tex.
Southwest Casualty Insurance Co., Fayetteville, Ark.
Standard Casualty Co., Sioux Falls, S. Dak.
Standard Casualty Co., Houston, Tex.
State Farm Fire & Casualty Co., Bloomington, Ill.
State Fire & Casualty Co., Miami, Fla.
Surety National Insurance Co., Omaha, Nebr.
Texas Casualty Insurance Co., Austin, Tex.
Transit Casualty Co., St. Louis, Mo.
Trans-Pacific Insurance Co., Phoenix, Ariz.
Transport Indemnity Co., Los Angeles, Calif.
Transport Insurance Co., Dallas, Tex.
United Benefit Fire Insurance Co., Omaha, Nebr.
United Fire & Casualty Co., Cedar Rapids, Iowa.
Universal Underwriters Insurance Co., Kansas City, Mo.
Utilities Insurance Co., St. Louis, Mo.
Vernon Casualty Insurance Co., Indianapolis, Ind.
Washington Fire & Marine Insurance Co., St. Louis, Mo.
Western Fire & Indemnity Co., Lubbock, Tex.
Western Pacific Insurance Co., Seattle, Wash.
Wolverine Insurance Co., Battle Creek, Mich.
Zurich General Accident & Liability Insurance Co., Ltd., Chicago, Ill.

Mr. MERTZ. Our organization is a national trade association of 230 fire and casualty insurance companies of which 103 are stock companies doing business in every State of the United States and Canada. The total assets of these stock companies alone exceed $600 million and their aggregate premium writings in 1953 were more than $500 million.

I might mention for the benefit of the Senator that we have at least one title company in membership. I don't know whether it was the title company who wrote you. If it was, we should keep our members better apprised of what we are doing for them.

Senator BENNETT. Apparently, yours is the American Title Insurance Co., of Miami, Fla. I got my telephone call from Los Angeles.

Mr. MERTZ. Our association is appearing in protest against a serious discrimination imposed upon stock insurance companies under House Resolution 8300. The discrimination consists of denying to shareholders of insurance companies—by which I mean all shareholders, individuals and corporate—the partial relief from double taxation of dividends which the bill extends to shareholders of corporations in general.

Senator Lucas, who appeared this morning before the committee in behalf of the American Finance Conference, has already explained to this committee that stock insurance companies presently pay the same corporate taxes that other business corporations pay, computed at the same tax rates. Yet, under the new code, shareholders of stock insurance companies are denied the dividend relief which shareholders of business corporations in general are to receive.

Specifically, individual shareholders are denied the dividends credit and exclusion under sections 34 and 116, and corporate shareholders are denied the 85-percent dividend credit under section 246. In view of the House committee's expressed objective of this dividend-relief provision, the denial of the 85-percent credit is particularly hard to understand. The House committee explained that the dividend-relief provision is intended to avoid double taxation of dividends. Yet, by excluding stock insurance companies from section 246 (a), the House is creating double taxation where none existed before.

The CHAIRMAN. I can't speak for the whole committee at this stage of the game, but I just want to say I think that will be corrected. I don't want to spoil your speech.

Mr. MERTZ. I don't care about my speech. I have no pride of authorship. I did want to emphasize that one point, though. It is hard to know whether one should mention these things at the expense of being repetitious, or let it go.

I haven't much more here. I just wanted to point out, as you undoubtedly know, under the present code, all corporate shareholders are entitled to this 85-percent credit against dividends from all sources, including corporate shareholders of insurance companies. Under this new bill, now, for the first time, the corporate shareholders of insurance companies will be taxed, not on 15 percent of the dividends from insurance stock as under present law, but on 100 percent of such dividends.

We believe this imposes a discriminatory tax burden on these corporate holders of insurance stocks which can have the most serious consequences for the whole insurance industry.

Let me just enumerate several of those consequences and then I will be through: First, we believe that under this present law, if it is allowed to stand as written, the capital stock of insurance companies will immediately suffer a substantial decline in market value as a result of the unfavorable tax treatment of their dividends. This will cause substantial capital loss to present investors, both individual and corporate.

Secondly, the present corporate shareholders will suffer a substantial loss of net investment income, and thirdly, investors will tend either to reject future offerings of capital stock by such insurance companies, or to exact more attractive terms as to dividends and security, thereby inhibiting expansion of this important segment of the insurance industry through capital stock offerings.

We, therefore, submit that House Resolution 8300 should be amended to eliminate the discriminatory provisions to which I have referred, and I am considerably heartened to know that you have that in mind.

I might add that representatives of our association have discussed these matters in detail with Mr. Stam and he has been furnished a copy of our memorandum.

Thank you for your kindness in allowing me to appear.

The CHAIRMAN. Thank you very much.

Is Mr. McDermott in the audience?

Well, I guess that finishes it for today. We will meet at 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

UNITED STATES SENATE,
COMMITTEE ON BANKING AND CURRENCY,
April 12, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Congress of the United States, Washington, D. C.

DEAR GENE: I am enclosing herewith suggested amendments to the foreign-trade provisions of H. R. 8300, which were submitted to me by one of the large pharmaceutical companies, located in New York City. It is my understanding that these proposed amendments will be submitted to your committee during the course of the hearings on H. R. 8300. The attached material is for your information and appropriate consideration.

With kindest personal regards, I remain
Sincerely yours,

IRVING M. IVES.

SUGGESTED AMENDMENTS TO FOREIGN TRADE PROVISIONS OF H. R. 8300

1. WHOLESALE ESTABLISHMENT

Under section 923 a domestic corporation cannot get the benefit of the 14-point tax reduction in respect of dividends from foreign corporations unless, inter alia, the dividends have been derived from the active conduct of a trade or business "through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country." The term "trade or business" is so defined as to give the quoted portion of the section a very narrow scope. For example, while a retail establishment would qualify for the benefit, a wholesale establishment would not. The section should be so changed that the 14-point reduction will be equally available, under the same conditions, to all companies having substantial trade and business operations in a foreign country or countries. This can be accomplished in 1 of 2 ways:

Suggestion 1: Strike out section 923 (b) (1), and amend section 923 (a) (3) (A) (ii) to read as follows:

"(ii) has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail or wholesale establishment, or other like place of business situated within a foreign country or countries, and"

Suggestion 2: Amend section 923 (a) (3) (A) (ii) to read as follows:

"(ii) has been derived to the extent of at least 90 percent from the active conduct of a trade or business within a foreign country or countries, and"
and section 951 (a) should be similarly amended.

Amend section 923 (a) (1) and section 951 (b) (1) to read as follows:

"(1) The term 'trade or business' shall include sales of goods manufactured by the seller or an affiliate in connection with operations which conform with the following requirements:

(i) A substantial stock of goods or merchandise is maintained in one or more foreign countries, or

(ii) A substantial staff of sales employees is maintained, or substantial advertising and promotion expenses are incurred, in one or more foreign countries; and"

2. STOCK OWNERSHIP REQUIREMENTS

(*a*) Under section 923 the domestic corporation cannot get the benefit of the 14-point tax reduction in respect of dividends from foreign corporations unless, inter alia, a domestic corporation, either alone or in association with not more than three other domestic corporations, owns more than 50 percent of the voting stock of such foreign corporation. Many companies have found it expedient or necessary to share the ownership of foreign operating subsidiaries 50-50 with local stockholders. Moreover, some foreign countries have laws which require stockholdings of 50 percent or more on the part of nationals of such countries. Accordingly, the present provisions of section 923 would unfairly penalize many domestic corporations which are actively engaged in foreign trade and have substantial investments therein.

Section 923 (a) (3) (B) (i) should be amended to read as follows:

"(i) such domestic corporation, either alone or in association with not more than three other domestic corporations, owned 50 percent or more of the voting stock of such foreign corporation, or the maximum percent allowable by the requirements of a foreign country in which such foreign corporation is doing business, whichever is lower, or"

(*b*) Section 923 treats as trade or business income a dividend received by a foreign corporation from another foreign corporation, but only if the foreign corporation owns more than 50 percent of the voting stock of such other foreign corporation. The situation related under (*a*) above is equally applicable in respect of this provision. Accordingly, section 923 (b) (2) (B) should be amended to read as follows:

"(B) at the date of the declaration of the dividend and during the whole of the years in which were accumulated such earnings and profits such foreign corporation owned 50 percent or more of the voting stock of such other foreign corporation, or the maximum percent allowable by the requirements of a foreign country in which such other foreign corporation is doing business, whichever is lower."

3. GOODS INTENDED FOR SALE IN THE UNITED STATES

Section 923 denies the 14-point reduction in respect of dividends received by a domestic corporation from a foreign corporation if the earnings and profits used in the payment of dividends are from a year in which more than 25 percent of the gross income was derived from the sale of articles and products manufactured in a foreign country and intended for use, consumption, or sale in the United States. The report of the Committee on Ways and Means makes it clear that this prohibition does not extend to the mining or processing of metals or the extraction or refining of oil in a foreign country, even though such metals or oil are intended for use, consumption, or sale in the United States. No reason exists for a broad discrimination against manufacturing in this respect. The prohibition should not be applicable to manufacturing which, as in the case of the exceptions in favor of the processing of metals or refining of oil, processes a basic raw material which originated in a foreign country. Accordingly, section 923 (a) (3) (A) (iii) should be amended to read as follows:

"(iii) does not (except where the manufacture involves the processing of raw materials at least 60 percent of which originated in a foreign country or countries) consist of more than 25 percent of gross income derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States,"

and section 951 (a) should be similarly amended.

4. ROYALTY INCOME

Section 923 extends the 14-point reduction to "compensation for the rendition of technical, engineering, scientific, or like services," but the committee report indicates that royalties from patents, etc., will not be deemed compensation for services rendered. There appears to be no good reason for this discriminatory treatment of income designated as royalties but arising out of like activities on the part of the taxpayer or an affiliate or predecessor. Moreover, as a practical matter, the exchange controls and other requirements of some foreign countries are such that it is highly desirable, if not imperative, to provide for compensation for technical, engineering, scientific, and like services, in whole or in part, in the form of royalty arrangements, as a means of withdrawing funds from such foreign countries.

Section 923 (a) (2) should be amended to read as follows:

"(a) as compensation for the rendition of technical, engineering, scientific, management, or like services, or as royalties for the use of a patent, trademark, or copyright;"

5. DIVIDENDS FROM WESTERN HEMISPHERE TRADE CORPORATIONS

The bill discriminates against the use of United States corporate subsidiaries for operations abroad. This is because the tax cost of doing foreign business through a domestic subsidiary, as compared with doing such business through a foreign subsidiary, would be higher by the amount of the corporate tax imposed, at the full rate, on 15 percent of the dividends received by a domestic parent corporation from such domestic subsidiary. The discrimination against the employment of United States corporate subsidiaries, including Western Hemisphere trade corporations for such foreign operations, is especially undesirable because such corporations afford a number of legal safeguards, not otherwise available, and the tax system should be so arranged to encourage rather than discourage the use of such corporations. To effect this, section 243 (a), which provides for the 85 percent dividends received credit, should be amended by adding thereto the following provision:

" *: Provided, however*, that there shall be allowed as a deduction 100 percent of the amount received as dividends from a Western Hemisphere trade corporation or from a domestic corporation substantially all the income of which qualifies, under section 923, for the credit provided for by section 3T."

(Whereupon, at 3:47 p. m., the committee recessed to reconvene at 10 a. m., Tuesday, April 13, 1954.)

THE INTERNAL REVENUE CODE OF 1954

TUESDAY, APRIL 13, 1954

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to call, in room 312, Senate Office Building, at 10 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Carlson, Frear, Bennett, Flanders, and Long.

Senator CARLSON (presiding). The committee will please come to order. The first witness this morning will be Mr. Walter Reuther, head of the Congress of Industrial Organizations.

Mr. Reuther, we are very pleased to have you before this committee this morning on this important subject. We are pleased to have your testimony.

STATEMENT OF WALTER REUTHER, CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. REUTHER. Thank you, sir. I am very pleased to have this opportunity of appearing in behalf of the Congress of Industrial Organizations and its 6 million members. I have a statement for the record, Mr. Chairman, which I would like to submit. Then, I would like to amplify that by making certain observations, if I may.

Senator CARLSON. The statement will be made a part of the record and you may proceed in any way you desire.

Mr. REUTHER. Thank you.

(The statement referred to follows:)

STATEMENT ON H. R. 8300, PRESENTED BY WALTER P. REUTHER, PRESIDENT OF THE CONGRESS OF INDUSTRIAL ORGANIZATIONS

H. R. 8300, which the House of Representatives passed on March 18, has been designated falsely a tax revision bill, composed only of technical revisions of the tax code. As it stands before you, the bill is not a tax revision bill. It is a tax reduction bill. It is a giveaway program for those groups in our economy who, at this particular point in time, need no tax relief.

While giving a huge bonanza to the wealthy, H. R. 8300 denies consideration to the great bulk of American taxpayers. It is restrictive in its application, but expansive in its benefits to corporations and wealthy individuals. One provision after another is designed to reduce the taxes paid by upper- and high-income taxpayers without specifically reducing tax rates. Each and every time an additional tax concession is made to a wealthy taxpayer, it places a greater tax burden upon the low- and middle-income taxpayers.

In addition to discussing the details of some of these provisions, I have attached an appendix to this testimony which describes the loopholes and tax concessions in H. R. 8300. This appendix contains an analysis by the Research

Institute of America, whose pamphlet, How the 1954 Tax Revision Bill Would Affect You, advises its clients on the provisions for reducing their taxes. Direct quotations from the pamphlet show conclusively that the CIO is not alone in believing that this bill opens new loopholes and grants new concessions to the wealthy. They give documentary proof that certain provisions of this bill are designed for this purpose. Here are a new examples, in question and answer form, quoted directly from the pamphlet:

Question to individuals: "Do you make fairly substantial contributions?"

Loophole: "The new law would approve a method of making contributions in trust which would permit you to make money on contributions."

Question to owners of corporations: "Do you and several others plan to incorporate a business?"

Loophole: "It could be accomplished tax-free even though the incorporators receive stock out of proportion to the cash or property transferred to the corporation."

Question to employers and employees: "Would you adopt a qualified pension or profit-sharing plan if it could be restricted to a narrow group of employees?"

Loophole: "This would now be permissible—especially for the smaller companies."

These are just a few examples of the questions and answers contained in the Research Institute of America's publication. Others are attached as an appendix to this testimony.

ADMINISTRATION'S PROPOSALS UNDERMINE TAX STRUCTURE

Each of the proposals which I shall discuss and many others to which I shall only allude are designed to undermine our progressive tax structure by making additional tax concessions and opening new and bigger loopholes.

Our entire tax structure grows out of the concept that taxes should be based upon the ability to pay. To move away from this fundamental principle would be to destroy years of work in developing our tax structure. This is the fundamental concept behind the income and corporate tax as well as the estate and gift taxes. This Congress should be striving to maintain the concept of taxation according to ability to pay instead of destroying it. The administration's bill is designed to shift the tax burden from the backs of those who can afford to pay to the backs of the taxpayers who can least afford to pay. The reduction of effective taxes upon the wealthy increases the taxes upon the low- and middle-income people. While the tax rates are not being increased, the effect of the tax concessions in the upper-income brackets is to increase the burden upon the other taxpayers.

Two major provisions of this bill, (1) reduced taxes on dividends and (2) liberalized depreciation allowances, are advanced as the best means of stimulating growth in the economy. This we do not believe. The advocates of the theory that business investment in new plant and equipment increases as taxes are cut on corporations and wealthy stockholders are laboring under false notions. Secretary of the Treasury George Humphrey, the modern-day reincarnation of Alexander Hamilton and Andrew Mellon, is now exhuming this theory. The 1929 depression buried the notion that straight stimulation of investment through this "trickle-down" theory would keep the economy operating at high levels of employment and production. Each time it has been tried it has failed.

We recognize, as do the administration and this committee, the tremendous importance of business investment to the maintenance of a full-employment economy in America. Without investment in new plant and equipment, without continued expansion of our productive capacity, our economy could not prosper and our workers could not be fully employed. Investment by American business is one of the major forces in our economy. Continued high levels of investment in the post-World War II years have enabled us to remain prosperous.

However, the high levels of investment in recent years have not been brought about by concessions and tax reductions to corporations. On the contrary, investment has remained high in the post-World War II years in spite of the high levels of corporate taxes and the old methods of depreciation. Even when accelerated tax amortization is taken into consideration, investments have still set new highs in each of the years except 1949–50.

The desire on the part of corporations to make a profit by meeting the demand of the American consumers for goods has been the basic stimulus in this post-World War II economy. Profits are made from actual sales, not anticipated sales. Sales are stimulated by demand, and demand grows out of the existence of adequate levels of income in the hands of all the people.

Secretary Humphrey's exhumed trickle-down theory is a smoke screen to secure tax concessions for corporations and wealthy stockholders.

We believe that business investment and the economy as a whole can best be stimulated by increasing the purchasing power and the take-home pay of the majority of the taxpayers. There is no better way for Government to stimulate purchasing power than by giving tax relief generally to taxpayers by increasing the individual income-tax exemptions.

We, therefore, recommend that the committee accept the proposal made by Senator George and his colleagues in the Senate to increase exemptions to $800 per dependent this year and $1,000 next year. This type of tax reduction will create the demand for American goods that, in turn, will stimulate corporations and business enterprises to invest in new plant and equipment.

SETTING THE RECORD STRAIGHT

Before discussing the specific provisions of the bill any further, I should like to set the record straight about some of the figures used by the House Ways and Means Committee in its report describing the revenue loss in this bill.

The committee reports that the loss totals $1,400 million. However, they claim that the retention of the 52 percent corporate tax rate for 1 year after April 1, 1954, when it was originally supposed to drop to 47 percent, will mean a revenue gain of $1,200 million. With this sleight of hand in using numbers, they arrive at the magic figure of a total revenue loss of $200 million.

This deliberate misrepresentation of the facts is based on three "oversights" in the committee report:

1. Tax loss in subsequent years

There is nothing in the majority report showing the revenue loss in the years after the fiscal year 1955. The committee fails to state that the loss in subsequent years will be considerably higher than in the first fiscal year. The minority members of the Ways and Means Committee pointed out in their minority report that the total revenue loss will be between $3.5 and $4 billion when the bill becomes fully effective.

The majority members heard the Joint Committee on Internal Revenue Taxation's estimates on the loss in revenue during subsequent years during the discussions on this bill. However, they refused to use these figures, because the results show that the loss will be considerably greater than the majority members want the American people to believe.

The two main items which create the rise in the loss are part of the give-away program: liberalized treatment of taxation of dividends and the revision of depreciation allowances.

The Joint Committee on Internal Revenue Taxation estimated that the dividend tax reduction would cost, as the majority indicated, $240 million in the first year. But, it went on to say that the second year would bring a $642 million loss, and each succeeding year, a loss of $840 million. Therefore, when the provision becomes fully operative, the loss in revenue is actually $600 million more per year than the majority report indicates.

In addition, the Joint Committee on Internal Revenue Taxation estimated that the liberalized depreciation allowances would mean a loss of $375 million in the first year, $1,050 million in the second year, and $1,550 million in the third year. These figures are projected beyond the third year in the minority report. By the sixth year, it points out the total loss from this provision will be $2.2 billion. If we limit ourselves to the joint committee estimates, the actual loss will be $1.2 billion greater than the majority report indicates and approximately $1.8 billion greater if the estimates of the minority report are used.

The total loss in revenue will be not $1.4 billion but $3.2 billion when the bill becomes fully operative. Projecting it to the sixth year, the loss will annually reach the point of $3.8 billion.

This omission by the Ways and Means Committee was not an oversight. It was a deliberate attempt to hide from the American people what everyone should know concerning the full impact of this bill.

2. 52 percent corporate rate extension means revenue of $1.2 billion retained

Another outrageous attempt to confuse the public is the statement that $1.2 billion in revenue will be raised by the extension of the corporate rate at 52 percent instead of permitting it to fall to 47 percent automatically on April 1.

In fiscal 1955, corporations will pay precisely the same normal and surtax corporate rates which they paid in 1954. It is difficult to see how this can be considered a gain in revenue.

Any good businessman knows that he does not make an extra profit by selling an article at its original retail price, even though he may have thought he would have to mark it down a little. Any wage earner knows that because he thought he would have to take a 5 percent salary cut, the fact that he still gets the same salary does not mean that he is making more money than he did before. Surely an administration made up of businessmen does not so deceive itself.

As a matter of fact, with the excess-profits tax eliminated last January 1, corporations will pay less in taxes. Not only is there not a revenue gain from corporations, there is a revenue loss, in spite of the Ways and Means Committee's misleading statements about the retention of the 52 percent corporate tax rate.

Furthermore, President Eisenhower's budget message, which recommended this extension, assumed that the rate would be extended and the budget estimates for 1955 included the $1.2 billion figure in budget receipts. To call this a $1.2-billion-revenue gain, as the committee now indicates, is a complete misrepresentation of facts for political purposes.

3. Understatement of some losses

The committe report also underestimates some of the loss in revenue resulting from specific recommendations in the bill. For example, the reduction in the tax on dividends for the first fiscal year will mean an annual loss which is not fully stated. The committee's estimates represent only 11 months' loss, because the provision is effective the 1st of August, not the 1st of July.

The committee report estimates the loss from the elimination of the premium test on life insurance at only $25 million. This seems incredible, since 6 years ago, when this provision was proposed in 1948, it was estimated to create a loss in revenue of $100 million.

We have not been able to check all the estimates made by the committee, but I would venture a guess that a careful examination would show that many of the estimates of loss are understated. Nor do I need any further detail. The examples already mentioned show clearly that the committee has not been completely honest in its presentation of the facts to the public.

WHO GETS THE TAX RELIEF?

Another skillful misrepresentation is the discussion of the tax relief granted to individuals according to H. R. 8300. There is no single provision in this bill which gives a general tax cut to individuals. I challenge anyone to find such a provision.

There are many provisions granting tax relief to special kinds of taxpayers. The greater portion of the relief is for corporations and wealthy individuals. Table I shows the breakdown of the specific items and the loss in revenue from each, arranged in 3 groups, showing the tax relief which is granted to (1) individuals with incomes under $5,000, (2) individuals with incomes of $5,000 per year and over, and (3) corporations when the provisions of the bill become fully operative.

TABLE I.—*Distribution of tax reductions, H. R. 8300*

[In millions of dollars]

Provision	To individuals		To corporations	Total
	Under $5,000	$5,000 and over		
All corporation provisions			$2,079	$2,079
Head of family [1]		$50		50
Depreciation [2]		440		440
Trusts		3		3
Life insurance exemption [1]		100		100
Charitable deductions		25		25
Dividend income exemption [3]	$109	731		840
Medical expense deduction [4]	25	55		80
Child care deduction [4]	12	28		40
Retirement income credit [4]	39	86		125
Others [4]	42	93		135
Total	227	1,611	2,079	3,917
Percent	5	42	53	100

[1] Minority report, p. B3.
[2] Proportion attributed to individuals in the majority report; based on highest year cost.
[3] Distribution suggested by U. S. News & World Report, Mar. 12, 1954.
[4] Distributed as suggested by U. S. News & World Report for income tax cuts.

Ninety-five percent of the tax relief clearly is granted to corporations and wealthy individuals. Only 5 percent of the tax reductions will go to individuals whose incomes are below $5,000 per year.

There is no mystery about who gets the tax relief under this bill. As you can see from these figures, low-income families who need tax relief get only a thimbleful. And the wealthy? Their cup is so full that it undoubtedly will run over.

EXAMINATION OF A FEW SPECIFIC PROVISIONS

The bill obviously has no one provision which helps all the general taxpayers. However, I should like to review with the committee a few of the provisions which help some members of this group:

Medical expenses

If you happen to be one of the unfortunate few who has extensive medical bills, you may receive some benefit. However, in order to receive it, you must itemize your total deductions on the long form and reach a total that exceeds 10 percent of your gross income. Otherwise, you cannot get any relief from the increase in deductions for medical expenses.

Child care

The same is true for the specific provision on child-care deductions: If a widow or widower or divorced person or working mother whose husband is handicapped hires a baby-sitter to take care of a child, the individual is permitted to take a deduction of up to, but not exceeding $600. Again, the long form must be used with a total of the other deductions reaching more than 10 percent of gross income. Even if such a total is reached, the provision is still inadequate, because it covers only a child under 10 years of age and does not apply to the child whose parents are both working in order to earn an income sufficient to maintain their livelihood.

It seems rather strange to assume that an 11-year-old child is able to take care of himself completely. It also seems strange to assume that $600 is enough to hire someone to take care of a child—$600 per year is about $11.50 per week. This results in a maximum tax saving for the average working widowed mother of $120 a year or $2.31 a week. There are not many communities in America where $600 a year is enough to hire such care for a child.

We do not oppose this provision, but we strongly recommend that it be applied to any dependent child who requires care while both parents are working, and that the deduction be considerably increased. Also, the provision should be applicable to all working mothers who have expenditures for the care of dependent children.

Income-splitting for head of family

This provision, which will lose some $50 million in revenue, will not help a head of a household who has 3 dependents unless his income is over $5,000 per year. It gives tax relief to those with incomes above $10,000, but the major relief is for those with incomes above $25,000. As a matter of fact, a taxpayer earning $50,000 per year saves more under this split-income provision than three-fourths of American families earn in any 1 year.

Reduction of taxes on dividends

The first such proposal is designed to reduce taxes upon dividend income. It is presented on the theory that there is now a "double" taxation of dividends which is unfair and must be eliminated. From the statements made by the Secretary of the Treasury and the leaders of the Republican Party on the Ways and Means Committee in the House of Representatives and other spokesmen for the administration, it appears that dividends are the only items which are doubly taxed, and that this "gross injustice" must be stopped. These same leaders fail to recall that during the political campaign of 1952, the Republican candidate for President discussed double taxation of another kind. For example, on September 18, 1952, Republican Candidate Eisenhower, in Des Moines, Iowa, stated: "When your wife buys a loaf of bread, she pays 151 taxes. When you buy an automobile, you pay 206 taxes. You may not know it—and I am sure your wife won't like the fact that I told you—but there are 150 different taxes on every woman's new hat."

"Double" taxation

While great cries of anguish were raised over the multiple taxation of bread, hats, and automobiles—which are used by all consumers—little if anything was said during the campaign about the multiple taxation of dividends, to stockholders who form only a small minority of voters. After their election victory, however, the Republicans forgot, apparently, about multiple taxation of bread and shifted their attention to the problems of stockholders.

There are countless examples of multiple taxation besides those imposed on dividends, if one looks for them. Any excise or sales tax represents multiple taxation. The manufacturer pays a corporate tax on his business income from the sale of his firm's products; the wholesaler, transportation company, and retailer pay their taxes on incomes from the handling and sale of those products. These taxes may or may not be passed on to the consumer in the form of higher prices. And if there is a sales or excise tax on the item, the consumer pays that tax, too.

In addition, wages and salaries are also taxed several times. The corporation pays a tax on its income; the payroll tax for social security applies against the gross wage before the payment of the income tax; then, there is the individual income tax on the wage.

One can find multiple taxation in almost any area of the economy. Yet the administration and the House Ways and Means Committee make it seem that there is a special moral issue involved in the taxation of stockholder's dividends.

A corporation is an institution

What about the special argument concerning the double taxation of dividends? Is it really unfair to tax both corporation income and dividend income?

The corporation is an institution operating under a public charter. As such, it receives special privileges—such as limited liability under the law—which partnerships and other nonincorporated businesses do not receive.

The corporation, therefore, is a special type of business enterprise that has been granted special privileges by law. It seems reasonable for the Government, which has granted these special privileges to the corporation, to establish a specific corporate income tax. The corporation, as a legally privileged enterprise, should be taxed as a separate entity.

If one were to assume that the corporation has no legal entity of its own—that it is a device for individuals to conduct business—then perhaps it would be unfair to tax both corporate income and the dividends paid by corporations to stockholders. But the corporation is a legal entity. And, in reality, a corporation is almost always something different from a handful of stockholders, who own the stock and also manage its affairs. In most corporations—certainly the middle-sized and large corporations that are responsible for almost all the publicly held stock—there is a separation of management from stockholders. It is the management that runs the corporation, and makes its policy decisions concerning investments, dividend payments, and financial reserves.

Stockholders generally buy stock either for trading purposes or for the receipt of dividend income. In relation to both cases, the corporation tax is built into the financial structure—of the price of the stock and the dividend payments.

"Double taxation" of dividends

The administration says that it is unfair to tax both corporate income and dividends paid by corporations to stockholders. This is inequitable, the administration states, because the dividends paid to stockholders are from corporate income that has already been taxed by the corporate income tax.

The selection of stockholders for privileged tax treatment is being made with moral overtones about the inequitable "double" taxation of dividends under the present law. The issue is a false one.

Unless the Nation were to adopt a complete single-tax system—on land alone, as proposed by Henry George in the 1880's or on personal income alone—we are bound to have countless examples of multiple taxation. There can be no logical reason for the administration to single out dividends for special consideration, while all other cases of multiple taxation remain. The President's recommendation for selecting one tiny part of the American population for special tax privileges can only be interpreted as a sop to upper-income families.

Obviously, there is no moral issue involved in "double" taxation. If anything, this proposal is completely contrary to sound tax policy. For many years, in fact, income-tax laws provided for an earned-income credit. There are many people who advocate the reenactment of the earned-income tax credit. We support such a proposal. But the present provision is to give an unearned income credit—an idea contrary to every accepted principle of crediting earned income.

It is hoped, I presume, by the administration and the leaders in the Congress that this proposal of reducing taxes on dividends can be sold to the American public. There is great concern expressed over the widows and orphans who live upon dividend income. The proposal is to exclude the first $50 and $100 of dividend income and then credit 5 to 10 percent of the rest. This will not help the widows and orphans, because few such people own stocks. To try to sell the proposal on such a soap-opera basis is ridiculous. To say stocks are widely held by low-income people and by unfortunate handicapped and widowed persons is poppycock.

WHO OWNS THE STOCK?

There is much information on stock ownership—many studies available to refute the nonsense about ownership by low-income persons. The most widely-quoted study is the one by the Survey Research Center of the University of Michigan, which prepares the Survey of Consumer Finances for the Federal Reserve Board.

This study shows that 92 percent of the American families owns not a single share of stock in publicly owned corporations. On the contrary, only 8 percent of American families—roughly 4 million—owns any stock whatsoever. However, the Survey Research Center points out that of the 8 percent owning stock, only a limited number owns the overwhelming majority of the publicly held stock. For example, the material shows that six-tenths of 1 percent—only 6 out of every 1,000—own 80 percent of all the publicly held stock in America. Every single one of these families—roughly some 300,000—owns $25,000 worth of stock or more.

This data is confirmed with only slight variations by similar studies made by other groups. One is the Brookings Institute study called, Share Ownership in the United States by Lewis H. Kimmel. Further corroboration for the conclusions of the Survey Research Center is contained in an article by the division of research of the graduate school of business administration at Harvard University. This study is called Effects of Taxation, Investments by Individuals by J. Keith Butters, Lawrence E. Thompson, and Lynn L. Ballinger. The following five paragraphs summarize the results of the Harvard study:

"It can be shown that a large fraction of outstanding marketable stock is being held by spending units with large incomes. Our base estimate is that as of 1949:

"1. Spending units with incomes of $50,000 and over—in the general order of one-tenth of 1 percent of all spending units—held about 35 percent of all the marketable stock owned by private investors.

"2. Spending units with incomes of $25,000 and over—in the general order of one-half of 1 percent of the population—held slightly over half of all privately owned marketable stock.

"3. Spending units with incomes of $15,000 and over—in the general order of the top 1 percent of the population—held about 65 percent of this total of marketable stock.

"4. Spending units with incomes of $10,000 and over—approximately the top 3 percent of the population—held about 75 percent of all marketable stock owned by private investors."

The most telling substantiating data on who owns American stocks and who receives the dividends can be found in the 1950 Statistics of Income, part I. An examination of the table showing individual returns for 1950 shows that 8 persons reported adjusted gross incomes of more than $5 million apiece. These 8 persons receive $37.7 million in dividend income. On the basis of the proposed provision in the tax bill, these 8 persons alone would appear to benefit by more than $3 million. Two hundred and nineteen persons reported adjusted gross incomes of over $1 million in 1950. They had altogether $190 million of dividend income.

The six-tenths of 1 percent of all individuals with gross incomes of $25,000 or more received in excess of one-half of all dividends. Four percent of all Americans who filed income-tax returns in 1950 had gross incomes in excess of $10,000 and received almost three-fourths of all dividend incomes. At the other end of the income scale we find 83 percent of all individuals with incomes of less than $5,000 per year receiving only 15 percent of the dividends paid out.

Whichever set of figures you take—the Statistics of Income, the Survey Research Center's study, the book by the Harvard School of Business Administration, or the Brookings Institution survey, you cannot escape the conclusion that: (1) Only a limited number of Americans own stocks, and (2) an extreme minority owns the overwhelming majority of American stocks.

Yet the proposal contained in H. R. 8300 to reduce taxes upon dividends is just the first step toward the eventual, complete elimination of taxation upon dividends. Congressman Dan Reed, chairman of the House Ways and Means Committee, in announcing the adoption by his committee of this proposal and the one relating to liberalized depreciation allowances said, "The committee approved two new tax provisions which take the first step toward the elimination of double taxation of corporate dividends." If dividends were to be completely exempt from taxation, the loss in revenue would be $3.4 billion.

We recommend that the committee reject the proposal to reduce taxes on dividends. It establishes a very serious precedent for the future. If the taxation of dividends is to be eliminated, the Federal Government will lose one important and legitimate source of Federal revenue.

Depreciation

The bill provides for liberalized treatment of depreciation by instituting a declining-balance method of accelerating depreciation as contrasted to the straight-line method which has been in effect for many years. There are various reasons advanced justifying the change. Congressman Reed, in presenting the issue to the House of Representatives, said: "This provision of the bill is anticipated to have far-reaching economic effects. Incentives resulting from the changes are vital in order to help create thousands of new jobs each year and to maintain the present high level of investment in plant and equipment."

That investment will be stimulated by tax concessions on depreciation is a peculiar notion. The theory seems to ignore the fact that investment in new plant and equipment during the postwar period, except for a brief sag in 1949–50, established new peaks year after year.

The administration's proposal fof faster depreciation is a device to reduce the tax impact on business. It dresses up a tax reduction in fancy terms, by reducing the tax payment without reducing the tax rate itself. It is an indirect way of granting a tax reduction to business. The proposal is a special tax loophole, granted to business firms.

Had the administration openly proposed a reduction in the corporation tax rate from 52 percent to, let us say, 47 percent, the public would have known immediately the meaning of the recommendation. Instead, the administration has suggested an indirect way of reducing business taxes, without directly reducing the rate.

The proposal to speed up depreciation allowances grows out of the argument that business would invest more money in new plant and equipment if a faster writeoff of the cost of such plant and equipment were permitted. This view is based on the idea that business investment has been stifled in recent years.

The simple fact of the matter is that business investment has been at the highest level in the Nation's history in the years since World War II. Tax rates have been high. Tax concessions have not been granted except for new plant and equipment for defense purposes. Yet business investment has been high, and it reached a new all-time peak in 1953.

Business expenditures for new plant and equipment were $5½ billion in 1939. They were at an annual average of $10.2 billion in 1946–49. In the following 4-year period, 1950–53, they averaged $25.1 billion a year, reaching the record $27.8 billion in 1953. These figures are not adjusted for price changes. But even if they were, the same general trend would be reflected.

Business investment in new plant and equipment seems to be stimulated much more by the demand for the goods produced than by tax rates or tax concessions.

The corporate rate in 1939 was only 34 percent, yet business investment in new plant and equipment was low. In the 4-year period 1946–49, the corporate tax rate was 38 percent, and business investment had risen tremendously. In the 4-year period 1950–53, the corporate tax rate was 45 percent in 1950, 47 percent in 1951, and in 1952–53 it was 52 percent. In addition, there was an excess profits tax of an extra 30 percent from mid–1950 through 1953. While tax rates were at their highest levels in 1952–53, except for the World War II years, busineses investment in new plant and equipment reached its all-time peak

The Harvard Business School study, which has already been mentioned, comes to the general conclusion that the tax structure has not undermined the normal development of the economy. This study points out that the present tax structure has not materially affected the flow of business investment in new plant and equipment. Yet the administration is proposing to grant tax relief to business on the general theory that such tax relief is required to stimulate business investment.

If these facts show anything, they show that with straight-line depreciation and with the corporate tax rates continually rising during the post World War II period, including the excess profits tax from 1950–53, that business investments were stimulated and encouraged. Even after allowances are made for accelerated depreciation for defense-connected plant and equipment, there is still indication of a continual rise through the post-World War II period.

Investment in new plant and equipment has not and will not lag behind because of the lack of funds. American business has never been in a more favorable liquid position than it is today. The Council of Economic Advisers, in their annual report to the President this year, said, "The generally strong financial position of business firms will likewise help to support a high level of investment expenditure. In nonfinancial corporations, the ratio of cash and Government security holdings to all current liabilities was substantially higher in mid-1953 than before the war * * *."

This proposal to liberalize the treatment of depreciation is advanced by many because it will be helpful to small business. The House Ways and Means Committee, in its report on H. R. 8300, said "Small business and farmers particularly have a vital stake in a more liberal and constructive depreciation policy."

If it is really small business which Congress wants tó help, an adjustment in tax rates on corporate incomes would be more helpful than the depreciation provisions. For example, if the Congress really wants to assist small business, it could reduce the corporate rate now applicable to income under $25,000 a year and adopt a provision permitting the lower corporate tax rate to apply to income below $50,000 or even $100,000. This would help small business much more than any attempt to liberalize depreciation allowances. However, the crocodile tears must be shed for small business—like the widows and orphans, they always receive sympathy. And, just as the widows and orphans are used as examples for reasons to give benefits to the wealthy few, so the needs of small business are the rationalization for helping big corporations. Liberalized depreciations are tax cuts for big business without the tax-cut label.

Liberalized depreciation provisions will not help stimulate the economy, will not help maintain job opportunities, will not create new jobs, as Congressman Reed has stated in his report. Business is not going to invest in new plant and equipment if the demand for the products that existing plant and equipment can produce is inadequate.

We, therefore, recommend that in the best interests of the economy as a whole this provision to liberalize depreciation be removed from the tax bill.

Income from foreign investment

H. R. 8300 makes specific tax concessions to corporations deriving income from investments overseas. We are opposed to this provision as it stands and urge this committee seriously to reconsider it.

We agree with the objective that investments overseas should be encouraged. Foreign investments play a significant role in our whole economic program abroad by giving to many countries some of the dollar exchange they need to buy products in the American market. We would support liberalizing the tax provisions on income derived from foreign investments if the provisions were restricted to encouraging new investment in underdeveloped countries. But the provision in this bill applies to all income earned from foreign investments. It is not designed to encourage new investment, but to give tax relief to those corporations who now earn income overseas from their foreign investments.

In 1951 the total income from direct investment overseas amounted to $1.6 billion. Almost one-half of this, $741 million, was earned by the petroleum companies. Another $344 million was earned by manufacturing companies operating, in the main, in the chemical, machinery, and motor vehicle field. In other words, over $1 billion of the total investment income earned in 1951 will go to the big manufacturing companies of America and the petroleum companies who have had very profitable overseas as well as domestic investments.

This is nothing more than a direct tax concession to companies that already have huge foreign investments.

If the tax provision relating to income from foreign investment were to be restricted to helping the development of under and lesser developed countries, it could have our wholehearted support. But, as it stands now, while it may encourage some investment in these countries, it will mainly give a tax bonanza to the already wealthy and prosperous American corporations.

The provision in its present form gives double tax relief to these corporations for their income from foreign investments. For example, if a corporation has earned $50,000 overseas and paid $12,500 in foreign taxes, it is permitted: (1) To deduct the amount of foreign taxes from income earned and then pay a United States corporate tax upon the remainder, but also (2) to deduct, after it has computed the amount of tax to be paid, the $12,500 in foreign taxes once again, even though this sum has already been deducted from the income earned from foreign investments.

This provision is a doubleheader. Under the guise of increasing overseas investment, it gives corporations already receiving large returns: (1) Lower tax rates, and (2) double deductions for.taxes paid to foreign countries. This proposal is grossly unfair and should not be included in its present form in the tax bill.

Carryback

The committee has adopted a proposal to permit corporations to carry their losses back for a 2-year period instead of a 1-year period. This provision, if enacted, would cost the Federal Government $100 million in revenue. The present law provides for a 5-year carryforward and only a 1-year carryback of corporate losses. In both the World War II and the post World War II periods, the carryforward provision enabled corporations to write off past losses against growing profits during the period of expansion in the economy.

As long as the economy was expanding and profits were mounting year in and year out, there was little discussion about the carryback provisions for losses. Most of the discussion centered around the carrying forward of losses. However, now that the economy has begun to reverse itself, with profits declining, with production falling, there is more interest in being able to take this year's loss and carry it back and apply it against last year's or the previous year's profits. This proposal, in our judgment, gives the impression that the corporations want to have their cake and eat it too. Regardless of when they might incur loss, they want an opportunity to write it off against either past or future profits.

When a worker loses his income, he cannot write it off against the payment of taxes in years in which he has a higher income. I have never seen any consideration given to the worker in connection with loss of his income, but much consideration is being shown for the corporation that might incur a loss at some point along the business cycle.

We have proposed to this Congress from time to time a plan which would permit workers to carry over or to carry back unused portions of their personal individual income-tax exemptions. We think this would be a fair and equitable proposal, but no serious consideration has been given to it by this Congress. To enact a provision extending the carryback to 2 years for corporations is to make just 1 additional concession to corporations and to lose an additional $100 million in revenue.

Provisions affecting high-income individuals

There are a substantial number of provisions in the bill which grant tax relief to individuals upon which I should like to comment. Up to this point, I have reviewed a few of the tax provisions which affect some of the lower, as well as the higher income individuals. I have also discussed the provisions that directly affect corporations and wealthy stockholders. I should like now to refer only to three specific proposals which reduce taxes upon individuals in the upper and higher income brackets.

1. Annuities.—Under the present law, if an employer buys an annuity for an employee, the premium paid by the employer is taxable as income to the individual. H. R. 8300 changes this provision by simply saying that the payment of taxes can be postponed until receipt of the annuity. This is nothing more than a means of reducing taxes. It is also a means of granting a tax-free wage increase to the employee for whom the annuity is purchased.

When the individual finally receives the annuity, he presumably has retired from active employment and no longer is drawing his salary. Obviously, the tax paid at this point is considerably less than he would have had to pay if he had been required to make the payment during the period when he was also drawing a salary.

The ordinary worker in the shop would not be a beneficiary of such an annuity. Such annuities are designed exclusively for the executives of the business. If a worker had sufficient money and went out to purchase an annuity on his own, he would have to pay income tax on the amount of money with which he purchased the annuity.

There is no rhyme or reason why such a provision should remain in the present bill.

2. Charitable trusts.—This provision enables a wealthy individual to place in trust for 2 years any type of income-producing property, provided that the income from such property is assigned for the 2-year period to a charitable organization. This provision would enable a wealthy taxpayer in the top income bracket to make a charitable contribution and simultaneously reduce his own taxes.

For example, assume that an individual has property that produces a $10,000 income per year. He can place this property in trust for the charitable organization for a 2-year period. The charitable organization would receive each year's income, or a total of $20.000, in a 2-year period. If the taxpayer had not placed this property in trust, but had included the income produced in his tax return, he would have had to pay $18,000 in taxes. This would leave him with a net of $2,000. However, the moment he placed the property in trust for 2 years, he is entitled to deduct from his income the total $20,000 as a charitable contribution. By so doing, he saves himself $18,000 in taxes. He is thereby $16,000 better off as the result of having made a charitable contribution. He has satisfied his own desires to aid charity. The charitable organization is pleased with the contribution. Simultaneously, the taxpayer has been able to increase his income after taxes by 800 percent; that is from $2,000, if he were to subject the entire income from the property to tax, as contrasted to the $16,000 he saves himself in taxes by permitting the charity to use the income from the property for a 2-year period.

No one can claim that this provision is anything but tax relief to the very wealthy and high-income taxpayers. There is no justification for its being retained in the present tax bill. Even though it helps charitable organizations, such contributions ought not to enable a taxpayer to make money. This is precisely what happens under this provision.

3. Pension trusts.—The establishment of pension trusts by businesses and corporations for their employees is a currently well-accepted practice. Moneys contributed to such trust funds are tax exempt. Individuals receiving benefits from the pension trusts are not taxed until they receive such benefits. Our tax laws have always provided safeguards to insure nondiscrimination in the establishment of such funds. For example, corporations could not set up trust funds which discriminate in favor of shareholders, company officials, or high-paid employees.

The minority members of the House Ways and Means Committee, commenting upon the changes made in pension trust provisions in H. R. 8300 said, "It is our belief that the changes provided in the bill go far beyond encouraging employees' trusts and plans and will open up the use of these plans in a manner which will favor high-paid employees, executives, and shareholders to the detriment of low-paid employees." Not only does this bill permit discrimination in favor of executives, shareholders, etc., but it also permits discrimination in terms of benefits received.

I do not want to go into the details of this provision or the many, many other provisions in this bill. I have only used three examples of annuities, charitable trusts and pension trusts to indicate the degree to which this administration and the House Ways and Means Committee have gone. Under the mask of "technical revisions," these provisions are undermining our progressive tax structure.

THE NEED FOR INCREASING INDIVIDUAL INCOME TAX EXEMPTIONS

I recommend that this committee increase individual income-tax exemptions from their present level of $600 per dependent to $800 this year and $1,000 next year. Such a proposal has been presented to the Senate by Senator George, the ranking minority member of this committee and the dean of tax authorities in the Senate. Senator George has been joined in his proposal by Senators Kerr and Frear, who are members of this committee, and others in the United States Senate.

I support Senator George's proposal because it not only reestablsihes some equity in the income-tax structure, but also because the continued growth of our economy requires that susbtantial levels of consumer income and purchasing power be maintained.

The present level of individual income-tax exemptions is inadequate from whatever standpoint one approaches it. The reason exemptions were included in the original income-tax law was to permit enough income to be carried tax free so that a family could maintain an essential maximum standard of living.

The Commissioner of Internal Revenue in 1866, commenting in his annual report upon a $600 level of personal exemption provided under the 1864 law, said, "It was, of course, the purpose of the law to exempt so much of one's income as was demanded by his actual necessities." He went on to say, "In other words, the tax principle or policy which was originally adopted to apply to this problem was one of exempting the amount necessary to enable the individual to provide himself with what were considered to be the absolute necessities."

Coming up to more recent years, one can examine the Congressional Record for the year 1913, when the income tax was again being considered by the Congress. In the legislative discussion in the 63d Congress in the House on May 6, 1913, it was stated that the income tax "ought to leave free and untaxed as a part of the income of every American citizen a sufficient amount to rear and support his family according to the American standard and to educate his children in the best manner which the educational system of the country affords." There is no question that the theory behind the adoption of individual income-tax exemptions was that an adequate standard of living was to be exempt and "that a sum below that ought not to be taxed." This latter statement is also taken from the discussions during the 63d Congress on the floor of the House of Representatives on August 28, 1913.

The Treasury Department, in a 1947 study on individual income-tax exemptions, pointed out that it has been a common practice for a long time to tie the level of exemptions to the level of maintaining an essential maximum standard of living.

The levels of exemptions, as can be seen in table II below, were $4,000 for a married couple; $3,000 for a single person, in 1913.

TABLE II.—*Individual income-tax exemptions*

Year	Married	Single	Dependents	Year	Married	Single	Dependents
1913-17	$4,000	$3,000	----------	1940	$2,000	$800	$400
1917-20	2,000	1,000	$200	1941	1,500	750	400
1921-25	2,500	1,000	400	1942-43	1,200	500	350
1926-31	3,500	1,500	400	1944-47	1,000	500	500
1932-39	2,500	1,000	400	1948 to present	1,200	600	600

This level of exemption was maintained up to the time the United States entered World War I, at which point, in accordance with the general concept of reducing consumption, the levels of exemptions were reduced during the war years.

Following World War I, exemptions were once again raised until by 1931, they were $3,500 for married couplies, $1,500 for a single individual, and $400 for each dependent. Since 1931, exemptions have steadily moved downward while prices, in the main, have moved up. More and more people have been added to the tax rolls as a result of declining levels of exemption, but they have simultaneously been squeezed harder and harder by rises in prices.

In 1939, just before World War II started, the level of exemption for a family of 4 was $3,300. These exemptions were steadily decreased in 1940, again in 1941, again in 1942, and again in 1944 until during the middle of the war, the exemptions for a family of 4 were only $2,000. In order to maintain the purchasing power of the $3,300 level of 1939, the exemption would now have to be $6,350. We are not, nor is anyone here, asking the Congress to raise exemptions to that level. This is the equivalent of roughly $1,600 per individual. Today's $600 individual exemption level is far less than this figure.

Our present exemptions even fall far short of maintaining the purchasing power level of exemptions of the war years 1944–45. During the peak of the war, exemptions were $2,000 for a family of 4. The reasons for World War II exemptions being low are obvious to all. There was a need to reduce purchases. Levels of civilian production were declining. American citizens were called up to make extreme war sacrifices. Inflation had to be controlled. Many commodities were being rationed. The deduction of exemptions to the level of $2,000 for a family of 4 was completely consistent with these war economy objectives.

If today we are to have the same purchasing power for exemptions as we had during 1944 and 1945, it would take close to $3,100 for a family of 4.. Our present exemptions of $2,400 fall far short of even this. Today, it is not necessary to make extreme war sacrifices. Civilian production levels are unrestricted. Defense and military material are being produced in sufficient quantities without interfering with domestic civilian production. We have more than enough industrial production to meet current demands. As a matter of fact, at the current levels of income, we have more productive capacity than is needed. We have idle plants; workers are being laid off; supplies are stacked in warehouses; inventories are extremely large. We have a superior abundance of goods, but we are exempting from income taxes less income in terms of purchasing power than we exempted during World War II.

We are arguing here today for an increase in individual income-tax exemptions not only because the economic situation has for the moment turned downward. We believe that there is an equity question involved. Exemptions should be increased. The level of exemptions today is manifestly unfair and should not be continued at present levels. They should be raised to $800 per individual this year and to $1,000 next year, as Senator George and others have proposed.

Raising the tax exemption from $600 to $1,000 per person, for a married worker with 2 children, earning $80 a week, would mean a tax saving of $25 a month. Higher income of $25 a month would make possible buying $500 worth of household equipment over a period of less than 2 years.

Here are 2 examples of combinations of goods that such a family could buy with its $25-a-month tax savings:

TABLE III

Modern 36-inch gas range	$135
Semiautomatic washing machine	122
Electric ironer	58
Vacuum cleaner with attachments	88
Sewing machine	90
Total	493
Two-piece living-room set (sofa, easy chair)	150
Nine-by-twelve-foot broadloom carpet	95
Seventeen-inch television	175
Five-piece dinette set	75
Total	495

Increased purchases of these items mean higher living standards for those who buy them and more jobs for the workers who make them.

There is no question that the adoption of the increase in the exemptions as proposed by Senator George would be a great stimulus to the economy. Not only would it reverse the present trends of production and employment, which we all know have been downward in the past few months, but it would also be a tremendous stimulus to a growing and expanding American economy. What could be more stimulating than an increase in purchasing power? This increase in purchasing power will increase demand; sales and production will rise, and investments in new plant and equipment will be expanded. Recovery, as well as expansion, would take place within an encouraging economic framework.

Senator George's proposal, which we wholeheartedly endorse, contrasts to the administration's tax proposal. The administration's proposal says that tax concessions to corporations and wealthy stockholders would work like magic in stimulating the growth of the American economy, even though consumer and farm incomes and general retail sales are declining and surplus stocks still make up substantial inventories.

It is hard to believe that this view is taken seriously by anyone who is sincerely inteŕested in seeing to it that the American economy continues to grow and expand and provide job opportunities for all Americans willing and able to work.

Who and how many would be removed from the tax rolls by increased exemption

It was argued by Secretary Humphrey, last week before this committee, that to increase exemptions "* * * would entirely remove millions of taxpayers from the tax rolls * * *." Let's look at the facts:

If exemptions were raised to $700 a year, 4 million taxpayers would be removed from the rolls. Seven million would be removed if exemptions were $800. Fifteen million would, if exemptions were raised to $1,000.

There is no question that many millions of American taxpayers would be relieved of the burden of Federal income taxation if individual income-tax exemptions were raised to the levels proposed by Senator George. But rather than examining the number of people who would be removed, we ought to be more concerned about who these people are, at what income level will they no longer be required to pay taxes.

Table IV below shows the amount of income which would be exempt at the various suggested levels of exemptions and various types of taxpayers with varying numbers of dependents.

TABLE IV.—*Income exempt from Federal income taxes at $700, $800, $1,000 exemption levels—by size of taxpayer family*

Exemption	Single	Married	Married with 1 dependent	Married with 2 dependents
$700	$777	$1, 555	$2, 333	$3, 111
$800	888	1, 777	2, 666	3, 555
$1,000	1, 111	2, 222	3, 333	4, 444

Table IV shows, for example, that if exemptions were raised to $1,000, a single individual would pay taxes on all income in excess of $1,111. A married couple would have the first $2,222 exempt from income. While a married couple with 1 child would have the first $3,333 of income exempt from taxes, a married couple with 2 dependents would not pay taxes on income up to $4,444. Of course, if exemptions were not to be raised to the $1,000, as proposed by Senator George for next year, the levels of income exempt from taxes would be proportionately lower, as is shown by the table above.

It was quite strongly argued by Secretary Humphrey before the committee that every American should pay a tax—he should feel that he is making a contribution to the cost of running his Government. This concept, of course, assumes that every American, regardless of his level of income should be required to help defray the cost of Government. This concept is contrary to the basic premise underlying our progressive tax structure. However, one cannot ignore the fact that almost all of our taxpayers are today engaged in paying some form or other of taxes besides individual income taxes. They pay excise taxes on a wide variety of commodities, as well as payroll taxes, in addition to the many State and local sales and excise and other types of taxes. I do not think there is an American citizen who is unaware of how much he pays to help run his Government. There are certain groups of American citizens, who, because of their income levels, ought not to be required to pay any income tax.

It must be remembered and kept in the forefront of our discussion that income taxes were designed at the outset to apply after the receipt of sufficient income to maintain an adequate standard of living and that "a sum below that ought not to be taxed." This was clearly stated by the Congress when the income-tax laws were first adopted.

There can be no greater stimulant to reversing the present economic trends and stimulating the economy to continue growth than to increase individual income-tax exemptions. I cannot help referring to a statement, Taxing to Spend, released by the United States Chamber of Commerce Finance Committee in March 1949.

This statement said, "The tax reduction (of 1948) helped to avert a business downturn by releasing additional purchasing power for goods no longer scarce and for which new markets were needed as a means of maintaining employment." For reasons which are, I assume, obvious to some and not so obvious to others, the chamber of commerce does not take the same position today.

CONCLUSIONS

We urge the Senate Finance Committee in considering H. R. 8300 to insert a provision similar to that recommended by Senator George of Georgia—a provision to increase individual income-tax exemptions to $800 this year and $1,000 next year. The removal of H. R. 8300 of the two major provisions which make up the largest tax cuts, namely, the ones dealing with dividends and depreciation, would greatly offset the loss in revenue from increasing exemptions.

If these two provisions were removed and some of the other noxious provisions corrected, our economy, in my judgment, would be on the road toward not only recovery from the present temporary downturn in employment and production, but toward our long range goal of expanding and improving the standard of living of the American people by "maintaining maximum production, employment, and purchasing power."

APPENDIX

NEW LOOPHOLES ("TAX SAVINGS") OPENED BY THE 1954 TAX REVISION BILL AS DESCRIBED BY THE RESEARCH INSTITUTE OF AMERICA[1]

The following list indicates some of the loopholes created by the 1954 tax bill as described by the Research Institute of America:

NEW LOOPHOLES

As they apply to individuals

"Do you own depreciable business assets?

"It would be possible to increase your depreciation charge-offs by 10 percent. New purchases or construction would be allowed twice the regular straight-line depreciation in the earlier years."

"Will you move your business to a community which will give you land, buildings, or other financial inducements?

"You would no longer have to worry that these will be taxable."

"Do you plan to sell your unincorporated business and realize a loss on the sale of the assets?

"Proper timing of the sale can result in added benefit through the recovery of prior years' taxes."

"Can you improve your farm by leveling, grading, construction of drainage ditches, planting of windbreaks, etc.?

"These expenditures would be fully deductible even though they add to the value of your property."

"Do you make fairly substantial contributions?

"The new law would approve a method of making contributions in trust which would permit you to make money on contributions."

"Do you speculate in commodity futures?

"It would not be necessary to sell a commodity future held for 6 months rather than take delivery of the commodities in order to keep the gain in the long-term capital-gain class."

"Have you shied away from buying annuities because of the unfavorable tax cost?

[1] Quotations from Preventive Tax Planning: How the 1954 Tax Revision Bill Would Affect You, Research Institute of America, 1954.

"The present inequitable method of taxing annuities (the 3-percent rule) would be replaced."

As they apply to owners of corporations

"Would you like to draw funds out of your corporation at no tax cost, or at most a capital-gains cost?

"If you are willing to have your percentage ownership reduced by 20 percent, corporate funds can be withdrawn without being hit as a dividend."

"Would you like to liquidate your corporation?

"The obstacle to liquidating a corporation has been the need to pay tax on any appreciation in value of assets, including good will. It would no longer be necessary to pay a tax on this amount."

"Do you plan to sell your corporate business?

"The new law would eliminate the involved procedure now required to eliminate the double tax on the sale of corporate assets."

"Do you plan to liquidate your corporation?

"The new dividend credit could make it worth while to pay a dividend prior to liquidation. * * * The tax consequences would be different under the proposed law."

"Do you and several others plan to incorporate a business?

"It could be accomplished tax-free even though the incorporators receive stock out of proportion to the cash or property transferred to the corporation."

As they apply to corporations

"Do you sell merchandise on the installment basis?

"You could switch to the installment basis without the double-tax penalty involved in changing from one method to another."

"Do you plan to subdivide real property?

"The timing of the sale of lots could result in preventing part of the gain from being taxed as ordinary income."

"Have you received funds or property which you think are exempt?

"If you explain the item on your return, the Commissioner would not be able to keep the statute open for more than 3 years, even though the item wasn't included in taxable income."

"Do you own a medium or small business which does not have an approved pension or profit-sharing trust?

"The requirements for setting up approved pension or profit-sharing trusts would be liberalized. This could make adoption of an approved plan advisable as a straight tax-saving procedure for the stockholder-employees and the key employees."

"Does your business expect to have a high income this year?

"It might be advisable to do development or research work. The costs could be deductible even though a valuable asset may be created."

"Does your corporation have a tenant which pays the corporate tax on rent received?

"The amount paid for the corporation may no longer be taxable to the corporation."

"Are you planning a spin-off or split-off of your corporation?

"While this would be made easier, the recipients would have their interests 'frozen' for 5 or 10 years."

As they apply to partnerships

"Will you move your business to a community which will give you land, buildings, or other financial inducements?

"You will no longer have to worry that these will be taxable."

"Could you use new plants, equipment or autos, trucks, etc.?

"Depreciation deductions could be substantially stepped up in the earlier years by using a 200 percent declining balance method."

"Does your business have machinery, buildings, etc., which are worth less than book value?

"These could be sold and the loss used to recover taxes paid in the last 2 years by the partners."

As they apply to employers and employees

"Would you adopt a qualified pension or profit-sharing plan if it could be restricted to a narrow group of employees?

"This would now be permissible—especially for the smaller companies."

"Do you have a qualified profit-sharing plan?

"Consider changing the plan so as to provide for the distribution of up to $5,000 as a death benefit to employees covered by the plan. This would give the employees' widows or heirs tax-free income.

"Some weighting in favor of key employees would be allowed. It could be advisable to reexamine the plan."

"Would you like to give certain employees individual rather than group health and accident policies?

"This could be done without tax to the employees."

"Are you a key employee of a corporation and do you own more than 10 percent of your company's stock?

"The advantage of a restricted stock option arrangement would be available to you."

"Would you, in effect, like to receive your pay now, but pay tax on it at a future date?

"This would be permitted through the purchase of annuity contracts or other deferred pay arrangements."

Estates and trusts

"Could you set up trusts for your children?

"The new law would give added incentive to establishing trusts for children."

"Do you have minor children to whom you would like to make gifts in trust?

"Gifts in trust to minors would be encouraged by making certain of the annual $3,000 gift-tax exclusion."

"Would you like to pass on part of your estate to your children free of estate tax and yet not give them the immediate use of the funds?

"This could be accomplished through the gift of life insurance, because the payment of premium test would be dropped.

"Another way would be to set up trusts whose principal would go to the children only on your death."

"Do you plan to leave your wife a life estate in your property at death?

"It may be possible to arrange this in such a fashion as to qualify for the marital deduction."

Mr. Reuther. Thank you. I appear this morning in opposition to H. R. 8300, because in our opinion this bill does not meet the standards of fairness to the American taxpayers, but what is perhaps of greater importance, it does not meet the economic necessities of our current situation in terms of our national economy.

Mr. Chairman, I think that every American, whether he works with his hands in a factory or whether he is tilling the soil or whether he be an employer, is fully aware of the fact that in the world in which we live the price of freedom comes very high, and that every American must be prepared to pay his proportionate share of the cost of defending our common freedom.

We oppose H. R. 8300, because we believe that currently low and middle income groups in America are already paying a disproportionately high share of the cost of defending our common freedom, and we think that H. R. 8300 will make that even worse than it presently is.

We believe that the only reasonable and fair basis by which a free society can raise the needed revenue to defend our common freedom and to provide the essential services is on the basis of the principle of ability to pay.

Senator Flanders. May I interrupt just a moment? You have, I see, this prepared statement. Are you, however, leaving this for the record? I was not here at the start of the hearing.

Mr. Reuther. That is right. I am leaving that for the record, and I am just making certain observations of a general character.

We believe that H. R. 8300 further undermines this very sound and essential principle upon which a free society must base its tax structure, and that is this principle of the ability to pay.

This bill gives very generous tax cuts to wealthy corporations and wealthy families who do not need that kind of tax cuts. It denies tax relief to millions of low- and middle-income families who do need tax relief in order to become the kind of consumers we need at a time when the greatest and most serious shortage in our economy is consumers who can translate their needs into demand and demand into jobs.

Senator FLANDERS (presiding). You will specify these advantages in detail to the higher-income groups?

Mr. REUTHER. I will. That is why, while we disagree with H. R. 8300 because of its lack of fairness to the taxpayer—we think it is not just—we think that the most compelling objection is the impact of this law upon the general economic situation.

This is more than a matter of justice. This is a matter of necessity. We believe that the American economy is freedom's greatest asset and we believe that America is the last best hope of freemen everywhere. We believe that the most decisive single factor in whether we are going to be strong in the world and whether the free world is going to be strong in facing the threat of Communist tyranny will be decided by how effectively we mobilize our productive power and how intelligently we distribute the abundance that our economy makes possible.

I think we have talked about this before, Senator Flanders. Essentially what we are trying to prove in America is that bread and freedom are compatible, that you can have economic security and material well-being without sacrificing your political and spiritual freedom. We can do that only if we demonstrate the capacity and the good sense to maintain full employment in peacetime.

Senator FLANDERS. Might I suggest a third thing? I think there are three things that we wish and hope we can get in combination. One of them is bread, one is freedom, and one of them is peace. There is a very strong undercurrent of opinion, and it is a subterranean undercurrent, that you can not have prosperity and peace together. I hope that you will agree that we can.

Mr. REUTHER. I have been shouting that from the housetops. I personally believe that peace, freedom, and economic wellbeing are all inseparably tied together.

Senator FLANDERS. Excuse me for interrupting.

Mr. REUTHER. We are developing economic difficulties, and while there is a wide use of terminology—some people call it a readjustment, others say it is a recession and some say it is just a corrective period—the facts are that more than 4 million American workers are unemployed. Our problem grows out of the fact that there is a very serious imbalance between our productive power, the ability to create wealth, and the purchasing power that is necessary, if we are to consume the wealth that we know how to create. I personally have unlimited faith in the future of the free American economy, and I certainly do not accept any defeatist point of view that depressions are inevitable or desirable or necessary.

The American economy is capable of sustaining full employment and full production in peacetime, making the good things of life for people. There is nothing fundamentally wrong with the American economy that an increase in the purchasing power in the hands of the American people will not cure.

We disagree very basically with the philosophy of Secretary of the Treasury Humphrey, and we believe that his thinking is dangerously unrealistic and that what he has tried to do is to apply in this modern-day situation the trickle-down theory that Mr. Mellon tried. It didn't work in 1929 and it will not work in 1954. We believe that in a mass-production economy you have got to balance mass productive power with mass buying power.

Secretary Humphrey would have us believe that you can build prosperity from the top down. We believe, of necessity, that you have to build prosperity from the bottom up.

Senator CARLSON (presiding). Mr. Reuther, do you mind being interrupted?

Mr. REUTHER. Not at all.

Senator CARLSON. We are all concerned about this situation. You mentioned the fact that we need to get some mass buying power out, and, of course, that is what makes our economy very operative and very virulent, but let us go back from about 1932 to 1939. We did try it in the way of what we called at that time pump priming.

We poured out billions of dollars. If I remember correctly we started in with about 9 million unemployed and in a few years we got down to something over 7 million, a reduction of over a million and a half.

Isn't that another evidence that it didn't work on that particular occasion?

Mr. REUTHER. I think that fundamentally the most basic unsolved problem we have got is to find a way within our free economy—and God only knows we want to keep it free—to achieve an expanding, dynamic balance between productive power and purchasing power.

I believe that what we need to do is to give maximum incentive within the free elements of our economy to try to bring that about.

Senator FLANDERS. We didn't solve that problem—or did we solve that problem—between 1932 and 1939?

Mr. REUTHER. We did not fully solve it. We made some progress but we did not fully solve that problem.

Senator FLANDERS. Do you have, then, a different approach now from what was tried then?

Mr. REUTHER. Senator Flanders, I believe most sincerely that if America has the good sense—I know we have the know-how, we have the technical and productive know-how—if we have the good sense to gear the productive power of the American economy to the tremendous unfilled needs of the American people, we can solve unemployment in peacetime. We can sustain our economy on a full-employment basis, on an expanding basis, and we can raise the living standards of the American people to unprecedented levels. Look at the slums. Look at the hosiptal needs. Look at the school needs. Look at the road needs. Look at the St. Lawrence seaway. Look at all the things that need doing. There is enough work in America to keep everyone fully employed for the next 25 years providing we have the good sense to find a way to put our manpower to work creating wealth and then getting purchasing power in the hands of the people to consume that wealth.

Senator FLANDERS. What was it that we left undone between 1932 and 1939 that we should have done to bring about this thing of which you speak?

Mr. Reuther. We had mass unemployment and the very people who were unemployed were living in the slums. We had mass unemployment and the very people whose children were being denied rightful educational opportunities were going to school in dilapidated schoolhouses. We had unemployment and the people who were sick were denied adequate medical care. Our problem is that we have never really demonstrated the kind of courage, the kind of vision, the kind of initiative when we face a crisis on the ecoonmic front that we have demonstrated on the military front when confronted with a military crisis. We have never done this job.

Senator Flanders. We didn't do it between 1932 and 1939 and it would seem that we must do something different now. I am trying to make out what that different thing is. Is it merely a matter of degree that we must do what we did between 1932 and 1939 on a larger scale, or do you suggest a difference in kind as well as in degree?

Mr. Reuther. When we came out of that depression we had to pick ourselves up from the very bottom. Obviously in that kind of period we had greater governmental intervention in the economic sphere because we were almost knocked out completely. I believe that if we take action early enough we can avoid getting into those difficulties and the earlier the Government acts, the less it will have to do. In other words, a little action in time will save greater effort later on. I personally believe that what happened in the period 1932 to 1939 is that we did not go after our slums, we did not try to meet our housing and our school and our hospital and other national deficiencies with the vigor and the intelligence that we should have in terms of our manpower and material resources. We came out of that period with slums. Why didn't we clean out the slums? We came out of that period with great deficits in terms of medical needs and educational needs and other basic national needs. The facts remain that America never has fully, in terms of its peacetime problems and the peacetime needs of the American people, mobilized its resources, both human and material, in peacetime as we have done in war, time and time again. I say, if America can demonstrate courage and initiative and vision and leadership in terms of the pressing needs of war, why can't we do the same thing in terms of the pressing needs of peace?

Senator Flanders. I am trying to get ideas as to the improvement in the 1932 to 1939 policy. I wanted to get this clear. I take it that one of your points is that if we had started earlier in the 1932 period the situation wouldn't have been as serious. Is that one of your points?

Mr. Reuther. That is absolutely correct.

Senator Flanders. I want to make sure that I can give you credit——

Mr. Reuther. We did too little too late.

Senator Flanders. So there you have too little too late. In the words, "too little," you mean perhaps that we should have done very much more along the lines we were trying to do in 1932 to 1939? That is where the too little comes in?

Mr. Reuther. That is right, and we started to do what we did too late.

Senator Flanders. I get that point. You also feel that we should have done very much more, that our expenditures for these things you are speaking of were too little, that we should perhaps have gone to twice as big a deficit, well expended within the terms of your program.

Mr. REUTHER. Senator Flanders, I think it very essential to make a distinction between a bookkeeping deficit and a real economic, human deficit. When we had 14 to 16 million unemployed, that was the greatest deficit, because we were throwing away hundreds of billions of dollars' worth of economic wealth that was not created that could have been created.

Senator FLANDERS. I might just say that I am not one of those who are frightened by the word deficit. I have been on one committee and have participated in the writing of one book in which it is suggested that we should incur deficits under certain circumstances. It is also suggested that we should begin to retire those deficits under certain circumstances.

Mr. REUTHER. I agree completely with that. It is a matter of timing.

Senator FLANDERS. Yes; it is a matter of timing. I just wanted to get myself out from under the deficit complex that I think some of us suffer from, but I also want to put myself under a feeling that we should work both ways, with some pluses and some minuses as a matter of timing. Excuse me for this interruption. You may go on. I just did want to find out what we should do differently than we did in 1932 and 1939. Your idea appears to be that we should start earlier and do more.

Mr. REUTHER. I am not suggesting that that means only governmental action. I am saying that what we need to do is to find a more realistic, a more effective, a more courageous way to gear our economic resources to the overcoming of these serious basic national deficiencies in housing, education, medical care, and so on, and that we ought to do that now. If the Government moves early enough it will have to do very little because it will stimulate the economic process and private initiative will take over most of the responsibility, which I am in favor of.

Senator FLANDERS. You say it is not entirely governmental. We are, however, considering legislation at this point. You think there are other things as well as legislation?

Mr. REUTHER. I certainly do. I do not think that legislation is a cure all. But I think legislation, timed properly, can be the thing that will stimulate the kind of movements that will get other voluntary economic pressures in motion.

Senator CARLSON. Mr. Reuther, I don't like to let this opportunity pass by without making a comment.

I think you are making a statement here that I am concerned about from a national standpoint. I think our Nation is on trial as to whether we can live in a period of peace and prosperity or war and prosperity. I think your statement has a lot of merit on that basis. But you mentioned some things that the Government should be doing. I would remind you that for the first time, I think, since I have been in Congress—I came in 1935—we have passed the St. Lawrence seaway. It is not completely through but the indications are that we will approve that. You mentioned that as one of the projects. You mentioned a highway program. We are using this year—it has already passed the House and Senate—the largest amount of money ever authorized for highway construction. We are considering at this time a lease-purchase program for construction of Federal buildings. So I think this administration is taking some steps that I hope will be helpful.

Mr. REUTHER. We have been supporting the St. Lawrence seaway project. We think it is long overdue. We think we need it for our security and economic well-being and it certainly will stimulate economic activity. We have got a $40 billion backlog of highway construction to catch up with in this country.

In pursuing this idea of the need for a mass market to sustain a mass productive economy, I would like to quote one very short sentence from Business Week of May 16:

> The United States economy has been made prosperous by the wants of the many, not the few.

I think we should never forget that that is basic, that our prosperity is based upon the demands and the needs of millions of people who make up the great majority of American families and not the needs or purchasing power of a handful on top. I think that the real genius of the American economy is that it has been based upon high volume of production, high productivity per man-hour, and that that has been sustained by high levels of consumption and high living standards. If you will take the Italian economy or the French economy, where they have a highly cartelized system, where the most inefficient producer is guaranteed a profit, where they keep the volume low and the prices high and the living standards low, you will find that is why the Communists have great power in those countries, because they exploit the social injustice and the economic insecurity and the poverty that this kind of economic policy makes possible, holding down the volume and holding up prices.

Senator FLANDERS. Mr. Reuther, have you analyzed the corporation-tax features of this bill and the changes in the double taxation of dividends and other features to see whether or not there is anything in them which leads to or encourages those business procedures which you just spoke favorably of for the United States and unfavorably so far as Europe is concerned?

As you must know, the purpose of this type of change in taxation is not built on the trickle-down theory at all. Trickle down is not applicable. It is built on the theory which may be right or may be wrong, that these provisions increase employment. There is no trickle down in the thing at all, not a trace of it.

The question is will or will not these tax provisions tend to an expansion of production and employment and the developing of new lines and areas of production and employment? That is the question.

Mr. REUTHER. Senator Flanders, I will get to that very point. I think that we in the labor movement—certainly we in the CIO—recognize the importance of investment policy, of encouraging expansion of the productive capacity of the American economy. Back in 1947—I just brought a copy along to refresh my own memory—I appeared before a subcommittee of the Small Business Committee of the Senate where I was fighting for the expansion of the steel industry.

I was urging in 1947 a 100-million-ton capacity by 1950 and the steel industry was talking about 79 million tons as being adequate. We have always realized that you can make peace and freedom secure in the world not by dividing up economic scarcity but by sharing economic abundance. There is no economic Santa Claus. You cannot have a higher living standard than the productive capacity of the country makes possible. We have said that all along. We have said also that what we need in America is a fifth basic freedom, freedom from the fear of abundance. That is one of our problems right now. We have got a tremendously productive economy and we are afraid of the surpluses it will create. We are the only country in the world plagued by the problem of having too much to eat or having a productive capacity which has outstripped the demands of its populace. What we have been saying all along is that you have got to encourage expansion, you have got to have the kind of investment policy that will provide adequate capital to expand your productive capacity, to modernize it where necessary, so that we can get the maximum output in terms of science and technology.

But right now the question is, are you for expanding investment opportunities or for expanding purchasing power? It is a question of the timing.

It is just like this deficit problem you talked about. Deficits under certain circumstances make sense. Yet under other circumstances the whole emphasis ought to be to retire the deficit rather than to expand it.

The same thing is true on the question of purchasing power versus expansion of productive power. It is a question of timing.

If you expand investment at a time when the crying need is to expand purchasing power, you get into trouble. Or if you expand purchasing power at the time when the crying need is to expand investment opportunity and productive power, you get in trouble on the other end.

We are in serious difficulty today because we have this serious imbalance between the capacity of the American economy to create wealth and the lack of purchasing power in the hands of the American people to consume that wealth.

Our productive capacity has not outstripped our needs. We don't have enough capacity to meet needs. What it has outstripped is demand, because millions and millions of middle- and low-income families lack adequate purchasing power in order to translate their needs into demand. All the needs in the world, if you haven't got the money to translate them into demand, will not stimulate jobs and full employment.

Senator FLANDERS. Mr. Reuther, there are, I believe, certain recent figures that have been compiled to indicate that the liquid holdings of purchasing power, in the middle-income groups, at least, are rather large, and that there seems to be a tendency to hold onto those liquid assets instead of spending them. That, if true, is at least one element in the situation that has to be reckoned with.

I have hoped and still hope that the changes in the excise taxes will release some of that. It should and I hope it will. I don't think we have had any chance yet to get any figures to indicate that they have. With those who have purchasing power the stimulus to purchase is not always there.

Mr. REUTHER. We, of course, supported the efforts to reduce the excise taxes. We think that is a consumer tax and anything you can do in the way of stimulating consumer-purchasing power is desirable, but I am told that when the full impact of the excise-tax reduction reflects itself in the BLS cost of living indexes, it will reduce the index by about three-tenths of 1 percent, so that is not world shaking.

Senator FLANDERS. That is not world shaking. The question is what does it do in the mind? Does it make the holder of moderate liquid assets more willing to buy? It is not a simple matter of that three-tenths of 1 percent.

Mr. REUTHER. The people that I have been talking to, Senator Flanders, are people who have been unemployed. They are not holding back huge savings. They are wondering how they are going to be able to avoid foreclosure on their homes and how they are going to avoid losing some of the utilities and the appliances which they have purchased on the installment plan. It is true that there are great liquid assets in the way of savings in the hands of the American people, but unfortunately the 10 percent at the top of the economic pyramid, the very people whom this tax bill is going to help, have already got 66 percent of the total liquid savings, and 29 percent, the people at the bottom who get a few crumbs out of this tax bill, have no liquid assets whatsoever.

The basic problem in America is not that we don't know how to create wealth. The problem is that our productive know-how has reached a high level of development but our distribution know-how is lagging seriously behind.

Our productive machine is a jet job but we are bouncing around in an old model on the distribution end.

Four percent of the American families at the top of the economic pyramid in 1952 had more income than 41 percent at the bottom of the economic pyramid. The groups on top have got the savings, but their needs are essentially satisfied and they don't translate savings into demand—they have got what they need. But the people at the bottom of the economic pyramid, the great mass of American families, lack adequate purchasing power and this tax bill would give the people who need the tax relief most very little relief, and it gives the families and wealthy corporations who don't really need tax relief a great deal.

Senator LONG. I would like to ask your judgment on this issue. Secretary Humphrey agreed with me that by providing relief for corporation dividends that would encourage a tendency to declare these funds out in corporate dividends rather than to retain earnings and expand the plant and equipment with them.

If that is to be done, the best information that I can get—and Secretary Humphrey doesn't like these figures, but he hasn't yet produced his to dispute them—is that 80 percent of the stock is held by six-tenths of 1 percent of the population. The figures that you have presented here indicate that those people already have enough income to supply all of their personal needs, that they can buy just as many clothes as they have any desire to buy.

They don't need to improve their diet. They are probably shopping at the low calorie counter rather than the high calorie counter. That food is usually more expensive than the more nourishing food. Those people are not going to spend any more if they do have more. If you want to expand production and relieve unemployment it makes good sense that your tax program should be designed to put the money in the hands of people who can't buy because they don't have the income.

I can't see that this program is going to do it and I can't see that this program is necessarily going to expand production, even if there is a good opportunity to make a profit when there is no market for the product. Are you in agreement with that general theory?

Mr. REUTHER. I am in absolute agreement, Senator Long. I do not question Secretary Humphrey's integrity. I seriously question his economic judgment. He is helping the wrong people. He happens to be helping the people that he is a part of. He has huge stockholdings. I sit across the bargaining table with his kind of people. I have respect for them as individuals. I question their economic judgment in this kind of situation. I say that when you give people who are in the upper-income groups greater relief than the people in the lower-income groups, you are not stimulating the American economy. As you say, they have got all they need and much more on top of that. I think the question boils down to this, what are we trying to do? Are we trying to raise the standards of luxury of the few who already have more than they need, or are we trying to raise the standards of living of the many who have too little? That is fundamentally what this boils down to.

Senator LONG. I read a statement the other day by an economist whom I do not know personally, but the logic of it impressed me. He contended that over the last 50 years our annual production has increased at least 3 percent per year on the average. If our economic production had increased at the normal average rate, rather than decreasing as at this last year, there would have been a difference of $30 billion. There is $30 billion of wealth that was not created because apparently there was no market for the product. If the market had been there, we could have expected the ordinary increase in production. That is $30 billion that everybody lost. It was $30 billion lost to the worker, $30 billion to the farmer, $30 billion to the Federal Government in taxes. Everybody took his share of that $30 billion loss.

If we can expand the production up to where we are steadily increasing, as we have done in the past, we would make that $30 billion to be shared by all the people of this Nation. Of course, some might get more than others. But, the point is that it is being lost to all of us at the present time.

Mr. REUTHER. Do you know what we could do with that $30 billion? We could build half a million $12,000 homes. We could double the amount of money we are spending for education in all forms. We could build hospitals with 250,000 beds. We could give every old couple $200 worth of social security, and have $7½ billion left to do some other things. We are wasting all that.

Senator LONG. I want to put you on the spot now, Mr. Reuther, because I am in agreement with you so far. Here is a point where I am inclined to disagree with you. It seems to me that one way we are contracting this economy is by draining off a considerable amount of liquid wealth by adding to this social-security trust fund. I have been one of those who has been inclined to think that as long as you had a sufficient curb on there to assure that you weren't going to be broke any time in the future that there wasn't much possibility that Congress is going to shut off the social-security benefits, that they would always be willing to raise at least enough to pay for the benefits year by year. My impression is that there is one field where a considerable amount of the economic liquid wealth is being drained out, to the extent of about $2 billion per year. I understand that your group does oppose putting that on a pay-as-you-go basis. I wondered if there would be some inclination on the part of your group to favor some program where in times of recession such as we have now it would at least revert to a pay-as-you-go basis, rather than trying to build up a fund both in good times and bad.

Mr. REUTHER. Fundamentally, what we have been trying to guard against is an effort to scrap the basic insurance concept that supports the social-security program. We think you have to have some basic provisions there so that the plan is funded. Otherwise, you may find that just when you have the greatest call upon the resources of this kind of program, the funds won't be there and then maybe under the pressures of political expediency you may deny to workers who made a contribution and who have an equity, the realization of that equity. We do believe that the insurance principle has to be safeguarded.

Senator LONG. As long as you add more to the fund year by year than you take out, there is no danger of the fund ever being bankrupt.

Mr. REUTHER. As long as what you add is adequate to meet future liabilities.

Senator LONG. I have never thought that trying to cover the needs of 40 million workers, or 60 million workers, would permit you to find enough liquid wealth to put in the fund to cover all of that need. That has been my feeling.

Mr. REUTHER. If I may go on Mr. Chairman, we have here an analysis of what we think will take place in terms of the various economic groups, based upon the January 1, 1954, tax changes and what is proposed in H. R. 8300. Our figures indicate that families under $5,000 income, who represent 74 percent of the American families, are getting out of these two tax arrangements only 9 percent of the tax relief, or $701 million in tax reduction. Wealthy families in the $5,000 and over class are getting 43 percent, or $3,424 million, and corporations are getting 48 percent, equivalent to around $3,779 million. Here you have a situation where the great bulk of the people, more than 74 percent, are getting 9 percent of the tax reductions, and 91 percent is going to wealthy families and wealthy corporations. We have got that broken down, and I would like to put that in the record so that it can be studied, because this is where we think we are going to get into very dangerous water—giving the relief to the people who don't need it and denying relief to the people who do need it. This is more than a matter of equity, more than a matter of justice, more than a matter of economic morality. This is a matter of economic necessity in terms of the needs of our economy. That is why we are worried about this thing.

The CHAIRMAN. Your figures may be put in the record.

(The information referred to follows:)

Tax changes made Jan. 1, 1954, and provided in H. R. 8300

[In millions of dollars]

	To individuals		To corporations	Total
	Under $5,000	$5,000 and over		
Changes Jan. 1, 1954:				
Income-tax reduction [1]	$924	$2, 063		$2, 987
Excess-profits-tax elimination			$2, 300	2, 300
Increase in OASI tax [2]	450	250	600	1, 300
Net reduction, Jan. 1, 1954	474	1, 813	1, 700	3, 987
Percent	12	45	43	100
Provided in H. R. 8300:				
Corporation provisions			$2, 079	$2, 079
Head of family [3]		$50		50
Depreciation [4]		440		440
Trusts		3		3
Life-insurance exemption [3]		100		100
Charitable deduction		25		25
Dividend income exemption [1]	$109	731		840
Medical expense deduction [5]	25	55		80
Child-care deduction [5]	12	28		40
Retirement income credit [5]	39	86		125
Others [5]	42	93		135
Total reduction, H. R. 8300	227	1, 611	2, 079	3, 917
Percent	5	42	53	100
Combined reductions	$701	$3, 424	$3, 779	$7, 904
Percent	9	43	48	100

[1] Distributed as suggested by U. S. News & World Report, (Mar. 12, 1954, p. 97).

[2] UAW-CIO estimated, developed in consultation with officials in Department of Health, Education, and Welfare.

[3] Minority report on H. R. 8300.

[4] Proportion of total reduction in revenue attributed to individuals in majority report on H. R. 8300 based on highest annual cost.

[5] Distributed as suggested by U. S. News & World Report (Mar. 12, 1954, p. 97) for reductions in personal income tax.

Mr. Reuther. The steel industry is currently operating at 68.1 percent of its capacity. Do we need more steel capacity, or more customers to consume the products of American industry made out of steel? The steel industry will lose 30 million tons of steel this year, if it remains at the current level of production. What do we want? A greater unused steel capacity or do we need more customers? Here is the New York Times of yesterday. I quote a headline: "Pittsburgh shows greater optimism. Sharp drop in steel output rate believed over for at least 2 months."

For 2 months it is going to get no worse and then it is going to take another nosedive. Why? It goes on to say that customers are buying steel in advance because they think maybe there will be a steel strike or there may be a price increase and they are trying to hedge against that. But, there is nothing basically underlying or supporting an improvement in the steel industry. I predict right now that in the fall the steel industry will feel the impact of the fact that customers are buying in advance of their needs now.

Now, take the automobile industry. The automobile industry is currently operating at around 74 percent of capacity for automobiles, for passenger cars, and 70 percent for trucks. In recent weeks we have been producing around 520,000 cars per month and 95,000 trucks. Mr. Harlow Curtice, president of the General Motors Corp., is extremely optimistic. He has made the most optimistic prediction to date as to what the levels of automobile production and truck production for 1954 will be. He says they will be around 6.3 million, trucks and cars combined. That is 66 percent of our capacity. We will lose more than 3 million passenger cars in 1954. In other words, we have got the capacity to make 3 million more new passenger cars than we will find customers for. What is the need in the auto industry? Is it for more plant capacity? No, we have got a serious shortage of customers. Therefore, what we need is not more productive capacity, but more purchasing power in the hands of the American people.

The only company that has more customers than capacity is the Cadillac Motor Car Co. I say America cannot ride to prosperity in a Cadillac. It has to ride to prosperity in Fords and Chevrolets and Plymouths and Studebakers and Willys Overland and Nashes and Hudsons, and all the thousands and millions of cars that little people in America buy. But, what happens is that Mr. Humphrey has a Cadillac approach to this question, when what we need is a program that all the people can ride in.

The General Motors Corp. announces a billion dollar expansion program, and I say I am for that. I am for modernizing American industry. I am for making it as productive as our science and technology make possible. But, I say that when you talk about expanding industrial capacity in a vacuum, whether it be theoretical or social or an economic vacuum, you are dealing with dangerous generalities. You have got to talk about expansion of capacity in terms of the economic facts of life in the day in which we live. What is General Motors really going to do with this money? Are they going to expand their basic productive capacity? The answer is no. They are going to modernize the present capacity to make it more efficient and more competitive. Let me just take a minute, Mr. Chairman, to give you some idea of what is happening in the auto industry, because this is inseparably tied together with, where we, as a free people, are going in the world. The Ford Motor Co. built a new engine plant in Cleveland. It is adjacent to the airport. It is the most modern engine plant in the industry, but when General Motors gets through with their building modernization program, they will have more modern plants than the Ford plant.

Ford takes a rough engine casting, Mr. Chairman, right from the foundry. It goes into a kind of machine called "automation." It is a continuous machine. No worker touches the block. This machine does a job that once used to take 24 hours, from the rough casting to the finished block. Then, the machinery we had 2 or 3 years back took 9 hours. The time was reduced from 24 hours to 9 hours. This new Ford engine plant—it is a marvel of science and technology—takes this rough cylinder block and 14.6 minutes later it comes out of the other end, untouched by human hands, complete. It bores the cylinder. When the boring tool is back up in position an electric eye measures the cylinder. If it is too small the electric eye sends an impulse to the brain of the machine and it makes an automatic adjustment and takes another cut and if it is O. K. then it goes on to the next operation.

I ask you, Mr. Chairman, is that good or bad? I think it is good, providing we have the good sense to gear that production power to the tremendous unfilled needs of the American people. If we do that, it will build a better world, and a better life for us. If we fail to do that, it can dig our economic graves.

That is the Ford six-cylinder line. But, before they had that one under way, the engineers had worked out a more efficient way to do it. Now they have got a Mercury line, which is the new line, that is 20 percent more efficient than the first line.

General Motors is going to spend its billions of dollars to do what? To introduce "automation," these automatic machines. You can't find the workers. When you find one he is just looking at a big switchboard with red, green, and yellow buttons. When the green lights are on everything is going perfect. When the yellow light is on that is a signal that the tool is still working but is getting fatigued. When the red light comes on he shuts down and changes the tool and goes on. General Motors is going to put its billion dollars into that kind of "automation" process.

You are going to have greater production with fewer workers and fewer customers. That is where we are. These machines won't eat potatoes and pork chops and they won't drink milk and they won't eat up our farm surpluses and they won't wear cotton shirts to eat up our cotton surpluses. The problem we have here is how to maintain a dynamic expanding balance between productive power and purchasing power, at the point where you need more productive power shifting the emphasis there, and at the point where you need more purchasing power shifting the emphasis in that direction.

If we were standing today in the position where we had greater purchasing power than productive power, I would be here arguing that the emphasis be shifted to productive power. But, the facts show right now steel is at 68 percent of capacity, automobiles at 66 percent, based upon the most optimistic predictions. What is true of steel and autos is true of agricultural implements. We are 30 percent below the 1951 level of agricultural implement production. Why? The farmer's income is depressed and that reflects itself there. So, what we need is not more productive power, but more purchasing power.

Senator Long. Mr. Reuther, I agree with you that we have some of the best planners and engineers in the world to show us how to get the greatest amount of production with the least amount of human effort.

Mr. Reuther. Which is what we want.

Senator Long. It is a wonderful thing, and I agree that it should be done. But, unfortunately some of those same people criticize others for trying to plan what happens when you get all this production. Apparently there is something wrong about planning on that, although it is fine to plan to power out a whole flood of goods on the market. Obviously someone should be planning to move all these goods. I have missed one possibility that someone might have in mind for getting these goods on the market, and that is for the average laboring man to go deeper in debt. That hasn't been explored yet.

Mr. Reuther. We have already expanded our installment buying credit by $13 billion since 1948. You can blow that bubble up. That is what happened in 1929. People were sustaining current prosperity in the period before 1929 by borrowing on future earnings. But, when that bubble got so big it broke then the world came tumbling down around our ears. You just can't sustain prosperity today by spending money you may earn 3 years from now. You can't get that too far out of proportion. The point is, why can't people have purchasing power that reflects their contribution to the creation of current wealth. That is what we are saying. Our problem, Senator Long, is that as a society we have made great progress in the physical sciences and the art of working with machines and materials, but we have lacked the making of comparable progress in the human and social sciences, in translating these things into people. That is what we are talking about here this morning. What can we do as a free people to create the maximum of abundance in terms of economic wealth? Then, within the framework of freedom, within the framework of our kind of political and social system, where the value of the individual and the worth and the dignity of the man are maintained, we can achieve economic well-being, with the fullest measure of political and spiritual freedom.

If we can't find the answer to that, we have lost the fight against Communist tyranny. This is not an ivory tower theoretical struggle against ideological windmills. This is a struggle to put food in the peoples' bellies without putting their souls in chains. But, the trouble with American big business is that they don't have any faith in America and any faith in themselves. If they did, they would say, this is a pushover. We have got enough to eat, we have this productive capacity, and why don't we gear it to the needs of people in peacetime. I think we are doing them a great favor. We have got to save them from their own selfishness, that is what we have to do. If we let them run the world, they will destroy themselves, but we are all in the same boat.

Senator LONG. I regret to see that this administration is taking the attitude that these farm surpluses are greatly built. That is an awful thing, that the country is worse off because we have them. That is the attitude the Secretary of Agriculture takes. Yet, our Secretary of the Treasury wants a tax policy that will rush industry into exactly the same position, that these vast surpluses will be on hand with enormous plants without the customers for them.

Mr. REUTHER. The food surpluses that we have in America, if we have the wisdom and intelligence and courage to use them constructively, have got more wallop than all the H-bombs in the fight against hunger and poverty in the world. Just turn the coin around. Supposing that Russia and her satellite countries had billions and billions of bushels of grain in surplus, that they had a great expansion of industrial and agricultural capacity. What do you think they could do to subvert the world to their corrupt, evil-doing ways? The point is that we have been sharing scarcity so long that we are afraid of abundance.

Before you came in, I said we need a fifth basic freedom. The four freedoms are not adequate. We need freedom from the fear of abundance. It is a tragic thing that a society has a problem because there is too much to eat. It is the first time it has ever happened in the history of the world.

Senator LONG. Here we have had these reductions. When the excess-profits corporation tax expired we have had $2 billion of tax reductions.

We had another 3 billion when that first 10 percent round of the personal income taxes occurred, although 50 percent of those people did not benefit from that because of the increase in social-security taxes. Then, we have had from this bill another 1.4 billion of tax reductions. I am inclined to think that if those tax reductions that would run around 6,400,000,000 were distributed among the people who really need more food, need more clothes, need more appliances, and need them right now, that you wouldn't have any surplus on hand. You would have full capacity operation.

Mr. REUTHER. If every schoolchild in America lived in a family that could afford to buy him all the milk he needed and every schoolchild in the elementary schools, not counting universities, consumed 8 more quarts of milk per year—that is a very small amount because many children are not even getting a half pint a day—there would not be one drop of milk surplus in America. We haven't got too much milk. Millions of families can't buy the milk that their kids need to grow up strong and healthy. Why haven't they got it? Because they haven't got the purchasing power. Our job is to get the purchasing power into the hands of those people. The tax bill before this committee proposes to give the people, who have already got more milk and champagne than they can drink, more relief, instead of giving it to the people who need it for food and these other basic necessities.

The serious thing is that all manufacturing has dropped in February of 1954, 10 percent below March 1953. Durable goods are down 13 percent. Retail sales are off 5 percent comparing the first 3 months of 1954 with the first 3 months of 1953. They say we are going through an inventory adjustment period. But, the basic question is why did we get an accumulation of these inventories. How come when we had high levels of employment with everybody earning wages, how come with purchasing power at a higher level we accumulated inventories? Why? Because even at relatively high levels of full employment, we still had an imbalance between purchasing power and productive power. Has our inventory situation gotten any better, Mr. Chairman? I regret to say it has gotten worse. Inventories from September to January came down $1 billion but sales came down $4 billion. Inventories are something you measure not in the absolute. You measure your inventories in their relationship to the level of sales. It is how many months sales have we got on hand. I say by that yardstick our inventory problem has gotten worse, not better. Why? Because unemployment breeds unemployment. When workers are laid off, their purchasing power is curtailed. It means that their demands are curtailed. It means that the things they would normally consume are not consumed and the people who make those things get laid off. Then, they reflect their lack of purchasing power upon the economy. The thing begins to breed within itself and the first thing you know, it snowballs and we are in trouble.

In the automobile industry you might think that we are beginning to boom again. It is true that automobile production has gone up. In February we made 401,000 cars. In March, we made 493,000 cars. But, at the end of March, we had 650,000 passenger cars in stock, which was an increase cf 13,000 over February. So, we are building up bigger inventories. All along the line you will find this.

We have got now in excess of 5 million unemployment. The figures from the Department of Commerce say that we have got 3,725,000 people who are completely unemployed. We have got 235,000 who are laid off for 30 days or less. But, the real loss is also in terms of the people who are working a short workweek. The figures put out by the Department of Commerce in December showed that 11 million workers in December were working less than 35 hours a week. When you compare the average workweek in the first 2 months of this year with the first 2 months a year ago, you find that this year we are losing 45 million man-hours of employment a week. That is the equivalent of full-time employment for more than a million workers.

Let me give you a couple of examples. In Detroit we have 140,000 unemployed, just in the city of Detroit. The Hudson Motor Car Co.—this is an example of the problem—had 15,000 workers at the peak of their production. They laid off 7,500 workers. But, the 7,500 workers that they kept on the payroll worked 16 days in the whole of January and February put together, although they are still counted as being employed. When you work 16 days in 2 months you are really not employed.

Senator LONG. How many workers are there, regarded as being employed?

Mr. REUTHER. Seventy-five hundred. They had 15,000, and they cut it down to 7,500, and the 7,500 only worked 16 days in 2 months. In the steel industry, I am told that there were 190,000 workers laid off completely and 257,000 working less than 40 hours a week. When you add all of those together, those completely laid off and those partially unemployed, I say that the number of unemployed is in excess of 5 million, and that is where this $30 billion of economic waste comes in, because the average worker can create, roughly, $6,000 worth of wealth in a year. I say that to look at this thing realistically we have got to agree that the one thing that we canot afford is to lose $30 billion worth of economic wealth a year, and that that is exactly what we are losing today.

Senator FREAR. Mr. Chairman, may I ask a question?

The CHAIRMAN. Senator Frear.

Senator FREAR. Your figures are quite interesting, there. Do you have a basis of man-hour comparisons? You gave an example of Hudson, where half the work force was laid off and the other half was reduced in the time they worked. Of course, if you multiplied 15,000 by their average workweek, versus 7,500, we would have a man-hour workmonth. Do you have any comparative figures on that?

Mr. REUTHER. Senator Frear, it is very difficult to get that kind of information.

Senator FREAR. May I ask a further question along that line? Just take these workers that were reduced in time, not those that were laid off. We know that their purchasing power has diminished to the extent of their wages. But those whose pay envelopes are not quite as full as they were for a month, what happens in the reduction of their pay envelope? What do they spend their first dollars per month for and on up the line? Where do we get the line to where they can buy things that will expand industry?

Mr. REUTHER. An unemployed worker falls back on the very inadequate unemployment compensation benefits.

Senator FREAR. That is the totally unemployed. I was thinking of the Hudson worker who worked 8 days in January.

Mr. REUTHER. What he has to do is tighten his belt. Instead of getting 4 quarts of milk for the kids every other day he winds up getting 1 quart. He begins to eat less meat and he begins to try to substitute the most inexpensive foods for the kind of food or diet that he ought to have. Immediately that begins to reflect itself in the farm markets.

Senator FREAR. Is his first reduction in the food basket? Do you think that is where he reduces it first?

Mr. REUTHER. First of all, the average family has got fixed payments to make on their refrigerators, on their radios and their televisions, and their homes. In order to avoid losing those, the fellow has to sustain the monthly payments. So, he meets that, although he would like to forget about those and concentrate on food and clothing. But he has to do those things or otherwise lose the things he has paid 75 percent of the bill for and he would like to keep. So, he tries to maintain those payments. He cuts down on food, doesn't buy the proper kind of clothing, doesn't call the doctor when the kids are sick. He figures, well, maybe a few aspirins or the things he can get out of the drugstore will take care of it. You can never measure the real tragic toll in terms of human welfare, because there are no measuring sticks by which you can measure that. How many kids in America now are going without the kind of diet that they ought to have to grow up strong and healthy because their fathers are partially unemployed? You can't measure that. Future generations will pay the price. Yet, there are farm surpluses.

Senator FREAR. The average worker will try to make his monthly payments that have been stipulated? He will try to make the payments that he has obligated himself for as long as he can. For instance, on his automobile he will try to keep up his payments on that to hold it, especially if it is necessary to furnish transportation to work?

Mr. REUTHER. He needs it to get to work, or to look for a job. An automobile is a necessity. How do you get around? If he sells his car and says this is a luxury he doesn't need and sits around, then he is condemned for having no initiative or gumption for not getting around. He needs his car to shop around to try to find some odd jobs and maybe ultimately a good job.

Senator FREAR. But the ordinary worker will try to maintain his obligations as far as possible to the extent of suffering, perhaps, under the doctor's bill and food bill and clothing bill.

Now, may I just take one further minute, Mr. Chairman? When Secretary Humphrey was before the committee he said that the reduction in taxes could not all be given to the consumer side of it. We would have to realize that the manufacturing side of it also has to have some decrease in taxes because we had to maintain a balance between the manufacture of heavy industry and the consumer purchasing power. Do you agree with that?

Mr. REUTHER. I said before that the whole secret of the future of our economic prosperity in peace time is to maintain a dynamic, expanding balance between productive power, the ability to create wealth, on the one hand, and purchasing power and the ability to consume the wealth and create it, on the other. What is wrong now is that currently our economic difficulties are a reflection of the serious imbalance between great productive power and the lack of adequate purchasing power. I cited figures to show how we were underutilizing the productive capacity of most of America's productive industry, steel, agriculture, automobiles, et cetera. What we need today is more customers, not more productive power. When we need more productive power, I will join forces with Secretary Humphrey in urging that the tax structure encourage the expansion of capital goods; and productive power. But, right now, we need customers.

Senator FREAR. I think in an earlier statement you said the same thing in other words. You spoke of this machine that the automobile manufacturers made, "automation." You were for that, which meant increased production. Did Secretary Humphrey mean, when he was talking about heavy production, the manufacture of machines for the manufacture of durable consumer goods?

Mr. REUTHER. I think what Secretary Humphrey is trying to do is to apply at this point to the economic development of America a theory which is sound in a period when we need to put great emphasis on capital expansion. What he is trying to say to the American people today is that you feed our economy on top by providing greater initiative and greater incentive to the people who invest their surpluses in capital expansion, that they will invest money, they will expand industry, and that economic activity at the top will stimulate economic activity at the bottom. That is where he is wrong. You have got to build this from the bottom up, not from the top down. I say that I do not question his integrity. I seriously question his economic judgment.

Senator LONG. Is it not possible that there is some merit to both sides of the argument, that perhaps we ought to do some of both?

Mr. REUTHER. I think there are certain American industries where we need to expand, but that is not true of the general cross section of American industry. I believe that there are adequate incentives already. You have got all kinds of tax writeoffs, all kinds of amortization provisions, and so forth, that I think are adequate to provide the capital. If you will get the facts—I could have presented them here this morning, but time would not permit—on the relationship between demand in terms of peoples' needs and the flow of investment capital into industry, you will find that they parallel each other. Investors do not invest money to expand industries that have 30 percent unused capacity already. You would be a poor investment man if you said that where to put your money is where there is already an excess capacity of 30 percent. But, if you had enough customers to use up that excess capacity and there was a market there, then you would find capital flowing in there.

Secretary Humphrey ought to understand that.

TheCHAIRMAN. Mr. Reuther, we have eight more witnesses to hear before noon. Let's let Mr. Reuther go ahead with his statement.

Senator LONG. Mr. Chairman, may I ask one more question that I'm afraid the witness is not going to touch on? I have been concerned that in this surplus of automobile production we might lose some of the competition that we have in the automobile industry. Although these smaller companies account for only a small percentage of automobile production, it is nevertheless a vital production, particularly in keeping competition alive to see that the customers get a good price for the automobile that they purchase. In your judgment, is there any danger that if this thing continues the way it is going, we might see some of these automobile companies closed or consolidated with major competitors?

Mr. Reuther. I think that the future of the small automotive producers, as in any other basic industry, is inseparably tied together with a full employment, full production economy. I say during periods of economic recession, when the market is contracting, the little fellow gets in trouble because there are many advantages that a volume producer has over the smaller one. It is not that they are better people. When you make a couple of million cars a year, you get tremendous economic advantages out of that volume. You are able to spread your tooling costs and your engineering costs and your overhead costs over a larger volume and yet get these real advantages. The future of these companies is tied together with our ability as a free people to maintain full employment and full production. It is the only hope there is. I agree with you. I think they perform a very vital and essential function in our economy. I think it would be a very sad situation if 2 or 3 companies wound up with a complete monopoly of the total market of any kind of production.

Mr. Chairman, we, of course, believe most sincerely that the Congress of the United States has an opportunity to make a vital contribution to meeting this serious economic problem. We are not coming here as a pressure group trying to ask for favors. We have come here motivated by what we believe are the economic facts of life. We are in favor of increasing the personal exemptions from $600 to $800 this year and $1,000 next year. We believe that an increase in the personal exemptions from $600 to $800 will put mostly into the hands of low- and middle-income groups about 4½ billion of high velocity purchasing power dollars. They are not going to put those dollars in salt brine. These low- and middle-income families are going to use those dollars. Those dollars will reflect their needs in terms of demands and that demand will show up in the market place and the market place will reflect that demand in terms of jobs and opportunity for farm products, for industrial products, for the services and goods that the American economy is capable of making in peacetime. Therefore, we are motivated more by the necessities of our national economy than we are by the question of the individual taxpayer.

This $4½ billion that will be forthcoming by increasing the personal exemptions from $600 to $800 is really an investment. You talk about investment in industry. This is investment in people, in purchasing power, in prosperity for America. I say that we can afford that investment. What we cannot afford is the continued loss of the $30 billion a year, based upon the 5 million unemployed.

Personal exemptions today are the lowest in the history of the income tax since 1913, when measured in terms of buying power, with the exception of only 1 year. In 1913, when we adopted our present tax structure, a family of 4 got $10,820 exemptions in 1953 dollars. In 1932 they got $6,465. Today they get $2,400. With the exception of 1947, this is the lowest it has ever been. The 80th Congress raised it in 1948. We have a chart which I would like to put in the record, to show the committee what has happened in the last 41 years.

(The information referred to follows:)

Personal exemptions for 4-person families under the Federal income-tax laws since 1913 and the buying power of such exemptions in terms of 1953 dollars

Year	Exemptions for 4-person family	Buying power in 1953 dollars	Year	Exemptions for 4-person family	Buying power in 1953 dollars
1913	$4, 000	$10, 820	1933	$3, 300	$6, 825
1914	4, 000	10, 665	1934	3, 300	6, 600
1915	4, 000	10, 540	1935	3, 300	6, 430
1916	4, 000	9, 820	1936	3, 300	6, 365
1917	2, 400	5, 010	1937	3, 300	6, 150
1918	2, 400	4, 270	1938	3, 300	6, 260
1919	2, 400	3, 710	1939	3, 300	6, 355
1920	2, 400	3, 200	1940	2, 800	5, 345
1921	3, 300	4, 940	1941	2, 300	4, 185
1922	3, 300	5, 270	1942	1, 900	3, 120
1923	3, 300	5, 180	1943	1, 900	2, 935
1924	3, 300	5, 165	1944	2, 000	3, 040
1925	4, 300	6, 559	1945	2, 000	2, 975
1926	4, 300	6, 505	1946	2, 000	2, 745
1927	4, 300	6, 630	1947	2, 000	2, 395
1928	4, 300	6, 710	1948	2, 400	2, 670
1929	4, 300	6, 710	1949	2, 400	2, 695
1930	4, 300	6, 890	1950	2, 400	2, 670
1931	4, 300	7, 565	1951	2, 400	2, 475
1932	3, 300	6, 465	1952	2, 400	2, 419
			1953	2, 400	2, 400

NOTE.—In the 29 years prior to World War II, the exemption for the 4-person family was $3,200 or larger in terms of 1953 buying power. In all but 2 of those years, it exceeded $4,000 in 1953 buying power.

Senator LONG. With regard to purchasing power, what was the year where the exemption was less favorable than it is at the present time?

Mr. REUTHER. 1947. Then in 1948 it was increased. The 80th Congress corrected this. I would like to submit for the record the results of the voting in Congress that brought about the change in 1948, because I think it is very interesting to see how that increase in the exemption was handled.

The first tax-reduction bill (H. R. 1) introduced by the Republican majority in 1947 contained no provision for increasing the $500 personal exemption.

An amendment by Senator McClellan (Democrat, Arkansas) to increase the exemption to $750 was defeated 44 to 27, with Republicans voting 37 to 4 against the increase and Democrats voting 23 to 7 for it.

An amendment by Senator Lucas (Democrat, Illinois) to increase the exemption to $600 was defeated 58 to 28, with Republicans voting 47 to 1 against the increase and Democrats voting 27 to 11 for it.

H. R. 1 was vetoed by President Truman as proposing excessive tax reductions and giving them to the wrong people, the upper income taxpayers.

The second tax-reduction bill (H. R. 3950) introduced by the Republican majority in 1947 likewise contained no provision for increasing the $500 personal exemption.

An amendment by Representative Forand (Democrat, Rhode Island) to increase the exemption to $600 was defeated 261 to 151, with Republicans voting 232 to 2 against the increase and Democrats voting 148 to 29 for it.

An amendment by Senator McClellan (Democract, Arkansas) to increase the exemption to $600 was defeated 47 to 43, with Republicans voting 38 to 10 against the increase and Democrats voting 33 to 9 for it.

H. R. 3950 also was vetoed by President Truman.

In 1948 a third tax-reduction bill (H. R. 4790) was introduced by th Republican majority and this one was described by Chairman Knutsoı of the Ways and Means Committee as "veto-proof." It contained provision for increasing the personal exemption from $500 to $600.

An amendment by Representative Rayburn, Democrat, of Texas, to increase the exemption to $700 was defeated 258 to 159, with Republicans voting 236 to 0 against the increase and Democrats voting 159 to 22 for it.

H. R. 4790 was vetoed by President Truman as a rich-man's tax bill but was passed over his veto.

I would like to dispose of several arguments raised against the increased exemption which we propose. One of the arguments against increasing the personal exemption from $600 to $800, and then to $1,000, is the fact that this would take 7 million taxpayers off the tax rolls. We have got to realize that under the present exemption structure, that in 1950, 15 million people didn't pay taxes, but nobody said that was wrong. They didn't pay taxes because their incomes were so low that we recognized the fact that they needed the money to buy the things that are necessary in life, and therefore, they shouldn't be taxed.

If we raised the exemptions to the $1,000, which is the top figure proposed for next year, a family of 4 would still have an income less than what the Bureau of Labor Statistics claims is the minimum requirements for a family of 4. So this thing isn't getting way out of line. Even with a $1,000 exemption, based upon the present purchasing power value of a dollar, a worker with 4 in his family would still not get an income adequate to meet what the BLS considers a minimum worker family budget for 4.

Another argument used is that wiping these 7 million people from the tax rolls would throw the whole tax burden on the remaining few. The University of Michigan made a study in 1948 that indicates very clearly the distribution of the tax burden in America.

Their study showed that 35 percent of the total Federal, State, and local taxes paid in America are sales and property taxes, and that families under $3,500 in 1948—which is about equal to families under $5,000 in 1954—paid 40 percent of the total sales and property taxes, or around $8 billion. So these people would still carry a very substantial portion of the total tax burden in America even if they paid no Federal income tax.

When you exclude low-income families from payment of Federal income tax, it does not mean that they are excluded from sharing any of the tax burden at all—they share far too much of it. What you are recognizing is the fact that people with low incomes cannot pay taxes except by cutting deeply into their purchasing power in terms of basic necessities, and that reflects itself unfavorably in terms of the total economic picture.

Then, there is the argument, Mr. Chairman, about double taxation, as though only dividends were subjected to double taxation. Nothing could be further from the economic truth. A loaf of bread is taxed

151 times. That is not double taxation. That is multiple taxation. An automobile is taxed 206 times. A woman's hat, according to the President's campaign speech made in Des Moines, Iowa, in September 1952, is taxed 150 times.

This proposal to begin to cut down taxation on dividend income is the first step toward eliminating taxes on corporate dividend income completely. I quote you the words of Mr. Dan Reed, the chairman of the House committee, when he said, on January 14, 1954, the following words:

> The committee approved two new tax provisions which take the first steps toward the elimination of double taxation of corporate dividends.

I would like to submit for the record, Mr. Chairman, a breakdown of the discriminatory treatment that wage earners would get as compared to stockholders if this dividend tax reduction is enacted. It will show you, for example, that favored families will get a greater tax saving out of this reduction in taxes on dividend income than a worker may receive as his total income. I say that is bad economics, and it is morally wrong.

(Comparison of treatment referred to follows:)

Tax on earned and unearned (dividend) income at various income levels if Republican plan goes through

Income before deductions and personal exemptions	Tax on earned income	Tax on dividends	Difference	Increase in take-home pay
				Percent
$4,000	$240	$110	$130	3.5
$10,000	1,372	700	672	7.8
$50,000	15,976	11,670	4,306	12.7
$100,000	44,724	35,905	8,819	16.0
$500,000	356,956	312,115	44,841	31.3

A worker earning $4,000 in wages would continue to pay a tax of $240; a stockholder receiving $4,000 in dividends would pay a tax of $110; a stockholder receiving $5,533 in dividends would pay only as much tax as a worker pays on $4,000 of wages $240; while a stockholder receiving $50,000 in dividends would get a tax reduction of $4,306, which is more than the worker's total wages.

Mr. REUTHER. Then the question is raised, when you give relief to dividend income, you are really helping everybody. It is the point Senator Long made, that everybody owns America. I wish more people owned a bigger share of America. It would be a better, healthier country, and freedom would be stronger in the world.

What are the facts? The facts are that 92 percent of the families of America had no corporate stock whatsoever, and that six-tenths of 1 percent do own 80 percent, and Secretary Humphrey is wrong. Mr. Fairless came up with a little sleight-of-hand operation the other day. I think that the people who fed this information to the President—and I consider the President to be a man of good will—did him a great disservice by giving him bad information.

I have got a statement here which analyzes exactly what kind of magic was used to come up with these figures. I will put that in the record.

(The information referred to follows:)

UNITED STATES STEEL CORP.'S REPORT ON STOCKHOLDERS' INCOMES NOT SUPPORTED BY ITS SURVEY

At his press conference March 18, President Eisenhower cited figures reported by United States Steel Corp. as refuting the charge that the bargain-rate tax on dividends contained in the tax-revision bill will give tax concessions chiefly to wealthy families.

The figures cited by the President were published in the Steel Corp.'s annual report for 1953. Examination of that report reveals that the survey conducted by the corporation made a biased sampling of the corporation's stockholders, provided no basis whatever for some of the published conclusions, and provided a most unreliable basis for others.

1. Fifty percent of the questionnaires mailed in the survey were not returned.

2. The survey covered only the holdings of individuals. Approximately 30 percent of all United States Steel shares are held by institutions (9.2 million out of 29.7 million). The largest shareholders among the institutions are brokers and nominees (6.3 million) and trustees, guardians, and estates (1.4 million). Such institutions hold shares chiefly for wealthy individuals, but they were excluded from the survey.

3. The questionnaire used in this survey contained three questions which have relevance to income: (a) Did you pay income tax? (b) What is the maximum Federal income-tax percentage which applied to your 1952 income? (c) If your income is below $5,000 omit question (b)—just check that fact.

From this it appears that the survey supplied no information whatsoever about the distribution of holdings by income brackets below $5,000. Nevertheless, the survey is claimed to show that the largest number of stockholders was in the $2,000 to $3,000 bracket, and that a stated percentage of stockholders had incomes below the $4,500 average steel worker's wage, all without a shred of evidence. The average income of stockholders below $5,000 income is said to be $2,800, which happens to be the 1952 median income of all United States spending units below $5,000 income as reported in the Federal Reserve Board's finance survey.

4. Incomes of shareholders above $5,000 were estimated from their answers to the question, "What is the maximum Federal personal income tax percentage which applied to your 1952 income?" This assumes that the stockholders (1) were truthfully computing their income tax, (2) understood what tax rate the question referred to, (3) had no nontaxable income, (4) had no income from capital gains, and (5) had typical exemptions and deductions as determined from Statistics of Income for 1950. Most if not all of these assumptions would result in underestimating the reporting stockholders' incomes.

5. The estimate of incomes of those above $5,000 has all the downward biases that are characteristic of income estimates derived from income-tax reports. The percentage of shareholders with incomes above $25,000 and their proportion of holdings is certainly underestimated.

6. Even if the survey had been conducted honestly, it would shed little light on the income distribution of shareholders in general. Conservative shares, such as GM, or United States Steel, are more widely distributed among lower-income brackets than all stock holdings.

[Excerpt from New York Times, March 18, 1954]

TRANSCRIPT OF PRESIDENTIAL PRESS CONFERENCE

Question: I wonder if you would like to answer them on this point: They said the dividend features of this tax bill would give only 6 families out of every 1,000 great benefits, and 80 percent of the people would not be benefited by the bill, and that those with incomes of less than $5,000 would really suffer.

Answer: United States Steel is probably taken as the example of big business as owned by rich families.

There are 300,000 men working for United States Steel; there are 300,000 stockholders in United States Steel.

Fifty-six percent of those stockholders are men who draw less than $5,000 a year in their total incomes. Of that number, he thought there was a total of 46 percent below the $4,500 mark, which was the average wage of the steel earners.

There are more stockholders in United States Steel that are in the bracket $2,000 to $3,000 income than there are in any other thousand-dollar bracket in the whole list of stockholders.

Now, to say that the bill that we have designed and worked on all these months is designed to help rich people, is an error.

Tax on earned and unearned (dividend) income at various income levels if Republican plan goes through

Income before deductions and personal exemptions	Tax on earned income	Tax on dividends	Difference	Increase in take-home pay
				Percent
$4,000	$240	$110	$130	3.5
$10,000	1,372	700	672	7.8
$50,000	15,976	11,670	4,306	12.7
$100,000	44,724	35,905	8,819	16.0
$500,000	356,956	312,115	44,841	31.3

The administration proposes to tax dividends at a lower rate than wages and it opposes the CIO proposal to give a tax cut to all families

A worker earning $4,000 in wages would continue to pay a tax of $240
A stockholder receiving $4,000 in dividends would pay a tax of 110
A stockholder receiving $5,533 in dividends would pay only as much tax as a worker pays on $4,000 of wages 240

While a stockholder receiving $50,000 in dividends would get a tax reduction of $4,306, which is more than the worker's total wages.

Mr. REUTHER. There is just one other point I would like to make, Mr. Chairman. There are really two basic facts in this tax question. As I said to begin with, the price of freedom is high. We ought to be prepared, from the lowest paid worker to the highest paid corporate executive, from the dirt farmer to the fellow who has a hundred thousand acres, to pay for the price of freedom, no matter how high it is.

What good are economic resources if we lose our freedom? The question arises: How do we, as a free society, go about working out a rational, equitable, sensible tax law that places the burden of defending our common freedom upon the people in such a way that it makes for equity and fairness, and, on the other hand, takes care of the basic economic needs of our total economy and our whole country? That is really the issue.

There are two points of view. The Secretary of the Treasury says if we get to the point where we can cut taxes more, we ought to have an overall cut in the tax rates. We say that is not the way to do it. What you will do there is give large tax cuts to the people who don't need them, and a few crumbs to the people who do need tax cuts. That is why we think the exemption approach is the real answer, because it puts the emphasis where it needs to be put. It gives the greater relief, proportionately, to the people who need it and the least to the people who do not need it. Here are a few examples:

LOWER TAX RATES VERSUS HIGHER EXEMPTIONS

An across-the-board cut of 15 percent in income-tax rates would have approximately the same effect on total revenue as an increase of the exemption to $800. But greater benefits of the 15-percent cut would go to taxpayers above $8,000. Some 3 million taxpayers would fare better; but 35 million taxpayers would fare worse than under the increased exemption.

Income after deduction but before personal exemption	Present tax	Reduced tax		Tax reduction	
		With $800 exemption	With 15 percent rate cut	With $800 exemption	With 15 percent rate cut
$3,000	$120	$0	$102	$120	$18
$5,000	520	360	443	160	77
$50,000	18,884	18,412	16,089	472	2,795
$100,000	51,912	51,336	44,229	576	7,683
$500,000	402,456	401,728	342,088	728	60,368

NOTE.—Figures are for 4-person families.

A worker with 4 in family with a $3,000 income gets a $120 tax cut under the $800 exemption. Under the 15 percent rate reduction he gets an $18 tax cut. A $5,000 family gets a $160 tax cut under the increased exemption and $77 under the rate reduction. A $500,000-a-year family of 4 gets a $728 cut under the increased exemption and $60,368 under the 15 percent rate reduction. I ask you in good conscience, does anyone believe that the people who are in the $500,000 bracket need $60,000 tax cuts, and the people in the $3,000 bracket need only $18? This is bad economics, and it is morally wrong.

I believe that this whole tax question is inseparably tied together with the question of where we are going in America. This is more than a matter of justice. This is a matter of economic necessity. I, personally, believe that while no single thing that you can do is a cure-all, raising the personal exemptions at this time and putting the emphasis of tax relief on the low- and middle-income groups, where it is needed, will expand purchasing power and will do more than any one thing to get this economy of ours back on the main track so that we can achieve full employment and full production in peacetime.

I say that the promise of peace and abundance has never been greater, that science and technology are giving us the tools of production with which we can build a brave new world, and between now and 1960 we can raise the productive power of America to more than $500 billion a year of gross national product. We can raise the living standards—not the money wages, but real living wages, purchasing power wages—of every American family by between $2,500 and $2,700 a year—that much increase for everyone between now and 1960 if we have got the courage and the good sense to mobilize this productive power of ours.

This tax legislation right now can do more than any other single thing to stimulate economic activity, to broaden purchasing power, and begin to create the demand upon which full employment must rest. I urge this committee to give careful consideration to changing this law to include the $800 personal exemption, to shift the emphasis from corporations and wealthy families to the low- and middle-income groups, as a matter of justice and as a matter of economic necessity.

Thank you, Mr. Chairman.

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

We are always glad to have you here.

Mr. REUTHER. I appreciate your patience and I am very pleased to have the opportunity.

The CHAIRMAN. Roland K. Risa. Is Mr. Risa here? I presume Mr. Risa is not present.

Samuel I. Kahn. Stay where you are, Mr. Kahn, if you are more comfortable there.

Mr. KAHN. I would rather step up, thank you.

The CHAIRMAN. Will you identify yourself to the reporter, please?

STATEMENT OF SAMUEL I. KAHN, CHAIRMAN, JOINT LEGISLATIVE COMMITTEE FOR HANDICAPPED

Mr. KAHN. My name is Samuel I. Kahn. I am the chairman of the Joint Legislative Committee for the Physically Handicapped.

Mr. Chairman and members of the Senate Finance Committee, the Joint Legislative Committee for the Physically Handicapped is composed of several affiliated organizations, namely, the Charles Rose League, Inc., of Irvington, N. J.; the Eastern Paralyzed Veterans Association; and the Paralyzed Veterans of America, whose present infirmities are nonservice connected, and the Physically Handicapped League at Clifton, N. J.

Gentlemen, we firmly believe that transportation expenses should be allowed to a person who is permanently paralyzed in his or her lower extremities, thereby necessitating the use of canes, crutches, or wheelchairs, and who must also use hand-operated automobiles or who must hire taxis or private vehicles for transportation to and from their places of business.

Our committee was organized for the purpose of obtaining for the disabled wage earner additional income-tax deductions to enable him to provide himself with the equipment and services needed to continue functioning as a productive citizen. We are vitally interested in having the present tax regulations revised in order to permit physically handicapped persons to deduct transportation expenses to and from their places of business. Disabled by such conditions as cerebral palsy and polio, and going around on canes or crutches or braces or wheelchairs, they are trying to spread a message across the United States, a message that has meaning to many Americans. The United States Government has failed to remove one barrier between the disabled and employment. The income-tax laws make no distinction between Mr. John Doe with good sturdy legs and the wage earner who is disabled. The cost of living for the physically handicapped is frequently higher than that of the average man. In many cases, the disabled cannot use job transportation. A bus or subway may not be managed, physically.

Often, getting to and from work is costly. Yet, at the end of the week, the deductions for income tax on the pay check are the same as for those who do not have these extraordinary expenses.

As a result, many disabled individuals find it hard to meet expenses and continue working. Under existing tax laws, this is not permissible. We feel that Congress should lift the unfair burden of taxes from the shoulders of the paralyzed wage earner. Congress, and only Congress, can help by modifying the tax laws in their application to the physically handicapped. In order to work, we must find substitutes for legs. Legs, those appendages to the body which normal people, including Congressmen, take so much for granted. We must buy hand-lever-operated automobiles. With them we are able to get around quite well. We are able to perform as good a job in many fields as the physically normal individual. We are an asset to the Nation. Without the use of hand-lever-controlled automobiles, many paralyzed persons would be unable to go to and from their places of business. This, therefore, becomes as important to us as an automobile is to a salesman, except that the latter does not require special equipment in order to normally operate his car.

If we are deprived of the right to earn a living, we must, necessarily, be dependent either upon relatives or upon public welfare, thereby becoming a parasitic drag upon the Nation's economy. This is the last thing in the world we desire. We want to work. We want to add to and not detract from the communities in which we live.

You are undoubtedly familiar with President Eisenhower's plans for revisions of the present tax laws. You are probably also familiar with the slogan and publicity which has been in effect for a considerable period of time advocating employment of the physically handicapped. You may recall that the United States Government has even printed the slogan, "Hire the Physically Handicapped; It Is Good Business," on their postage stamps.

The CHAIRMAN. Are you talking both for veterans and people who——

Mr. KAHN. No, I am not. I am only here on behalf of persons who are permanently paralyzed in their lower extremities and we are not affiliated with those whose so-called disabilities are service connected. There is one organization, the Eastern Paralyzed Veterans Association, whose present infirmities are not service connected.

The CHAIRMAN. And you confine yourself to those who are not service connected?

Mr. KAHN. That is correct. It is also common knowledge that State agencies throughout the Union have spent thousands of dollars to educate, train, and give vocational guidance to the physically handicapped, and then tried to find suitable employment for them.

Now, the gainfully employed disabled persons have finally attained their goal of earning their own living and being self-supporting. Many disabled persons are compelled to use taxis or privately owned automobiles in order to go to and from work because they are physically unable to use public conveyances. Under present tax laws, these physically handicapped people are not permitted to claim any deductions for car expenses. These physically handicapped people, in most cases, are compelled, because of their disability, to purchase automobiles even though they are unable to afford them, because they would be unable to go to business without them. It seems only fair that they should receive consideration by Congress so that they could claim car expenses as legal deductions. The average person who is not physically disabled uses his automobile as a convenience to get to a place of employment, whereas the physically handicapped has no choice in this respect.

The CHAIRMAN. Do you suggest any degree of disability?

Mr. KAHN. Mr. Chairman, if you will be patient until I have concluded this little text, I have prepared a little bill which I think is concise and will answer your question.

The CHAIRMAN. I will be patient.

Mr. KAHN. He must either purchase his auto—referring now, to the physically handicapped—in order to get to and from work, or else he cannot be gainfully employed. If Congress doesn't enact legislation along these lines, many physically disabled persons who would otherwise be employed would ultimately become public charges and a tax burden upon the communities in which they reside. Why should salesmen be permitted to deduct their automobile expenses and not the physically handicapped persons?

Once enabled to take their places as useful, independent citizens, there is no question that the handicapped will contribute immeasurably to the resources of this Nation. Congress has been wanting to do something about this problem for years. Our objective is not humanitarian, and closely ties in with the Federal program of rehabilitation of the physically handicapped. The benefits thereby derived are as follows:

A. Revenues gained by employment of the severely disabled individuals who otherwise would remain unemployed.

B. Incorporation of unemployable disabled individuals into the Nation's manpower pool.

C. Elimination of employable disabled individuals from local relief rosters.

For the community and society as a whole, nothing is so costly as an idle person who might otherwise be eligible for gainful employment. The point is that if the cost to the Nation to support these individuals is staggering, the savings to the Nation in employing the disabled would be equally staggering.

All obstacles in the way of employing these useful human beings should be removed. An important obstacle blocking such employment is their extraordinary cost of living. If deductions of these costs from their income taxes makes it economically feasible for them to accept employment, the proposed bill would add resources to this Nation at a time during which we have no right to spurn the slightest augmentation to our defense manpower pool. Without help to pay for his extraordinary expenses, he is forced to remain housebound, dependent upon relatives, charity, or welfare, and fails to contribute to the society in which he lives. It is our contention that a certain proportion of these specially assisted individuals would be able to accept employment with their tax burdens reduced and thus not only save the Government money by reducing the Federal bill for aid to the permanent and totally disabled, but also add to the Federal income by the amount of taxes they would pay as the result of employment. It is our intention to relieve the tax burden of the severely handicapped whose ability to enjoy life, liberty, and the pursuit of happiness is impaired by placing them in the same tax category as the physically normal individual. It should be noted that permission to deduct transportation expenses will not encourage such expenses, since the savings in taxes are only a fraction of any expenditure made.

The number of persons who will actually benefit thereby will be so small that it will be infinitesimal. Transportation expenses should be treated as a business deduction, instead of a medical deduction. This class of persons will definitely add to the economy of the Nation, and by their ability to keep steady employment, will definitely increase the revenue of our Government.

We are not asking for charity, only for your consideration of a very serious and humanitarian problem. The fundamental principle is that any person is entitled, under the law, to a deduction on his income for every expense, ordinary or necessary in the production of his income. Certainly, a commutation expense is essential to the jobholder who cannot find a home near his job and who, therefore, must travel long distances to warrant his taxable pay. Medical science has made it possible for the paralyzed to contribute to, rather than live off, our economy. Today, a great number of paralyzed people are wage earners. Any failure to regard their problems in a special category would not only be unjust but would brand our Government's thinking as obsolete.

We believe that the measures included in the enclosed bill are the best practical solution to the problem at the present time. We trust that you will give them your support and help to expedite their enactment into law.

Now, with your permission, Mr. Chairman, this is very brief, and I should like to read this proposed bill.

The CHAIRMAN. All right.

Mr. KAHN (reading):

A BILL To grant deductions of transportation expenses to taxpayers who are severely disabled

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled, That section 62 (2) (d) is hereby amended to read as follows:

"Transportation expenditures of disabled individuals. For the purpose of this section, the term 'disabled' shall be defined as 'a person or individual who is permanently paralyzed in his or her lower extremities, thereby necessitating the need of a wheelchair, crutches, or canes for locomotion.'

"The determination of whether an individual is disabled under the provisions of this section shall be made at the close of the taxable year. A taxpayer claiming deductions as a disabled individual shall submit such proof of his allowances as the Commissioner, under regulations approved by the Secretary, may prescribe. These regulations shall include the following provisions:

" '1. That proof of disability shall be certified by a physician authorized by any county medical society.

" '2. That the certifying physician shall specify the nature, cause, and physically limiting effects of the disability, and shall, in addition, make an appraisal of the disabled individual's ability to use a streetcar, bus, subway, train, or other similar public means of transportation.

" '3. That proof of disability shall be submitted simultaneously with regular income-tax return submitted by the disabled individual invoking the provisions of this section and shall not be submitted again in subsequent years unless specifically required by the Commissioner.

" 'In the case of a disabled individual whose taxable income is reported as salary or wages, transportation expenses shall be reported as net operating loss under the provisions of section 122.' "

Thank you very much.

The CHAIRMAN. Thank you very much. Mrs. Springer, will you ask Mr. Stam to make a study of this?

Is Mr. McGee here?

STATEMENT OF MORRIS G. McGEE, EXECUTIVE SECRETARY, EASTERN PARALYZED VETERANS ASSOCIATION

Mr. MCGEE. Yes, sir. I am Morris G. McGee. I am executive secretary of the Eastern Paralyzed Veterans Association. I am representing the paralyzed veterans of America. It is a group of veterans who have taken an interest in this bill of which Mr. Kahn just spoke to grant deductions for extraordinary living and transportation expenses. As a group of veterans, we are covered in the main by congressional laws that have protected us and given us special housing, given us automobiles. I am one of the fortunate men who received those benefits.

I was fortunate in that I was a Marine Reserve, called up to active duty for the Korean war. I was fortunate in getting disabled in service, so I received those benefits. I can well imagine how the people who are not connected with the service have to live. Their expense is the same as mine. Consequently, as a group, the paralyzed veterans of America is backing this legislation to the fullest extent. We want not just sympathy, because we know that these people are capable of doing a decent job, earning a decent living, rather than being charges of the local, State, or Federal government.

Mr. Chairman, you can add the paralyzed veterans as being in favor of that bill.

(Mr. McGee's prepared statement follows:)

STATEMENT OF MORRIS G. MCGEE, EXECUTIVE SECRETARY, EASTERN PARALYZED VETERANS ASSOCIATION, MEMBER OF THE JOINT LEGISLATIVE COMMITTEE FOR THE PHYSICALLY HANDICAPPED

Mr. Chairman and gentlemen of the committee, I am Morris G. McGee, executive secretary of the Eastern Paralyzed Veterans Association, representing the paralyzed veterans of America. We are in favor of legislation to grant deductions of extraordinary living and transportation expenses to taxpayers who are severely disabled.

Our objective is not humanitarian but economic, and closely ties in with the Federal program of rehabilitation of the physically handicapped. We believe that the revenues cut from the Federal income by the proposed bill will be equalized by:

(*a*) Revenues gained by the employment of severely disabled individuals, who otherwise would remain unemployed;

(*b*) Incorporation of unemployed disabled individuals into the Nation's manpower pool; and

(*c*) Elimination of employable disabled individuals from local relief rosters.

To support this argument, the following quotation from the Operations Manual, New York State Division of Vocational Rehabilitation, is presented:

"For every dollar spent on him, the rehabilitant may be expected to pay $10 in Federal income taxes during the remainder of his anticipated period of employment (based on 1948 fiscal year). The rehabilitation program was carried on at a total cost of $24,568,814, of which the Federal Government paid $17,706,843. But the rehabilitants during the same year paid an estimated $5 million in income taxes for their first year of employment. To this must be added the numerous other and hidden taxes paid annually in addition to State income taxes and other States taxes."

A great portion of the rehabilitants referred to in this quotation, of course, would not be eligible for deductions under the provisions of the proposed bill because their disability is not severe enough to come within the limitations of the definition contained in the bill. However, the quotation gives an idea of the revenues to be expected from the employment of individuals presently not employed.

The point is that if the cost to the Nation to support these individuals is staggering, the savings to the Nation by employing the disabled would be equally staggering. All obstacles in the way of employing these useful human beings should be removed. An important obstacle blocking such employment is their extraordinary costs of living. If deductions of these costs from their income tax makes it economically feasible for them to accept employment, the proposed bill would add resources to this Nation at a time during which we have no right to spurn the slightest augmentation to our defense manpower pool. It should be further pointed out that no publicity exhorting industry to employ the handicapped can be effective so long as the expenses of the disabled individual are greater than his income after taxes. Without help to pay for his extraordinary expenses—the clothes torn by artificial aids to locomotion, the services he must hire, the special quarters in which he must live, the cost of acquiring such means of transportation as he needs to substitute for legs—he is forced to remain housebound, dependent upon relatives, charity, or welfare, and fails to contribute to the society in which he lives.

The Federal Government in conjunction with the States now gives aid to permanently and totally disabled people. According to figures of the Government, in April 1953, 35 States plus Hawaii, the Virgin Islands, Puerto Rico, and the District of Columbia were dispensing such aid, and a total of 170,152 individuals were receiving assistance. In order to be eligible for such relief these individuals, according to the law had to "show clearly through medical and other evidence that the individual's impairment does in fact render him incapable of performing any substantially gainful activity." It is our contention that a certain proportion of these publicly assisted individuals would be able to accept employment were their tax burden reduced and thus not only save the Government money by reducing the Federal bill for aid to the permanently and totally disabled but also add to the Federal income by the amount of taxes they would pay as the result of employment.

The definition of a disabled individual as contained in the proposed bill was developed in consultation with Dr. Samuel Sverdlik, chief of the department of rehabilitation, St. Vincent's Hospital, New York City. "Lesions of the central nervous and musculo-skeletal systems" is the best way to include all diseases and injuries which affect the individual's ability to walk. The definition encompasses amputees and cerebral palsy people as well as victims of diseases like polio and multiple sclerosis and spinal injury cases. Not all such individuals are capable of earning income. And, not all individuals in the category defined will be eligible for deductions, since, according to the provisions of the definition, they must not only be disabled in the manner described above but must be disabled to a degree severe enough to prevent use of public means of transportation.

This severe definition will eliminate from eligibility a great many handicapped individuals who are able, even though with difficulty, to get around. Such individuals will not be relieved of their extraordinary expenses in living and to that extent will suffer a certain inequity, just as other disabled by diseases of the internal organs will face an inequity. However, it is not the intention of the proposed bill to provide a bonus to all disabled persons, whose extraordinary expenses are present but not so overwhelming as to prevent their functioning as self-sufficient, employable individuals. Instead the intention is to relieve the tax burden on the severely disabled, whose ability to enjoy life, liberty, and the pursuit of happiness is impaired by placing them in the same tax category as the physically normal individual.

Since the granting of extra exemptions to disabled individuals would provide tax relief in excess of the extraordinary expenses incurred by these persons, the proposed bill provides for deductions in accordance with their excessive costs of living. Even among the severely disabled, in many cases, deductions for extraordinary expenses will not amount to as much as one $600 exemption. In the case of individuals who operate an automobile, extraordinary expenses will amount to much more than one $600 exemption. It should be pointed out that the permission to deduct extraordinary expenses will not encourage such expenses since the savings in taxes represents only a fraction of any expenditure made.

At the suggestion of a member of the Committee on Ways and Means, at the hearing on June 17, 1953, transportation expense was separated from other extraordinary expenses and treated as a business deduction instead of a medical deduction. Also, in order to avoid any criticism of possible fraudulent reporting of disability, administrative procedures were incorporated into the proposed bill, specifying medical certification of the disabled individual in a manner that will discourage application for eligibility by persons who fail to come under the provisions of the bill.

I want to impress this committee with the urgency of such legislation; the urgency of giving tax relief to keep the severely disabled employed. At present, there is no legal deduction for specialized transportation as opposed to public means of conveyance. The one basic question will be, of course, how to define the disabled. As an example, each of the armed services has its individual rating schedule and the Veterans' Administration, at present, is using the 1945 rating schedule of disability. Similar rating schedules could be arranged and administered by the taxpayer's own physician.

I want to thank you for allowing me the privilege of appearing.

The CHAIRMAN. Thank you very much for the testimony.

Mr. Ayers, will you make yourself comfortable and identify yourself to the reporter?

STATEMENT OF ALLAN F. AYERS, JR., ATTORNEY, NEW YORK CITY

Mr. AYERS. I am Allan F. Ayers, Jr. I am a practicing attorney in New York City.

Mr. Chairman, I am appearing here, I think, consistently with the purposes of H. R. 8300, which were stated to be to eliminate inequities. I should like to devote myself to the very narrow point of a suggested revision in section 303 which relates to the redemption of stock to raise funds for payment of State taxes and administration expenses. Over a period of years, beginning in the early thirties, the settlement of estates which have stock in closely held corporations has become more and more difficult because of the attitude of the Government, which treats the redemption of stock as the payment of a taxable dividend. In many cases, the estates can't be closed because there are unpaid debts for which there are no available funds. In the Revenue Act of 1950, Congress alleviated this situation to some extent by permitting the redemption of stock for purposes of the paying of State taxes. The proposed bill goes one step further and permits the redemption of stock for the payment of administration and funeral expenses.

No provision is made for estates which have debts, so at the present time an estate holding stock in a closely held corporation can redeem that stock for the purpose of payment of estate taxes and assuming passage of the bill, payment of administration and funeral expenses. However, the effective dates of the legislation would be such that no estate, the time for the assessment of taxes of which had passed prior to the enactment of H. R. 8300, would be protected.

I should like to respectfully suggest to the committee that section 303 could be expanded in 1 of 3 ways: (1) to permit the redemption of stock in order to pay debts which have been recognized and allowed as deductions for estate tax purposes; (2) if that is too broad, and there seems to be some feeling on the part of the Treasury that that is too broad, because it might open loopholes and possible avoidance, to permit the redemption of stock to pay debts which have been incurred, say, 2 years prior to the death of the decedent; or (3) to permit the payment of debts which had been incurred prior to the enactment of the bill, itself.

In addition to that, I should like to suggest that the act should be made effective with respect to the estates of persons the time for the assessment of estate taxes of which have passed, but give an 8 months' period after the enactment of this act so that those older estates which are now barred from any benefits could at least be brought within the proposed benefits of the new law so that they can be settled and the administration closed.

Mr. Chairman, I have submitted to the committee a formal statement, and in view of the present condition of time, I think there is nothing further that I need to say at the moment if the record can incorporate my statement as submitted.

The CHAIRMAN. The statement will be incorporated as submitted.

(Mr. Ayers' prepared statement follows:)

PREPARED STATEMENT OF ALLAN F. AYERS, JR., ON SUGGESTED CHANGES IN SECTION 303 OF H. R. 8300

In H. R. 8300 the Ways and Means Committee proposed under section 303 to liberalize the provisions with respect to redemption of stock of closely held corporations to pay death taxes. One of the liberalizations as compared with the existing law was an expansion of the section to permit sale of stock by an estate to a closely held corporation in order to provide funds for payment of administration expenses as well as payment of death taxes.

Until the Revenue Act of 1950 there had been no provision permitting an estate to sell stock to a closely held corporation in order to raise funds for the payment of death taxes or for other purposes. Prior to the Revenue Act of 1950 the Bureau of Internal Revenue had asserted, in many cases, that redemption of stock held by an estate in a closely held corporation resulted in the distribution of taxable dividends. Consequently the settlement of many estates was delayed because the executors and trustees were unwilling to subject their estates to substantial income taxes which, in many cases, when added to the estate-tax liability would decimate or even wipe out the assets of the estate.

The legislation in 1950, as subsequently amended, facilitated the settlement of the estates where the period for assessment of estate taxes had not expired prior to the enactment of the legislation and permitted the sale of stock under the circumstances described in order to provide funds for the payment of death taxes.

The Ways and Means Committee has recognized that under existing law settlement of estates is still delayed where estates owning stock in closely held corporations are unable to sell such stock to the corporation to raise funds for the payment of administration expenses.

No provision has been made in H. R. 8300 nor is there any provision in existing law which permits a closely held corporation to redeem stock owned by an estate in order to provide funds for the payment of claims which have been allowed as deductions for estate-tax purposes.

While it is not a frequent occurrence, there are numerous estates the settlement of which is impeded because the executors are unable to raise funds for the payment of claims against the estate which have been allowed as deductions for estate-tax purposes.

If redemption of stock under the circumstances being considered is limited in the case of claims to claims which have been allowed for estate-tax purposes, the possibility of abuse is avoided since it can be assumed that the Bureau of Internal Revenue will not allow improper claims as deductions in determining the amount of the estate taxes due.

If it is felt that limitation of redemptions in the case of claims to claims allowed for purposes of determining estate taxes provides insufficient protection to the revenue two alternatives are available.

First, a limitation might be required which would permit redemption of stock to pay debts only if such debts were incurred at some stated period prior to the death of the decedent, for example, 2 years. Second, a limitation might be provided which would permit redemption of stock to pay debts in the case of decedents dying prior to the date of the enactment of H. R. 8300, or alternatively prior to a fixed date as for example, January 1, 1954. This latter alternative would permit the settlement of estates which cannot be closed under existing or proposed new law. Such a provision would not discriminate against estates coming into being in the future since the law in this field has been developing over a substantial period of time and holders of stock in closely held corporations can make arrangements during their lifetime to avoid problems which have been created in the past as a result of the development of the law with respect to redemption of stock by closely held corporations.

Neither existing law nor section 303 of H. R. 8300 make any provision for relief of estates where the period in which a deficiency in estate tax could be assessed expired prior to the enactment of the legislation. Thus numerous estates in which the period for assessment had expired prior to the enactment of the Revenue Act of 1950 have been barred from the benefits of that act insofar as redeeming stock for purposes of paying estate taxes is concerned and similarly estates with respect to which the period for assessment of deficiencies has expired prior to the enactment of H. R. 8300 will be barred from the benefits of that act with respect to the redemption of stock for the payment of administration expenses and from the liberalized provisions of that act with respect to redemption of stock for payment of estate taxes.

This inequity can be cured if estates now barred from the benefits of the provision are permitted to redeem shares within 6 months after the date of enactment of the act.

Attached hereto are proposed amendments to cure the defects under section 303 of H. R. 8300 discussed above.

SUGGESTED AMENDMENTS TO H. R. 8300, SECTION 303

Add a new subsection 303 (a) (3).

"(3) the amount of claims[1] against the estate allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident not a citizen of the United States)".

Amend subparagraph 303 (b) (1) (A) to read as follows (italic indicates new material):

"(A) within the period of limitations for the assessment of estate tax provided in section 6501, determined without the application of any other section, or within 90 days after the expiration of such period, *or within 6 months after the date of enactment of this act, whichever is later, or*".

Memorandum Submitted by Allan F. Ayers, Jr., and Peter J. Repetti on Subchapter C of H. R. 8300

We are practicing attorneys, members of the bar of the State of New York. We are members of the firm of Hodges, Reavis, McGrath, Pantaleoni & Downey, 20 Pine Street, New York, N. Y., and specialize in Federal tax matters.

As is indicated in House Report No. 1337, the proposed bill, H. R. 8300, seeks to accomplish two main purposes:

1. To make substantive changes in the code itself "to remove inequities and to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."

2. To make a complete revision of the present code "to express the internal revenue laws in a more understandable manner."

Neither purpose has been accomplished.

The substantive changes proposed in the new bill are based upon new theories of tax law and, in many instances, arbitrary rules are adopted in the interest of simplicity. The committee report sets forth numerous instances where equitable treatment of taxpayers was sacrificed in favor of simplicity of rules. However, the rules adopted are in fact complex, so that the virtue of simplicity is not gained, and harassment of the taxpayer by arbitrary and inequitable treatment is aggravated and continued.

The attempt to express the internal revenue laws in a more understandable manner is also unsuccessful. Many sections of H. R. 8300 are much more complicated and less understandable than the provisions of the present Internal Revenue Code which they are designed to replace. In many instances new words of art have been coined to replace old words of established meaning. The definitions of the new words are not always clearly set forth in the bill, and it is therefore inevitable that taxpayers, instead of having a more definite and certain understanding of the tax laws, will be subjected to even more confusion.

One of the principal contributions to the reduction of "tax barriers to future expansion of production and employment" would be a clarification and simplification of the rules relating to corporate distributions and corporate reorganizations. The new bill treats of this subject in subchapter C.

Instead of simplifying and clarifying the rules respecting corporate distributions and reorganizations, subchapter C may have quite the opposite effect and may complicate the rules and burden normal corporate transactions which otherwise would be carried on.

The subject matter of corporate distributions and corporate reorganizations is so important and so vital to the economy of the Nation that a radical change in tax treatment should not be effected without careful consideration and a thorough understanding of the effects of the new legislation. Subchapter C is so complicated and its effects may be so widespread that it seems far more desirable to retain the old statutory provisions with respect to corporate distributions and

[1] If a time limitation is desired, this could be accomplished by making the clause read "claims against the estate arising more than two years prior to the death of the decedent" or "claims against the estates of decedents dying prior to the date of enactment of this act."

reorganizations pending opportunity of careful and expensive study by business and professional people interested in the subject matter.

In general, it is not feasible to suggest minor changes to subchapter C of H. R. 8300 because of the constant interrelation of the various sections in the subchapter.

It would unduly lengthen this memorandum to undertake a section-by-section analysis of subchapter C. A consideration of the effect of three sections upon a normal business transaction is sufficient to illustrate the point.

Certain provisions were incorporated in the bill with a view to preventing preferred stock bail-outs. These provisions as drafted not only prevent preferred stock bail-outs but also prevent normal and desirable corporate recapitalizations. They will also certainly interfere with traditional corporate financing by way of preferred stock issues.

As an example, the Doe Corp., was organized in 1920 and presently has outstanding 100,000 shares of common stock and 30,000 shares of preferred stock. The common and preferred were issued in 1934 in exchange for debentures in a bankruptcy reorganization of the company. The debentures had previously been issued by the company in return for assets acquired by it in 1925. Both classes of stock are presently held by numerous stockholders. The company wishes to redeem its preferred stock in order to improve its financial position.

The treatment of the redemption to Doe Corp., and its stockholders is clear under present law. The effect of a redemption under the present law would be as follows:

1. The company would incur no tax liability by virtue of the redemption.

2. The stockholders would have capital-gains treatment on the shares of preferred stock redeemed by the company. (None of the factors necessary for treatment of the redemption as a dividend under 115 (g) are present.)

The consequences of the redemption to Doe Corp. and its stockholders under the proposed bill is uncertain.

1. The company may, by virtue of the provisions of section 309 of the bill, be subject to a penalty tax in the amount of 85 percent of the redemption price paid by it to its stockholders.

2. In addition to the uncertainty of tax treatment to the company, the company will not be in a position to advise any of its stockholders as to the tax treatment to them of a redemption of its preferred stock.

Because of the penalty tax imposed by section 309, the company cannot redeem its preferred stock unless it is certain that the section will not apply to it. The penalty tax of 85 percent of the redemption price of the preferred stock imposed under section 309 is operative unless the company can qualify under certain exceptions set forth in the section.

The amount subject to the penalty tax is not limited to accumulated earnings. The only subsection under which the company might qualify for an exemption is subsection 309 (a) (3) which reads:

"(3) NONPARTICIPATING STOCK ISSUED FOR SECURITIES OF PROPERTY. If the transfer is in redemption of nonparticipating stock issued for securities or property (or which takes the place of nonparticipating stock which was issued for securities or property) to the extent of 105 percent of the fair market value of such property."

In order to establish its exemption under this subsection, the Doe Corp. must satisfy itself that the preferred stock was issued for an amount of money or property having a fair market value of at least 105 percent of the redemption price of the stock. In order to do this, the company must be in a position to allocate the value of the common and preferred stock issued in exchange for its debentures in 1934. In addition, the company must be in a position to ascertain the market value of the property received by it in exchange for the issuance of debentures in 1925. In 1925 when the debentures were issued and in 1934 when the common and preferred stock were exchanged in the bankruptcy proceeding for the debentures, the company had no reason for collecting evidence and establishing the facts required to prove its exemption under subsection (3) of section 309 of the present bill.

The cases under the present code which have arisen by virtue of a dispute on the question of the fair market value of property are voluminous. The main exemption afforded under section 309 is based upon a continuation of such a principle.

The application of section 309 to a redemption in 1954 of Doe Corp.'s preferred stock which was issued in 1934 is based upon an additional arbitrary rule established by section 309. The section's application is limited to any preferred stock which has been outstanding less than 10 years computed after January 1, 1954. Preferred stock which was issued long before that date is nevertheless deemed to have been issued on January 1, 1954, for this purpose. If there is any reason for exempting preferred stock which has been outstanding for 10 or more years after the enactment of the bill, there is more reason for exempting an issue which has been outstanding for a similar period prior to the enactment of the bill.

The tax consequences of the redemption to the company's stockholders are also uncertain. Sections 301 and 302 of the bill contain numerous provisions requiring dividend treatment or capital-gain treatment to individual stockholders, depending upon whether certain facts are met by each stockholder individually. As a result, uniform treatment of all stockholders is unlikely. Some of the stockholders whose preferred stock is redeemed may be permitted to treat the transaction as a capital transaction and therefore realize either a capital gain or loss. Other stockholders, on the other hand, may be required to report the entire amount received by them on the redemption as a dividend.

As a matter of corporate and business practice, the company must be in a position to advise its stockholders of the tax treatment to them before the stockholders can be called upon to act upon the question of whether the stock should be redeemed by the company.

In the future, no company will be able to advise its stockholders of the tax consequence to them of a redemption by it of preferred stock.

The wisdom of imposing a penalty tax upon a company by virtue of the redemption of its preferred stock is open to question. This would be true even though the penalty tax were limited to accumulated earnings held by the company. It is especially true where the penalty tax applies, regardless of earnings. Even if the wisdom of such an enactment is conceded, it seems abvious that because of the severe penalties imposed by the section, the section should be clearly drafted. The standards for exemption against its operations should be based upon equitable and realistic factors. In addition, the company's stockholders should receive uniform treatment.

In its effort to prevent preferred stock bail-outs, the proposed bill has incorporated a provision which by its terms is applicable to all corporations without in any way attempting to limit its application to situations which have traditionally been recognized as preferred stock bail-outs.

The foregoing illustration sets forth one of the examples of the interference with normal business transactions which would result from the enactment of subchapter C of H. R. 8300. There are numerous situations in which other sections of subchapter C would similarly interfere with usual and normal business transactions.

As stated earlier, it is unwise to attempt a correction of the defects in subchapter C by making piecemeal amendments at the present time. It would be far more desirable to take more time for a careful and exhaustive analysis of the effects of subchapter C and of the amendments necessary to make it workable from a business standpoint.

We respectfully submit to the Finance Committee of the Senate that subchapter C of H. R. 8300 should be deleted and that the existing provisions of the Internal Revenue Code with respect to corporate distributions and reorganizations should be continued in effect pending a further study of this matter.

The Chairman. Thank you very much for coming.

Mr. James.

STATEMENT OF GEORGE F. JAMES, CHAIRMAN, TAX COMMITTEE, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. James. Mr. Chairman, I am George F. James, chairman of the tax committee, National Foreign Trade Council.

On behalf of the National Foreign Trade Council, we appreciate this opportunity to testify on those provisions of H. R. 8300 that relate directly to taxation of business income derived from foreign sources. These provisions were evidently intended to implement sound proposals in the President's budget message. Our council appreciates this recognition of the special problems and needs of its members.

We believe that the basic principles advanced by the President in this field and approved by the House of Representatives, if they were adequately implemented, would improve our system of taxation and offer needed encouragement to foreign trade and investment.

Unfortunately, the principles expressed and the objectives sought have been to a considerable degree frustrated in the technical drafting of H. R. 8300. The text of the bill, of course, became available only at the time that it was introduced before the House of Representatives, where no further hearings were held. This is the first opportunity that taxpayers' representatives have had to advance specific proposals for the improvement of the bill. The National Foreign Trade Council has prepared a memorandum suggesting several changes in the provisions of H. R. 8300 designed, so we believe, better to effectuate the objectives of the law. These proposals include:

(1) Relaxation of certain of the conditions limiting the 14-percent credit provided in section 923; (2) extension of this 14-percent credit to foreign branches whether or not they elect to be taxed in a manner similar to foreign subsidiaries, and certain technical improvements in the provisions applicable to branches which do so elect; (3) the extension of this credit to cover specifically companies engaged in construction as well as engineering abroad; (4) the preservation of the present section 131 (h), the so-called in-lieu-of tax credit, at least until we have time to see how this new concept of a principal tax is going to work out, and some improvements in the form of this principal tax proposal; (5) permitting the taxpayer an election between the per-country and the overall limitations on the foreign tax credit, rather than merely repealing the overall limitation, which is the present provision in the bill, and finally, a clarifying amendment removing the restriction on purchases outside the Western Hemisphere by Western Hemisphere trade corporations. There is a provision to that effect in the bill. We think that slightly more inclusive language is needed and we hope that the record will make it clear that this is regarded as a clarifying amendment, rather than as a change in the present statute.

In the short time available for an oral presentation, I would like to discuss just one aspect of the first point, the limitations on the 14-percent credit extended to certain foreign-source business income.

There has been for some time, strong sentiment for extending to business income on a global basis the tax advantage which is presently enjoyed by Western Hemisphere trade corporations. In a general sense, this is the effect of section 37 and section 923 of the bill. However, section 923 (a) has very restrictive language in that the benefit is restricted to earnings or profits derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment or other like place of business situated within a foreign country.

Further, in subsection (b), there is specifically excluded from the definition of a trade or business, the operation of an establishment engaged principally in the purchase or sale, other than at retail, of goods or merchandise. It is principally to those points that I wish to address myself.

If there were any policy for the exclusion of wholesale business from the benefits of the act—and I believe there is not, and I will return to that point—we don't believe that the exclusion would work. A very large volume of American foreign investment is in businesses which are integrated in various ways. For example, you may have the same corporation in a single country carrying on a completely integrated operation from production or manufacture through wholesale distribution. The Treasury experts say that such a business would come within the meaning of the law and I think probably they are right, although we would like it to be a little clearer than it is.

You can get a second situation where the same integrated group of enterprises has in one country a distributing or merchandising corporation, operating in part or wholly at a wholesale level, and either through a different corporation in the same country, or through a different corporation in a neighboring country, but all the same essential ownership, they will have the production or manufacture which supplies the wholesale enterprise. In a situation of that sort, the wholesale enterprise apparently does not get the benefit of the 14-point advantage.

To illustrate this point, I would like to take instances from my own industry, just so I will know what I am talking about. There are several oil-distributing companies in the Philippines. The corporation tax rate in the Philippines is 28 percent. There are other taxes, principally an exchange tax, which bring the burden up to something approaching the burden in the United States. But the only creditable tax, the corporate income tax, is 28 percent. At the present time, there is no refinery in the Philippines. The Philippines business currently is being supplied largely by American companies from refineries owned and operated by those same or affiliated interests in other foreign countries. Very little oil of United States source goes into the Philippines. The Philippine distributing companies don't get any benefit, although they are part of an integrated operation.

To bring it still closer to home, my own company has a wholly owned subsidiary in South Africa, where the tax rate is around 35 percent. It is a marketing company with a very substantial investment in plant and distributing facilties. We also have a refining subsidiary in South Africa, the capacity of which will take care of about half of our needs. The gentlemen from the Treasury are unable to advise me what the position would be if the refining subsidiary and the marketing subsidiary were merged so that we had a single, partially integrated operation there. I don't believe you can get effective incentive to foreign investment out of a law so ambiguous. That is only one side of the picture, though.

The elimination from benefit of wholesale business, as such, cuts out a tremendous segment of American foreign investment. According to Department of Commerce statistics, there is $700 million in United States private investment simply in wholesale merchandising abroad, and that is a great understatement of the actual amount, because a large part of the wholesale distribution is carried in those statistics under other categories; petroleum, for example.

Why is this tremendous investment excluded from benefit?

Well, one suggestion was that operations of that kind don't necessarily involve foreign investment. The answer to that is quite simple. In fact, they do involve large foreign investment. At least the $700 million figure I have mentioned, quoted from Department of Commerce statistics, and a great deal more. It certainly isn't because there is something bad about foreign trade. In his recent message to Congress, the President coupled foreign trade and investment as objectives of American economic policy, saying:

> Great mutual advantage to buyer and seller, to producer and consumers, to investors and to the community where the investment is made, accrue from high levels of trade and investment.

The President apparently saw no reason for distinguishing unfavorably against trade and in favor of investment, nor do we see any reason.

It has been suggested that an income tax rate advantage, extended to enterprises which export from the United States into a foreign country, would somehow infringe on trade policies of the United States. In the first place, if that proposition were true, it would not explain the language of the bill. There isn't a line in the bill distinguishing between importation from the United States into a foreign country and importation into foreign country A of goods produced in foreign country B. There simply isn't any basis in the bill for placing the distinction on the source of the goods exported. Quite apart from that, in the research we have been able to do in the past week we haven't found any basis for the contention that there is something in our trade treaties or trade policy which would be contrary to giving a preferential tax rate to earnings derived from mercantile operations overseas. We know that many Western European countries either exempt or give a preferential rate to the earnings derived overseas from foreign branches and subsidiaries. This is the same group that makes up the membership of GATT.

The 14-point rate advantage, if extended to American mercantile operations overseas, would not put the United States in the lead of the procession by any means. It would close a part of the gap which now exists between the position of the American investor and the position of our competitors. I would like to stress that point.

We don't need merely an incentive in some charitable sense. We need protection against the competition of investors from foreign countries and operators in the country in which we operate. The essential proposal which the National Foreign Trade Counsel is advancing on this point is that instead of a somewhat arbitrary list of enterprises to be benefited, and instead of the restrictions of 923 (b), the Congress adopt the principle that the 14-point rate advantage shall apply to income, whether branch or subsidiary earnings, derived from operations which are carried on within a foreign country or countries through a permanent foreign establishment. That is a concept with which there has been a great deal of experience under our tax treaties. It is the essential basis under our tax-treaty system and under recognized international jurisprudence from the League of Nations Committee down, by which the tax jurisdiction of the foreign country is established.

It seems very reasonable and convenient to say that the same test under which our Government generally recognizes the jurisdiction of the foreign country to tax shall be the test determining whether the preferential rate shall be enjoyed in the United States. It would not lead to tax avoidance because you could not get the preferential rate in this country without accepting the jurisdiction of the foreign country. So far as investment is concerned, I am sure you would find that where it was necessary to operate with a permanent foreign establishment, the investment would be made by the taxpayer consonant with the objectives of his operation.

It is by a large number of small investments that you are going to get the maximum total of trade and investment moving. Under the present restrictive language, almost the only taxpayers who could qualify with investments such as mines and factories overseas are the big corporations. If you want to bring in smaller investors, you have to open the gate at the point where initial investment starts, which is in distribution, and then you move on to a better integrated operation overseas.

We are pushing against time and while there is a great deal more that could be said on this point, there is one other point which we would like to refer to briefly. That is the matter of the old 131 subsection H. With the indulgence of the committee, may Mr. Carroll, my associate, have about 5 minutes on that point.

STATEMENT OF MITCHELL B. CARROLL, SPECIAL COUNSEL, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. CARROLL. This matter of giving an incentive to carry on business investment abroad has long been of concern to your committee. You will remember that way back in 1918 Congress introduced the credit for foreign taxes to prevent international double taxation.

However, that credit was limited to income taxes. It did not take cognizance of the fact that in other countries, especially in Latin America, there are a number of near income taxes, or rudimentary taxes to which countries less efficient than the United States in their income tax administration have resorted.

Usually such a tax has preceded the modern income tax. Sometimes a government adopts an income tax and then introduces one of these rudimentary taxes as a more facile way of collecting income taxes, and sometimes it will superimpose an income tax on such a tax. Generally speaking, these taxes are what might be described as taxes wholly or partially in lieu of an income tax. In 1942 this matter of the inadequacies of the foreign tax credit was brought to your committee's attention and you adopted section 131 (h), IRC. The interpretations of that section by the administrative authorities have been so restrictive that 2 years ago the then chairman wrote a letter to the Treasury published in the Congressional Record of June 27, 1952, protesting against this restrictive interpretation and asking for a more liberal interpretation along the lines expressed in your own committee's report in 1942.

Instead, we find in the bill something entirely different. The President, in his budget message of January 21, 1954, and again in his recommendations on foreign economic policy of March 30, 1954, declared that the present definition of foreign taxes which may be credited against the United States tax should be broadened to include any tax other than an income tax which is a principal form of taxation of business in the country, except for certain kinds of taxes. This seemed to be good news. We thought that all of the contentions of the National Foreign Trade Council before your committee, that what Senator George had written in his letter of May 29, 1952, to the Treasury, that what had been reflected in the Randall Commission report, were coming true. But what did we find? We found that this provision on which taxpayers have relied since 1942 was to be repealed. I ask you, Is that broadening the section?

Furthermore, we find that this provision was to be replaced by a new concept of a principal tax, which is actually narrower in scope than the old concept. It is narrower in two ways. In the first place, if you take a credit for this so-called principal tax you lose the credit for the income tax. Secondly, the definition of principal tax is rather technical but it is a certain kind of tax that is not generally imposed. The report indicates that it is allowable if it is selectively imposed, a brand new capricious concept. We respectfully urge that when the President announces that you are going to broaden the credit, that should be literally what you do.

What there is today in the law should be maintained because the President says "the present definition should be broadened." Hence, section 131 (h), IRC of 1939, should be maintained, together with some liberializing language, such as your own committee asked for in a the letter to the Treasury in 1952 and stated in its original report on section 131 (h) in 1942.

Furthermore, we think that the new concept, if amended somewhat, can be helpful but it should not be allowed as a credit in complete substitution for the income tax as it is now framed, but rather as an additional allowance. Credit should be allowed for the aggregate of all the income, "in lien," and "principal" taxes within the limitations of what the United States tax would be on the foreign income, so as not to permit the credit to cut into the domestic tax on domestic income.

Another reason why we are apprehensive about this new credit is the following: The Treasury gives as one of its reasons for resorting to this new concept the fact that the allowance of a credit for foreign income taxes has, so it is said, induced certain countries to increase their income tax rates so as to absorb the full allowable credit. What will happen under the new concept? A foreign country can resort to any kind of a tax that is selectively imposed.

I say any kind of a tax because the list given is so broad that it will cover any kind of tax, which has no relationship to income and which is large enough to absorb the credit and the taxpayer will be worse off than he is today.

As it is today, it is much better for the United States to give an incentive for foreign countries to resort to income taxes, than to resort to arbitrary taxes which have no relationship to income.

Any businessman is perfectly aware of that fact. Therefore, Mr. Chairman, we urge that section 131 (h), IRC of 1939, be preserved in the new bill, together with the clarifying amendment that reflects the essence of your committee's 1942 report and your predecessor's letter to the Treasury, namely, to insert before "in lieu of" the phrase "wholly or partially," and also you might add some clarifying language which we have in the statement we are submitting. Moreover, to make more practical this new concept, we have suggested various changes in that provision. This is a very technical matter, sir, and we would be glad to go into the details with Mr. Stam and your technical staff.

The CHAIRMAN. Have you seen Mr. Stam?

Mr. CARROLL. We will be glad to see him.

Mr. JAMES. Yes, sir, thank you.

The CHAIRMAN. We will be very glad to put your paper in the record and we have been happy to have you with us.

(Mr. James' and Mr. Carroll's prepared statement follows:)

STATEMENT BY GEORGE F. JAMES, CHAIRMAN, NFTC TAX COMMITTEE, ACCOMPANIED BY MITCHELL B. CARROLL SPECIAL COUNSEL, NFTC TAX COMMITTEE

H. R. 8300, the proposed Internal Revenue Code of 1954, includes several important changes with respect to the taxation of business income derived from foreign sources. These changes were intended to adopt sound and vital proposals made by the President in his budget message. The principles so adopted by the Committee on Ways and Means and by the House of Representatives are commendable in their objectives. Unfortunately, the technical provisions of the bill designed to implement these objectives to a considerable degree fail in their intended purposes by reason of needless restrictions and to some extent actually impede the desired objectives.

I. THE 14 PERCENT CREDIT FOR BUSINESS INCOME FROM FOREIGN SOURCES

The President of the United States recommended that "business income from foreign subsidiaries or from segregated foreign branches which operate and elect to be taxed as subsidiaries should be taxed at a rate 14 percentage points lower than the regular corporate rate." This recommendation constitutes an important part of the encouragement which the President sought for private investment abroad to supplement Government economic aid.

Section 923 of H. R. 8300 contains needless restrictions with respect to the types of business activities which can qualify for the 14 percentage point tax differential. One of the most important restrictions requires that the gross income must have been "derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public-utility facility, retail establishment, or other like place of business situated within a foreign country." The statute excludes from the definition of trade or business "the operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise."

This attempt to enumerate qualifying types of business has many serious defects. In the first place, there are many other types of businesses, including plantations, transportation, construction, banking, insurance, and doubtless many more, which should be included in the enumeration if an enumeration were attempted. Secondly, the attempt to enumerate qualifying businesses creates serious ambiguities and anomalies. If a factory is operated in a foreign country, is all of the gross income to be considered derived "through a factory" whether or not extensive wholesale merchandising activities are carried on? If not, the entire income, including that derived from the factory, is denied the intended rate differential. If, however, widespread merchandising activities do not result in disqualification, it is anomalous that the same kind of activity carried on through a separate corporation or business activity will fail to receive the tax differential. Activities designed to supplement a line in part manufactured in a foreign country will probably destroy qualification. Many businesses with very substantial existing and prospective investments abroad will find it necessary to consider artificial divisions of their integrated business in an attempt to qualify a portion of the gross income within the restrictive language of section 923. Furthermore, there seems no reason to exclude from the intended benefit genuine and real business activities conducted abroad merely because they fall in the trading or wholesale category. The President, the Secretary of State and the Director of the Foreign Operations Administration have stressed the necessity from the point of view of our national interest of a sound and expanded foreign trade.

The objectives intended can be properly carried out by substituting for the restrictions mentioned above a requirement that the gross income be derived to the extent of at least 90 percent from the active conduct of a trade or business through a permanent establishment situated within a foreign country. Permanent establishment should be defined in a manner consistent with the tax treaties which the United States has entered into with 14 of the leading commercial countries of the world. This definition would be adequate to require a genuine business activity abroad and be consistent with the principles carefully considered by the Senate and adopted by the United States in connection with the tax treaties.

The same principles should be used in ascertaining whether branch income of a domestic corporation qualifies for the 14-point rate differential. Section

923 is also unduly restrictive in its stock ownership requirements relating to the amount of stock a domestic corporation must hold in a foreign company. A provision corresponding to that found in section 902 relating to the foreign tax credit and requiring the ownership of at least 10 percent of the shares should be adequate. It should also be made clear in the statute that gross income from technical services includes gross income from construction.

II. THE 14 PERCENT TAX REDUCTION FOR BRANCH INCOME SHOULD NOT DEPEND ON ELECTING DEFERRAL

The 14-percent reduction section 923 (a) (1) should be granted for branch income whether or not the corporation elects to defer its income under part IV. Its income can be determined in accordance with a method of accounting which clearly reflects the taxable income the branch would derive if it were an independent entity.

Moreover, the provisions of section 951 of H. R. 8300 should be amended as follows:

(*a*) The election should apply for each separate branch or for all branches in a country. The latter is desirable in order to obviate the unnecessary allocation of income and expense to separate branches and to facilitate taking credit for foreign taxes applicable to the entire net income of all the branches in the country.

(*b*) As the elected branch is to be treated as a separate corporation, the domestic corporation should be allowed to deduct a loss sustained when the assets of a foreign branch become worthless.

(*c*) The taxpayer should have the right to terminate the election if regulations are issued or amendments to the law are adopted which are prejudicial to the taxpayer.

III. CREDIT FOR "IN LIEU" TAXES SHOULD BE PRESERVED AND "PRINCIPAL TAX" PROVISIONS MODIFIED

Since 1918 Congress has sought to encourage business and investments abroad by granting its citizens and corporations a credit against the United States tax for income, war profits, and excess profits taxes paid to foreign countries on income derived from sources in their territories. This relief from international double taxation has contributed appreciably to the expansion of markets abroad for American goods and the development abroad of industries engaged in producing minerals, petroleum, and other raw materials needed for national defense, as well as sugar, coffee, fruits, and other foodstuffs.

Difficulties have arisen because some foreign countries have tax systems that are less developed than our own and embody rudimentary or empirical taxes that are intended to reach income but are easier to collect than a tax on net income. They sometimes preceded the modern type of an income tax or were employed in addition to the income tax, and in either case they often partially replaced the income tax by being allowed as a credit or deduction. In other instances, they wholly replaced the income tax. Our Treasury frequently disallowed them as credits because it did not consider them to be created in the exact image of our own income tax.

Therefore, the Senate Finance Committee in 1942 tried to extend the scope of the section and enacted in subsection (h) of section 131 a provision to allow a credit for taxes in lieu of an income, war profits, or excess profits taxes otherwise generally imposed. In its report on the bill, the committee specifically mentioned taxes measured, for example, by gross sales, gross income, or the number of units produced.

The Treasury in its regulations, however, covered only a tax in complete substitution for an income tax. The example given was based on a Cuban tax on gross income which had been held creditable as an income tax. Its rulings were likewise too restrictive. Hence, on May 29, 1952, Senator George, then the chairman of the Senate Finance Committee, wrote a letter to the Treasury, published in the Congressional Record of June 27, 1952. He said he was disturbed because the regulations did not conform to the intent of Congress as reflected in the committee report, and suggested certain tests and certain taxes that met those tests.

The President in his budget message of January 21, 1954, and again in his recommendations on foreign economic policy of March 30, 1954, declared that "the present definition of foreign taxes which may be credited against the

United States income tax should be broadened to include any tax other than an income tax, which is the principal form of taxation on business in a country, except turnover, general sales or excise taxes, and social security taxes." This seemed at first to be good news as it implied that taxpayers would retain what they have now and would receive something more.

When H. R. 8300 appeared, what did the taxpayers find in section 901, etc.:

1. The credit for taxes in lieu of income taxes to which taxpayers had been entitled since 1942 was to be repealed.

2. In its place was a new concept of principal tax which would be allowed as a credit in complete substitution for a foreign national income tax. In other words, if the taxpayer took credit for a principal tax he would lose the credit for the income tax. Instead of broadening the credit, the new concept narrowed the scope of the credit.

3. The principal tax is defined by excluding every conceivable form of tax, but some will get by if they are not generally imposed, that is to say, according to the report, if they are selectively imposed on a particular industry. A tax now allowable as an in-lieu tax if generally imposed would be disallowed as a principal tax if generally imposed. The bill does not throw any light on what is generally or not generally imposed. The capricious test of selectivity in the House renort cannot be relied on.

Tax officers of companies who are acquainted with taxes in countries in all parts of the world know of very few taxes that would clearly come under the new concept. When an income tax also is paid, they would not as a rule want to give up the credit for the income tax in order to take the credit for the principal tax. They find this new concept in its present form to be too academically conceived to be of much practical value.

4. This repeal of section 131 (h) would mean that the Treasury would have to reexamine many cases to see if taxes formerly credited as in-lieu taxes would meet the strange new tests for principal taxes and many taxes now covered might be disallowed.

5. The Treasury has given as a reason for the new concept that the present United States credit for income taxes may induce foreign countries to raise their rates of income taxes to absorb the allowable credit. Under the principal tax concept a foreign government could impose any kind of a tax not related to income on a particular industry carried on mainly by one or more American-owned companies and still absorb the credit. The taxpayer might be worse off as the result, Congress thus giving foreign countries an incentive to resort to taxes other than income taxes.

Conclusion

We therefore urge the Senate Finance Committee to carry out the express intent of the President's statement and keep the present credit for taxes in lieu of income taxes, with a clarifying amendment to carry out the committee's intent and set forth in its report on the 1942 bill and the letter of its former chairman to the Treasury. A suggested draft is contained in our statement which we offer for the record.

The committee might also broaden the scope of the credit by also giving a credit for a principal tax but after amending the provisions along the lines suggested in our statement so as to make it more practical and realistic.

IV. ELECTION OF LIMITATION FOR PURPOSES OF THE FOREIGN TAX CREDIT

The National Foreign Trade Council has heretofore recommended the elimination of the per country limitation on the foreign-tax credit. H. R. 8300 retains such limitation but repeals the overall limitation. It is recommended that in lieu thereof the taxpayer be permitted to elect to be bound by either the per country limitation or the overall limitation.

V. INEQUITABLE RESTRICTION ON PURCHASING OUTSIDE HEMISPHERE BY WESTERN HEMISPHERE TRADE CORPORATIONS SHOULD BE REMOVED

Section 921 of H. R. 8300 is intended to correct an inequitable ruling disqualifying a domestic corporation which was otherwise entitled to the benefits of section 109, Internal Revenue Code, 1939, because it purchased goods outside the Western Hemisphere.

This section 921 is intended to reflect what is believed to have been the intent of Congress when it enacted section 109. We urge that it be amended so that a Western Hemisphere trade corporation may not be disqualified because of purchases outside the hemisphere incident to the conduct of its business (a phrase borrowed from sec. 39.109–1 of regs. 118). Our statement suggests the language and asks that it be made applicable to section 109 in the Internal Revenue Code of 1939.

Provisions Relating to Income Derived From Foreign Sources, Internal Revenue Code of 1954 (H. R. 8300, 83d Cong.)—Statement by George F. James, Chairman, NFTC Tax Committee, Accompanied by Mitchell B. Carroll, Special Counsel, NFTC Tax Committee

INTRODUCTION

The President in his budget message proposed certain principles with respect to the taxation of foreign business income that are highly important in the expansion of our foreign trade and foreign private business investment. The Committee on Ways and Means of the House of Representatives endorsed these principles. The National Foreign Trade Council believes that adoption of these principles and their proper implementation would greatly improve our system of taxation, and would increase foreign business activity and investment.

Unfortunately, the principles and objectives sought have been needlessly frustrated to a very substantial extent by rigid, and in many cases arbitrary, restrictions contained in H. R. 8300. One of the most important examples of such needless restriction is found in the attempt to enumerate certain types of foreign business activities entitled to a 14-point-rate differential. The restriction excludes many businesses that are just as much entitled to the advantage of the rate differential as those named; it also excludes many businesses that are named but involve a substantial element of wholesale activity. It is the purpose of this memorandum to suggest changes in the bill to cure such difficulties and to achieve the stated objectives.

The most important changes in H. R. 8300 concerning foreign business income are the following:

(*a*) Section 37 and section 923, providing a 14 percent credit with respect to certain business income derived from foreign sources;

(*b*) Sections 951–958, which permit the deferral of the income of certain foreign branches of United States business corporations;

(*c*) Sections 901 (b) (1) (B), 902 (a) (2), 902 (b) (2), 903, and 955 (2) which substitute for the credit in lieu of income tax now provided by I. R. C. section 131 (h) a new credit for a "principal tax" allowable only as an alternative to the credit for income taxes paid provided in sections 901 (b) (1) (A), 902 (a) (1), 902 (b) (1), 955 (1); and

(*d*) The elimination of the overall limitation on the foreign tax credit now in I. R. C. section 131 (b) (2).

I. Discriminatory Features of Credit for Business Income from Foreign Sources Should Be Removed

In his budget message and again in his recommendations to Congress on the foreign economic policy, the President of the United States recommended, among other matters, that:

"Business income from foreign subsidiaries or from segregated foreign branches which operate and elect to be taxed as subsidiaries should be taxed at a rate 14 percentage points lower than the regular corporate rate."

This recommendation has been dealt with in section 37 and section 923 of the proposed Internal Revenue Code of 1954. The basic purpose of these sections is stated in the report of the Committee on Ways and Means to be:

"To offset some of the factors adversely affecting foreign investment by giving special tax treatment to business income from foreign sources."

This decision to extend generally to foreign source business income the preferential rate presently enjoyed by Western Hemisphere trade corporations, if enacted in sound and workable form, would be by far the most important of the tax reforms proposed applicable to foreign business operations. The basic decision reached by the administration and the House of Representatives on this point is appreciated by American foreign investors and traders. Unfortunately, the purpose defined by the President and the Ways and Means Committee is not accomplished by the form of section 923, because eligibility to benefits under that section has been rigily and unnecessarily limited.

The credit provided by section 37 is limited in section 923 (a) to income derived from sources within any foreign country:

"(1) As branch income includible in gross income under part IV;

"(2) As compensation for the rendition of technical, engineering, scientific, or like services;

"(3) As dividends from a foreign corporation if—

"(A) The earnings and profits used in the payment of such dividend (including the earnings and profits of the year in which the dividend is paid), determined under subchapter C (sec. 301 and following) have been accumulated after December 31, 1953, and are earnings and profits of a year the gross income of which year—

"(i) Has been derived to the extent of at least 95 percent from sources without the United States;

"(ii) Has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country; and

"(iii) Does not consist of more than 25 percent of gross income derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States;

but the credit shall apply only to the dividend or portion thereof paid out of earnings and profits conforming to the provisions of this subparagraph; and

"(B) At the date of the declaration of the dividend and during the whole of the respective years in which were accumulated the earnings and profits specified in subparagraph (A)—

"(i) Such domestic corporation, either alone or in association with not more than 3 other domestic corporations, owned more than 50 percent of the voting stock of such foreign corporation; or

"(ii) Such domestic corporation owned not less than 10 percent of the voting stock of such foreign corporation, and the trade or business of such domestic corporation was related to the trade or business of such foreign corporation by reason of the rendition of technical, engineering, scientific, or like services or assistance, incident to the operation of the trade or business of such foreign corporation; and

"(4) As interest from a foreign corporation if, throughout the year in which the interest is paid, such foreign corporation fulfills the income requirements in paragraph (3) (A), and such domestic corporation fulfills one of the alternative requirements in paragraph (3) (B)."

The limitations of section 923 (a) (3) (A) (ii) are further limited by section 923 (b) which provides in part:

"(b) For purposes of subsection (a)—

"(1) The term "trade or business" does not include—

"(A) The operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise; or

"(B) The maintenance of an office, or employment of an agent, other than a retail establishment excepted from subparagraph (A), to import or facilitate the importation of goods or merchandise."

Under these restrictions, only a small fraction of American foreign investors could qualify for the 14 percent credit proposed in section 37. The very industries which have been in the forefront of American foreign trade and which have provided the bulk of American private foreign investment would, under the proposed narrow statutory language, be ineligible for the special tax treatment which is intended to offset the factors adversely affecting foreign investment and to encourage foreign trade.

LIMITATIONS BASED ON TYPE OF ACTIVITY

The most serious liimtation on the 14-point credit for foreign business income is that which restricts the benefit to earnings derived from narrowly defined categories of earnings; dividends and interest from the earnings of a foreign corporation derived "at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment or other like place of business situated within a foreign country"; income derived from a foreign branch satisfying these same criteria (the limitations applicable to foreign corporations under secs. 923 (a) (3) and 923 (b) are restated as applicable to foreign branches in pt. IV, secs. 951–958, inclusive); and compensation for the rendition of technical. engineering, scientific, or like services.

The purpose of the Committee on Ways and Means in so restricting eligibility in section 923 is stated in the committee report as being in order that "differential tax treatment be restricted to enterprises actively engaged in a significant economic activity abroad" and to exclude enterprises "which are not engaged in the conduct of a business involving a significant investment abroad." The limitations adopted in the proposed Revenue Code, however, go far beyond what is necessary or appropriate to attain the stated end. The specific restrictions, the omissions and the uncertainty of application of the section as written would largely destroy its value as an incentive to the prospective foreign investor.

SIGNIFICANT ACTIVITIES DENIED CREDIT

In the first place, certain very significant economic activity abroad is entirely omitted from the enumeration of businesses eligible for the credit. The production abroad of raw materials, primarily minerals and agricultural products, is the commercial inducement for a large volume of American direct foreign investment, which investment may serve very important economic and strategic ends. In this category, section 923 would apparently apply to mines and oil and gas wells but not to agricultural production. American investment in rubber plantations in Sumatra and Malaya, sugar plantations and mills in Cuba, coffee plantations in Central and South American countries, pineapples, vegetable oils or fibers in the Philippines or cocoa in West Africa illustrate this type of investment, substantial in amount and important both in the American economy and to the economy of the underdeveloped areas in which such investment might be made.

Mining and manufacturing ventures (including oil production and refining) which might otherwise be eligible for credit under section 923 will, in many cases, fail to qualify because of the inclusion of a segment of wholesale business in an integrated operation. Direct investment in manufacturing abroad is usually the outgrowth of trading ventures by American producers and most such ventures involve wholesale trading activities which, if separate, would account for a substantial fraction of the earnings and profits of the integrated venture. Similarly, extractive industries often combine production, processing and marketing abroad. Where a single branch or subsidiary, in a single country, combines production or manufacturing with wholesale distribution, section 923 is entirely ambiguous as to whether or not the enterprise is entitled to the 14 percent credit. If wholesale operations were confined to the distribution of products produced or manufactured in the same venture, the wholesale distribution might be regarded as incidental to the production or manufacture. It might, on the other hand, be argued that where the wholesale distribution represents a substantial part of the investment and activities of the subsidiary or branch and where it appeared that a substantial part of the total earnings resulted from wholesale distribution, the entire venture was ineligible. The investor in this situation would be placed in the difficult position of having to decide whether to dismember his organization, contrary to sound business principles, in order to obtain the favorable tax rate for a portion of his operations or to continue his vertical integration and hope that the credit would apply to the entire earnings of the venture. Where the same investor carries on production or manufacture through one subsidiary and wholesale distribution through another, it appears clear (although inexplicable in principle) that the 14-percent credit would be denied to the wholesale operations. It is likely under the bill, although ambiguous, that the credit is also denied when an integrated foreign business manufactures in one foreign country and distributes the goods in a second foreign country.

Very frequently manufacturers in foreign countries supplement their line with imported goods and imported parts. In such cases if the importation and wholesaling activities are substantial, qualification for the credit would be denied. Ventures in international commerce do not naturally or conveniently fall into distinct compartments nor can all operations in an integrated veture be carried on in each foreign country where investment is made and business activities conducted. It is certainly not desirable that the taxpayer should have to resort to artificial or unnatural separation or combination of functions in order to qualify for a tax benefit nor that tax considerations should have an overriding influence on the corporate and organizational form of American foreign investment.

Even without considering integrated investments, "trading," as tabulated by the Department of Commerce, involved almost a billion dollars of American private direct investment abroad at the end of 1952. This figure is a most conservative estimate of the American capital actually employed in marketing in foreign lands; 70 percent of this billion dollars is employed in wholesale selling. The expansion of foreign trade is as much a part of our foreign economic policy as is the expansion of American direct foreign investment. In his message on foreign economic policy to Congress on March 30, 1954, President Eisenhower said:

"The national interest in the field of foreign economic policy is clear. It is to obtain, in a manner that is consistent with our national security and profitable and equitable for all, the highest possible level of trade and the most efficient use of capital and resources. * * * Great mutual advantages to buyer and seller, to producer and consumers, to investor and to the community where investment is made, accrue from high levels of trade and investment."

The activities of American-owned ventures in the purchase and sale of goods in commerce between foreign nations contribute directly to that expansion of international trade which this Government so persistently advocates as the material basis for the development and well-being of the free world. If it is the policy of Congress to provide reasonable tax incentives to foreign investment, there is no reason for excluding from these benefits a direct investment of at least $700 million employed exclusively in wholesale distribution in foreign lands.

Finally, there are services carried on abroad through American investment and in aid of other American foreign investment and foreign trade. These include such activities as banking, insurance, transportation, engineering, and construction. There is no reason why these important collateral activites should be excluded from benefit under the statute or relegated to the uncertain protection afforded by mention in a committee report.

It appears that the majority of American direct investments abroad would either be clearly ineligible for benefit under section 923 or, like most integrated foreign businesses, at best be dependent on doubtful interpretations of ambiguous statutory language. This utterly unsatisfactory situation results from an effort to exclude from benefit enterprises "not engaged in the conduct of a business involving a significant investment abroad" by listing eligible types of activities and by specifically excluding wholesale establishments. Such extreme precautions are not necessary. So long as eligibility is restricted to income from business activities conducted outside of the United States, each venture will involve investment and activity commercially appropriate to that venture, and the more items that are added, the larger and more significant will be the aggregate capital investment, which is the real end to be served. The original investment is also most likely to be a trading venture, which can expand into other and larger activities more rapidly under moderate taxation.

INCENTIVES OFFERED BY COMPETING COUNTRIES

The governments of other capital-exporting nations provide substantial fiscal incentives to their nationals to invest abroad or expand their foreign investments, amounting in many cases to outright exemption of income from such investments. None of these incentives or inducements is so restricted as to exclude trading activities as such from their benefits. They rather accept the obvious fact that international commerce is a complex of trade and investment, from which neither can be realistically separated.

In addition to the substantive objections, the administrative problems, arising out of the rigid limitations of section 923 would be very serious. The workload on the Internal Revenue Service involved in canvassing eight or ten thousand cases to determine merely whether they satisfy the two principal requirements of 95 percent foreign income, and 90 percent "active conduct of a trade or business," may demand considerable time and able personnel. To superimpose upon the taxpayer the obligation to report upon every separate activity engaged in abroad, and to add to the Service's job, that of investigating and placing in arbitrary categories, each of the activities of these thousands of ventures, is to demand something quite disproportionate to any useful end that can be served. The chances are that if the restriction be literally construed by the Service, the result will be not only to frustrate the incentive effect in most cases but also to produce unnecessary controversy and extensive litigation.

SUGGESTED CRITERION FOR ELIGIBILITY TO 14 PERCENT CREDIT

The single, appropriate basic condition of eligibility for the 14 percent "foreign business income" credit should be whether the business from which the income is derived is in fact actively conducted within a foreign country or countries. This condition being satisfied, tax legislation should not discriminate among types of business which produce the income.

The test for the active conduct of business within a foreign country should be one that is simple, reasonably reliable and not subject to manipulation. Such a criterion is readily available. It is the maintenance of a permanent establishment in a foreign country through which the income-producing functions are carried on.

ADVANTAGES OF PERMANENT ESTABLISHMENT TEST

Not only is this criterion simple and reliable, but it is the one uniformly adopted in our complex of income-tax treaties, which now govern our fiscal adjustments with 14 foreign nations, including the principal trading countries of the world. The negotiation of these treaties has been repeatedly sanctioned by Congress in successive revenue acts and in the Internal Revenue Code. Each such treaty has received the careful scrutiny of the Senate, and in some cases has been renegotiated to secure the Senate's approval. Together they form a pattern carefully and expertly worked out.

One feature of this treaty pattern is that all the signatory nations including this Government, accept the existence within the borders of a permanent establishment to which business income may be allocated as the test of whether they may impose income taxes upon an enterprise which is a national of the other party. Thus, this Government has conceded the right of other governments to tax business income attributable to a foreign "permanent establishment". To be consistent, the same basic criterion should determine whether income is to be eligible for the favorable rate of tax provided by section 923. Such consistency between our treaty arrangements and our domestic legislation is highly essential, and in this respect it is easily attainable. All that is required is to eliminate the invidious discriminations now contained in section 923 (a) (3) (A) (ii), 923 (b) (1), and 951 (a) and (b) (1) of the bill and substitute the simple concept of income from—"the active conduct of a trade or business through a permanent establishment located in a foreign country."

CONCEPT OF PERMANENT ESTABLISHMENT

The definition of "permanent establishment" should be based upon our treaties. While the various definitions are not precisely the same, in general they are sufficiently broad to include those activities entitled to consideration. Moreover, they can be reliably and realistically interpreted, and little controversy has arisen over their application While the enumeration of specific types of activity is fairly broad, these treaties also contain explicit exclusions from the definition of "permanent establishment" which would be useful in confining the benefits of the section to bona fide investors. Such a definition would accomplish the objective stated by the Committee on Ways and Means, without arbitrary discrimination against substantial foreign investment in agricultural production, service and construction businesses, wholesale establishments and integrated businesses including a substantial element of wholesale activities. Without attempting a mechanical, numerical test of "significant investment" it would attain the same end, since business considerations would ensure that the investment in a permanent foreign establishment would be appropriate to the business carried on. A definition of permanent establishment substantially in the following form, which is based on the definitions in tax treaties and includes the types of establishments mentioned in the bill, would be appropriate.

SUGGESTED DEFINITION OF PERMANENT ESTABLISHMENT

Delete paragraph (1) from section 923 (b) and section 951 (b) and substitute therefor the following:

(1) "The term 'permanent establishment' shall be deemed to include branches, mines, oil or gas wells, public utility facilities, plantations, farms, timberlands, factories, plants for assembling, refining, or processing, or otherwise changing

the form of products, workshops, warehouses, offices for buying, selling at wholesale or retail, or other purposes, installations, or the use or installation of substantial equipment or machinery for construction, operations, and any fixed place of business of an enterprise.

"The maintenance of a fixed place of business exclusively for the purchase of goods or merchandise, or the casual and temporary use of merely storage facilities shall not be deemed a permanent establishment for the purposes of this part.

"Engaging in business transactions in a foreign country through a bona fide commission agent, broker, or other independent agent, acting in the ordinary course of his business as such and receiving customary remuneration therefor, shall not constitute the maintenance of a permanent establishment for the purposes of this part."

RESTRICTION BASED ON DESTINATION OF GOODS MANUFACTURED

A further restriction contained in section 923 excludes manufacturing activities, 25 percent of whose gross income is "derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States." (Sec. 923 (a) (3) (A) (iii).)

This restriction is wholly inappropriate to revenue legislation. The regulation, or prohibition, of imports into the United States is a matter of tariff policy, legislation, and administration. It is unlikely that any considerable danger exists from such imports from American-owned concerns. But, today, opportunities to produce goods for the American market are accorded other foreign producers as a matter of considered national policy—subject only to tariff or quota restrictions. Many of such imports are definitely not competitive with domestic manufacture in the United States. The application of this exclusion would accordingly be much broader than the legitimate ends to be served.

Again, the administrative job of determining what percent of gross income was derived from sales of goods as to which there were "objective manifestations of an intention to turn out a product which is to be marketed in the United States" is hardly within the usual range of tax administration. When we have added to this, the suggestion that even if a third party buys such goods and ships them here, the producer will be deemed to have intended them for this market, the implications are quite unrealistic. This illustrates the inappropriateness of such speculative and unreliable criteria to revenue legislation. Moreover, such a provision might operate as in indirect evasion of the obligations this country has assumed in its commercial treaties to accord equal treatment tariffwise to imports from various foreign nations.

We accordingly suggest the outright deletion of this restrictive provision.

RESTRICTION BASED ON STOCK OWNERSHIP

The complex and unrelated limitations as to stockownership contained in sections 923 (a) (3) (B) and 923 (b) (2) (B) seem unduly restrictive and differ for no apparent reason from those provided in section 902 (a) and (b) respectively. In our opinion, it would be desirable and practical to make these requirements the same, namely the ownership in the one case of at least 10 percent of the voting stock of the foreign company, and in the other case the ownership by the foreign company of at least 50 percent of the voting stock of its subsidiary.

COMPENSATION FOR CONSTRUCTION SERVICES SHOULD BE INCLUDED

Section 923 (a) includes, as coequal with branch income in class (1) and dividends in class (3), compensation for the rendition of technical engineering, scientific, or like services. House Report No. 1337 on page A 254 says that this class would include income derived from such services as the design or construction of projects, such as roads, bridges, railroads, harbors, docks, irrigation systems, water-supply systems, and power systems. As in practice the term "engineering" does not necessarily include "construction," it is recommended that the intent evident in the report be carried out by inserting after "engineering" the term "construction" in the list of activities in class (2).

Engineering and construction activities would also be covered in the recommended definition of permanent establishment applicable under sections 923 (a) (3) (A) (ii) and 951 (a) of H. R. 8300.

H. Credit Should Apply to Foreign Branch Income Whether or Not Includible in Gross Income Under Part IV

Section 923 (a) (1) allows in the case of certain domestic corporations a credit of 14 percent as provided in section 37 with respect to taxable income of a foreign branch which is "includible in gross income under part IV." This wording permits the inference that, in order to have the rate reduction of 14 percent apply, the corporation must elect to defer its foreign branch income as provided in sections 951 and 952, thus coupling the 14-percent reduction in rate with the election to defer.

There seems to be no sound reason for requiring the election to defer in order to obtain the 14-point benefit for income from branch operations in foreign countries. Such operations have been conducted by domestic corporations over a period of many years, and there has been little difficulty encountered by these corporations in determining the income from the branch operations for purposes of inclusion in taxable income and also for purposes of foreign tax credit. It should not be necessary to set up an entirely new regime for such operations. The same procedures could be continued except that the branch income entitled to the 14-percent tax benefit will be that attributable to the branch dealing at arm's length as a separate entity with the organization of which it is a branch.

The taxpayer should not be required to elect a regime of deferring income under part IV as a condition precedent to the enjoyment of the reduced rate of tax, especially since the acceptance of part IV will mean the substitution of new and uncertain accounting concepts in place of those principles of branch accounting now established and generally accepted for tax purposes.

The deferment of tax under part IV postpones the determination and payment of the actual United States tax, and forces the taxpayer to conjecture as to future United States tax rates and the resultant foreign tax credits. Many taxpayer corporations will prefer to pay United States taxes on the income of a "pay as you earn" basis rather than to delay calculation and payment until the income is withdrawn from the foreign branch.

If the taxpayer wishes to compute and pay his taxes to the United States on a "pay as you earn" basis rather than to delay calculation and payment until profits are withdrawn from the foreign branch, the United States Treasury is enriched that much sooner, and the taxpayer has discharged his tax obligation based on presently known tax rates and with certainty as to the credit he will obtain for foreign taxes paid. The taxpayer should be entitled to report on such a basis without foregoing the 14-percent reduction in the tax rate.

Accordingly, it is recommended that section 923 (a) be clarified to read as follows:

"SEC. 923. BUSINESS INCOME FROM FOREIGN SOURCES.

"(a) Allowance of Credit.—In the case of a domestic corporation (other than a corporation described in subsection (d)) there shall be allowed a credit as provided in section 37 with respect to taxable income derived from sources without the United tates (determined under part I)—

"(1) as branch income—

"(A) as determined in section 923 (b) (3) if such income—

"(i) has been derived to the extent of at least 95 per centum from sources without the United States, and

"(ii) has been derived to the extent of at least 90 per centum from the active conduct of a trade or business through a permanent establishment located in a foreign country, or

"(B) as branch income includible in gross income under part IV."

It is recommended that section 923 (b) be amended by adding a new paragraph (3), as follows:

"923 (b) (3). Determination of branch income.—Items of gross income, expenses, losses, deductions, and other items shall be allocated to a branch for purposes of section 923 (a) (1) in accordance with a method of accounting which clearly reflects the taxable income of such branch, treated as a separate distinct entity dealing at arm's length with the organization of which it is a branch."

With respect to part IV, it is further recommended:

(1) Definition of branches should be enlarged

The definition of the branches under section 951 (a) to which the part IV provisions apply is too restrictive and should be altered to include all income derived to the extent of at least 95 percent from sources without the United States and to the extent of at least 90 percent from the active conduct of a trade or business through a permanent establishment located in a foreign country.

(2) *Election for all branches in a single country on a unit basis should be allowed.*

Apparently sections 951 (a) and 952 (1) require an election for each separate branch in a foreign country. The election should be not only for each branch in a foreign country but also for all branches in a country as a unit; especially if the net income from their activities has to be reported in the aggregate for tax purposes in said country. A permissive per country election (which was incorporated in the Simpson bill) will obviate arbitrary and unnecessary allocations of income and expense to different branches. It will also allow a taxpayer to obtain proper foreign tax credit for taxes paid to any foreign country which, generally speaking, are based on the entire net income from sources in the country.

(3) *Losses sustained upon the liquidation of a branch should be allowed as ordinary losses*

Inasmuch as section 165 (g) (3) of the proposed Internal Revenue Code of 1954 (H. R. 8300) allows a domestic corporation to deduct as an ordinary loss securities in an affiliated foreign corporation which become worthless, and allows the deduction of advances to such affiliated corporation which become worthless under section 166 as bad debts, there is no justification for denying to a domestic corporation a deduction for a loss sustained when the assets of a foreign branch become worthless or when the advances to the foreign branch become uncollectible.

This disallowance of these losses destroys the incentive character of an election under part IV and discriminates against foreign branch operations as compared with operations through a foreign subsidiary. It deprives the investing entity of its right to deductions for general operating losses and losses of a catastrophic nature, such as from flood, fire, disease, storm, seizure, theft, etc., all of which are a prevalent risk in the foreign investment field.

(4) *The regulations concerning withdrawal should be equitable*

Under the part IV provisions, the income of a foreign branch becomes subject to tax when it is considered to be withdrawn from the branch. The amount of branch income withdrawn for any taxable year is an amount equal to the excess of the taxpayer's investment in the elected branch at the beginning of the year plus the branch income, or minus the branch loss, of such branch for such year, over the taxpayer's investment in such branch at the close of the year. The basis on which the taxpayer shall determine the investment it has in an elected branch at any time may be prescribed through regulations issued by the Secretary or his delegate. Likewise, the Secretary or his delegate, by regulations, may determine from the branch income of what year or years an amount of income determined to be withdrawn was paid, treating withdrawals as having been paid from the most recent income of the branch.

It will be seen that under part IV the determination of whether income is withdrawn or deferred, and also how much income is withdrawn, will depend to a large degree on the regulations prescribed by the Secretary or his delegate. Thus, until regulations are issued the exact results of an election under part IV are not ascertainable.

(5) *Taxpayer should have right to terminate election*

Inasmuch as the regulations can be changed at will by the Secretary and changes in the law also might materially affect the consequences of the election, the law should provide that the taxpayer shall have the right to terminate his election under part IV voluntarily upon the issuance of regulations or upon amendments to the code involving a change which would materially affect the consequences of such election.

III. Credit for In-Lieu Taxes Should Be Preserved and Principal Taxes Modified.

The President in his budget message of January 21, 1954, declared that "the present definition of foreign taxes which may be credited against the United States income tax should be broadened to include any tax other than an income tax, which is the principal form of taxation on business in a country, except turnover, general sales or excise taxes, and social-security taxes." He repeated this statement in his recommendations to Congress on foreign economic policy of March 30, 1954. This certainly implies retaining what is now granted and giving something more.

The Ways and Means Committee report (H. Rept. 1337) also states that the foreign tax credit provision in section 131 Internal Revenue Code. was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or abroad (p. 76). Inequalities have resulted because certain taxes that were imposed in lieu of income taxes were not recognized by the Treasury as income taxes according to the American concept of an income tax, and were disallowed as credits. This meant that the taxpayer would have to bear a heavier aggregate burden in the foreign country than at home.

This is another expression of the idea contained in the Senate Finance Committee report made in 1942 on section 131 (h), Internal Revenue Code, which noted that in substance (1) the Treasury and the courts had construed the section too narrowly, (2) the amendment was to extend the scope of the section and cover such foreign taxes as those measured by gross income, gross sales, or a number of units produced within a foreign country which were in lieu of an income tax that would otherwise be imposed, and (3) the only limitation on the credit is in section 131 (b), Internal Revenue Code.

Under the regulations, however, since the 1942 amendments, credit has been allowed only for a tax in complete substitution for an income tax. Neither the regulations nor Treasury rulings have reflected the liberal intent of Congress.

In view of this situation, the chairman of the Senate Finance Committee at the time the liberalizing amendment was adopted, Senator Walter F. George, wrote a letter to the Secretary of the Treasury on May 29, 1952 (Congressional Record, June 27, 1952), stating that he was disturbed because the regulations of the Treasury were not conforming to the intent of Congress as reflected in the committee report covering section 131 (h), Internal Revenue Code. He said the present Treasury regulations cover only one class of taxes intended to be allowed as a foreign tax credit, as shown by the explanation in the 1942 Senate Finance Committee report (S. Rept. 1631, 77th Cong., 2d sess., pp. 131, 132).

Briefly, Senator George proposed adding to the existing regulations provisions to cover a tax allowed as a credit or a deduction in computing the foreign income tax, and, in the latter case measured, for example, by gross income, gross sales, or the number or price of units produced in a foreign country or possession of the United States, which, as shown by its legislative history, is intended to reach income in its broadest sense. Such a tax would, of course, have to be paid by the taxpayer and not passed on to the consumer.

After considering the letter of Senator George for a year and a half, the Treasury has brought forth the new concept which, according to the statement in the President's budget message, is intended to broaden the credit "to include any tax other than an income tax, which is the principal form of taxation on business in a country, except turnover, general sales or excise taxes, and social-security taxes."

Section 901 (b) of H. R. 8300 allows the credit for a principal tax plus the amount of any income taxes paid to a political subdivision but only as an alternative to the credit for income, war profits, and excess-profits taxes paid to a foreign government. In other words, only a national principal tax will qualify and the credit for it is in complete substitution for the credit for the national income tax. This is simply a reaffirmation of the existing Treasury concept of a credit under section 131 (h) for a tax in complete substitution for an income tax and does not reflect the broader interpretation proposed by Senator George or implied by the President's message.

The "principal tax" concept is actually narrower than the "in lieu of tax" concept in two respects:

(1) Under existing law, the credit, within the limitations of section 131 (b), can cover one or more "in lieu of" taxes plus any income tax. The new concept allows credit only for one principal tax on each separate trade or business and then only as an alternative to the income tax.

(2) An in-lieu tax can be a tax that is generally imposed, but section 903 excludes from the definition of a principal tax any sales, turnover, property or excise tax that is generally imposed.

Moreover, the new concept is also objectionable because it does not overcome two criticisms of the present provisions:

(1) House Report 1337, at page 76, says the foreign tax credit "has created substantial incentives for foreign governments to increase their taxes on Ameri-

can-owned firms and has led others to pattern their systems after the American's tax structure, irrespective of whether it is appropriate to their economies." While it may be true that some governments have been induced to raise their rates of income tax to absorb the United States credit, they would, under the new concept, merely have to levy on a particular American company, or its subsidiary, any kind of tax, which would not be related in any way to income, but would be large enough to absorb the credit allowed by the United States.

(2) The explanation given for repealing section 131 (h) was that it gave rise to difficulties in interpretation, yet the very repeal of the existing subsection would probably make it necessary for the Treasury to pass anew on each case to determine whether the particular tax would qualify as a principal tax. As the terms "sales, turnover, property, or excise taxes" seem to embrace virtually every kind of tax (excepting possibly social-security and income taxes mentioned immediately thereafter), the only criterion for a principal tax is whether it is not generally imposed. The bill contains no clue to the meaning of "generally imposed," although the House report distinguishes "selectively imposed" taxes. It seems clear that difficulties of interpreting the bill will be as great, if not greater, than those which have been experienced in interpreting the in lieu provisions. The concept of a tax wholly or partially in lieu of an income tax in the light of its legislative history is much more reliable.

It is significant that Senator George's interpretation of the congressional intent in enacting section 131 (h) would allow credit for excise taxes paid by the taxpayer, whereas section 903 would cover them only if selectively imposed. Senator George's reference to taxes measured by gross income gross sales, or the number or price of units produced corresponds to the taxes in section 903 called turnover, sales, and excise taxes, and the reference in the report to production taxes (p. A251).

However, the former concept would cover them even if generally imposed, whereas the new concept covers them only if selectively imposed.

Senator George said that the present law should cover the aggregate of one or more "in lieu of" taxes and any income tax, whereas the new concept allows credit for only one principal tax, and if such credit is taken, no credit is allowed for the income tax. This is so even if the aggregate of all said taxes was less than the United States tax on income from sources in the foreign country.

It is therefore concluded:

The new concept in its present form narrows, rather than broadens, the scope of the credit, deprives those entitled to the benefits of section 131 (h) since 1942, and may give in return nothing, or something less than they would have previously received.

The substance of section 131 (h) should be incorporated in the Senate bill, with a clarifying retroactive amendment to carry out the objectives of Senator George. The "in lieu of" tax should be allowed as a credit against the United States tax whether (1) serving as a credit or deduction in computing the foreign income tax, or, (2) in any other way to reduce the amount or the rate of such foreign income tax.

The concept of "principal tax" should be amended so as to broaden the definition of taxes allowable as credits and assure the credit for all such taxes as well as any income tax or tax in lieu thereof, within the limitation of the amount of the United States tax on income from sources in the foreign country.

Briefly, in order to obviate the restriction of the credit's scope by the new concept, it is necessary—(*a*). to restore the "in lieu" concept; (*b*) to remove the requirement that the principal tax be an alternative to the income tax; and (*c*) to remove the exclusion of the principal tax when generally imposed.

Suggestions for amendments follow.

SUGGESTED AMENDMENTS TO SECTIONS 901 (B), 902, 903, AND 955—H. R. 8300

(1) Amend section 901 (b) (1) to read:

"(1) CITIZENS AND DOMESTIC CORPORATIONS.—In the case of a citizen of the United States and of a domestic corporation the sum of—

"(A) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to a foreign country or to a possession of the United States; and

"(B) the amount of any principal taxes described in section 903 for each separate trade or business of the taxpayer paid or accrued during the taxable year to a foreign country or possession of the United States."

(2) Amend section 902 to read:

"SEC. 902. CREDIT FOR CORPORATE STOCKHOLDERS IN FOREIGN CORPORATION.

"(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION.—For purposes of this subpart, a domestic corporation which owns at least 10 per centum of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of the sum of the following taxes as the amount of such dividends bears to the amount of the accumulated profits of such foreign corporation from which such dividends are paid—

"(1) any income, war profits, or excess profits taxes paid or accrued by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to such accumulated profits, and

"(2) at the election of the domestic corporation, for each year involved in the computation of the credit permitted by this section, any principal taxes described in section 903 for each separate trade or business paid or accrued during such year to the government of any foreign country or any possession of the United States by such foreign corporation, but only in the proportion of such principal taxes which the accumulated profits of such foreign corporation for such year bear to its gains, profits, or income for such year; and not exceeding an amount computed by multiplying such foreign corporation's accumulated profits for such year by a percentage equal to the sum of the normal tax rate and the surtax rate prescribed in section 11 which apply to the taxable income of the domestic corporation for the taxable year of the domestic corporation in which such dividends are includible in its gross income; and

"(3) the taxes deemed to have been paid by such foreign corporation under subsection (b), but only in the proportion specified in paragraph (2) of this subsection.

"(b) FOREIGN SUBSIDIARY OF FOREIGN CORPORATION.—If such foreign corporation owns 50 per centum or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of the sum of the following taxes as the amount of such dividends bears to the amount of the accumulated profits of the corporation from which such dividends are paid:

"(1) any income, war profits, or excess profits taxes paid or accrued by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to such accumulated profits; and

"(2) at the election of the domestic corporation, any principal taxes paid or accrued by such other foreign corporation to the government of any foreign country or of any possession of the United States, under the circumstances and subject to the limitations described in subsection (a) (2), but as if such other foreign corporation were the foreign corporation described in such subsection."

(3) Amend section 903 to read:

"SEC. 903. DEFINITIONS.

"(a) TAXES IN LIEU OF INCOME, ETC., TAXES.

"(1) For the purpose of section 131 (h), Internal Revenue Code of 1939, as amended, and sections 901, 902, and 955 and section 164 (b) (6), the term "income, war profits, and excess profits taxes" shall include a tax paid *wholly or partially* in lieu of a tax upon income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

"(2) *In determining whether a tax is wholly or partially in lieu of an income tax such as, for example, by reason of being imposed on a statutory definition of income, or by being based on gross income, gross sales or the number or price of units produced, or by including in its base the assets which produce the income, or by being allowed as a credit or deduction in computing an income tax, or in any way reducing the amount or the rate of such tax, or through replacing the general profits tax is supplemented by an income tax, and whether or not such tax is shown by its legislative history to reach income in its broad sense, the Secretary or his delegate shall take into account the terms of the law of the country which imposes the tax.*

"(b) PRINCIPAL TAX.

"For purposes of this subtitle, the term "principal tax" means any tax paid or accrued during the taxable year to the government of a foreign country or of a possession of the United States which is attributable to the operation of a trade or business regularly carried on by the taxpayer and which constitutes a principal source of tax revenue to such government from such trade or business, except that—

"(1) no general sales or real property tax imposed by such government, and,

"(2) no income, war profits, or excess profits tax, shall be included as a principal tax or be considered for the purpose of determining such principal source of tax revenue.

"(c) FOREIGN COUNTRY OR POSSESSION.

"For the purpose of sections 901, 902, 903, and 955, the term "foreign country or any possession of the United States" includes any political subdivision of such country or possession."

(4) Amend section 904 to read:

"SEC. 904. LIMITATIONS ON CREDIT.

"(a) LIMITATIONS.—The amount of the credit in respect of all taxes, *including those defined in section 903*, paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken (computed without regard to the credit under section 37 relating to credit with respect to business income from foreign sources) which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. In the case of a corporation allowed a credit under section 37, the amount determined under the preceding sentence shall be reduced by the amount of such credit *in respect of income from sources in such country*."

(5) Amend section 955 to read:

"SEC. 955. FOREIGN TAX CREDIT.

"For purposes of section 901, a domestic corporation which has withdrawn branch income from an elected branch under section 954 for any taxable year shall be deemed to have paid the same proportion of the sum of the following taxes as the amount of such branch income withdrawn bears to the amount of the branch income (as determined under section 954 (c)) from which such branch income is withdrawn—

"(1) any income, war profits, or excess profits taxes or accrued by such branch to any foreign country or to any possession of the United States, on or with respect to such branch income; and

"(2) at the election of the domestic corporation, for each year involved in the computation of the credit permitted by this section, *any* principal taxes described in section 903 for such trade or business paid or accrued during such year to such government by such branch, but only in the proportion of such principal taxes which the branch income of such branch for such year bears to such branch income (computed without the deduction for any income, war profits, and excess profits taxes paid or accrued to any foreign country or to any possession of the United States) allocable to such branch for such year; and not exceeding an amount computed by multiplying the branch income of such branch for such year by a percentage equal to the sum of the normal tax rate and the surtax rate prescribed in section 11 which apply to the taxable income of such domestic corporation for its taxable year in which such branch income withdrawn is includible in its gross income."

The reference to the opening sentence of the proposed amendment to section 903 (a) (1) inserts the language "for the purpose of section 131 (h), Internal Revenue Code of 1939, as amended" so as to indicate with maximum clarity and directness the retroactivity of the restored provision. As an alternative to such method of showing retroactivity, a similar result could be achieved by amending section 7851 (a) (1) (A) to read as follows (additional language indicated by italic):

(A) Chapters 1, 2, 4, and 6 of this title shall apply only with respect to taxable years beginning after December 31, 1953, and ending after the date of enactment of this title, and with respect to such taxable years, chapters 1 (except sections 143 and 144) and 2, and section 3801, of the Internal Revenue Code of 1939 and hereby repealed, *except that section 109 of such code is clarified by section 921 of subtitle A and section 131 (h) of such code is clarified by section 903 (a) of subtitle A of the Internal Revenue Code of 1954.*

IV. Taxpayers Should Be Allowed To Elect per Country or Overall Limitation on Foreign Tax Credit

In 1921 Congress placed on the foreign tax credit a provision, to prevent the credit from reducing the tax on domestic income, which is known as the overall limitation. This means that the total amount allowed as credit for foreign taxes may not exceed the proportion of income from sources without the United States to the entire taxable income or, in other words, the part of the United States tax that corresponds to income from foreign sources. It does not prevent the taxpayer from treating his foreign business as a whole and contains no provision concerning the allocation of items of income and expense to the subsidiary or branch in each foreign country. Furthermore, it does not prevent the averaging of the rates in certain countries that are higher than the United States rate with the rates in other countries that are lower.

This was the only limitation on the foreign tax credit during the great period of expansion of American investments abroad until 1932, when the so-called per country limitation was introduced; that is to say, in addition to the foregoing limitation the foreign-tax credit was limited also by the same proportion of the United States tax as income from sources in a given foreign country bears to entire net income. This prevents the averaging of foreign tax rates just described.

Section 904 of H. R. 8500 provides as a limitation on the foreign-tax credit only the per country limitation and repeals by omission the overall limitation. House Report No. 1337 explains that the repeal of the overall limitation is because "it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years." This means that a domestic corporation with a branch in country A, which realizes a loss, may offset said loss against domestic income, thereby reducing the domestic tax on domestic income. Incidentally, this benefit may be nullified if said corporation elects the regime of deferral of income in order to enjoy the 14-percent reduction (granted in sections 37, 923, and 951), because in that case the corporation may not take the branch loss as a current deduction or as a deduction on the termination of the branch (H. Rept. 1337, pp. A261 and A262).

Some taxpayers are benefited by the amendment in section 904 of H. R. 8300, which permits the offset of foreign losses against domestic income. Other taxpayers feel very strongly that it would be to their advantage to repeal the per country limitation instead of the overall limitation. The latter proposal has been advocated by NFTC.

We, therefore, urge that you grant taxpayers the election as to whether they will apply the overall or the per country limitation in computing their foreign tax credit.

V. Inequitable Restriction on Purchasing Outside Hemisphere by Western Hemisphere Trade Corporations Should Be Removed

Section 921 of H. R. 8300 replaces section 109 of the existing code with an amendment intended to correct *prospectively* an inequitable ruling disqualifying otherwise eligible concerns merely because they purchase goods outside the Western Hemisphere. The ruling having been contrary to congressional intent and what had generally been considered the well-established rule, it should be overruled *retroactively*, and the new matter phrased as a clarifying amendment. This could be accomplished by an amended text as follows:

"for purposes of this subtitle *and of section 109, Internal Revenue Code of 1939 as amended*, the term 'Western Hemisphere Trade Corporation' means a domestic corporation all of whose business (*other than purchases incident thereto*) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions": etc.

The language indicated by the first italic in the above paragraph appears to be the most clear and direct method for accomplishing retroactivity. An alternative method for accomplishing same result would be the following clarifying amendment to section 7851 (a) (1) (A) (additional language indicated by italic):

(A) Chapters 1, 2, 4, and 6 of this title shall apply only with respect to taxable years beginning after December 31, 1953, and ending after the date of enactment of this title, and with respect to such taxable years, chapters 1 (except sections 143 and 144) and 2, and section 3801, of the Internal Revenue Code of 1939 are hereby repealed, *except that section 109 of such code is clarified by section 921 of subtitle A and section 131 (h) of such code is clarified by section 903 (a) of subtitle A* of the Internal Revenue Code of 1954.

It should also be noted that the parenthetical phrase in section 921, "(other than incidental purchases)" is ambiguous since it is not clear whether the word "incidental" should be interpreted according to dollar volume, on a percentage basis, on the basis of frequency or whether incident to the trade or business conducted in the Western Hemisphere. In lieu of the above parenthetical insertion whose ambiguities would lead to administrative difficulties and litigation, there should be substituted "(other than purchases incident thereto)" which is similar to the phrase "incident to the conduct of its trade or business" contained in section 39.109-1, regulations 118 with which taxpayers are familiar.

(The following letter and enclosure was later received for the record:)

NATIONAL FOREIGN TRADE COUNCIL, INC.,
TAX COMMITTEE,
New York 6, N. Y., April 21, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR MILLIKIN: May I supplement the material submitted to your committee last Tuesday, April 13, by Mr. James and myself on behalf of the National Foreign Trade Council with the enclosed copy of a letter to the Honorable Marion Folsom, Under Secretary of the Treasury, which states as briefly as possible what we feel should be done in order to make the provisions in H. R. 8300 concerning the 14 percent credit and the credit for foreign taxes conform to the President's statements on these subjects in his messages on the budget and foreign economic policy.

Yours respectfully,

MITCHELL B. CARROLL.

NATIONAL FOREIGN TRADE COUNCIL, INC.,
TAX COMMITTEE,
New York 6, N. Y., April 12, 1954.

HON. MARION FOLSOM,
Under Secretary of the Treasury, Washington, D. C.

DEAR MR. FOLSOM: We wish to thank you for giving us at 5 p. m. on last Friday, April 9, an opportunity to express to you and Messrs. Smith and Sauer our concern about certain provisions of H. R. 8300 which do not conform to the pertinent statements in the President's messages on the budget and foreign economic policy as follows:

(a) To conform the 14 percent credit to the unqualified objective of giving it to "business income from foreign subsidiaries and from segregated foreign branches which operate and elect to be taxed as subsidiaries," the bill should be amended (1) by removing the discrimination against permanent establishments abroad engaged principally in wholesale, regardless of whether the goods are manufactured abroad or in the United States; (2) by replacing the present list of beneficiary establishments by the concept of permanent establishment in the 14 income tax treaties to which the United States is a party (see NFTC statement No. M.-5968, p. 12); (3) by removing the 25 percent restriction on the destination of goods manufactured (ibid. p. 12) and by modifying the stock ownership requirements (ibid. p. 13) and

(b) To conform the bill to the House Report 337, (p. A. 254), the term "construction" should be inserted after "engineering" in section 923 (a) (2) of H. R. 8300.

(c) To carry out the President's statement in the above messages that the "present definition of foreign taxes which may be credited against the United States income tax should be broadened to include any tax other than an income tax, which is the principal form of taxation on business in a country except turnover, general sales or excise taxes, and social security taxes," H. R. 8300 should be amended:

(1) by incorporating therein the provisions of section 131 (h), Internal Revenue Code 1939, with a clarifying amendment to carry out the original intent as set forth in the Senate Finance Committee report 1942 and the

letter from that committee's chairman to the Treasury of May 29, 1952 (ibid. pp. 19, 20), such as by inserting "wholly or partially" before "in lieu of," by adding other clarifying language (ibid. pp. 24, 26), and allowing credit for the aggregate of such taxes and any income tax within the prescribed limitations;

(2) by allowing the credit for a principal tax in addition to the credit income taxes and taxes wholly or partially in lieu thereof within the prescribed limitation (ibid. pp. 23-26).

The definition of principal tax should be made less restrictive (ibid. p. 24).

Arguments to support the above and other proposals are set forth in the attached statement (ibid. pp. 19-23). We should welcome the opportunity of discussing with your technical experts these proposals, which were carefully considered and unanimously adopted by the NFTC Tax Committee.

Yours respectfully,

George F. James,
Mitchell B. Carroll.

The Chairman. Mr. Nathan, please make yourself comfortable and identify yourself to the reporter.

STATEMENT OF ROBERT R. NATHAN, AMERICANS FOR DEMOCRATIC ACTION

Mr. Nathan. My name is Robert R. Nathan. I am a consulting economist, and I appear here on behalf of the Americans for Democratic Action, of which I am chairman of the national executive committee.

Mr. Chairman, we have submitted a statement, and I will just make a few very brief comments, in view of the time.

(Mr. Nathan's prepared statement follows:)

Statement of Americans for Democratic Action on Tax Reduction Proposals Presented by Robert R. Nathan

Gentlemen, my name is Robert R. Nathan. I am a consulting economist, and I appear here today on behalf of Americans for Democratic Action, of which I am the chairman of the national executive committee.

ADA appreciates the opportunity to appear here to present its views on the important question of tax revision which is now being considered by this committee. These hearings are particularly significant in view of the fact that the House Ways and Means Committee refused to permit nongovernmental witnesses to appear before it and to address themselves to the revenue aspect of H. R. 8300, a bill to revise the internal-revenue laws of the United States.

ADA has stated in the past and emphasizes again the importance of recognizing that the threat of Communist expansion in many parts of the world continues to demand large outlays by our Government for security purposes. The dangers facing the free nations of the world require that this economically powerful Nation of ours give primary attention to defense mobilization essential for securing the peace. The cause of peace and security will certainly not be furthered by principal emphasis on lower taxes and a balanced budget, with spending for defense a residual consideration. We fear that there has already been too much of this kind of perverse thinking.

ADA has confidence in the ability of the American economy to meet the needs of an adequate defense program, to provide assisance to the undeveloped and underdeveloped countries of the world, and to support essential governmental programs for resource development and for expanding welfare services. Our growing productive capacity permits us to satisfy these requirements and at the same time to support a sizable investment program and an expansion in private consumption. We do not share the defeatism of those who fear that our economy will be bled white by supporting essential governmental activities.

The primary prerequisite for meeting all our needs is a fully employed and expanding economy. If we dedicate ourselves to sustained high levels of employment and prosperity, then high levels of expenditures for security and for the well-being of our citizens can be paid for out of record incomes and profits of corporations and individuals. Therefore, we suggest respectfully that in considering this problem of taxation your committee give particular attention to both the economic health of the country and the total needs of our Nation.

Since the middle of 1953, economic activity in the United States has been declining. We do not believe that a deep and prolonged depression is in prospect. Yet we are concerned about tendencies toward complacency with respect to the present level of unemployment and of wasted resources. Underproduction and unemployment are wasteful—yes, they represent a waste of the productivity of our manpower and of our machinery and equipment. The loss of production is a waste because it cannot and will not be recovered. Today, our national production is some $10 billion lower than it was in the middle of 1953. Even that is not a true reflection of the loss and waste because our increasing population and rising productivity make possible a higher level of output in 1954 than in 1953. At the same degree of full employment which prevailed in the middle of 1953, our present level of production would probably be about $20 billion—at an annual rate—higher than it was then. We are literally throwing that amount of production down the drain to be lost forever.

There are many in the administration and in Congress who speak boastfully about our present prosperity. In essence, they state that: "This year, 1954, will be just a little short of 1953, and last year was the best year in our history. Production in 1954 will be the second highest in our history. We cannot expect to reach new peaks every year." Gentlemen, these men sell America short. We can reach new peaks every year and we should strive to reach new peaks every year. We do not mean to imply that the same conditions prevail now as prevailed in 1930, but it might be of interest to note that production in 1930 was only moderately below that of 1929 and economic activity in 1930 was one of the best years up to that time.

We cannot afford to stand on past records. Even if production and employment were to continue at the same absolute level of 1953, in a few short years we would be faced with catastrophic levels of unemployment. We must move ahead and our economic policies must be geared to steady growth.

ADA does not believe that depressions or even recessions are inevitable. Fluctuations in economic activity in a free economy are likely to occur. As a matter of fact, the history of the American economy leads to the conclusion that booms and busts of varying severity will certainly recur if nothing is done to prevent them. We believe that great progress has been made in the last 20 years to overcome business cycles which previously had been accepted as inevitable phenomena. We believe that, without compromising the basic principles of a free and democratic society, even moderate fluctuations in business activities can be minimized bv appropriate Government action. We urge your acceptance and dedication to this belief.

The principal deterrent to continued economic growth has been an inadequate demand for the goods and services which our economy can produce. Businessmen do not like to curtail their production and to reduce their working staffs. Given a market for the products which they can turn out, businessmen will employ all available workers and will fully utilize the productive capacity of their plants. The present business slump can be traced directly to the problem of inadequate demand. Some say that the present decline is an inventory recession but this is mistaking the symptom for the cause. Inventory adjustments could be readily made without general unemployment if there were adequate total demand.

Some people contend that the present recession can be overcome primarily by reducing taxes on individuals with high incomes and taxes on corporations so as to provide greater incentives for investment. ADA does not believe that this provides the correct solution to our present difficulties. The administration has published figures indicating that plant and equipment expenditures of American business will be 4 percent lower in 1954 than in 1953. These figures obscure the true trend, because on the basis of the administration's own figures, analyzed on a quarterly basis, the level of investment expenditures for plant and equipment will be about 10 percent lower before the end of this year than it was in the third quarter of 1953. This represents a serious decline in business spending. We do not believe that this reduction in business investment expenditures can be traced to high taxes, nor do we believe that just reducing taxes on higher incomes and corporate profits will reverse this trend. Businessmen will not invest, even if taxes are lower, if they do not have confidence that there will be a market for the goods which this expanded capacity can produce. Why will investment increase when there is idle capacity? The greatest inducement to investment is a growing market for the products of industry. We believe we cannot emphasize this point too strongly. We believe the greatest error in the tax policy of the present administration derives from the failure to recognize the importance of consumption as a determining factor in the level of investment.

The primary damper on investment and production at the present time is the inadequate consumer market for the products and services of business. The way to increase investment at this time is to increase consumption.

Tax reductions at an annual rate of approximately $6 billion have already occurred. Of this total, $2 billion went to corporations when the excess-profits tax expired on December 31, 1953. Another $3 billion in revenue was lost when reduced invididual income-tax rates went into effect after December 31, 1953. One billion drop in revenue resulted from the reduction in excise levies which became effective April 1.

There are three comments which we should like to make with respect to the tax reductions to date.

First, we abhor the deception which has been practiced by those who have contended that these tax reductions were made possible by curtailed expenditures by the new administration. Actually, governmental expenditures have not been reduced by anywhere near this magnitude. In the first half of the current fiscal year cash disbursements by the Federal Government were approximately equal to the cash disbursements of the first half of the preceding fiscal year. For the total fiscal year, ending June 30, 1954, Federal Government cash disbursements will only be fractionally lower than in the fiscal year ending June 30, 1953. When the final figures on actual disbursements and actual receipts for the current fiscal year are tabulated, we believe that the American people will realize that they have been misled by the false claim that the huge tax reductions have been made possible by huge savings. We believe that if the budget for fiscal year 1954–55 makes adequate provision for the necessary defense of the United States and the necessary assistance to our allies and friends throughout the world and for essential welfare programs, the projected expenditures will not justify the claims that have been made so glibly about the tax cuts coming from the elimination of waste and the reduction of expenditures.

As a second observation, we believe that in and of itself a balanced budget is desirable. However, we would prefer an unbalanced budget to mass unemployment. Therefore, any substantial reduction in taxes designed primarily to bolster a weakening economy and to restore full employement and expansion is commendable, even though it results in an unbalanced budget. We do not believe that most of the tax reductions to date have been designed primarily for the purpose of halting the decline in business and of reestablishing full employment. Had this been the principal objective, the nature and the character of the reductions would have been considerably different. That leads us to our third observation.

The tax reductions to date have served principally to give relief to corporations and to the higher income groups. The benefits to the lower income groups have been relatively insignificant. On that score, we believe that these reductions have not been designed primarily to bolster the economy. There is little point in making additional funds available for investment when these funds are not likely to be invested because of uncertainty of consumer demand. When the businessman has doubts about the market for his goods and his services, he is not likely to increase his productive capacity. That is just plain commonsense and good business. Had the tax reductions to date been dictated by the needs of the economy, there would have been much more relief for those in the low-income levels and much less relief for those in the higher income levels. Even the cut in excise taxes will have limited effects on the lower income groups because the savings relate principally to luxuries and semiluxuries. The very mild opposition of the administration to the cut in excise taxes as distinguished from the very determined opposition to raising the exemptions is a manifestation of a failure to appreciate the simple economic fact that in our present situation increased consumer demand is the key to renewed prosperity and expanding production. The decision to delay recommendations for increasing the minimum wage is similarly a manifestation of unsound economic thinking.

The emphasis in tax reductions to date on giving greater incentives to investment rather than to increasing consumption is also apparent in the tax bill now under consideration by your committee. It is well and good to worry about taxation effects on investment incentives when there is plenty of demand for goods and services and a lack of investment capital; but we should make sure now that there is enough demand to make investment profitable in the first place. Our major objection to the tax bill which is being considered by your committee is that this bill will primarily benefit corporations and individuals in the upper income levels. We believe in incentives for business and we believe in rewards for risk and for venture capital. But, we believe that it is unsound economics to ignore the very important fact that consumer demand is the principal determinant of the level of investment.

By 1956, when the full effect of the present tax bill would be felt, revenue losses would exceed $3 billion. The overwhelming proportion of the benefit will go to corporations and individuals in the upper income levels. This bill, coupled with the tax reductions to date will significantly reduce the degree of progressivity in our entire tax structure.

As already stated, we are fully cognizant of the importance of incentives to business and to individuals for investing their funds. Yet, we believe that progressive taxation is not only equitable but also in the best interests of the economy. As a matter of fact, progressive taxation helps to bring stability to the economy. When taxes are progressive, the total level of Government revenue tends to rise or fall proportionately more than the increase or decrease in the national income. Therefore, in periods of boom, the disproportionate rise in Government revenues becomes anti-inflationary and helps to yield budget surpluses and to stabilize the economy. In periods of declining activity or deflation, the more than proportionate drop in Government revenues tends to result in deficits and to halt the drop in the economy. We believe that this is a desirable economic consequence of a progressive tax system. Tendencies to make our tax system less progressive will introduce a greater element of instability in our economy.

There is one specific provision of H. R. 8300 to which ADA takes particular exception. The preferential treatment of income in the form of dividends is particularly undesirable and unwarranted. If the present provision for benefiting dividend recipients is enacted into law, about $250 million of tax savings will be enjoyed by stockholders in the first year and over $750 million of tax savings will be enjoyed by stockholders each year by 1956. These stockholders represent only a very small percentage of the families in our countries and the great bulk of these savings would be enjoyed by a fraction of 1 percent of all our citizens, all of whom are in the higher income brackets. Contrary to tendencies in the past to give preferential tax treatment to earned income, today the administration proposes to give preferential treatment to unearned income. We believe that the method which has been proposed for this tax relief is contrary to every principle of fairness and soundness in the whole field of taxation.

The supporters of preferential treatment for dividend recipients have suggested that this measure is designed to restore equity in the tax structure by eliminating double taxation. We have serious doubts about this argument about double taxation. Corporations are separate entities. In periods of full employment there are many who believe that corporate income taxes are largely passed on to the consumer in the form of higher prices. In any case, paying a pay many taxes in many forms.
be imposed on the amount accumulated which is reasonable and a deduction

Even if the principle of double taxation and the desirability of dividend tax relief were acceptable, the method proposed in H. R. 8300 is a singularly inequitable one, as Prof. Richard A. Musgrave of the University of Michigan pointed out in his letter to the Washington Post several days ago. Those dividend recipients who are in higher income brackets will benefit much more than those who are in the lower income brackets. This particular tax-relief provision violates every principle of justice and equity and sound economics as between individuals of different income levels. The way in which the benefit applies hardly justifies any expression of concern for the poor widow who relies on dividend income for her means of livelihood. Proportionately, the very high income people will be the particular beneficiaries of this unjust provision. It would be much more logical to exempt dividends from the corporate income tax and apply the corporate tax only to the undistributed profits. Then, all dividends received by individuals could be taxed at the appropriate rate.

Again we wish to emphasize that we have serious doubts about this whole question of double taxation and the need for special relief for dividend recipients. The retention of a large portion of corporate profits by the corporation and the resulting rise in the value of corporate equities which are ultimately subject to the low tax rate on capital gains should be taken into account when considering the position of corporate shareholders. It should be further noted that dividend payments have been rising whereas other types of income have been declining. It is not sensible to give big benefits to those who have suffered no shrinkage of income as compared with those whose incomes have been falling. Relief to dividend recpients will probably increase savings more than spending.

To greater or lesser degree, most of the other provisions in this present tax bill are geared to help the higher income groups and corporations rather than the lower income groups. Even some of the provisions which on the surface appear to help those with low incomes are drawn up in a way which reduce their usefulness for the low-income brackets. For instance, the exemption for working wives must be recorded as itemized reductions, thereby eliminating the standard 10 percent reduction. Income splitting for heads of households will give relief principally at the middle and higher income levels. The exclusion of life insurance proceeds from estates will be primarily beneficial to the middle and higher income groups rather than the lower income groups.

ADA recognizes that the present tax structure and tax provisions reflect an accumulation of new taxes on top of new taxes over a period of war years and that a major review of the tax structure is appropriate. We do not believe that the present bill meets the needs of the economy and, therefore, should not be looked upon as a fundamental revision and rewriting of our tax laws. We believe that there has been too much deviation from the principle of ability to pay and too much emphasis on incentives for investment and too little emphasis on expanding the buying power of the mass of American consumers. We believe that the present bill and the tax reductions to date may well bring less prosperity to the country rather than more prosperity and, therefore, will shrink the revenue of the Government to an even greater degree than the tax reductions themselves contemplate.

If reductions in taxes are justified, and we believe the present economic situation does call for tax reductions, then measures should be taken to increase consumer purchasing power by adjusting taxes to leave more money in the hands of those families in the lower income levels. They will increase their consumption and will spend the increased funds made available to them. Increased exemption or lower rates at the lower income brackets are now preferable to the tax reductions which have already taken place and which are contemplated in the bill.

In conclusion, ADA expresses its belief that this tax bill and the tax reductions which have already been made in recent months reflect a backward step toward the policies of a generation ago. This country has made great progress in economic policies in the past generation and the businessmen of America have enjoyed unprecedented sustained periods of prosperity under the progressive policies of the previous administrations.

Taxation is an important instrument in economic policy. The present bill will weaken that instrument and will not serve to insure stability and expansion for the country. This is especially distressing at a time when the United States is the leader of the free world. The responsibility for that leadership must be taken seriously. The economic success of the United States may well determine the survival of freedom everywhere.

Mr. Nathan. First, it is our very strong belief in the ADA that the real threat in the world today is Communist aggression.

Therefore, we restate our position in favor of an adequate defense program. We are rather concerned that in recent times there has been a tendency to consider tax cuts first and then balancing the budget and then leaving the defense expenditures as a residual consideration.

We believe this it not in the interests of the security of the country nor in the best interests of the free world. Therefore, we especially urge that tax cuts be considered in light of our defense needs rather than as an initial and independent consideration.

Secondly, we have always been convinced and feel very strongly that the security of the United States and of the free world in real measure depends upon the economic strength and economic well being of the United States, and that any loss in production and any considerable unemployment in the United States has a very serious consequence in terms of our ability to be strong militarily and in terms of our ability to give real leadership and to have the confidence of the other free nations of the world, so we believe that the tax program which is being considered by this committee must take into very serious consideration the economic conditions in the United States and that the role of taxation is an exceedingly positive and important role.

The idea that taxes provide only the power to destroy, we believe is not very realistic. We think the power to tax is also the power to create and tax measures can be possible in terms of their help to a healthy economy as well as adverse tax practices can be destructive to a healthy economy. We are concerned about the existing unemployment, although it is not serious and we do not foresee a calamitous depression. Nonetheless, the fact that production in the United States has gone down some 10 to 15 billion in the last 9 months, when by normal increase in labor force and productivity it should have gone up some 10 billion, means that we are losing, actually wasting, some 10 to 20 billion dollars worth of goods and services which could help our people and help our military strength and help the free world very much.

With respect to the tax bill before this committee and the tax program specifically, we feel that inadequate attention has been given to the function of consumption in our economy and excess of attention has been given to the function of investment. We think that the tax cuts to date with respect to the excess-profits elimination, which we favored, and the across-the-board cut in income tax of about 10 percent, have been primarily beneficial to corporations and the high-income groups.

We believe in incentives for investment and for risks. On the other hand, it is our conviction that businessmen will not invest, no matter how low taxes are, unless they can foresee a market for their goods.

If I may recall the effect of the excess-profits tax elimination, it was clear by the middle of 1953 that the excess-profits tax was going off at the end of 1953. It was clear to American corporations that they would save $2 billion in taxes in 1954.

Yet, gentlemen, investments in the United States hit a peak in the third quarter of 1953 and have been going down ever since.

To use official Government figures, it is expected that plant and equipment expenditures by business will be 4 percent less in 1954 than in 1953 and much more important, if those figures are put on a quarterly basis as published by the United States Government, the decline in plant and equipment expenditures by business before the end of 1954, if their projections persist, will be down about 10 percent from the third quarter of 1953.

I think it is worth pondering that situation because here was a tax cut of $2 billion for corporations and following the commitment for that cut came a very substantial and serious drop in investment.

We believe that businessmen will not invest in full measure if there is a question whether there is a market for the products which that investment makes possible.

Idle capacity is a discouragement to invest. If there is inadequate consumer demand there is discouragement to invest. Tax cuts, as such, alone will not necessarily correct the situation in terms of increasing investment. We believe that the progress in the last 20 years—and I emphasize the word progress—in terms of introducing a more progressive tax system in the United States, one based more on ability to pay, has had a very stabilizing influence in this economy and has tended in and of itself to modify and minimize business cycles.

In the boom period when the tendency is for income to rise more than proportionately in the high incomes and in corporate profits, a tax which hits increasingly at those concentrations tends therefore to bring about a Government surplus in boom times and a progressive tax means that Government revenue will drop proportionately more than the national income when business falls off. That automatically tends to bring deficits or stimulating activity from the Government fiscal policy.

Therefore, we believe that progressive taxation inherently builds into our economy stability which we never had before because we never had any substantial degree of progressive characteristic in our society.

It is our belief, gentlemen, that the tax cuts to date have been primarily concentrated in the corporate area and in the high-income groups. We believe that defect in terms of the economic characteristics of our tax changes is also characterized in the present bill.

We do believe that tax revision and a whole review of the tax structure is appropriate. We have a tax program which was built up through war, cold and hot, for 20 years without basic reappraisal and we believe that reappraisal is appropriate. But we believe that if the requisites for full employment and the economic condition of the United States are given full recognition, this bill will be changed substantially in terms of providing more benefit to those at the lower levels as distinguished from the high-income levels. There has been much discussion about the dividend provisions and I will not go into detail except to say that we believe this is a tendency contrary to past tendencies to benefit earned income and this is a tendency—I don't mean to use the word "unearned" in the sense that dividends are not justified, but rather unearned in the traditonal sense. It tends to distinguished unearned income from earned income. I personally have serious doubts about the validity of the argument of double taxation from an economic point of view. But, even if we accept the principle that there is double taxation, we believe there are other methods. For instance, giving a credit on undistributed profits, but let the dividends be taxed at the recipient level in accordance with the income level of that individual, and not by the credit which is now proposed. We believe that there are other provisions in this law with respect to insurance, estates, pension trusts and the like, which are not beneficial to the lower income people, the working people, the mass of consumers.

And we believe if we will give encouragement primarily to consumption, that is what will induce investment and we can have full employment, prosperity, a high income base for taxation, and a balanced budget and prosperity. We don't believe that measures are moving in that direction.

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

Mr. Seghers.

STATEMENT OF PAUL D. SEGHERS, FEDERAL TAX FORUM

Mr. SEGHERS. Thank you, Mr. Chairman, for the opportunity to appear here today. My name is Paul D. Seghers, attorney, of New York City, appearing as the chairman of the committee on Federal tax legislation of the Federal Tax Forum in New York City and also individually in support and amplification of the forum's recommendations regarding the taxation of business income from foreign sources. We have supplied the committee with copies of statements presenting our recommendations. The forum's recommendations are really in three parts, the introductory text, the summary of the recommendations, and then a separate sheet for each provision with respect to which we recommend changes, setting forth our interpretation of the provision and the reason why we think the change should be made and what the change should be.

(The statement of the Federal Tax Forum and then the statement of Mr. Seghers follow:)

STATEMENT OF THE FEDERAL TAX FORUM, INC., (OF NEW YORK CITY)

Presented by Paul D. Seghers, Chairman, Committee on Federal Tax Legislation, Recommending Changes in the Provisions of the Proposed Internal Revenue Code of 1954 (H. R. 8300)

The Federal Tax Forum, Inc. of New York City is a professional, non-political organization of attorneys, tax practitioners and privately employed heads of tax departments of large industrial organizations. Its 200 members represent, through their clients and employers, a large segment of industry and finance.

The Federal Tax Forum considers that it is not within its province to make recommendations concerning reductions in income-tax rates, personal exemptions, or similar matters. The Forum feels that it is appropriate to make recommendations with respect to technical changes believed to be required because of errors in draftsmanship or with respect to provisions which, on the basis of practical and long experience with business and taxation, are believed to result in inequities and discrimination whereunder some taxpayers are subjected to a heavier tax burden than others in almost identical circumstances.

Even the enormous amount of labor and manhours which have been devoted to the drafting of the proposed Internal Revenue Code of 1954 could not be sufficient for such a major undertaking in the limited time available. It is astonishing, not that the proposed code contains errors, but that such a tremendous task could be so successfully accomplished. Numerous unintentional errors, inconsistencies and injustices in the proposed new code were bound to creep into the work.

Congress has always sought to correct such inequities, and the Federal Tax Forum, whose members devote their professional lives to the study of the theory and practice of taxation, has always sought to assist Congress in its efforts to make corrections. To that end the recommendations set forth in the attached summary and detailed in the accompanying text are submitted.

The Forum is anxious to emphasize that the making of recommendations with respect to only certain provisions of the proposed code should not be construed as an approval of all its other provisions. Time has not permitted a complete review of all the provisions contained in such an enormous undertaking. The provisions of the code will continue to be studied as thoroughly and as completely as possible, and as the need for other changes is discovered, the Forum will prepare and present careful analyses and further recommendations for changes as quickly as possible.

The accompanying recommendations for changes in the proposed code are believed necessary to correct errors and prevent injustices; it is not believed that they will cause the Treasury any substantial loss of revenue. On the contrary, the Federal Tax Forum firmly believes that the elimination of technical errors and injustices promotes taxpayer morale, which is essential to effective administration of our tax laws.

Following the accompanying summary of recommendations are separate sheets presenting the facts with respect to the need for each of the changes recommended and suggestions, in general terms, of the manner in which it is believed that the necessary relief may best be effected.

Numerous recommendations along similar lines were presented by the Federal Tax Forum to the Hon. Colin Stamm, chief of the technical staff of the Joint Committee on Internal Revenue Taxation on January 9, 1953, at a meeting with representatives of his office and of the Treasury, and a formal statement of those recommendations was presented at a hearing before the Ways and Means Committee on June 9, 1953. The accompanying recommendations deal specifically with new and in many instances entirely radical provisions of the proposed Internal Revenue Code of 1954 which were not, and could not have been, dealt with specifically in those previous statements and appearances.

The Federal Tax Forum looks forward to an opportunity for a further conference with the technical staff of your committee and of the Joint Committee on Internal Revenue Taxation for the purpose of explaining at greater length the need for the recommendations set forth in the accompanying statement and answering any questions which may be asked.

The accompanying recommendations were prepared by the committee on Federal tax legislation of the Federal Tax Form on the basis of suggestions made by members of that committee and of the forum at large. These recommendations were then submitted to the entire membership for their approval, in accordance with the procedure consistently followed by the Federal Tax Forum in past years, which undoubtedly accounts for the very high percentage of its recommendations which have been accepted by Congress in the past and in H. R. 8300.

Many of those who have been studying the provisions of the new code have come to the conclusion that the effective date of the technical changes therein should be advanced to January 1, 1955. They urge that time would thereby be afforded for business generally to understand and adjust to the impact of the new technical changes and for tax practitioners thoroughly to study the new provisions, so as to enable them (a) properly to advise business, and (b) to call to the attention of the congressional committee situations where inequities have been created by removing old equities, new loopholes occasioned in the attempt to close old ones, etc.

A poll is being taken by the Federal Tax Forum to obtain the views of the members on this important question. In the meantime, our committee can only ask that this suggestion be given careful consideration.

Respectfully submitted.

PAUL D. SEGHERS,
Chairman, Committee on Federal Tax Legislation
of the Federal Tax Forum, Inc.

Members of the Committee: Ralph W. Button, Dallas Blair-Smith, Walter T. Cardwell, Lindley H. Clark, Jr., John F. Costelloe, Henry J. Dohrmann, John F. Duffy, Peter Guy Evans, J. Stanley Halperin, Benjamin Harrow, Robert S. Holzman, J. H. Landman, Martin M. Lore, Charles Meyer, Vincent H. Maloney, Alfred S. Pellard, Maurice E. Peloubet, Ludwig B. Prosnitz, Wm. J. Reinhart, Jr., C. L. Savage, David Stock, Gustave Thorkilsen, Walter W. Walsh.

SUMMARY RECOMMENDATIONS OF THE FEDERAL TAX FORUM

Section 165 (e)—Losses from theft

Theft losses should be made deductible in the years sustained or in the year discovered, at the option of the taxpayer.

Section 171 (b) (1) (B)—Amortizable bond premium

(1) A minimum chargeoff period of 3 years from date of purchase (where purchased after January 22, 1954) should be permitted, regardless of date of issue, with the statutory assumption, in the case of a bond callable at any time after date of issue, that the earliest call date is 3 years from date of purchase, and

(2) Where a bond is called for redemption within such 3-year period, the unamortized balance of premium should be deductible in the year of redemption.

In the alternative, if the date-of-issue test is to be retained, the controlling date of issue should be January 22, 1954.

Section 172—Net operating loss deduction

The provisions for adjustments on account of the dividends-received credit and percentage depletion should be eliminated.

Section 243—Dividends received by corporations

(1) The deduction for dividends received by a corporation from a domestic corporation which is subject to tax should be increased from 85 to 100 percent, to prevent triple taxation of 15 percent of such dividends.

(2) In any event, such triple taxation should be avoided, and the credit increased from 85 to 100 percent in the case of dividends received by a corporation from a domestic corporation taxed as a Western Hemisphere trade corporation under section 922.

(3) As to dividends received from certain insurance companies, see section 831, below.

Section 248—Organizational expenditures

Organizational expenditures should be defined as including the cost of issuing and listing stocks, and the reorganization of corporations, and not limited to initial expenditures.

Section 267 (a) (2) (B)—Losses, etc., between related taxpayers

No deduction should be disallowed under this section if the related taxpayer to whom the expense or interest is due (*a*) includes that income in his return for the year in which the accrual is made or in the following year and (*b*) signs a binding election to be taxed on the amount so reported in his return.

Section 333—Gain from the sale of property in connection with corporate liquidations

The benefits of this section should, at the option of the taxpayer, be allowed where a plan of liquidation was adopted after December 31, 1953.

Section 472—Last-in, first-out inventories

LIFO inventories should be permitted to be valued at the lower of cost or market.

Section 505—Allowable investments for employees' trusts

(1) Investment in wholly owned real-estate holding corporations, exempt under section 501 (c) (2), should be specifically authorized.

(2) The limitation on any one investment in real estate should be increased from 5 percent to 15 or 20 percent.

(3) Real estate should be valued at its cost of acquisition less allowable depreciation.

Section 514—Business leases

This section should not be applicable to any business lease indebtedness created or existing prior to March 1, 1954.

Sections 531–536—Corporations improperly accumulating surplus

The tax should not be imposed on so much of the amount accumulated as is reasonable, and a deduction should be allowed for any such amount. The 10-percent stock ownership test in the case of publicly held corporations should apply only to directors of the corporation during the taxable year.

The new burden of proof of its rule should be made effective immediately in every case where no hearing before the Tax Court has been held before enactment of the bill.

Section 831—Tax on insurance companies (other than life or mutual)

(1) Sections 34 (c) (1) and 246 (a) (1) should be amended to eliminate the exclusion therein of dividends received from stock insurance companies taxable under section 831 and

(2) Sections 923 (d) (2) and 951 (c) (4) should be similarly amended to eliminate the exclusion therein of such stock insurance companies.

Section 923—Business income from foreign sources

Complete exemption of income from foreign sources would be the wisest move. In the alternative:

(1) The 14-point tax credit should be allowed with respect to income from the sale abroad of goods manufactured by the seller or its parent or affiliate

where substantial inventories, personnel, and a permanent establishment are maintained abroad.

(2) The requirement of ownership of "more than 50 percent" of the stock of a foreign subsidiary or sub-subsidiary should be changed to "50 percent or more * * * or the maximum percent allowable [by the] * * * foreign country in which * * * doing business."

(3) Income entitled to the benefit of the 14-point tax credit should include compensation for management services and royalties for use of a patent, process, trade-mark, or copyright.

(4) Dividends received by a corporation from a domestic corporation taxable as a Western Hemisphere trade corporation should be allowed the benefit of the dividends received credit to the extent of 100 percent rather than 85 percent. (See sec. 243, above.)

(5) The 14-point tax credit should not be disallowed in the case of income from the manufacture of goods abroad which are intended for sale in the United States, if the manufacture involves the processing of raw materials, at least 60 percent of which originated in a foreign country or countries.

Section 1014 (a) (9)—Basis of property acquired from a decedent

The provisions of this section should apply to all property described therein and disposed of subsequent to December 31, 1953, regardless of date of death of the decedent.

Section 1235—Sale of patents by person other than inventor

Gain realized upon the sale of a patent by a person other than the inventor should be deemed gain from a sale or exchange, regardless of the method used in determining the amount of the sale price.

Section 1321—Involuntary liquidation of LIFO inventories

Income of the year of liquidation of a LIFO inventory should be adjusted by the difference between cost of the inventory liquidated and current replacement cost. Any difference between such inventory replacement cost and the actual cost in the year of replacement should be reflected by an adjustment to income in the year of replacement. If the replacement is not made within the time permitted, the adjustment in the liquidation year should be reversed in the last year in which the replacement would have been permitted.

Section 1514—2 percent penalty tax on consolidated returns

The tax rates applicable in the case of a consolidated return should be the same as in the case of a return filed by a single corporation.

Section 6901 (d) (1)—Extension of time for assessment

The last sentence of this section should be changed to cover a situation where the overpayments were made by the transferor.

Section 165 (e)—Losses from theft

This section provides that theft losses shall be treated as sustained during the taxable year when discovered. This helps corporations and may help individuals in the higher tax brackets, but may be of no help in the case of the individual in a low tax bracket whose securities are stolen by an employee over a period of years, inasmuch as theft losses apparently are not includible in computing the loss carryback of an individual.

We recommend that theft losses be made deductible in the years sustained or in the year discovered, at the option of the taxpayer.

Section 171 (b) (1) (B)—Amortizable bond premium

This section does not provide equal treatment for all callable bonds, regardless of when issued. Hence, it will induce prospective issuers to insert restrictions on redemptions, restrictions which are frowned upon by the SEC. It discriminates unfairly between pre-January 23, 1951 bonds (which are given preferential treatment) and those issued on and after that date. It will cause unfair retroactive application of the House provision to investors in post-January 22, 1951 bonds.

We therefore recommend that section 171 (b) (1) (B) should be amended so as (1) to permit a minimum chargeoff period of 3 years from date of purchase (where purchased after January 22, 1954), regardless of date of issue, with the statutory assumption, in the case of a bond callable at any time after date of issue, that the earliest call date is 3 years from date of purchase, and (2) to provide that where the bond is called for redemption within such 3-year period, the unamortized balance of premium may be deducted in the year of redemption.

In the alternative, we recommend that, if the date-of-issue test is to be retained, then this section should be amended so that the controlling date of issue is January 22, 1954.

Section 172—Net operating loss deduction

In computing a net operating loss the deduction for dividends received provided in section 243 is disallowed and the excess of percentage over cost depletion is not allowed as a deduction. If the loss is not fully absorbed in the first year to which it is carried, the remaining amount carried to another year is further reduced by the excess of percentage over cost depletion and the deduction for dividends received in the first year. If there were any remaining portion of the loss to be carried to later years, there would be similar adjustments for each of the intervening years. The result of these adjustments is that a taxpayer experiencing some years of profit and others of loss, pays tax on more income than a taxpayer which has income in every year, although in both cases the same net income may be realized over a period of years.

The modifications in paragraphs (5) and (6) of subsection (d) should be eliminated.

Section 243—Dividends received by corporations

(1) The deduction for dividends received by a corporation from a domestic corporation which is subject to tax is limited to 85 percent. Inasmuch as the dividend income has already been taxed in the hands of the distributing corporation and will be taxed again when distributed to the individual stockholders, there is a triple tax on 15 percent of the dividends received by the corporation.

The deduction provided in section 243 (a) for dividends received should be increased from 85 percent to 100 percent.

(2) In any event, such triple taxation should be avoided, and the credit increased from 85 percent to 100 percent in the case of dividends received by a corporation from a domestic corporation taxed as a Western Hemisphere trade corporation under section 922.

(3) As to dividends received from certain insurance companies, see section 831, below.

Section 248—Organizational expenditures

This section provides for the deduction of the "organizational expenditures" of a corporation ratably over a period of not less than 60 months, beginning with the month in which the corporation begins business. "Organizational expenditures" are, however, defined as only those incident to the creation of the corporation. These may be very small. The expenses of reorganizing an existing corporation, or of subsequently issuing stock may, on the other hand, be substantial, and, as no provision is made with respect thereto, they will be treated in the same manner as organizational expenditures have been treated in the past, i. e., disallowed as deductions and not allowed to be amortized by a corporation with a perpetual charter. The provisions of section 248 would put a premium on organizing a new corporation every time there is a change in capitalization of a business.

Organizational expenditures should be defined as including the cost of issuing and listing stocks, and the reorganization of corporations.

Section 267 (a) (2) (B)—Losses, etc., between related taxpayers

This section disallows, in the same manner as section 24 (c) of the present code, the deduction of accrued expenses due to a related taxpayer, unless paid within 2½ months after the close of the taxable year, if, by reason of the accounting method of the person to whom the payment is to be made, such income is not currently includible in the gross income of such person. Hence, if such accrued amount is not paid within 2½ months after its accrual, it must, in the case of an amount due to a cash basis taxpayer, be constructively received by such taxpayer within the 2½-month period.

We recommend that this section be amended to provide further that no deduction will be disallowed where the related taxpayer to whom the expense or interest is due (*a*) includes that income in his return for the year in which the accrual is made or in the following year and (*b*) signs a binding election to be taxed on the amount so reported in his return.

Section 333—Gain from the sale of property in connection with corporate liquidations

Under the provisions of section 391 (a) (1), a taxpayer cannot obtain the benefit of section 333 with respect to distributions made in pursuance of a plan of liquidation adopted before March 2, 1954.

Chairman Reed, of the House Ways and Means Committee, announced the proposal that the provisions of the Internal Revenue Code of 1939 should apply where the resolution is adopted prior to March 10, 1954. This, however, would deny the benefits of the proposed new code in the case of such transactions.

In order not to deprive taxpayers of that benefit, we recommend that section 333 be amended so as specifically to provide that its benefits may, at the option of the taxpayer, be obtained where the plan was adopted after December 31, 1953.

Section 472—Last-in, first-out inventories

This section requires taxpayers using the elective, last-in, first-out, method of valuing inventories to use only cost prices and does not permit use of market prices. In view of the widespread expectation of a decline in market prices, this requirement results in substantial inequities as between taxpayers. Those who originally elected to use the LIFO method in the early 1940's ordinarily would not be affected by a decline in prices, but taxpayers who did not then elect to use the LIFO method because of erroneous adverse Treasury rulings are precluded, for practical reasons, from electing to use the LIFO method. This is because, if the expected decline in prices occurs, such taxpayers would have to carry some or all of their LIFO inventories at values in excess of their real worth. This is contrary to accepted accounting principles. Furthermore, taxpayers who have elected to use the LIFO method in recent years may also find themselves in the same situation.

These inequities would be minimized, and at the same time the accepted accounting principle involved would be sustained, by allowing taxpayers to write down their LIFO inventories to market values. This would preserve the original concept of the LIFO method, which is to apply current costs to current sales; would not prevent a taxpayer from building up his LIFO inventories at times when otherwise it would be economically advantageous to do so; and would eliminate a large element of guesswork when a taxpayer tries to determine the best time to make the election to follow the LIFO method.

All other taxpayers now have the right to value their inventories at the lower of cost or market, and it would seem just and equitable, particularly in view of the above-noted inequities, to grant this same right to taxpayers using the LIFO method of valuing inventories.

We therefore recommend that section 472 be amended to provide for the valuing of LIFO inventories at the lower of cost or market.

Section 505—Allowable investments for employees' trusts

(1) This section is defective in that it does not specifically authorize investment in a wholly owned real estate holding corporation (exempt under section 501 (c) (2)). This should be done.

(2) The limitation of investment in any one piece of real estate to not more than 5 percent of the fund is too restrictive. Real estate is different from securities. A limitation of 15 to 20 percent would be more realistic.

(3) Compliance with section 505 (a) will necessitate quarterly appraisals of assets. This would involve no hardship in the case of marketable securities. In the case of real estate, however, this requirement would result in unnecessary expense.

This section should provide that real estate is to be valued at its cost of acquisition less allowable depreciation.

Section 514—Business leases

This section is made applicable to a section 101 (14) corporation (exempt under section 501 (c) (2)). There is no cutoff date. It would apply to all business lease indebtedness, even though created in good faith many years ago. Since the new investment criteria are effective only from March 1, 1954, this scetion should not be applicable to any business lease indebtedness created or existing prior to March 1, 1954

Sections 531–536—Corporations improperly accumulating surplus

(*a*) *Imposition of tax*—The tax is imposed on the entire undistributed earnings for the taxable year. The purpose of the tax is to penalize the accumulation of earnings beyond the reasonable needs of the business. It should not be imposed on the amount accumulated which is reasonable and a deduction should be allowed for such amount.

(*b*) *Publicly held corporations*—Publicly held corporations are not subject to this tax. The definition restricts this exemption to a corporation whose outstanding stock is held by more than 1,500 persons and not more than 10 percent in value or voting power of the outstanding stock is held by any one individual. For purposes of the 10 percent test stock owned by an individual's relatives, partners, etc., is attributed to him. This restriction imposes problems of proof which many corporations will not be able to solve. The 10-percent test should apply only to directors of a corporation during the taxable year.

(*c*) *Effective date of new burden-of-proof rule*—The burden of proof in proceedings before the Tax Court is shifted to the Commissioner if the taxpayer files a statement of its grounds for accumulating earnings. This rule is made effective only for cases involving taxable years beginning after December 31, 1953. Since this is a procedural change, it should be made effective immediately in every case where no hearing before the Tax Court has been held before enactment of the bill.

(*d*) *Subsidiary corporations*—It is not clear under the new provisions whether a subsidiary (as defined in section 336 (h) of the new bill) would be considered liable for the tax because its retention of earnings avoided the income tax with respect to its corporate shareholder. To eliminate this uncertainty the phrase "with respect to its shareholders or the shareholders of any other corporation" in section 532 (a) should be amended to read: "with respect to its individual shareholders or the individual shareholders of any other corporation."

Section 831—Tax on insurance companies (other than life or mutual)

Casualty and other stock insurance companies subject to taxation under section 831 are taxed in the same manner and to the same extent upon their taxable net income as all other operating companies. They do not enjoy the special privileges and the special methods of computing their taxable income which are allowed to life-insurance companies and mutual-insurance companies.

Except for the method of computing unearned premiums, the taxable income of such casualty-insurance companies is determined in substantially the same manner as income of corporations engaged in other lines of business. The proposed treatment of dividends received from life-insurance and mutual-insurance companies may, because of the special tax benefits they receive, be justified in the case of those companies. However, there is no such reason for treating dividends received from stock insurance companies taxable under section 831 in any different manner from dividends of corporations engaged in other businesses.

For the same reasons, we believe that the benefit of the 14-point tax reduction in the case of income from certain foreign operations, and the right to defer such income in certain circumstances, should not be denied stock insurance companies taxable under section 831.

We therefore recommend that:

Sections 34 (c) (1) and 246 (a) (1) be amended to eliminate the exclusion therein of dividends received from stock-insurance companies taxable under section 831 and sections 923 (d) (2) and 951 (c) (4) be similarly amended to eliminate the exclusion therein of such stock-insurance companies.

Section 923—Business income from foreign sources—Complete exemption of foreign income from United States tax

This would be the wisest move, and one that would not, it is believed, cost the Treasury much, if any, tax revenue and would certainly best promote the objectives of encouraging foreign investment. If, however, our recommendation for such exemption is unacceptable to Congress this year, the following amendments of the proposed code are urgently needed and strongly recommended:

1. *Income from the distribution of goods in foreign countries.*—(*a*) The denial of the 14-point credit with respect to income derived from the sale of goods other than at retail, is wrong. The credit should be allowed with respect to income resulting from all sales of goods outside the United States where substantial inventories, personnel and a permanent establishment are maintained abroad for that purpose.

(*b*) This is an "all or nothing" limitation, entirely denying the credit if less than 90 percent of the income meets the unduly narrow tests prescribed in the bill. Such a limitation is unfair in principle and would force changes (where possible) in methods of doing business and forms of corporate organization, in the effort to obtain the 14-point credit with respect to that portion of the income which can qualify under these tests.

2. *Stock ownership of foreign subsidiaries.*—(*a*) The requirement of ownership of "more than 50 percent" of the stock of a foreign subsidiary or subsubsidiary should be reduced to a smaller percentage, say 45 percent, or at least changed to "50 percent or more" (as provided in connection with the credit for foreign taxes) so as not to deny the credit where the United States corporation is forced to give local capital a majority stock interest in the subsidiary, or at least a 50–50 split.

(*b*) There should be a further provision that the benefit of the 14-point credit should not be denied because of ownership of less than 50 percent of the stock, if the ownership of a greater amount of stock would be in violation of applicable local law.

3. *Income from royalties.*—Royalties received for the use of patents, trademarks or other intangible assets should be entitled to the 14-point tax reduction. In many cases such royalties afford a means of legally obtaining funds earned in foreign countries which otherwise would be blocked.

4. *Dividends received by a United States corporation from a Western Hemisphere trade corporation.*—Income of a Western Hemisphere trade corporation should not be taxed again when received as dividends by a United States parent corporation. Such double taxation not only is out of harmony with the purpose of the proposed legislation, but also places a heavier burden on such income than if earned by a qualified foreign corporation or foreign branch of a United States corporation.

5. *Income from the manufacture of goods "intended" for sale in the United States.*—The denial of the credit (again, "all or nothing") where more than 25 percent of the income results from the manufacture abroad of goods "intended for sale in the United States" should be changed, so as not to apply where more than, say, 60 percent of the cost of raw materials used consists of materials originating outside the United States.

With this change, the 25 percent limitation would not take away the intended encouragement of development of industry in foreign countries, and would still prevent the abuses at which this provision was aimed.

Section 1014 (a) (9)—Basis of property acquired from a decedent

This section provides that the basis of property includible in the taxable estate because transferred inter vivos in contemplation of death shall be the value at date of death, or 1 year later if the optional valuation date is used. This is in accordance with the statement of the Committee on Ways and Means that: "There appears to be no justification for denying some property included in a decedent's gross estate for estate tax purposes a new basis at date of death, while giving this new basis in most cases."

The proposed new provision, however, limits its application to property includible in the estate of a decedent dying after December 31, 1953. There does not appear to be any reason why the benefit of this new provision should be denied with respect to dispositions of property subsequent to December 31, 1953, regardless of the date of death of the decedent from whom the property was received.

We recommend that the provisions of this section apply to all such property disposed of subsequent to December 31, 1953, regardless of the date of death of the decedent.

Section 1235—Sale of patents by person other than inventor

This section provides that an inventor (regardless of whether amateur or professional) may receive capital gain treatment on the outright sale of his patent, provided the contract of sale does not make the sales price dependent, for a period of more than 5 years, on the productivity, use or disposition of the patent in the hands of the buyer.

This section of the proposed code has clarified the problem of the professional inventor, but it fails to clarify the distinction between royalties and installment sales, which is essential in the case of sale by one who is not the inventor.

Until recently, the cases consistently and correctly held that the method of determining the amount of the sales price has no bearing on whether or not the transfer of the patent constitutes a sale.

Recently, however, the Treasury Department has arbitrarily held that if the amount of the sales price of a patent is dependent on the productivity, use or disposition of the patent in the hands of the buyer, the installment payments constitute "royalties" and are taxable as ordinary income rather than as capital gain. The result is to render uncertain the taxable nature of the gain upon the sale of a patent for a price to be so determined.

Because of the nature of patents, which ordinarily involve a product or a process of uncertain value, it is frequently impossible for the person who is to exploit them to agree upon a fixed overall purchase price acceptable to both parties. Consequently, for business reasons, it is necessary in such cases to measure the consideration to be given for the patent by the result of its exploitation.

We recommend that section 1235 be amended to provide that the gain realized upon the sale of a patent by a person other than the inventor shall be deemed gain from a sale or exchange, regardless of the method used in determining the amount of the purchase price.

Section 1321—Involuntary liquidation of LIEO inventories

(*a*) The time for replacing involuntary liquidations occurring in the period 1950–54 is extended through 1955. No change is made in the present law with respect to liquidations in the 1941–47 period. Adjustment for this period will not be permitted unless replacement was effected by the end of 1952. This imposes a hardship because many taxpayers were unable to replace World War II liquidations by 1950 and have suffered further involuntary liquidations. The period for replacing the 1941–47 liquidations should be extended through 1955.

(*b*) Where there has been an involuntary liquidation in any taxable year, it remains open for tax purposes until the year of replacement. For example, the year 1941 would still be open if replacement occurred in 1952. Income of the liquidation year should be adjusted by the difference between cost of the inventory liquidated and current replacement cost. Any difference between such replacement cost and the actual cost in the year of replacement could be reflected by an adjustment to income in the year of replacement. If the replacement is not made within the time permitted, the adjustment in the liquidation year could be reversed in the last year in which the replacement would have been permitted. This treatment would avoid the present practice of keeping the liquidation year open over an extended period.

Section 1514—2-percent penalty tax on consolidated returns

The corporate surtax rate is increased by 2 percent for any taxable year for which an affiliated group makes a consolidated return. This is a discriminatory tax imposed in lieu of the tax on dividends between members of an affiliated group.

The tax rates applicable to a consolidated return should be the same as for the return of a single corporation.

Section 6901 (d) (1)—Extension of time for assessment

The language of the last sentence of section 6901 (d) (1) does not cover a situation where the overpayments were made by the transferor; it only covers the overpayments of tax by the transferee.

In order to correct this defect, it is suggested that the language of section 6901 (d) (1) be amended along the following lines:

"For the purpose of determining the period of limitation on credit or refund to the transferee or fiduciary, such agreement and any extension thereof shall be deemed an agreement and extension thereof referred to in section 6511 (c), provided, however, that such refund or credit shall not exceed the amount of the overpayment to which the transferee or fiduciary is equitably entitled."

Statement of Paul D. Seghers, Attorney at Law, New York City, Regarding Taxation of Business Income From Foreign Sources (Sec. 923)

This statement is submitted individually, although it supports and amplifies that part of the statement submitted herewith on behalf of the Federal Tax Forum dealing with these provisions of the proposed new Internal Revenue Code.

The whole system of United States taxes on income from foreign operations, including the system of credits for foreign income taxes, inevitably tends to eliminate collection by the United States of income tax from that source, because it encourages foreign countries to levy taxes which completely "eat up," by means of the foreign tax credit, the United States tax theoretically levied on income from foreign operations, but not actually collected by the United States Treasury to the extent that the United States tax is offset by the credit for foreign taxes.

All patchwork tax relief measures for foreign trade, supposedly intended to relieve United States taxpayers from United States tax handicaps in doing business abroad, are ineffective. The present trend indicates that the actual cost to the United States Treasury of exempting from United States taxes all income derived by United States taxpayers from activities abroad would be very little at the present time and is aprpoaching zero.

Accordingly, it would seem that the wise move, and one that would actually cost very little net tax revenue, would be to exempt from United States taxes all income derived by United States taxpayers from activities abroad. Such a step would eliminate all the complexities and discriminatory inequities which are inherent in the new proposal as well as in the present system of United States taxes on income from foreign operations and would, in the long run, increase tax revenue through a real and substantial encouragement of foreign activities by United States taxpayers, and resulting increased United States income.

The Ways and Means Committee states: "It is estimated that the provisions dealing with foreign income would involve a revenue loss of $147 million in the fiscal year 1955. However, on a long-run basis the revenue loss is apt to be substantially less because foreign governments are steadily increasing their taxes on American firms and each year are thereby reducing the yield from United States taxes on income derived abroad." (Ways and Means Committee report on H. R. 8300, p. 78. See also statement of Paul D. Seghers, before Ways and Means Committee hearings, 83d Cong., August 5, 1953, General Revenue Revision, p. 1482, at top of p. 1483 and bottom of p. 1484.)

If the proposal to grant to income from foreign sources complete exemption from United States taxes is unacceptable to Congress at the present time, I wish to emphasize that the provisions for the 14-percentage point tax credit in their present form fall far short of their purpose as announced by the President in his budget message of January 21, 1954, in which he recommended: "Business income from foreign subsidiaries or from segregated foreign branches which operate and elect to be taxed as subsidiaries should be taxed at a rate 14 percentage points lower than the regular corporate rate."

The present provisions of the proposed code grossly discriminate between United States taxpayers engaged in different forms of business abroad. As it now stands, section 923 prescribes rules for the 14-point tax reduction on an "all or nothing" basis, and thereby denies that benefit to a very substantial segment (certainly a majority aside from those operating mines and oil wells) of United States taxpayers engaged in foreign operations. We are confident that the Congress concurs in the view that, as a general philosophy, tax laws should not so discriminate.

In order to prevent such discrimination, and to effectuate the announced intention of this portion of the proposed code, the following recommendations are submitted with respect to the provisions in the proposed code relating to business income from foreign sources:

1. INCOME FROM THE DISTRIBUTION OF GOODS (AT WHOLESALE) IN FOREIGN COUNTRIES

The 14-point tax reduction is allowable in the case of a domestic corporation which receives dividends from a foreign corporation only if the earnings and profits used in the payment of the dividends have been "derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country." Although the report of the House Ways and Means Committee indicates that a "like place of business" might include a bank or an air transportation company, a great many other types of businesses would be denied the benefit of the 14-point reduction because of definitions now prescribed in the proposed code. Section 923 (b) (1) (A) specifically provides that the term "trade or business" does not include the operations of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise.

These restrictions obviously discriminate against companies having substantial investments in inventories, buildings, etc., in foreign countries and employing bona fide administrative and sales staffs to promote and distribute goods therein. They may force a company which has operations in more than one country, some of which qualify for the 14-point tax reduction and others of which do not, to reorganize (if possible) into 2 more components to obtain the 14-point reduction for those operations which could qualify thereunder. This would be at the expense of a great deal of time, effort and confusion and, in some cases, would be impossible because of local laws and regulations.

It is recommended that this be corrected by allowing the 14-point credit with respect to income from the sale of goods in foreign countries provided that:

(*a*) Not less than 80 percent of the goods sold are manufactured or processed by the seller or an affiliated corporation,

(*b*) A substantial stock of goods or merchandise is maintained by the seller in one or more foreign countries, and

(*c*) A substantial staff of sales employees is maintained, or substantial advertising and promotion expenses are incurred, by the seller in one or more foreign countries.

Subject to these limitations, operations which involve investment risks or provide employment in foreign countries would qualify for the benefit of the 14-point tax reduction. This amendment would eliminate the harshly discriminatory provisions of the proposed code which otherwise would give the benefit of the 14-point tax reduction to some types of operation and deny this benefit to others which have equally substantial investment risks in operations abroad.

2. STOCK OWNER'S REQUIREMENTS

The benefit of the 14-point reduction is available with respect to dividends received from a foreign corporation where the domestic corporation, together with not more than three other corporations owns more than 50 percent of the voting stock of the paying foreign corporations. It is further provided that a dividend received by a foreign corporation from another foreign corporation will be deemed to be income derived from the active conduct of a trade or business for the purpose of qualifying for the 14-point reduction if the foreign corporation owns more than 50 percent of the voting stock of such other foreign corporation. Many companies with heavy foreign investments in subsidiaries would find it impossible to qualify under these provisions. Many countries have laws which require majority holdings by nationals, with the result that United States companies in such countries have heavy investments in holdings of less than 50 percent of the capital stock of their subsidiaries in such countries. Other companies engaged in foreign operations have found it expedient or necessary to share the ownership of foreign operating subsidiaries 50–50 with local stockholders. In both of these circumstances, a United States corporation, or its foreign subsidiary, holding such a 50–50 or minority interest in the stock of a foreign subsidiary or sub-subsidiary may have at risk a very substantial investment in operations abroad. Hence the denial of the 14-point reduction benefit where not more than 50 percent of the stock is owned would unfairly penalize many domestic corporations which have substantial risk of investment in foreign operations.

It is, therefore, recommended that the phrase "more than 50 percent" in both section 923 (a) (3) (B) and section 923 (b) (2) be changed so that the requirement will be satisfied by ownership of 50 percent or more of the voting stock of the foreign corporation, or the maximum percentage allowable by the requirements of the foreign country in which it operates, whichever is lower. The adoption of this recommendation would still exclude casual noncontrolling investments from the benefit of the 14-point reduction, but would accord it to companies that must make substantial investments in foreign operations even though they are unable to retain more than 50 percent ownership because of local requirements.

3. INCOME FROM MANAGEMENT SERVICES AND ROYALTIES

The 14-point reduction benefit is applicable to "compensation for the rendition of technical, engineering, scientific, or like services," but the House Ways and Means Committee report on H. R. 8300 indicates that royalties from patents, etc., are not deemed compensation for services rendered. There appears to be no good reason for this discriminatory treatment of income designated as royalties but arising out of like activities of the taxpayer (or an affiliate or predecessor). Moreover, as a practical matter, the exchange controls and other requirements of some foreign countries are such that it is almost imperative for the domestic corporation or its foreign subsidiary which has an investment in an operation in such a country to receive royalty payments as the preferred method of obtaining income from its subsidiary. The position stated in the report of the House Ways and Means Committee obviously discriminates against this very important method of receiving income, even though the use of such method is virtually compelled by the regulations of the country in which the operations are conducted.

It is recommended that compensation qualifying for the 14-point tax reduction benefit should include both compensation for management services and payments of royalties for patents, processes or know-how, or for trade-marks or trade names developed by the taxpayer or an affiliate or predecessor. Such inclusion might be subject to the condition that the payments, if they had been received from the payor as dividends, would have qualified for the 14-point reduction.

4. DIVIDENDS FROM W. H. T. C.'S AND FROM OTHER DOMESTIC CORPORATIONS ENTITLED TO THE 14-POINT REDUCTION BENEFIT

The proposed code taxes at the full corporate rate 15 percent of dividends paid by one domestic corporation to another. Therefore, the income of a Western Hemisphere trade corporation and the income of a foreign branch of a domestic subsidiary which qualifies for the 14-percent tax reduction, would still be subject, to the extent of 15 percent of the dividends paid from such earnings, to the full United States tax. Obviously, this discriminates against the use of United States subsidiaries for operations abroad as compared with the use of foreign subsidiaries which qualify for the 14-point tax reduction.

This is so because:

(*a*) Income of a foreign subsidiary which qualifies for the 14-point reduction and is received by its United States parent corporation as a dividend pays only one corporate tax (e. g., 52 percent less 14 percent), whereas

(*b*) A Western Hemisphere trade corporation or a domestic corporation which qualifies under section 923 pays the same rate of tax on its income, and 15 percent of any dividend it thereafter pays to its parent corporation is taxed once more at the full corporate tax rate (e. g., 52 percent).

This discrimination against the use, for foreign operations, of United States corporate subsidiaries, including Western Hemisphere trade corporations, is especially undesirable because the legal safeguards afforded by use of such corporations, and not otherwise available, should not be denied to the United States parent, and the tax system should be so arranged as to encourage rather than discourage the use of such corporations.

It is recommended that section 243 be amended so that a deduction of 100 percent, instead of the present 85 percent, be allowed for amounts received as dividends from a Western Hemisphere trade corporation or from a corporation, all of whose income qualifies under section 923 for the 14 percent tax reduction.

5. GOODS INTENDED FOR SALE IN THE UNITED STATES

Section 923 denies the 14 percent tax reduction on dividends received from a foreign corporation if the earnings and profits used in the payment of such dividends consist, to the extent of more than 25 percent, of gross income derived from the sale of articles or products manufactured in a foriegn country and intended for use, consumption or sale in the United States. The report of the House Ways and Means Committee makes a particular point that this restriction applies only to manufacturers. That report states that the provision does not apply, for example, to the mining or processing of metals or the extraction of or refining of oil in a foreign country, even though intended for consumption, use or sale in the United States. It does not seem fair to single out manufacturing as such for denial of this benefit, inasmuch as manufacturing entails a like risk of investment in operations abroad and in many situations is instrumental in developing local raw materials.

This restriction should not be applicable to manufacturing which, as in the case of the processing of metals or refining of oil, processes a basic raw material which originated in a foreign country. Hence, it is recommended that section 923 (a) (3) (A) (iii) be amended so as not to apply where the manufacture involves the processing of raw materials, 60 percent or more of which are obtained from sources outside the United States.

This amendment would avoid discrimination against industries having substantial investments in operations in foreign countries and developing the natural resources of such countries.

6. OTHER PROVISIONS

There are other defects in the provisions of the proposed code relating to income from foreign sources. For example, the provisions for deferring income from foreign operations are said, by those who have had years of experience in foreign trade, to be so complicated and unpredictable in their effect as to be, not only unworkable, but completely unacceptable. Furthermore, their "benefits" are denied to Western Hemisphere trade corporations.

The proposed "in lieu of" provisions of the present code relating to foreign tax credits, are said to be no better, if not worse, than the present unsatisfactory ones. And similar defects are to be found in other provisions relating to business income from foreign sources.

There has not yet been sufficient time, since H. R. 8300 was brought into the light of day, for adequate study of these and other provisions of the monumental proposed code dealing with these situations.

Others likewise will present their views as to defects in such provisions. We sincerely hope that the Senate Finance Committee will consider and act upon these recommendations, in order that the new code may be as free as possible from defects and inequitable discriminations.

CONCLUSION

In conclusion, I wish to emphasize my belief that the adoption of the recommendations made herein would:

(*a*) Carry out more fairly the announced intention of the President and of the House Ways and Means Committee to afford the 14-point tax reduction benefit to United States taxpayers having investments in operations abroad,

(*b*) Contribute materially to the improvement of economic conditions at home and abroad, and thereby strengthen our good-neighbor ties throughout the world, and

(*c*) Result in little, if any, immediate loss of net tax revenue (for the reasons already set forth) and in the long run no loss, but rather a gain (through increased United States income).

Mr. SEGHERS. I hope the chairman will grant me sufficient time to emphasize a few points in both of these statements.

The CHAIRMAN. Not over 15 minutes. We will stop you in 15 minutes.

Mr. SEGHERS. I will do my best in the next 15 minutes.

I want to be fair to the Federal Tax Forum because I have come as their representative and I want to be fair to myself.

The CHAIRMAN. Whatever is left unsaid I assume is in your statement and will be digested by the staff and will be presented to the committee and the Federal Tax Forum will receive a good hearing.

Mr. SEGHERS. Thank you, sir.

First, as to the Forum's recommendations. In my oral presentation of neither statement will I attempt to go into detail regarding their specific provisions, because these are set out in the statements, but I hope to bring out certain collateral matters. First of all, because of the vast scope of the bill and its many novel and radically different concepts of taxation, the time needed for study is much greater and we therefore necessarily cannot cover in our statement all the points which further study will undoubtedly develop.

The CHAIRMAN. I would like to suggest not as a substitute for what you are saying but in this committee we will probably have 150 witnesses before we finish, so I suggest that probably any idea that you pursue here will also be pursued by others.

Mr. SEGHERS. I don't doubt it, but I am only excusing ourselves for not taking up many things which later study will show we should have found to need correction.

The CHAIRMAN. The only point that I am making is that since we have to hear so many witnesses, since we are operating under limitations of time, it would be a little bit burdensome if every witness reviewed the whole gamut of 900 pages in the bill.

Mr. SEGHERS. We haven't, we can't and we are not attempting to.

The CHAIRMAN. Thank you, sir. I have taken I minute of your time.

Mr. SEGHERS. There is no intention to emphasize our recommendations for changes as being the most important that we have found. They are not the result of a process of selection, but rather of chance. Speaking for myself, I will say that I am a little concerned by the fact that every man who has given intense study to any part of the bill seems to find that it badly needs revision.

The CHAIRMAN. I may say I have had some experience with tax laws before I ever came here. I have found that true with everything that I do not agree with.

Mr. SEGHERS. That isn't exactly the point. I am not saying that we criticize what we don't agree with. I am saying that as we study portions of the bill, each man who studies any part intensively finds something wrong with it. Ordinarily we should expect that if a group has studied intentively a number of provisions, they should find a substantial number of which they approve and some that they like very much.

There undoubtedly are some very good provisions in the bill, but I am just wondering whether the good outweighs the bad. That brings up the discussion in the Forum just before I came down to Washington, as to whether we should recommend a postponement of the effective date of all but the tax rates and exemptions and a few other very essential provisions, a postponement until January 1, 1955. We are taking a poll and so far the response has been almost unanimous that there should be such a postponement. That would hurt many of us who would like to see this or that provision go through in a hurry, but the danger is that if some of the radically new and different provisions go through business will be inclined to postpone action until they can be thoroughly studied and their probable results determined.

Already business is finding itself in trouble with transactions which have been commenced since January 1. Now that the bill has been made public, many are afraid of what may be the tax results of what they started.

The CHAIRMAN. The other side of the coin is that the longer you postpone, the more business will be upset.

Mr. SEGHERS. If we know what the new code will provide, we can safely act under the existing law until next January 1.

The CHAIRMAN. You would be surprised how many people want some of the provisions in this bill, and they don't want any delay.

Mr. SEGHERS. We don't take a position on that, but I have mentioned it to you.

My own views concerning foreign trade, that is, the taxation of business income from foreign sources, are concurred in fully by the Forum as far as our discussions have extended. I am presenting them individually because I go into greater detail than I have been able to discuss this statement with our committee. You know what are the problems in such matters—I am talking to an expert.

We believe that the complete exemption of income from foreign sources not only would be good, but it would cost the Treasury little and is costing it less and less because the conditions which Mr. Carroll mentioned in connection with the foreign tax credit simply mean that foreign governments are gradually eating up all the foreign tax credit. As the maximum foreign tax credit is the maximum United States income tax, it means that the Treasury is collecting less and less of the income tax which is theoretically levied on United States income from foreign operations. If our recommendation for complete exemption is not acceptable, or is not feasible at this time, then we have alternative suggestions to offer.

The basic spirit of these alternative recommendations is to give the same tax treatment to the same kind of income regardless of the corporate setup or the legal relationships through which that income is collected and reaches the United States taxpayer. That seemed to have been the intention, but it certainly is not the effect of the present bill.

We also stress that under the tests in the present bill, the 14-percent tax reduction is on an all-or-nothing basis. There are many operations where, if the present organization is retained, even though as much as 89 percent of the income is what could be called qualified income, the United States taxpayers eventually receiving that income will get no benefit from the 14-percent reduction. That means there will have to be corporate reorganizations, operations split up between various corporations, and that is not a good thing. We also object to the discriminatory distinction not between the kind of income, but between the kind of business establishment maintained, contained in the provision which allows the 14-percent reduction if there is a retail establishment or factory, but does not allow the exemption where there is an equally large or greater investment in a foreign country in facilities for distribution. That is not equality of treatment of like income. Those points are dealt with specifically and are summarized in the Forum's statement and dealt with at greater length in my own.

If I may take just time enough to summarize the five points that we are raising as to income from foreign sources, I will be very happy to do so.

First, that the 14-percent tax reduction should be allowed with respect to income from the sale abroad of goods manufactured by the seller, its parent or affiliate, where substantial inventories, personnel, and an establishment for the operation is maintained abroad.

Second, the requirement in section 923 for the ownership of more than 50 percent of the stock of a foreign subsidiary or sub-subsidiary should be changed to 50 percent or more, or the maximum percent allowable by the laws or requirements of the foreign country where it is doing business. The requirement that more than 50 percent be owned seems unnecessarily strict, especially as, in the case of the foreign tax credit, the corresponding limitation is 50 percent or more.

The point is that, in certain instances because of Government regulations and in other instances because of what is found feasible where neither party will give way, an American corporation may have a large investment in a foreign business and yet only have a 50–50 stock interest in it. To deny the benefit of the 14 percent just because of the lack of a small fractional additional percentage so as to exceed 50 percent, seems unfair.

Third, the income entitled to the benefit of the 14-percent tax reduction should include compensation for management services as well as engineering and technical services and include royalties for the use of a patent or process, trade-mark or copyright, possibly subject to the qualification that the patent or trade-mark was developed by the taxpayer or predecessor or affiliate. Such a provision regarding a predecessor or affiliate is necessary because of the frequent necessity of having different corporations to operate in different countries. The provision as to royalties, patents, processes, know-how, trade-marks, or copyrights, is needed because, as a practical matter, it is often essential to have income in that form in order to be able to withdraw profits from certain foreign countries, because of their foreign exchange restrictions.

The fourth point is that dividends received by a corporation from a foreign corporation entitled to the benefit of the 14-point tax reduction should be allowed, in place of the present 85 percent dividends received credit, a full 100 percent credit. Under H. R. 8300 the receipt of dividends from a foreign corporation entitles the parent company to the full 14-percent tax reduction and there is no further United States corporate tax. In other words, at the present 52-percent tax rate, that would be a net rate of 38 percent. A Western Hemisphere trade corporation or a United States corporation operating abroad through a branch, likewise pays the full United States rate minus 14 percent (or, say 38 percent) but then, when it pays a dividend to the parent corporation, there is a further tax at, say, 52 percent on 15 percent of that dividend. We say that that 15 percent of the income should not bear a higher tax than if received as a dividend from a foreign corporation.

Finally, the 14-point tax reduction should not be disallowed in the case of income from the manufacture of goods abroad which are intended for sale in the United States, provided that the manufacture involves the processing of raw materials, at least 60 percent of which originated in a foreign country or countries. I think that would answer any objection that the bill otherwise would encourage taking manufacturing establishment out of this country. We recommend allowing the 14-percent reduction where the raw materials originate outside the country, in which case the United States company would be placed at a handicap if it were not allowed to manufacture those goods and ship them in.

I didn't look at the clock. I have attempted to cut my presentation as short as possible in order to spare the committee's time and in the hope that, if the chairman or the commitee have any questions to ask, I will have the benefit of them.

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

Are there any questions? Thank you very much, indeed.

(The following letter made a part of Mr. Seghers' statement:)

CHARLES H. WEISS & ASSOCIATES, INC.,
New York 36, N. Y., April 12, 1945.

Mr. PAUL D. SEGHERS,
Chairman, Committee on Federal Tax Legislation,
Federal Tax Forum, Inc.,
New York, N. Y.

DEAR MR. SEGHERS: I am please to send you herewith comments on certain of the sections in the proposed bill which will affect pension and profit sharing plans.

Regarding section 501 (e), I am enclosing a photostat of the comments read by Mr. Samuel Ain, consulting actuary, before the American Pension Conference last week since it covers the inconsistency of this section most adequately.

I hope that this reaches you in time so that you will be able to file these comments with the Senate Finance Committee on April 13.

Very truly yours,

CHARLES H. WEISS.

Section 505 of the bill describes the allowable investments for employees' trusts. In order for a trust which presently qualifies under section 165 (a) of the code, or which would qualify under 501 (e) of the bill, to retain its exempt status, the investments must be limited to the enumerated items in section 505 (a). As presently enumerated, they would have a far-reaching effect on existing plans and plans that may be adopted in the future. For example, many hundreds of pension plans now in existence use some form of insurance contract other than retirement annuities or retirement income contracts as part of the plan. Section 505 would prohibit the use of such insurance contracts and, in fact, would require any existing plans using such contracts to terminate them. This would affect the amount of insurance upon which hundreds of employees now covered by such plans are relying. The confusion that the omission of life insurance from this section would cause, if it were permitted to become law even for a short period of time, would be most disruptive to the economic planning of employers with such plans as well as to the employees they cover.

There are many instances where it is most desirable to permit trusts to invest in life insurance. For example, section 505 would permit investments in retirement income contracts where the face amount is 100 times the monthly annuity payable at normal retirement age. Many plans provide for the same benefit to employees by the purchase of life insurance contracts and funding the additional amounts required to provide full benefits at retirement by converting the life policy into an annuity through the payment of the additional amount from other investments of the trust. As it affects the employee beneficiary, the benefit is identical to that of the retirement income contract described above. As far as the employer is concerned, the latter method may be advantageous to him if he is at all concerned with the cost of the plan. Thus, the retention of the prohibition of investments in insurance contracts will cause confusion and increased cost in existing plans. Small corporations which wish to adopt new plans will either have to pay additional costs or else adopt plans less suitable to their needs. It is desirable that section 505 be amended to permit such combination plans (ordinary life plus a separate investment fund). It will thus provide a method of funding which is between complete self-administered plus group insurance and the use of the retirement income policy.

If the purpose of section 505 is to provide protection to participants in a tax-exempt trust, then the effect of this section as presently written distorts the purpose. The most serious problem of investment in such a trust is the likelihood that a large amount would be invested in securities of the employer to the detriment of the participating employees. Under section 505, any amount of funds may be invested in securities of the employer without any test as to the investment quality of such securities. On the other hand, under section 505, a trust cannot invest more than 5 percent of its assets in the securities of any one issuer. Thus, a trust of $30,000 cannot invest any more than $1,500 in securities such as those issued by American Telephone & Telegraph Co. or General Electric. The same trust, or even a substantially larger trust, would be precluded from investing in an amount above 5 percent of its assets in desirable, sound, real estate. Furthermore, it is interesting to note that first mortgages are not included as allowable investments in any amount.

If the Senate should determine that it is desirable to prohibit investments in real estate or in life insurance contracts, and if the bill should become law, many trusts presently established will automatically be taxable because of the effective date in section 505 (b) (2). That paragraph provides that such investments are prohibited after March 1, 1954. A trust which owned real estate prior to March 1, 1954, and improved such real estate after March 1, 1954, if the investment in real estate is more than 5 percent of its assets, is automatically denied exemption for the current taxable year. A trust which provides part of its benefits through insurance contracts and pays premiums after March 1, 1954, is automatically denied exemption from tax.

Section 101 (b) (1) excludes from gross income the first $5,000 paid on the death of an employee by or on behalf of an employer. This would cover, within this limitation, payments made from pension and profit-sharing trusts. However, a special benefit is given to payments made from profit-sharing trusts which is not present in the case of payments made from pension trusts. Amounts payable from pension trusts which are nonforfeitable immediately before the death of the employee are not subject to this exemption whereas payments from profit-sharing trusts whether forfeitable or nonforfeitable are exempt. There would appear to be no reason for this special privilege in the case of profit-sharing plans. Benefits payable from pension and profit-sharing trusts have in the past been treated uniformly. There is no apparent reason for any change in this respect.

Section 501 (e) of the bill describes the characteristics required of pension, profit-sharing, or stock bonus trusts organized in the United States in order that they be exempt under 501 (a). The characteristics are described in four paragraphs. The first 2 paragraphs can be considered to be the same as the first 2 paragraphs in the existing section 165 (a). They require that there be a plan providing for the distribution of the corpus and income of the trust and that there be a statement that the assets cannot be diverted to purposes other than for the exclusive benefit of employees or beneficiaries. Paragraph (3) says that the classification of covered employees must be nondiscriminatory and sets forth the rules for determining whether they are nondiscriminatory. Paragraph (4) sets forth the permissible allocation of contributions or crediting of benefits among participants.

The rules set forth in paragraph (3) may be summarized as follows: The plan will be considered discriminatory only if:

(*a*) More than 30 percent of the contributions under the plan are used to provide benefits for shareholders who own directly or indirectly 10 percent of voting stock, or

(*b*) More than 10 percent of the participants are key employees. Key employees are defined as the employees who are within the highest paid 10 percent of all regular employees, but not more than a total of 100.

Except, that even if the classification falls into one of these two categories of discriminatory plans, it is deemed nondiscriminatory if a sufficiently high percentage of regular employees participate in the plan. These percentages work out so that if there are: Less than 20 regular employees, 50 percent will have to participate; 20 to 40 regular employees, 10 employees will have to participate; more than 40 regular employees, 25 percent will have to participate.

Regular employees are all employes of the employer excluding those not employed for the minimum period prescribed in the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in 1 week or not more than 5 months in any calendar year.

Participants are those employees included in the classification of participants who, if they remained employees at their current rate of compensation until normal retirement age, would be entitled to full benefits under the plan.

If you have read paragraph 3 rather hurriedly you may feel that I have omitted a very important part, namely the six enumerated classes of employees which may be covered. If you read it more closley, you will see that nothing follows from the enumeration and whether your group is one that falls within or without the enumerated classes, it will be acceptable, provided it complies with the rules.

I would like to illustrate the rules with some examples.

Example 1: Employer A has 40 regular employees. He adopts a plan to cover the 10 highest paid of the 40. The group has 4 key employees (10 percent of 40) and all 4 are in the plan. Regardless of how the plan works out on the 30 percent rule, it discriminates according to the 10 percent key employee rule, because more than 10 percent of the participants are key employees. However, it complies with the percentage of covered-employees rule and is therefore deemed nondiscriminatory as to coverage.

Example 2: Employer B has 10,000 regular employees. He adopts a plan providing full benefits to the 1,000 highest paid employees. This plan will almost certainly not discriminate under the 30 percent rule and cannot discriminate under the key employee rule because there cannot be more than 100 key employees so that not more than 10 percent of participants will be key employees. The plan therefore is deemed nondiscriminatory as to coverage, without any necessity of applying the coverage rule to determine that at least 25 percent of the regular employees are participants. Similarly, any group as large as 1,000 will qualify.

Example 3: Employer C has 20 salaried employees and 100 wage employees. He wants a plan for all the wage employees. This plan will be nondiscriminatory under the 30 percent rule, as well as under the 10 percent rule. It would also qualify under the percentage of coverage rule.

As example 4, let us use the same hypothetical situation as in example 1 under which an employer had 40 regular salaried employees, 10 of whom were covered in a plan which is nondiscriminatory under the rules, but, add the fact that the employer has 200 regular wage employees—a total of 240 regular employees of whom 24 are key employees. Here he cannot set up a plan to cover the 10 top employees. In fact he cannot set up a plan to cover all salaried employees because he will come up against the key-employee rule since now more than 10 percent of the participants will be key employees, and he will come up against the percentage of coverage rule since 40 is less than 25 percent of 240. Suppose the wage employees are unionized and have their own plan. Under the bill there is no device by which consideration can be given to benefits outside the plan. This employer is in a straitjacket and cannot adopt any plan for his salaried employees. Thus we see that under example 1, an employer can pick and choose one-fourth of all his employees—by name if you wish—whereas in example 4, a very reasonable employer cannot adopt any plan.

Example 5 is that of an employer who has 14 regular employees (with more than 5 years of service), 8 of whom earn in excess of $3,600. He also has employees with less than 5 years of service. He adopts a plan covering employees with 5 or more years of service who earn over $3,600. This plan would qualify under the percentage of coverage rule. After the plan is in existence for 1 year, 3 additional employees complete 5 years of service and are therefore regular employees under the rules but are not participants because they earn less than $3,600. The plan now covers 8 regular employees out of 17 and ceases to qualify. (The tests for discrimination thus go into the fourth dimension with time as the additional variable and what qualifies today may not qualify tomorrow.)

Consider example 6, a modification of 5. An employer has 800 employees with more than 5 years of service, 200 of whom earn over $3,600 and 300 employees with 1 to 4 years of service, 50 of whom earn over $3,600. He wants to adopt a plan providing uniform benefits on compensation over $3,600. If he covers employees with 5 or more years of service, he will have 200 out of 800 and therefore it will be deemed to be nondiscriminatory, but if he wishes to cover employees with 1 or more years of service he will be covering 250 out of 1,100 regular employees and it will discriminate. (Bear in mind that regular employees in this case would include all employees with more than 1 year of service if the plan covers some employees with 1 or more years of service.) Thus we see by making the plan broader in a manner most people would consider nondiscriminatory, a nondiscriminatory plan becomes discriminatory.

Perhaps more in line with what the bill was intended to cover, is example 7, that of an employer with four employees including the principal stockholder and his wife. A plan covering just these two top employees will qualify as a nondiscriminatory plan from the standpoint of coverage because 50 percent of the regular employees are participants.

Example 8: Let us consider the case of a corporation which employs 40 persons including 10 salaried employees 1 of whom is the principal stockholder. If the corporation wishes to set up a plan covering all 10 salaried employees the plan will be nondiscriminatory as to coverage, even though violating the keyman rule, since it just satisfies the requirement that 25 percent of the employees be participants. However, if it is desired to cover only salaried employees under the plan but exclude the principal stockholder, the plan will be discriminatory because it still violates the keyman rule and can no longer avail itself of the 25 percent participation exception from that rule. Thus we see that the effect of removing the principal stockholder from a plan is to convert it from an acceptable one to one which will be deemed discriminatory.

At this point I would like to refer you once more to the definition of participants as those employees included in the classification of participants who, if they remained employees at their current rate of compensation until normal retirement age, would be entitled to full benefits under the plan. Note the word "full." It would thus seem that if you are using a step rate plan, like 1 percent on the first $X, plus 2 percent on the excess, you cannot include in your participants, for testing nondiscrimination of coverage, those employees making $X or less. I have not attempted to explore the ramifications introduced by this word, but it is worthy of careful consideration, inasmuch as it seems likely that an effort will be made to qualify many plans under the coverage exclusion principle rather than under the dual tests laid down by the 30 percent stockholder and 10 percent keyman rules.

By the way, two employers in the same industry competing in the same labor market could not necessarily adopt the same plan because what under the rules is nondiscriminatory for one may be discriminatory for the other.

Paragraph 4 sets forth the measure of acceptability in benefits. In a pension plan the benefits are acceptable if the contributions or benefits of or on behalf of employees under the plan do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower, except that the first $4,000 of annual compensation may be disregarded.

Assuming then, that you have a suitable coverage classification, you can provide benefits in any amount on compensation in excess of $4,000 a year. For example, you can provide nothing on the first $4,000 and 75 percent of compensation in excess of $4,000. Similarly you could provide nothing on the first $3,000 and anything at all on the excess, or 1 percent per year of service on compensation between $3,000 and $4,000 and 2 percent per year of service on compensation in excess of $4,000.

You could not eliminate benefits on the first $4,500 and provided 24 percent on compensation in excess of $4,500 as you probably could under existing integration rules. On the other hand, if you have a suitable coverage classification, you could cover only employees earning over $5,000 and give them full benefits starting at $4,000 or even starting at $1 so that an employee earning $5,000 will get no benefit and an employee earning $5,001 will get substantial benefits, that is, $3,000 a year. Such a classification would be acceptable under the bill.

The $4,000 exclusion provision would introduce no problem into many of the popular type plans but will introduce serious problems, as well as encourage discrimination, in others.

As example 9, consider a plan providing benefits of 25 percent of final pay less primary social security. At $4,000 the social security amounts to $1,020 a year which is more than 25 percent of pay so that a $4,000 man would get no benefit under the plan. This plan would not be acceptable because it provides less under the plan at $4,080 on the $80 in excess of $4,000 than at $4,100 on the $100 in excess of $4,000. As you know, under the existing rules the plan would be considered nondiscriminatory. On the other hand the plan that provided nothing to employees earning less than $6,000 and 50 percent, starting at the first dollar of income, to employees earning in excess of $6,000 would be definitely discriminatory under the existing rules. Until 1941 the most discriminatory plan I saw was of this type but not so flagrant. It provided nothing to employees earning less than $3,000 but employees who earned $3,000 immediately started off with very substantial benefits. And it was plans of this latter type which brought about, in my opinion, the limitations of section 165 (a).

If the proposed social-security bill becomes law, benefits and contributions under social security would be based on the first $4,200 of income. However, under the bill you could not provide for benefits on compensation in excess of $4,200 only.

Under the bill there would be no means of taking employee contributions into account in testing acceptability. A plan providing for no contributions on compensation under $5,000 and 5 percent on compensation in excess of $5,000 with benefits of 1 percent per year of service on compensation between $4,000 and $5,000 and 1½ percent per year of service on compensation in excess of $5,000 would not be acceptable because you look at benefits only and at the $5,000 level the ratio of benefits to compensation in excess of $4,000 is greater than at $4,500. Under the present law this plan could be considered nondiscriminatory. On the other hand in example 10 where benefits are 1 percent per year of service on all compensation in excess of $4,000 and contributions 5 percent on compensation between $4,000 and $20,000 with no contributions on compensation in excess of $20,000, the benefits would be deemed acceptable under the bill but discriminatory under the present law because higher paid employees get the same benefits for smaller contributions. It may be noted that this latter situation is not likely to be found in undisguised form, but methods of disguising it can readily be suggested.

I indicated before that a plan providing for no benefit on the first $4,200 or $5,000 and a benefit on the excess would not be acceptable. This may be a general rule, but there are exceptions. Consider as example 11 an employer who has 4 employees, 2 of whom earn $12,000 and 2 earn $8,000. He wants a plan providing for 20 percent on compensation between $4,000 and $8,000 and 40 percent of the excess. This would appear not to be acceptable under paragraph

(4). On the other hand, the employer could establish 2 plans, 1 covering the 2 top people and the other covering the other 2. Each of the plans would qualify separately under paragraphs (3) and (4), and paragraph (4) says "Any classification which meets the requirements of paragraph (3) of this subsection shall be considered separately in the application of this paragraph." Under the bill this plan would therefore be acceptable.

Before we leave subparagraph (A) I would like to mention another type of plan which would be deemed acceptable as to benefits, i. e., 0 percent on the first $3,000, 1 percent per year of service on the next $2,000 and 2 percent per year of service on compensation in excess of $5,000. First we can disregard compensation under $4,000. An employee earning between $4,000 and $5,000 will get at least 2 percent on his compensation in excess of $4,000 because he gets the 1 percent on the compensation between $3,000 and $4,000 as well as 1 percent on the compensation in excess of $4,000. Participants therefore can be said to get at least 2 percent on the compensation between $4,000 and $5,000 and 2 percent on the excess. The plan would therefore qualify.

I would like to spend another minute on the type of plan permitted by the bill providing for coverage of all employees earning in excess of $5,000 a year in which employees making $5,000 a year or less receive no benefits under the plan but employees earning a cent more will get benefits of 50 percent of pay or $2,500 a year. The present law prohibits this sort of thing on the grounds that discrimination exists as between the $5,000-a-year employee and the employee making $5,000.01. In my opinion this plan is undesirable. It tends to create deep and wide cleavages between groups of employees. You might say it is the employer's money and therefore up to the employer to determine the pattern that his plan is to take. We don't want Government interference and while this may be an unwise thing to do you can't distribute wisdom by legislation. Perhaps so, but the Government does grant tax advantages and it seems to me that those advantages should be limited to desirable plans. Moreover, the proponents of the bill cannot escape the criticism with such a disclaimer because if we look at the profit-sharing provisions we see not only that this thing is permitted—but there is no alternative. If you cover employees earning in excess of $5,000 a year in a profit-sharing plan and the plan provides for contributions of 15 percent of compensation, in a year that profits are available the $5,000-a-year employee will of course get nothing while the employee earning $5,000.01 a year will get $750. Paragraph (4) (B) of the section 501 (e) is very clear on this point. Profit-sharing distributions must be based on compensation starting at the first dollar for covered employees regardless of who is excluded.

The rule for allocations under a profit-sharing plan is described in subparagraph (B) of paragraph (4). This rule provides that at least three-quarters of each year's contribution (as well as all forfeitures) must be allocated so that the ratio of allocations to compensation be no greater for any covered employee than for a lower paid covered employee. The balance (which would be no more than one-quarter of each year's contribution) can be allocated in any manner at all, on a pick-and-choose basis if you wish, so long as the ratio of total allocation to compensation for any covered employee be no more than two times the ratio for any lower paid covered employee.

A profit-sharing plan that allocates contributions on the basis of compensation only would, of course, qualify. As for the three-fourths of the total contribution there does not seem to be any room for an allocation formula involving years of service. Similarly, as for the three-fourths of contribution there does not seem to be any room for an allocation based on the amount of employees' contributions as under a thrift plan. Of course, the one-quarter can be allocated in any way as long as no employee gets a percentage allocation more than twice any other participant. This one-fourth may or may not give you the necessary elbowroom to adopt the type of plan you could at present. Also, at present you can integrate a profit-sharing plan with social security so that if you have no other qualified deferred compensation plan you could adopt a profit-sharing plan which would provide no allocations on the first $3,600 of compensation and up to 9⅜ percent on compensation in excess of $3,600. Under the proposed rule this would not be possible.

Because one-quarter of the pie can be divided any way the employer chooses (with the limitation factor of 2) there is very substantial room for discrimination, in the old-fashioned sense, in favor of shareholders and highly paid. There is, of course, no reason why the shareholders cannot each get 29 percent of pay and all other employees 14½ percent of pay. It cannot be denied that there are advantages in giving the employer an opportunity of rewarding individual accomplishment by higher deferred profit-sharing distributions. But also consider the opportunities it affords for discriminatory practices.

It seems to me that under the bill there is room for almost unlimited discrimination in this area, i. e., not even limited to a factor of 2. This could be done by a large employer who sets up a series of trusts. For example, trust 1 would cover all employees in division 1 plus the president, trust 2 would cover all employees in division 2 plus the president, trust 3 would cover all employees in division 3 plus the president. In this way, with 3 trusts, the president would get a total annual allocation of 6 times the percentage of anyone else, i. e., he could get 87 percent of his salary against 14½ percent for anyone else. The bill says that the 15 percent limitation on contributions also applies to the compensation of all covered employees in all plans but does not seem to prevent this abuse as to benefits.

On the use of compensations other than basic or regular compensation as a basis for benefits, the bill would allow less leeway than is currently permitted. It would permit total compensation only if the total compensation is determined under a definite formula. Total compensation has, to my knowledge, always been permitted if it is determined under a definite formula and frequently a much more liberal policy has been permitted depending upon individual circumstances.

I would like to refer briefly to the problem of the union-sponsored multiemployer plan for the benefit of workers represented by the union. As you know, hundreds of such plans have been adopted and an increasing number of workers are relying on such plans to fill out their retirement programs. The Internal Revenue Service has in the past read into section 165 (a) the authorization for qualification of such plans. Certainly section 165 (a) does not lend itself readily to this interpretation. Many attorneys feel that it cannot ever be strained to give the necessary interpretation in certain instances. Thus, in rewriting the code there is the opportunity of adequately taking care of this problem. The drafters of the bill referred to the problem in the committee report but did not deal with it in the bill itself. The report states that such plans will continue to qualify as employee plans. There may be serious questions whether the opinions expressed in a committee report are to be deemed as approved by all the Members of Congress who vote for the bill and by the President who signs it. Would it not be better to give adequate consideration to this important problem in the bill itself?

What is the effect of the proposed changes to the requirement of qualification of pensions, and profit-sharing plans? The prohibition against discrimination which is the keystone of 165 (a) has been eliminated. The adjective "discriminatory" can still be found in the bill and the report, but it has acquired new meaning. As a result of the arbitrary rules there set forth, a plan established unilaterally by an employer to cover all employees whom he can legally cover (namely those employees not represented by a collective bargaining agent) is deemed discriminatory even when no stockholders are to be covered; a plan intended to provide nominal benefits (perhaps less than under social security) to persons earning in excess of $3,600 is deemed discriminatory; a plan which does not discriminate today may automatically be discriminatory tomorrow because of normal happenings which do not remotely affect discrimination. The addition of relatively low-paid employees on a uniform basis to a nondiscriminatory plan will make it discriminatory while the addition of a high-paid employee who is a sole stockholder will make a discriminatory plan nondiscriminatory. A plan whose participants have been selected on a name basis is automaticaly approved and a bona fide plan covering all the employees that the employer can cover is discriminatory. A plan providing no benefits to some employees and providing disproportionate benefits to others is approved. * * * What can we expect if these provisions should become law? The extreme cases which will be established under the encouragement of these provisions will become national scandals which might very well engulf the entire field of pensions and profit sharing and bring it into disrepute. As a result some later Congress will be forced into a position of adopting legislation much more stringent than that existing today.

The CHAIRMAN. Mr. Bullock.

Sit down, Mr. Bullock, and identify yourself to the reporter, please.

STATEMENT OF THOMAS M. BULLOCK, CORPORATE TAX ACCOUNTANT, MECHANICS & MERCHANTS BANK, RICHMOND, VA.

Mr. BULLOCK. My name is Thomas M. Bullock. I am the corporate tax accountant for the Mechanics & Merchants Bank of Richmond, Va.

Mr. Chairman, may I read certain portions of my prepared statement?

The CHAIRMAN. Very well.

Mr. BULLOCK. Thank you.

The CHAIRMAN. You will file for the record your whole statement?

Mr. BULLOCK. Yes, sir.

Mr. Chairman and gentlemen of this distinguished committee, I am the corporate tax accountant for the Mechanics & Merchants Bank, Richmond, Va.

My appearance before you today is on behalf of this bank and all other Federal income-tax payers operating a trade or business, affected by H. R. 7598, dealing with allowing losses sustained by voluntary demolition of a building, effective for taxable years beginning after December 31, 1953.

I respectfully urge you gentlemen to enact H. R. 7598 into the Revenue Act of 1954 because it is sound, equitable, and does not provide for any so-called class Federal income-tax legislation whatsoever. If you were not to enact H. R. 7598, now, then the taxpayers would continue to be taxed on their gross income, and I'm sure that such is not your desire.

The following is quoted from Accountant Handbook, third edition, edited by W. A. Paton, Ph. D., C. P. A., professor of accounting, University of Michigan.

SEPARATION OF LAND AND BUILDING COSTS

Improved real estate is often purchased without any explicit provision in the transaction for division of costs between land and improvements. Nevertheless, it is necessary for the buyer to make an apportionment in his accounts, for tax purposes and otherwise, particularly in view of the fact that improvements are subject to depreciation and replacement and land in general is not. In this case, as in that of residual timber and mineral land, a convenient approach in apportioning is to determine the value of the land directly through a study of market values of similar unimproved land in the vicinity. On the other hand, particularly where the value of the buildings or other improvements clearly represents a major part of the total, it may be desirable to proceed from the other direction, by estimating the replacement cost of the improvements and from this basis, with proper adjustments for depreciation and other factors, obtaining a reasonable figure for the improvements.

Urban land is often purchased with buildings and other structures thereon which must be removed before the site can be utilized for the purpose intended. In such cases care must be taken that no large amount of the purchase price is attached to the improvements subject to removal. In fact the maximum value of the improvements in such conditions is their net salvage value, if any, the balance of the purchase price being the cost of the site.

If the buyer acquired the property expecting to use the buildings or other improvements for any considerable time before removal, it is necessary to attach a value to the improvements as usable property. If the buyer acquires an improved property expecting to use the buildings for a time but later finds it impossible to do so, either as a result of poor judgment at the outset or of unfavorable changes in conditions, the cost of the land is presumably unchanged but the value tentatively attached to the improvements becomes a loss.

Existing regulation 111 of the Treasury Department, section 29.23 (e)-2:

> Voluntary removal of buildings, loss due to the removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.

The Mechanics & Merchants Bank, Richmond, Va., of which I am corporate tax accountant, owns two residential houses and at the present time they are occupied by family tenants from whom the bank receives gross rental income.

This bank plans to demolish these residential houses during 1954 and use the land for automobile parking for the customers of the bank.

This bank purchased these residential houses for ultimate demolition thereof and families were living in them at the time the houses were purchased by the bank.

Under existing regulations of the Bureau of Internal Revenue no demolition loss would be allowable against gross income of this bank in the event these houses were demolished, and the adjusted basis of these buildings would be added to the original cost of the land.

Under existing regulations of the Bureau of Internal Revenue, the Mechanics & Merchants Banks is not permitted at the present time to deduct depreciation on the appraised values by the real-estate profession of these residential homes; notwithstanding the fact that the bank is presently being assessed Federal income taxes on the rents now being received from the occupant family tenants.

Under existing regulations of the Bureau of Internal Revenue the Mechanics & Merchants Bank would be permitted to deduct against its gross income the adjusted basis of its bank building in the event the bank building were demolished, regardless of whether or not either a new bank building were erected or the unimproved land were used by the bank.

Here we have a case where the Bureau of Internal Revenue says, yes, the bank would have an allowable demolition loss on the bank building, and the Bureau of Internal Revenue says, no, the bank would not have an allowable demolition loss on the residential houses.

Such treatment on the part of the Bureau of Internal Revenue adversely affects economically all classes of Federal income tax payers, regardless of whether or not they are banks, corporations, or individuals, operating a trade or business.

In addition to the desirability of H. R. 7598 from the standpoint of fairness and equity, it seems that it should have the effect of encouraging the purchase of obsolete properties in urban areas. H. R. 7598 should also encourage the replacement of outmoded buildings by modern structures, which might be deferred under existing regulations or might otherwise be forced into suburban areas, to the detriment of existing urban developments. H. R. 7598 should provide an immediate stimulus in the building industry and permanent improvements in our cities, which would yield better tax returns and improve the efficiency and appearance of our cities.

The Mechanics & Merchants Bank bought two residential houses for ultimate demolition thereof to use the land for automobile parking for customers of the Mechanics & Merchants Bank. This bank is merely attempting to expand its available space to carry on its trade or business. At the present time the Mechanics & Merchants Bank is paying Federal income taxes on the gross rents now being received from family tenants presently living in the two residential homes. At the present time no depreciation is permitted to this bank because the cost basis of the two residential homes is zero. If these residential homes were sold today, the cost basis for determination of gain or loss for Federal income tax purposes would be zero and any proceeds from sale thereof would not be any return of capital because the cost basis is zero. The Mechanics & Merchants Bank plans to demolish these residential homes during 1954 for use of the land for automobile parking for their customers.

My appearance here today is because H. R. 7598 was not placed on the agenda for consideration by the Ways and Means Committee for either their acceptance or rejection thereof.

I would respectfully recommend that section 125 of the existing Internal Revenue Code be repealed in toto and that no bond premium loss ever be an allowable deduction against gross income, by the Internal Revenue Code revisions of 1954, H. R. 8300, if you gentlemen and the other Members of the Congress of the United States were to prove conclusively that the provisions in H. R. 7598 are unsound and inequitable to the Federal Government and the Federal income-tax payers operating a trade or business because the only basic difference, in my opinion, between the aforesaid two classes of assets is that section 125 of the existing Internal Revenue Code deals with bond premiums invested in intangible assets which presently permits a taxpayer holder of a bond to deduct the amortizable premium thereon against gross income or the adjusted basis thereof including premium, in case of sale thereof, whereas H. R. 7598 deals with demolished buildings, tangible assets, which would permit the taxpayer to deduct against gross income the loss from the voluntary demolition of a building.

The taxpayer is compelled to pay a premium on a premium bond purchased in the bond market and he cannot buy such premium bond at the par amount thereof, notwithstanding the fact that the obligor of the bond promises to pay at maturity date the par amount only and the same taxpayer is compelled to pay and invest his monetary capital in a building regardless of whether or not he uses the building in his trade or business or whether or not he demolishes the building and uses only the land in his trade or business, or whether or not he erects thereon and uses a new building in his trade or business.

Therefore, he is compelled to pay a premium on a premium bond and he is also compelled to pay a monetary premium for a demolished building in order to buy the land for either use of the vacant land or use of a new building thereon in his trade or business. He has no control or economic choice over either type of the tangible or intangible assets in that he cannot buy a premium bond at the par amount thereof and he cannot buy land without paying for the building as well as paying for the land. The taxpayer would never have any monetary investment or economic loss in the demolished building if he could have bought the building for a monetary cost of zero. The taxpayer can never recover his capital loss of the bond premium and he can never recover his capital loss of a demolished building for Federal income-tax purposes unless he can deduct them from his gross income.

The real-estate professional appraisers throughout the United States would place a monetary and economic value on a building as of the date of purchase regardless of whether or not the taxpayer buys the building for use in his trade or business or whether or not he buys the building for ultimate demolition thereof; moreover, the assessed valuations for real-estate tax purposes by the local governments throughout our Nation would reduce the assessed valuations for subsequent years after the building was demolished.

For the Congress of the United States to allow the loss on the one and to not allow the loss on the other would, in my opinion, be incongruous, illogical, and inconsistent in the extreme.

The findings of fact presented to you gentlemen here today compel me to believe conclusively that every Member of the Congress of the United States; chief of staff of the Joint Committee on Internal Revenue Taxation, Colin F. Stam; Secretary of the Treasury, George M. Humphrey; Under Secretary of the Treasury, Marion B. Folsom; and assistant to the Secretary of the Treasury, Kenneth W. Gemmill, would feel that the subject losses from the demolitions of buildings, if applicable, should be allowable deductions on their respective personal Federal income tax returns and that H. R. 7598 should be enacted into the Revenue Act of 1954, for taxable years beginning after December 31, 1953, for all classes of Federal income-tax payers operating a trade or business.

H. R. 7598 would permit Federal income-tax payers operating a trade or business to be assessed Federal income taxes on their actual and realistic net income and not on their gross income, and with equity to all classes of Federal income-tax payers and special privilege to none.

I thank you.

The CHAIRMAN. Thank you very much.

(Mr. Bullock's presentation follows:)

STATEMENT OF THOMAS M. BULLOCK, CORPORATE TAX ACCOUNTANT, MECHANICS & MERCHANTS BANK, RICHMOND, VA., RE H. R. 7598

Mr. Chairman and gentlemen of this distinguished committee, my name is Thomas M. Bullock. I am the corporate tax accountant for the Mechanics & Merchants Bank, Richmond, Va.

My appearance before you today is on behalf of this bank and all other Federal income-tax payers operating a trade or business, affected by H. R. 7598, dealing with allowing losses sustained by voluntary demolition of a building, effective for taxable years beginning after December 31, 1953.

I respectfully urge you gentlemen to enact H. R. 7598 into the Revenue Act of 1954 because it is sound, equitable and does not provide for any so-called class Federal income-tax legislation whatsoever. If you were not to enact H. R. 7598 now, then the taxpayers would continue to be taxed on their gross income, and I'm sure that such is not your desire.

In 1940 the Lynchburg National Bank & Trust Co. purchased improved real estate, land and building, for $37,500, immediately adjacent to its bank buildings. That bank allocated $32,274.75 to land and $5,225.25 to the building. That property was acquired by the Lynchburg bank with the intent of demolishing the building and erecting in its place an addition to its main bank building in order to expand its available space to carry on its banking business activities. At the time of purchase, the building was rented to a retail shoestore and restaurant. Thereafter, the real half of that building was destroyed by fire on April 29, 1946. The restaurant tenant occupied the premises continuously until the time of such fire on April 29, 1946, paying rent therefor to the owner. Lynchburg bank. The shoestore tenant occupied the premises continuously until eventual demolition on the front half of the building in 1949, paying rent therefor to the owner, Lynchburg bank. On June 13, 1946, the owner, Lynchburg bank, received fire-insurance proceeds of $9,902.84 because of the fire loss to the building. The fire damaged the entire rear half of the building to such an extent that that portion was demolished in 1946. The cost of that demolition, plus the cost of cleaning up the debris, amounted to $2,273.51. In 1949, the front half, or remainder, of the building was demolished and construction of an addition to the bank was begun on the entire property.

The new building occupies the same land as the old building. No part of that building was used for rental purposes.

The Tax Court of the United States held in its decision rendered on June 25, 1953, and affirmed by the United States Court of Appeals, Fourth Circuit, on December 5, 1953, that the full amount of fire-insurance proceeds of $9,902.84 was taxable income to the Lynchburg Bank, and the allocated cost of the building of $5,225.25 was allocable in toto to the land, and that the cost basis of the building was zero, and that the depreciation was disallowed because of the cost basis of the building being zero.

The following is quoted from Accountants' Handbook, third edition, edited by W. A. Paton, Ph. D., C. P. A., professor of accounting, University of Michigan, Separation of Land and Building Costs, page 597:

"Improved real estate is often purchased without any explicit provision in the transaction for division of costs between land and improvements. Nevertheless, it is necessary for the buyer to make an apportionment in his accounts (for tax purposes and otherwise), particularly in view of the fact that improvements are subject to depreciation and replacement and land in general is not. In this case, as in that of residual timber and mineral land, a convenient approach in apportioning is to determine the value of the land directly through a study of market values of similar unimproved land in the vicinity. On the other hand, particularly where the value of the buildings or other improvements clearly represents a major part of the total, it may be desirable to proceed from the other direction, by estimating the replacement cost of the improvements and from this basis, with proper adjustments for depreciation and other factors, obtaining a reasonable figure for the improvements.

"Urban land is often purchased with buildings and other structures thereon which must be removed before the site can be utilized for the purpose intended. In such cases care must be taken that no large amount of the purchase price is attached to the improvements subject to removal. In fact the maximum value of the improvements in such conditions is their net salvage value, if any, the balance of the purchase price being the cost of the site.

"If the buyer acquired the property expecting to use the buildings or other improvements for any considerable time before removal, it is necessary to attach a value to the improvements as usable property. If the buyer acquires an improved property expecting to use the buildings for a time but later finds it impossible to do so, either as a result of poor judgment at the outset or of unfavorable changes in conditions, the cost of the land is presumably unchanged but the value tentatively attached to the improvements becomes a loss."

Existing regulation 111 of the Treasury Department, section 29.23(e)-2:

"Voluntary removal of buildings: Loss due to the removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building."

The Mechanics & Merchants Bank, Richmond, Va., of which I am corporate tax accountant, owns two residential houses and at the present time they are occupied by family tenants from whom the bank receives gross rental income.

This bank plans to demolish these residential houses during 1954 and use the land for automobile parking for the customers of the bank.

This bank purchased these residential houses for ultimate demolition thereof and families were living in them at the time the houses were purchased by the bank.

Under existing regulations of the Bureau of Internal Revenue no demolition loss would be allowable against gross income of this bank in the event these houses were demolished, and the adjusted basis of these buildings would be added to the original cost of the land.

Under existing regulations of the Bureau of Internal Revenue, the Mechanics & Merchants Bank is not permitted at the present time to deduct depreciation on the appraised values, by the real-estate profession, of these residential homes; notwithstanding the fact that the bank is presently being assessed Federal income taxes on the rents now being received from the occupant family tenants.

Under existing regulations of the Bureau of Internal Revenue the Mechanics & Merchants Bank would be permitted to deduct against its gross income the adjusted basis of its bank building in the event the bank building were demolished, regardless of whether or not either a new bank building were erected or the unimproved land were used by the bank.

Here we have a case where the Bureau of Internal Revenue says "Yes, the bank would have an allowable demolition loss on the bank building," and the Bureau of Internal Revenue says "No, the bank would not have an allowable demolition loss on the residential houses."

Such treatment on the part of the Bureau of Internal Revenue adversely affects economically all classes of Federal income taxpayers, regardless of whether or not they are banks, corporations or individuals, operating a trade or business.

The purchase price of this bank's office building represents an actual monetary investment therein and the bank can recover the adjusted basis cost thereof from year to year for Federal income-tax purposes, by allowable depreciation, or allowable demolition loss if demolished, or by sale thereof. The purchase price of the bank's residential buildings represents an actual monetary investment therein, and the bank can recover the adjusted basis thereof for Federal income-tax purposes only by sale of the unimproved land, after the buildings have been demolished. Such adjusted basis thereof can never be recovered for Federal income-tax purposes by depreciation or by a demolition loss. The adjusted basis cost of the residential biuldings is an economic and realistic financial loss to the bank when they are demolished.

The adjusted basis cost of the residential buildings of the Mechanics & Merchants Bank is as much an economic and realistic financial loss of the bank in the event these residential buildings be demolished, as the adjusted basis cost of the bank's office building would be an economic and realistic financial loss of the bank in the event the bank's office building be demolished.

The purposes for which the bank's residential buildings were acquired can never prevent the adjusted basis cost thereof from being an economic and realistic financial loss of the bank in the event of demolition thereof. I am of the opinion that Mr. Dan Throop Smith, who is presently an economist for the Treasury Department, would support this sound and commonsense statement.

No person could conclusively prove that the Mechanics & Merchants Bank did not pay some money for the residential houses. No person could conclusively prove that the former owner of these residential houses sold them to the bank for no monetary price whatsoever. No person could conclusively prove that the former owner did not have invested monetary capital in the residential houses at the time they were sold to the bank. No person could conclusively prove that the residential buildings were of no economic and realistic financial value to the bank at the date of acquirement thereof.

I do not think that you gentlemen of this distinguished Finance Committee, or any other Member of the Congress of the United States, would sell his personal land at the fair market value thereof and give away free a building thereon when the building had a fair market value at such time and when such Members could receive money for the conveyance of the building simultaneously with the sale of the land. I do not think that any Member of the Congress would feel that he had not incurred a personal economic and realistic financial loss if he had owned the two subject residential houses and had they been demolished. I believe that any Member of the Congress would feel that such demolition losses should be allowable deductions on his personal Federal income-tax return.

The national bank examiners' and the Federal Reserve bank examiners' general requirements are that the subject losses from demolitions of buildings be charged off of the books of banks. Such requirements of the bank examiners appear to support the recognized economic and financial losses incurred by banks upon the demolitions of buildings or residential houses, and it is immaterial to the bank examiners as to the purposes for which the buildings were acquired and subsequently demolished.

The charging off of losses from demolitions of buildings is recognized and practiced by the accounting profession throughout the United States, irrespective of whether or not the Federal income-tax payers are banks, corporations, or individuals.

The practice of the Bureau of Internal Revenue in holding that the adjusted basis cost of a demolished building is not an economic and realistic loss to all classes of Federal income-tax payers appears to be without support from the economists throughout our Nation, the national bank examiners, the Federal Reserve bank examiners, the Federal Deposit Insurance Corporation bank examiners, the national accounting profession and the standard practice of business entities throughout the United States.

I am of the opinion that you gentlemen and all the other Members of the Congress of the United States would hold sound and equitable H. R. 7598, on the basis of Federal income taxes being assessed on the true and realistic net income of all classes of Federal income-tax payers operating a trade or business.

In addition to the desirability of H. R. 7598 from the standpoint of fairness and equity, it seems that it should have the effect of encouraging the purchase of obsolete properties in urban areas. H. R. 7598 should also encourage the replacement of outmoded buildings by modern structures, which might be deferred under existing regulations or might otherwise be forced into suburban areas, to the detriment of existing urban developments. H. R. 7598 should provide an immediate stimulus in the building industry and permanent improvements in our cities, which would yield better tax returns and improve the efficiency and appearance of our cities.

SUMMARY

The Lynchburg Bank's building had no cost basis for any Federal income-tax purpose. The cost basis was zero. No depreciation was allowed because the cost basis of the building was zero. The gross rental income from the shoestore and restaurant tenants was taxable income to the Lynchburg Bank. The fire-insurance proceeds of $9,902.84 was taxable income to the Lynchburg Bank because the cost basis of the fire-damaged building was zero. The fire-insurance proceeds of $9,902.84 was not any return of capital because the cost basis of the fire-damaged building was zero. The Lynchburg Bank was merely attempting to expand its available space to carry on its trade or business when they bought the land and building.

The Mechanics & Merchants Bank bought two residential houses for ultimate demolition thereof to use the land for automobile parking for customers of the Mechanics & Merchants Bank. This bank is merely attempting to expand its available space to carry on its trade or business. At the present time the Mechanics & Merchants Bank is paying Federal income taxes on the gross rents now being received from family tenants presently living in the two residential homes. At the present time no depreciation is permitted to this bank because the cost basis of the two residential homes is zero. If these residential homes were sold today, the cost basis for determination of gain or loss for Federal income-tax purposes would be zero and any proceeds from sale thereof would not be any return of capital because the cost basis is zero. The Mechanics & Merchants Bank plans to demolish these residential homes during 1954 for use of the land for automobile parking for their customers.

My appearance here today is because H. R. 7598 was not placed on the agenda for consideration by the Ways and Means Committee for either their acceptance or rejection thereof.

I would respectfully recommend that section 125 of the existing Internal Revenue Code be repealed in toto and that no bond premium loss ever be an allowable deduction against gross income, by the Internal Revenue Code Revisions of 1954, H. R. 8300, if you gentlemen and the other Members of the Congress of the United States were to prove conclusively that the provisions in H. R. 7598 are unsound and inequitable to the Federal Government and the Federal income taxpayers operating a trade or business because the only basic difference, in my opinion, between the aforesaid two classes of assets is that section 125 of the existing Internal Revenue Code deals with bond premiums invested in intangible assets which presently permits a taxpayer holder of a bond to deduct the amortizable premium thereon against gross income or the adjusted basis thereof including premium, in case of sale thereof, whereas H. R. 7598 deals with demolished buildings, tangible assets, which would permit the taxpayer to deduct against gross income the loss from the voluntary demolition of a building. The taxpayer is compelled to pay a premium on a premium bond purchased in the bond market and he cannot buy such premium bond at the par amount thereof, notwithstanding the fact that the obligor of the bond promises to pay at maturity date the par amount only and the same taxpayer is compelled to pay and invest his monetary capital in a building regardless of whether or not he uses the building in his trade or business or whether or not he demolishes the building and uses only the land in his trade or business or whether or not he erects thereon and uses a new building in his trade or business.

Therefore, he is compelled to pay a premium on a premium bond and he is also compelled to pay a monetary premium for a demolished building in order to buy the land for either use of the vacant land or use of a new building thereon in his trade or business. He has no control or economic choice over either type of the tangible or intangible assets in that he cannot buy a premium bond at the par amount thereof and he cannot buy land without paying for the building as well as paying for the land. The taxpayer would never have any monetary investment or economic loss in the demolished building if he could have bought the building for a monetary cost of zero. The taxpayer can never recover his capital loss of the bond premium and he can never recover his capital loss of a demolished building for Federal income tax purposes unless he can deduct them from his gross income.

The real-estate professional appraisers throughout the United States would place a monetary and economic value on a building as of the date of purchase regardless of whether on not the taxpayer buys the building for use in his trade or business or whether or not he buys the building for ultimate demolition thereof; moreover, the assessed valuations for real-estate tax purposes by the local governments throughout our Nation would reduce the assessed valuations for subsequent years after the building was demolished.

For the Congress of the United States to allow the loss on the one and to not allow the loss on the other would, in my opinion, be incongruous, illogical, and inconsistent in the extreme.

The findings of fact presented to you gentlemen here today compel me to believe conclusively that every Member of the Congress of the United States, Chief of Staff of the Joint Committee on Internal Revenue Taxation, Colin F. Stam, Secretary of the Treasury, George M. Humphrey, Under Secretary of the Treasury, Marion B. Folsom, and Assistant to the Secretary of the Treausry, Kenneth W. Gemmill, would feel that the subject losses from the demolitions of buildings, if applicable, should be allowable deductions on their respective personal Federal income tax returns and that H. R. 7598 should be enacted into the Revenue Act of 1954, for taxable years beginning after December 31, 1953, for all classes of Federal income taxpayers operating a trade or business.

H. R. 7598 would permit Federal income taxpayers operating a trade or business to be assessed Federal income taxs on their actual and realistic net income and not on their gross income, and with equity to all classes of Federal income taxpayers and special privilege to none.

I thank you.

[H. R. 7598, 83d Cong., 2d sess.]

A BILL To amend the Internal Revenue Code to provide a deduction from gross income for losses sustained by reason of the voluntary demolition of a building by a taxpayer operating a trade or business, effective with respect to taxable years beginning after December 31, 1953

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the heading of subsection (j) of section 117 of the Internal Revenue Code is hereby amended to read as follows:

"(j) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OF EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS AND LOSSES FROM CERTAIN VOLUNTARY DEMOLITIONS OF BUILDINGS.—".

SEC. 2. Section 117 (j) (2) of the Internal Revenue Code (relating to general rule for determining gains and losses) is hereby amended to read as follows:

"(2) GENERAL RULE.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than six months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, and the recognized losses (which shall be the adjusted basis of the buildings provided in section 113 (b)) from the voluntary demolition of buildings held for more than six months if the land upon which the demolished building stood is to be used in the trade or business of the taxpayer demolishing such building, such gains and losses shall be considered as gains and losses from sales or exchange of capital assets held for more than six months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

"(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than six months shall be considered losses from a compulsory or involuntary conversion."

SEC. 3. Section 23 (i) of the Internal Revenue Code (relating to basis for determining loss) is hereby amended to read as follows:

"(i) BASIS FOR DETERMINING LOSS.—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e), (f) or (gg), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property."

SEC. 4. Section 23 (l) of such Code (relating to deductions from gross income for depreciation) is hereby amended by striking out the period at the end of paragraph (2) and inserting in lieu thereof a comma and the word "or", and by adding after paragraph (2) the following new paragraph:

"(3) of buildings purchased with the intent to voluntarily demolish in order to use the land upon which any such demolished building stood in the trade or business of the taxpayer demolishing such building."

SEC. 5. Section 23 of the Internal Revenue Code (relating to deductions from gross income) is hereby amended by adding at the end thereof the following new subsection:

"(gg) LOSSES DUE TO VOLUNTARY DEMOLITION OF BUILDINGS.—Losses resulting from the voluntary demolition of buildings if the land upon which the demolished building stood is to be used in the trade or business of the taxpayer demolishing such building."

SEC. 6. Section 113 (a) of the Internal Revenue Code (relating to adjusted basis for determining gain or loss) is hereby amended by adding at the end thereof the following new paragraph:

"(24) BUILDINGS ACQUIRED WITH INTENT TO DEMOLISH.—If the property consists of a building or buildings purchased by the taxpayer with the intent to demolish such building or buildings in order to use the land upon which such building or buildings stood in the trade or business of the taxpayer then the basis shall be the same as it would be if the property had not been acquired with such intent to demolish the building or buildings."

SEC. 7. The amendments made by this Act shall apply only with respect to taxable years beginning after December 31, 1953.

The CHAIRMAN. Mr. Carroll. Sit down, Mr. Carroll, and identify yourself to the reporter.

STATEMENT OF E. J. CARROLL, DIRECTOR OF ECONOMIC RESEARCH, SHARPE & DOHME DIVISION OF MERCK & CO., INC.

Mr. CARROLL. I am E. J. Carroll, director of economic research for Sharpe & Dohme.

I should like, at this time, to present for the record a statement of the American Drug Manufacturers Association, of which association we are a member.

The CHAIRMAN. It will be put in the record.

(The statement referred to follows:)

AMERICAN DRUG MANUFACTURERS ASSOCIATION,
Washington 5, D. C., April 7, 1954.

STATEMENT ON TAXATION OF FOREIGN INCOME

The tax committee of the American Drug Manufacturers Association has previously presented its views to the Treasury Department and to the staff of the joint committee with respect to the tax treatment of foreign income. We recommended:

(1) All enterprises engaged in substantial activities in foreign countries should be treated equally by the tax laws. All American goods sold abroad compete with foreign-made goods subject to lower tax rates, regardless of the method of conducting business in the foreign countries.

(2) To accomplish this purpose:

(*a*) Section 119, defining "sources of income," should be amended to provide that income from the sale of goods exported, for use or consumption outside the United States, shall be considered as income from sources outside the United States.

(*b*) (i) Section 109, granting a preferential tax rate to Western Hemisphere trade corporations, should be extended to apply to worldwide trade, and

(ii) A dividends-received credit of 100 percent (in lieu of the present 85 percent) should be allowed for dividends from such a trade corporation, in order that the parent may not be deprived of the full benefit of the preferential tax rate.

H. R. 8300 recognizes the principle of preferential treatment of foreign income. However, the provisions as drafted (particularly sections 923 and 951) are restricted to a limited class of foreign enterprises, and discriminate against others engaged in substantial activities abroad for whom a like incentive is needed, and by whom like risks of a substantial character are assumed.

In entering foreign markets, it has been customary for a pharmaceutical company first to establish in each foreign market its name and reputation and the therapeutic qualities of its products. This involves substantial activities and expenditures which are as irrevocably committed to the foreign country and represent proportionately as great an expenditure as the cost of fixed assets required for manufacture within the country. These substantial activities of our members include:

(1) maintaining salesmen abroad;
(2) advertising their brand names;
(3) making samples available;
(4) sending special representatives to acquaint foreign physicians and hospitals (both individually and in convention), with the characteristics and uses of their products;
(5) conducting clinical investigations to obtain health certificates;
(6) obtaining and protecting foreign patents and trademarks in each foreign country.

These activities require substantial investment before a market exists for most pharmaceutical products in foreign countries. Further expenditures are required to maintain and expand such markets. Surely this constitutes the active conduct of a trade or business in foreign countries.

Our preference is still for the adoption of the suggested amendment to section 119 of the present code (now sec. 862 (a) (6) of H. R. 8300). However, if the committee wishes to accept the philosophy expressed in sections 921 to 923 of H. R. 8300, at least the following amendments, to avoid discrimination, should be adopted:

(1) The term "trade or business" appearing in section 923 (a) (3) (A) (ii) and in section 923 (b) (1) should be amended to include the distribution at wholesale of goods or merchandise, subject to one of the following limitations:

(*a*) The maintenance, in one or more foreign countries, of either
(i) a stock of goods or merchandise; or
(ii) a staff of sales employees; or
(iii) substantial activity in the form of advertising, promotion, patent or trademark expenditures; or

(*b*) The goods or merchandise distributed are principally those manufactured by the taxpayer, or its parent or another subsidiary of the parent.

Comparable changes should be made in section 951.

A less desirable alternative amendment having a somewhat similar effect would be the amendment of section 922, extending Western Hemisphere treatment to all areas of the world. This has the advantage of simplicity and the existence of prior administrative interpretation. If this amendment is adopted, a 100-percent dividends-received credit should be allowed for dividends from such a trade corporation.

(2) Section 923 (a) (1) should be amended to permit the preferential tax rate for branch income (otherwise qualified) which is not deferred in accordance with the election granted in part IV. This appears to be the intention of the bill, although the present language seems to exclude nondeferred income of branches.

(3) Section 923 (a) (2) should be amended to include royalties derived from patents, trade-marks, and know-how, and also management fees for services rendered. In the majority of cases, these are alternative methods of taking profits out of foreign countries under existing exchange restrictions and should be given the same treatment as dividends.

(4) The ownership requirement in 923 (a) (3) (B) (i) and 923 (b) (2) (B) of more than 50 percent of the voting stock of a foreign corporation should be changed to "50 percent or more, or the maximum percent allowable by the requirements of a foreign country in which the foreign corporation is doing business." This is necessary because of the restrictions in some countries on the ownership of majority stock interests by foreigners.

Mr. CARROLL. My appearance today is on behalf of Merck and Co., and its affiliates and subsidiaries. In addition to that, the following pharmaceutical firms have asked me to appear for them in lieu of personal appearances: Abbott Laboratories, Chicago, Ill.; Johnson & Johnson, New Brunswick, N. J.; Eli Lilly & Co., Indianapolis, Ind.; Parke, Davis & Co., Detroit, Mich.; Chas. Pfizer & Co., Inc., Brooklyn, N. Y.; G. D. Searle & Co., Chicago, Ill.; The Upjohn Co., Kalamazoo, Mich.

All of these firms operate abroad now and collectively we have over $100 million invested in foreign assets.

I should like to file a statement with the clerk and ask that this be placed in the record. If you will give me about 3 minutes, we will try to get to the ball game on time.

The CHAIRMAN. Good.

Mr. CARROLL. The proposed bill would not allow a very substantial part of our operations to qualify. We are asking that a manufacturer who sells his own products for consumption abroad should be allowed to qualify such sales. We are proposing in our statement three methods by which that may be accomplished. A moment ago someone testified as to the advisability of using the test of a personal foreign establishment to qualify a firm such as ours. We do not feel that this would qualify us. We do believe that the Senate might wish to have in mind that the permanency of operations of a firm abroad be used as a test. Our objection to the personal foreign establishment goes back to the lack of a definition of what is a personal establishment. We have now tax treaties embodying this principle and even in those treaties we have a variation as to what is and is not included. Too often the personal establishment implies the possession of a certain type of a receipt. It even encourages firms to operate on legal fixes in contravention with their usual practices. We do business in the United States and all 48 States. I think we only have 17 branches which might be classified as personal establishments here. We hope that the Finance Committee will so reconstruct the proposed sections dealing with foreign income so that manufacturers selling products which they make will be able to qualify sales made for consumption abroad.

Thank you, Mr. Chairman.

(Mr. Carroll's prepared statement follows:)

STATEMENT OF E. J. CARROLL RELATING TO INCOME FROM FOREIGN SOURCES AS PROPOSED IN H. R. 8300 (REPT. NO. 1337)

My name is E. J. Carroll. My residence is 210 Ladbroke Road, Bryn Mawr, Pa. I am director of economic research for Sharp & Dohme division of Merck & Co., Inc., with division headquarters in Philadelphia, Pa. I am appearing today on behalf of Merck & Co., Inc., its subsidiaries and affiliates, to give you our suggestions relative to the sections of H. R. 8300 dealing with income earned abroad.

Complying with the committee's request that testimony be consolidated in the interest of conservation of time, the following pharmaceutical firms endorse these suggestions in lieu of personal appearances: Abbott Laboratories, Chicago, Ill.; Johnson & Johnson, New Brunswick, N. J.; Eli Lilly & Co., Indianapolis, Ind.; Parke, Davis & Co., Detroit, Mich.; Chas. Pfizer & Co., Inc., Brooklyn, N. Y.; G. D. Searle & Co., Chicago, Ill.; the Upjohn Co., Kalamazoo, Mich.

All of these firms are at present engaged in foreign trade and all have assets in foreign countries subject to the risks of foreign investments. The eight firms endorsing these suggestions have well over $100 million invested in such foreign assets as accounts receivable, inventories of finished goods and raw materials held abroad, wholesale and manufacturing establishments.

In section 923 of the bill, the House of Representatives has recognized the advantages of making American scientific and technical know-how available abroad by providing preferential tax treatment for income derived from professional services. Likewise, favorable treatment is afforded income derived from a trade or business conducted through a factory, mine, oil or gas well, or public utility facility or a retail establishment. The intent of this section is to give encouragement to foreign investment by providing favorable tax treatment. The proposed measure fails to favorably recognize income derived from that gray area between these two classes where payment for the imparting of scientific knowledge or technical know-how is contained in the sales price of a commodity manufactured in the United States but sold in a foreign country. The section has overlooked the fact that investments of a business nature may be made in other than tangible property, and that the amount of these investments for a given industry may be greater than that required for a manufacturing establishment. Risks on such investments are equally as hazardous as those borne by permanent establishments. In the case of pharmaceuticals as well as other products, the present bill would offer a premium to firms building foreign plants for the purpose of manufacturing products which are now supplied by United States factories.

The sale of pharmaceuticals is largely dependent on the dissemination of scientific knowledge. Not only is highly specialized knowledge utilized in our laboratories, it is also necessary to impart scientific knowledge concerning a product, its actions and reactions in the human system, to medical practitioners before they can use these products effectively and with safety. The knowledge of chemistry as related to the treatment of human illness has advanced so rapidly in recent years that only a small percentage of practicing physicians in foreign countries have had formal training in the chemistry of many of our modern drugs. Those who would introduce new pharmaceutical products in foreign countries assume the burden of imparting scientific knowledge to the medical practitioners in those countries.

When a pharmaceutical company enters a foreign country it must first establish its name, its reputation, and the therapeutic qualities of each of its products. Considerable expenditures are often required to comply with local regulations and in obtaining and protecting foreign patents and trade marks. Investments are required to maintain a sales force, the sending of special representatives to acquaint physicians and hospitals with the characteristics and uses of particular products. Clinical investigations and demonstrations are often required. Products must be made available to meet the potential demand. In short, a substantial investment in other than tangible property is required before a market exists. The sum of such investments necessary to launching a foreign venture is frequently greater than the investment that is subsequently required for a manufacturing operation. These expenditures and investments create income and purchasing power in the foreign country just as do investments in permanent establishments.

Until a market for a product in a foreign country has been developed to the point where local manufacture is economical, products are supplied from United States plants. We are of the opinion that the Congress does not wish to discriminate against investments to develop markets abroad nor to encourage location of manufacturing facilities abroad to the detriment of United States manufacturing facilities now supplying these markets. These inequities exist in the proposed bill.

We are hopeful that the Finance Committee will thoroughly examine the sections of this bill relating to foreign income. Should the committee feel that investments in foreign countries provide a yardstick by which a firm's eligibility should be determined, it is strongly urged that all types of investments and expenditures which may indicate permanency of foreign operations be favorably considered rather than investments in permanent establishments as now recommended in H. R. 8300.

While we feel strongly that all enterprises engaged in substantial activities in foreign countries should be treated equally by the tax laws and eligible for preferential rates, we are mindful that present conditions may preclude the accomplishments of this goal immediately. For the consideration of the committee, however, we are attaching hereto plan No. 1 which indicates the amendments to the present bill which would be required to accomplish these ends.

We are confident that the committee will wish to extend to any American manufacturer preferential rates where the manufacturer creates a market and passes title for his goods outside the United States. Such transactions increase foreign trade, the desirability of which has been emphasized by this, and previous administrations. If the committee should decide that such operations are deserving of favorable treatment, two plans are suggested for accomplishing these ends. These plans are labeled plan No. 2 and plan No. 3 and are attached to this statement.

Plan No. 2 permits a manufacturer to qualify when he wholesales or distributes in a foreign country goods principally of his own manufacture. He must, of course, comply with the other restrictions and possess the other qualifications set forth. It will be noted that this revision does not recognize wholesaling per se, but only wholesaling done by a manufacturer ancillary to the sale of his product. This plan is considerably less extensive in its coverage than plan No. 1.

From the technical standpoint, the simplest way to cover the deficiencies pointed out above is to extend the provisions of existing law applying to Western Hemisphere trade corporations to worldwide application. It should be pointed out that the extension of the Western Hemisphere trade corporation concept to include worldwide trade is considerably broader than plan No. 2 in that it allows more types of business ventures to qualify.

The principal amendments required to effectuate plan No. 3 are described in the attachments to this statement.

PLAN NO. 1—SUGGESTED AMENDMENTS TO H. R. 8300 RELATIVE TO FOREIGN INCOME

Section 862 (a):

"(6) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States, and gains, profits, and income derived from the sale of goods exported for use or ultimate consumption outside the United States where such sale is of goods manufactured by the taxpayer, its parent, or another subsidiary of the parent."

Section 921. Definition of world trade corporations:

"For the purposes of this subtitle, the term 'world trade corporation' means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries outside the United States, its Territories and possessions, and which satisfies the following conditions:

"(1) If 95 percent or more of the gross income (excluding therefrom the proceeds of insurance covering any properties outside the United States, its Territories or possessions) of such domestic corporation for the three-year period immediately preceding the close of the taxable year (or for such period during which the corporation was in existence) was derived from sources without the United States; and."

Section 922. Special deduction:

"In the case of a world trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows:"

PLAN NO. 2—SUGGESTED AMENDMENTS TO H. R. 8300 RELATIVE TO FOREIGN INCOME

Section 923a (3) (A):

"(ii) has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, wholesale or distribution establishment servicing or selling goods principally manufactured by the taxpayer or its parent or another subsidiary of the parent, or other like plan of business situated within a foreign country; and".

Section 951 (b) (1):

"(A) The operation of an establishment engaged principally in the purchase or sale (other than at retail or at wholesale if the goods so wholesaled or distributed are principally of the manufacture of the taxpayer, or its parent or another subsidiary of the parent) of goods or merchandise; or

"(B) The maintenance of an office, or employment of an agent, other than a retail establishment or a wholesale or distribution establishment excepted from subparagraph. (A), to import or facilitate the importation of goods or merchandise."

PLAN NO. 3—SUGGESTED AMENDMENTS TO H. R. 8300 RELATIVE TO FOREIGN INCOME

Section 921. Definition of world trade corporations:

"For the purposes of this subtitle, the term "world trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries outside the United States, its Territories and possessions, and which satisfies the following conditions:

"(1) If 95 percent or more of the gross income of such domestic corporation (excluding the proceeds of insurance against losses on foreign shipments) for the three-year period immediately preceding the close of the taxable year (or for such period during which the corporation was in existence) was derived from sources without the United States; and".

Section 922. Special deduction:

"In the case of a world trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows:".

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

Is Roland K. Risa here? It appears he is not present.

We will meet at 10 o'clock in the morning.

(Whereupon, at 12:55 p. m., the committee recessed, to reconvene at 10 a. m., April 14, 1954.)

THE INTERNAL REVENUE CODE OF 1954

WEDNESDAY, APRIL 14, 1954

United States Senate,
Committee on Finance,
Washington, D. C.

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Williams, Hoey, and Kerr.

The Chairman. The meeting will come to order.

Mr. Walter Evans, who was on our schedule for this morning, is unable to appear, but will probably submit a statement in behalf of the Virginia Association of Businessmen for the record at a later date.

Mr. M. R. Runyon, of the American Cancer Society. Mr. Runyon, make yourself comfortable and identify yourself for the reporter.

STATEMENT OF MEFFORD R. RUNYON, EXECUTIVE VICE PRESIDENT, AMERICAN CANCER SOCIETY

Mr. Runyon. My name is Mefford R. Runyon. I am the executive vice president of the American Cancer Society.

I wish to address myself to section 117 of the bill, which deals with the taxation of fellowship grants.

The grants of the American Cancer Society are almost invariably to individuals who have already received their degrees. Under the bill, these postdegree grants are fully taxable to the recipient if the amount of the grant is 75 percent or more of the individual's earnings for the 12 months preceding the award. Since even the society's minimum grant of $3,300 is usually more than 75 percent of the prefellowship earnings, the grants will be taxable under the bill, although they are nontaxable gifts under existing law.

The American Cancer Society is a nonprofit organization supported entirely by contributions from the public responding to a nationwide campaign. The general purpose of the society is to devote its funds and its energy to the problem of cancer and its control.

An important phase of the problem is training young doctors before they start to practice, to become competent in the detection and treatment of cancer and also to train young scientists for careers in cancer research. It is generally recognized by authorities in the field that a most serious obstacle in achieving an understanding of the abnormal mechanism of malignant growth is the shortage of trained investigators and of doctors qualified to apply the investigators' laboratory developments to the diagnosis and treatment of the patient.

Treatment is presently by surgery, by radiation, and by chemotherapy. In the cancer field, all these methods require special training.

The CHAIRMAN. What do you mean by "chemotherapy"?

Mr. RUNYON. Chemotherapy is treatment with drugs.

To meet this problem, the society sponsors two training programs for research fellows and clinical fellows. Sinoe both are postdoctoral programs, the recipient has already had advanced training and, thus, can most effectively contribute to the cancer control effort in the shortest practicable time.

The research fellowship program has been designed for the society by the committee on growth of the National Research Council. Under that program, fellowships are offered by the society to provide research training at universities or laboratories in such relevant fields as cytology, biochemistry, virology, biology, and in clinical studies in which the laboratory developments are applied to the patient. The clinical fellowships are made available only through those medical schools and hospitals, approved by the council on medical education and hospitals of the American Medical Association, which offer postgraduate training in such fields as malignant diseases, surgery, certain surgical specialties, radiology, pathology, and internal medicine.

The American Cancer Society fellowship programs require that the particular fellow and his training be approved by the institution or hospital where the research or clinical investigation is to be conducted and, also, by the supervising scientist or doctor. The institution undertakes to provide suitable facilities and to make available adequate teaching time.

Stipends, in the case of research fellowships, range from $3,300 to $4,500, based on the number of dependents. Clinical fellowships are fixed at $3,600 or less. In both cases, the period of the fellowship is limited to a maximum of 3 years.

That the research fellowship program has been successful not only in training for research but in securing candidates who will remain in the research field is indicated by the fact that out of 118 fellows that have thus far been trained under the society's program, 30.6 percent are now giving their full time to cancer research. An additional 59.3 percent are devoting their efforts to some combination of research and teaching. This means that the latter are not only engaged in research but, also, through their teaching, are contributing to the training of other young scientists.

As for the clinical fellowships, a recent survey discloses that out of 188 fellows who have received training, 41 percent are members of the staff of cancer clinics and 44 percent are members of medical school faculties. Thus, the beneficiaries of the program are in a position to exert lasting influence on the training of future doctors in the techniques of the diagnosis and treatment of cancer.

In no case is the fellow obligated to, or required to, perform any service, present or future, for the society, the committee on growth, or the training institution; nor is any prospective employment held out to him as an inducement. He is not required to publish his accomplishments, but he may do so if he chooses, without restriction.

Because the society's fellowship stipends are not compensation, the Internal Revenue Service has long ruled, under existing law, that they are gifts and not taxable income. Under proposed section 117 of the bill, however, beoause the fellow is not working for a degree, the stipend would be taxable if it is more than 75 percent of the earned income of the fellow for the 12 months preceding the month of the granting of the fellowship. The result of this provision will be to tax virtually all of the fellowship stipends of the society, notwithstanding they will still remain gifts.

The CHAIRMAN. Just a moment, please. Mr. Stam, what is the idea of this provision?

Mr. STAM. Generally, I think, the thought was that a lot of people would be encouraged to get these grants and fellowships and really receive quite an added advantage over their present salary. So that is why it had to go down to 75 percent.

The CHAIRMAN. What is the extent of it? What is the revenue?

Mr. STAM. Not much revenue. But there was a lot of criticism, not about this particular matter but about a lot of people going abroad on these grants and not paying taxes at all on their earnings. And the idea was that some reduction should be made in their prior earning experience, if they were going to accept this, because it would be free of tax. That was the point.

The CHAIRMAN. Go ahead, Mr. Runyon.

Mr. RUNYON. This result could be avoided if fellowships were granted only to predoctoral candidates for they would then be working for a degree and in such case there would be no limit under the bill on the tax-free stipend which they could receive.

This avenue of conserving its funds is not open to the society, however, because experience has conclusively demonstrated that the objective of the fellowship training program is better obtained, and the public interest better served, by making the awards primarily for postdoctoral training.

The 75 percent provision contained in the bill will not afford any relief from tax purposes because the fellows of the society, although not working for a degree, are in most cases continuing their training without interruption after receiving their doctorates, and so have little or no earnings experience.

For example, of the 85 clinical trainees for 1953–54, their prefellowship occupations are clearly indicative of their low earnings: 7 were in military service; 49 were hospital residents with approximate maximum earnings of $1,200 and board; 7 were interns with approximate maximum earnings of $600 and board; 14 were instructors, research assistants or fellows. The situation with regard to the 1953–54 research fellowships is similar. Since the society's fellowship grants to these individuals is greater than their prefellow earnings, the grants will be fully taxed under the provisions of this bill.

Only if the fellow earned more than $6,000 during the 12-month period would the $4,500 stipend be nontaxable because only then would the stipend be less than 75 percent of the prefellowship earnings and, thus, meet the exemption test of section 117. Thus, what is as a factual matter a nontaxable gift must, under this bill, turn on whether the fellow is earning more or less than $6,000 for the 12-month period preceding the month of the gift.

It may be that this result is intended, but we respectfully draw specific attention to the matter so that it may be considered by the committee. The society's fellowship stipends are believed to be the minimum required for decent subsistence. Any increase in the grants which may be made necessary in order to make allowance for the tax would, of course, diminish the society's limited funds for the fellowship program.

Thank you, sir.

The CHAIRMAN. Thank you very much.

The next witness is Mr. Seidman. Make yourself comfortable, Mr. Seidman and identify yourself for the reporter, please.

STATEMENT OF M. L. SEIDMAN, CHAIRMAN OF TAX COMMITTEE, NEW YORK BOARD OF TRADE

Mr. SEIDMAN. My name is M. L. Seidman. I am chairman of the tax committee of the New York Board of Trade.

Considering the howl that has gone up from some quarters that this revenue revision bill favors the rich by allowing a 5 percent or 10 percent dividend credit, one wonders why the complete silence about tax-free interest on State and municipal bonds. There is about the biggest loophole in our tax law. One would have assumed that in as thorough an overhauling of our tax laws as this bill represents, some attempt would have been made to close this loophole.

The New York Board of Trade has repeatedly recommended and now reiterates its recommendation that interest on all future issues of State and municipal bonds be made fully taxable.

The CHAIRMAN. I think there are some constitutional questions there, but that is a much larger question than we need to go into now. Go ahead.

Mr. SEIDMAN. Reference to this major leak in our Federal revenue is in no way intended as a reflection upon this revenue revision bill. To the contrary, a marvelous job has been done by its drafters. Failure to do anything about tax-free interest is merely another indication to us that our tax laws are often more strongly influenced by what is considered good politics rather than good economics.

This omnibus tax bill which we are considering accomplishes many reforms, some of them basic and long overdue. It also corrects some grave inequities, closes many loopholes and eliminates much obsolete material from our revenue code. Its enactment will represent a historic achievement by the 83d Congress.

In extending the invitations for witnesses to testify on this bill, your committee stated that when it is know there are several witnesses holding the same opinion on the same subject, it is highly desirable that testimony be consolidated into a single presentation. I have taken advantage of this suggestion and will not comment on a large number of technical changes which will be recommended to your committee by the American Institute of Accountants.

Testimony on these items will, I understand, be presented before your committee by J. S. Seidman, chairman of the tax committee of that organization, who happens to be a brother as well as a partner of mine. I have reviewed these recommendations with him and I am in agreement with substantially all of them. I shall therefore confine my comments to certain provisions in this bill and others not in this bill which I believe should be there. I shall do this entirely from the businessman's point of view.

Generally speaking, the provisions of this bill, unless otherwise indicated, become effective retroactively to January 1, 1954. In many cases, March 1, 1954, is so indicated.

I would like to direct particular attention to provisions covering "corporate distributions and adjustments," which are to become effective as of March 1, 1954. The new rules make revolutionary changes in the tax treatment of many corporate transactions. Many transactions which under the old law would be tax-free would now be taxable, and vice versa. I call your attention also to provisions affecting "partners and partnership transactions." Here, too, basic changes are made in concept and tax effect of partnership distributions, dispositions and transactions between a firm and its partners. Their effective date is January 1, 1954, with some phases effective March 1, 1954.

Presumably, the retroactive March 1, 1954, date was chosen because the curtain on the new code was raised on or about that date. Actually, the Ways and Means Committee released part of these new code provisions daily and the complete code became available a week or 10 days later. But even if the public had ample notice of these changes, which of course it did not, it would seem that when such basic and revolutionary changes are made, they should under no circumstances be made retroactively.

The appropriate thing to do now is to make these changes effective a reasonable time after the passage of the bill. Our recommendation is to make them compulsorily effective on January 1, 1955, and give the taxpayers the option of coming under the old law or the new, with regard to transactions consummated before that date.

Bearing in mind that we are in general agreement with the American Institute of Accountants on the many technical changes which they will propose, I will comment only on the following provisions of the code.

Declarations and payment of estimated tax by corporations: Section 6016, together with 6074, 6154, and 6655, relate to a new system for advance payments of corporation income taxes. This system contemplates that advance payments be made during the taxable year on the current year's estimated income. It would, over the next 5 years, have a corporation, whose tax is over $50,000, pay not only the full tax for each year but an additional 10 percent, to apply against the current year's income, so that by 1960 and thereafter, 50 percent of the tax on the current year's income will have been paid in the same year in which the income is earned.

It will be recalled that when the pay-as-you-go system was adopted for individuals, the tax liability for 1942 was forgiven. No such thing is proposed here. Instead, the corporation is asked to carry 110 percent of its tax burden in each of the 5 years.

The pay-as-you-go plan with respect to individuals was a practical necessity. The income of an individual is generally in cash, spread over the year and can be reasonably estimated in advance. Also, as a collection proposition, it was necessary to collect the tax currently if the Government was to collect it at all. This is not so with business corporations. There is usually a substantial time lag in converting taxable income into cash. This provision, therefore, is sure to cause hardship, particularly to small businesses that have had difficulty in retaining earnings needed as working capital. We recommend the elimination of this requirement.

Depreciation: Section 167 of the code proposes to liberalize depreciation provisions. It grants higher depreciation deductions, chiefly by permitting the original user of depreciable property to adopt a declining balance method of depreciation, at rates double those permitted under the straight-line method. The eventual additional cost to the Treasury in taking this approach to depreciation may be expected to be zero.

While this change is a step in the right direction, it is our opinion that the provisions are entirely too restrictive. Certainly, there is no good reason why this more liberalized treatment should apply only to new acquisitions after January 1, 1954. Taxpayers, we feel, should be left free to chose any method and adopt any rates, as long as they accord with good accounting practices.

Allowable investments for employee trusts: This new provision in our law prescribes certain allowable investments for stock bonus, profit-sharing and pension trusts. Such a trust would be denied exemption from tax under section 501 (a) unless, at the close of each quarter of the taxable year, all of its assets are represented by certain specified investments, such as cash and cash items, Government securities, annuity contracts, securities of the employer which established the trust, et cetera. This looks to us like an encroachment by the Federal Government on local government administration of trust funds. We recommend the elimination of this provision.

The CHAIRMAN. Is your sole reason the encroachment on local authorities?

Mr. SEIDMAN. There are other reasons but I limited my 10-minute statement to that one.

The CHAIRMAN. I will give you a couple more minutes to tell me some more.

Mr. SEIDMAN. Well, I don't know why the Government should go into the investment business, to begin with. I don't know what machinery is going to be required to police this thing. Certainly, a quarterly examination of the portfolio would seem to be impractical. If it is intended to have it quarterly, I suppose it would be the result of an examination made after the year to see whether to qualify each quarter.

Also, I doubt whether the provision is broad enough to take in all worthwhile securities. It is entirely too limited to specific securities.

The CHAIRMAN. Mr. Stam of the staff has suggested the purpose is, among other things, to prevent too much competition by these trusts with other business.

Mr. SEIDMAN. Well, that may be. There may be some good reason that I hadn't thought of, but it looked to me like in any event in every locality in the country there are authorities who are in charge of the supervision of trust funds, and that is where, in our opinion, this matter belongs.

Stock insurance companies: Sections 34 (c) and (d) contain limitations and special rules for determining the types of distribution which are treated as dividends for the purpose of the dividend credit. Thus, section 34 (c) provides that the credit shall not be allowed with respect to dividends from (1) insurance companies taxed under subchapter L. The subchapter covers both mutual and stock companies. Where a mutual company is not taxed as an ordinary corporation, this withholding of dividend credit is understandable. It should not, however, apply to stock insurance companies which are taxed as other corporations. We consider this provision discriminatory and we recommend its elimination.

I now want to direct your attention to several provisions which, in our opinion, should be in the bill but are not there:

Optional tax treatment for certain corporations and partnerships: President Eisenhower, in his budget message last January, had the following to say on the subject of optional tax treatment of small corporations and partnerships:

> Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations.

It does not seem right that the tax status of a small business should vary radically because of the mere form of its organization.

And the New York Board of Trade has called this to your attention a number of times. I suppose there are administrative and other difficulties in managing a situation of that kind, but it should be adopted if it is at all possible—and we think it is possible.

Consolidated returns and intercorporate dividends: President Eisenhower, in his message, had the following to say on the subject of multiple surtax exemptions, consolidated returns and intercorporate dividends:

> I recommend that the law be tightened to remove abuses from the use of multiple corporations in a single enterprise. I also recommend that the penalty tax on consolidated returns and intercorporate dividends be removed over a 3-year period.

There is now a penalty of 2 percent on the entire taxable income for filing consolidated returns. No fair basis exists for such a penalty. Frequently, businesses are compelled to operate through several subsidiaries in order to conform with local laws. In such cases, the true income of the business is reflected in a consolidated return of parent and subsidiaries. There should be no penalty for reporting the true income.

The President also recommended that intercorporate dividends be tax free. An intercorporate tax on dividends represents not a double tax but a triple tax on corporate income when it ultimately reaches the stockholder of the parent company.

Charity contributions: It is frequently the case that charity contributions in any 1 year, exceeding the 20-percent limit, are lost forever as a deduction. It would seem only fair that a 2-year carryback and a 5-year carryforward provision be made applicable to the unused excess.

That, as you know, is the proposed arrangement for ordinary net losses.

Double taxation of dividends: I have left until last the controversial subject of the double tax dividend credit versus personal income tax exemptions. President Eisenhower, in his budget message, had the following to say with respect to double taxation of dividends:

> At present, business income is taxed to both the corporation as it is earned and to the millions of stockholders as it is paid out in dividends. This double taxation is bad from two standpoints. It is unfair and it discourages investment. I recommend that a start be made in the removal of this double taxation by allowing stockholders a credit against their own income taxes as a partial offset for the corporate tax previously paid. This will promote investment which in turn means business expansion and more production and jobs.

Some relief to the taxpayer whose corporate income is subjected to double tax is long past due. The taxation of corporate earnings in the hands of the stockholder is highly discriminatory, and has undoubtedly had a restrictive effect on the availability of working capital for small businesses. This bill falls far short of giving full relief from the discriminatory tax for most stockholders. It leaves the rate structure still heavily weighted against stockholders in almost all tax brackets.

I am not exactly clear where our good friend, Senator Walter F. George, stands on this subject today in view of his espousal of increased personal exemptions, but here is what he is reported to have said about this very thing in 1949:

> The law should be changed to allow a credit to the individual stockholder for taxes already paid by the corporation. As a starter, we should provide a credit of a certain percentage, say 10 percent or perhaps 16.6 percent, the amount of the first bracket individual income tax. Ultimately, we should exempt dividends from taxation completely.

That is the way Senator George felt about it in 1949, and I hope he feels the same way about it today.

Increased personal exemptions: It is too bad that the controversy over relief from double taxation of dividends has been matched up with personal exemptions. One certainly has nothing to do with the other, and each should be considered on its own merits.

A $200 increase this year in the personal exemptions is estimated to shrink revenue by $4½ billion. A $400 increase next year is estimated to shrink revenue by $8 billion. The number of taxpayers who would be excused from paying income tax altogether if these exemptions were increased total 7½ million and 15 million, respectively. Our Federal budget is still unbalanced by about $3 billion. We simply cannot afford to increase the deficit by any such amounts.

When the time comes to reduce taxes, it should not be done by way of increasing exemptions, but rather by decreasing tax rates. Our only hope for escaping deadly inflation is to have as many of our people as possible fully tax conscious. They must be aware at all times that it is their money and not the other fellow's money that the Government is spending.

Finally, a word on the 52-percent corporate tax rate, which was to have died automatically on April 1, 1954, and reduced to 47 percent, but which this bill would extend for a year. A 52-percent tax on corporate income in peacetime is grossly excessive and detrimental to our economy. The rate should be lowered as quickly as Government finances permit. We appreciate, however, that only by reducing Government expenditures can we reduce taxes. Our objective still is a balanced Federal budget at the earliest possible moment. You can count on our wholehearted cooperation in striving to attain that goal.

Thank you, gentlemen, for the privilege of making this statement.

The CHAIRMAN. Thank you for coming, Mr. Seidman.

Mr. Bentley, be seated and identify yourself for the reporter, please.

STATEMENT OF BERT C. BENTLEY, CHICAGO, ILL.

Mr. BENTLEY. My name is Bert C. Bentley. I am appearing on behalf of 10 organizations in Chicago engaged in pension and profit-sharing plan work.

I would like to make one comment. Mr. Seidman just mentioned the restrictions on investments for profit-sharing trusts. The report of the Ways and Means Committee says that these restrictions are not to have any effect upon existing investments. The language of the bill does not seem to make that clear. It would indicate that existing investments would have to be changed within the first quarter after this bill becomes law. I believe that existing investments ought not to be changed or be compelled to be changed by reason of this new bill.

The CHAIRMAN. Mr. Stam, is that the result?

Mr. STAM. That gets into this problem of retroactivity of the provision, which we are looking into in connection with the whole bill. We have to give some thought to that.

I might say, along this whole section that the gentleman is referring to, that we are restudying that, and there will be some suggestions made to correct some of the things that I think he is talking about.

Mr. BENTLEY. There are trusts that have invested in real estate. They shouldn't be compelled to make a sacrifice sale.

The persons in whose behalf I am appearing today are men whose livelihood depends upon being able to assist employers in developing and installing pension and profit-sharing plans. They have had a great deal of experience in this work. I have been in the work myself as an attorney for 18 or 19 years. We hope that our experience may be of some assistance to this committee.

We do not represent any insurance company. We are not in any way opposing the interests of organized labor. If it was possible for me to employ the ability of a Bishop Sheen to dramatize my remarks, I wouldn't hesitate to do it, but I would just like to say that the objections we are raising here are so serious we would prefer to have the law not changed at all, rather than to have it go in as is, in H. R. 8300.

I don't want to use a shotgun. I want to use a rifle, and concentrate my few remarks on exactly two points. Section 501 (e) (3) (A) sets up purported classifications of employees who may become participants under a pension or profit-sharing plan. However, those are only guides, because the sentence winds up that—

> no such classification may be discriminatory in favor of shareholders or key employees.

And we have no quarrel with that.

It then goes on with a provision that—

> a classification shall be considered discriminatory only if more than 30 percent of the contributions are used to provide benefits for shareholders.

A shareholder is defined as one who directly or indirectly owns 10 percent or more of the voting shares of the employer corporation.

Also, if more than 10 percent of the participants in a plan are key employees, the plan is automatically discriminatory. A key employee is defined as any 1 of the 100 highest paid employees of the employer.

Those are the two things to which we object. In the first place, they are mechanical rules, and are to be applied to 10,000 different situations, and mechanical rules will not work in all of those situations. They are discriminatory against small business. They will have no effect upon the executives or salaried employees of a large corporation, but they do discriminate against the small businesses.

The CHAIRMAN. Give me an example.

Mr. BENTLEY. I will be happy to give you an example of that. Take just a medium-sized business. Take a manufacturing company, and say they have 1,800 employees, and 1,600 of them are factory employees, under union collective bargaining. Therefore, any plan for them must be the result of collective bargaining. You have a thousand employees who have at least 5 years of employment. Therefore, those thousand are called regular employees. You have 50 office employees. You have 150 salaried employees, but you use a 5-year eligibility provision; therefore, you only have 100 salaried employees eligible to participate in a plan for salaried and white-collar workers.

You cannot qualify that plan, because it will contain more than 10 percent of the key employees, as key employees are defined in the bill. So, you would be prohibited, if you were unable to work out a collective-bargaining agreement with the union employees, which would have to come first—you could never qualify a plan for the benefit of the salaried employees.

Now, we have no objections to plans for union employees, but you can't always work one out with them, one that suits them and one that is satisfactory to the employer.

There is another discrimination here, which is not readily apparent: In 1948 this Congress passed the so-called marital deduction laws, because of community property States. However, the laws of various States on corporations are not identical. In Illinois every share of stock is a voting share. In Delaware practically all of your stock may be nonvoting stock. Therefore, some plan might qualify as to shareholders and their benefits in Delaware that couldn't conceivably qualify in Illinois, because of the 10 percent of voting shares owned. So, there is a radical difference between what could be done in various States.

Now, we have not come down here to be entirely destructive. We have a suggestion to make for the replacement of some of the language. We would like to suggest that the language setting up the 30 percent contributions for the benefit of shareholders, and limiting to 10 percent of key employees as participants, be removed from the bill, and in place thereof we would put in language of this kind:

> Discrimination in favor of employees who are shareholders or key employees shall not be determined by any fixed percentage of contributions or benefits, or both, or by any limitation upon the number or classification of participating employees.

We would leave it to the Commissioner to issue regulations, but we do not want the Commissioner to have the right to issue a regulation such as he did a few years ago, in which he attempted to limit the use of contributions for shareholders to 30 percent of the total contributions. Incidentally, in the bill it is very vague. It doesn't say whether the contributions are to be computed on an annual basis, upon an aggregate basis, or upon any other basis. It merely says "contributions."

We feel that the bill should be clear in some respects, but we feel that neither the code nor the Commissioner should have the right to impose percentage limitations which are purely mechanical rules.

Thank you, sir.

The CHAIRMAN. Thank you very much. Mr. Stam and the staff will give your suggestions very careful study.

Mr. BENTLEY. Thank you.

(The prepared statement of Mr. Bentley follows:)

STATEMENT OF BERT C. BENTLEY, CHICAGO, ILL., ON OBJECTIONS TO PROVISIONS OF PARTS OF SECTION 501 AS SET FORTH IN H. R. 8300

Appearing on behalf of—

Guy S. Burtis & Associates, employees benefit plan consultants, 1 North La Salle Street, Chicago, Ill.

Earl Schwemm Agency, Great West Life Assurance Co., 135 South La Salle Street, Chicago, Ill.

Earl Jordan Agency, Massachusetts Mutual Life Insurance Co., 1 North La Salle Street, Chicago, Ill.

Anthony Organization, pension and preferred shareholders plan consultants, 29 South La Salle Street, Chicago, Ill.

Pension Service, Inc., John O. Todd, president, 141 West Jackson Boulevard, Chicago, Ill.

Louis Behr Organization, pension plan consultants, 29 South La Salle Street, Chicago, Ill.

Paul W. Cook Agency, Mutual Benefit Life Insurance Co., 1 North La Salle Street, Chicago, Ill.

Ferrel M. Bean Agency, John Hancock Mutual Life Insurance Co., 39 South La Salle Street, Chicago, Ill.

Raymond J. Wiese Agency, Provident Mutual Life Insurance Co., 1 North La Salle Street, Chicago, Ill.

Dan A Kaufman Agency, Northwestern Mutual Life Insurance Co., 110 South Dearborn Street, Chicago, Ill.

Objection is made to section 501 (e) (3) (A), subheading, "Nondiscriminatory Classifications"; in particular to portions of subparagraph (A), reading as follows:

"A classification shall be considered discriminatory only if more than 30 per centum of the contributions under the plan are used to provide benefits for shareholders or more than 10 per centum of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case, if, in the case of an employer having not more than 20 regular employees, 50 per centum or more of all of such regular employees are participants in the plan, and, in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 per centum or more of all such regular employees, whichever is greater, are participants in the plan."

The requirement that no more than 10 percent of participants may be key employees, and the 30 percent limitation on contributions for the benefit of participating shareholders, are deemed objectionable.

Section 501 (a) exempts from tax an organization described in subsection (e), which includes "a trust forming part of a stock bonus, pension or profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries."

The exemption is subject to certain limitations. It is necessary to keep in mind that the type of trust and plan referred to is primarily a means of providing retirement incomes, with or without death benefits, and that, with very few exceptions, it would be quite proper to call them retirement plans and retirement trusts.

This presentation refers to only two of the limitations described as "nondiscriminatory requirements," both of which are found in the language of section 501 (e) (3) (A). Clauses (i) to (vi), inclusive, list certain classifications of employees who may be covered under a plan or trust without a resulting discrimination. Clause (vii) permits an employer to use any other classification, or a combination of any of the classifications set up in clauses (i) through (vi). These classifications, however, are merely guides, since paragraph (A) continues by superimposing provisions that any such classification selected by an employer must not be discriminatory in favor of employees who are shareholders or key employees, thus giving full discretionary power to the Commissioner of Internal Revenue to reject any classification. A shareholder is one who, directly or indirectly, owns 10 percent or more of the shares of the employer corporation. A key employee is anyone in the highest paid 10 percent of the regular employees, up to a limit of the 100 highest paid employees. A regular employee is one who has been employed for a specified period of time not exceeding 5 years.

It will be helpful if we give consideration first to the coverage or eligibility restrictions to which objection is made.

First, if we accept the language of the bill, which is questionable, the limitation that no more than 10 percent of the participants may be key employees is waived only if an employer with 20 or less regular employees covers at least half of the regular employees, or an employer with more than 20 regular employees covers at least one-fourth of the regular employees, but in no event less than 10 of them.

If this limitation had been in force during the past several years, it would have invalidated a substantial number of presently existing qualified plans. These are plans which the Commissioner of Internal Revenue has found are not discriminatory in favor of shareholders or key employees. It would prohibit a plan under these conditions:

A building contractor has a total of 80 employees: 72 are members of various building trade unions; 2 are office employees paid on an hourly basis and entitled to overtime pay for overtime work; the remaining 6 are salaried employees. The union employees, through negotiated contracts, get various welfare and retirement benefits paid for by the employer, which are not available to nonunion employees. The 6 salaried employees include shareholders and superintendents. All are within the key employee definition, so that more than 10 percent of the proposed participants are key employees. To qualify this plan, since there are more than 20 regular employees, it will be necessary to include at least 25 percent of the regular employees. To do this, the employer would have to cover a certain number of union employees, and it is respectfully submitted that he could not safely include a selected group of union employees and omit the remaining ones. No plan to provide retirement benefits for these salaried employees, who meet the primary requirement of being employees in the salaried class, can ever qualify.

The limitation on key employees would prohibit a plan under the following facts:

A manufacturing company has 1,800 employees, 1,600 of whom are factory employees and members of a union working under a negotiated contract; 1,000 employees have at least 5 years of employment and are, therefore, regular employees; 50 are office employees compensated on an hourly basis; 50 salaried employees have less than 5 years of employment, and the remaining 100 are salaried employees with 5 or more years of employment. In this group of 100 salaried employees are all the key employees. The bill says that key employees in this case would be the 100 highest paid regular employees. Of these 100 salaried employees, at least 50 would be ruled to be key employees; therefore, more than 10 percent of the participants would be key employees, and the plan could not qualify.

Illustrating more vividly the effect of the limitation on key employees, assume that a company has 100 employees, none are union members, 70 are regular employees. The automatic qualification rule would require 18 employees to be covered. If there are only 16 salaried employees and that is the group the employer wants to cover, the plan cannot qualify, because obviously salaried employees are the higher paid employees and are in the key-men class in substantially every business organization. A similar result would follow in most every case with an attempt to qualify a plan for employees in a designated plant, division, department, or other operating unit of the employer. It should be clearly evident that in any group of employees, the higher percentage of key men will be found among those with the greater amounts of service. Elimination by any number of years of service increases the percentage of key men in the group having the required years of service.

The figures shown in the immediately foergoing example might well apply to a retail or wholesale organization, as well as to a manufacturing company. There are many good reasons why it is advisable to have a plan for salaried employees only, with or without a companion plan for hourly paid employees. The requirement that no more than 10 percent of the participants in a plan may be key employees is patently unjust, and destroys the general intent of the law. It is a purely mechanical rule, and no such rule can be used unless it permits multiple variations. This requirement should be removed.

May we now consider the second limitation or restriction to which objection is made.

Any plan which meets even the objectionable coverage restrictions will still fail to qualify if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders. It must be emphasized here that the language used does not state whether the contributions are those made by the employer only, or those made by both employer and employees under a contributory plan. The language does not say whether the 30 percent limitation is to be measured by annual contributions or by the aggregate contributions contemplated until a participant reaches his retirement age. If for no other reason, the restriction is faulty because it is indefinite.

It is much more objectionable, however, for other reasons, which can be easily shown. Following is an example of how drastic this limitation could be.

Assume a corporation with a total of 100 employees, 40 of whom are regular employees, 8 are salaried and to be covered, and the Commissioner finds the plan is not discriminatory. Their ages, salaries, desired amounts of pensions, and annual funding costs are as follows:

Name	Annual salary	30 percent annual pension	Age	Annual funding cost
President	$15,000	$4,500	55	$6,009.38
Secretary	12,000	3,600	50	3,074.70
Treasurer	10,000	3,000	38	1,251.00
Employee	7,500	2,250	59	2,761.91
Do	6,000	1,800	57	2,759.40
Do	6,000	1,800	50	1,537.35
Do	5,000	1,500	52	1,523.38
Do	4,800	1,440	35	521.04

The three officers are also shareholders within the meaning of the law. Here, both salaries and pensions are modest. Mostly because of age, the shareholder costs take more than 30 percent of total contributions. Under the proposed limitation, the employer would be compelled to reduce the desired pension amounts for shareholders by more than two-thirds. The calculation of the 30 percent limitation is tricky. The company could not make a tentative computation of the costs for full pensions, and then cut back to 30 percent of that cost for shareholders. In our example, the tentative annual cost would be $19,438.16, and 30 percent of that, or $5,831.45, would, at first glance, be the amount allowable for shareholders. Actually, the 30 percent would have to be computed by first taking the cost for nonshareholders, or $9,103.08, as being 70 percent of the total contribution, 100 percent would then be $13,004.40, and 30 percent would be $3,901.32. This amount, prorated for the 3 stockholders, would compel reduction of the desired pensions as follows: From $4,500 to $1,191; from $3,600 to $953; and from $3,000 to $794.

In every instance, this would be less than the lowest nonshareholder pension. This is clearly inequitable, and further demonstrates the difficulty flowing from the use of mechanical rules which cannot fit every situation. The example used is typical of various small manufacturing, sales, and service organizations, but under the law as proposed, they could never have a retirement plan which would give equitable treatment or even similar treatment to covered employees. Many more examples could be shown where plans otherwise reasonable and sensible would be automatically disqualified.

The proposed law would, furthermore, set up an automatic discrimination against employees in certain States and favor those in other States. The test of whether or not an employee is a shareholder is based upon ownership of voting stock. In Illinois and many other States, all classes of shares are voting stocks. In Delaware and other States, only one class need be a voting class. Manipulation of classes of shares would permit the employees of a Delaware corporation to be covered under a retirement plan, and prohibit the employees of a similar Illinois corporation from being covered on the same basis. This unfairness resulting from State laws was recognized by this Congress in 1948 when it adopted the so-called marital deduction measures, and it should not be overlooked at this time.

As constructive measures, it is urged (1) That the following language in section 501 (e) (3) (A), to wit:

"A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification * * *" be deleted.

(2) That in the place of the deleted language, there be substituted the following language:

"Discrimination in favor of employees who are shareholders or key employees shall not be determined by any fixed percentage of contributions or benefits, or both, or by any limitation upon the number or classification of participating employees. A plan * * *"

A provision of this nature is not mechanical, specifically grants power to the Commissioner of Internal Revenue to approve or disapprove plans, but prohibits the use of any fixed percentages in determining whether or not discrimination exists. It will give the Commissioner the power he has thought necessary since his 30 percent regulation was withdrawn, and will permit proper consideration of each plan on its own merits. Subject to some general rules, individual consideration is the only fair method of determining whether or not a stock bonus, pension or profit-sharing plan is discriminatory.

The CHAIRMAN. Mr. Nathans. Sit down, Mr. Nathans, make yourself comfortable and identify yourself to the reporter.

STATEMENT OF RICHARD M. NATHANS, PRESIDENT, MACHINERY DEALERS NATIONAL ASSOCIATION

Mr. NATHANS. Thank you.

Mr. Chairman, and members of the committee; I would like to take this opportunity to thank you for hearing the Machinery Dealers National Association on the subject of depreciation, as contained in H. R. 8300.

My name is Richard M. Nathans and I am a partner of the Kings County Machinery Exchange in Brooklyn, N. Y. As president of the association, I have been asked to appear before you today on a subject that affects all industry. The President, Secretary Humphrey, Secretary Weeks, and others high in the administration have stressed time and again that the new depreciation proposals contained in H. R. 8300 will stimulate business, create more jobs, and thus increase purchasing power through increased competition and more efficient production methods. I respectfully submit that while that aim is a worthy one, the present proposals will not accomplish that result.

Almost without exception all users of metalworking machine tools believe that an accelerated depreciation program would permit them to upgrade the equipment in their plants much faster than under the present straight-line method of depreciation. The term "upgrading" has a definite meaning in the machine-tool industry, which I shall try to explain later in this statement.

By restricting the benefits of rapid depreciation to new machine tools, that is, machine tools built after January 1 of this year, a large percentage of our manufacturing concerns will not be able to take advantage of its provisions. Thus, a large potential market is eliminated. Only the established manufacturer who has established credit lines or is able to finance the purchase of new equipment through the sale of stocks or bonds, will be able to buy the equipment which is expected to accomplish the desired results.

I say to you that 96 percent of American business is small business by any standard, and that group does not have the financial resources with which to take advantage of this new proposal.

We asked to be heard this morning to bring to your attention some of the many reasons why the bill should be amended to permit the proposed declining balance method of depreciation to be applied to used machine tools, as well as new machine tools.

Our members are small-business men and a large percentage of our customers are small-business men. While the number of employees in our industry ranges from 1 to approximately 200 persons, the average is 10 persons. We have no way of knowing the average number of employees of our customers, but I am personally satisfied that by any standards this committee cares to use, the vast majority of our customers constitutes small business. For an accurate picture of the importance of small business to the American economy, I would like to call your attention to an article in the current Nation's Business which contains a statement by Wendell Barnes, the Administrator of the Small Business Administration, in the Department of Commerce, which says that 96 percent of American business is small business.

The CHAIRMAN. What is his definition of "small business"? Or, if you haven't got it, what is your definition?

Mr. NATHANS. I have a specific copyright here, Mr. Chairman, which defines that in about three pages. However, it says that small business comprises any enterprise that is less than 100 employees.

The CHAIRMAN. Less than 100?

Mr. NATHANS. Yes, sir. And he also says that large business is any enterprise that comprises more than 1,000 employees.

The CHAIRMAN. Thank you.

Mr. NATHANS. I have that right here, sir.

I would like to state briefly exactly what our association has done and what the members of our industry do. For the past 13 years our association has worked with and tried to be of assistance to the various governmental agencies in the many problems which have involved machine tools. During that period we have urged to these various agencies that a realistic depreciation policy on machine tools is vital to our national defense and private industrial economy. We are gratified that the proposed bill recognizes in part that accelerated depreciation will be a stimulus to industrial expansion. Because the present provisions of H. R. 8300 restrict the new method of accelerated depreciation to machine tools constructed after January 1, 1954, we feel that it discriminates against a large segment of industry. We feel it would be disastrous to the tremendous number of small manufacturing concerns if the present proposal becomes law. In our judgment, it favors the larger and well-established firms and places small but growing firms at a competitive disadvantage.

The business of our industry is the purchasing, reconditioning, or rebuilding and sale of used machine tools. There are approximately

700 firms in the United States who are engaged in this business. They are constantly working with metalworking manufacturers, most of whom are small-business men, trying to sell them on the idea of buying more modern machine tools. They are experienced machine-tool experts and collectively have a wide variety of practical and technical knowledge which is available to the manufacturer in many ways. They advise the manufacturer on what tool to buy, how it may be financed, and occasionally do the financing themselves.

They also work with his factory personnel in explaining how the equipment may be operated to the best advantage. He is continually trying to persuade the manufacturers to upgrade their machine tools. The benefits from this upgrading process are increased efficiency and lower prices.

The Chairman. Explain the upgrading process.

Mr. Nathans. Yes, sir.

When a small business starts activity, they generally have limited capital, with some experience. Perhaps 1 or 2 men get together and want to go out and create a shop. In order to do so, with limited capital, they cannot buy the average tool that goes from $7,000 to $10,000, or sometimes $15,000, which is new. Therefore, they seek a good used tool, or as good as they can afford to buy. So that a lathe that sells normally for $7,500 today would probably sell between $1,500, $2,500, and $3,500, depending upon its age and condition and, therefore, they could afford to buy that tool. They may buy it on time.

So, they start in business, and as they progress they would buy a better tool, and upgrade their tool, and replace that machine with a later type tool.

The Chairman. What do you mean by the expression "upgrade"?

Mr. Nathans. They would upgrade the type of machine. I mean the machine that is in better condition.

Let me illustrate it this way, Mr. Chairman: If I get myself a $55 a week job, or $60 a week, and want to use a car to go to work, I buy a car that is a 1942 model, because I can't afford anything else, and I buy it on time. After a couple of years, if I have been consistent on my job, I go out and buy a 1946 car.

The Chairman. You mean as they get along, they buy better machinery?

Mr. Nathans. Yes, sir, up to the point where they can buy a better machine.

Now, the reasons why a manufacturer buys used machine tools are as follows:

1. Availability: Many manufacturing concerns buy used machine tools because they are immediately available, they can be purchased and shipped today and be on the production line tomorrow.

2. Price: Satisfactory used machine tools can be purchased at a substantially lower price than would be required for the purchase of a new machine tool.

3. Capital investment: Less original capital is required to purchase good used machine tools for production purposes.

4. Tooling-up process: In the tooling-up process for a new contract, it is advisable to buy a good used machine tool until experience indicates the type of machine that proves best for the particular job,

considering the cost and availability of a new machine. In other words, they don't have to experiment with too great an expenditure.

5. Special contracts: Many small manufacturing concerns will take a contract for a limited run of items to be produced or will take a subcontract to help another manufacturer produce a certain item for a specific job. For financial reasons, it is only practical to buy a used machine tool for this type of contract.

6. Emergencies.

(*a*) Peacetime: During peacetimes there are emergencies such as a fire, a flood or a hurricane which require certain manufacturers to draw on the available inventories of surplus machine tools so that their production will not be delayed too long. This inventory permits the manufacturer to reestablish his normal production line without delay.

If you will recall, gentlemen, the recent GM Livonia fire, where the gearshift plant there was virtually knocked out overnight, and which was the key to the automobile industry at the time, they called upon the used machine tool people. They bought what they had, and shipped them immediately into that plant. And also the rebuilders reactivated those machine tools, where it was possible, and in jigtime, in record time, that production was set back—I would say it was stimulated and set back in the production in the course of 3 months. It started at approximately the end of July, and by October and November it was underway.

(*b*) Wartime: The history of our past national emergencies shows that the inventories of machine-tool dealers are the first to be drafted. This inventory provides our Government with production tools, in addition to those already owned by the Government, for immediate use until such time as new machine tools can be built, delivered and put into operation on the production line for defense materials.

Deliveries are sometimes 1 or 2 years. We have seen where backlogs have been as far back as 2½ years in the case of an emergency. But our stockpiles are always available to them. They can put them back on the line overnight, virtually.

It is a well-known fact that in our national defense structure, used metalworking machine tools provide an extremely important position in the early stages of production for war. These machines are in uniformly heated warehouses, have been tested under power and serviced by experienced machine-tool men, and are available for immediate productivity. As production expands, used machine tools will continue to serve a vital part in national defense by providing machines available immediately when breakdowns occur.

H. R. 8300 discriminates against small businesses because small businesses buy used machine tools. Small businesses are usually started by one or a few individuals, as I pointed out before, Mr. Chairman, with an idea, experience, and limited funds. Usually they buy suitable used machine tools for their immediate needs and save the balance of their meager financial resources for other use in the business. Most of our large manufacturing firms of today got their start in this way. It is part of our economy.

Experience shows that, with the exception of the Government in emergency periods with unlimited funds, there are very few firms, including the very largest firms, which set up a new plant with brand new machinery and equipment. The reason is that there is a tremendous floating inventory of good used machine tools and equipment on the market, available at a fraction of the cost of new equipment.

Another reason for this initial caution is the high mortality rate of new, untried and/or unproven projects.

We believe that this group of manufacturers is important to the national economy. We also believe it imperative that this committee do everything possible to encourage the start, growth, development, and expansion of the small-business man who provides so many jobs in all sections of the United States, and is the very foundation of our productive strength.

Perhaps the most important single factor in the development of small businesses in the metal working field has come about as the result of a service function initiated and developed by the machine-tool dealers during the last 50 to 60 years. I refer to "up-grading" and would like to define it so that this committee will appreciate its importance.

This up-grading service has helped most new businesses to become established and, in our judgment, must be encouraged. Basically, it is very simple and works like this: A firm with a 30-year old machine tool is encouraged to replace it with a later, more modern machine tool, say, 15 years old. The advantages are increased efficiency and lower cost. Later, the firm replaces that machine tool with a machine tool that is 10 years old. This process is continued until the firm has the financial resources to buy a large percentage of new machine tools. The declining balance method of depreciation, if granted to the purchaser of used machine tools, will speed up this perpetual process of technological improvement.

Accelerated depreciation will be of great help to metal working manufacturing concerns in that it will help them to continually "upgrade" their equipment with limited funds. However, the current bill would assist only those firms who buy new equipment. It would penalize a great number of firms who cannot or who, for many reasons, do not choose to buy new machine tools. We feel that the same privileges should be accorded the firm which buys used machine tools as is granted the purchaser of new tools.

We believe that the maintenance and expansion of jobs in the United States is one of our most serious responsibilities as citizens. The expansion of our economy and industry is an avowed aim of this administration, but it must be emphasized that machine tools are the basic tools of industry. It follows, therefore, that if industry is to be encouraged to expand, the machine tool industry of which we are an important part must also be encouraged.

We would like to refer to the paragraph in the Ways and Means report citing their reasons for not permitting used industrial equipment to enjoy the privileges of the new declining-balance method of depreciation. That statement may have been correct for many types of property, but we do not believe it applies to the industry of used machine tools for the many reasons given in other parts of this statement.

To me, the important sentence in the House report is as follows: "The stimulus to investment through liberalized depreciation is most important with respect to the creation of new assets." I say to you that the stimulus to investment actually comes from the creation of new businesses and the expansion of the existing small business.

It is our position that the new liberalized depreciation policies must apply to used machine tools because they are the foundation stone of any industrial expansion. We read in the papers that the Secretary of the Treasury is seriously concerned about the national budget. That concern is proper but he should also be concerned about the creation of new jobs with which to finance that budget.

To insure that this supply of machine tools is available when needed, it is necessary that the "up-grading" link not be disturbed by discriminatory depreciation systems that would disturb the natural economics of metal working industrial production. In essence, this is what the Honorable Sinclair Weeks, Secretary of Commerce, has stated on many occasions, when he has said, "The economy of our country and Government is so delicately balanced that no individual or group can be permitted to disturb this balance."

The CHAIRMAN. What does that mean? Never mind. Go ahead. I was going to ask you what that means, but that would take too much time.

Mr. NATHANS. I have a very small closing paragraph.

The CHAIRMAN. I didn't want you to take the burden of justifying Sinclair Weeks' statement.

Mr. NATHANS. Thank you.

In conclusion, gentlemen, I have endeavored this morning to set forth some of the reasons why the manufacturer who, for a variety of reasons, desires a used machine tool, should be allowed the same competitive advantage that is given the purchaser of a new machine tool under the House bill.

If there are any questions or any additional information necessary, I will be glad to furnish that information to the members of this committee or your staff.

Thank you, gentlemen.

The CHAIRMAN. Thank you very much.

Now, Mr. Terborgh. Mr. Terborgh, be seated and identify yourself for the reporter, please.

Mr. TERBORGH. May I stand, please?

The CHAIRMAN. Yes.

STATEMENT OF GEORGE TERBORGH, RESEARCH DIRECTOR, MACHINERY AND ALLIED PRODUCTS INSTITUTE

Mr. TERBORGH. My name is George Terborgh. I am research director of the Machinery and Allied Products Institute, and appear here on behalf of the institute.

Mr. Chairman, I have a formal statement, which I don't intend to read, and would like to submit for the record.

The CHAIRMAN. It will be put in the record.

(The prepared statement of Mr. Terborgh follows:)

STATEMENT OF GEORGE TERBORGH, RESEARCH DIRECTOR, FOR THE MACHINERY AND ALLIED PRODUCTS INSTITUTE ON INTERNAL REVENUE CODE OF 1954 (H. R. 8300)

Mr. Chairman and gentlemen of the committee, as national spokesman of the capital-goods industries, the Machinery and Allied Products Institute is of course keenly interested in the subject now before this committee, the revision of the Internal Revenue Code. As its spokesman on this occasion, I should like first of all to express the appreciation of the institute for the opportunity to comment briefly on H. R. 8300.

Your telegram of invitation made it clear that you propose to take cognizance of our testimony before the Ways and Means Committee of the House and do not desire its repetition here. We shall respect this wish. Our statement will be confined, therefore, to a few comments on the pending bill.

The institute testified before the Ways and Means Committee, not only on tax depreciation, but on the treatment of consolidated returns and intercorporate dividends, loss carrybacks and carryovers, the double taxation of dividends, section 102, and the treatment of foreign-source income. We propose to deal at some length with the provisions of the bill on tax depreciation, leaving until the end of this statement some brief comments on its provisions with respect to the other subjects on which we submitted recommendations.

REFORM OF TAX DEPRECIATION

Section 167 provides for a liberalization of depreciation policy with respect to both the estimate of the useful life of property and the method of allocating the depreciable cost over the years of service. As to the latter, the House has accepted our recommendation for a double-rate declining-balance depreciation method but has limited its use to new assets acquired after December 31, 1953.

While we recognize that this limitation was imposed for budgetary reasons, we wish to emphasize that a realistic depreciation policy cannot be achieved until: (1) The double-rate declining-balance writeoff is allowed as to all assets, regardless of their date of acquisition, and (2) taxpayers are permitted to adjust original-cost book values to their equivalent in present dollars, thus correcting for the deficiency in depreciation accruals resulting from the decline in the value of the dollar since the assets were acquired. We endorse the provisions of the bill so far as they go (subject to some technical changes to be suggested presently), but only as a first step in the right direction. They do not constitute an adequate program and should be supplemented as soon as budgetary considerations permit.[1]

How small a first step it is now proposed to take is made evident by a comparison of our estimate that tax depreciation allowances are now deficient by some $7 billion a year (on business fixed assets alone), with the Treasury's estimate that the depreciation provisions of H. R. 8300 will provide tax relief of only $375 million in fiscal 1955. Obviously, this implies an increase in that year of much less than $1 billion in permissible allowances, or less than one-seventh of the real deficiency. We earnestly admonish the committee to consider whether a more adequate adjustment should not be provided here and now.

The desirability of bolder action is accented by the revolutionary proposals advanced by the British Chancellor of the Exchequer in his budget speech of April 6. In recognition of the need for accelerating the modernization of British industry and strengthening its international competitive position, he has proposed the conversion of the present initial allowances of 20 percent on equipment and 10 percent on plant, which now operate to reduce future depreciation, into allowances over and above full future depreciation. The Chancellor's observations on the proposal are so interesting and important that we have appended them to this statement.

Determination of service lives

We are heartily in favor of subsections (d) and (e) of section 167, which are intended to reduce irritation and controversy in administering depreciation policy. As the committee knows, these sections provide substantially as follows:

1. Where the taxpayer and the Internal Revenue Service have agreed in writing to a rate of depreciation to be applied to any property, that rate will continue to be allowable for tax purposes until such time as evidence is produced that was not taken into consideration when the agreement was made.
2. Where a change in preagreed rate is proposed, the burden of proving the existence of facts and circumstances justifying the change rests with the party initiating the proposal to change.
3. The Internal Revenue Service may not disturb a depreciation rate used by a taxpayer without preagreement so long as the useful life determined by the IRS to be correct does not differ by more than 10 percent from the useful life used by the taxpayer.

[1] A complete documentation of the institute's position on depreciation is included in its latest book, Realistic Depreciation Policy, now in press. A pamphlet summary of this book has been furnished each member of the committee.

We believe these provisions will help materially to mitigate controversy over life estimates and depreciation rates.

The alternative-method rule

Paragraph (3) of subsection (b) attempts to lay down a standard for other methods of depreciation than the double-rate declining-balance writeoff authorized in paragraph (2) of the subsection. This standard prescribes that cumulative allowances by such other method shall not exceed the total of such allowances that would have been computed under paragraph (2).

This is not a workable formula as it stands, since any method that writes off 100 percent of cost over the service life, including the ordinary straight-line writeoff itself, will accumulate a larger total of depreciation by the last years of the asset life than that acumulated under the declining-balance method. That method, applied at twice the straight-line rate, leaves generally some 10 to 12 percent of cost unrecovered at the end of the life. The cumulative depreciation test could of course be applied to the first half or two-thirds of the asset life, or, alternatively, the Secretary could be given administrative discretion to decide whether an alternative method is within the acceleration provided by the allowable declining-balance writeoff.

Treatment of used assets

In its depreciation recommendations to the Ways and Means Committee, the Machinery Institute urged that the double-rate declining-balance method be applicable to all depreciable assets regardless of date of acquisition. The bill limits the availability of the new writeoff method to assets acquired after December 31, 1953, and even then to assets acquired in new condition.

This involves, obviously, a double discrimination: (1) Against taxpayers acquiring assets, new or used, before the deadline; (2) against taxpayers acquiring used assets after the deadline. The first discrimination is of course much more serious in its immediate impact, but is a once-and-for-all affair, whereas the second will continue to recur indefinitely whenever used assets are purchased in the future.

The purchase of used productive equipment is quite common in many fields, and the purchase of used buildings and real-estate improvements is very widely prevalent, so much so that the bulk of all buildings are owned at any given time by investors who acquired them in used condition. The denial of declining-balance depreciation to used acquisitions is therefore a rather substantial discrimination against some of the purchasers concerned.

This denial is presumably in recognition of the impropriety of doubling the remaining-life straight-line rate on such acquisitions. In our judgment, however, the remedy is not to exclude them from eligibility, but rather to permit declining-balance depreciation, if desired, at twice the full-life straight-line rate (the rate computed on the sum of the expired life and the remaining life). The buyer of used assets could then choose between this method and the presently-available method, straight-line depreciation over remaining life.

This proposal would still leave a disparity between the options available to the purchaser of used property and those that would be available to the seller if he continued to hold the property. The latter, having started with declining-balance depreciation, would presumably be debarred from switching to straight-line depreciation when that became advantageous. One obvious way to remove this disparity would be to give the same options to a taxpayer who holds his assets for life that are here proposed for the purchaser of used assets. This would permit him to write off the first half of cost by the double-rate declining-balance method and then to switch to the straight-line method for the remainder of the writeoff. We commend this suggestion to the consideration of the committee.

All-or-nothing rule

I turn now to a couple of points which ought properly to be handled by administrative action rather than by statute, but which should be dealt with in the law unless a change in present regulations is assured. The first of these is the all-or-nothing rule which the Internal Revenue Service has attempted to apply to taxpayers using declining-balance depreciation within the limits heretofore allowed (1.5 times the straight-line rate).

This rule requires the taxpayer to put all his assets, or at least all assets in certain categories, on the declining-balance writeoff if he elects that writeoff as to any of his assets or as to any in a class thereof. I assume that it is the intent of H. R. 8300 to permit a free and unrestricted election as to new assets acquired after December 31 last. In other words, a taxpayer may divide his acquisitions between the declining-balance and other methods at his discretion provided he continues these methods over the lives of the assets, or the depreciation accounts, concerned. The committee should either obtain the assurance of the Internal Revenue Service that the provisions of the bill will be so interpreted, or amend the bill to require this interpretation.

Group-accounting requirement

The other respect in which existing Internal Revenue Service regulations need amendment has to do with the requirement that taxpayers must follow group-accounting procedures wherever possible. This method of accounting denies the right to take losses or gains on retirements from group accounts. So far as the regulations are concerned, the only way a taxpayer with assets capable of being grouped for depreciation purposes can take losses and gains on retirements is to use as the basis of depreciation the life of the longest lived asset in the account, rather than the average life of the assets therein.[2] This restriction is in effect prohibitive, and the practical result is mandatory group accounting.

The term "group accounting" has a somewhat different meaning as applied to a declining-balance or net-account writeoff than it does when applied to gross-account writeoffs such as the conventional straight-line. In the latter case, assets continue to be depreciated as long as they survive, but not longer. Under the declining-balance method, on the other hand, the net account, or undepreciated balance of cost, continues to be depreciated indefinitely (so long as the account goes on) regardless of whether the particular assets represented in this undepreciated balance are still in existence. This means that a declining-balance account, if continued indefinitely on an open-end or revolving basis, continues to accumulate undepreciated remainders from all the assets formerly included in the account. It is important therefore that this method of depreciation have some way to close out these undepreciated remainders.

Two alternatives suggest themselves: (1) Depreciation accounts can be set up by year-of-origin groups and handled by group accounting rules, the undepreciated balance of each such group being closed out either with the retirement of the last survivor or when the estimated average life of the group is attained. (2) Each retirement from group accounts, whether year-of-origin or open-end, can be closed out when it occurs by computing loss or gain at that time. In this computation the remaining balance on the retired item can be derived simply by the application of the group depreciation rate over the attained life of the item.

We strongly recommend that this close-out privilege be made available with the declining-balance method. The justification for this position is developed at length in the book, Realistic Depreciation Policy, to which I referred earlier, and I shall not undertake to redevelop it here.[3] Suffice it to say that in terms of averages, or probabilities, the closeout privilege is eminently fair both to the taxpayer and to the Treasury. Again, if the committee can be assured of appropriate modification of existing regulations of the Internal Revenue Service, the matter need not encumber the statute. If not, an amendment to the bill is in order.

OTHER RECOMMENDATIONS

Consolidated returns and intercorporate dividends

Although the President proposed in his budget message "that the penalty tax on consolidated returns and intercorporate dividends be removed over a 3-year period", the House bill takes no action in this direction. The Machinery Institute has consistently recommended that these penalty taxes be eliminated, and we wish to reiterate our views at this time.

Taxation of corporate retained earnings

Sections 531–536 of H. R. 8300 incorporate most of the changes in the present section 102 which were recommended by the Machinery and Allied Products Institute. However, the new bill still requires that if a finding of improper accumulation is sustained the penalty tax must be paid on the full amount

[2] An exception is made in the case of abnormal retirements from average-life accounts.

[3] The text is available in mimeograph if the committee or its staff wishes to consult it before the printed volume is at hand.

of accumulated surplus. We believe that the committee should amend H. R. 8300 to provide that the penalty tax is applicable only to that part of the surplus found to be beyond the reasonable needs of the business.

Double taxation of dividends

The House bill provides for an exclusion from gross income of small amounts of dividend income ($50 the first year and $100 thereafter), and also provides a tax credit for dividends received by individuals of 5 percent the first year and 10 percent thereafter. We believe this to be a desirable start in the abatement of double taxation of dividends, but it is only a start, and further steps should be taken as soon as revenue needs permit.

Loss carryover and carryback

In accordance with the President's recommendation, the House has provided in section 172 of H. R. 8300 for the retention of the present 5-year carryforward and an increase in the carryback from 1 year to 2 years. This again is a step in the right direction but still falls short of the 10-year period determined to be equitable.[4] The MAPI recommendation is for a 6-year carryforward and a 3-year carryback.

Taxation of foreign-source income

H. R. 8300 incorporates, we are glad to note, substantially all of the recommendations presented by MAPI to the House Ways and Means Committee, and we hope this committee will concur in them.

Research and development costs

Section 174 of H. R. 8300, permitting either deduction or capitalization of research and development expenditures, is completely in accord with the longstanding MAPI position. The section provides a long-needed clarification of the law.

This statement has covered only a few of the provisions of H. R. 8300. We wish to commend the Congress, the Ways and Means Committee, and the Senate Finance Committee for undertaking such an important and comprehensive revision of the Internal Revenue Code. Our study of the principles involved in the bill, and of its technical provisions, will of course continue, and we shall appreciate permission to submit to the committee in writing any further recommendations which appear appropriate in the light of this study.

Excerpts From the Budget Message of the Chancellor of the Exchequer, Mr. Butler, to the British House of Commons, April 6, 1954

COMPANY TAXATION—INVESTMENT ALLOWANCES SYSTEM

I now wish to end as I began, with our primary need: that is, to improve our competitive power. In my survey of last year I have already commented on the inadequate level of investment by private industry. Our rate of industrial modernization is strikingly less than that of America, and it seems probable that the Germans are now moving ahead of us. We shall not long continue to compete successfully in the export field with these, our principal rivals, unless our plant and equipment is completely up to date.

In accordance with my pledge last year, I have reviewed the whole question of company taxation. I have tried to devise some fresh encouragement to industry to put money into productive investment. This is the more essential since the physical and financial resources at our disposal are now sufficient to allow a substantially higher rate of investment than we are undertaking. Last year I restored the initial allowances to 20 percent. This was a step in the right direction, but a limited one, since its effect is essentially that of an interest-free loan. As the cash resources of companies increase, this incentive becomes of less importance.

After considerable reflection, therefore, I have decided to take a further step, and to replace, subject to a few exceptions, the present initial allowances by a new system which I call investment allowances. At present the cost of investment in plant, machinery, industrial building, or mining works may be offset

[4] See, for instance, Capital Goods Industries and Federal Income Taxation, Machinery Institute, 1940.

against gross profits during the life of the asset by means of depreciation allowances. The initial allowance merely anticipates a part of the annual allowances, so that tax liability is less in the year in which investment takes place, but may be larger later on.

The new investment allowance will do more. It will give a tax-free allowance equal to a part of the cost of investment in the assets which I shall describe as qualifying for it. It will be given in addition to the full annual depreciation allowances. Thus, the initial allowances gave some extra help in the year in which the investment was undertaken, but at a cost of smaller allowances for that investment in later years. In contrast, the new investment allowance gives similar help in the first year, but with no reduction in subsequent allowances.

In general, the field over which the new investment allowance will operate will be the same as that of the initial allowance, which applies to plant and machinery generally and to new industrial buildings and mining works. But in view of the purpose of the new allowance, which is to encourage fresh investment, and of its nature, which is to give a tax-free allowance over and above the cost of the qualifying assets, there must be both additions to, and deletions from, the initial allowance list. I propose that agricultural buildings and also plant and buildings used for scientific research, neither of which attract initial allowances, shall rank for the new investment allowance. (Hear, hear.) Investment in up-to-date buildings can assist farm production no less than industrial production, and the importance of scientific research to our economy can hardly be overestimated. The new allowance should also help the shipping industry—(cheers)—to carry out the big replacements which are necessary in the years ahead, and thus to maintain its vital contribution to our economy.

On the other hand, I do not think that this tax free benefit should be available either for secondhand plant or machinery which does not represent new investment, or for ordinary motor cars—(Opposition cheers)—which can, and often do, serve both business and private purposes. (Renewed Opposition cheers.) These assets will however continue to rank for the existing initial allowance at 20 percent.

I propose that the new investment allowances shall apply, in the case of qualifying assets, to capital expenditure which is incurred, that is, which becomes due and payable, after today. In respect of expenditure on such assets, the initial allowance will in general cease from today. The rates of investment allowance will be 20 percent for expenditure on new plant and machinery and new mining works, and 10 percent for new industrial and agricultural buildings. For plant, machinery, and industrial buildings, these are the same as the existing rates of initial allowance, but they will be more favorable in the long run. The 20 percent investment allowance for mining works is not immediately so favorable as the existing initial allowance of 40 percent. But since it will be given over and above allowances up to the cost of the works, it will practically always be better in the long run. However, I will allow any mining undertaking to choose between the new investment allowance and initial allowances at the 40 percent rate.

There will have to be provisions safeguarding the new allowance from abuse. But these and other details must wait for the finance bill.

The cost of changing from initial allowances to investment allowances will be negligible in 1954–55 and about £4m. in 1955–56. Thereafter the cost will increase year by year, and although the actual amount will, of course, depend on the level of new investment I expect it to reach a considerable figure in the future. But insofar as this new allowance succeeds in its object of creating additional assets, those assets will, of course, be yielding additional revenue, for the country, for their owners, and for me.

The CHAIRMAN. Give us a summary.

Mr. TERBORGH. The statement covers a number of matters on which we testified before the Ways and Means Committee but, in order not to repeat previous testimony, we are merely commenting upon the pending bill with reference to these matters.

My own remarks here will be confined entirely to one subject, the proposed reform of tax depreciation.

We are very much gratified at this first step, and it may be ungracious to criticize——

Senator KERR. Are you speaking in favor of the provision against which the previous witness appeared?

Mr. TERBORGH. I shall comment later on the question of used assets.

We are very much gratified with this proposed reform, as a first step. We regard it only as such, however. How small a step it is can be exemplified by a comparison. Our estimates are that the present annual deficiency in tax depreciation allowances is about $7 billion a year. For fiscal 1955 the proposal now pending will increase allowances by somewhat less than $1 billion——

Senator KERR. From what to what?

Mr. TERBORGH. It will increase present allowances by less than $1 billion for fiscal 1955, although in subsequent years, of course, the difference will increase.

Senator KERR. You estimate a total of $7 billion?

Mr. TERBORGH. That is our estimate of the current annual deficiency in tax allowances.

I want to emphasize in passing that, in our opinion, the pending proposal should be regarded simply as a small first step in a direction in which it is necessary as soon as possible to go further.

I should like to make four technical comments on the provisions of the bill. The first has to do with section 167 (b) (3), which proposes a definition of acceptable alternative methods (other than the double-rate declining-balance method authorized in par. 2 of that subsection).

The criterion is whether, under the alternative method, the accumulated depreciation reserve exceeds at any time in the life of the property the reserve that would be accumulated under the double-rate declining-balance method. If the accumulated reserve at no point exceeds the latter, then the method is presumed to be acceptable.

It is one of the disabilities of the declining-balance method, even when applied at twice the straight-line rate, that it does not complete the writeoff of property by the end of the service life. Indeed, if the service life is correctly estimated, there will remain about 10 to 12 percent of cost unliquidated at the end. This means that any alternative method that does accomplish a 100 percent writeoff over the service life will, in the late years of service, have accumulated a reserve that exceeds the double-rate declining-balance reserve.

This subsection must be redone in some fashion to eliminate this absurdity. Taken literally, it would exclude even the conventional straight-line method itself.

There are two ways out here, as we see it: The cumulative-reserve criterion can be applied, provided its application is limited to, say one-half or two-thirds of the service life of the property; or, the Commissioner of Internal Revenue can be given discretion to determine whether an alternative method is more accelerated than the double-rate declining-balance writeoff and whether, therefore, it is presumptively reasonable.

I come now to the point you raised, Senator Kerr, the treatment of used assets. While my organization is primarily interested in new machinery and equipment, I may say we regard the used asset exclusion as extreme and unwarranted. As the preceding witness has said, there is a very large traffic in used productive equipment. When we turn to real estate, the traffic is even larger. Because of the long life of real estate improvements, most properties change hands many times over their service life. At any given moment most of the holders of real estate are those who acquired it in used condition. The present bill would exclude from eligibility for declining-balance depreciation every purchaser but the original one——

Senator KERR. And the purchase of everything, other than something new.

Mr. TERBORGH. That is correct.

Now, the reasons, I think, why used assets were excluded are probably two: It was felt, first, that incentives for the acquisition of used assets are somewhat less stimulative economically than those given for the purchases of new assets. The new assets have to be produced to be purchased.

The other reason probably is this. Under existing practice a purchaser of used property makes a remaining-life estimate, and straight lines his cost over that remaining life. It is not appropriate to double the remaining-life straight-line rate for declining-balance purposes on used assets.

We are suggesting an alternative, however. Instead of excluding used assets categorically, as is now proposed, the purchaser could be given the option of using straight-line depreciation over remaining life, or declining-balance depreciation over total life, total life to be arrived at by the addition of the expired life to the estimated remaining life. The straight-line rate appropriate to that total life would be doubled for declining balance application. This would give the purchaser of the used equipment substantially the same declining-balance rate the seller would have gotten if he had held it. To that extent——

Senator KERR. Isn't it entirely possible that a lot of the products you are talking about, that are sold, their original life is not known?

Mr. TERBORGH. Yes. I point out, however, Senator, that after an asset is fairly well along in its service life and is sold in used condition, the purchaser is much better off straight lining over remaining life, than by taking declining balance over total life, by the rule we have suggested. The declining-balance option would in fact be applied only to fairly young assets. The younger they are, of course, the easier it is to ascertain their attained age. Remaining life always has to be estimated anyway, and, if necessary, expired life can be estimated.

This would still leave a minor disparity between the privileges available to the purchaser of used assets and those that would have been available to the previous owner had he continued to hold them. This owner would have had no option to straight line out over remaining life. Having elected initially to depreciate on the double-rate declining-balance basis, he would have been forced to continue.

One suggestion the committee might very well ponder is to give all owners of property a standing option to elect whichever writeoff gives them the better result. Let them take the straight-line rate on their gross property or double the straight-line rate on their net property.

Under this option, taxpayers would depreciate an asset by the declining-balance method until it is 50 percent reserved, and thereafter would run it out by the straight-line method. This would eliminate this cardinal defect in the declining-balance method already referred to, its failure to complete the writeoff of cost. Moreover, it would put the purchaser of used property on a precise parity, with respect to his options, with a taxpayer who continues to own the property over its full service life.

Our third technical suggestion is not properly one which should be accommodated by statute. It should be handled by regulation. However, the committee should either assure itself that it will be done by regulation, or put it in the statute. I refer to the repeal of the "all or nothing" rule which the Internal Revenue Service has heretofore applied to the declining-balance method.

As you know, it has been possible for taxpayers to use declining-balance depreciation, provided they do not claim more than 1½ times the straight-line rate. But the Service has attempted to insist that they make the declining-balance election as to all of their assets, or as to none. In some cases the election has applied to all of certain classes of assets, or to none. We take it that it is the purpose of the pending legislation to give the taxpayers an unrestricted option. They can apply different methods to different assets or groups of assets at their discretion, provided they apply them consistently once the election is made.

My last comment has to do with the practice of the Internal Revenue Service in requiring group accounting. The existing rule is that if a taxpayer wants to use an average-life rate (as distinguished from a maximum-life rate) on group accounts, he is denied the privilege of taking gains and losses on retirements.

With the declining-balance method, this rule is much more objectionable than with the straight-line method, since the declining-balance writeoff never does complete the liquidation of cost. Even though assets have long since been retired, there still remains in the group account a residium of unliquidated cost. It is important, therefore, to find some method of cutting off these balances.

There are 2 or 3 ways to do this. It is possible to allow taxpayers to group their assets by year of origin, and then to close out undepreciated balances with the retirement of the final asset from each group. Or they can be closed out upon the attainment of the estimated average life of the group. A better method, however, is to permit the closing out of gains and losses as the retirements occur.

I shall not discuss this further, but do wish to admonish the committee to look into the question. If it is not possible to get a commitment from the Internal Revenue Service that the group accounting requirements will be relaxed, a relaxation should be written into the law itself. Again the preferred method is to get it done administratively. It is a detail that hardly belongs in the code.

Thank you very much.

The CHAIRMAN. Thank you very much.

Now, Mr. Dawson.

STATEMENT OF ALBERT DAWSON, CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL LICENSED BEVERAGE ASSOCIATION

Mr. DAWSON. Mr. Chairman and gentlemen of the committee, my name is Albert Dawson. I live in Devils Lake, N. Dak., where I own and operate a bar and lounge, selling beverages for consumption on the premises. I am chairman of the legislative committee of the

National Licensed Beverage Association and appear before this committee on behalf of its membership.

Our association is a national trade association of proprietors of restaurants, taverns, hotels, bars-cafes, and cabarets. Our membership of approximately 45,000 is affiliated with our national association through 34 State and local institutions in 25 States and the District of Columbia. A list of affiliated associations is appended to my statement.

(The list referred to follows:)

AFFILIATES OF NATIONAL LICENSED BEVERAGE ASSOCIATION

Arizona Retail Liquor Dealers Association, Inc.
Associated Tavern Owners of Brooklyn, Inc.
California Licensed Beverage Association
California Tavern Association
Chicago Tavern Owners Association
Colorado Retail Liquor Dealers Association, Inc.
Connecticut Restaurant Association, Inc.
Idaho Licensed Beverage Association
Illinois Tavern Owner's Association
Licensed Beverage Association of Illinois
Indiana Retail Alcoholic Beverage Association, Inc.
Maryland State Licensed Beverage Association, Inc.
Massachusetts Retail Liquor Dealers' Board of Trade
Michigan Table-Top Licensees' Congress
On-Sale Liquor Dealers of Minneapolis, Inc.
Minnesota Licensed Liquor Retailers, Inc.
Montana Licensed Liquor Dealers' Association
Nebraska Licensed Beverage Association
Nevada Licensed Beverage Association
United Licensed Beverage Association of New Jersey
State Restaurant Liquor Dealers Association, Inc. (New York)
North Dakota Beverage Dealers Association
Buckeye Retail Liquor Dealers' Association (Ohio)
Oregon Licensed Beverage Association
Retail Liquor Dealers of Pennsylvania
United Tavern Owners of Philadelphia
Rhode Island Retail Liquor Dealers' Association
St. Paul On-Sale Liquor Dealers' Association
South Dakota Retail Liquor Dealers' Association
Associated Tavern Owners of Utah, Inc.
Restaurant Beverage Association of Washington, D. C., Inc.
Wisconsin Tavern Keepers Association, Inc.
Tavern League of Wisconsin, Inc.
Wyoming State Retail Liquor Dealers' Association

Mr. DAWSON. I am here to ask your help in the solution of a problem with which our industry is troubled. The problem is the increasing competition for public patronage which we, as licensed taxpaying retailers, are receiving from tax-exempt organizations such as private clubs, fraternal organizations and veterans' groups.

At the outset, I want to make clear that neither I nor the retailers I represent are unfriendly to these exempt organizations. In fact, among our members are found probably the greatest group of "joiners" in the country. A very large majority of our membership is active in the life of such groups. I, therefore, limit my discussion here to that part of their activities which is not related to their general purpose of organization. I would also like to say that as members of these groups we are cognizant of the fine civic and patriotic work accomplished by them and that the occasional money-raising activities for such purposes are a necessary part of their activities.

We do, however, earnestly object to the present trend among such exempt organizations to actively solicit public patronage for their food and beverage business. From our observation, over the years, it appears to us that the elimination of the use of slot-machines a few years ago by most of such organizations has caused them to look elsewhere for a source of revenue. Since a great many of them already have facilities for serving food and beverages to their members, it is an easy matter for them to serve the general public with little increase in overhead costs. The result has been an increasing activity by them in the solicitation of public patronage.

The problem of competition with private enterprise by organizations exempt under section 101 of the code was recognized by the Congress in the Revenue Act of 1950, when the law was changed so as to tax the unrelated business net income of organizations exempt under the provisions of subsections (1), (6), (7), and (14), except churches. That change in the statute made the corporate income tax applicable to their income derived from a trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101.

We now ask the Congress to extend this principle of equal taxation so as to include the organizations exempt under subsections (3), (8), and (9), which are the fraternal organizations, veterans' groups and private clubs.

Our members throughout the country have complained of this competition from tax-exempt groups, and lately have been sending to our association headquarters clippings from newspapers which show the advertising activities of the exempt organizations. From those clippings we have selected a number which we believe indicate the magnitude of their solicitation of public patronage and have appended a reproduction of them to this statement as an exhibit. The exhibit does not contain all of the clippings received, but is representative of the public advertising now used by our tax-exempt competitors. The clippings are taken from the newspapers of 29 cities and towns in 11 States, extending from Montana in the West to Massachusetts in the East.

(The exhibit referred to was made a part of the committee file.)

Mr. DAWSON. Most of the advertising used by the tax-exempt organizations shows clearly that the general public is welcome to use their facilities. In some cases, the advertising carries a notation "Members and Guests" or some similar phrase, but even in these cases it is obvious that the general public is invited since it is unreasonable to suppose that in towns and cities of the size indicated in the exhibit, that it is necessary to advise their membership by newspaper of the facilities and activities available to them. Some of the advertising, you will note, even offers publicly the facilities of the clubs for catering to weddings, banquets, and various types of social functions.

When we ask the Congress to apply the Federal income tax to the unrelated business net income of the now tax-exempt organizations, we believe that our request is fair. We do not ask that any difficulties or hurdles be placed in the path of such organizations. We ask only that when they solicit public patronage to compete with the taxpaying retailers, that they, too, pay a Federal income tax on the profits they derive from that public patronage.

Mr. Chairman, that concludes my statement.

The CHAIRMAN. Thank you very much, indeed.

Mr. DAWSON. Thank you, gentlemen, for the opportunity to appear.

The CHAIRMAN. Mr. Willard A. Weiss.

STATEMENT OF WILLARD A. WEISS, PARTNER, EUGENE M. KLEIN & ASSOCIATES, CLEVELAND, OHIO

Mr. WEISS. Mr. Chairman, and members of the committee, my name is Willard A. Weiss. I am a partner in the firm of Eugene M. Klein & Associates, Cleveland, Ohio. Our firm serves as actuaries and consultants to several hundred clients in the Midwest in connection with the study of administration of profit-sharing and pension plans. In the time allotted to me, I would like to discuss certain provisions of the proposed Internal Revenue Code relating to pension and profit-sharing trusts.

In addition to my oral testimony, I would also like to submit for the record a written memorandum, covering specific recommendations.

The CHAIRMAN. It will be put in the record.

(The memorandum referred to follows:)

MEMORANDUM SUBMITTED BY WILLARD A. WEISS TO THE SENATE FINANCE COMMITTEE IN CONNECTION WITH CERTAIN PROVISIONS OF THE PROPOSED INTERNAL REVENUE CODE OF 1954 RELATING TO PENSION AND PROFIT-SHARING TRUSTS

I. PRELIMINARY STATEMENT

This memorandum is submitted to the Senate Finance Committee in connection with certain provisions of the proposed Internal Revenue Code of 1954 relating to pension and profit-sharing trusts. The report of the Committee on Ways and Means accompanying H. R. 8300 sets forth as one of the objectives of the proposed revisions a simplification of the pertinent provisions and more precise rules to minimize the ambiguities and inconsistencies under present law. It is an unfortunate consequence that the proposed revision itself has generated an entirely new series of ambiguities and inconsistencies. What was intended according to the committee report to constitute "greater flexibility" has apparently imposed considerable limitations. What was intended to have provided adequate safeguards, on the other hand, may have unintentionally provided for new bases for discrimination.

II. STATEMENTS RELATING TO PROPOSED REVISIONS IN EMPLOYEE-COVERAGE REQUIREMENTS

1. Reference

The following statements apply to section 501 (e) (3) of H. R. 8300 which covers the subject of nondiscriminatory classifications under pension and profit-sharing plans.

2. Background

The overwhelming nature of the proposed changes in the employee coverage requirements necessitates a re-examination and reminder of the purpose of the last major revision of the Revenue Code applying to pensions which occurred in 1942. The purpose then was to improve the welfare of employees by encouraging the establishment of pension trusts for their benefit while at the same time preventing utilization of such trusts for tax avoidance purposes. The purpose was to weed out the narrow, discriminatory, selfish type of pension and profit-sharing plan which casts suspicion over bona fide plans. The legislation of 1942 was the culmination of efforts of the Joint Committee on Tax Evasion and Avoidance of the 75th Congress in 1937.

The Revenue Act of 1942 removed the tax avoidance and tax evasion questions then existing. Since that act was passed, there has been no clamoring for a major revision in the substance of section 165 (a) of the present code.

There has been no charge that the many thousands of plans covering millions of employees, or even a few of such plans, are discriminatory in favor of officers, shareholders, supervisors, or highly compensated employees.

There has been no charge that the present law is infested with tax loopholes. Yet the changes proposed in the coverage requirements under employee trusts are, in certain instances, unduly restrictive on one hand, and in other instances they incorporate unanticipated generosities.

What apparently was intended to be a simplification in form to ease the procedure of qualifying an employees' trust has resulted in a material change in substance that appears to be without justification or need.

3. *Specific Application of Proposed Revision in Employee Coverage*

Table I below sets forth an illustrative application of the nondiscriminatory classification requirements under the proposed section 501 (e) (3) (A) and (B) as to 80 existing pension plans already qualified under section 165 (a) of the Internal Revenue Code of 1939.

The application of the proposed tests against certain existing and qualified plans is made for illustrative purposes only with the understanding, of course, that the continued exempt status of such plans is not affected by the proposed legislation. The study of the problem retroactively in the light of existing plans is an important criteria in determining the potential effect of the proposed legislation on future plans.

TABLE I.—*Application of nondiscriminatory classification requirements under proposed sec. 501 (e) (3) (A) and (B), for illustrative purposes only, to 80 existing pension plans already qualified under sec. 165 of Internal Revenue Code of 1939*

Description	Companies meeting 10-percent shareholder requirement [1]	Companies meeting key employee requirement [2]	Companies meeting percentage participation requirement [3]
(1)	(2)	(3)	(4)
Number	64	0	42
Percent of total	80	0	52.5

[1] Based on requirement that not more than 30 percent of the contributions under the plan may be used to provide benefits for shareholders (as defined in proposed legislation).

[2] Based on requirement that not more than 10 percent of participants in the plan may be key employees.

[3] Based on requirement that a classification shall not be considered as discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all of such regular employees, whichever is greater, are participants in the plan.

The 80 cases studied were taken from a group of several hundred pension plans administered by our firm. The study was confined primarily to plans for salaried employees and such cases were taken in alphabetic order. Combination pension plans as well as plans involving the exclusion of employees earning under a certain rate of compensation were eliminated from the study in view of certain questions concerning the application of such tests to combination plans, and certain distortions which would be produced by including plans with a minimum salary requirement. The plans studied, therefore, are straightforward types of plans covering, in general, salaried employees who have completed a certain number of years of service, not in excess of 5, and attained a minimum age of not more than age 35.

All of such plans studied were and are qualified under section 165 (a) of the present code. Their basic entitlement to qualification is found in the provisions of section 165 (a) (5) which provides that "A classification shall not be considered discriminatory * * * merely because it is limited to salaried or clerical employees."

The number of companies studied was restricted to 80 solely because of time limitations.

Table I shows:

(*a*) That none of the companies studied meet the key employee requirement.

(*b*) That 80 percent of such companies meet the 10 percent shareholder rule.

(*c*) That 52.5 percent of such companies meet the percentage participation requirement.

On the basis of the foregoing, of the 80 companies studied, only 42, or 52.5 percent, would be able to qualify their plans if they were establishing the same plan under the nondiscriminatory classifications of section 501 (e) (3).

A few further facts as to details of the study are of importance:

(*a*) Of the 80 companies, 19 companies employed 20 regular employees or less. The plans of all such so-called smaller companies met the percentage coverage requirement but failed to meet the key employee rule. The qualification of such plans would, therefore, have been satisfactory under H. R. 8300 and all would have been controlled in their acceptability by the percentage coverage rule.

(*b*) In the group of 19 companies, 17.2 percent of the participants were key employees, as opposed to the 10-percent limitation imposed under the proposed legislation.

(*c*) In the 80 companies studied, 42.4 percent of the participants were key employees (as defined in the proposed legislation), as opposed to the 10-percent limiation under the proposed legislation.

The basic defect in the proposed key employee rule as well as the percentage employee coverage rule is attributable to the fact that when the rule is applied to a group of employees, such as a salaried group, its acceptability depends upon the size, and age and service distribution of all employees including hourly employees.

A plan covering salaried employees which may be initially qualified may subsequently become disqualified. For example, a greater number of hourly employees can increase the size of the group of regular employees to the point where the number of participating salaried employees would no longer meet the 25 percent requirement for continued qualification.

The present law specifically prevents such a possibility as it does not require measuring the salaried group of employees against the hourly paid employees. However, contrary to this, the principle of comparison is an integral part of the proposed legislation. The inappropriateness of its use is evident from the foregoing study. The foregoing results do not conform to the committee's statement that the coverage requirements of H. R. 8300 are more liberal than the requirement under the present code.

More reasons exist today than existed in 1942 for continuing the acceptability of a salaried classification without relationship to any other unit. For example, under the Labor Management Relations Act of 1947, an employer cannot establish a pension plan for his bargaining unit employees without negotiating the subject. With respect to a pension plan for salaried employees, he has the opportunity to act unilaterally.

4. Further statements concerning employee coverage requirements

(*a*) The proposed classifications do not make provision for the inclusion of the former employees of the employer or cover the practice whereby employees who are overage at the inception of a plan are frequently excluded. As to the first point, it should be recognized that there are many plans, particularly of the union-negotiated type, which at the inception of the plan include employees retired without pension during a period of 1 to 2 years prior to the effective date of the plan. In addition, there are many plans which, for cost reasons, do not fund pensions for employees who are overage at the establishment of the plan. Also, it is not an infrequent practice to find that employees who do not meet certain service requirements at the time of reaching normal retirement age are not entitled to receive pensions.

(*b*) The provisions relating to percentage requirements for qualification would virtually force the issue of employee contributions. Since the voluntary entry or withdrawal of a participant from participation could upset the percentage required for continued qualification to the detriment of the employer, an employer would virtually be compelled to establish a noncontributory plan. A committee report states that greater flexibility is provided for the establishment of pension plans to enable employers and employees to adjust their plans to meet their individual needs. It is doubtful whether this form of confinement meets the purposes so stated.

(*c*) In the event consideration is given to the retention in section 501 (e) (3) of the provision to the effect that a classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders, it is suggested that the word "contributions" be preceded by the word "employer." The present phraseology may be construed to include employee contributions in view of section 501 (e) (1) which in part reads "If contributions are made to the trust by such employer, or employees, or both, * * *"

(*d*) Section 501 (e) (3) is not clear as to how the percentage requirements for employee coverage would be treated where there is a differential percentage in the benefit formula. For example, if a plan provides a benefit of 1 percent of the first $4,000 and 2 percent of the excess over $4,000, must 2 plans be qualified under the percentage requirements.

(*e*) In a technical construction of the classification set forth under section 501 (e) (3) (A) it appears that subsection (vii) nullifies and renders meaningless subsections (i) through (vi).

(*f*) Section 501 (e) (3) (B) (iii) uses the word "full" with reference to benefits and its meaning or application is not clear.

5. Recommendations as to employee coverage requirements

The recommendations below apply specifically to section 501 (e) (3) of H. R. 8300. It is recommended that consideration be given to these principles:

(*a*) That the present automatic qualifying provisions under section 165 (a) (3) (A) should be expanded. The House Ways and Means Committee report stated that virtually all plans which qualify under the present law required a determination as to acceptability by the Commissioner of Internal Revenue and did not fall within the automatic qualifying provisions. This being the case, it would appear that the automatic coverage requirements should be made more effective so as to cover under such definite rules at least three-quarters of the plans submitted to the Internal Revenue Service.

(*b*) That for the odd but justifiable case not meeting or desiring or able to meet rules for automatic qualification, the employer be given the opportunity to obtain individual approval in a manner similar to that provided for under section 165 (a) (3) (B) of the present law provided that the effect of his plan is not to favor the enumerated shareholders or key employees.

(*c*) That the present permissible classifications for hourly or salaried employees be retained; that a plan for one acceptable class need not be governed or influenced by conditions existing under any other class. The ineffective nature of a rule which is based upon a comparison between classes of employees has already been demonstrated.

(*d*) That the proposed key employee test be eliminated in its entirety. It is clear as shown in the case of the salaried employees' plans studied and discussed previously that the definition must be inadequate if all of the present qualified plans failed to meet the test. Actually, the test favors only the larger companies. For example, a company with 100,000 employees could readily qualify a plan under which its 1,000 highest-paid employees comprise the entire class of participants. It should be evident that the key employee question cannot be properly controlled by a percentage requirement; but, it can be controlled by the use of proper classifications and by individual treatment of cases not meeting the automatic classifications.

(*e*) That the proposed rule regarding discrimination where more than 30 percent of the contributions are used to provide benefits for shareholders be modified. The reasons therefor are as follows:

(i) A percentage-of-contributions test can result in the loss of exempt status due to factors beyond the control of the principals, such as a fluctuation in the number of employees covered or a change in the level of compensation of employees. To avoid this harsh effect, we recommend that any excess over the limitations set be treated on the same tax basis as a nonqualified plan. This treatment would be justified since the employer could have established a nonqualified plan for the excess under a separate instrument and a qualified plan to meet the shareholder rule and thus avoided being confronted with a total disallowance under his qualified plan. What the employer is able to do separately, in this instance, he should be able to accomplish on a combined basis without incurring penalties.

(ii) The rule is not easily computable under all types of pension plans. For example, in the case of self-insured plans, where costs are usually determined on a group basis, the application of the rule would require special actuarial treatment.

(iii) The need for the rule in its present form is questioned in view of the provisions of the proposed section 403 (a) (1) (B) under which the remaining unfunded cost with respect to any 3 individuals, if more than 50 percent of the total remaining unfunded cost, is required to be distributed over a period of

5 years for the individuals affected. This, in itself, affords a control over the rate of funding.

(iv) The rule is inflexibly associated with the age of the shareholder. Younger shareholders automatically become entitled to larger pensions than the older shareholders. If the 30 percent limitation was related to aggregate pensions instead of to contributions, the influence of age would be removed.

It is, therefore, recommended that the shareholder rule be modified.

(*f*) While time limitations make it impossible to prepare specific language suggestions concerning all of the foregoing suggestions, it is recommended that section 501 (e) (3) be revised to allow exemption to the trust, or two or more trusts, or the trust or trusts and annuity plan or plans designated by the employer as constituting parts of a plan intended to qualify, which benefits the regular employees:

(i) Who are included within a general payroll classification such as hourly, salaried, piece-rate, or commissioned, or any combination thereof;

(ii) Who have been employed for a minimum period, not exceeding 5 years;

(iii) Who have reached a specified age, which age is not more than age 35;

(iv) Who have not reached a specified age, which age is not less than age 60;

(v) Who are compensated at an annual rate in excess of a specified amount, which amount does not exceed $4,000, or the maximum annual amount covered under the provisions of the Social Security Act, or the Railroad Retirement Act, or any similar Federal act under which the employee may be covered, if greater;

(vi) With respect to whom the employer is required to bargain pursuant to the provisions of the Labor Management Relations Act of 1947;

(vii) Who qualify under any classification which is a combination of any of the classifications specified in clauses (i) through (vi); or

(viii) Who qualify under any other classification set up by the employer with the approval of the Secretary or his delegate.

The words "regular employees" as used in the above suggestions should be defined as proposed in section 501 (e) (3) (B) (iv).

(*g*) In connection with the above classifications, it is recommended that limitations be imposed to prevent discrimination in favor of shareholders or highly compensated employees. These suggestions are as follows:

(i) In the case of shareholders, it is suggested that the definition of shareholder as proposed in section 501 (e) (3) (B) (i) be retained. In the case of a pension plan, allow shareholders to benefit under the plan up to the greater of—

(A) 30 percent of the employer contributions under the plan; or

(B) 30 percent of the expected pensions of all employees on account of employer contributions under the plan;

and provide that in making such determination the first $150 monthly pension of each such shareholder should be excluded. This exclusion is advisable in order to allow a reasonable base with respect to which no discrimination would be attached. Also, notwithstanding the foregoing limitations, it is suggested that such limitations not be applied to a shareholder where his expected monthly pension would not be in excess of 30 percent of his average monthly compensation averaged over a period of not less than 5 years (proportionately reduced if he would have less than 15 years' service at normal retirement age under the plan).

In the case of a profit-sharing plan analogous limitations should be provided.

Under the proposed legislation where contributions would exceed the limitations imposed with respect to shareholders, the plan automatically becomes disqualified. It is suggested that in the event contributions or benefits, as the case may be, exceed the foregoing limitations, that the plan not be disqualified, but the excess not qualified be treated as under a nonqualified plan according to the proposed section 403 (a) (5).

(ii) In considering the question of further limitations which should be imposed to avoid discrimination in favor of more highly compensated employees, it is important to recognize that the present rules governing allowable pension formulas—particularly where membership in the plan is limited to employees receiving compensation above a stated amount, such as $3,600 a year—are exceedingly beneficial in controlling and limiting the question of discrimination in favor of such employees. The proposed provision under section 501 (e) (4) (A) can give rise to material discrimination in favor of more highly compensated employees. It is believed that a properly constituted "integration test" comparable in objective, but simpler in form to that which exists under present law, can fully control this question of discrimination. Time limitations do not permit further consideration of this particularly important limitation.

III. STATEMENTS REGARDING DEFINITENESS OF FORMULA IN CASE OF A PROFIT-SHARING PLAN

1. Reference

The following statements relate to that part of section 501 (e) (4) which states in part:

"A trust which otherwise qualifies under this subsection shall not be denied exemption from tax * * * merely because (1) contributions are not made in accordance with a definite predetermined formula in the case of a profit-sharing plan * * *"

2. Comments

Under present practice of the Internal Revenue Service, profit-sharing plans are not approved unless they contain a definite formula regarding contributions. The Lincoln Electric and Producer Reporter cases have both held in effect that this form of requirement is not provided for by law. However, we would venture to say that at least 95 percent of the qualified profit-sharing plans in operation in this country currently include as an integral portion of their plan a definite formula for contributions. In our opinion, a requirement for a definite predetermined formula should be made a part of the law. Failure to include such a requirement would produce unfavorable results both from the point of view of the American taxpayer as well as from its effect on employees covered under such plans. The effect of the passage of the proposed legislation may be as follows:

(*a*) It would permit the operation of one-shot plans. An employer may establish a plan for only 1 year which may be his best business year and make a contribution for only that year.

(*b*) A company could establish a plan and make no contribution other than a token payment and be able to carry forward the limitation of 15 percent of the compensation of participants during all years in which he makes no contributions. At a time when the profits of the organization may be exceedingly high, or during a high tax period, this employer could begin to take deductions for contributions to a profit-sharing plan at a level of 30 percent of the compensation of covered employees.

(*c*) The proposed legislation would enable employees to delete definite contribution formulas from existing plans and thereby remove the security now provided by such plans. As stated above, we would estimate that probably 95 percent, at least, of all profit-sharing plans presently contain definite contribution formulas.

(*d*) In any event, it is recommended that the carry-forward features of the proposed section 403 (a) (3) (A) be made applicable solely to a company having a definite predetermined contribution formula.

IV. STATEMENT RELATING TO DEFINITION OF COMPENSATION

Under section 501 (e) (4) compensation which is not determined in accordance with a definite formula cannot be used in determining pension benefits. The present section 165 (a) permits the use of total compensation in determining pension benefits. The present practice of the Pension Trust Division is to permit total compensation to be used where compensation in excess of the basic or regular rate of compensation has been paid in accordance with long-established practice. We believe that the proposed definition of compensation would unduly restrict the use of total compensation beyond that which is called for by present practice. There are many types of pension plans, including union-negotiated plans, which employ total compensation in the determination of benefits. We believe that the provision in the present law allowing the use of total compensation should be retained.

V. STATEMENTS RELATING TO MULTICOMPANY PENSION PLANS

The House Ways and Means Committee report states that contributions by an employer would be considered geared to factors pertaining exclusively to his own employees where such contributions are measured by units of production of his own employees, a percentage of his own payroll, or cents-per-hour worked by his own employees, notwithstanding the fact that such contributions are commingled with contributions of other employers. Since the proposed law makes it impossible for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of the employers' employees or their beneficiaries, it would be advisable to specifically incorporate in the law the treatment afforded multicompany pensions plans, as suggested in the committee report.

VI. STATEMENTS REGARDING COMPUTATION OF MAXIMUM TAX DEDUCTIBLE AMOUNT

Section 403 (a) (1) (C) prescribes one of three limitations upon the deduction of contributions to pension plans. It appears that an inadvertent error may have occurred in the drafting of this section. The limit of tax deduction is stated to be an amount equal to the employer's normal cost of the plan plus 10 percent of the sum of the unfunded cost and total payments in prior years in excess of total normal cost for all the years of the plan's existence. Under the proposed provision, it would appear that after the unfunded cost becomes zero an employer could continue to contribute and obtain a deduction on the basis of 10 percent of total payments in prior years in excess of total normal cost for all years during the plan's existence. Consistent with other provisions of the code, we believe it was intended that the employer should be allowed a deduction for past service costs only up to the point when his past service costs have been fully funded and deducted.

VII. STATEMENTS RELATING TO EXEMPTION OF COST OF LIFE-INSURANCE PROTECTION PROVIDED UNDER SECTION 402 (a) (4)

The proposed section 402 (a) (4) eliminates, in the case of newly established plans, the necessity of computing the cost of life-insurance protection under life-insurance contracts held in trust and the inclusion of such costs in the gross income of the individual. It appears that the language of 403 (c) applying to the continued exempt status of plans established prior to January 1, 1954, does not carry with it the exemptions allowed under section 402 (a) (4). This may have been intentional in view of the fact that employees under present trusts have been charged for the cost of such life-insurance protection and a division of the treatment into two parts would be cumbersome. However, the effect of the provision is to require that computations still be made under existing plans.

We would recommend that under existing plans the inclusion of the cost of such life-insurance protection be forgiven in future years. The difficulty of computation and reporting in relation to the size of the item makes it of nuisance value only. An examination of 77 plans selected in alphabetic order has disclosed that the average cost of life-insurance protection which each participant was required to add to his gross income during 1953 amounted to only $34.36.

VIII. SUMMARY OF RECOMMENDATIONS

The recommendatons of this memorandum may be summarized as follows:

(*a*) The employee coverage requirements should be revised as follows:

(i) Expand the present automatic qualifying provisions under section 165 (a) (3) (A) of the present law.

(ii) Eliminate the principle of comparison between classes of employees as proposed under the percentage qualification rule under section 501 (e) (3).

(iii) In cases not meeting or desiring or able to meet rules for automatic qualification, grant the employer the opportunity to obtain individual approval as under present law.

(iv) Eliminate the key employee test in view of its clear inadequacy.

(v) Modify the shareholder rule so as to base the limitation on employer contributions and expected pensions, and exclude the first $150 monthly pension from such determination.

(vi) Eliminate disqualification in cases where limitations are exceeded, and substitute a rule whereby the excess will be treated as a nonqualified plan.

(vii) Retain the theory of integration with social security so as to avoid the key employee problem.

(*b*) Require a definite contribution formula in the case of a profit-sharing plan in order to avoid the potential use of such plans for tax avoidance purposes and the removal of the security provided under most existing profit-sharing plans.

(c) Revise certain definitions and correct certain inconsistencies as set forth in this memorandum.

The CHAIRMAN. Are you representing yourself, or some organization?

Mr. WEISS. I am a partner in the firm of Eugene M. Klein & Associates.

Senator KERR. That doesn't answer the chairman's question.

Mr. WEISS. I am representing myself, sir.

The CHAIRMAN. All right.

Mr. WEISS. It is perhaps an unfortunate consequence of the proposed revision that what was sincerely intended to constitute greater flexibility has imposed considerable limitations, and what was intended to have provided adequate safeguards may have unintentionally provided for new bases for discrimination.

I wish to direct my remarks particularly to the proposed revisions in the employee coverage requirements. These are set forth in the proposed section 501 (e) (3) of H. R. 8300. In general, this section allows an employer to select any class of employees for his plan, provided the class is not discriminatory.

The class is automatically acceptable if it meets a stockholder and key employee test, or if it meets certain percentage coverage requirements. These terms—that is, stockholder test, key employee test and percentage requirements—have already been defined by a previous speaker, and I will not take the time of the committee to repeat that.

In studying the application of the proposed tests for nondiscriminatory classifications, we examined 80 cases from a group of several hundred plans administered by our firm. The study was confined primarily to plans for salaried employees and such cases were taken in alphabetical order.

In general, the plans covered salaried employees who had completed at least 5 years of service, and who had attained a minimum age not more than age 35. All of such plans studied were and remained qualified under section 165 (a) of the present code. Their entitlement to qualification is found in the provisions of section 165 (a) (5), which provide that a classification shall not be considered discriminatory merely because it is limited to salaried or clerical employees.

The results of our study were as follows: First, none of the companies met the key employee test.

Second, 20 percent of the companies failed to meet the test for shareholders.

Third, 38 or 47½ percent of the 80 companies failed to meet the percentage participation requirement.

Thus, of the 80 companies studied, only 42 or 52½ percent, would be able to qualify their plans if they were establishing the same plan under the nondiscriminatory classifications of the proposed legislation.

That these highly restrictive limitations should now be imposed is seriously questioned. The Revenue Act of 1942 removed the tax avoidance and tax evasion questions then existing. Since that act was passed, there has been no clamoring for major revision of the substance of section 165 (a) of the present code. There has been no charge that the present law is infested with tax loopholes. Yet, certain of the changes proposed in the coverage requirements under employee trusts would indicate that such a condition exists.

What apparently was intended to be a simplification in form, to ease the procedure of qualifying an employee trust, has resulted in a material change in substance that appears to be without justification or need. Time does not allow me to analyze the detailed recommendations we are making. Specific recommendations are set forth in our memorandum. However, the recommendations may be summarized as follows:

First, expand the present automatic qualifying provisions under section 165 (a) (3) (A) of the present law. The House Ways and Means Committee report states that practically all plans today require special approval under the present law. That is what they are trying to avoid now. Automatic coverage requirements should apply to at least three-quarters of the plans submitted to the Internal Revenue Service. I would venture to say that more than three-quarters of today's plans qualify on the basis of a classification not narrower than one which covers employees who are between the ages of 35 and 60, who have completed at least 5 years of service, who are either salaried or hourly rate employees, and who earn over $3,600.

The proposed law would not approve this type of classification in most instances on account of the interrelating percentage requirements. Our memorandum covers specific recommendations regarding automatic qualifying provisions.

My second point: Eliminate the principles of comparison between classes of employees, as proposed under the percentage qualification rule. The basic defect in this rule is attributable to the fact that when the rule is applied to a group of employees, such as salaried employees, its acceptability depends upon the size, the age, and service distribution of all employees in the employer's organization.

A plan covering salaried employees, which may be initially qualified, may subsequently be disqualified merely by a shift in percentages over which the employer has absolutely no control.

My third point: For the odd but justifiable case which does not meet the rule for automatic qualification, grant the employer the opportunity to obtain individual approval on the same basis as he has that right to date.

Fourth: Eliminate the key-employee test, in view of its clear inadequacy. Not one of the companies in our study could meet this test. The test favors only the larger companies.

Fifth: Modify the shareholder rule. Allow shareholders to benefit up to, say, 30 percent of the employer contributions or 30 percent of the expected pensions of all employees on account of employer contributions, if greater, but modify the rule in the case of profit-sharing plans; and for each shareholder exclude the first $150 monthly pension, in the case of a pension plan, and exclude the first $1,000 allocation in the case of a profit-sharing plan.

This exclusion should be made in order to allow a reasonable base with respect to which no claim of discrimination could be attached.

In addition to these limitations regarding stockholders, it is suggested that a stockholder, as defined in the proposed legislation, be permitted to have a monthly pension which would not be in excess of 30 percent of his average monthly compensation, averaged over a period of not less than 5 years, if he would not meet the other restrictions. In other words, a reasonable minimum base for a pension.

My sixth point: Eliminate disqualification in cases where limitations are exceeded, and substitute a rule whereby the excess will be treated as a nonqualified plan. Under the proposed legislation, where contributions to the plan would exceed the limitations imposed with respect to shareholders, the plan automatically becomes disqualified.

It is suggested that in the event contributions, or benefits, as the case may be, exceed the stipulated limitations, that the plan not be disqualified but the excess not qualified be treated as a nonqualified plan, according to the proposed section 403 (a) (5).

My seventh point: Retain the theory of integration with social security. This retention would avoid the key employee problem.

Eighth: In the case of a profit-sharing plan, we would recommend that a definite contribution formula be required, in order to avoid the potential use of such plans for tax avoidance purposes, and also, to avoid the removal of the security provided under most existing profit-sharing plans.

We heartily make these recommendations for your consideration. If we can be of any service to your committee, please call upon us.

The CHAIRMAN. Thank you very much.

Mr. WEISS. Thank you for the time granted.

The CHAIRMAN. Mr. Kay. Sit down, Mr. Kay, and be comfortable and identify yourself for the reporter.

STATEMENT OF LEON KAY, DETROIT, MICH.

Mr. KAY. My name is Leon Kormisaruk—Kay, for short, from Detroit, Mich.

The CHAIRMAN. Are you representing yourself or any organization?

Mr. KAY. I represent myself, sir.

I want to express my appreciation for the privilege extended to me in appearing before this committee, and I want to discuss the subject matter of treatment of bad debts. I stated I speak for myself and some of my friends who have——

Senator KERR. What is your business?

Mr. KAY. I am engaged in the oil-refining industry, and became interested in another industry, which I and my friends have organized. And because of the need of additional capital, we in the last 5 or 6 years have kept on advancing considerable sums for the purpose of developing it.

Unfortunately, business did not succeed, and we are on the verge of folding up. The loans that we have advanced this new enterprise are of a considerable sum. The way I understand it, under section 23 (k), Internal Revenue considers such loans as nonbusiness bad debts, and considers it on the par with securities and bonds or any registered indebtedness, and considers it as a capital loss.

As it happens, we are not engaged in any speculative enterprise, so consequently we cannot look for any relief whatsoever in the field of capital gains, because we are primarily interested in the industry.

We would therefore like to suggest to this committee for consideration the proposition that when the loans are advanced to a corporation for the purpose of establishing it or developing it, and if such loans become, in due time, worthless, that they may be considered as a business bad debt, so that some relief can be provided for the parties who have loaned the moneys to the corporations. Especially, in view of the present taxation, it is almost catastrophic for an individual or a group of individuals who have advanced sums in terms of loans for such new enterprises, and if they do not get any relief it may present a situation where the suffering would be of such an extent that it actually may ruin them.

The CHAIRMAN. Don't the individuals get any relief at all now?

Mr. KAY. Under the present conditions, the only relief they can look for, as I understand it, is from capital gains.

Senator KERR. That is, if they loan $10,000, and they lose it, what they actually save is $2,500, and when they might be in the 75 percent bracket, in which event, under your recommendation, they would save $7,500.

Mr. KAY. That is true. But the main difficulty consists of the fact that, for instance, a group like mine is not engaged in any speculative enterprises, where we can expect even a relief in the sense of the 25 percent, because in order to get the 25 percent relief you would have to obtain some form of capital gain.

Senator KERR. You would have to have had capital gain income, against which you could charge off this so-designated capital gain loss.

Mr. KAY. That is right. But as long as one is not engaged in speculative enterprises, and does not seem to have any possibility whatsoever of recapturing such a loss, even to the extent of the 25-percent recapture, the situation is that he is losing 100 percent of the loans that he has advanced to the corporation.

Senator KERR. And he gets no offset in tax benefit.

Mr. KAY. And gets no relief whatsoever.

In view of those considerations, though it is a subject matter in which I and my friends are personally vitally interested, I want to assure you that I would have not dared to appear before this committee if I would not have felt that the case, as such, is perfectly justified for your proper and due consideration on a general level, to provide relief for that classification of our society who were unfortunate in making such advances.

The CHAIRMAN. We are glad to have your testimony. The fact that you have a personal interest doesn't disqualify you from testifying. It may give you some added knowledge.

Mr. KAY. I want to make this point clear, that had I felt that it was merely a question of an individual case, and based upon some concept of injustice, I would have not dared to appear. But I feel that there is a considerable group of people who have had the same experience, and unless some form of relief is provided, I am afraid you will find that the flow of private capital in the smaller industries, where certain portions would have to be advanced in the form of loans, would be curtailed to a degree that the economy of the whole country would feel it in one form or another.

I earnestly submit those experiences for your consideration, and urge upon the committee to provide some form of relief whereby we do not suffer too much because of such experiences.

The CHAIRMAN. Thank you very much.

Mr. KAY. Thank you.

(The following letter was subsequently received for the record:)

KEYSTONE OIL REFINING CO.,
Detroit, Mich., April 16, 1954.

Senator MILLIKIN,
Chairman, Senate Finance Committee.

DEAR SENATOR: I am suggesting that loans advanced by individuals to corporations and subsequently such corporations are in no position to repay such loans, that such loans be considered by the Internal Revenue Department as business bad debts, deductible by the lender from his income tax, and not be considered as a nonbusiness bad debt which can be deducted from capital gain only, as it is being considered by the Internal Revenue under section 23 (k). This suggestion is made on the premise that:

1. The money loaned is capital saved after income tax has been paid.
2. If profits would have been made by those individuals who are stockholders and/or directors of the corporation, they would have had to pay income tax on such profits.
3. Those, like I and my associates, who are not engaged in any speculative enterprises and are primarily interested in industrial development, cannot look for relief from capital gains.
4. Having no opportunity whatsoever of obtaining relief from capital gain, and having no opportunity to obtain relief from income tax, the loss of capital loaned, which was obtained by saving after income tax was paid upon such saved capital, may prove to be ruinous to the lender.
5. Present treatment of such losses will hamper flow of capital into new industry.

I hope the above proposals will meet with your favorable consideration.

Very truly yours,

LEON KOMISARUK (KAY).

The CHAIRMAN. I think we have now gone through the list of those who were supposed to have testified today. Are there any additions to that?

We will recess until 10 o'clock tomorrow morning.

(By direction of the Chairman, the following is made a part of the record:)

APRIL 13, 1954.

Re H. R. 8300, Internal Revenue Code of 1954, sections 7602, 7604

Hon. EUGENE D. MILLIKEN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SIRS: Your attention is directed to the substantial change in a citizens rights made by sections 7602 and 7604 of the proposed Internal Revenue Code of 1954.

Under the prior acts, a subpena issued by the Commissioner was not self-enforcing but required a petition to the United States district judge wherein its validity and propriety could be tested before the Commission of a contempt.

Under the proposed act the failure to obey the subpena is a punishable contempt. The citizen must run the risk of its invalidity or impropriety.

Before the recent reorganization of the Internal Revenue Service, I became aware of numerous misuses of the then self-enforcing collector's subpena; an instrument created for the collection of assessed taxes being used to aid purported audit of the taxpayer's returns. (Internal Revenue Code, section 3615.)

The protection of citizens' rights under our form of government would seem to require something like the previous procedure under section 3614 of the Internal Revenue Code of 1939 and not the self-enforcing subpena proposed by section 7602 of the proposed act.

Very truly yours,

KALMAN A. GOLDRING.

SOUTH BEND, IND., *April 14, 1954.*

MRS. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building,
Washington, D. C.

DEAR MADAM: With reference to the provisions of H. R. 8300 pertaining to estates and trusts there is a situation here in Indiana which it is considered desirable to bring to the attention of the Senate Finance Committee. It is hoped this letter can explain the situation to the committee; otherwise we await your instruction.

The situation is this.

For the record, Albert J. Stahl, of LaPorte, Ind., died testate. The provisions of his will contemplated that the estate should be carried on after his death as he had done prior thereto. The will specified that the estate should be incorporated under Indiana nonprofit corporation law in order to relieve the administrators of the personal liabilities under which executors and administrators usually have to labor. The will provided that the estate should be held in trust for the purposes and disposition as specified therein as to both income and principal.

Specific bequests of small monthly amounts extending into 1962 to named individuals are set out in the will but other than these specific items, all income and principal shall be devoted to the establishment of a home for the aged, or some alternative provisions concerning two old people's homes already in existence or a church. When these provisions have been complied with and the purposes accomplished, the will directs that the corporate cloak be dissolved and the individuals comprising the board be discharged.

The situation is now before the Bureau of Internal Revenue for discussion.

Application of present and past legislation is not clear. The estate, in our opinion, is completely (and competently) governed by sections 162 (b) and 162 (a) of the present code and which, we understand, are continued in the proposed revision. But because of the corporate shell or cloak the BIR is leaning toward treating the estate under the corporation sections of the code. There appears to be no precedents or similar instances wherein previous consideration has been had; so, despite testimony and the provisions of the will itself that the affairs of the decedent is an estate, that the maangement and control flows from and is governed by the will of the decedent, and that the complete substance of the situation is that of an estate, the Bureau of Internal Revenue (understandably, perhaps) seems to think that it cannot completely ignore the corporate cloak which the decedent stipulated his executors should use.

The matter has been under study for over 2 years now and still is continuing but it occurs to us that it should be laid before the Senate Finance Committee for consideration in connection with the proposed Internal Revenue Code of 1954. It would, of course, be very helpful if the present discussions can be resolved in the light of suggestions that might be provided by the committee.

Yours respectfully,

WATSON M. KOONTZ,
Certified Public Accountant,
Attorney in fact for the Albert J. Stahl Estate Inc.

Re Section 4381, H. R. 8300 BALTIMORE, MD., *April 14, 1954.*

MRS. ELIZABETH B. SPRINGER,
Chief Clerk, Finance Committee,
United States Senate, Washington, D. C.

DEAR MRS. SPRINGER: Enclosed herewith please find 35 copies of statement re section 4381, H. R. 8300, which we have prepared.

Will you kindly bring this statement to the attention of the members of the Senate Finance Committee.

Very truly yours,

MUECKE, MULES & IRETON,
By BERTHOLD MUECKE, Jr.

Statement Re Section 4381, H. R. 8300

1. INTRODUCTION

1.1. Prior to the decision in the case of *G. M. A. C.* v. *Higgins* (161 Fed. 2d 593), which was rendered in 1947, the Treasury Department had ruled consistently that instruments evidencing corporate obligations, which did not bear coupons or were not in registered form, were not subject to the stamp tax imposed by I. R. C. 1801 (26 U. S. C. A. 1801).

1.2. Since 1947 the Treasury Department has sought to impose that tax on practically all corporate obligations, on the theory that they were "debentures," except, peculiarly enough, those secured by mortgage or trust deed. Prior to September 28, 1953 (Internal Revenue Bulletin 20, Revenue Ruling 203) it even attempted to exact the tax in respect to ordinary commercial paper.

1.3. A mass of litigation has resulted from this effort to tax what, until 1947, had never been deemed to be subject to the tax. Unfortunately, the courts have been and continue to be at variance in the interpretation of I. R. C. 1801 and the term "debenture," as used therein. In consequence, corporate executives and their counsel cannot know in advance whether certain corporate obligations are or are not subject to the tax. The proposed revision, section 4381, H. R. 8300, which is supposed to clarify the situation, fails utterly to do so, and, if enacted, will but compound and perpetuate the confusion.

2. STATUTES AS NOW IN FORCE

2.1. I. R. C. 1800 and 1801 (26 U. S. C. A. 1800, 1801) provide as follows:

"Sec. 1800. IMPOSITION OF TAX.

"There shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned in and described in sections 1801 to 1807, inclusive, * * * the several taxes specified in such sections.

"Sec. 1801. CORPORATE SECURITIES.

"On all bonds, debentures, or certificates of indebtedness issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereof, 11 cents: * * *."

3. PROPOSED REVISION

3.1. Sections 4311 and 4381 (a) of H. R. 8300 propose to revise the foregoing sections to read as follows:

"Sec. 4311. IMPOSITION OF TAX.

"There shall be imposed a tax on all certificates of indebtedness issued by a corporation at the rate of 11 cents on each $100 of face value or fraction thereof."

"Sec. 4381. DEFINITIONS.

"(a) Certificates of Indebtedness. For purposes of the taxes imposed by sections 4311 and 4331, the term 'certificates of indebtedness' means bonds and debentures; and also includes all instruments, however termed, issued by a corporation with interest coupons or in registered form, known generally as corporate securities."

4. LEGISLATIVE HISTORY

4.1. In 1898 Congress enacted a 5-cent-per-$100 stamp tax on bonds, debentures, or certificates of indebtedness and a separate 2-cent-per-$100 stamp tax on "any promissory notes except bank notes issued for circulation" (30 Stat. 451, 458, 459). In 1902 the tax on both promissory notes and bonds, debentures, and certificates of indebtedness was repealed (32 Stat. 97). In 1914 the stamp tax on promissory notes was reenacted, along with that on "bonds, debentures, or certificates of indebtedness" (38 Stat. 753, 759, 760).

4.2. From the time this tax was first imposed in 1898, and until 1917, it applied to "Bonds, debentures, or certificates of indebtedness issued after the first day of July *by any association, company, or corporation* * * *." [Italics ours.]

4.3. In 1917 the statute was expanded (40 Stat. 319, 321, 323) to include bonds issued by individuals as well as those issued by business concerns, and, as a consequence, the description in the schedule was changed to "Bonds, debentures, or certificates of indebtedness issued after the first day of December 1917 *by any person, corporation, partnership, or association* * * *." [Italics ours.]

4.4. In the Revenue Act of 1918, Congress added the phrase: "* * * issued by any corporation with interest coupons or in registered form, known generally as corporate securities."

However, since the instruments covered by the first phrase "bonds, debentures, or certificate of indebtedness" were taxable whether issued by individuals, partnerships, or corporations, Congress could not, as it did in every other instance, have the phrase "* * * issued by any corporation with interest coupons or in registered form, known generally as corporate securities" refer back to or modify "bonds, debentures, or certificates of indebtedness," because the second phrase applied only to corporations, whereas the first phrase referred not only to the bonds of corporations, but also those of individuals and partnerships. Accordingly, the description in the schedule was changed to read:

"* * * all bonds, debentures, or certificates of indebtedness issued by any person, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities * * *."

4.5. In 1926 Congress decided to eliminate the tax on bonds issued by individuals, and did so in the simplest way possible by merely deleting the word "person" and inserting in lieu thereof the word "corporation" (Revenue Act of 1926, 44 Stat. 99), so that the present statute reads:

"* * * all bonds, debentures, or certificates of indebtedness issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities * * *."

4.6. The language last quoted has remained unchanged to the present day, and, until *G. M. A. C.* v. *Higgins*, supra, the Treasury Department, the courts, and the taxpayers interpreted it as imposing the tax only on bonds, debentures, certificates of indebtedness, and other instruments, however termed, which are issued by a corporation with interest coupons or in registered form, known generally as corporate securities.

5. LITIGATION

5.1. *G. M. A. C.* v. *Higgins*, supra, held that 84 instruments of a series, in large denominations, in the form, size, and appearance of corporate securities, sold to eight different parties at negotiated prices, were "debentures" and not "notes," and that, therefore, they were subject to the stamp tax imposed by I. R. C. 1801.

5.2. In *Commercial Credit Company* v. *Hofferbert* (1950, 188 Fed. 2d 574), the Court went a step further, and held that a simple form of note, in large denomination and of 15-year maturity, issued pursuant to a loan agreement which contained covenants against liens on assets, etc., was a "debenture" and not a "note," and that, therefore, it was subject to the tax.

5.3. In *Belden Mfg. Co.* v. *Jarecki* (1951, 192 Fed. 2d 211), on facts closely resembling those in the Commercial Credit Company case, the Court arrived at the opposite conclusion and ruled that a $1 million, 5-year note was a "note" and not a "debenture," and, therefore, not subject to said stamp tax.

5.4. In *Shamrock Oil & Gas Co.* v. *Campbell* (1952, 107 F. Supp. 764),, a $4 million note executed pursuant to an agreement containing various prohibitive covenants was held to be a note, and not subject to the tax.

5.5. In *Allen* v. *Atlanta Metallic Casket Company* (1952, 197 Fed. 2d 460), a $600,000 note executed by a manufacturer in favor of a life-insurance company, and secured by a mortgage containing various prohibitive covenants, was held to be a note and not subject to the tax.

5.6. In *Ely & Walker Dry Goods Co.* v. *U. S.* (1953, 201 Fed. 2d 584), corporate notes in the amounts of $1 million and $6,500,000 were held to be "notes" and not "bonds," "debentures," or "corporate securities" as defined in section 1801, and, accordingly, were held not subject to the tax.

5.7. In *Leslie Salt Co.* v. *U. S.* (1953, 110 F. Supp. 680), long-term promissory notes in the amounts of $1 million and $3 million, respectively, executed by a manufacturer in favor of an insurance company lender, pursuant to loan agreements containing various prohibitive clauses, were held to be notes, and not "bonds" or "debentures," and, therefore, not taxable.

5.8. In *Niles-Bement-Pond Co.* v. *Fitzpatrick* (1953, 112 Fed. Supp. 132), 29 serial promissory notes aggregating $3,125,000, with maturities spread over 7 years, were held to be debentures, and so subject to the tax.

5.9. In *Gamble-Skogmo, Inc.*, v. *Kelm* (1953, 112 Fed. Supp. 872), a $13 million note executed by a manufacturer in favor of a life-insurance company pursuant to a loan agreement was held to be a "debenture," and, therefore, subject to the tax.

6. TREASURY DEPARTMENT RULINGS

6.1. The Treasury Department has consistently taken the position that a promissory note secured by a mortgage is a note and not subject to the tax, despite the fact that the mortgages contain various prohibitive covenants, most of which are of the same type as are mentioned in some of the cases cited above which were decided adversely to the taxpayer. Some of these special rulings are those dated July 14, 1948, August 18, 1948, and June 23, 1949. There is, of course, no ground for such an artificial distinction.

6.2. In the special ruling dated July 14, 1948, the Treasury Department announced, in the following language, certain arbitrary criteria which might lead it to the conclusion that a note is not a note but a debenture, and so subject to the tax:

"In determining whether particular notes should be classified as debentures, the Bureau will take into consideration, inter alia, not only the circumstances under which the notes were issued but also the conditions to which they are subject. Included in the conditions, some or all of which if present, directly or indirectly, will cause the notes to be regarded as prima facie coming within the classification of debentures, are: (1) provision for amortization, (2) requirement of maintenance of a specified minimum capital on the part of the issuer, (3) impost upon the issuer of a limitation upon the creation or assumption of other indebtedness, (4) impost upon the issuer of a prohibition against conveyance of assets, (5) provision for an acceleration of the maturity or prepayment prior to maturity, and (6) requirement that issuer furnish the note holder with copies of annual balance sheets or other information of similar character."

Internal Revenue Code 1801 affords no basis for choosing one set of determining factors as against another. This ruling alone demonstrates the need for clarification, and section 4381, H. R. 8300, in no way satisfies that need.

7. INCONSISTENCY WITH OTHER PROVISIONS

7.1. H. R. 8300 not only will fail completely to bring order out of chaos, but will perpetuate ambiguity and compound the confusion by including dissimilar definitions of like terms in such sections as 4381, 165 (g) (2), 1232, 582 (c) and 171 (d).

8. CONCLUSION

8.1. In order to carry out the congressional intent as clearly disclosed by its legislative history, and in order to lay at rest, once and for all, the confusion which has resulted from conflicting court opinions and special rulings of the Treasury Department, it is submitted that proposed section 4381 (a) should be changed to read as follows:

"(a) CERTIFICATES OF INDEBTEDNESS. For purposes of the taxes imposed by sections 4311 and 4331, the term 'certificates of indebtedness' means bonds, debentures and all other instruments which are issued by a corporation and which have interest coupons attached or are in registered form."

Respectfully submitted the 14th day of April 1954.

MUECKE, MULES & IRETON,
By BERTHOLD MUECKE, Jr.

(The writer is a member of the bars of Maryland and New York, a member of the law firm of Muecke, Mules & Ireton, 14 Light Street, Baltimore, Md., and has had extensive experience in connection with the subject of the foregoing statement.)

New York, N. Y., *April 14, 1954.*

Hon. Eugene D. Millikin,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

Dear Sir: In connection with the hearings being conducted by your committee on H. R. 8300, I desire to call your attention to the provisions of subsection (c) of section 1304, inserted, as the House report states, to overrule the decision of the fourth circuit in *Hofferbert* v. *Marshall* (200 Fed. (2) 648). It is respectfully submitted that the insertion of this provision is violative of the spirit and purpose of sections 51 (b) and 12 (d) enacted in 1948, when H. R. 4790 was passed.

The last-named sections were enacted, as set forth in the report submitted by your honorable self as chairman of the Committee on Finance, No. 1013, 80th Congress to equalize the tax burdens between residents of community-property States and those of common-law States. As the report sets forth, numerous common law States (of which New York was one), were proposing the adoption of community property status in order to eliminate the existing tax discriminations, but in reliance on relief to be granted by the Congress, deferred taking action along that line. The passage of H. R. 4790 granted such relief by putting residents of common-law States on a par, taxwise, with residents of community-property States, whereupon all agitations and proposals for conversion to community-property status were abandoned by the common-law States.

The enactment of subsection (c) of section 1304, would, as hereinbefore set forth violate the spirit and purpose of this remedial legislation, by reinstating, to a large extent, the discrimination between the two types of States that had existed prior to the passage of H. R. 4790, as I read he language of that section.

Subsection (c) provides that income from services rendered over a period of 36 months or more, hereinafter termed "long-term compensation," "shall be considered income only of the persons who would be required to include the item of gross income in a separate return filed for the taxable year in which such item was received or accrued." In community-property States, one-half of the earned income of a husband belongs to the wife. Accordingly, half of the long-term compensation would represent an item of income which the wife would be required to include in a separate return that might be filed by her. She would therefore be entitled to the benefit of proration which a wife in a common-law State would, because of such subsection (c) be barred from getting.

I respectfully submit that a spirit of fairness should bar the revocation of the full equalization anticipated from, and granted by, H. R. 4790. Subsection (c) should be eliminated.

Respectfully,

Benjamin Mahler,
Counselor at Law.

Wisconsin Bar Association,
Section on Taxation,
Milwaukee, Wis., April 14, 1954.

Re H. R. 8300

Hon. Eugene D. Millikin,
Chairman, Committee on Finance,
United States Senate,
Senate Office Building, Washington 25, D. C.

Dear Sir: The taxation section of the Wisconsin Bar Association has reviewed a number of provisions now contained in the proposed Revenue Code of 1954. In connection with the public hearings which your committee is now undertaking, we respectfully call your attention to the following subjects which relate to matters of substance contained in the proposed code.

(1) SECTION 302 ENGENDERS CONFUSION AND INEQUITIES

After a careful study of this section, we are convinced that if enacted, it will generate great confusion in the minds of taxpayers, their representatives, Internal Revenue administrators, and the courts, and will result in much unnecessary litigation in future years inevitably required to resolve the strange and unanticipated problems of construction. Moreover, the overall effect, we believe, will be to make it much more uncertain and difficult for the stockholders of small closely held companies to dispose of their stock in spite of the most compelling reasons. So also, because of the narrow and very limited application of the exceptions contained in section 302 (a) (1) to (6), it is clear that the application of the dividend treatment rule of the present section 115 (g) (1) will be greatly extended under section 302 (b) of H. R. 8300 in the case of small companies whose stock is not widely held.

Although subsection 302 (a) (3) allows capital gain treatment on a stock redemption which is "in complete redemption of all of the participating and nonparticipating stock held by a shareholder," subsection 302 (c) requires the "attribution of ownership" test to be applied thereto unless the provisions of subsection 302 (c) (2) are applicable. Under subsection 302 (c) (2), the attribution of ownership test (of sec. 311 (a) only) is not applicable if immediately after the redemption, the distributee has no interest in the corporation other than that of a creditor and does not acquire any such interest within 10 years of the date of distribution. However, subsection 302 (c) (3) contains an "exception to the exception" set forth in section 302 (c) (2), and provides that the attribution of ownership test of section 311 (a) shall apply notwithstanding subsection 302 (c) (2): (i) to such portion of the redeemed stock as was received as a gift by the distributee within 10 years prior to the date of redemption, or (ii) if the distributee had made a gift of stock within 10 years before the date of redemption "unless the transaction did not have as one of its principal purposes the avoidance of income tax." Our objections to these various subsections will be discussed in order.

(a) Section 302 (c) (2) leads to unconscionable results

The following example illustrates the unconscionable results which are possible under this subsection:

X owns 15 percent of the common and preferred stock of Y corporation, and the other 85 percent is owned by his two sons, who had purchased it from him at fair market values 10 years previously. X wishes to retire and to completely sever his relationship with Y corporation, and since there is no market for his stock, the corporation redeems all of his stock in 1954. He immediately resigns as an officer and director of the corporation and completely severs all other business relations with it. At this point, the redemption qualifies for capital gain treatment under subsection 302 (a) (3), and X files his return and pays capital gain tax on his gain. In 1963, the sons, who then own 100 percent of Y corporation, die in an accident (or are forced to retire due to ill health or some other compelling reason). Because X is the only person familiar with the technical operation of Y corporation and capable of its management, it becomes imperative that he reenter the employment of the company to keep it in operation. At this point, the "attribution of ownership" test of section 302 (c) would then be retroactively applicable to the 1954 redemption and automatically, the distributions which X received in 1954 would be treated as dividends to the extent that Y corporation had earnings and profits. Thus, not only would X be faced with a substantial tax deficiency, but also, interest has accrued thereon for a 9-year period, totaling 54 percent. At this point, it becomes financially impossible for X to resume the management of Y corporation because of the huge deficiencies and accrued interest which he would be forced to pay. Because of this fact, the operation of business is impossible and must be disposed of in a forced sale.

To further illustrate the harsh and incongruous results of this section, assume that at the time of redemption in 1954, X retained debenture bonds in Y corporation. Because of a business failure in 1963, a bankruptcy reorganization occurs, and in the reorganization, under court order (and perhaps against X's wishes) bonds must be exchanged for stock in Y corporation. In this case, X does not again become an officer, director, or employee, but only a stockholder pursuant to court order. Here again, the same results as set forth in the foregoing example apply, and X, the involuntary stockholder, is subjected to substantial deficiencies and interest which have retroactively accrued on the 1954 redemption.

(b) Subsection 302 (c) (3) introduces inflexible tests and leads to unanticipated results

This subsection places an exception upon the exception contained in section 302 (c) (2) to the general rule of constructive ownership set forth in section 302 (c) (1), and thereupon is subjected in the last clause to a further exception to the exception. Not only is this drafting process of pyramiding exceptions upon exceptions conducive to complete confusion even to the trained tax experts, but moreover, these multiple exceptions lead to strange, harsh, and unanticipated results, as illustrated by the following examples:

Example 1.—In 1946, X, in order to stimulate the interest of his two sons in the business and to reduce his own income taxes, gives 85 percent of the common and preferred stock of Y corporation to his two sons. In 1954, X completely severs his connection with the business and the company redeems his remaining 15 percent common stock interest and his remaining 15 percent preferred interest. The entire proceeds of the common and preferred redemption would be taxed as a dividend. (The common redemption is not within section 302 (a) (4), and therefore, both redemptions stand or fall under section 302 (a) (3), as limited by section 302 (c) (3).)

Example 2.—In 1947, A's father, who owned 10 percent of the common stock of B corporation, gave one-fifth of his stock, or 2 percent of the total outstanding common stock, to A in order to stimulate A's interest in the business, and also to minimize his own income taxes. The gift was bona fide and recognized as such by internal revenue in the audits of the 1946 gift tax return and subsequent income tax returns. In 1954, A decided he wished to study medicine and not go into the business of B corporation, in which he had never been employed or had any connection except as a minor stockholder. To finance his professional education, he sold his 2 percent common stock interest to the corporation. Because of the provisions of section 302 (c) (1) and (3), retroactively applied to a perfectly proper gift made 9 years before the enactment of this section, the transaction would be treated as an ordinary dividend.

Under the present statutory provisions of section 115 (g) as construed by the courts, the examples referred to would not require treatment as dividends, and we cannot believe that either the House or the Senate committees intend such an incongruous and illogical result.

We should like to point out that the apparently innocuous requirement that a gift have a "business purpose" as is required by section 302 (c) (3) is completely new and startling in our tax laws and retroactively imposes a severe penalty on prior gifts which was certainly not contemplated by either Congress or taxpayers during the past 10-year period.

It seems apparent that the results set forth in the above examples could not have been completely appreciated by the House of Representatives when it passed this section of the 1954 Revenue Code. Not only are these results much more harsh than those which have been previously evolved by the courts, but the rules set forth in section 302 allow no flexibility. We cannot believe that the quest for certainty should be deemed of such importance as to give rise to many instances of extreme hardship and obvious arbitrary treatment.

(2) SECTION 309 RETROACTIVELY IMPOSES SEVERE AND UNWARRANTED PENALTIES

This section is also an attempt to impose, retroactively, rules which go far beyond the present statutory and judicial principles regarding redemptions of preferred stock. Objections to specific subsections are separately discussed.

(*a*) *Subsection 309 (a) (3) is deficient in draftsmanship and is commercially unrealistic*

This section imposes the 85 percent penalty tax upon redemptions of preferred which were originally issued for money or money's worth to the extent that the redemption price exceeds 105 percent of the fair market value of the property for which the stock was originally issued. Here again, it appears clear that in the quest for certainty the bill has imposed a commercially unrealistic and unworkable standard. We respectfully invite your attention to the fact that many commercially negotiated preferred stocks must provide for a redemption or "call" price in excess of 105 percent of issue price in order to make the issue attractive to investors. This subsection retroactively imposes a severe penalty on the redemption of this stock to the extent that the redemption price exceeds 105 percent of issue price. Thus, a preferred stock issue sold to the public in 1935 at $100 per share, under the inducement of a redemption in 20 years at $110 per share, would subject the corporation to this grave penalty when it redeems the stock in 1955.

Another commercial problem left unanswered by section 309 (a) (3) is the treatment to be accorded underwriters' commissions paid by the issuer in connection with a public offering. In the normal underwriting agreement, an underwriter's commission of 5 percent to 10 percent of issue price is exacted on a public offering of preferred stock. In many instances the corporation receives from the underwriter a price determined by subtracting from issue price the underwriters' commission and the original certificate or certificates are then issued directly to the underwriter. The underwriter then sells shares as a public offering at an established issue price. Subsection 309 (a) (3), as written, could be construed to require the base (upon which the 105 percent is computed) to be issue price less commission. If this construction is placed upon this subsection by the Treasury or by the courts, the effect thereof would be to practically eliminate the possibility of issuing preferred stock through an underwriter. Although we feel that such a construction would be unwarranted, there is some precedent therefor furnished by *Cleveland Graphite Bronze Co.* ((1948) 10 TC 974), wherein it was held that for the purpose of computing the "net capital addition" under section 713 of the World War II excess-profits-tax law, invested capital must be reduced by the amount of underwriters' commissions paid by the issuer. As stated, it is felt that the two situations are not analogous, but that such a construction is possible. The following example will illustrate the effect of this possible construction:

X corporation agrees with an underwriter for a public issuing of $40 preferred stock. The underwriter exacts a commission of $3 per share so that the net received by the issuing corporation is $37. In order to market the security, a redemption price of $42 is provided. Because 105 percent of $37 equals approximately $38.85, upon redemption $3.15 of the redemption price would be subjected to the 85 percent penalty tax, even though the redemption price is only 105 percent of the amount which each particular stockholder has actually paid to the underwriter.

We feel that subsection 309 (a) (3) is seriously deficient as regards this particular problem and would recommend that an appropriate clarification be inserted either in section 309 or in section 312, which deals with definitions.

(b) Section 309 (c) is discriminatory and confiscatory

The effect of this subsection is to attribute an issue date of January 1, 1954, to any preferred stock issued prior to that date, regardless of its actual date of issuance. Our study of the report of the Committee on Ways and Means indicates that this provision was hastily inserted in answer to ill-founded objections made in the minority report. (See p. B21, Report.)

The entire concept set forth in section 309 is novel and goes far beyond any provisions of present law. To impose this provision retroactively appears to be extremely discriminatory against those preferred stock issues which have been outstanding for many years. It places shareholders who received preferred stock dividends on January 1, 1954, in the same holding period status as stockholders who received preferred stock dividends in 1913. So also, the section covers stock sold for cash many years prior to 1954, to the extent that the redemption price exceeds 105 percent of the issue price. Thus, stock sold in 1939 under a contractual obligation to redeem at 108 percent of issue price in 15 years will precipitate an 85 percent transfer tax upon redemption in 1954. Either that contractual obligation must be honored or the stock must be frozen until 1964. Thus, old preferred stock is discriminated against by being frozen for many years beyond the ten year period imposed on future issues of preferred stock.

The practical effect of this provision is to "lock-in" old preferred stock which should be retired as a matter of good business. Although it is the piously announced intention of the Ways and Means Committee to "remove inequities" and to "reduce tax barriers to future expansion of production and employment" (p. 1, Report), this provision spawns an unparalleled inequity and forcibly "locks-in" for a 10-year period high dividend preferred, outstanding up to 40 years, the redemption of which might be dictated by a desire to use preferred dividends for "future expansion of production and employment." It is obvious that the supposed evil which the minority seeks to enjoin has been replaced by a provision which is on its face inequitable and consficatory.

(3) SECTION 359 TREATS SMALL CORPORATIONS UNFAIRLY

This section sets forth the rules regarding the tax-free nature of reorganizations involving corporate acquisitions of stock and property and corporate separations. Particular reference is made to the treatment of corporate acquisitions of stock or property as regards those corporations which are not "publicly held." The House committee report expresses the opinion that many reorganizations of small corporations have as their purpose the distribution of earnings to shareholders at capital gain rates (p. 39, Report). It is apparently for this reason that different ownership tests have been imposed on closely held corporations. However, upon review, it appears clear that if this evil did exist the attempted correction thereof by a blanket discrimination against closely held corporations would appear to be extremely unwise.

The adoption of this "limitation of relative size" requirement would result in the taxing of transactions which do not involve disguised distributions of earnings and will require the payment of tax upon exchanges which are not sales and for which there is no receipt of liquid assets out of which the tax may be discharged. The 25 percent and 400 percent tests which must be met by closely held corporations, but not my industrial giants, is not only discriminatory, but imposes new, doubtful and ambiguous concepts into the reórganization law, which has been painfully and gradually developed since the 1920's.

Many business factors have influenced smaller corporations to merge into larger listed competitors. In many instances, the acquiring corporation does not have sufficient liquidity (primarily because of high income tax rates) to purchase the transferee corporation's stock for cash. The traditional method of acquisitions in such cases is to enter into a tax-free reorganization (almost always with Treasury sanction) wherein the stockholders of one company receive stock of the acquiring corporation in exchange. It is difficult to envision the reasons behind the new philosophy that this established practice is now non grata if the transferee is not "publicly held" but is perfectly permissible taxwise if the parties concerned are listed companies. We, therefore, recommend that the distinction between "publicly held" and "closely held" corporations be abolished and the 25 percent and 400 percent tests be eliminated from the bill (secs. 354(b) and 359).

Several ambiguities and uncertainties inherent in the language of sections 354 and 359 become apparent when that section is considered with respect to proposed corporate acquisitions and reorganizations which involve the combining of corporations in which there previously existed interrelations of shareholdings. Although examples of these uncertainties are not included herein because of space limitations, we understand that specific examples of these ambiguities have been furnished to your committee by other organizations, and we, therefore, do not repeat them here.

CONCLUSIONS

This letter has dealt only with three major provisions of subchapter C of the proposed code. Because of time and space limitations, we have not referred to other sections which appear to be deficient either in draftsmanship or in substance. Our study of the proposed code has convinced us, however, that it is unwise to eliminate technical language which has been developed and construed over a 40-year period and under the guise of simplification and clarification, to substitute for it other language even more technical which has not been construed. We are not opposed to simplification or clarification as such, but feel that any wholesale revision such as that contained in this bill should receive full consideration by not only those charged with administering the laws, but also those who, as tax practitioners, must use it to advise clients.

We think that it is particularly unwise and unfair to enact such a far-reaching revision with retroactive features. It would seem more desirable if a new code is to be enacted at this session that its provisions which make substantive changes should be prospective in application (other than the recommendations made to Congress by the President) and that taxpayers should be afforded a reasonable length of time in which to rearrange their affairs so as to avoid undue hardships to which they would otherwise most certainly be subjected. The principal offender in this regard is subchapter C, and we recommend to your committee the suggestion that this subchapter be held in abeyance and that present law dealing with that field be reenacted until such time as it has been thoroughly considered and improved.

The fact that time limitations which were imposed made adequate consideration of the technical and complex provisions of the bill completely impossible is demonstrated by the minority view of the committee which states:

"We fear, that, in the hasty manner in which this most complicated legislation has been handled, we will have to spend many weeks straightening out the law in the future, if the bill becomes law" (p. B6, Report).

Respectfully submitted.

JOHN S. BEST,
Chairman, Wisconsin Bar Association Taxation Section.

Secretary, John L. Palmer.

Directors of Wisconsin Bar Association, Taxation Section: Joseph R. Barnett, John S. Best, Robert E. Nelson, Louis L. Meldman, Edmund B. Shea, S. R. Stroud, Walter W. Hammond, Henry P. Hughes, Henry O. Schowalter, Richard L. Greene, Richard R. Teschner, and William McNamara.

JOSEPH GETZ & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
New York, N. Y., April 14, 1954.

Recommendations re basis of property acquired from a decedent, section 1014 Revenue Code of 1954

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, D. C.

GENTLEMEN: In the proposed section 1014 of H. R. 8300, the bill to revise the internal revenue laws of the United States passed by the House of Representatives, there is presented the provision with regard to the basis of property, in the hands of a person acquiring the property from a decedent. It was evidently the intention of the House, when revising the old law on this subject, to correct certain inequities and discriminations which existed under section 113 (a) (5) of the Internal Revenue Code of 1939, as amended. The House Ways and Means Committee report very clearly states this intention as being an underlying purpose for the revision of the section, as is stated in the following excerpt from House Report 1337, chapter XXVI, Gain or Loss on Sale of Property:

"There appears to be no justification for denying some property included in a decedent's gross estate for estate-tax purposes a new basis at date of death while giving this new basis in most cases."

The provisions of the present law in connection with basis of property acquired from a decedent, does not permit the taxpayer to use the basis of the property as it was included in decedent's gross estate for estate tax purposes, if the property had been transferred in contemplation of death, or it had been acquired by the surviving tenant of a joint tenancy or a tenancy by the entirety. or it had been included in the gross estate as a reserved income transfer.

The writer desires to call your committee's attention to two instances wherein the section, as it presently stands, does not give the relief to taxpayers from the discrimination and inequities which is the evident purpose of the revision of the present Internal Revenue Code covering this subject.

Proposal I—That where a taxpayer according to the terms of the decedent's will, is permitted to acquire property from the decedent's estate at a price which is less than the value of such property as used for estate tax purposes in the decedent's estate, the basis to the taxpayer of such property should be the value for estate tax purposes and not the amount paid therefor by the taxpayer:

The above proposal relates to another very important situation, which should be rectified in order to remove the discrimination and inequity of the present law.

There are many taxpayers who would be affected by the proposal. Testators frequently provide in their wills that the subjects of their bounty should receive specific property from the legal representatives of their estate at a price which is below the fair market value of such property at the time of decedent's death, and as valued for estate tax purposes. It is their intention to make a testamentary gift to the person of a part of the property, which gift is conditioned upon the legatee making payment of a specific sum or percentage of the value to the estate. Estate planners encourage this technique of distribution as a method whereby certain heirs may acquire an interest in a business conducted by the testator at a price which would be within the financial means of such heirs, and yet provide funds in the estate which would be available for distribution to the surviving widow, other legatees, administration expenses and estate taxes. This method is also used in cases where the testator wishes that key employees should acquire an interest in his business, so that they may continue in its employ and run the business for the benefit of his family and other heirs.

The Internal Revenue Service for estate tax purposes considers the difference between the fair market value and the prescribed purchase price as a testamentary disposition by the decedent and the full value of the asset is taxed in the decedent's estate. As regards the subject of the testator's bounty, the person who elects to acquire the property from the estate at the reduced price, the Internal Revenue Service, however, takes the viewpoint that such property was acquired for a consideration equal to the price paid therefor. The basis of the property to the person so acquiring it, is held to come under section 111 of the present Internal Revenue Code, which is similar in context to the proposed section 1001 of the Revenue Code of 1954, as passed by the House. At the present time, there is a situation which requires clarification, because of the conflict under the present law between section 113 (a) (5) (basis of property acquired from decedent) and section 111 (basis of property acquired by consideration paid). The courts have already resolved this conflict of law adversely to the taxpayer. In the decision *J. Gordon Mack* v. *Commissioner of Internal Revenue* (3 T. C. 390 (1944) aff'd 148 F. (2d) 62 (C. C. A. 3, 1945), certiorari denied by Supreme Court (326 U. S. 719)), it was held that the taxpayer's right to purchase stock of a corporation from the decedent's estate at 50 percent of its fair market value, was an option right, to which no value could be accorded because it was acquired by the taxpayer without cost. The basis to the taxpayer was the price paid for the stock, despite the fact that the decedent had specifically designated the taxpayer (his son) as one of the persons entitled to purchase the stock at the reduced price, and the stock was valued for estate tax purposes at 100 percent of its value.

It appears to be a clearcut discrimination, if a person to whom has been given a valuable right, or option by a decedent, which right or option has been taxed as a testamentary disposition in the decedent's estate, is deprived of the value of such right or option in the determination of the basis of the property acquired by the person. This in inequitable, because it seems that the form which the transaction takes, governs under the present law, instead of the substance of the transaction. To aid in clarification, it is recommended that a revision of the code, so that it covers transactions of this type, should be specifically made, and there not be required any forced construction in this respect.

Paragraph (a) (9) of section 1014 of the proposed code, it is believed would not cover the situations discussed above, because "property * * * acquired from the decedent by reason of death, form of ownership, or other conditions" would seem to cover only transfers of property in contemplation of death, property acquired by a surviving tenant of a joint tenancy or tenancy by the entirety, or property the subject of a reserved income transfer.

A suggested revision of the applicable paragraph of the proposed code, so as to meet the objections raised herein, is submitted at the end of this memorandum.

Proposal II—That the effective date of section 1014 paragraph (a) (9) should be to transactions occurring after December 31, 1953, instead of being applicable to cases of decedents dying after December 31, 1953:

Since the purpose of the amendments which are contained in section 1014 was to correct discriminations and inequities with reference to "the basis of property acquired from a decedent," the effectiveness of the amendments would be extremely diluted, and its present benefits to taxpayers would be greatly diminished if it is effective only in cases where the decedent died after December 31, 1953. The matter of basis for property to a taxpayer is important when such taxpayer sells the property, and where the property is depreciable or exhaustible and the taxpayer may be entitled to deductions for depreciation or amortization thereon. If the amendments are made effective only to cases where the decedent died after December 31, 1953, then the matter of basis would in perhaps the majority of situations not arise until some future date, or perhaps never. There would be no relief from discrimination and inequity to the many taxpayers who had acquired property from decedents who had died prior to December 31, 1953, and who would have transactions after that date, where the question of basis was important. If the new amendments are made applicable to transactions which occur after December 31, 1953, these amendments would benefit the class of taxpayers who are presently discriminated against. The transactions which fell in the category in which the use of the estate tax basis was not allowed, could use such basis on or after that date. Such a change would not permit refunds upon transactions closed in years prior to December 31, 1953. It would not produce a deluge of claims for refund. The recommendation would be entirely prospective in its mature and would be of benefit only to those taxpayers who had transactions after January 1, 1954.

The following is submitted to your committee, as a draft of the wording of section 1014 (a) (9) to give effect to the two proposals submitted above (new matter in italics):

Section 1014 (a) (9):

"*For taxable years beginning after December 31, 1953*, property (other than annuities described in section 72 *which was* acquired from the decedent by reason of death, form of ownership, or other conditions, and if by reason thereof the property was required to be included in determining the value of decedent's gross estate under chapter 11 of subtitle B, or section 811 of the Internal Revenue Code of 1939. If property was acquired upon an option or right to acquire such property from the decedent's estate by will of the decedent at an amount less than the value of such property required to be included under chapter 11 of subtitle B or section 811 of the Internal Revenue Code of 1939, the basis for such property shall be the value at which such property was required to be included.

Respectfully submitted.

JOSEPH GETZ.

STATEMENT SUBMITTED BY HARRY E. GREEN, ATTORNEY AT LAW, NEW YORK, N. Y., RE SECTION 923 OF H. R. 8300

Section 923 of H. R. 8300 contains in subparagraph (iii) of paragraph (3) under section (a) a provision that the foreign tax credit with regard to dividends from a foreign corporation cannot be claimed if the earnings and profits out of which the dividends are paid relate to a year more than 25 percent of the gross income of which is derived from the sale of articles or products "manufactured in such foreign country and intended for use, consumption, or sale in the United States * * *."

In the House committee report relating to this section, the following statement is made at page A255:

"The requirement that, in order for earnings and profits to qualify for preferred dividend purposes, not more than 25 percent of the gross income of the foreign corporation for the year must be derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States, is confined to manufacturing. Thus the requirement would not apply, for example, to the mining or processing of metals or the extraction or refining of oil, in a foreign country and intended for consumption, use, or sale in the United States. The words 'intended for use, consumption, or sale in the United States' contemplate objective manifestations of an intention to turn out a product which is to be marketed in the United States as evidenced by the design of the product, the packaging or labeling thereof, descriptive material thereon or other indicia of intent that the product will ultimately be marketed in the United States * * *."

I believe that under the foregoing statutory provisions a substantial question will arise with regard to what is intended to be included and what is intended to be excluded by the phrase "articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States." For example, I represent a company that is engaged in the production of raw sugar in Cuba and in the Dominican Republic. Our company grows or buys the cane, which is then ground in a raw-sugar factory, the end product of which is raw sugar. Raw sugar is not marketed in the United States to the ultimate consumer. However, raw sugar is sold to American refiners, who further refine and process it and then sell it under their own trade names. My client does not in any way distribute sugar to the wholesale or retail trade.

In addition, blackstrap molasses is produced as a byproduct in the manufacture of raw sugar. This blackstrap molasses is sold to distillers for the production of alcohol or to distributors as cattle food. My client does not in any way sell molasses directly to the retail trade.

Under the Sugar Act of 1948 the amount of raw sugar which can be brought into the United States from Cuba, the Dominican Republic, and other countries is fixed by quota. Hence Congress has already legislated with regard to how much sugar from such foreign countries can be marketed in the United States as raw sugar by the sale thereof to refiners. With such legislation already on the books, it would appear to be unreasonable and superfluous to have the 25-percent limitation above expressed applicable to raw sugar companies since it will not result in any additional competition in the United States market over and above that which has already been approved by Congress.

Furthermore, if this 25-percent limitation is retained and if it is applicable to the production of raw sugar, the anomalous result is that a country which Congress previously sought to benefit by the Sugar Act is now prejudiced by this provision. For example, under the sugar quota for Cuba a sufficient amount of raw sugar can be sold each year to United States refiners so that a raw-sugar company operating there would derive more than 25 percent of its income from such raw sugar. This is because Congress has set up a quota that results in this, and this quota was set up to benefit Cuba. On the other hand, the permissible quota for raw sugar from the Dominican Republic is so low that no company operating there is able to sell a sufficient amount of raw sugar in the United States market to produce 25 percent of its income from that source. Hence earnings and profits from the production of raw sugar in the Dominican Republic, a country which Congress did not see fit to benefit by a large quota, would qualify for the tax credit, whereas earnings and profits from the production of raw sugar in Cuba, a country which Congress did see fit to benefit by a large quota, would not be able to qualify for the tax credit.

The question thus presented is whether or not the production of raw sugar constitutes "manufacturing" or whether it is comparable to the examples stated by the House committee of the mining or processing of metals or the extraction or refining of oil. This question is of broad general interest since several million tons of sugar are produced in Cuba and other foreign countries in the raw form for sale to United States refiners and also to refiners in other countries. This problem should be clarified in the statute and not left to litigation in the courts.

To clarify the statute and to effect the basic objectives, it is suggested that the following parenthetical expression be added at the end of section 923 (a) (3) (A) (iii):

"*Provided, however*, That the requirement of this subparagraph (iii) will not apply where the basic raw materials employed in the manufacturing are obtained from sources outside the United States."

SERVTEX MATERIALS CO.,
New Braunfels, Tex., April 14, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR: It is respectfully requested that the attached "Statement in Support of 15 Percent Depletion Allowance for Chemical and Metallurgical Grade Limestone Producers" be received for the attention of the committee as appropriate and placed in the printed record of the committee's hearings on H. R. 8300. A copy of the statement is being sent to each member of the committee.

We realize that revision of the tax code is a painstaking task. While we do not want to add to the demands upon your time, we do hope the committee will see that the original intent of Congress in establishing a 15-percent depletion allowance for chemical grade and metallurgical grade limestone regardless of end use is restated and preserved by appropriate language in H. R. 8300 or in the report. From all indications this has always been the intent of Congress.

As pointed out in the attached statement, Treasury has had difficulty interpreting the meaning of the 1951 Revenue Act, as pertains to chemical grade and metallurgical grade limestone. The proposed 1953 treasury regulations would create unjustifiable hardships and unfair competitive advantages as between minerals with identical uses.

The problem is a national one, and although we would not attempt to suggest to the committee the details of a solution we do feel that we should lay the facts before you for consideration. We cannot feel that it is desirable to construe the theory of depletion allowances in such a way as to permit virtual subsidies to one competitive product over another.

Your kindness in giving attention to this problem will be greatly appreciated. We shall be happy to have an expression of your opinion and should additional information be needed we will gladly supply it.

Yours very truly,

H. R. SCHNEIDER,
Secretary-Treasurer.

STATEMENT IN SUPPORT OF 15-PERCENT DEPLETION ALLOWANCE FOR CHEMICAL GRADE AND METALLURGICAL GRADE LIMESTONE PRODUCERS

Mr. Chairman, members of the committee, my name is E. Eikel. I am president of Servtex Materials Co., of New Braunfels, Tex. I am also a regional vice president of the National Crushed Stone Association and a member of the board of directors of that association.

I am before the committee as a producer of chemical and metallurgical grade limestone.

I do not ask for myself or for the industry of which I am a part any relief or special treatment. My purpose is to seek the establishment of proper safeguards guaranteeing that the intent of the Congress will be followed in the administration of our revenue laws.

Briefly, the situation which brings me here is this:

In 1951, the Congress of the United States established a 15-percent depletion allowance for limestone of chemical or metallurgical grade.

The reason for this lies in the needs of modern industry. There are, it is true, many varieties of limestone. Some laymen, of course, regard limestone as merely a sort of common rock. Actually, however, limestone is a valuable nonmetallic mineral. It is one of the great five chemical reagents: water, air, coal, sulfuric acid, and limestone. Modern industry, especially the chemical and metallurgical industries, are requiring limestone in greater and greater quantities. Limestone suitable for such purposes is relatively rare. The wisdom of the Congress in establishing a 15-percent depletion rate for this mineral is unquestionable.

After the Revenue Act of 1951 was passed, the Treasury Department encountered the problem of definition. Although the terms "chemical grade" and "metallurgical grade" as applied in the act to limestone were not specifically defined, the statute itself established a grade, not an end use, test for chemical and metallurgical grade limestone. There is no basis anywhere in the legislative history of the statute for changing the plain language of the Congress.

For nearly 3 years, however, the problem of definition was unsettled. Finally, the Treasury Department, in regulations issued last year, decided that the terms should be defined by use—that is, "chemical grade" meant "used or sold for use in the chemical trades"; "metallurgical grade" meant "used or sold for use in the production of metals."

On the surface, this might to some appear as a logical definition. In reality, such an approach to a definition is wholly illogical and the practical results not only are inequitable but actually would prove costly to producers of such premium grade limestone.

It is illogical, in the first place, to assume that the use of any raw material can determine its grade. The grade is determined by the composition or nature of the commodity. Crude oil, for example, is graded according to how pure it is; using high-grade oil for a low-grade purpose does not in any way alter its grade.

What this Treasury Department standard meant to us illustrates the inconsistency of such an approach. From our quarry, we produce only one grade of limestone. Yet in the Treasury Department's eyes, this limestone was high grade if a chemical industry bought it, and it was not high grade if the State Highway Department or the Federal Government bought it. In other words, who the customer was and what he did with the stone determined our rate of depletion allowance—although our costs and our loss through depletion were the same no matter who bought the stone.

The real effect of this was to place us at a severe competitive and economic disadvantage. In Texas we are in the relatively early stages of industrial growth. We have customers for our limestone in the chemical and metallurgical industries, but the total demand for these nearby industries is not sufficient to consume the total production we must maintain to conduct a profitable business.

The bulk of our business is with the State highway department, which uses our limestone for highway construction purposes. This is the same stone which the chemical and metallurgical trades use. Rock asphalt and crushed limestone are strong competitors in the highway construction industry in Texas. Deposits from which rock asphalt is being quarried principally for highway and related construction are located west of Uvalde, Tex. For all practical purposes identical problems are faced by the quarryman whether the deposit be of limestone, or rock asphalt. The opening of such a deposit is an expensive undertaking.

The question of end use is not considered by the Treasury Department in granting 15 percent depletion to rock asphalt. Texas rock asphalt is limestone naturally impregnated with a small amount of asphalt varying roughly from 1 to 12 percent. This crushed limestone rock asphalt is sold as crushed stone for highway- and road-building purposes, for ballast, and for other purposes in direct competition with our crushed limestone.

Mixtures of rock asphalt and flux oil and mixtures of crushed limestone and liquid asphalt, such as we produce, also compete directly as ready-for-use paving materials on State highway and other road-construction projects. It is not contended that the added value brought about by this further processing should be subject to percentage depletion, but rock asphalt is allowed 15 percent depletion whereas crushed limestone used for the same purpose is listed at 5 percent by Treasury Department.

So, the net effect of this is that when a producer of chemical or metallurgical grade limestone bids for a highway-construction project he finds himself facing a competitor who enjoys a 10-percent advantage—a 10-percent subsidy from the Treasury Department.

This situation arises solely because the Treasury Department defines the grade of a limestone by its use. If the definition rested upon the characteristics of the material there would be no such discrimination.

Last year, this problem was presented by us to the House of Representatives through the Ways and Means Committee. The reception was entitrely favorable. In an effort to correct The Treasury Department's misinterpretation of congressional intent, the House committee made the provisions in H. R. 8300 quite specific regarding the 15 percent depletion on chemical and metallurgical grade limestone.

The House report specifically states that "The rates designated for the minerals specifically provided for in this subsection shall apply regardless of the use to which such minerals are put."

Representative Simpson, of Pennsylvania, further stated on the floor during debate on this measure that it was the intent of the committee that the 15 percent rate apply to chemical and metallurgical grade limestone regardless of use, and that such had always been the intent. In this connection, Mr. Simpson stated: "* * * that is exactly right, that those specified metallurgical or chemical limestones shall have the depletion allowance of 15 percent regardless of how used."

That is why we are here asking the committee to make certain that the intent of Congress is followed. Congress intended "chemical grade" and "metallurgical grade" to describe the type or characteristics of the limestone, not the use of the limestone. Congress had in mind grade, not end use. Yet the Treasury Department ruling runs directly counter.

We hope that this committee will find time, in the course of your deliberations, to restate the original intent of Congress in such manner as to eliminate this misinterpretation of the law by the Treasury Department.

Recently, the Treasury Department did provide the Joint Committee on Internal Revenue Taxation with a possible new definition which I want to mention. This definition provided that chemical and metallurgical grade limestone should be defined as meaning calcium or magnesium limestone containing an aggregate of not more than 5 percent by weight of sulfur and the oxides of silicon, iron, and aluminum.

Let me say that, insofar as our production is concerned, this definition would be quite satisfactory. However, it should not be adopted by the Congress without full knowledge of the possible effects.

Let me explain this point: there is no standard "book" definition of these terms. Generally, it means high-calcium limestone, with a very low impurity content. However, there are many other factors involved. Such limestone, for example, must ordinarily be used in great quantities by industry; thus freight rates and shipping costs become an important consideration. The more nearly pure the limestone the less the amount needed for certain uses. Industry will generally use the most economical source of limestone, taking into consideration impurity content and freight costs.

In some sections of the country, such as the White River Valley of Arkansas, I understand industry has located plants near the source of high-calcium limestone deposits and is utilizing large quantities of limestone which contains more than 5 percent impurities. This has opened a whole new market for a mineral resource which might, otherwise, never have been economically produced. Impurities in limestone deposits of the White River Valley, according to my information average about 7.45 percent. In this connection, it should be noted that the United States Department of Agriculure in two States, I believe, has defined limestone containing not less than 60 percent calcium carbonate equivalent as chemical grade.

Now if the Congress should adopt the 5 percent impurities limit proposed by the Treasury Department the result might be to classify out of the 15 percent depletion rate some limestone producers who are selling to the chemical and metallurgical trades. This would be undesirable.

Because the range of acceptability of such limestone to these industries is relatively flexible, ranging somewhat beyond 5 percent it would seem more desirable to set the limit at 8 or 10 percent. Such a limit would be beyond the arbitrary level involved at the 5-percent limit. It would not be so great, however, as to grant 15 percent depletion to limestone wholly unsuited to chemical or metallurgical uses.

Or, the committee might wish to provide a definition not subject to frequent and arbitrary change, by merely adding to the Treasury Department language the words, "or limestone suitable for use in the chemical and metallurgical trades." Thus, if a technological development or economic condition justified the use of limestone with a higher impurity content the "suitability" test, rather than the "use" test, would allow equitable treatment.

The courtesy of your consideration of this matter is greatly appreciated.

LEACHMAN, MATTHEWS & GARDERE,
Dallas 2, Tex., April 14, 1954.

Re Proposed Internal Revenue Code of 1954, part II of subchapter C of chapter 1 of subtitle A, dealing with corporate liquidations.

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee of the Senate,
Washington 25, D. C.

DEAR SIR: I am writing with regard to the proposed provisions of section 333 (a) of part II of subchapter C of chapter 1 of subtitle A, which has to do with "Gain from the sale of property in connection with corporate liquidations."

Section 333 provides that, "No gain shall be recognized to a corporation upon a sale of an asset *after the adoption of the plan of partial or complete liquidation* (as defined in section 336 (a) and (b)) if such sale is incident to such liquidation and the distribution and liquidation of all of the assets of the corporation * * * is completely within the taxable year in which such sale occurs or within the succeeding taxable year," except with respect to certain exceptions not relevant here. [Emphasis supplied.]

Section 336 makes it clear that a distribution by a corporation shall be considered as having been made pursuant to a plan of liquidation if the distribution is made "*subsequent to, and in accordance with, a resolution adopted by the shareholders or the board of directors* under which the termination of the business or businesses and the transfer of assets and redemption of all or a part of the stock is authorized." [Emphasis supplied.]

As in the case of the other income-tax provisions of the code, these provisions of the law are effective with respect to all taxable years beginning after December 31, 1953.

In Texas and many other States the affairs of closely held corporations are not handled as punctiliously with respect to written records of board of directors and stockholders meetings, formal resolutions, and other such similar matters, as is true in the case of large widely held corporations where such procedures are more or less mandatory because of the diversity of ownership and the consequent third party responsibility of the board of directors and other officers of the company. Since there is no real necessity for formal resolutions to be adopted in advance, it is quite frequently true that the corporate officials may take steps leading and, for that matter, irrevocably committing the corporation to a certain transaction, prior to the adoption of an authorizing resolution by the board of directors. For example, the board of directors who for the most part control corporation X through stock ownership may intend liquidating the company and may accordingly begin selling off all or a major portion of the operating assets prior to the time that any formal resolution of liquidation is adopted. Of course, in order to consummate such sales, the appropriate officials of the company would necessarily be given the authority to sell the properties in question, but this would ordinarily take the form of a simple resolution, authorizing such dispositions, furnished primarily for the protection of the purchaser. In most instances, the resolution would contain no mention of liquidation or the distribution of the sales proceeds to the stockholders. While the board of directors would intend to liquidate the company after the disposition of all or the major portion of its assets and would thereafter proceed to carry through with the liquidation, the adoption of the enabling resolution would not be accomplished until shortly before the actual liquidation of the company.

The above-described provision of the proposed act will severely penalize many smaller and closely held corporations that for many years have carried out this and similar transactions in an informal manner without any knowledge of the necessity for the formal adoption of such a resolution at any one point of time. In fact, neither the laws of Texas nor the existing provisions of the Internal Revenue Code have heretofore made it necessary for such a liquidation resolution to be adopted prior to the sale of assets by the company as the first step towards its ultimate liquidation.

In the case of companies which during the latter part of 1953 or during 1954, prior to the publication of H. R. 8300, have undertaken the sale of all or a substantial portion of corporate assets with the intent of liquidating the corporation at the earliest possible time, many will not have complied with the requirement of section 333 to the effect that such sales must be made after the adoption of a resolution not only providing for the sale of such assets but also for the liquidation of the corporation and the distribution of all assets to the stockholders. Consequently, such corporations will be required to pay a tax on the gain realized from such sales whereas, had they had any knowledge of this requirement, they could and would with no difficulty have adopted the required resolution. It is no answer to this problem to say that the corporations could have gone through with a complete liquidation prior to the sale of such assets, for in some cases the court holding company problem may have been involved and in others, because of the nature of the assets held, it is mandatory that the corporation itself carry out the sales of its operating properties.

It is submitted in the light of the foregoing that the requirements of section 333 are unduly restricted and place an unwaranted premium on the form of transactions already cast or initially undertaken prior to the release of H. R. 8300, the first time at which such taxpayers would have had any notice of the proposed provisions.

Certainly the purposes intended to be served by the enactment of the provision in question are wholesome and justifiable. Nevertheless, equity will not be served unless those corporations making such sales during the early part of 1954, as a preliminary to liquidation, are accorded the benefits of section 333 despite their failure to adopt the required formal resolution prior to the consummation of the sales.

It is believed that this provision of the law should be so modified as to extend to sales made during any taxable year beginning after December 31, 1953, and and prior to the actual enactment of the Internal Revenue Code of 1954, regardless of the nonexistence of any formal resolution prior to such sales, provided that at the time of making the sales, the corporation intends liquidating. The existence of such an intent that the sales would be followed by complete liquidation should be conclusively presumed in the event the corporation is completely liquidated within 1 year after the date of the enactment of the Internal Revenue Code of 1954. Concededly, Congress is entitled to place any restrictions considered desirable with respect to the applicability of section 333 to any sales made after the enactment of the act. To make this provision retroactive to January 1, 1954, however, but to restrict its application to situations in which a mere formal act took place is to unfairly distinguish between smaller and closely held corporations justifiably operated on a more informal basis and larger widely held concerns the nature of whose operations requires that such steps be taken as a matter of course. Certainly no justifiable purpose would be served by making such a distinction. Moreover, the intent of the act would be served by eliminating the double tax, and the good faith of the selling corporation would be guaranteed by the requirement that it be completely liquidated within one year after the date of the enactment of the proposed act. Should the present provision become law, its application to sales made prior to the issuance of the proposed bill will be completely fortuitous depending as it does upon the mere adoption of a resolution which, for one reason or another, some corporations will have delayed without any reason to believe such omission of any real significance. From the standpoint of existing law, such a delay in the adoption of the resolution would be of no consequence.

It is respectfully recommended that the presently proposed section 333 of H. R. 8300 be amended by the addition of paragraph (d) providing substantially as follows:

(d) Sales prior to effective date of act: In any case in which a corporation sells assets during its first taxable year beginning after December 31, 1953, and prior to the effective date of this act and such corporation would have been entitled to the benefits of (a) above had it adopted a plan of complete liquidation (as defined in section 336 (a) and (b)), such corporation shall be conclusively presumed to have adopted such plan of complete liquidation if the corporation is completely liquidated within 12 months after the effective date of this act.

I am also concerned by the statement of Congressman Reed to the effect that, despite the language of H. R. 8300, the House did not intend the provisions above discussed to apply to liquidation transactions undertaken pursuant to a plan or resolution adopted on or prior to March 9, 1954. In this connection Congressman Reed stated, "in such cases, the resulting tax consequences at both the corporate and shareholder level will be determined under the Internal Revenue Code of 1939."

I think it quite obvious that while Congressman Reed intended to reassure certain taxpayers who had undertaken transactions on or prior to March 9, 1954, with the expectation that they would be taxed under existing law, there are probably just as many corporations and individual stockholders who would like to receive the benefits of the new law with respect to the same types of transactions even though their plans may have been adopted prior to March 9. Here again, it would seem unfair to extend relief to one group who, for one reason or another, may have delayed the adoption of a formal resolution and deny it to others who have gone ahead and taken such action. By way of meeting the understandable objections of both groups to a completely retroactive application on the one hand or to a completely nonretrocative application on the other, it is suggested that taxpayers might be afforded an election as to whether the existing law or the new Internal Revenue Code provisions should apply to such transactions. In the alternative, an acceptable solution to this problem may be furnished by a provision similar to the following:

"In the event that any transaction governed by the provisions of this subchapter was consummated prior to March 10, 1954, or consummated thereafter pursuant to a resolution adopted by the stockholders or board of directors of any corporation prior to such date, the income taxes to the corporation or to any of its stockholders resulting from such transaction shall not exceed the taxes that would have been due under the provisions of the Internal Revenue Code in effect on March 8, 1954."

It will be appreciated if you and the members of the committee will give serious consideration to the foregoing suggestions.

Yours very truly,

THOMAS O. SHELTON, Jr.

COMMERCIAL CREDIT CO., *Baltimore, April 12, 1954.*

Senator EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Attached is a copy of a brief which represents our views in opposition to all section 246 (a) (1) of H. R. 8300, whether life or casualty insurance companies are involved. It will take just 4 minutes to read this brief, and I am sure you will see our opposition is well founded.

Your committee is now conducting hearings on this legislation, but we are using this method of conveying our views to you and your group principally in the interest of economy of time.

If there are any questions, please don't hestitate to contact us.

Very truly yours,

E. L. GRIMES,
Executive Vice President.
Received April 13, 1954

INCOME TAXES

SECTIONS 246 (a) (1), 923 (d) (2), 951 (c) (4), H. R. 8300

THIS BRIEF IS DIRECTED TO AND IS AN OBJECTION TO ALL OF SECTION 246 (a) (1)

FACTS

1. Commercial Credit Co. is owned by 29,814 stockholders.
2. Last year they received $10,969,267 in dividends.
3. To enable it to pay these dividends, Commercial Credit Company received, in addition to its own earnings, dividends in excess of $20,000,000 from 44 finance, banking, and loan subsidiaries; 7 manufacturing subsidiaries; and 2 insurance subsidiaries.
4. Each of these subsidiaries paid a normal and surtax averaging 52 percent on its earnings.
5. One of these subsidiaries writes the largest amount of credit insurance written in the United States. This type of insurance is an important factor in our economy.
6. Section 246 of H. R. 8300 provides, in effect, that the earnings of these insurance companies be taxed twice at the 52 percent rate before being available to the 29,814 stockholders of the parent company.
7. Section 246 of H. R. 8300 states, in effect—

(*a*) That an 85 percent dividend credit (to avoid double taxation at the corporate level) may be applied to the dividends of the 44 finance, banking, and loan subsidiaries and the 7 manufacturing subsidiaries, but not to the dividends of the 2 insurance subsidiaries; and

(*b*) That the earnings of the insurance subsidiaries are subject to a penalty tax because they will be distributed by way of dividends to the parent company, although that is the only way the 29,814 individual stockholders can get the benefit of such earnings.

8. Each of the 28,917 stockholders would receive substantially less income if this arbitrary tax were imposed.
9. Commercial Credit Co. could not change its form of corporate setup to eliminate the insurance companies, even if it so desired, because State laws require that its credit insurance and casualty and fire insurance subsidiaries be separate corporations.
10. Although Commercial Credit Co. does not own an active life insurance company, it nevertheless has a substantial interest in such companies, since its insurance subsidiaries carry life insurance stocks in their portfolios. Why should those investments be depreciated by a curious and capricious tax device?
11. Those who invest in insurance company stocks, whether they be corporations or individuals, are entitled to the same treatment as those who make investments in a chemical company, steel company, automobile manufacturer or any other type of American business.
12. The tax imposed upon a corporation, whatever its rate, should be determined by its operations, not by its ownership.
13. All life-insurance companies, whether mutual or owned by stockholders, presently pay the same tax rate on their operations, being a flat rate of 3¾ percent on first $200,000 and 6½ percent on excess of net investment income with certain adjustments. These reduced rates (applicable alike to both stock and mutual companies) are intended to be equated to the application of ordinary corporate rates of 30 percent on the first $25,000 and 52 percent on net income above $25,000, after applying "the reserve and other policy liability credit."
14. Casualty and fire mutual companies presently pay a much smaller rate than do casualty, fire and credit insurance companies owned by stockholders. In fact, the latter pay the same rate as ordinary business corporations.

15. If we impose a penalty on the stockholder group as proposed by section 246, we do two things:

(*a*) We create an inequality in the life group.

(*b*) We create an additional inequality in the casualty, fire, and credit insurance group.

16. The proposed tax is, in effect, a capital levy because based upon stock ownership only.

17. The stock insurance companies could not survive under this proposed double taxload.

CONCLUSION

Section 246 should be amended to eliminate all of paragraph (a) (1), and the remainder should be renumbered accordingly.

Dated at Baltimore, Md., the 12th day of April 1954.

Respectfully submitted.

COMMERCIAL CREDIT CO.,
By E. L. GRIMES,
Executive Vice President.

STAMP TAXES—SECTIONS 4311, 4331, 4381, H. R. 8300

This brief is directed to and is an objection to the wording of section 4381 (a)

FACTS

1. Commercial Credit Co., in company with other finance companies, is a borrower of large sums of money that are used in its business, and whether or not those borrowings are subject to the stamp tax imposed by section 1801 has been uncertain since 1947.

2. The confusion centers around the question as to "what is a debenture" and is the result of a court decision which changed the whole concept of section 1801. (See exhibit A.)

3. Has the code defined a "debenture" or "bond"?

Not under section 1801, according to the above decision, but the phrase "bonds, debentures, or certificates of indebtedness" is used in numerous other sections of the Internal Revenue Code, and in each instance Congress has limited the application of the section to those instruments which bear interest coupons or in registered form. (See exhibit B.)

4. Has the Treasury defined a "debenture"?

"Not under section 1801. (See exhibit C for a Treasury release of July 1948, which states the determining factors as to whether a particular note should be classified as debenture.)

5. Has there been any consistency in the assessments made by the Treasury?

The answer here is "No," also. In one case they ruled that a promissory note secured by a mortgage is a "note" and not subject to a tax. In another case they ruled that a note issued pursuant to a loan agreement containing covenants against liens on assets, etc., was a "debenture" and subject to the tax. In another case a revolving credit arrangement with a bank that was paid out in 3 months was taxed and refused a refund, and in yet another case the tax was refunded.

6. Have the courts been any help in defining a debenture?

None whatsoever. (See exhibit D for a résumé of some of the last eight decisions. There are still more pending in the district courts.)

7. Does H. R. 8300 help the situation?

It does not.

(*a*) It does not define a bond or debenture.

(*b*) Contrary to all the other sections of the code (see exhibit B), it states that for the purposes of imposing the stamp tax under section 4381, a bond or debenture need not be in registered form or issued with interest coupons.

8. Why is Commercial Credit Co. so interested?

(*a*) We have been put to considerable expense and time since 1948 involving both court decisions and rulings as to whether a particular borrowing is a promissory note not subject to tax or a "debenture" or similar to a debenture that would make it subject to the stamp tax. This expense and uncertainty we would like to end and believe that Congress should determine what is taxable. For example, if Congress has determined what is a debenture in five separate sections of the Tax law it should also in the sixth and not leave that to the administrative office or the courts as the case may be.

(*b*) None of the confusion outlined in the Treasury releases referred to in exhibit C and none of the court decisions outlined in exhibit D would be any different under section 4381 of H. R. 8300.

CONCLUSION

In conclusion, if bonds and debentures are defined and contain identical definitions in five other sections of the code, no reason is known why they could not be similarly defined under section 4381.

Section 4381 (a) should be changed to read as follows:

"(a) CERTIFICATES OF INDEBTEDNESS.—For purposes of the tax imposed by sections 4311 and 4331, the term 'certificates of indebtedness' means bonds, debentures and all other instruments which are issued by a corporation and which have interest coupons attached or are in registered form."

Dated at Baltimore, Md., the 14th day of April 1954.

Respectfully submitted,

COMMERCIAL CREDIT COMPANY,
By E. L. GRIMES,
Executive Vice President.

EXHIBIT A. A BRIEF HISTORY OF SECTION 1801—INTERNAL REVENUE CODE

(*a*) In 1898, Congress enacted a 5-cent-per-$100 stamp tax on bonds, debentures or certificates of indebtedness and a separate 2-cent-per-$100 stamp tax on "any promissory notes except bank notes issued for circulation" (30 Stat. 451, 458, 459). In 1902, the tax on both promissory notes and bonds, debentures, and certificates of indebtedness was repealed (32 Stat. 97). In 1914, the stamp tax on promissory notes was reenacted, along with that on "bonds, debentures or certificates of indebtedness" (38 Stat. 753, 759, 760).

(*b*) From the time this tax was first imposed upon bonds, 1898, and until 1917, it applied to:

> "Bonds, debentures, or certificates of indebtedness issued after the first day of July *by any association, company or corporation* * * *". [Italics ours.]

(*c*) In 1917, the statute was expanded (40 Stat. 319, 321, 323) to include bonds issued by individuals as well as those issued by business concerns, and, as a consequence, the description in the schedule was changed to:

> "Bonds, debentures or certificates of indebtedness, issued after the first day of December, 1917, *by any person, corporation, partnership or association* * * *." [Italics ours.]

(*d*) In the Revenue Act of 1918, Congress added the phrase: "* * * issued by any corportaion with interest coupons or in registered form, known generally as corporate securities." However, since the instruments covered by the first phrase "bonds, debentures, or certificates of indebtedness" were taxable whether issued by individuals, partnerships, or corporations, Congress could not, as it did in every other instance, have the phrase "* * * issued by any corporation with interest coupons or in registered form, known generally as corporate securities." refer back to or modify "bonds, debentures or certificates of indebtedness," because the second phrase applied only to corporations, whereas the first phrase referred not only to the bonds of corporations but also those of individuals and partnerships. Accordingly, the description in the schedule was changed to read:

> "* * * all bonds, debentures, or certificates of indebtedness issued by any person, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities * * *."

(*e*) In 1926, Congress decided to eliminate the tax on bonds issued by individuals, and did so in the simplest way possible by merely deleting the word "person" and inserting in lieu thereof the word "corporation" (Revenue Act of 1926, 44 Stat. 99), so that the present statute reads:

"* * * all bonds, debentures, or certificates of indebtedness, issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities * * *."

(*f*) The language last quoted has remained unchanged to the present day, and, until *G. M. A. C.* vs. *Higgins*, 161 Fed. 2d 593, 1947 CCA 2, which was decided in 1947, the Treasury Department, the courts and the taxpayers interpreted it as imposing the tax only on bonds, debentures, certificates of indebtedness and other instruments, however termed, which are issued by a corporation with interest coupons or in registered form, known generally as corporate securities.

EXHIBIT B. DEFINITION OF "DEBENTURES" APPEARING IN THE INTERNAL REVENUE CODE

Section 23 K 3: "securities" means bonds, debentures, notes, or certificates or other evidence of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form.

Section 23 K 5: "Bonds, debentures, notes, or certificates or other evidence of indebtedness issued with interest coupons or in registered form issued by any corporation."

Section 117 (f): "bonds, debentures, notes, or certificates, or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form."

Section 117 (i): Same as above.

Section 125 (d): Same as above.

EXHIBIT C. SPECIAL RULING JULY 14, 1948 (STANDARD FEDERAL TAX REPORTER, C. C. H. 1948, SEC. 6223)

"Stamp tax: Issue of corporate securities: Notes.—In determining whether particular *notes* should be classified as *debentures*, the Bureau will take into consideration, inter alia, not only the circumstances under which the notes were issued but also the conditions to which they are subject. Included in the conditions, some or all of which if present, directly or indirectly, will cause the notes to be regarded as prima facie coming within the classification of debentures, are: (1) Provision for Amortization, (2) Requirement of Maintenance of a specified minimum capital on the part of the issuer, (3) Impost upon the issuer of a limitation upon the creation or assumption of other indebtedness, (4) Impost upon the issuer of a prohibition against conveyance of assets, (5) Provision for an acceleration of the maturity or prepayment prior to maturity, and (6) Requirement that issuer furnish the note holder with copies of annual balance sheets or other information of similar character."

EXHIBIT D. RÉSUMÉ OF SOME OF LEGISLATION AROUND WORD "DEBENTURE"

(*a*) In *Commercial Credit Company* v. *Hofferbert* (1950, 93 Fed. Supp. 562, U. S. D. C., Md., aff'd 188 Fed. (2) 574), a $50 million 15-year note issued pursuant to a loan agreement to which it referred, the loan agreement containing covenants against liens on assets, etc., was held to be a debenture and not a note, and, therefore, subject to said stamp tax.

(*b*) In *Belden Mfg. Co.* v. *Jarecki* (1951, 192 Fed. (2d) 211, C. C. A. 7), a $1 million, 5-year note was held to be a note and not a debenture, and, therefore, not subject to said stamp tax.

(*c*) In *Ely & Walker Dry Goods Co.* v. *U. S.* (1952, 107 F. Supp. 298), corporate notes in the amounts of $1 million and $6,500,000 were held to be notes and not bonds, debentures or corporate securities as defined in section 1801, and, accordingly, were held not subject to the tax.

(*d*) In *Shamrock Oil & Gas Co.* v. *Campbell* (1952, 107 F. Supp. 764), a $4 million note executed pursuant to an agreement containing various prohibitive covenants was held to be a note, and not subject to the tax.

(*e*) In *Atlanta Metallic Casket Co.* v. *Allen* (1952, 197 Fed. 2d 460), a $600,000 note executed by a manufacturer in favor of a life-insurance company, and secured by a mortgage containing various prohibitive covenants, was held to be a note and not subject to the tax.

(*f*) In *Leslie Salt Co.* v. *U. S.* (1953, 110 F. Supp. 680), long-term promissory notes in the amounts of $1 million and $3 million, respectively, executed by a manufacturer in favor of an insurance-company lender, pursuant to loan agreements containing various prohibitive clauses, were held to be notes, and not bonds or debentures.

(*g*) In *Niles-Bement-Pon Co.* v. *Fitzpatrick* (1953, 112 Fed. Supp. 132), 29 serial promissory notes aggregating $3,125,000, with maturities spread over 7 years, were held to be debentures, and so subject to the tax.

(*h*) In *Gamble-Skogmo, Inc.* v. *Kelm* (1953, 112 Fed. Supp. 872), a $13 million note executed by a manufacturer in favor of a life-insurance company pursuant to a loan agreement was held to be a debenture, and, therefore, subject to the tax.

(See supplemental statement on p. 1147.)

D'Ancona, Pflaum, Wyatt & Riskind,
Chicago, April 12, 1954.

Re section 6501 (e) and section 7851 (d) of H. R. 8300 (Internal Revenue Code of 1954), passed by the House of Representatives on March 18, 1954.

Senate Finance Committee,
United States Senate,
Senate Office Building,
Washington, D. C.
(Attention: Mrs. Elizabeth B. Springer, clerk.)

Gentlemen: In connection with the proposed enactment of section 6501 (e) corresponding to the present section 275 (c) of the Internal Revenue Code, we respectfully submit the following:

Section 6501 (e) (1) (A) proposes to change the 5-year period of limitations provided under section 275 (c) to a 6-year period if a taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return.

Section 6501 (e) (1) (A) in addition to stating the above general rule, includes two subparagraphs (i) and (ii) which, respectively, explain what constitutes "gross income" and what is an "omission" from gross income for the purpose of the application of section 6501 (e) (1) (A).

We believe that these two explanatory subparagraphs (i) and (ii) are proposed to be included in the new statute in order to put an end by legislative fiat to the hardships demonstrated in the interpretation of section 275 (c) as contended for by the Internal Revenue Service, and to resolve the disagreement evidenced by the case law between the Internal Revenue Service and some of the courts as to whether:

(1) In the case of a business, the term "gross income" should be construed as gross receipts and gross sales, or as net receipts and net sales;

(2) There was an "omission," where the full receipts were set forth in schedules attached to the return or were otherwise fully disclosed on the return, but were not recorded as a particular figure of gross income on a particular line on the face of the return. In this last connection, where the taxpayer had fully disclosed his gross receipts in schedules or separate statements forming part of his return, the injustice of charging him with an omission from gross income was all the more palpable since for many years the form of the Federal income-tax return requested to be used by the Internal Revenue Service included no particular line on the face of the return captioned "Gross Income."

We believe that subparagraphs (i) and (ii) of section 6501 (e) (1) (A), as adopted by the House of Representatives on the strength of the recommendation of the Committee on Ways and Means, were proposed to reflect the rule of reason announced by cases like *Uptegrove Lumber Company* v. *Commissioner*, decided by the Court of Appeals for the Third Circuit on June 29, 1953, ruling that section 275 (c) referred to understatements of gross receipts and not to an overstatement of cost of goods sold and *Maurice Van Bergh* (18 T. C. 518 (1952)) holding that a taxpayer setting forth on proper schedules, and thus apprising the Internal Revenue Service of, the full amount of income received by him in the taxable year was not to be charged with an omission from gross income, although taxable income as disclosed on the first page of the return did not include the full amount of such gross receipts by reason of the basis of reporting taxable income, adopted by the taxpayer.

In this respect, the House of Representatives and its Committee on Ways and Means are to be commended for eliminating an alleged ambiguity in the law and terminating the unfair technical construction of section 275 (c) asserted by the Internal Revenue Service.

However, the report of the House Committee on Ways and Means accompanying H. R. 8300 omitted to make two things clear:

(1) That subparagraphs (i) and (ii) do not represent a change in preexisting law, but are a mere change in the form of the statute clarifying it in the light of its legislative history, its purpose, and intent, and its interpretation by decisions like those in the two above-cited cases;

(2) That these explanatory rules of interpretation should accordingly apply to all open years.

May we respectfully suggest, therefore, that in the consideration of section 6501 (e) (1) (A), the Senate Finance Committee recognize in its explanatory statement that subparagraphs (i) and (ii) of section 6501 (e) (1) (A) of H. R. 8300 do not represent a change in the law but are a mere clarification of preexisting law.

In addition, there should be added to section 7851 (d) of H. R. 8300 which deals with the effective date of the new law in respect of periods of limitation, a sentence at the end of paragraph (d) reading substantially as follows:

"Subparagraphs (i) and (ii) of section 6501 (e) (1) (A) shall be deemed applicable to all open years."

We believe that in the above suggested way the object of the enactment of subparagraphs (i) and (ii) will be effectively carried out. It is the obvious purpose of these two subparagraphs to stop an unjust penalization of a taxpayer, small or large, who, in good faith, has tried to carry out the mandates of the complex tax law, by acknowledging that there is no need for the extended period of limitations where the Internal Revenue Service and its agents have been fully apprised by the taxpayer of his gross receipts, whether or not such receipts were stated on a particular line of the return or were stated on schedules or accompanying statements. Therefore, Congress in granting relief by eliminating ambiguities created by the Government itself, should make that relief effective as to all taxpayers, past and present, who have tried in good faith to disclose the transactions involved in connection with their annual income-tax liability as fully as the form of the income-tax return, prescribed by the Government, permitted them to do.

Very truly yours,

D'Ancona, Pflaum, Wyatt & Riskind,
By Harry N. Wyatt.

Dresser Indusiries, Inc.,
Dallas, Tex., April 7, 1954.

Hon. Eugene D. Millikin,
Chairman, Finance Committee of the Senate,
Senate Office Building, Washington, D. C.

Dear Senator Millikin: We have been reviewing the provisions of H. R. 8300, the Revenue Code of 1954. Time has not permitted us to thoroughly review the new code, but it is obvious that many changes are being made which either were not publicized or were not publicized in sufficient detail to acquaint the taxpayers with this proposed law. It is somewhat frightening to us to have such an important law completely rewritten, and perhaps passed, without adequate time for review by the taxpayers of this country. I understand that your committee is now starting hearings on this matter. I earnestly suggest that these hearings be continued until such time as you are assured that responsible organizations and taxpayers have had sufficient time to thoroughly review the law and have had an adequate opportunity to be heard.

I do not intend this letter to be critical of the revised code, for, in general, I believe that there has been a long-existing need for such a general revision. In specific instances, however, changes are being made to existing law which I cannot help but feel are unwise. For example, in reading the provisions relating to corporate reorganizations, I find that a substantial change has been made.

As you know, section 112 of the existing law treats as a tax-free reorganization any statutory merger or consolidation, and any transaction in which one corporation acquires substantially all the assets, or 80 percent of all classes of stock, of another, in exchange solely for shares of its own voting stock.

Section 359 of the new code would change this rule by treating the transaction as a taxable exchange unless the stockholders of the acquired corporation receive at least 25 percent as much stock in the acquiring corporation as the old stockholders of the acquiring corporation had before the transaction. Putting it another way, the transaction is taxable unless the stockholders of the acquired corporation end up with at least 20 percent of the stock in the continuing venture. The only exception is where both corporations are "publicly held," as that term is defined. However, as no corporation in which members of 10 families own as much as 50 percent of the stock is regarded as publicly held, the exception applies principally to transactions between corporations both of which have their stocks listed on an exchange.

We are opposed to the insertion of the 25-percent rule, for it would penalize the shareholders in smaller corporations. Very often, a company manufacturing a particular product finds it desirable from an economic standpoint to become integrated with a larger company offering a fuller line of products in order to be able to compete with other concerns in the business. Likewise, a company operating in a particular locality often finds it economic to become integrated with a company manufacturing the same products in a wider area. When such transactions are effected through what is now a tax-free transaction, the stockholders of the smaller corporation end up with stock in the continuing enterprise and a very real continuity of interest exists.

The proposed change would, in many cases, compel a shareholder in the smaller corporation to sell part of the new stock he receives in order to pay his capital gains tax. This would be particularly burdensome in a case where neither corporation was widely held, so that there might be no ready market for sale of the shares in the continuing corporation. The net effect of the change would be to discourage transactions of the type in question—a result which I believe is unwarranted, as in most cases there is a sound economic basis for integrations of this kind.

You will note that a distinction has been drawn between corporations which are "publicly held" and those which do not meet this definition. Such a distinction is without merit. The House committee report seeks to justify the distinction on the grounds that acquisitions between corporations which are not publicly held are sometimes shaped with a view to minimizing the stockholders' tax. I do not believe that this is accurate evaluation of past reorganizations.

Except for a few minor exceptions, I think you will agree with me that reorganizations of established independent businesses are based on a genuine business purpose. The method of reorganizing is then chosen to minimize the taxes on the transaction. Actually, such tax-free transactions are not a means of tax avoidance, but merely a deferment of the tax until an economic gain has been realized.

I sincerely hope that your committee will oppose this particular change in the reorganization provisions and will permit adequate time for review and discussion of the substantial changes in the proposed code.

Very truly yours,

R. E. Reimer, *Vice President.*

(See supplemental letters on p. 1146.)

Mutual Chemical Co. of America,
New York, N. Y., April 12, 1954.

Re H. R. 8300, section 359

Hon. Eugene D. Millikin,
Senate Office Building, Washington, D. C.

Dear Senator Millikin: I am writing to you as a member of the Senate Finance Committee and respectfully call your attention to section 359 of H. R. 8300, the proposed revision of the Internal Revenue Code. If this section is not materially revised before enactment, my associates and I believe that it will seriously impede the future development of the business of our company, and that it will result in unfair hardship on our stockholders.

Mutual Chemical Co. of America was incorporated in New Jersey in 1908; has plants located at Baltimore, Md., and Jersey City, N. J.; has about 600 employees; and was one of the pioneers in the chemical industry; its origin going back over 100 years.

As the result of gradual dispersion through succeeding generations, the stock of the company is now held by 96 stockholders. However, due to the family origin of some of these stockholders, the effect of section 359 of H. R. 8300, after applying the arbitrary "attribution" provisions of section 311, is to permit Mutual to merge, on a tax-exempt basis, with another company provided such other company is not more than 4 times as large as Mutual; but to impose capital gains taxes on the Mutual stockholders if Mutual merges with, or is acquired by, a company more than 4 times as large as Mutual. This result seems to us to be obviously unfair to smaller enterprises, and to discriminate in favor of larger enterprises.

Obviously many other companies would be similarly affected, and discouraged or prevented from effecting mergers in accordance with what has been a normal process of corporate growth and development by which companies adjusted their affairs to changing competitive and economic conditions. The proposed limitations therefore seem arbitrary, unreasonable, and discriminatory; and we believe they would cause damage without any apparent offsetting benefits.

Mutual is engaged in the manufacture and sale of chromium chemicals. It is essentially a single-product company, subject to the risks inherent in such a business. In addition it is dependent on South Africa for its chrome ore, so that, in event of war or political disturbance, it could be cut off from the principal source of its raw material. Furthermore, Mutual's chief competitors market their chromium chemicals as part of a diversified line of products through their own branch offices and warehouses.

For these reasons the management and stockholders of Mutual have concluded that it would be advtantageous if the company's operations were associated with a larger enterprise which could promote the sale and development of chromium chemicals as part of a broad line of chemical products. For Mutual itself to expand its operations into other lines would require additional know-how, a large increase in trained and experienced personnel, more research facilities, and the outlay of a substantial amount of capital, none of which is readily available to it.

Therefore, we believe Mutual should merge with, or be acquired by, a larger company. It is likely that any company meeting the desired specifications would be more than four times as large as Mutual. For the new tax law to refuse to permit such a merger on a tax-exempt basis would be a great hardship on the stockholders of Mutual. Moreover, it would seem that our stockholders would be unjustly discriminated against, since the stockholders of a much larger company would be allowed to merge on a tax-free basis under the provisions of H. R. 8300.

Mergers such as the one proposed for Mutual serve a vital purpose in the economic growth of the country. Often it is only by this means that a solution can be found to problems of the smaller business enterprises, such as the need for diversification of products, wider distributing facilities, broader research base, a larger pool from which to select management personnel, and the loss of business to larger, more diversified companies.

However, if there is some controlling reason, not apparent to us, why the policy of section 359 and the "attribution" provisions of section 311 should be adopted in the new tax law, it would seem only fair that the effective date of the new provisions should be postponed at least to January 1, 1955, so as to enable companies which have laid plans under the old tax law to get their affairs in order before the impact of the changed rules. Such plans may have been months or years in the making; and abrupt frustration of them could cause considerable hardship, including loss of the heavy expenses already incurred.

I shall be very grateful to you for your consideration of this problem, which I am sure affects not only Mutual Chemical Co. of America, but many other relatively small enterprises throughout the country.

Respectfully yours,

Mutual Chemical Co. of America,
George A. Benington, *President.*

New York Hotel Trades Council,
April 13, 1954.

Re Tax Bill H. R. 8300.

We wish to express our opposition to the tax bill H. R. 8300, which continues hardship on low-income groups and favors those of high and unearned income. We do not approve of a tax cut which benefits only 1 percent of the taxpayers of the country.

Under the proposed bill the burden of taxation would continue to be borne by those of little income earned by the sweat of their brows, while corporations and investors who can best bear the burden would be given preferential treatment by getting income-tax cuts.

We ask that the proposal for tax cuts for stockholders and corporations be eliminated from the bill, that the various loopholes by which big business escapes its great share of taxation also be eliminated from our tax laws, and that the personal income tax exemption be raised from $600 to $800, both to relieve low-income workers from their intolerable burdens, and to increase their purchasing powers as an aid to economic stability.

We are making this request in behalf of 35,000 organized hotel workers of this city who are our members and whom we represent as sole collective bargaining agent.

The New York Hotel Trades Council, A. F. of L., has had contractual relations with the Hotel Association of New York City since 1939.

Our contract is in effect in 187 hotels in this city, comprising more than 95 percent of the hotel industry of New York. Our council represents 10 local unions belonging to 8 international unions affiliated with the A. F. of L.

Respectfully submitted.

New York Hotel Trades Council, A. F. of L.
Jay Rubin, *President.*
Peter A. Moroney, *Secretary.*

Reliable Finance Co., Inc.,
Huntington, W. Va., April 12, 1954.

Re H. R. 8300, sections 275 and 312 (c) and (d)

Senate Finance Committee,
Elizabeth B. Springer,
Clerk, Senate Office Building,
Washington, D. C.

Gentlemen: It has just come to my attention that should the above sections of the Internal Revenue Code of 1954 be passed by the Senate, the interest on corporation notes and bonds would not be allowed as a deductible expense for Federal income-tax purpose, if the money should be borrowed from 25 percent or more of the corporation common-stock holders.

Such a law would certainly impair the operating ability of many companies, inasmuch as they would not be able to get sufficient capital to continue operation, if they had to look to outsiders, who would no doubt require more security.

This would particularly work a hardship on any money-lending institution. Other businesses are not to be deprived the benefit of taking advantage for income-tax purposes the cost of obtaining their merchandise to sell, so why should a loan company not be allowed a similar expense deduction for the cost of obtaining the money they loan, regardless of whom, or under what terms they obtain the money.

Neither should a person be discriminated against in being allowed to loan a company money just because he owns 25 percent or more of the corporation stock.

This law would be a handicap to the small corporations, and the writer would sincerely appreciate your seeing that this section of the above-mentioned bill is not passed by your committee.

Very truly yours,

Kathryn A. Moore,
President and General Manager.

Barnes Hospital,
St. Louis 10, Mo., April 6, 1954.

Dear Senator Hennings: I would like to call your attention to what I consider to be an unfair provision of section 117 of the new omnibus tax bill, at present being considered by the Senate Finance Committee, following passage by the House of Representatives.

Up to the present time, research fellowships, when given without obligation or specified duties on the part of the recipient, have been free of income-tax obligation. I have been informed that the new law proposes to tax fellowships, if the income from them is more than 75 percent of the recipient's income in the previous year. Since such fellowships are usually given to individuals who have had little or no income in the previous year, either students or resident physicians in training, the new law, in effect, makes all such fellowships taxable.

For example, at present I am a resident physician at Barnes Hospital in St. Louis, earning $50 per month. For next year, I have been awarded a fellowship by the National Foundation for Infantile Paralysis, at a stipend of $5,000 per year, for advanced study and research on a subject of my choice in the Department of Internal Medicine at Washington University which, however, does not lead to any specific academic degree. As noted above, such fellowships, which are in effect gifts to the recipient by either the Government or charitable foundations, without obligation to do any specified work, have in the past been tax free; however, since the stipend is more than 75 percent of my previous income, it will be taxed under the new law.

Here at Barnes, there are at least six other resident physicians who face the same problem next year, and there must be many others elsewhere in the country, including graduate students in the arts and sciences, whose income prior to the award of their fellowships amounted to little or nothing.

I hope that you will consider this problem and will give it any attention which you feel might be indicated.

Sincerely yours,

GEORGE L. FISCHER, M. D.

ASSOCIATED PLYWOOD MILLS, INC.,
Eugene, Oreg., April 8, 1954.

Hon. GUY CORDON,
Senator of State of Oregon,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR: We understand that H. R. 8300 (the Revenue Code of 1954) is now being considered by the Senate Committee on Finance. This bill includes two sections (272 and 631) which tend to reduce the effectiveness and clarity of the income-tax provisions with respect to gain upon the cutting of timber as embodied in section 117 (k) of the present Internal Revenue Code.

Section 117 (k), Internal Revenue Code, was originally created to eliminate the inequitable treatment and disadvantages to timber owners under a former code. We object very strongly to any change in the provisions of section 117 (k) of the present code insofar as timber is concerned.

We will ask you to use your good influence with the Senate Committee on Finance to amend section 631, and eliminate reference to timber in section 272 of H. R. 8300 so as to restore the language of section 117 (k) of the present code.

Very respectfully,

WALLACE O. GREIG, *Treasurer.*

J. NEILS LUMBER CO.,
Portland, Oreg., April 6, 1954.

Hon. Senator GUY CORDON,
Senate Office Building, Washington, D. C.

DEAR SENATOR CORDON: The Senate is now or will be soon considering the proposed technical revision of the Internal Revenue Code passed by the House as H. R. 8300 on March 18, 1954.

We call your attention to sections 631 and 272 of H. R. 8300. Section 631 is a reenactment of section 117 (k) with one very important change contained in the second sentence of 631 (a), which reads as follows: "If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair-market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer plus the deductions disallowed under section 272." Section 272 is a new section to the code which provides "that where the cutting of timber is considered to be a sale or exchange of such timber under section 631 (a), no deduction shall be allowed on account of certain expenses of the taxpayer incurred in connection with the holding and quantity measurement of the timber cut. * * * It is intended that only that portion of such expenses allocable to the timber cut will be disallowed as a deduction."

The effect of the foregoing is to reduce the capital gain arising under section 631 (a) from the cutting of timber and to increase the amount taxable as ordinary income by the amount of the disallowed expenses.

We believe that this is undesirable for the following reasons:

(1) Capital gain from the cutting of timber was first enacted as a relief measure under section 117 (k) (1). The proposals under new sections 631 (a) and 272 would drastically reduce the amount of such relief at a time when the industry is hard put to keep afloat in a period of declining prices and still increasing costs, and

(2) The enactment of these provisions will create complicated burdensome problems of expense allocations and materially widen the area of possible disagreement as between Treasury Department officials and taxpayers, thereby resulting in further unnecessary litigation.

We thank you for the privilege of writing you in this manner and ask only your consideration of this proposed change in the law.

Yours very truly,

PAUL NEILS, *President.*

SPENCER R. COLLINS & CO.,
Eugene, Oreg., April 9, 1954.

HON. GUY CORDON,
United States Senate Office Building,
Washington 25, D. C.

DEAR MR. CORDON: Thank you for your letter of March 4, 1954, regarding the Internal Revenue Code of 1954.

There is enclosed herewith a copy of a letter which we have today addressed to Mr. Seidman, chairman of the legislative committee of the American Institute of Accountants, which is self-explanatory.

We feel so strongly the injustice and inequity of the section of the proposed Internal Revenue Code of 1954 referred to that we most earnestly solicit your cooperation in procuring its revision.

We have here a situtaion in which a taxpayer may be forced into a position where he is severely penalized due to circumstances beyond his control, and which we think is inherently unjust and in direct contravention of the avowed purpose of the enactment of the proposed legislation.

Thank you for your consideration of the foregoing and the enclosure, I am,

Cordially yours,

SPENCER R. COLLINS.

SPENCER R. COLLINS & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
Eugene, Oreg., April 9, 1954.

MR. J. S. SEIDMAN,
Chairman, Federal Taxation Committee,
American Institute of Accountants,
New York, N. Y.

DEAR MR. SEIDMAN: At a meeting of the Eugene Chapter of the Oregon Society of Certified Public Accountants, held April 6, 1954, at which Messrs. James E. Hammond, vice president of the American Institute of Accountants; William P. Hutchison, member of the council of the American Institute of Accountants; and Guy R. Neely, president of the Oregon Society of Certified Public Accountants, were present, the writer as chairman of the legislative committee of the chapter was unanimously instructed to write you earnestly soliciting the cooperation of your committee in opposing the enactment of section 706 (b) (1) (B) of the Internal Revenue Code of 1954, which provides as follows:

"SEC. 706. TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

* * * * * * *

"(b) ADOPTION OF CALENDAR OR FISCAL YEAR.—

(1) PARTNERSHIP'S TAXABLE YEAR.—The taxable year of a partnership shall be determined as though the partnership were a taxpayer. Except with the approval of the Secretary or his delegate—

* * * * * * *

"(B) no partnership organized after June 30, 1954, may adopt a taxable year other than a calendar year."

The objection voiced by the Eugene Chapter to the above quoted subsection is basically that the proposed law is directly in contravention of the avowed purpose of the revision of the Internal Revenue Code which is stated on page 1 of the report of the House Committee on Ways and Means to be as follows:

"* * * In general, the purpose of these changes has been to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."

It was the unanimous view of those present at the meeting, including our distinguished guests, that it is unsound and unwise to give the Commissioner of Internal Revenue full discretionary powers over the right of a new partnership to establish a fiscal year of its choice, and that such right should be a taxpayer's as a matter of law as it will continue to be in the case of a corporation. The obvious purpose of the new provision being to force all partnerships eventually to report on a calendar year basis, it may be assumed that such discretionary power will be directed to that end, and this in turn will constitute a major catastrophe to the members of the accounting profession by concentrating in a short period a workload which is now spread over the entire year, and place individual taxpayers concerned in positions where it is impossible for them to break up the year-end workload of their own accounting departments or to make accurate estimates of income under section 6015, and subjecting them to the penalties set out in section 6654, all beyond their control unless they may have been able to have filed estimates based on income of the previous year, which latter privilege more often than not has no applicability and may be impossible of attainment.

Taxpayers who are engaged as partners in occupations such as general contracting, lumber manufacturing, wholesale and retail merchandising, and all other forms of business activity have no assurance of future earning power and are subject to severe income fluctuations from year to year based upon the various economic trends and other external influences. Many taxpayers who have in their business lives paid millions of dollars of income taxes may tomorrow be faced with bankruptcy, or vice versa. The violent income fluctuations in these situations are not foreseeable and the only way taxpayers so engaged have of making reliable estimates of income for the purposes of sections 6015 and 6654 is to have partnership income reported on a fiscal year basis which will enable their accountants to determine in advance of the close of the calendar year what the income will be, within reasonable limits. Any penalty to be exacted should take this state of facts into account, be based upon known income factors, and not related back to earlier dates during such year when the income factors were wholly unknown, as it is proposed to do under section 6654.

The courts have upheld the proposition that reasonable cause is not a basis for a waiver of penalties for underestimation, that Congress intended that this penalty be mandatory where an underestimation has occurred. We think it would be appropirate to consider this feature also as it affects the foregoing, on the theory that taxpayers should be penalized only where the circumstance creating the penalty was subject to the control of the person being penalized.

Under our new partnership rules, a partnership may be continued without dissolution, and will be held to continue under certain circumstances, somewhat in the same fashion as a corporation continues so long as it has not been dissolved. If restrictions are placed upon the adoption of a fiscal year by partnerships generally, this will have the effect of creating a market value in any fiscal year partnership, solely on account of the fiscal year which then becomes a valuable asset, and will cause taxpayers to resort to the expediency of going out in the open market and purchasing partnerships merely to acquire the fiscal year had by such partnerships, and resorting to all manner of subterfuges to establish them. Any such deplorable situation as this would lead to innumerable disputes and trouble which certainly is unjustified.

It should also be noted that in the House Committee on Ways and Means' report in the discussion of section 706, page A225, it is stated that—

"* * * A partnership taxable year shall be determined as though the partnership were a taxpayer. For example, the partnership must annualize its income for a short year caused by a change of its accounting period."

It would appear that the Ways and Means Committee did not consider the end result of this provision. The distortion and the complexity of a calculation involving the annualization of part of a taxpayer's income may also result in harassment and persecution, and we think this provision should also be opposed.

As will be observed from the foregoing, some of our comments are directed to provisions which will enlarge the discretionary powers of the Commissioner of Internal Revenue. During the history of income taxation there has been a constant pressure on the part of the United States Treasury Department seeking enlargement of its discretionary powers over taxpayers so as to enable it to make generally what has been described as "equitable assessments," but taxpayers have seldom been permitted to seek equitable relief and have been consistently held to the tax consequences of their acts. The capricious abuses of discretionary powers on the part of past administrations are a matter of public record, and from the utterances of our President it is clear that the Republican Party has pledged itself to curing these evils and to the betterment of the mental and physical well-being of the American people. We submit that the sections referred to above proposed for enactment in the Internal Revenue Code of 1954 do not accomplish these purposes, but rather that they will cause an important segment of our taxpayers to become embittered and uncooperative to the detriment of the revenue.

We have forwarded a copy of this letter to Senator Cordon and it is requested that your committee discuss this matter with him also. You will find him courteous and understanding of the problems concerned, and he will no doubt be able to assist you in arranging a hearing before the Senate committee if you wish him to do so.

Respectfully submitted.

SPENCER R. COLLINS,
Chairman, Legislative Committee, Eugene Chapter,
Oregon Society of Certified Public Accountants.

DRESSER MANUFACTURING DIVISION,
DRESSER INDUSTRIES, INC.,
Bradford, Pa., April 12, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee of the Senate,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: We understand that the Finance Committee of the Senate is now starting hearings on the provisions of H. R. 8300, "The Revenue Code of 1954."

It is our opinion that the general revision of the revenue laws fills a definite need and, for the most part, has ben handled well in H. R. 8300.

Some changes have been made, however, which perhaps should be publicized. We earnestly recommend that such changes should not be incorporated into law until affected organizations and taxpayers have had a chance to review them thoroughly and have had the opportunity for adequate hearings.

One change which may be unduly punitive is included in section 359 of the new code, which requires that after acquisition of one company by another in exchange for stock, the stockholders of the purchased company must own at least 25 percent as many shares of the purchasing company as were outstanding before the exchange of stock, or else the exchange is taxable. This is a substantial change from section 112 of the existing law which requires that 80 percent of the stock must be acquired and places no limitation on how many shares of the acquiring corporation must be exchanged.

This new provision penalizes the owners of small companies who find themselves in need of capital to produce and market new products, to buy equipment to maintain their competitive position or to increase sales. Present tax rates make it difficult to accumulate capital from earnings and such companies often do not have access to sources of new capital available to larger companies. In such cases, the only practical alternative is to unite with a larger company.

The present code makes it possible to exchange stock tax free with the larger company, resulting in a desirable continuity of interest because the stockholders have partial ownership in the new company. Of course, taxes will be payable whenever they sell any of the stock they have received.

The purchasing company, if it is large enough to provide the needed capital, will very likely have enough stock outstanding to put it outside the 25-percent provision in the revised code. In such a case, the sellers may have to sell immediately a substantial portion of the stock received to pay taxes on their profits. These sales may have to be made in a depressed or inactive market and may involve serious loss, as well as affecting the sellers' continuity of interest.

In this particular case, the revised code appears to penalize unjustly a legitimate business transaction. For this reason, we respectfully request that the Finance Committee of the Senate give full consideration, with proper allowance for hearings of interested parties, to the proposed changes in H. R. 8300.

Very truly yours,

M. H. NELSON, *Controller.*

WINTHROP, STIMSON, PUTNAM & ROBERTS,
New York, N. Y., April 12, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN : I will appreciate it very much if you will give careful consideration to the plea made in this letter.

I appeared before the Ways and Means Committee in support of a proposed amendment to section 113 (a) (5) of the Internal Revenue Code entitled "Basis of Property Included in Decedent's Gross Estate." I enclose a printed copy of the memorandum which I submitted to the Ways and Means Committee, but with some changes in language to make it more clear.

As shown on page 2 of the memorandum, an estate which I represent properly included property transferred in trust on which an estate tax was paid on a value of $8,050 per share. However, the trustee's cost basis for this stock is not the estate-tax value but the decedent's cost which was only $100 per share. A total of 50 shares was involved, of which 30 shares had been transferred in trust, and 20 shares were owned by the decedent at the time of his death. The executors have as their cost basis for the stock $8,054 per share, whereas, as above stated, the trustee's cost basis is $100 per share. The result is that no matter how desirable or even necessary for the trustees to sell the stock, their doing so would result in a combined estate tax and income tax which would obviously be in a confiscatory amount. This would be a very great hardship which my amendment was intended to relieve.

Under my proposed amendment as shown in the corrections made on the enclosed printed copy, it is urged that the amendment be made applicable and effective as to all sales or other disposition of such property made by the transferee after the enactment of the amendment. It is such sale or other disposition of property which causes the incidence of the income tax and, therefore, it would not really be retroactive in effect. I respectfully submit that it is only fair that where the transferee still holds the property on the date of the enactment of the amendment, he should be permitted to use as his cost basis the estate-tax value of the property.

This subject would appear to be intended to be covered in H. R. 8300, section 1014 (a) (9), which reads as follows:

"(9) In the case of decedents dying after December 31, 1953, property (other than annuities described in sec. 72) acquired from the decedent by reason of death, form of ownership, or other conditions, if by reason thereof the property is required to be included in determining the value of decedent's gross estate under chapter 11 of subtitle B."

The language of that subparagraph is not clear to me, as I do not understand what is meant by "form of ownership, or other conditions." Those words may be intended to mean ownership acquired by transfer by the decedent before his death, but it is not at all clear.

Also, subparagraph (9) is made effective only with respect to the estates of decedents dying after December 31, 1953, and this would not remedy the hardship arising in a case where the decedent had transferred property before that date, even though still held by his transferee and not yet sold at the date of death.

I respectfully and earnestly urge a change in the proposed amendment either in the language proposed in my printed memorandum or in some other language which will enable the trustees in such a case as that described in my memorandum to use as his cost basis, the estate-tax value, instead of the decedent's cost, in any case where the trustee or other transferee still holds the propery after the enactment of the amendment.

Respectfully yours,

PERCY W. CRANE.

MEMORANDUM IN SUPPORT OF A PROPOSED AMENDMENT TO SECTION 113 (A) (5) OF THE INTERNAL REVENUE CODE ENTITLED "BASIS OF PROPERTY INCLUDED IN DECEDENT'S GROSS ESTATE"

My name is Percy W. Crane. I am an attorney associated with Winthrop, Stimson, Putnam & Roberts, 40 Wall Street, New York City.

The amendment which I respectfully urge is one which would correct an obvious inequity existing under the present law, but which would not materially affect revenue.

Under the present law where a decedent during his lifetime transferred property in trust or otherwise, which is included in his estate tax return as having been transferred in contemplation of death or to take effect at or after death, the trustee's cost basis for gain or loss on his sale or transfer of the trust assets, is the original cost to the decedent and not the value of the property on which the estate tax is paid. Where such original cost is very much lower than the estate tax value, real hardship results. In order to correct this inequity, it is proposed to amend section 113 (a) (5) (relating to adjusted basis of property transmitted on death) by adding at the end thereof, the following:

"If a decedent, prior to his death, transferred property which has not been sold, exchanged, given, or otherwise disposed of by the transferee prior to the decedent's death, then, for the purposes of this paragraph, such property, to the extent includible in a decedent's gross estate pursuant to section 811, shall, after such death, be considered to be property 'acquired by bequest, devise, or inheritance,' from the decedent.

"This amendment shall be effective as to all sales or other disposition of such property made by the transferee thereof after the enactment hereof."

This amendment would enable the trustees of a trust created by a decedent in his lifetime and which has been included in his taxable estate, to use as their cost basis on a transfer of trust assets, the values on which estate tax has been paid, instead of the decedent's original cost.

Where such original cost is very much lower than the estate tax value real hardship results. There is a current estate which illustrates how inequitably the present law works. The decedent, some 25 years ago, organized a corporation of which he held all the stock consisting of 50 shares. His total cost of the stock was $5,000 or $100 per share. Shortly prior to his death he transferred 30 shares of the stock to trustees in trust for his children and retained 20 shares. The 30 shares so transferred by the deed of trust were properly included in his estate tax return as property transferred in contemplation of death. The remaining 20 shares constituted part of the residuary estate which was bequeathed in trust to the same trustees for the same children. At the time of the decedent's death the 30 shares which had been transferred in trust were valued for estate tax purposes at $241,634, or $8,054 per share, whereas the decedent's cost of that stock was only $3,000, or $100 per share, which, under the present law, would be the cost basis to the trustees if they were to sell the stock or liquidate the company. Furthermore, the present law would result in the anomalous situation in the case referred to that, whereas the testamentary trustees under the decedent's will owning 20 shares of the stock could use the estate tax value as their cost basis on a sale, the trustees under the deed of trust owning 30 shares of the same stock would be obliged to use the low cost basis of the decedent notwithstanding that the trustees in both trusts are the same and the beneficiaries are the same.

It is respectfully submitted that such an anomalous situation should not exist, and that it is inequitable for the Government to collect an estate tax on the value of the stock at the date of death, and not permit that value to be used as the cost basis on a future disposition of the stock.

A case might well arise where the combination of the income tax based on the decedent's low cost and the estate tax based on the high value of the same assets at date of death, might nearly, if not entirely, absorb the entire trust.

It is urged that, if the principle of this amendment appeals to the committee, it be made effective as to all sales or other disposition of such property made after the enactment of the amendment, and that its effect be not limited to cases where the decedent dies after the enactment of the amendment. The taxable event which gives rise to income tax does not arise until the trustees sell or dispose of the trust assets, and it is therefore fitting that the amendment apply to any transfers made after the enactment. Unless it should so provide the trust to which I have referred would suffer a grevious hardship. Since such effective date would apply only to sales or other disposition of the property made by the transferee after the enactment of the amendment such effective date is not really retroactive and is needed to avoid confiscatory combination of estate and income taxes.

A similar amendment was contained in section 127 of H. R. 4775 introduced by Mr. Camp and referred to the Committee on Ways and Means of the House of Representatives July 12, 1951. The difference between that amendment and the one herewith submitted is that the amendment proposed in H. R. 4775 also included property held by the decedent at the time of his death as a joint tenant or tenant by the entirety, or an interest in an annuity contract which are omitted in this proposed amendment which is aimed primarily at property transferred by the decedent whether outright or in trust, which is includible in the gross estate because made either in contemplation of death or to take effect at or after death.

Respectfully submitted.

PERCY W. CRANE.
WINTHROP, STIMSON, PUTNAM & ROBERTS.

INLAND CONTAINER CORP.,
Indianapolis 6, Ind., April 5, 1954.

Senator WILLIAM E. JENNER,
Senate Office Building, Washington 25, D. C.:

Reference is made to one of the unpublicized changes which is of little interest to the general public but is of vital interest to those who may have devoted their lives and invested all of their capital in the building of a small business in which the ownership is closely held.

The provision to which I refer is the proposal that would bar the sale of a closely held business for the marketable securities of a listed corporation unless the owners of the closely held corporation received at least 25 percent of the stock of the listed corporation. The average small closely held corporation is seldom large enough to obtain so high a percentage of the listed or buying corporation's stock. Specifically, this proposal and the selection of 25 percent would appear to have no basis of fact or reason. It would appear to be an arbitrary action designed for the collection of immediate taxes on the accumulated net worth of a small business which exchanges its shares for stock of a larger corporation. In the normal course of events the seller would be subject to a tax based upon the accumulated gain between his original cost and the amount realized at the time he disposed of the stock received in exchange for the business. The proposal as I interpret it would assess a tax on a gain which cannot be realized until the assets received for the business are sold as a marketable item for cash or the equivalent.

This provision favors the large corporation as opposed to the small business. Under the present law the small business can avail itself of the opportunity of affiliating with a larger unit when it reaches the point in its business life when it may need assistance in the form of marketing, finance, production, raw materials and numerous other reasons which might prompt individuals or small businesses to become a part of a larger organization. This is a normal economic process which will be restricted by the revision through the mechanics of taxation.

Other than the apparent intent for immediate revenue we can see no business or economic reasoning for this provision and it should be stricken from the bill in its entirety. The basis idea in itself is unsound, and beyond that the idea of 25 percent being established as the breaking point is another indication of the unsoundness of the provision.

I urge your immediate action to have this provision withdrawn from the bill. In the event it should be put to a vote in any way I suggest you vote against it. You have always been an exponent of sound taxation and we respect your judgment. May we have your further assurance of the elimination of this provision from the bill, assuming that you agree with the soundness of the position which has been stated.

Cordially,

GEORGE B. ELLIOTT.

THE HURON MILLING CO.
Harbor Beach, Mich., April 9, 1954.

Hon. HOMER FERGUSON,
Senate Office Building, Washington, D. C.

DEAR SENATOR FERGUSON: This letter will confirm our visit this morning.

The Huron Milling Co. was incorporated in 1902 and has maintained the same corporate identity since that date. The company's plant is located at Harbor Beach, Mich., and employs approximately 600 people and is the only industry and means of employment in Harbor Beach and is the largest industrial plant north of Port Huron and Saginaw-Bay City.

The principal products are starches, adhesives, and monosodium glutamate, all derivatives of wheat. The company is one of the largest users of wheat flour in industry in the United States, 100 million pounds annually, and prides itself on this contribution to the American farmer and agriculture.

In February of 1954, an opportunity presented itself to increase substantially the use of wheat and wheat flour in the manufactures of additional products—some of which had not heretofore used products of agriculture as a raw material. This step would involve additional capital, extensive research facilities and a much larger marketing and sales organization.

Accordingly, negotiations were entered into between The Huron Milling Co., and a large industrial organization which had the required capital, research and sales organization for the acquisition of the Huron Milling Co., by the larger company so as to make possible further expansion of the Harbor Beach factory and employment and insure the future of the old established company.

Under current law, one corporation may transfer all of its assets (subject to liabilities) to another corporation solely in exchange for voting stock of the transferee corporation; and the transferor corporation can then exchange the newly acquired stock for its stock in the hands of its stockholders, and both such transactions are tax free.

It was on this basis that the officers and directors of the Huron Milling Co. and the larger company undertook to negotiate a statutory merger or consolidation which under existing law would be tax free and make possible a general strengthening and expansion of the Huron Milling Co. which is so important to its stockholders, employees, and agriculture.

Section 359 (c) of the House bill 8300 provides a new rule with respect to acquisitions of assets and provides that in the case of other than publicly held corporations, such a transaction as above described, is no longer tax free, unless immediately after the transaction the shareholders of the transferor corporation own more than 25 percent, but not more than 400 percent of the amount of the capital stock of the acquiring corporation. In our case which we have pending, the shareholders would receive less than 10 percent.

The proposed law for the first time makes a distinction between publicly held corporations and small corporations. Under the proposed bill a company will be considered to be publicly owned unless 10 or fewer stockholders own more than 50 percent of the stock, ownership being determined with the application of the family attribution rules (father, children, grandchildren, wife, etc. count as one). In the case of the Huron Milling Co. we would not be classed as publicly owned because of the foregoing rule and thereby denied the privilege accorded a publicly held corporation of a tax-free exchange of stock, as we are classed as closely held in spite of the fact that the Huron Milling Co. has 229 stockholders, 181 of whom own less than 1 percent of the outstanding stock and 56 are employees owning 15 percent of the company. We believe this is unfair discrimination against a comparatively small company, its 600 employees and 229 stockholders offering sole employment to an important area in Michigan and using such a substantial amount of wheat flour, a product of American farmers.

Literally, what this change in the law means is that unless a small company receives as much as 25 percent of the capital stock of the acquiring company, it may no longer do what other small companies have done for the last 25 years, and that is exchange, tax free, its assets for stock of a larger company.

An examination of the bill indicates that two large corporations may merge or consolidate or acquire assets tax free, whereas 1 large one and 1 small one may not. This seems to put a premium on being large and to give an advantage to largeness over that accorded by the law to smaller companies.

It is equally important that smaller companies be able to reorganize for sound business purposes with larger companies as it is that two larger companies have that privilege. The proposed legislation appears harsh, arbitrary and discriminatory.

Section 391 of the law as passed by the House provides that the effective date of the new bill shall be March 1, 1954. The provisions of the bill are bad enough and discriminate against small companies but to make the act retroactive simply stops all such business transactions immediately. Many business organizations had on that date entered into negotiations, and in some cases, binding agreements which were nontaxable under the provisions of existing law. Completion of the transactions after March 1, 1954, under the new law would subject them to large and unforeseen taxes. The very instance of such proposed revisions on a retroactive basis makes the tax so uncertain and unpredictable that business is now of necessity marking time, which is harmful to the country. As a general rule such transactions require several months for completion due to the necessity of stockholders meeting, printing proxy statements and fulfilling

SEC and other requirements. Therefore, while not approving the substance of the bill, I would at least plead that such changes as are made in subchapter (c) be made applicable only to taxable years commencing after December 31, 1954.

On behalf of our stockholders and employees we shall appreciate your help in this most important matter. The writer is ready and willing to return to Washington to discuss this matter with you or whomever you suggest. The matter is of extreme importance to the Huron Milling Co. and that part of Michigan, as well as agriculture, and we know it must be of extreme importance to many other small-business companies similarly situated throughout the United States.

Respectfully submitted.

Robert M. Farr, *President.*

American Medical Association,
Chicago, Ill., April 13, 1954.

Hon. Eugene D. Millikin,
Chairman, Senate Finance Committee,
Washington, D. C.

Dear Senator Millikin: The American Medical Association would like to inform the Senate Committee on Finance of the association's views on one portion of the tax bill, H. R. 8300, that directly concerns medical practice. Section 213 (pp. 54–55 of the bill) provides for increasing the amount of medical, dental, and related expenses a taxpayer may deduct during the taxable year; this would be accomplished by allowing deductions of all amounts over 3 percent of adjusted gross income instead of the present 5 percent. The section also more clearly defines "medical care."

The board of trustees and the committee on legislation of the American Medical Association have considered a number of bills introduced in the 81st, 82d, and 83d Congresses and designed to bring about a measure of tax relief through increased medical expense deductions. In each instance the principle involved has been actively supported by the association.

The association likewise favors the inclusion of prepayment health insurance premiums as a part of medical expenses for tax purposes. This provision will serve as inducement for more families to join voluntary medical and hospitalization plans, will further encourage the improvement of existing health plans and will help reduce or eliminate the financial burdens of long and costly illness. Most important of all, it will encourage the voluntary approach to the solution of health problems rather than promote more dependence on Government.

The American Medical Association firmly believes that the present structure of medical care, with its rapidly expanding system of voluntary health insurance, will continue to provide the best and most economical care for the American people. Accordingly, we favor enactment of section 213.

Yours sincerely,

George F. Lull, M. D.,
Secretary and General Manager.

Arthur M. Jenkins,
Attorney at Law,
Charlotte 2, N. C., April 13, 1954.

Re Section 1211 (b) of the proposed Internal Revenue Code of 1954.

Mrs. Elizabeth Springer,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

Dear Mrs. Springer: I respectfully request permission to express an opinion to the Senate Finance Committee relative to the above section which limits to $1,000 (or the income of the taxpayer whichever is smaller) the amount which an individual taxpayer may deduct by reason of losses from sales of capital assets.

The limitation used to be $2,000. See section 117 (d), Revenue Act of 1934.

Later no limitation was placed on deduction of long-term capital losses, but short-term capital losses were allowed only to the extent of short-term capital gains. See section 117 (d) as amended by act of October 21, 1942.

A loss of $2,000 in 1934 was a very substantial loss. By comparison, a loss of $1,000 today is quite small.

I believe that the figure appearing in section 1211 (b) of the proposed Internal Revenue Code of 1954 should be increased substantially, to $5,000 or more.

I have no personal interest in the change I propose. I have sustained no losses to which the section would apply. But, I have seen many instances of the inequity, which results from such a restrictive limitation being placed upon the dedution of capital losses, and the limitation places a real deterrent upon risk capital so necessary to business expansion. A man could be ruined financially through investment losses and still obtain only token tax relief by reason thereof (provided he lives long enough to claim that token relief).

Very truly yours,

ARTHUR M. JENKINS.

LAW OFFICES,
MONTGOMERY, MCCRACKEN, WALKER & RHOADS,
Philadelphia, April 12, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: We represent the Reading Hotel Corp. which has had about $750,000 of second mortgage bonds outstanding since prior to the 1930 depression years. In the early 1930's, the second mortgage bondholders agreed to reduce the interest rate from 6 to 4 percent and to make the lesser interest contingent on earnings. The principal indebtedness continued to be payable on a fixed maturity date.

We respectfully suggest revision of section 312 (c) and (d) of the new H. R. 8300 for the following reasons:

1. Because the interest is contingent on earnings, the bonds in question are arbitrarily classified as "nonparticipating stock" and, if a bondholder owns more than 1 percent of the common stock, the entire redemption proceeds (which must be paid on the maturity date) will be taxed as dividend income under section 302. Apparently, the cost basis of these debentures will simply evaporate and be neither recovered by the debenture holder nor the subject of a deductible loss.

2. It is possible that the 85 percent transfer tax on the corporate level under section 309 may apply to all or a part of the redemption proceeds if, as an alternative, dividend treatment is not applied to the bondholder as described under point 1 above.

3. Under section 275 the interest would no longer be deductible even though there is clearly an indebtedness which section 163 would recognize for the purpose of deductibility of interest.

We have discussed this matter with the Treasury Department personnel and are hopeful that revision will be made which would eliminate the obvious inequity of the arbitrary definition of "securities" in section 312 (c). At the very minimum, our suggestion is that the term "securities" should include debentures, even though their interest may be contingent on earnings, if (*a*) they were originally issued as valid indebtedness with a fixed rate of interest, although such rate may have been later made contingent; (*b*) the debentures were, in fact, issued and outstanding before the effective date of the new law; and (*c*) the debentures are secured by real estate similar to a mortgage security. In our opinion, the interest on any of such debentures should be deductible and the principal amount should be treated as valid indebtedness.

If you should so desire, I would be happy to present this matter formally before your committee, or informally with the staff of the joint committee.

Respectfully,

STEPHEN T. DEAN.

MORGAN, LEWIS, & BOCKIUS,
COUNSELORS AT LAW,
Philadelphia 9, Pa., April 12, 1954.

Re Sections 504 (a) (1) and 681 (b) (1), H. R. 8300

Senator EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I am writing to suggest that paragraph (1) of section 504 (a) and paragraph (1) of section 681 (b) of the proposed Internal Revenue Code of 1954 (H. R. 8300) be eliminated from the bill.

The first of these provisions provides for the denial of the exemption provided in section 501 (c) (3) for charitable and other organizations in any taxable year in which accumulations of income of such year or of any prior year are unreasonable in amount or duration in order to carry out the purpose or function constituting the basis for exemption. The second provides in effect that the unlimited deduction under section 642 (c) allowed to a trust in respect of income required to be permanently set aside for charitable or other exempt purposes shall be denied if the amounts so set aside are unreasonable in amount or duration in order to carry out the exempt purpose of the trust, and in lieu thereof the deduction shall be limited to the amount actually paid out, not to exceed 20 percent of the trust income. The above proposals are patterned after sections 3814 (1) and 162 (g) (4) (A) of the Internal Revenue Code of 1939.

It is submitted that legislation of this character should not be perpetuated. Not only does the language give rise to extreme difficulties of interpretation and administration, but these provisions create a real danger of vast amounts of money and property intended for charity being diverted through taxes. It seems evident that the only purpose intended to be served by provisions such as these is the prevention of tax avoidance, since it is difficult to see why there should be a policy against accumulations per se. Sections 504 (a) (2) and (3) and 681 (a) (2) and (3) are designed to prevent the use of exempt organizations for tax avoidance purposes, and they should afford entirely adequate protection in this regard.

It is respectfully urged that paragraph (1) of section 504 (a) and paragraph (1) of section 681 (c) of H. R. 8300 should be entirely eliminated from the bill.

Very truly yours,

ALFRED J. McDOWELL.

SIMONOFF, PEYSER & CITRIN,
CERTIFIED PUBLIC ACCOUNTANTS,
New York, April 12, 1954.

Re Medical Expense

Hon. Senator EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

SIR: I am taking the liberty of enclosing for your consideration, in connection with the proposed revision of the revenue code, several editorials, etc., that have been published in this city on the subject "Medical Deductions."

Respectfully,

MORRIS CITRIN.

[The Wall Street Journal, April 3, 1953]

Editorial

THE TAX ON HEALTH

Ohio's Mr. Bolton has introduced into the Congress a bill which, in our view, represents a sensible approach by Government to the health needs of the Nation.

What he proposes is to allow deductions from income taxes of all medical and dental expenses, as well as costs of membership in voluntary medical insurance and hospitalization plans.

As the law is written now, only those over 65 may deduct all medical expenses. Below that age those who face heavy health costs may deduct only those medical bills in excess of 5 percent of their gross incomes. To say that this is unfair selectivity is to say the obvious. Medical costs are not generally arranged on an age scale any more than is the common cold.

Let's see how the deduction that is allowed works. Suppose a man with a family has a gross annual income of $3,500 (the average factory wage in 1952 was $3,540). If that man spends on doctors, dentists, medicine, and hospital costs a total of $175, he is out of luck and must pay income taxes on that amount. But if he spends a total of $180 for the same purposes—to make his family well or to keep them healthy or to prepare for future illnesses—the Government will let him deduct $5. But he still pays income tax on the other $175 he spent for his family's health.

Mr. Bolton's bill is appealing for other reasons. It is a part answer to the false lures of socialized medicine, and it doesn't put the Government in the business of issuing pills or listening through stethoscopes. It places before the taxpayer an inducement to see the doctor and the dentist while they've still got something to work on, too, by allowing the deduction.

As the law is now, the taxpayer actually pays taxes on his efforts to maintain or improve his health. Even business gets a better break from the taxwriters than this, for businesses can depreciate a building or a new piece of machinery.

Such a system as this doesn't make much sense to Mr. Bolton and it's a safe guess that it doesn't make sense to anyone who knows how it works. We hope his bill passes, for it's time the Government cease taxing the health of the people.

Deducting Medical Expenses—Attention by Congress Is Asked to Problem of Cost of Illness

To the Editor of the New York Times:

The Times of September 24 carries a news item headed "Vinson Left $7,163 But He Owed $6,000."

The news items announcing the death of Justice Vinson called attention to the fact that there has been illness in the family for five years. Justice Vinson was allowed as a deduction on his income-tax return only a portion of his medical bills; since his salary as Chief Justice was $25,500, only that portion of his medical expenses above $1,275 was allowed (5 percent of $25,500).

Taxpayers faced with serious illness have little or no control over the amount to be spent; the destitute receive medical and hospital care free at the public hospitals. All others are expected to pay in accordance with their means. An illness of 3 or 4 months can cost anywhere from $5,000 to $10,000; a prolonged illness of 2, 3, or 4 years can wipe out the savings of a lifetime.

Congress has never faced the fact that taxpayers are treated unfairly in the matter of medical deductions—especially where a catastrophic illness is involved. For 30 years taxpayers were not allowed any deductions for medical expenses, although all sorts of other nonbusiness deductions were allowed. Ten years ago Congress woke up to the fact that a dedduction should be allowed taxpayers for medical expenses, but the amount presently allowable is still inadequate in the case of a prolonged illness.

At recent hearings before the House Ways and Means Committee various partisan groups appeared to plead their special problems—the fur people, the tobacco people, the manufacturers of ladies' handbags, the cosmetic people, and so forth. The NAM wants an excise tax at the manufacturers' level—the retail people do not want any sales or excise tax. No testimony appeared in the press on behalf of the sick.

Members of Congress have sidestepped the question of a proper allowance for medical expense despite the fact that this is not a partisan issue, but rather one that is of vital concern to every member of the community.

Morris Citrin.

New York, *September 24, 1953.*

Deducting Medical Expenses

To the Editor of the New York Times:

As reported in the New York Times of September 1, Mrs. Oveta Culp Hobby, Cabinet Secretary of Health, Education, and Welfare, pointed to the financial burden of catastrophic illness as "one of the most pressing burdens on the average American family."

It is unfortunate that our income-tax laws have generally failed to recognize this burden. A taxpayer may deduct from his taxable income a number of nonbusiness items—in fact, he is given the privilege of writing off certain casualty losses over a period of 7 years. But the most serious casualty of all, serious illness which may result in partial or permanent impairment of his earning ability, will result in all too frequently a tax reduction of a negligible nature.

Let us make a few comparisons: The taxpayer, whose car is being used for pleasure purposes, may deduct the full cost for repairs resulting from an accident. However, the taxpayer is allowed to deduct a much smaller amount for medical bills incurred as a result of that accident.

A married taxpayer earning $5,000 a year loses a deduction of $250 for his medical expenses, while ceiling on this deduction is $2,500 for self and wife. Compare the tax situation of the taxpayer whose medical expenses are far in excess of the maximum deduction allowed with that of another taxpayer whose loss of stolen jewelry may be deducted in full. Compare the solvency of these taxpayers. Whose tax burden should be greater?

And, to indicate the further unreasonableness of the law, medical costs of treating livestock are deductible in full; the human does not fare so well.

Since the problem of catastrophic financial burden resulting from medical costs is so pressing, as Mrs. Hobby pointed out, it would be well for the reader to give support to legislation providing for full medical expense deductions, as well as permission to offset medical costs against income in several years, as is the case with many casualty losses.

WILLIAM MEYERS.

NEW YORK, *September 1, 1953.*

[The New York Journal of Dentistry, October 1952]

Editorial

INCOME-TAX DEDUCTION FOR MEDICAL AND DENTAL CARE

There are certain inequities in our present Federal tax structure which deserve the attention of the profession, and perhaps some concerted action to bring these inequities to the attention of Congress. I refer to the deductions allowable for medical and dental expenses.

Our concern in this matter is twofold. We are interested in the welfare of our patients, and in easing the financial burden of extensive mouth care and dental rehabilitation. And we are also deeply concerned as individuals who are particularly hard hit by serious or chronic illness or disability. Not only are we faced with an abrupt curtailment of income, but in addition, the provisions for tax relief are completely inadequate compared to the deduction allowable for items such as contributions to charity, or losses from bad debts or theft. A few examples will highlight the contrasts involved.

1. Any sum up to 5 percent of income is not deductible. Thus, an individual earning $7,500 and spending $375 for medical costs has no deduction on his tax return. If the same individual contributes up to $1,125 to charity, the entire sum would be deductible.

2. A taxpayer can deduct no more than $5,000 for medical expenses provided he has three or more dependents. A married man without dependents has a maximum deduction of $2,500. A single man is limited to $1,250. In contrast, there is no limit on the deduction allowable for a loss from theft. An individual with a yearly income of $25,000, who sustains a loss from theft of $25,000, is required to pay no tax. The same individual with comparable severe medical expenses would pay the tax on at least $20,000 of his income.

3. According to the law, a taxpayer who sustains a casualty loss can deduct the entire amount. If the loss exceeds the income for the current year, the excess can be spread over a period of 6 additional years (namely the year prior to the one in which the casualty loss occurred and 5 years after). A dentist who is incapacitated for a full year and has no income for that period, nevertheless pays the full tax for the year prior to his illness as well as for the succeeding years when he has resumed practice. His medical deductions for the fiscal year of illness become almost meaningless, since he has had no income during that period.

If an individual is riding in a car with his wife and family and an accident occurs, he can deduct the full amount of the damage to the car. However, moneys spent to rehabilitate the persons injured in the collision are limited as described in item 2.

4. If farm animals are sick, the full cost of medical care for them is deductible as a business expense. If a man's wife is sick, however, the minimum and maximum limits prevail.

The problem of medical expense is a serious one for all of us. The savings of a lifetime can be wiped out by a prolonged illness. We should encourage action to correct the unfair provisions of the present tax laws and to afford additional relief to those afflicted with serious, chronic illness or disability.

TITLE GUARANTEE AND TRUST CO.,
New York, N. Y., April 12, 1954.

Re H. R. 8300, sections 34 and 246 thereof limiting dividend credits

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

SIR: The principal business of this company is title insurance and the majority of its income is derived therefrom. As with all title insurers throughout the United States, a single premium is charged for the policy. It is not a renewable policy with renewal premiums but remains in force so long as the insured retains the insurable interest.

Title insurance is similar to steam-boiler insurance in that risks are carefully examined by extensive research into the history of the title of real property before the policy is issued. Losses are small in relation to total premium because most of the amount thereof is expended in advance to determine insurability.

Our taxable net income (except for a small unearned portion approximating about 4 percent thereof which is deferred for a period of 15 years under provisions of the New York statutes) is computed substantially as is the net income of general business corporations.

We therefore believe and respectfully request that consideration be given to revision of the above bill to permit stockholders of title insurance companies to receive the benefit of contemplated dividend credits and to allow said companies to continue to receive the deduction for dividends received from subsidiary corporations which are now afforded them by the present law.

The amendments to H. R. 8300, sections 34 and 246, proposed by attorneys for the California Land Title Association, representing 15 California title-insurance companies (copy of which is attached), will remove the discriminatory provisions which enactment of the bill in its present form would create.

Respectfully submitted.

WILLIAM H. DEATLY, *President.*

MEMORANDUM RE PROPOSED AMENDMENTS TO SECTIONS 34 (C) (1) AND 246 (A) (1), H. R. 8300, RELATIVE TO DIVIDENDS PAID ON STOCK OF CALIFORNIA TITLE INSURANCE COMPANIES

1. PROPOSED AMENDMENTS

It is submitted that the following provisions should be substituted for the provisions proposed under H. R. 8300 for the following subsections:

"*SECTION 34. DIVIDENDS RECEIVED BY INDIVIDUALS*

"(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

"*SECTION 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED*

"(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11 and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

AIR TRANSPORT ASSOCIATION OF AMERICA,
Washington, D. C., April 13, 1954.

Re H. R. 8300, the Internal Revenue Code of 1954

Mrs. ELIZABETH B. SPRINGER,
Chief Clerk, Committee on Finance,
United States Senate, 310 Senate Office Building,
Washington 25, D. C.

MY DEAR MRS. SPRINGER: Referring to our recent telephone conversation regarding our desire to testify on the above bill, we are enclosing copy of a letter to the Honorable Eugene D. Millikin, chairman of the Senate Committee on Finance, in which we have outlined two suggested amendments to H. R. 8300. Similar copies have been sent to all members of the Finance Committee as well as to Mr. Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation.

We respectfully request that you have this letter inserted in the printed hearings on H. R. 8300 which are now being held before the Senate Committee on Finance.

It is our understanding that the committee's hearing schedule has been closed. However, if additional witnesses are heard, we should like very much to testify with regard to these two amendments which are of great importance to the airline industry.

Very truly yours,

S. G. TIPTON, *General Counsel.*

APRIL 12, 1954.

Re. H. R. 8300, the Internal Revenue Code revision bill.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
Suite 310, Senate Office Building,
Washington, D. C.

DEAR MR. CHAIRMAN: The scheduled air lines of the United States, which compose the membership of the Air Transport Association of America, urge the Senate Committee on Finance to make two amendments to H. R. 8300.

We urge the committee to approve a clarifying amendment to section 274, to make it clear that this section does not apply to State and municipal public airports. Secondly, we urge the committee to approve an amendment to section 4261, which imposes the 10 percent transportation tax, to plug a serious loophole which now exists in the present law, and to remove the discrimination presently existing against travel to Canada, Mexico, Central America, and the Caribbean.

CLARIFYING AMENDMENT TO SECTION 274 OF H. R. 8300

While it appears from the press notices and from the report of the Ways and Means Committee that it was not the intention of that committee to achieve such a result, section 274 might be interpreted to apply to State and municipal public airports.

Section 274 disallows as a tax deduction any amounts paid to a State or municipality for the use or occupancy of property acquired or improved out of the proceeds of industrial revenue bonds. Such bonds are defined to mean obligations (*a*) issued to finance the acquisition or improvement of real property to be used to any substantial extent by private persons for manufacturing, and (*b*) which do not pledge the full faith and credit of the issuing authority for payment of interest and principal.

Various municipal and State airport authorities are now financing airport improvements or construction by means of bonds which are dependent on revenues generated at the airport for the payment of interest and principal (and, thus, are not backed up by the full faith and credit of the political subdivision). Moreover, airport authorities are more and more endeavoring to attract to their fields business concerns, such as aircraft manufacturing companies, which will increase the use of and the revenue from the field. This is certainly a commendable goal since,it relieves the aeronautical users and the taxpaying public of the sole burden of supporting the field. A good example of a field of the above type is the new Kansas City Industrial Airport.

However, in cases where a State or municipality desires to finance airport improvements by means of bonds which are dependent on airport revenues, and where that governmental body desires to put the airport on a sound financial basis by attracting to it aviation business, as for example, an aircraft manufacturing company, it can be argued that section 274 would have the effect of rendering landing fees and other charges paid by the airlines for the use of the field nondeductible for tax purposes. Moreover, it can also be contended that the rent paid by the aircraft manufacturing company, or by other companies in the general field of aviation, for the use of space in buildings on the field, is nondeductible. That the Ways and Means Committee did not intend such a result is supported by the following sentence of its report:

"Obligations issued for the acquisition or improvement of real property used principally for recognized governmental purposes shall not be considered industrial development revenue bonds even though a minor portion of the property may be availed of for manufacturing purposes incidental to the primary activity for which the entire property is used" (p. A69, H. Rept. No. 1337).

However, a zealous tax collector might argue that, based on court decisions relative to tort liability, an airport is not "used principally for recognized governmental purposes." A question might also be raised as to whether a building of substantial size on the airport for aircraft manufacturing purposes is a "minor portion" of the airport, and whether it is being used for a purpose "incidental to the primary activity" for which the field was built.

Because of possible points of contention like the foregoing, we urge that the section be clarified so that it will be clear that it does not apply to public airports of States and municipalities. This can be done by the insertion in section 274 (b) (1), after the phrase "real property," of the words ", except public airports,".

We urge the committee to approve this clarifying amendment.

AMENDMENT TO SECTION 4261 OF H. R. 8300, TO PLUG TAX LOOPHOLE AND REMOVE DISCRIMINATION

Section 4261 of the bill imposes the tax on the transportation of persons. Under this section as presently drawn, and under the present law (code sec. 3469 (a)), when the transportation is purchased outside the United States, the tax applies only to trips which begin and end in the United States. This permits a person to avoid the tax simply by purchasing his ticket in a border city in Canada or Mexico, and by beginning his trip from that point. For example, suppose a resident of Detroit desires to make a round trip, by air, between Detroit and San Francisco. He purchases his ticket across the bridge in Windsor, and also purchases connecting transportation by Greyhound bus or train from Windsor to Detroit. This makes the trip one that does not begin and end in the United States and, therefore, one which is nontaxable, even though it is actually a domestic trip.

Due to the widespread practice which has grown up of buying transportation in border cities in Canada and Mexico, the Bureau is losing a substantial amount of tax revenue each year. Moreover, this practice is diverting sales from ticket offices of the airlines and the railroads in the United States to travel agents in Canada and Mexico and thus is costing the carriers hundreds of thousands of dollars in commissions each year.

We urge that the committee plug this loophole by amending section 4261 to make domestic transportation taxable regardless of where purchased, and by defining "domestic transportation" to include transportation which begins or ends in the United States or at so-called border cities in Canada or Mexico. The elimination of this tax evasion would yield, we believe, an additional tax of approximately $1 million annually.

Under section 4261 of the bill (and sec. 3469 (a) of the code) transportation purchased in the United States to Canada, Mexico, Central America, or the Caribbean is completely taxable. On the other hand, transportation to Europe, South America, and the Far East is nontaxable, except on the portion of the trip which lies within the United States, Canada, and Mexico. There is no logic to this concept. There can be no defense for a tax which discriminates against travelers to Mexico, Canada, Central America, and the Caribbean, and in favor of travelers to European, South American and far-eastern countries. They should all be treated alike.

Nor is there any sense in the discrimination which results under the bill (and the present law) against American-flag carriers, and in favor of foreign carriers. For example, the New York-Caracas, Venezuela, route is served by

LAV, the Venezuelan national airline, and by the combined services of Eastern Airlines and Pan American Airways. On the LAV service the passenger is tax free. On the Eastern-Pan American service he must pay tax on the New York-Miami segment.

We urge the committee to remove these discriminations by making the transportation tax apply only to domestic transportation regardless of where purchased.

Our studies, based upon estimates made by the Treasury Department, indicate that restricting the tax to domestic transportation only would result in a loss of transportation-tax revenues of approximately $11 million per year. Taking into account the increase in such revenues which would result from plugging the so-called border loophole, the estimated net revenue loss from the amendment we are proposing would be approximately $10 million per year.

There is attached hereto a suggested amendment to section 4261 which would plug the border loophole and remove the tax discriminations referred to above. It would have the effect of making domestic transportation, as defined in the amendment, taxable regardless of where purchased and would limit application of the tax to such transportation. It makes no other change in existing law.

We urge the committee to approve this amendment.

Yours very truly,

S. G. Tipton, *General Counsel.*

Amend subsections (a) and (b) of section 4261 of H. R. 8300 to read as follows (with an appropriate relettering of the remaining subsections):

"SEC. 4261. IMPOSITION OF TAX.

"(a) Amounts Paid Within or Without The United States.—There is hereby imposed upon the amount paid within or without the United States for the domestic transportation of persons by rail, motor vehicle, water, or air a tax equal to 10 per centum of the amount so paid. As used in this subsection the term 'domestic transportation' means—

"(1) transportation which begins and ends in the United States, no part of which is outside the United States, Canada, or Mexico; and

"(2) transportation which begins or ends in the United States and, respectively, ends or begins at a point in Canada or Mexico 25 miles or less from the border between that country and the United States.

"The term 'domestic transportation' does not mean—

"(1) one-way or round-trip transportation, other than transportation included in clause (2) of the preceding sentence, between a point within the United States and a point outside of the United States;

"(2) transportation, otherwise taxable under clauses (1) or (2) of the preceding sentence, which is covered by a separate ticket or order but which is part of transportation from or to a point outside the United States, where it is definitely established, pursuant to regulations prescribed by the Commissioner, at the time payment for the transportation is made that the several portions of the trip are being purchased for use in conjunction with each other."

Note.—The above amendment renders unnecessary section 4262 (a) of H. R. 8300, which exempts from the transportation tax certain international travel. Consequently a technical amendment to section 4262 is needed which would delete subsection (a) of that section and appropriately reletter the remaining subsections.

The Wabash Employees' Hospital Association,
Decatur, Ill., March 30, 1954.

To All Members, House Committee on Ways and Means.

To All Members, Senate Committee on Finance.

Dear Sirs: We have noticed in press release by the Ways and Means Committee of the United States House of Representatives on the general revenue revision bill for 1954 that—

"The Commitee on Ways and Means adopted a provision designed to end the confusion as to the tax status of meals and lodging furnished an employee by his employer, it being stated under the committee provision these meals and lodging are to be excluded from the employee's income when (*a*) they are furnished at the place of employment, and (*b*) the employee is required to accept them to hold his job."

Conditions are such in most hospitals that it is difficult to release employees to eat lunch, for instance, as they are required in the hospital to serve the patients.

Also it is difficult to keep track of lunch served to employees. It varies from day to day. Most employees are married and eat with their families for the most part, other than possibly lunch. There are also several who are required to be available 24 hours a day. These vary also, some alternating days or weeks, as the case may be, all requiring considerable record and bookwork.

We should like to urge the members of these two committees and also all other Members of the House and Senate to adopt this provision.

Yours very truly,

W. E. GOLLINGS, *Superintendent.*

RUSSELLVILLE-LOGAN COUNTY CHAMBER OF COMMERCE,
Russellville, Ky., April 5, 1954.

Hon. JOHN SHERMAN COOPER,
United States, Senate,
Senate Office Building, Washington, D. C.

DEAR SENATOR: For almost 2 years our chamber of commerce and our city officials have been negotiating with a leading manufacturer of air-conditioning units in Minneapolis, Minn., with the view of establishing a plant in Russellville which would employ up to 500 persons.

We had proposed to finace this building and a part of the machinery under the Kentucky law (K. R. S., 1948, sec. 103.200–103.280) which permitted cities to issue revenue bonds which would be retired over a period of years by rent paid by the industry. Our first difficulty came late in 1952 as a result of a resolution adopted by the Investment Bankers Association which amounted to a boycott for this type of financing. However, last October we started dealing with a southern financial institution and had devised means of financing this project.

Last week a committee, composed of our city attorney, Mr. Granville Clark, the chairman of our industrial committee, Mr. B. M. Stuart, and myself met with the officials of the industry and the prospective purchasers of our bonds, in Minneapolis, confident that we were about to consummate this million-dollar deal. Much to our surprise, during the second day of our negotiations there, the attorney for the industry informed us that he had just been advised by an associate in Washington that the new Internal Revenue Code (H. R. 8300), which had already been passed by the House, would prohibit industries from deducting rent as an expense on Federal income-tax returns if such rent was paid to a municipality for the lease of real-estate property acquired through revenue bonds. This would have the effect of denying our people the benefits of the factory.

We understand that this bill has now been referred to the Senate Finance Committee for their consideration. It appears to us that this section 274 of H. R. 8300 is nothing more than a means for defeating the financing plans that several of our Southern States had devised for luring industry. Our Commonwealth already has several new plants in operation employing many people, which were financed by these revenue bonds and has the potential for many more including our own, the boycott of the Investment Bankers Association notwithstanding.

We respectfully urge that you give this matter your careful consideration in the light of its immediate effect upon the people of Kentucky.

We wish to express our appreciation for your efforts, which resulted in the restoration of a part of our tobacco acreage reduction, and in other matters on which we have from time to time asked your assistance.

With kindest regards and the personal hopes of the writer we will be able to address these communications to the same addressee for many years to come.

Sincerely,

EARL V. DAVIS, *President.*

P. S.—Our city attorney, Mr. J. Granville Clark, is also contacting Senator Earl C. Clements in regard to this subject.

DEPARTMENT OF STATE,
Washington, April 10, 1954.

HON. EUGENE DONALD MILLIKIN,
United States Senate.

MY DEAR SENATOR MILLIKIN: The attention of the Senate Finance Committee is invited to certain difficulties related to Federal income-tax matters that have been encountered by the Department of State in carrying out the international educational exchange program authorized by section 32 (b) (2) of the Surplus Property Act of 1944, as amended (Public Law 584, 79th Cong., 2d sess.).

Public Law 584 amended the Surplus Property Act of 1944 by authorizing the Secretary of State to dispose of surplus property located outside the United States for, among other things, foreign currencies and credits. It further authorizes the Secretary of State to enter into agreements with foreign governments for the use of such foreign currencies and credits for the purpose of providing, by the formation of foundations or otherwise, for the financing of studies, research, instruction, and other educational activities of or for American citizens in schools and institutions of higher learning located in foreign countries. The act provides further for the appointment, by the President, of a Board of Foreign Scholarships to supervise the program and to select grantees and educational institutions to participate in the program.

Pursuant to the legislation, binational foundations have been established by international agreements in 28 countries for the purpose of making payments to persons participating in the exchange program and to otherwise administer the program in such countries. These foundations are considered by the Treasury Department to be agencies of the United States Government for Federal income-tax purposes. As a result, grants made in foreign currencies to American professors, teachers, and lecturers, as well as salaries paid by the foundations to American employees abroad, are held to be taxable by the United States for any services rendered abroad in return for such grants or salaries. Taxes so imposed are payable in United States dollars. Since the foreign currencies are available for the program by virtue of the inability of the foreign country to pay dollars for the surplus property received, payments to grantees and employees are not considered convertible into dollars for payment of income tax or other obligations.

The difficulties encountered by American grantees, as well as employees of the binational foundations, in meeting Federal income-tax obligations pose a major problem in the administration of the educational exchange program. The effect is to restrict the Board of Foreign Scholarships in its endeavor to select the best qualified Americans to represent our country as professors, teachers, and lecturers in schools and institutions of higher education abroad. Oftentimes an almost intolerable financial burden is placed on those who do participate in the program as they must draw on dollar resources to meet tax obligations imposed on the foreign currencies received.

The Department of State and the Board of Foreign Scholarships are gravely concerned over this aspect of the program. Both the Department and the Board appreciate the objectives of our revenue statutes and support the administration of the statutes in such a way as to realize maximum revenue. On the other hand, the Department is concerned continuously with the accomplishment of our foreign policy objectives through such means as the exchange of persons for the improvement of international relations. At present there is a point at which the two seem to conflict.

It is believed that the problem could be solved by permitting American participants in the educational exchange program to meet their income-tax obligations by payment in foreign currency of taxes imposed on such currencies received by them. The taxpayer would be discharging his obligation to the Government and the Government could use the foreign currency in financing the educational exchange and other Government programs abroad.

The Department concurs in the suggestion of the Board of Foreign Scholarships that provision be made by appropriate means for acceptance of foreign currency in payment of income tax obligations imposed on grants and salaries paid in such currency under the Fulbright amendment to the Surplus Property Act of 1944. The Department respectfully requests the Senate Finance Committee to take this problem into account in its consideration of H. R. 8300.

A somewhat related problem exists in connection with a limited number of foreign nationals brought to this country under various Government programs. Appropriated funds are used for payment of transportation and minimum expenses for such persons while they are in this country. No payments are made, however, for support of their families or for other of their expenses in their home country. In some instances their employers or former employers contribute to the official programs by making limited payments in foreign currency for such expenses of the families while the individuals are in this country. Such foreign currency payments are considered for Federal income-tax purposes as "income from sources within the United States" and therefore taxable in United States dollars. The adverse effect of this tax on the goodwill the Government seeks to promote is usually completely out of proportion to the amount of tax collected. It is hoped that here, too, the Congress will provide a solution. The problem is especially acute in the foreign-trainee program of the Foreign Operations Administration.

The Department will be glad to furnish any additional information which the committee may desire in considering these problems.

Because of the urgency, this matter has not been cleared with the Bureau of the Budget, to which agency copies of this letter are being submitted today.

Sincerely yours,

THRUSTON B. MORTON, *Assistant Secretary*
(For the Secretary of State).

SPRINGFIELD, OHIO, *April 9, 1954*.

Senator EUGENE MILLIKIN,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR: I am writing you at the suggestion of our mutual friend, Congressman Clarence J. Brown. I had written to Congressman Brown relative to the problem of a small but very stable corporation employing around 125 people, which I represent. As so often happens, these smaller corporations are located in fairly closely built-up sections of cities, and very often they are surrounded by not too desirable residential properties. This is the situation of our corporation. The corporation desires to expand and secure options from the owners of five residential properties. All of these properties were owned by the families living in them, and of course these families do not care to sell except for such a price as will enable them to secure more desirable residential properties elsewhere. We can readily understand their position and our company has, under its option, agreed to pay a price for each of these residences far in excess of the normal value thereof.

It was the thought of the president of the corporation that after acquiring the properties he could fix a fair value for the land and a fair value for the buildings and that he could thereafter tear down the buildings and charge off the fair value thereof as a loss. However, before exercising his options he sought my advice and I was forced to inform him that he could not follow this procedure under regulation 118, paragraph 39.23 (e) 2, which reads as follows:

"*Voluntary removal of buildings.*—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building."

Since the value of the land will be considered as the cost of the land plus the buildings, he feels that the price is so exorbitant that he must give up his idea of expanding.

Since this is the second time within a year that such a situation has come to my notice, it has occurred to me that perhaps there are many hundreds of industries, large and small, which are faced with the same problem. It appears to me that the present regulation is somewhat shortsighted in that if the razing or removal of the buildings were allowed as an expense and the fair value thereof considered as a loss, there would be perhaps many new additions and enlargements to present industries, which would result in increased employment, which produces taxes, and that even those whose properties are purchased would normally pay capital gains taxes, since properties of this sort are usually sold at a premium, and in addition thereto those who sell their properties would normally buy or build elsewhere, which, in turn, would stimulate business resulting in taxes.

It is to be noted that the present section allows a loss due to the voluntary removal or demolition of old buildings incident to renewals and replacements if these old buildings are on property already owned by the corporation, but does not allow the same treatment for the same sort of thing if the corporation purchases land and buildings for expansion. It would seem that there is a very good argument for allowing the same treatment to be had in the latter situation, particularly in view of the stimulation such a provision would give to business, with beneficial results to everyone concerned, including the Government even in the limited field of taxation. Over the long pull it would seem that the Government would benefit in taxes to a greater extent if the regulation were changed as herein suggested than it does under the present regulation.

I know that the present administration is making a sincere effort to revamp our tax structure so as to be beneficial to everyone concerned but without too much loss in taxes, and it is my thought that your committee may wish to give consideration to changing the present regulation 118 so as to allow the removal or razing of buildings on land purchased for purposes of expansion to be charged as an expense and the fair value thereof to be charged off as a loss.

I know that the effect of many of these regulations cannot be known except as their effect is known to the committee through the experience of those who are affected thereby and so I am taking this opportunity to bring this matter to your attention with the thought that the commitee may find that the same has merit.

Sincerely yours,

KENNETH L. RUSH.

GREAT LAKES CARBON CORP.,
New York 17, N. Y., April 1, 1954.

Hon. EUGENE MILLIKIN,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: I am enclosing a copy of a memorandum which sets forth the facts concerning the acquisition by Great Lakes Carbon Corp. and Capital Co. of the stock of Palos Verdes Corp., the inequitable results produced by the effect of H. R. 8300 on this transaction, and some suggested changes in the new law, which changes would correct the unfair results.

You requested a copy of this memorandum in your conversation yesterday with Mr. George Skakel, chairman of the Board of Great Lakes Carbon Corp.

Very truly yours,

RICHARD MCAVOY,
Vice President and General Counsel.

CORPORATE LIQUIDATIONS UNDER H. R. 8300

On December 30, 1953, Great Lakes Carbon Corp. and the Capital Co. purchased for approximately $8 million all of the capital stock of Palos Verdes Corp., a real-estate corporation whose principal assets consist of approximately 6,800 acres of land on the Palos Verdes Peninsula, Los Angeles, Calif.

Great Lakes is engaged in the business of mining diatomaceous earth and processing it for industrial filter aids.

The 6,800 acres include a substantial deposit of diatomaceous earth located near Great Lakes' plant at Palos Verdes. The corporation made efforts to purchase the deposit from Palos Verdes Corp., but the stockholders refused to sell. They did, however, agree to sell all of the stock in the corporation, which was done so that the deposit could be acquired.

Capital was brought into the transaction because of its real-estate experience and the desire of Great Lakes to dispose of all of the real estate, other than the diatomaceous earth deposit, as promptly as possible. It was proposed to dissolve Palos Verdes Corp. and liquidate it in a taxable liquidation under the provisions of the Internal Revenue Code now in effect. This would mean that the shareholder corporations would surrender their stock and receive the assets at their fair market value, which would presumably equal the price paid for the stock, $8 million.

The provisions of sections 331 through 336 and section 391 of H. R. 8300, however, not only defeat this proposed plan but burden the shareholders with a tremendous financial loss.

Palos Verdes Corp. has a very low tax basis for the 6,800 acres of real estate (about $1,000,000) which were acquired many years ago. This real estate constitutes "appreciated inventory" under the provisions of H. R. 8300 (sec. 336 (e)) and, therefore, the shareholder corporations will be required to take over the same $1,000,000 basis as their tax basis for the real estate upon liquidation. Furthermore, the real estate remains "inventory" until sold. Thus, if the shareholders were then to sell the real estate for the same sum which they paid for the stock, to wit, $8,000,000, they nevertheless would be taxed on the $7,000,000 "profit" at the 52 percent tax rate—which would actually constitute a tax levy on their capital investment in the stock.

This harsh and inequitable result is attributable solely to the proposed law, which, by its terms, is made applicable to all such distributions made pursuant to a plan of liquidation adopted after March 1, 1954 (sec. 391 (a) (1)), and which deprives Great Lakes and Capital of the basis to which they were entitled under the law in effect in December 1953 when the purchase of the stock was consummated and upon which law they relied when they entered into the transaction.

The purpose of these particular sections of the new law is to discourage the formation of "collapsible corporations" which are formed for the manufacture of property and are then immediately liquidated to provide the stockholders with a capital gains tax on the inventory distributed rather than a tax to the corporation at the ordinary 52 percent corporate tax rate. This purpose is commendable but the law can, and should, be so composed that it will not deprive a bona fide business taxpayer of a tax-free return of its captial. This can be accomplished by change in the proposed law in either one of two ways:

1. Section 391 (a) (1) can be amended by changing the effective date "March 1, 1954" to "thirty days after enactment of this Act,".

This amendment will exclude from the new provisions any distribution made under a plan of liquidation adopted within 30 days after enactment of the law. Such an amendment would also prevent the incongruous and unintended result that would ensue where stock in a "collapsible corporation" was sold in 1953 and the corporation liquidated after March 1, 1954. In such a case the original shareholders would be obliged to pay tax on the gain realized at ordinary income tax rates under section 117 (m) whereas the purchasers would also be obliged to pay the same taxes when they disposed of the assets under the provisions of the proposed law, thus producing a double tax upon the same "profit."

2. Section 336 (d) (1) and (2) can be amended by adding thereto the following: "except property held for more than three years." This amendment will assure for the shareholder a basis for the assets commensurate with his capital investment in the stock. Furthermore, such an amendment is consonant with the provisions of section 117 (m) (3) (C) (the "collapsible corporation" section of the present Internal Revenue Code) which except from the application of such section gain realized by the shareholder upon his stock in the collapsible corporation after the expiration of 3 years.

As indicated at the beginning of this memorandum, the proposed law as presently worded would destroy the solvency of a taxpayer by the exaction of a large tax on a statutorily computed profit where no profit in fact exists. Changing the effective date of the law is the most direct way of relieving present shareholders from this unintended hardship; the amendment, however, of section 336 (d) (1) and (2) will produce the same immediate relief and will also prevent the exaction of such an overwhelmng penalty in the future.

New York, N. Y., *April 14, 1954.*

Hon. Eugene D. Millikin,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

Dear Senator Millikin: We are writing in the interest of certain of our corporate clients having outstanding issues of nonparticipating (preferred) stock which would be affected by section 309 of H. R. 8300 to urge the elimination of subsection (c) thereof which gives retroactive effect to this section.

Section 309 imposes a tax at the corporate level of 85 percent on amounts distributed after the date of enactment of the act in certain redemptions of nonparticipating stock within 10 years from the date of its issuance. The avowed purpose of this provision, as stated at page 36 of the report of the Committee on Ways and Means to accompany H. R. 8300, is to eliminate the use of the "preferred stock bailout" by closely held corporations.

While the 85 percent tax is made applicable only with respect to amounts distributed after the date of enactment of the act (sec. 391 (a) (2)), retroactive effect is nevertheless given to section 309 by the provision of subsection (c) that "nonparticipating stock shall be deemed issued on the date of issuance of such stock or January 1, 1954, whichever date is later." Consequently, a nonparticipating stock issued say 25 years ago with retirements still being made under a sinking fund provision could be subject to the operation of section 309 for the next 10 years. While the tax is aimed primarily at family or closely held corporations, it will include all corporations, even those whose stock is widely or publicly held. Furthermore, section 309 will apply retroactively to all such prior issues even though there was not any intention either at the time of issuance or redemption to distribute corporate earnings.

In view of the severe and drastic penalty imposed upon the corporation by section 309 it is submitted that the tax should not in any case be applied upon the redemption of nonparticipating stock, issued prior to the date of enactment of the act, at a time when the corporation had no knowledge that subsequent redemptions might subject it to substantial tax burdens.

In the event that section 309 should be made applicable to the redemption of stock issued prior to the date of its enactment, it is then urged that the 10-year holding period should run from the actual date of issuance where the stock was issued prior to the date of enactment and not from the actual date of issuance or January 1, 1954, whichever is later, as is now provided. There would seem to be no reason why nonparticipating stock issued after January 1, 1954, with full knowledge of the provisions of section 309, can be redeemed after 10 years free from the 85 percent transfer tax, whereas similar stock issued in 1944 would actually have to be held for 20 years from the date of issuance in order to gain immunity from the tax.

Respectfully,

BREED, ABBOTT & MORGAN.

STANDARD OIL CO. (INDIANA),
Chicago, Ill., March 31, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: My attention has been directed to certain provisions of the proposed 1954 Internal Revenue Code (H. R. 8300) which, it seems to me, will prevent many corporate reorganizations which have bona fide business purposes. Some of the problems arising under subchapter C which deal with such corporate adjustments are discussed in the attached memorandum dated March 29, 1954.

I invite your attention particularly to the advisability of deferring the effective date of the act to at least 60 days after its enactment. This, I believe, is necessary to avoid dealing unfairly with taxpayers who have undertaken reorganization and financing programs in reliance on present laws. It seems to me, also, that there is a serious defect in the underlying policy in subchapter C. Whether there is a corporate business purpose or a shareholder purpose for a reorganization cannot be determined by application of the arbitrary rules proposed in the bill.

I hope you will exert every effort to have the bill changed in the particulars set out in the attached memorandum.

Very truly yours,

A. W. PEAKE.

MEMORANDUM—H. R. 8300

The 1954 Internal Revenue Code undoubtedly represents many months of work by the tax staffs of the Treasury, and the Congress, as well as members of the Ways and Means Committee. They are all to be congratulated upon this tremendous effort. It would seem inevitable, however, in view of the nature and magnitude of the task that further modification of some provisions may be required to achieve the desired objectives which, it is understood, include the removal of inequities, reduction of restraints on economic growth, creation of jobs, closing of loopholes, and simplification of the tax laws.

This memorandum is concerned with the effect on these objectives of subchapter C, corporate distributions and adjustments, of chapter 1 of subtitle A, and more particularly with: (1) Hardships anticipated because of the retroactive application of subchapter C, and (2) problems arising out of the proposed classification of corporations into publicly held and nonpublicly held corporations.

1. The effective date of subchapter C is March 1, 1954. The effective date should, in any event, be deferred until a reasonable time (60 days) after the enactment of H. R. 8300.

Corporate adjustments, whether between small or large corporations, are usually the result of extended negotiations running over a period of months and sometimes years. Many such adjustments have, no doubt, been agreed upon or are in process, all in reliance upon laws now in effect. Obviously, taxpayers so involved should not be penalized by retroactive application of the revised statutes.

In this connection, it should be noted also that the whole structure of the law is to be changed. Corporate reorganizations which fall within the express terms of the old statutes and which have received judicial approval will be denied tax exemption under the bill, as now drawn. This was not within the reasonable anticipation of taxpayers, nor was any advance notice given.

It may well be questioned whether it is necessary or even advisable to throw aside reorganization procedures which have been confirmed and established by judicial construction in favor of a completely new approach to reorganization problems. This much, however, seems quite certain—that if H. R. 8300 is to be made effective March 1, 1954, it will necessarily require that proposed corporate adjustments, refinancing, etc., be held in abeyance pending enactment of the law. It is believed this will unnecessarily restrain business transactions.

The situation above discussed may be corrected—we believe—if H. R. 8300 is made effective a reasonable time (say 60 days) after enactment into law. Corporate adjustments, reorganizations, etc., could then go forward in reliance on laws now in effect and without any adverse effect upon the revenues.

2. The fundamental policy defect in subchapter C consists of the adoption of artificial and arbitrary classifications for the purpose of determining whether a stockholder or a corporate business purpose will be served by a reorganization.

It appears from the House committee report that the committee was concerned about the use of reorganization procedures by closely held corporations for the purpose of getting tax benefits for shareholders, rather than to promote the business purposes of the corporations. To guard against such practices (which it is noted the committee does not state categorically exist), it is proposed to adopt several arbitrary rules.

First. It is proposed to classify corporations into 2 groups: (1) Publicly held corporations, and (2) nonpublicly held corporations. The nonpublicly held group includes those corporations in which 10 or fewer shareholders own 50 percent or more of the stock. A more than 50 percent owned subsidiary would fall in this group, although it obviously is quite different from a family closely held corporation. All other corporations are publicly held corporations.

Second. It is proposed to establish an arbitrary size limitation on reorganizations. By this device, corporations falling within the range of specified sizes will automatically be regarded as qualifying for tax deferment, whereas those without the size limitation will be regarded as serving a stockholder purpose and tax deferment denied.

It is submitted that the proposed policy is not only unsound, but that the procedures proposed to make it effective will seriously restrict corporate reorganizations which have bona fide business purposes, rather than stockholder purposes.

Let us now examine the reasons assigned by the committee for classifying corporations in this manner.

In the report of the House Ways and Means Committee on H. R. 8300, an attempt is made to justify classification of corporations on the following basis:

"Publicly held corporations usually have a corporate existence separate from that of their shareholders and as a result do not merge or consolidate with a view to the tax advantages which might result therefrom at the stockholder level. There is ample evidence, however, that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates. Accordingly, your committee's bill makes a distinction in the requirements applicable to the determination of whether gain or loss shall be recognized between transactions involving only publicly held corporations on the one hand and closely held corporations on the other. The relatively unrestrictive requirement of existing law that there be merely a statutory merger or consolidation in order to preclude recognition of gain or loss is in substance retained for transactions involving only publicly held corporations."

It appears from the foregoing that a certain class of corporations involved in reorganizations are to be classified as suspect taxwise without regard to the purposes which prompted the corporations to reorganize. This classification is apparently to be made because it is assumed that shareholders of nonpublicly held corporations own nonmarketable stocks which, through a merger or other reorganization, may be converted into marketable stocks. Such marketable stocks may then be sold and the profits taxed at capital gain rates.

Reorganization procedures, it will be recalled, only provide for the deferment and not the avoidance of tax. They have been approved heretofore as desirable corporate adjustments, irrespective of the marketability of the stocks or securities involved. Moreover, the stocks or securities of parties to reorganizations may be marketable and the equivalent of cash, whether the corporations involved are publicly held or nonpublicly held. As indicated, whether the stocks or securities received in a corporate reorganization are the equivalent of cash or lacking in marketability has never been and should not now be decisive in determining whether the tax should be deferred. If this were the controlling factor, substantially all corporate reorganizations would constitute taxable transactions. A policy which so drastically restricts corporate reorganizations is obviously unsound. In any event, it is apparent that the absence or presence of a marketable stock or security in corporate reorganizations affords no reasonable or reliable basis for determining whether a corporate or shareholder purpose will be served and, hence, no sound basis for the proposed classification of corporations.

(*a*) More than 50 percent owned subsidiaries should, in any event, be eliminated from the nonpublicly held group.

A more than 50 percent owned subsidiary is a nonpublicly held corporation under the proposed statutory classification. Such corporations—as a class—are generally quite different from family or closely held corporations. The remaining shares of a more than 50 percent owned subsidiary might well be publicly held and, in the broadest sense, highly marketable. Moreover, it will be recalled that a subsidiary may distribute its earnings and profits to its parent at an effective tax rate of 7.8 percent to the parent. Quite clearly, the parent (being in control of the subsidiary) would not permit a corporate readjustment (such as is discussed in the committee excerpt, supra) for the purpose of acquiring marketable stock so that it could get the higher capital gain tax rates upon profits realized upon the sale thereof. Such corporations would not gain the indicated advantage under reorganization proceedures and obviously would not adopt them for the purposes expressed in the committee report. It follows that if there is merit in the proposed classification, it is quite clear that a more than 50 percent owned subsidiary should not be included in the so-called nonpublicly help group. Particularly should this be true where the parent corporation is, in fact, a publicly held corporation. Reorganizations involving a more than 50 percent owned subsidiary would necessarily seem to involve a corporate business purpose, rather than a shareholder purpose.

3. The attempt to regulate or control corporate reorganizations by fixing the size of a corporation with which a nonpublicly held corporation may merge or reorganize is wholly arbitrary, serves no useful revenue purpose and will discriminate against smaller corporations. The size limitation should be eliminated.

Under the terms of sections 359 (c) and (b) of H. R. 8300, a nonpublicly held corporation may reorganize only with a corporation (nonpublicly held or publicly held) at least one-fourth its size and not greater than 4 times its size. The size limitation is, of course, arbitrary. It quite clearly does not serve revenue purposes. Certainly, the objectives sought (disallowance of capital-gain treatment on earnings and profits of a nonpublicly held corporation) will not be served by the size limitations. The shares of a small publicly held corporation with which a nonpublicly held corporation may reorganize might be just as marketable as the shares of a large publicly held corporation. Marketability, or cash equivalency, is not necessarily related to the size of corporations.

The arbitrary nature of the size limitation is apparent from a consideration of the following schedule. It should be kept in mind that all publicly held corporations, whether large or small, may merge with any other publicly held corporation, large or small. A nonpublicly held corporation of the size indicated in the first column below may only reorganize with a corporation of the size within the range indicated on the same line in the second and third columns. It follows that the practical effect of the limitation will be to deprive shareholders of smaller corporations (which are usually nonpublicly held) of reorganization procedures which are available to larger corporations.

Value of nonpublicly held corporation	Value of nonpublicly held or publicly held corporation with which corporation in the first column may reorganize
(1) $50,000	$12,500 to $200,000.
(2) $200,000	$50,000 to $800,000.
(3) $800,000	$200,000 to $3,200,000
(4) $3,200,000	$800,000 to $12,800,000.
(5) $12,800,000	$3,200,000 to $51,200,000.
(6) $51,200,000	$12,800,000 to $256,000,000.
(7) $256,000,000	$51,200,000 to $1,024,000,000
(8) $1,024,000,000	$256,000,000 to $4,096,000,000

It is certainly far from apparent why it is presumed that a corporate business purpose will be served by a merger of a $50,000 nonpublicly held corporation with a nonpublicly held or publicly held corporation within the size range of $12,500 to $200,000, but that only a shareholder purpose will be served where a $50,000 corporation undertakes to reorganize with a corporation of a size less than $12,500 or greater than $200,000.

The arbitrary nature of the size limitation and the publicly held classification becomes more apparent when it is realized that 2 publicly held corporations of the size indicated in brackets (7) and (8) above may merge tax-free, but if the smaller corporation is a more than 50-percent-owned subsidiary of the larger and therefore classified as nonpublicly held, then the transaction becomes taxable.

In effect, the bill establishes a conclusive presumption that a corporate reorganization beyond the size limitation is for shareholder, and not corporate purposes. Under such a ruling, a reorganization having unquestioned corporate business purposes (but exceeding the size limitation) would nevertheless constitute a taxable transaction. It is submitted that whether a shareholder or corporate business purpose will be served by reorganization should be determined in the light of the particular facts in each case and not under such arbitrary and inflexible rules.

4. The capital gain provisions are, in any event, available to shareholders of nonpublicly held corporations.

It should be recalled that justification for the classification of corporations and the use of size limitations in regulating reorganizations rests upon the assumption that shareholders of smaller corporations (through mergers with larger publicly held corporations) may receive a marketable security which they will then sell. The profits so realized, it is assumed, will reflect earnings and profits of the smaller corporations, with the result that they may be taxed at capital-gain rates.

The right to use capital-gain treatment has been and will continue to be available to shareholders of nonpublicly held corporations. Thus, shareholders of such corporations may, of course, sell their shares and receive capital-gain treatment. This, they may also do by liquidating such corporations and selling their assets. Furthermore, under the specific terms of the proposed bill, if a shareholder of a small corporation exchanges his stock for the stock of a large publicly held corporation, he will be entitled to capital-gain treatment upon the profits realized.

5. Additional illustrations of the arbitrary and inflexible nature of the proposed procedures.

A publicly held corporation, whether large or small, may reorganize tax free with any other publicly held corporation without regard to size limitations if a statutory merger or consolidation procedure is used. Within the size limitations, other practical procedures—the equivalent of section 112 (b) (3) and section 112 (b) (4) of the present Internal Revenue Code—are also available. Beyond the size limitations, such practical procedures are not available. The practical effect of this is only to require such corporations to use statutory mergers or consolidations. No reason is apparent why they should not also be permitted to use the practical reorganization procedures which are available to corporations within the size limitations.

The shareholder purpose, rather than the corporate purpose, is difficult to determine where the nonpublicly held corporation transfers down into a smaller nonpublicly held corporation or transfers up into a larger nonpublicly held corporation. The reasoning is also impossible to follow where a publicly held corporation transfers its assets outside the allowable size limitations to a larger or smaller nonpublicly held corporation. There is, in such circumstances, no "control group" in the transferor to which a shareholder purpose, rather than a corporate purpose, can be attributed. Notwithstanding this, such transactions are taxable under the bill.

LAW OFFICES,
NAYLOR AND LASSAGNE,
San Francisco, Calif., April 13, 1954.

The Honorable EUGENE G. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR MILLIKIN: I would like to have the privilege of placing in the record of the hearings of the Senate Finance Committee on the tax revision bill H. R. 8300 a statement of my personal views in regard to section 1235 of that bill dealing with the treatment of capital gains and losses occurring in connection with the sale of patents by an inventor.

In order that your committee may appraise my qualifications to address you on this subject, I would like to say that while I have practiced patent law for over 20 years, I have at the same time had substantial experience with the tax laws as they relate to the treatment of capital gains and losses arising out of the sale of patents by inventors. I was patent counsel to Mr. Harold T. Avery at the date of the well-known Avery case (47 B. T. A. 538) which originated the present distinction between amateur and professional inventors recognized as "arbitrary and confusing" by the House report on the present bill. Since that time the tax aspects of patents have been a matter of great concern to me, and in addition to appearing in the Tax Court in behalf of other clients, I was for 2 years chairman of a special committee of the patent section of the American Bar Association concerned with such matters. I do not, however, wish my views to be interpreted as necessarily reflecting the position of any such committee or of the association on these matters, and state my connection therewith only for the purpose of advising you of the extent of my experience in this field.

I am opposed to section 1235 of H. R. 8300 because, contrary to the import of the House report and the detailed discussion of the bill supplied by the Bureau of Internal Revenue, it would effectively eliminate the opportunity of an inventor to secure capital gains treatment for the proceeds of the sale of an invention and place every inventor in a position less favorable than he enjoys under existing law.

It accomplishes this manifestly undesirable result primarily by reason of its inclusion of the provision that gain from the sale or exchange of a patent or application shall be deemed gained from the sale or exchange of a capital asset "if and only if" the entire proceeds thereof are received by the seller within a period of 5 years from the date of the sale or exchange. In order to make clear to you why this 5-year limitation will necessarily have the effect of totally depriving inventors of an opportunity for capital-gain treatment, it is necessary to know the nature of the usual transaction in which a manufacturer purchases a patent right.

No appraisal of the value of a patent right is possible in the absence of actual commercial experience with the manufacture and sale of the thing patented. No manufacturer will obligate himself to pay a large fixed sum for a patent right in the absence of such commercial experience. No inventor would be adequately compensated by payment to him of a sum as small as a manufacturer would be willing to pay in the absence of such commercial experience. It is for these reasons that sales of patent rights on commercially untried inventions are conventionally made on an "indeterminate price" basis; the price paid the inventor being a percentage of the sums received by the manufacturer from sales of devices embodying the invention. Gains from sales of this type have been held to be capital gains by the Tax Court in the Myers case (6 T. C. 258) in which the Bureau of Internal Revenue first acquiesced and 4 years later withdrew its acquiescence.

The 17-year term of a United States patent (the term varies from 14 to 18 years in other countries) has been fixed by Congress as a reasonable period for an inventor to acquire a financial gain commensurate with the benefit his invention confers upon the public. Congress has thus recognized that a shorter term would not afford an incentive to inventors, particularly in the case of really important inventions. This is because for 5 years or even 10 years after commercialization of an invention begins, manufacturing costs are higher, and sales are smaller and more costly to make than they are after the invention has been popularized and mass production undertaken. The early years of commercialization of an invention do not afford any substantial gain either to the inventor or the manufacturer of a new invention.

In view of these plain facts of life, already recognized by Congress in setting a 17-year term for patents, the "5-year" limitation of the present bill effectively deprives all inventors of all opportunity for capital gains treatment of the proceeds of sales of their inventions. It thus is of no moment that it abolishes the distinction between "amateur" and "professional" inventors.

I therefore respectfully submit that unless section 1235 of H. R. 8300 is revised to eliminate the "5-year" limitation, inventors would be very much better off under existing law than under the provision in question.

Very truly yours,

THEODORE H. LASSAGNE.

LEGISLATIVE COMMITTEE, PATENT LAW ASSOCIATION OF LOS ANGELES,
April 13, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: The legislative committee of the Patent Law Association of Los Angeles, at a meeting on March 29, 1954, gave careful consideration to the provisions of section 1235 of H. R. 8300. This section relates to treatment of gain from the sale or exchange of patents by an inventor.

The report of the House Committee on Ways and Means states, among other matters, that the purpose for enacting this legislation is as follows:

"Under existing law, only amateur as distinct from professional inventors can obtain capital gain treatment; and, to make this distinction, it has become necessary to determine whether sufficient prior inventions exist to warrant placing the taxpayer in the business of selling inventions to customers, a requirement that has in many instances caused confusion and litigation. To obviate this difficulty in the case of gain, and to provide a larger incentive to all inventors to contribute to the welfare of the Nation, this section is applicable equally to all inventors, whether amateur or professional, regardless how often they sell their patents." (House Rept. 1337, p. A280.)

It is the opinion of our committee that the above statement of purpose does not properly reflect the conditions existing among inventors insofar as the income-tax law is concerned. We also believe the above statement presents an erroneous interpretation of this new section which would accomplish results seriously detrimental to the best interests of the country because, in fact, it would decrease, rather than increase, incentive to inventors.

The report states that making a distinction between the professional and amateur inventor has, in many cases, caused confusion and litigation. However, an examination of the reported cases will reveal that there are many more cases involving the question of whether or not there is a sale of the patent, than cases involving whether or not the inventor is in the trade or business of selling inventions.

The proposed law would eliminate all possibility of capital gain to any inventor when sales proceeds are received as a percentage of sales of products manufactured under the patent, if such payments continue for a term longer than 5 years. As a practical matter, it is the opinion of the legislative committee of this association that such agreements are, almost without exception, made for the life of the patent, or a term much longer than 5 years. Any other provision would be unrealistic and not in accordance with common business practices.

It is a matter of common experience that it may take longer than 5 years to engineer and place in full production a new invention. In advance of widespread sales it is impossible to accurately forecast revenues from a patent so that a cash sale price or a sale price based on earnings over the first 5 years is ordinarily comparatively low. The inventor has greater prospects of a larger return only if he can share the early risks as well as the later profits. Accordingly he wants to have his income spread over a long term extending beyond the initial years when net earnings are generally low. It is almost universally true that the later years of a patent are its most profitable ones and therefore it is the justifiable aim of every inventor to share in the revenue during that profitable time by receiving his income over the full life of the patent.

The arbitrary limitation to a 5-year period would operate in practice to make all income to inventors from patent licensing or sales agreements ordinary income rather than capital gain, regardless of whether the transaction results in a sale, or whether the patent would otherwise be a capital asset in the hands of the inventor. Thus, it would actually discriminate against inventors by placing them in a less favorable position than other owners of patent rights, with respect to treatment of gains from the sale or exchange of a patent or patent application. Such a provision certainly cannot be helpful to inventors, and is more unfavorable to inventors than the present laws. Nor can it help but be detrimental to the best interests of the country because of the decreased incentive to inventors.

After due consideration of these matters, the legislative committee of the Patent Law Association unanimously adopted a resolution, as follows:

"*Be it resolved*, That the enactment of section 1235, contrary to its announced purposes, would substantially decrease incentive to inventors in making and disposing of inventions and, as a result thereof, a great detriment would be done to the best interests of the country; be it further

"*Resolved*, That, in our opinion, the statement of the purposes set forth in the report of the House Committee on Ways and Means is misleading and does not properly reflect existing conditions; be it further

"*Resolved*, That the arbitrary limitation of the section to proceeds received under an agreement for a term not longer than 5 years represents a new principle inconsistent with equitable principles; be it further

"*Resolved*, That the provisions of section 1235 should be eliminated entirely from any revenue bill adopted by the Congress of the United States, so that gain from the sale or exchange of patents would continue to be treated as is appropriate under other provisions of the law relating to sale or other disposition of property; and be it further

"*Resolved*, That, if it is deemed necessary to enact some specific provision with respect to gain from the sale or exchange of patents, the heading of section 1235 and subsection (a) thereof should be amended to read substantially as follows:

" 'SEC. 1235. SALE OR EXCHANGE OF PATENTS.

" '(a) GENERAL.—Gain from the sale or exchange of property consisting of a patent or application therefor, or an undivided interest therein which includes a part of all rights in such patent or application shall be deemed gain from the sale or exchange of a capital asset if, and only if, the entire proceeds of such sale or exchange are received by the seller during the life of the application and/or patent. For purposes of this section, any proceeds due and payable within such period which are received thereafter solely by reason of failure of the purchaser (or any successor in interest of such purchaser) to fulfill a contractual obligation shall be deemed to have been received within such period.' "

Respectfully submitted.

ALFRED W. KNIGHT, *Chairman.*

DEDUCTIBILITY OF INTEREST ON SUBORDINATED BONDS UNDER THE PROPOSED INTERNAL REVENUE CODE OF 1954 (H. R. 8300)—PREPARED BY JOHN E. PETERSON OF THE IOWA BAR, DES MOINES, IOWA

INTEREST DEDUCTIONS BARRED ON CERTAIN SUBORDINATED BONDS

The proposed Internal Revenue Code of 1954 (H. R. 8300) as passed by the House on March 18 provides that interest on corporate notes and bonds is not deductible for income-tax purposes if the obligations are held by persons who together own (directly or indirectly) 25 percent or more of the corporation's common stock and the obligation is subordinated to claims of other creditors. The corporation would be denied an interest deduction because of the subordination. See sections 275 and 312 (c) and (d) of H. R. 8300. (Copy of these sections is attached.) (See p. 8.)

AFFECTS SMALL CORPORATIONS

This provision will work a real hardship on many small corporations which are owned by a small group of persons such as family-owned corporations whose stockholders must lend money to their firms under subordination agreements in order to enable the company to borrow money and obtain lines of credit from banks and other lenders who are not stockholders.

EFFECT OF SUBORDINATION

The position of a subordinated noteholder is comparable to that of a second mortgageholder except that the obligation generally is not secured by a lien on any property of the issuer. The person who invests in subordinated notes agrees that his obligations will be junior in right to the superior indebtedness and that his obligation will not be paid until the superior debt has been retired.

The law relating to corporate finance has long recognized the fact that certain creditors may have a preference over other creditors in order to induce those who want a superior position to extend credit to the company.

In financial circles, the holder of a subordinated obligation is always regarded as a creditor and not a stockholder so long as the obligation has all the attributes of an indebtedness; namely, (1) a fixed maturity date; (2) a promise to pay a sum certain in money on that date; (3) a definite obligor; (4) a definite obligee.

Dividends paid on capital stock are not a deductible expense whereas interest paid on indebtedness is deductible.

OWNERSHIP NOT PROPER TEST OF DEDUCTIBILITY

The question of whether a corporate security issued to an investor is to be classified as a stock or an indebtedness should depend on whether the instrument has all the attributes of stock or debt. In practically all cases of subordinated obligations, it is not difficult to determine whether the instrument in fact creates a debtor-creditor relationship or a stockholder relationship.

If the instrument has all the characteristics of a debt, then interest paid thereon should be allowed as a deductible expense even though it is subordinated, regardless of whether the noteholder owns more or less than 25 percent of the common stock of the issuer. Allowance of an interest deduction should not depend upon whether the holder of the note is also a stockholder, but, rather, on the question of whether the instrument is, in fact, a debt.

Let us assume that a corporation has two identical subordinated notes outstanding which contain all the characteristics of a debt. One note is held by a nonstockholder and the other by a person who owns 25 percent or more of the corporation's common stock. This provision of H. R. 8300 would allow an interest deduction for the interest paid on the note held by the nonstockholder but would disallow the interest paid on the other note merely because it was held by a person who owns a certain amount of stock in the company. In this case, it must be conceded that the obligation is a debt; otherwise the interest paid to the nonstockholder would not be deductible. But even though it is a valid debt, no deduction would be allowed when the interest is paid to a creditor who is a stockholder. If the instrument evidences a valid indebtedness, a deduction should be allowed for the interest paid thereon regardless of who owns the security.

An individual taxpayer who has a first and second mortgage on his home is allowed a deduction for the interest paid on both mortgages regardless of who holds the mortgage and a corporation should have the same right.

INTEREST OR DIVIDEND?

How will the income from such bonds be taxed to the bondholder who owns 25 percent or more of the common stock of the company? Would such income qualify for the dividend credit under section 34 of the proposed law?

If no deduction is allowed because of the prohibitions in sections 275 and 312 (d), would the interest paid on such subordinated obligations give rise to the 85 percent dividend credit in those cases where a corporation owned the subordinated obligation and also owned 25 percent or more of the stock of the company that issued the note?

COURTS HAVE ALLOWED DEDUCTION

The courts have consistently held that interest is deductible on subordinated notes if they have all the characteristics of debt even though such notes are held by stockholders. Subordination to the claims of general creditors is not fatal to the holder's status as a creditor and the numerous cases to this effect show that this criterion usually is not of outstanding importance (see table of cases on p. 9).

To upset the long-standing precedent established by these cases would bring chaos to the financial structure of many small family-owned corporations and impose on such companies a very heavy tax burden. Our tax laws should be so designed that those who have relied on the law and the court decisions in planning the long-range financial structure of their business will not suddenly find the law overturned.

This provision is an effort to accomplish by legislation that which has failed in the courts. Congress is now being asked to sanction a theory which the courts have consistently refused to approve.

UNEXPECTED TAX DEFICIENCIES

If this provision becomes a part of our tax law, it will result in tax deficiencies which were never anticipated at the time subordinated bonds were issued. For example, if a corporation issues subordinated bonds to nonstockholders, the company would immediately lose the interest deduction on such bonds if they were later sold by the nonstockholder to a person or group of persons who together own 25 percent or more of the common stock of the company. If the subordinated bond was originally issued to a nonstockholder in good faith without any intention that it would later fall into the hands of a stockholder, then it would seem unfair to deny an interest deduction because of some act by a bondholder that was entirely beyond the control of the corporation.

SUBORDINATED NOTES HAVE A BUSINESS PURPOSE

If stockholders are willing to take a position junior to that of general creditors, then the question may be asked, "Why doesn't the stockholder invest in additional stock (either preferred or common) rather than in subordinated bonds?" The answer lies in the fact that stock of smaller corporations generally is not marketable and is difficult to sell. Therefore, a stockholder may not want to invest additional money in the business unless he knows the company is obligated to repay the money at a definite due date.

A subordinated obligation serves a twofold purpose:

(1) It enables the company to obtain additional funds from stockholders which might not be obtainable by the issuance of nonmarketable stock because subordinated bonds have a definite maturity which assures the investor of his right to repayment at maturity.

(2) Subordinated bonds strengthen the position of the superior debt and thus enable the company to borrow money from banks and other sources at lower interest rates than might otherwise be possible.

Therefore, the issuance of subordinated bonds does serve a valid business purpose aside from any tax considerations. There are numerous instances where a deduction or exemption will be allowed for tax purposes if there is a valid business purpose for the transaction which gave rise to the deduction or exemption. If subordinated bonds are issued for a valid business purpose and have all the characteristics of indebtedness, then the interest paid thereon should, by all reason and logic, be allowed as a deductible expense the same as any other interest regardless of who holds the bonds.

This provision would impede the growth of many small companies who do not have the credit standing of larger competitive companies and the ability of such larger companies to raise unlimited funds without the issuance of subordinated bonds.

EARNINGS MAY BE INSUFFIFIENT TO PAY NONDEDUCTIBLE INTEREST OR DIVIDENDS

Sections 275 and 312 (c) and (d) would create a real dilemma for many small corporations whose earnings may be insufficient to pay nondeductible interest or dividends. For example, a corporation which now has 5 percent subordinated bonds outstanding held by stockholders must earn at least 5 percent on the borrowed money in order to pay the interest thereon. If the corporation is actually earning 7 percent from the use of this money, then it has a profit of 2 percent. If the interest paid on these obligations is not deductible, then with a 52 percent income-tax rate this corporation must earn about 10½ percent in order to pay the 5 percent rate on these bonds. If the corporation is earning 7 percent then it will suffer a loss of 3½ percent (10½ percent minus 7 percent), instead of a 2 percent profit.

The only way an interest deduction could be obtained would be to convert these obligations into bonds without subordination which would place them on a parity with other creditors. Such a conversion would be difficult, if not impossible, to accomplish since the other creditors might object and refuse to extend further credit on the ground that their position as a superior creditor has been weakened. Those who hold the subordinated obligations might refuse to convert their bonds into nonmarketable stock, particularly if they want their money returned to them on a definite due date. Conversion to stock would not help the corporation out of its dilemma since dividends paid thereon are not deductible and would still leave the company with a 3½ percent loss.

UNDERCAPITALIZED CORPORATIONS

If this provision remains in the bill, it should be amended so that interest would be disallowed as a deduction only in those cases where the corporation is undercapitalized (sometimes referred to as "thin" incorporation) with an abnormal amount of debt in relation to a nominal amount of capital.

This change could be accomplished by providing that no interest would be deductible with respect to subordinated obligations held by persons who own 25 percent or more of the common stock if the total principal amount of subordinated obligations held by such stockholders exceeds 75 percent or 66⅔ percent of the net worth (capital and surplus) of the issuing corporation. This would mean that the net worth (capital and surplus) must be at least 133 percent or 150 percent of the total principal amount of subordinated obligations held by such stockholders; otherwise, no deduction would be allowed for the interest paid thereon. This change would prevent any interest deduction in all cases of this kind unless the stockholders have a substantial stock equity in the business.

Sections of H. R. 8300 Disallowing Interest Deduction on Certain Subordinated Bonds

SECTION 275. NONPARTICIPATING STOCK

No deduction shall be allowed for any amounts paid with respect to nonparticipating stock (as defined in sec. 312 (d)), which, but for this section, would have been deductible from gross income.

SECTION 312. DEFINITIONS RELATING TO CORPORATE DISTRIBUTIONS

(c) Securities.—The term "securities" means an instrument representing an unconditional obligation (or obligations) of a corporation to pay a sum certain in money other than open-account indebtedness—

(1) which in the case of obligations held by persons who together own 25 percent or more of the participating stock is not subordinated to the claims of trade creditors generally;

(2) payments, if any, for the use of the principal amount of which are not dependent in amount upon the earnings of the corporation and are unconditionally payable not later than the maturity date of the principal amount.

(3) For the purpose of (1), above, in determining the ownership of stock and debt, section 311 shall be applicable.

(d) Nonparticipating stock.—The term "nonparticipating stock" means an instrument, issued by a corporation, known generally as a corporate stock or security, other than an instrument to which subsection (b) or (c) is applicable.

(See supplemental letter, p. 1148.)

Table of Cases

Roosevelt Hotel, Inc. (par. 53,177 P–H Memo TC).
B. M. C. Mfg. Corp. (par. 52,106 P–H Memo TC).
Sabine Royalty Corp. (17 TC 1071).
H. E. Fletcher Co. (par. 51,317 P–H Memo TC).
Echota Cotton Mills v. *Allen* ((DC Ga.; 1951), 97 F. Supp. 800, 40 AFTR 902).
The Bowersock Mills & Power Co. v. *Comm.* ((10 Cir.; 1949), 172 F. 2d 904, 37 AFTR 960).
Elliott-Lewis Co., Inc. (par. 45,047 P–H Memo TC, affirmed (CCA–3; 1946), 154 F. (2d) 292, 34 AFTR 1101).
John Kelley Co. (1 TC 457, affirmed (1946), 326 U. S. 521, 90 L. Ed. 278, 66 S. Ct. 299, Ct. D. 1660, 1660–A, CB 1946–1, p. 190, 191, 34 AFTR 314).
Clyde Bacon, Inc. (4 TC 1107).
Idaho Lbr. & Hardware Co. (par. 45,085 P–H Memo TC).

Comm. v. *H. P. Hood & Sons, Inc.* ((CCA-1; 1944), 141 F. (2d) 467,32 AFTR 423, affirming Par. 42,615 P-H Memo TC).
Idaho Department Store, Inc. (par. 44,049 P-H Memo TC).
Annis Furs, Inc. (par. 43,050 P-H Memo TC, dismissed (CCA-6; Oct. 9, 1943)).
Washmont Corp. v. *Hendricksen* ((CCA-9; 1943), 137 F. (2d) 306, 31 AFTR 390, affirming (DC, Wash.), 51 F. Supp. 792, 31 AFTR 717).
U. S. v. *Title Guarantee & Trust Co.* ((CCA-6; 1943) 133 F. 2d 990, 30 AFTR 1008, affirming (DC, Ohio), 29 AFTR 1425).
Western Dredging Co. (par. 42,601 P-H Memo TC).
Fidelity Finance Service, Inc. (par. 42,467 P-H Memo BTA).
Comm. v. *Page Oil Co.* ((CCA-2; 1942), 129 F. (2d) 748, 29 AFTR 971, affirming 41 BTA 952).
O. P. P. Holding Corp. (30 BTA 337, affirmed (CCA-2; 1935), 76 F. (2d) 11, 15 AFTR 379).
Southport Mill, Ltd. (6 BTA 1073, affirmed (CCA-5; 1928), 26 F. (2d) 17, 6 AFTR 7633, 13 BTA 555 reversed 38 F. (2d) 986, 8 AFTR 10463).
Bolinger-Franklin Lbr. Co. (7 BTA 402).
H. R. De Milt Co. (7 BTA 7).
Webb Press Co. (3 BTA 247).

OREGON SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS,
April 8, 1954.

Hon. GUY CORDON,
Senate Office Building, Washington, D. C.

DEAR SENATOR CORDON: Please be advised that at a regular meeting of the Oregon Society of Certified Public Accountants held on April 7, 1954, the following resolution upon being put to vote was unanimously adopted, to wit:

Resolved, That the Oregon Society of Certified Public Accountants go on record as being unalterably opposed to the proposed section 706 (b) of the Internal Revenue Code of 1954 which provides: that a partnership may not change its taxable year from a calendar year to a fiscal year; nor may partnerships organized after June 30, 1954, adopt other than a calendar year; nor shall any member of a partnership change his taxable year; all of the foregoing prohibitions being mandatory unless permission to do otherwise is first obtained from the Secretary of the Treasury or his delegate.

We urge you to present the strongest possible opposition to this section of the proposed Internal Revenue Code of 1954.

Yours very truly,

RALPH B. COULSON,
Secretary.

LAW OFFICES OF BROWN, FOX, BLUMBERG & MARKHEIM,
Chicago 4, Ill., April 13, 1954.

ELIZABETH B. SPRINGER,
Chief Clerk, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: I acknowledge receipt of your telegram of April 3, 1954, denying the request for an appearance before the Senate Committee on Finance on behalf of Arthur S. Bowes, contained in my letter to Senator Millikin under date of March 31, 1954.

I have delayed responding to your telegram pending Mr. Bowes' return to Chicago, which occurred today.

We deeply regret the denial of the request because we feel that Mr. Bowes had a definite message concerning a clear and easily rectifiable error in the present draft of the Internal Revenue Code. We understand that in the past the policy of the committee has been more liberal in entertaining the views of responsible witnesses.

In compliance with your suggestion, I am enclosing herewith a written statement covering Mr. Bowes' viewpoint and I trust that the subject will be sufficiently presented and favorably considered by the committee.

If you have any further word which may be of interest or assistance, we shall appreciate hearing from you.

Very truly yours,

HARRY MARKHEIM.

Statement of Arthur S. Bowes to Senate Finance Committee Relative to Section 1014 (a) (9) of the Pending Revenue Bill

This statement is submitted by Arthur S. Bowes, whose address is 1420 Lake Shore Drive, Chicago, Ill. Bowes is a director of Automatic Canteen Corp. and other corporations.

The purpose of this statement is to direct attention to a manifest and indefensible injustice and inconsistency in section 1014 (a) (9) of the pending revenue code.

The section provides, in effect, that all property included in the estate of a decedent for estate-tax purposes, takes as its basis (or cost) for the purpose of computing gain or loss on a future sale, the value at which it was included in the decedent's gross estate. This is most commendable. Under present law there are circumstances where a person who receives a gift of property by reason of the death of a decedent is required to measure the gain or loss from a future sale by its cost or other basis to the decedent, even though the property was included at fair market value in the decedent's estate for Federal estate-tax purposes. This rule has resulted in discrimination since the general rule has been long established that property included at fair market value in the estate of a decedent for estate-tax purposes shall have such fair market value as its basis in the hands of the person to whom the property passes.

The catch in proposed section 1014 (a) (9), however, is that it is provided that the new section shall be limited to "decedents dying after December 31, 1953." This limitation, as expressed, continues the discrimination with respect to property acquired by gift from decedents dying prior to January 1, 1954, and in reality restricts even the future application of the new provision.

It is understood that one of the policies adopted with respect to H. R. 8300 by the House Ways and Means Committee was to avoid making retroactive substantive changes in the law. I have been advised that that policy is the reason for limiting section 1014 (a) (9) only to the cases where the death of the decedent has occurred after December 31, 1953.

To accomplish the real purpose of eliminating discrimination and injustice, and at the same time avoiding a change having a retroactive tax effect, the new section should be made applicable to sales occurring after December 31, 1953, irrespective of when the decedent died, rather than to property acquired from decedents dying after December 31, 1953. The taxable event for income tax purposes is the sale or other disposition of the property by the donee. No income tax liability can arise at the time of acquisition of the property by gift or at the time of the donor's death. It is the Federal estate tax, measured by the fair market value at the time of the donor's death, which is imposed at that time. For the purpose of future sale, so long as the property has borne the burden of the estate tax, the basis in the hands of the donee should be the value taxed to the estate regardless of the date of decedent's death. Otherwise, discrimination between donees is perpetuated.

Take an illustration. Assume two individuals each established an irrevocable trust in 1953 reserving to the donor a life estate. The trust property will be includible in the estate of each upon his death and will be subject to the Federal estate tax. Assume further that the first donor died in December 1953 and the second in January 1954.

Obviously there is no reason for discrimination in the tax consequences upon a subsequent sale of the respective properties, say in 1954, unless some imperative reason concerned with the administration of the tax law, such as a desire to avoid refunds, intervenes, but in this instance there are no such reasons, yet the proposed law perpetuates the discrimination between the two cases cited.

If the person who succeeds to the trust property upon the death of the donor who died in December 1953, sells the property in 1954 at the exact price at which it was valued for estate tax purposes he must nevertheless take as his basis or cost—not the value at which the property was taxed in the estate, but the cost to the donor who may have acquired the property in 1910 at a fraction of its present value. On this basis the individual would have to pay a substantial income tax in addition to the estate tax levied at almost precisely the same time. Or the individual might hold the property until 1975, but he still would have to revert to the 1910 value as his basis for income tax purposes notwithstanding that the identical property had been previously taxed at a much higher valuation in the estate of the donor of the trust.

On the other hand, the individual who succeeds to the property of the second trust, the donor of which died in 1954, takes as his basis the estate tax valuation and thus he may sell the property immediately without any income tax.

Clearly there is no basis for this discrimination and there is no retroactive aspect to the correction of this injustice. In both instances the taxable event occurs in the current year and no question of refund or undoing something that occurred prior thereto is involved.

If the suggested correction is made, the principle that no substantive changes relating to taxable events shall be made retroactive will still be preserved inviolate.

The correction of the existing draft could be accomplished by amending section 1014 (a) (9) to read as follows:

"(9) Property (other than annuities described in sec. 72) acquired from the decedent by reason of death, form of ownership, or other conditions, if by reason thereof the property was includible in determining the value of decedent's gross estate under chapter 11 of subtitle B or section 811 of the Internal Revenue Code of 1939."

LOS ANGELES, CALIF., *April 14, 1954.*

Senator EUGENE D. MILLIKIN,
Chairman, Finance Committee,
Senate Office Building, Washington, D. C.:

I am a Republican, have been all my life. My family and I own a small corporation, have been trying to sell to larger concern stock for stock for many years. I must retire culmination of one deal that was started a year ago, is about to take place. These deals take time and we have now arrived at the point where a complete transaction would take place in May or June but your proposed new tax law affecting small corporations merging with larger ones stabs us in the back. The amount of stock we would receive under present law would give us a living. Legislating the merger clause in your new tax bill and making it retroactive would diminish our income to existence only. I am too old to start anew or expand. For the Government to come in and take a man's life's earnings on which he hoped to retire is criminal. Why should publicly held corporations have preference over small family corporations? How would you like a law made retroactive so that it could take away your family earnings as far back as 1920? That is what it amounts to, with a small corporation trying to sell to a larger one and facing capital-gains tax. To make such a punitive law against the small fellow is New Dealism. These retroactive clauses are like putting mortgages on businesses that have already paid the mortgage off in years past. Why can't you men in office understand the little fellows' viewpoint? I understand hundreds of small family corporations trying to exchange stock with larger corporations are being put in jeopardy due to this proposed retroactive merger tax clause. If any nonpublicly held corporations could prove that it was in negotiations with any other corporation for exchange of stock prior to March 1 it should be allowed to complete the deal without penalty. Having no advance warning is like a thief in the night with a gun cocked for action. Months plus hundreds of hours and thousands of dollars have to be spent to transact such a deal. It is unjust, unfair, and criminal to exact such a penalty without cause.

RULON R. FREE,
President, California Carbonic Co.

(Whereupon, at 11:40 a. m., the committee recessed, to reconvene at 10 a. m., Thursday, April 15, 1954.)

THE INTERNAL REVENUE CODE OF 1954

THURSDAY, APRIL 15, 1954

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Martin, Williams, Carlson, Kerr, and Frear.

The CHAIRMAN. The meeting will come to order. Mr. Walker. Mr. Walker, we are glad to have you. Identify yourself for the benefit of the reporter.

STATEMENT OF HULEN C. WALKER, LEGISLATIVE ANALYST, AMERICAN FOUNDATION FOR THE BLIND; ALSO REPRESENTING THE AMERICAN ASSOCIATION OF WORKERS FOR THE BLIND, GREATER NEW YORK COUNCIL OF AGENCIES FOR THE BLIND, NEW YORK STATE FEDERATION OF WORKERS FOR THE BLIND, AND OTHER ORGANIZED GROUPS

Mr. WALKER. I am Hulen C. Walker, legislative analyst for the American Foundation for the Blind.

Mr. Chairman and members of the committee, we appreciate the opportunity of appearing here to go on record in support of a small amendment that we would like to suggest to the tax bill. It is very small, and I am not going to take but just a minute of your time.

I have a statement, which I have filed with you, that I would like to have included in the record.

The CHAIRMAN. It will be put in the record.

(The prepared statement of Mr. Walker follows:)

STATEMENT OF H. C. WALKER, LEGISLATIVE ANALYST, AMERICAN FOUNDATION FOR THE BLIND

First, I wish to thank you for the privilege of appearing before you to suggest a slight amendment to H. R. 8300.

After considerable research by agencies for the blind into the cost incident to blindness, it was determined that a blind person is burdened with an additional cost for the purchase of sight. This is in the form of the many extras which he is required to pay for because he must depend on someone else to exercise functions which he normally would perform were it not for his blindness.

The United States Congress took cognizance of this fact and provided the taxpayer with an extra exemption to offset the cost of his blindness. Congress also recognized the extra cost of living by inserting a provision into the Social Security Act directing that an amount equal to the present exemption be disregarded in determining need for aid to the blind. The committees of Congress making these recommendations are certainly to be commended for their efforts in the direction of equalizing the blind person's economic burden with that of the sighted. However, through oversight on the part of the workers in developing the statistics and giving the testimony, a slight inequity was allowed to remain in this attempt to be liberal.

The present law provided for exemption for the blind taxpayer or for the blind spouse of the taxpayer. But stopping here, the burden of blindness is not fully offset when computing the Federal income tax. Many blind persons are supported by someone other than a taxpaying spouse. The parent of a blind child must assume all the additional expense incident to blindness but in computing his tax, he does not get the benefit of the extra cost incident to blindness, he is only allowed the exemption for a dependent.

The child supporting a blind parent likewise is burdened with the additional cost of blindness in supporting his blind parent, but there again, he is denied the benefits of the extra exemption. Harsh as it may seem, many blind people in this country today are forced onto the public-relief rolls and into institutions, thereby cared for at the taxpayers' expense because of the additional financial burden to relatives supporting them. To amend the tax law to provide that the exemption for blindness be extended to members of the immediate family supporting the blind person would, in my opinion, not only give a certain amount of relief to taxpayers but would also give a greater amount of relief to the Government by reducing the number of blind people being supported by tax funds in institutions. In other words, this added exemption to the member of the family supporting the blind person would make many blind persons more welcome in the homes of close relatives.

The income which the Government would lose by this slight amendment would be nil compared to the humanitarian angle. It would further, no doubt, be a profit-making measure to the Government due to the possibility of reducing the relief rolls by making the blind person more welcome in private homes.

Therefore, I would like to suggest that H. R. 8300 be amended by rewriting part V, section 151 (d) (1), to read as follows:

"(1) For taxpayer.—An additional exemption of $600 for the taxpayer if he or a dependent is blind at the close of his taxable year."

Mr. Walker. The statement sets forth that several years ago the American Foundation for the Blind, and other agencies interested in the welfare of the blind, made a survey and determined that due to blindness, we have an additional cost of living. In other words, to purchase sight. And the Congress took cognizance of that fact and granted an extra exemption for the taxpayer or the spouse of a taxpayer who happened to be blind.

Now, I think that probably we were not clear enough in our testimony to the Congress then, when that exemption was granted. We didn't point out that many times a sighted person may have a blind child, and there is just as much of an expense for that child. Yet, the exemption does not extend to the dependents supported by a sighted person.

So, we would like to recommend that section 151 (d) (1), near the bottom of page 33, in H. R. 8300, be amended to read—I believe if I can quote it from memory, Mr. Chairman—to read: "An extra exemption of $600 for the taxpayer if he or his dependent is blind at the end of the taxable year."

I have put in quotas at the bottom of my statement the wording that I believe would take care of the extension of this exemption to the taxpayer supporting the blind child, or the child of a blind parent who has the burden of supporting that individual.

We also believe that if this little amendment could be granted, many blind persons today who are forced to live in institutions and be supported by tax funds, would be more welcome in the homes of children who could offset the extra cost by that little deduction.

As I said, I am not going to take up much of your time, and I put that in a very few words, and I do appreciate the opportunity of getting that in the record here this morning.

The CHAIRMAN. You may talk longer if you wish.

Mr. WALKER. I think that is about all, unless there are some questions.

The CHAIRMAN. Thank you very much.

Mr. WALKER. I would like to say, just as a matter of record, that only a small number of people would be affected. There are only about 6,000 to 10,000 children that we know of today, of school age. We don't know, of course, about the parents, but it would be a small number, compared to the millions of people affected by this bill.

Thank you.

The CHAIRMAN. Thank you for coming.

Now, Mr. Butler. Be seated, Mr. Butler, and identify yourself to the reporter.

STATEMENT OF EUGENE J. BUTLER, DIRECTOR, LEGAL DEPARTMENT, NATIONAL CATHOLIC WELFARE CONFERENCE

Mr. BUTLER. My name is Eugene J. Butler, and I represent the National Catholic Welfare Conference.

Senator, I have a rather lengthy statement, which I would like to file for the record.

The CHAIRMAN. You may.

(The prepared statement of Mr. Butler follows:)

STATEMENT OF EUGENE J. BUTLER, DIRECTOR, LEGAL DEPARTMENT, NATIONAL CATHOLIC WELFARE CONFERENCE

Mr. Chairman and members of the committee, I am grateful for the privilege of appearing before you today on behalf of the National Catholic Welfare Conference, an organization consisting of the cardinals, archbishops, and bishops of the Catholic Church in the United States.

I would like, if I may, to direct the attention of the committee to certain sections of H. R. 8300 now pending before you. Section 170, page 46, of the bill provides that a taxpayer shall be allowed, as a deduction, any charitable contribution which is made within a taxable year. The section further provides that a contribution shall be allowable as a deduction if verified under regulations by the Secretary or his delegate. Under existing law, a deduction up to 20 percent of the adjusted gross income, is allowed provided such contribution is made, among others, to religious, charitable, or educational organizations. The pending bill raises the charitable contribution limit for individuals from 20 percent to 30 percent. This amendment is designed to aid certain institutions in obtaining the additional funds they need in view of their rising costs and the relatively low rate of return they are receiving on endowment funds. This is a laudable recognition of the importance which the House of Representatives attaches to these very worthwhile organizations and the part they are playing in the troubled life of our country today. We recommend most heartily to this committee that the same spirit guide your deliberations in considering this bill. We respectfully call your attention, however, to the proposed limitations on this extra 10 percent deduction which is proposed in the bill. Heretofore, and in pursuance of long tradition in tax legislation, the Congress has seen fit to encourage contributions to religious, charitable, and educational organizations. It is proposed now to limit this extra 10 percent deduction on contributions made to—

(1) A church, a convention, or association of churches or a religious order.

(2) Certain educational organizations.

(3) Certain hospitals.

This provision would rule out this extra benefit from such institution as orphanages, homes for the aged, and correctional institutions for youth operated under religious auspices. It may very well be that the House of Representatives had a purpose in limiting this extra benefit, but it is difficult to imagine that such worthy institutions as these should not be accorded full benefits of this legislation. The National Catholic Welfare Conference recommends these worthy institutions to your favorable consideration.

The National Catholic Welfare Conference is concerned particularly with the meaning of clause 1 which reads, "a church, a convention, or association of churches, or a religious order." The use of the term "church" and "religious order" in the same clause disturbs us. Religious orders have been an integral part of the Catholic Church every since the earliest days of Christianity. They continue to be so today. Canon law, the fundamental law of the church, so regards them.

Bouscaren and Ellis, in their definitives commentary on the canon law of the church, state on page 742:

"Since the term 'church' will recur with great frequency in the canons which follow, the legislators has given us a definition and determined its extension for us. It includes not only the church universal and the apostolic see, but also all moral persons in the church (as defined in canon 1492, S. 2) unless the contrary is evident from the context or from the nature of the matter treated (c. 1498). The term 'church' is taken in a broad sense to mean not only a place in which divine worship is held, but also every ecclesiastical moral person constituted as such by church authority for the purpose of religious or charitable activity; e. g., hospitals, schools, religious houses, and institutes, as well as chapters of religious persons.

"The term 'church' therefore, does not include any ecclesiastical associations which are merely approved by the church, such as pious and charitable societies; nor does it include pious and social works established by private persons which do not require ecclesiastical approval and which are not subject to the ordinaries such as the Society of St. Vincent de Paul (S. C. Conc., Nov. 14, 1920; AAS, 13 (1921) 135; Digest, I, p. 174), or the various fraternal organizations of the Catholic laity, e. g., the Knights of Columbus, the Catholic Foresters, Catholic Men's Benefit Association, Ladies' Catholic Benefit Association, and the like. These organizations may be incorporated by the civil law and may be entitled to hold and administer their own property, but such property is in no sense church property within the meaning of the canons of this chapter."

It therefore follows that religious orders and other moral persons such as dioceses, parishes, et cetera, come within the meaning of the term "church" as that term is defined in canon law. To classify separately religious orders would indicate that they are not considered a part of or come within the meaning of the term "church." To do so ignores facts and pertinent church law resulting in a legislative determination of what is or is not a church. This the Congress has never done. This would be a dangerous precedent. Consequently we respectfully suggest that the phrase "or a religious order" be stricken from section 170 (A) (i) and that appropriate explanation thereof be made part of the committee report, or alternatively, we suggest that the Congress restore its traditional terminology by inserting the term, "religious organization." This terminology is thoroughly understood and is broad enough to include the structure of all religious denominations.

In the field of excise taxes religious charitable and educational organizations have, like most citizens, felt the burden. Ever since 1941 when the Congress set the rate and the list of items to be so taxed these organizations have been met with demands for increasing their facilities to take care of a shifting population and a growing clientele.

The need for relief has been accentuated not only by the above factors, but also by the general increases in the cost of items subject to the Federal excise taxes and by the expanded needs for those items on the part of such institutions. For instance, in the field of education nonprofit schools are developing extensive transportation services which are privately financed. Each school bus, for example even a Sunday school bus, purchased by a nonprofit school or a church, is subject to the payment of a substantial excise tax. Educational authorities protest that this factor is a serious deterrent to the expansion of indispensable school-bus-transportation services. Similarly, many such schools, to meet current requirements in the educational field, have established business courses, which necessitate the procurement of typewriters. Public schools may purchase typewriters without having to pay an excise tax, but all other nonprofit schools rendering the same service are required by law to pay a substantial tax. This is likewise true with respect to other educational supplies such as audiovisual equipment. In short, the whole development of nonprofit institutional enterprise is burdened by Federal excise taxes.

Even though the Congress and this committee has recently concerned itself with the problem of excise taxes, we respectfully request that in your deliberations on the bill before you this matter be given your thoughtful consideration.

Mr. BUTLER. The purpose of appearing before the committee today is to call your attention to the pending bill which raises ihe charitable contribution limit for individuals from 20 percent to 30 percent. This amendment is designed to aid certain institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds.

Mr. Chairman, we would like to say that this is a laudable recognition of the importance which the House of Representatives attaches to these very worthwhile organizations, and the part they are playing in the troubled life of the country today. We recommend most heartily to this committee that the same spirit guide your deliberations in considering this bill.

We call to your attention, however, the proposed limitation on this extra 10-percent deduction, which is proposed in the bill. Heretofore, and in pursuance of long tradition in tax legislation, the Congress has seen fit to encourage contributions to religious, charitable, and educational organizations. It is proposed now to limit this extra 10-percent deduction to contributions made to—

(1) A church, a convention, or association of churches or a religious order.

(2) Certain educational organizations.

(3) To certain hospitals.

This provision, it seems, would rule out this extra benefit from such institutions as orphanages, homes for the aged, and correctional institutions for youth, operated under religious auspices. It may very well be that the House of Representatives had a purpose in limiting this extra benefit, but it is difficult to imagine that such worthy institutions as these should not be accorded the full benefits of this legislation.

The CHAIRMAN. Just 1 minute. Mr. Smith, was there any debate, any reason given for the distinction that the gentleman is pointing out?

Mr. SMITH. There was some thought of changing the limitation from 20 percent to 40 percent or 50 percent, but some members didn't think it should go quite that far, and they recommended the extra 10 percent but limited it to these particular organizations at the time.

The CHAIRMAN. Was there any particular discussion on the point which the gentleman is making?

Mr. SMITH. No, sir.

Senator CARLSON. Mr. Chairman, on that point, it does seem to meet that when it comes to making provisions for tax exemptions for any contributions to religious organizations, certainly orphanages, homes for the aged, and correctional institutions should be given some consideration, and I would urge that Mr. Stam look into it.

The CHAIRMAN. I think so. My first impression agrees entirely with your own, and I ask that it be brought to Mr. Stam's attention, especially the point the gentleman is making.

Mr. BUTLER. Senator, we are very grateful for that sentiment.

Now, if I may skip over into the field of excise taxes. In the field of excise taxes, religious, charitable, and educational organizations have, like most citizens, felt the burden. Ever since 1941, when the Congress set the rate and the list of items to be so taxed, these organizations have been met with demands for increasing their facilities to take care of a shifting population and a growing clientele.

The need for relief has been accentuated not only by the above factors, but also by the general increases in the cost of items subject to the Federal excise taxes, and by the expanded needs for these items on the part of such institutions.

For instance, in the field of education, nonprofit schools are developing extensive transportation services which are privately financed. Each school bus, for example, even a Sunday school bus, purchased by a nonprofit school or a church, is subject to the payment of a substantial excise tax. Educational authorities protest that this factor is a serious deterrent to the expansion of indispensable school bus transportation services.

Similarly, many such schools, to meet current requirements in the educational field, have established business courses, which necessitate the procurement of typewriters. Public schools may purchase typewriters without having to pay an excise tax, but all other nonprofit schools rendering the same service are required by law to pay a substantial tax. This is likewise true with respect to other educational supplies, such as audiovisual equipment. In short, the whole development of nonprofit institutional enterprise is burdened by Federal excise taxes.

Even though the Congress and this committee have recently concerned itself with the problem of exise taxes, we respectfully request that in your deliberations on the bill before you, this matter be given your thoughtful consideration.

Mr. Chairman, if I may illustrate, shortly after the excise taxes were adopted on typewriters, in one of our cities a typewriter company went to the purchasing agent for the public schools in the city and offered him a lot of typewriters at a special price. The public schools couldn't use the whole lot. And the agent went to the superintendent of the Catholic parochial school system in the city, and asked if he would take some of them. An arrangement was made, and I believe there were 1,000 typewriters involved. The public school system took 750 of them, and the parochial school system took 250. And when it came to billing for the typewriters, the excise tax was omitted, of course, from the public schools, and the parochial schools were subject to it, where the typewriters were being used for identically the same purpose. In other words, for teaching high school students how to use them.

That, in short, highlights the situation.

The CHAIRMAN. I will tell you very frankly—this is my personal opinion—I think it would be very difficult to get any excise tax amendments on this bill. Let me suggest to you, though, that within a year we are going to have to review the subject of excise taxes again, and I am sure the committee will appreciate it if at the appropriate time you come in again and bring it to our attention.

I am not saying that nothing is possible now, but I am giving you what I think is a practical piece of advice.

Mr. Butler. Thank you, Senator. I will be glad to bring it to your attention.

The Chairman. Thank you very much.

Now, Mr. Brittingham. Be seated, please. We are glad to have you. Identify yourself to the reporter.

STATEMENT OF THOMAS E. BRITTINGHAM, JR., WILMINGTON, DEL.

Mr. Brittingham. I am Thomas E. Brittingham, Jr., and I represent myself. I come here to discuss some ideas for a foreign scholarship plan, which involves taxation.

Everything that has come up is the result of the Brittingham scholars that we brought, that we started bringing over this year. We started with one 2 years ago, involving Scandinavian students, and my wife and I are now going over and personally selecting 7 each year, and we now have our 7, all at the University of Wisconsin.

I might say that what I have to present here is endorsed by President Fred of the University of Wisconsin, who is likewise on the committee of the Government for foreign scholarship plans.

To begin with, this plan will accomplish a much better job on the part of the scholars that we are bringing over here now, at a net reduction in cost to the Government. As far as I am concerned, my only reason in being here is one of a patriotic nature, to explain what I have seen in my own travels abroad in connection with picking out these scholars.

What the plan is, is that we would deduct up to 100 percent of the expenses, up to $3,000 annually, on students brought over here, particularly where they had been contacted through visitation within the previous 2 years, and 90 percent without that visitation.

Now, that has many merits. In the first place, it puts the emphasis on the bringing over by private contacting of individuals (as opposed to a Government agency doing so), and that is just exactly what our Government stands for today. It puts emphasis on the personality and the leadership that is demonstrated, as opposed to what we are doing now, under the Fulbright and Smith-Mundt program, where we are bringing these students over here based almost entirely on their scholastic ability.

I myself, in the first time over to Scandinavia, which was a year ago January, saw and interviewed any number of the prospective Fulbright scholars, and I was appalled at the type that we were bringing over. They will be great scientists, but I am sure that many, many of them will never be great leaders of their respective governments. And, after all, that is the point of bringing these students over.

So, on the Brittingham program, we are paying no attention to the scholastic angle. That is automatically taken care of by the 25 percent that are washed out through their "studenten" examinations, and so we are putting it all on the other side, where these boys will have demonstrated their leadership ability, and have a personality that I am sure in the years to come will be very constructive for our Government, as they go back. Incidentally, these students are all brought over for one year.

So, the thing that likewise is impressive is—as it is now, the students have no particular contacts, because they are Government students.

They come over in a group, and as they do when they go to the University of Wisconsin—on that I am thoroughly familiar—they are picked out by committees. They come over with no personal contacts, and they go to the university.

The Chairman. Senator Martin, this is Mr. Brittingham, the witness.

Senator Martin. How do you do.

Mr. Brittingham. How do you do, Senator.

As I said, they go to the university, and unfortunately they center around the foreign students club there. And, why? Because they don't have any contacts to introduce them to friends in Madison, and they are all poor financially, because of their getting by on the minimum amount of money.

So, in many cases, they might just as well, I think, have gone to college some place abroad, rather than to be brought over here and not mix around.

I think probably the best example—and I think this it what you would like to know—was the case of Oscar Semb, who is a brother of one of the students we have over now, one of the Norwegians. He came over some years ago and spent 2 years attending MIT. This boy was a very strong personality individual, so I know that that was the case—it was not his fault for the poor results obtained at MIT. He told me this fall that he said about Lars, "All you have done has obtained far more out of America than I did at MIT, because I have lived in the foreign students' dormitory. There were only 6 American students there, and in the 2 years I was in Boston, I was never once asked into an American home."

The Chairman. What can this committee do about that?

Mr. Brittingham. By this plan, if we put it down to an individual, where any individual traveled abroad—I mean they would tend to be the wealthier class, but that would be a variation of all degrees. It would tend to be our business people, and if they were bringing them over here, as I am doing now, they naturally would then make sure that they got in their homes. They would go into their homes at Christmastime and at other times and meet their friends.

The Chairman. What can this committee do about it?

Mr. Brittingham. This committee can pass a law, which Representative Warburton is already prepared to introduce, which would allow a deduction for money spent on foreign students. So that is my purpose in being here.

The Chairman. Would the deductions tend to cause a better mixing?

Mr. Brittingham. Very, very much so, because any individual that was bringing these students over at some of his expense, would certainly see that they get mixed around, and that they are very much a part of his family. That I know, from my own experience.

The Chairman. I am going to put on the dunce cap now. Just what is your point?

Mr. Brittingham. I am sorry I haven't made it clear, sir. The point is, by allowing our citizens to deduct money spent on bringing over foreign students, that would tend to put everything on a personal basis, as opposed to what we are doing now, where it is entirely on a governmental basis, and where there is no personal contact. Is that clear, sir?

The CHAIRMAN. Yes.

Mr. BRITTINGHAM. And we bring over around 5,600 students, under the Fulbright program, and that would be partially continued, but the rest would be cut down, as these other students were brought in.

I have discussed this with Senator Frear, who reported when he came back from South America—I think he was down there with you, was he not?

The CHAIRMAN. I was not there, I am sorry to say.

Mr. BRITTINGHAM. I thought you were. No; I guess I am wrong.

He reported that the way to combat communism in this country was through more foreign scholarships, and I am certainly convinced of that myself, from what I have seen.

Are there any other questions?

The CHAIRMAN. Are there any questions, gentlemen?

Senator MARTIN. I have none.

The CHAIRMAN. Thank you very much.

Mr. BRITTINGHAM. Thank you.

(The prepared material of Mr. Brittingham follows:)

FOREIGN SCHOLARSHIP PLAN AS PROPOSED BY THOMAS E. BRITTINGHAM, JR., WILMINGTON, DEL.

1. Summary

A method of increasing greatly the long-term influence of our foreign scholarship program, at a net reduction in cost to the Government. Plan is result of my personal experience to date in carrying out the Brittingham 10-year scholarship program in the Scandinavian countries.

2. Plan involves

(*a*) Deduction of 100 percent of expenses (up to $3,000 annually per student) incurred in bringing foreign scholars here, where personal contacts have been made in the previous 2 years through visitation in foreign countries.

(*b*) Deduction of 90 percent of the expense, where no personal contact is made; with lower percentage deduction allowed for such countries as Canada, Cuba, the Bahamas, etc.

(*c*) The Fulbright and Smith-Mundt program would be carried on but on a lesser scale as the activity in the personally sponsored scholarship program increased. Hence, a net reduction in total cost to the Government.

3. Basic merits of plan

(*a*) It puts emphasis on personal contacts made in this country, and tends to carry out the basic philosophy of our Government that things are carried out more efficiently by private industry rather than by Government.

(*b*) It stresses the selection of students more from a personality and leadership viewpoint than from one of scholastic standing, which is given the greatest weight in choosing today's candidates. It would appear that such students offer greater promise of returning to their native lands and assuming positions of influence than those chosen under our present system of selection.

(*c*) It gives the students practically an automatic entry into our American homes and a real opportunity to really know Americans, highlighted especially by their visits during the Christmas and Easter holidays.

(*d*) Under present laws, a very wealthy man can set up his own foundation and bring in such students on a tax-free basis. The plan being proposed herein would enable the person of average wealth to adopt such a program, albeit on a smaller scale.

(*e*) The passing of a law to cover these circumstances would put the people on notice as to the Government's position in such matters and would thereby outline the background for work designed to encourage people to bring students over here.

4. Demerits of present system

(*a*) All emphasis is put on high scholastic marks, under our present method of selection. In interviewing many of these candidates, my own experience has shown a good size percentage of them to be almost pitiful from a personality test.

(*b*) There may well be future scientists among some of these students. However, once here they find no worthwhile American contacts, and, because of their personality makeup, tend to withdraw into the foreign-student circle. Such students actually benefit little from the money spent on them, other than gaining the opportunity to attend classes here. My experience bears out that students of his introverted type are not ones likely to assume positions of leadership after returning to their respective countries.

(*c*) I would think that the matter of personal contacts is of even greater importance where the foreign students are of other than the Caucasian race. The news item quoted below from the New York Herald-Tribune of February 18 illustrates the importance of this angle.

(*d*) President E. B. Fred, of the University of Wisconsin, is highly in favor of this suggested program, because of the conditions it would correct at Madison.

(*e*) Very favorable reactions have been received from the following—and only—people in the Government with whom I have discussed this plan:

1. Dr. Sam Brownell, head of education, of Government.
2. Representative Herbert B. Warburton, sole Representative from Delaware.
3. Senator J. Allen Frear, Jr., whose enthusiasm prompted him to make an appointment for me with you, and who wants me to see Senator George shortly.

2. (*a*) It is my theory that a slight premium—roughly 10 percent—should be allowed to encourage contacts being made through visitation. Our wealthier people would be the ones more apt to travel abroad; an incentive offered them in the way of an income-tax deduction would make them realize that they could afford to bring students to this country at a small net cost to themselves. This is exactly how the Brittingham foreign scholarship program was initiated, as explained in the enclosed mimeographed outline. It is obvious that such people would tend to choose students from the homes of various prominent people. Also, as a group, there would be more of an inclination to select individuals possessing such personalities as would naturally attract the American visitor. The scholastic requirements would be pretty much taken care of automatically, since in most foreign countries and certainly those in Europe, the students have to pass what is known as the studenten examinations. Through this means, the lower 25 percent of the class are automatically eliminated; this, in effect, is assurance that those students brought over here will be able to stand up easily to our college requirements. Those still will remain for clearance and checking; first, our consuls who will issue the visas, and second, the scholastic problems would go through the Institute for International Education who are doing such a good job at present on handling details for the Fulbright scholarships.

(*b*) It is evident that the same deduction should not be allowed for a nearby country such as Canada, as would be applicable to European and South American countries, particularly. Likewise, Cuba and the Bahamas would seem to be too close to warrant the allowance of full deductions in their cases. I should think it would be possible for the State Department—through Presidential edict—to determine the percentage deduction allowable for the respective countries, varying this procedure from year to year. This would add a great degree of flexibility to the program, enabling us to increase the flow of students from certain countries, where such an increase was thought desirable, and, conversely, if felt advisable, to reduce the quota coming from any country at some particular time.

(*c*) It is apparent that the Fulbright and Smith-Mundt program should continue to be carried on but as our suggested program gained momentum it would seem that the supply of funds required to finance these earlier plans could be materially reduced. Thus, there would be obviously a net reduction in the total cost of this program to the Government.

3. (*a*) I would like to cite at this point what seems to me to be an outstanding example of a field of endeavor that can be pursued more efficiently through private channels than through governmental agencies. The motive behind such a plan seems to me to tie in nicely with the expressed philosophy of the Eisenhower adminsitration. When we were in Oslo (Norway) this past fall, selecting our students for the coming year, we met Oscar Semb, a brother

of Lars Semb, one of our present students. Oscar, age 27, is just an all-around wonderful young chap—one possessed of an extremely individual and forceful personality. He had been sent, at great sacrifice on his family's part, to a small college in New Hampshire, and then for 2 years he attended MIT in Boston. While at school here he had lived in the foreign students' dormitory, and was afforded little opportunity to mix with his fellow American students and their families and friends. There were 6 American students living in that dormitory but he was not asked once into a single American home during his whole 2 year stay in Boston. With his younger brother, Lars, now studying at the University of Wisconsin under our present program, Oscar had remarked that Lars had already gotten so much more out of his short stay in this country (then 3 months) because of the nature of our program, than he had during his entire time here. This one experience probably did more than anything else to crystalize in my mind the inherent weaknesses in our present system. The results found up to now at Wisconsin simply tend to bear out Oscar Semb's unfortunate experience. It would, therefore, seem imperative that greater emphasis be placed on the element of personal contacts made in this country by the foreign student, and I feel sure that our suggested program would be instrumental in making this possible.

(*b*) Students are chosen today on the basis of their scholastic ability and on their desire to apply for scholarships in this country. That statement is based on the experience gained by me in visits to the various branches of the American-Scandinavian Foundation in Norway, Sweden, and Denmark. In discussions with others, I must assume that the same factors are followed in other scholarship selections. I feel sure, in my own mind, that the students we have selected, where personality and leadership qualities are given greater emphasis, offer far more promise of developing into tomorrow's leaders than do many of the others that I had to interview, even though these students possessed more than the necessary requirements for entering this country under our present scholarship program. It seems to me that greater weight certainly should be given to the factors of personality and leadership. If somewhat higher credit were to be allowed for the making of personal contacts, it should automatically result in the selection of just that type of student.

(*c*) It should be taken for granted that any American citizen going to the expense and trouble of bringing a foreign student to this country will make certain that that student meets boys of his own age in America. Endless opportunity would be afforded for inviting the student to visit with him at his home, especially during the Christmas and Easter holidays, not to mention the few days before and after the school term. I have learned, through conversations I have had with my own students, that the thing that impresses them the most about our scholarship program is the generous opportunity afforded them to make contacts here in Wilmington as well as in Madison. Then, too, these boys have all joined fraternities, and, through the associations made there, have been given the chance to visit various American homes during some of their shorter vacation periods such as Thanksgiving, and, in some instances, over the Christmas holidays.

(*d*) As brought out in the outline, the very wealthy can set up their own foundations, using the tax-free income derived therefrom to finance their foreign student programs. This suggested plan simply would make it easier for the person of average wealth to do what the wealthy individual can do now anyway.

(*e*) I am sure that, were Congress to pass this provision in the tax law, it would be a moderately easy job to get a movement started to encourage people to do far more work and show more interest in foreign students than is now the case.

A rather shocking instance was brought to my attention by Henrik Gad, our first,student, who came over a year ago last September. As he was departing for Denmark last June, he informed me that the foreign students at the University of Wisconsin were actually looked down upon. He told of meeting a very attractive girl at the Foreign Students' Club, who cautioned him not to tell anybody where he had met her since she felt in her own mind that she very definitely had been "slumming." All this shows that there is terrific room for improvement in our present system.

4. (*a*) From what I have seen, particularly on my first trip abroad, where my program was not originally clear in anyone's mind as to how it was to work, I certainly ran across the typical student applying for a scholarship in this country. I can vouch for the fact that, in far too many instances, he was pitiful from a personality viewpoint, and, while he had the brains, the money expended on him by our Government I think would be largely dissipated, because his personality, lack-

ing in qualities of a positive nature, offered little promise of his returning to his native land to assume a position of leadership and influence.

(*b*) By bringing these students over as we now do, there are few individuals to whom they can go to make personal contacts. Being in so many instances of the reticent type, they band together quickly into their own small circle, and this tendency is further accentuated by the fact that most of them are compelled to get by on just the minimum amount of money. Even students who come from wealthier families abroad are seriously restricted on account of the foreign exchange difficulties. Thus, many of them do not really mix with the student body, particularly. Certainly, in the group I am thinking about, I would say that practically all of them were more of the introvert type, and very much on the shy side of those coming from the Scandinavian countries.

One interesting example of what I mean in the difference between the personalities involved is this case. We have had Scandinavian and many other foreign students at Wisconsin for years. However, through no contacts of mine whatsoever in this particular case, two of my Swedish students were invited to attend a session of the Wisconsin Legislature at Madison. Later, the proceeding of the House were stopped, and both boys were asked to get up and describe to the Wisconsin House the Swedish system of government. Here, in this particular case, we can see foreign influence working in reverse, in a very happy way.

(*c*) The matter of personal contacts is of even greater importance where the students are of other than the Caucasian race. John Jenny, of the Du Pont Co.'s foreign department, had told me some time ago that the Communists made a general practice of going after the students from the British African colonies and making Communists out of them as they were brought to the English schools at government expense. Certainly, our South American students should be brought up here and there should be plenty of people interested in personally bringing this about. J'ust what can be done along these lines is forcefully brought out in the enclosed news item, taken from the New York Herald-Tribune, of February 18:

"BRITISH REDS OUTWITTED

"LONDON, February 17.—The British Council, a government-supported cultural agency, asserted today it has beaten the British Communists at their game of taking in tow and playing host to some 10.000 students who come here every year from Commonwealth and colonial countries.

"Gen. Sir Ronald Adam, chairman of the council, disclosed in a speech to the London Rotary Club that the Communists have been going down to harbors to meet these students as they came off ships and would tell them: 'You will find there is a great color bar in this country. But there is one club where every one is welcome—come with us.' Most of the students from the colonies are colored.

"In this way, the Communists undoubtedly took over and converted many colored students with the expectation they would return home to lead Communist uprisings in the colonies against Great Britain.

"Sir Ronald said that after discovering this Communist tactic he went down to meet the ships himself and succeeded in reaching the overseas students before the Communists could get to them. 'I have an advantage,' he said, 'because I can meet them in the customs shed'."

(*d*) President Fred, of the University of Wisconsin, has been intimately acquainted with the whole program; he has gotten to know our boys and is himself on a governmental committee having to do with foreign students. He is very enthusiastic over this proposal of mine. He considers it far better than anything that has so far been suggested and, in his estimation, it is the right approach. I know he will be only too glad to help in any way possible to assure the carrying out of this program.

(*e*) This is my first experience at taking up an idea with our Government people. If I do not seem to be too adept in my approach, I hope that will be overlooked. I am a neophyte in this regard.

Dr. Sam Brownell, head of Government education, gave me a highly enthusiastic reception, I thought. I next saw Representative Warburton, who could not have been more praiseworthy over the idea. Senator Frear had returned from a South American trip at just about the time I got back from Scandinavia. He had been quoted to the effect that a good way to combat the spread of communism in Latin America would be through the medium of more foreign scholarships.

After having voiced these sentiments, I knew a meeting with him would produce some constructive suggestions. Senator Frear felt that this program held much merit, and saw fit to make arragements for me to see Senator Wiley and, later, Senator George.

NOVEMBER 10, 1953.

To the Candidates for the Brittingham Scholarships:

I thought, to save time, that I would outline the background of the Brittingham scholarships, relating the story of what I am trying to accomplish, and then have each of you read this, so that I may avoid repeating all the details and, at the same time, enable you to know the purpose of the program. Please leave this here for the other candidates to read who are to come later.

Interesting enough, neither Mrs. Brittingham nor I are of Scandinavian descent. I think that fact makes the ideals behind this scholarship all the more effective. Our interest in the Scandinavian people dates back to the year 1931, when we took a good many trips on the motorship *Kungsholm.* I imagine we have taken at least 10 or 12 trips on this ship, and, during those travels, we found ourselves becoming particularly enthusiastic over the Swedish people. On that ship in the year 1933 we had the pleasure of meeting Mr. and Mrs. Nils Stahle, with whom we have kept in constant contact ever since. Mr. Stahle is today the executive director of the Nobel Foundation.

Four years ago, George Weymouth, of Wilmington, Del., accompanied me on a trip to visit the Stahles. Mr. Josiah Marvel, at that time American Ambassador to Denmark, was a great friend of Mr. Weymouth, and, because of that fact, we dropped down to visit him. We found the Danes to be a cheerful and friendly people, and, through Mr. Marvel, we met many of them. As a result of this visit, we acquired an active interest in this country and its people. Also through the good offices of Mr. Marvel, we met the Gad family, of Copenhagen, and took a great liking to young Henrik Gad. We heard from Henrik's mother, as time went on, and, about 2 years ago, she wrote, suggesting the possibility of Henrik's getting an American scholarship. I must confess that at that time I was highly irritated. However, upon thinking the matter over, I realized that I had some Brittingham family funds that I could use only in connection with the University of Wisconsin, located at Madison, Wis. I reasoned that, with the aid of these funds, I could well give Henrik a scholarship for 1 years of undergraduate study.

The question came up as to how Henrik's stay here should be directed, and, particularly, how much money he should have. I realized, as I got into the scholarship problem, that while we have many students from foreign countries at Wisconsin, most of them were postgraduates and older than the undergraduate student body. Also, due to the shortage of foreign exchange, most of their activities were restricted and they were not able to take part, particularly, in student life. Thus, although they were in the United States, they were still pretty much on the outside of things at the university, through no fault of their own. I reasoned that Henrik, for whom I had such a high regard, should be given more liberal consideration financially, enough to enable him to join the fraternity system at Wisconsin. The facts were that none of the Scandinavian boys was a member of any fraternity, and this is one of the major differences in the scholarships, as compared to other scholarships.

There is nothing in your own system that is comparable to a fraternity. The word "fraternity" comes from the Latin word "frater," which means "brother." Some Greek letters are combined to make up the name of each fraternity. The fraternity itself is a nationwide organization, there being chapters of the same Greek letter fraternity in different colleges. At Wisconsin, the fraternities have their own lodges or houses, of which they are extremely proud. The boys live and eat there and there is much social life involved in connection with these houses. There is also great rivalry among the different fraternities on the university campus. In America, there is far more outside activity in college involved in our concept of education. Personally, I feel the outside activities constitute one of the most important parts of the education, and this again is something that I find so different from your own colleges in Scandinavia.

On the other hand, the fraternities only choose their members after several weeks of a period that is known by the word "rushing." One has to be asked to join a fraternity; thus, he cannot get into a fraternity simply because he wants to. I am, therefore, put in the position of where the boys I select have to be of enough social quality to be asked to join these groups. From our selection of boys last year, I might say that they were overwhelmed by the enthusiasm by which they were met, and they received the maximum number of invitations to join the various fraternities.

As you can appreciate, it means that the foreign student becomes extremely well acquainted with the 40 or 50 members of his group, and thus gets to know each one of them very well indeed. His influence is a wonderful thing for the fraternity and, in turn, I think the fraternity is an excellent thing for the foreign student. That is why these scholarships involve enough in dollars to cover all those expenses and enough spending money to put him on an even basis with all his fellow students. That is why these scholarships involve considerably more in dollars than any other scholarship given in your countries.

In addition to this, the concept of these scholarships is different, because Mrs. Brittingham and I are working together and plan each year to personally select the boys. Once chosen, we have treated them as though they were practically our own children. They all came over on the boat together, and stopped by Wilmington, Del. Our home is nearby, and they visited us there for almost a week. During that time we got them invited to several large parties, which gave them an opportunity to meet many of our young friends in Washington. I must say the ones we selected last year took to these parties like a "duck takes to water." From Wilmington, the boys went to Madison, Wis., which is some 1,000 miles away, and they stayed at my home out there for almost a month, while they got settled in college and while they were getting acquainted with the fraternity group. My wife and I flew out there twice to be with them during that short period and to help them become settled there. After receiving the fraternity invitations in early October, they immediately moved into the various fraternity houses. When I interviewed them a year ago, I asked that each go a different fraternity, and certainly that will be the understanding with the ones we pick out this year. Furthermore, I hope that the group we pick this year will tend to go a different group of fraternities than the ones which the boys joined this year, because I think the more we can spread this foreign interest around, the better off it it will be for everyone.

You will be interested to discover that scholastic attainments mean very little in this selection. It is based entirely on personality and leadership demonstrated to date, as proved in your own schools. Hence, Mrs. Brittingham and I are engaged in a very pleasant task of selecting 2 Danes, 2 Swedes, and 2 Norwegians, to whom I am sure we will become as extremely attached as we have to our present boys.

By this time you will be asking, "Well, what is the long-term purpose of this whole program?" My feeling is that if we can come over to the Scandinavian countries and personally select the candidates each year, as we intend to do, we will be picking out young men who hold out promise for developing into future leaders in their respective countries. I am particularly interested in those who are going into Government work and into business. I feel that if we have come over here and really picked out some boys, who are already leaders, and who have oustanding personalities, as judged by us, then a certain percentage of them are bound to be important people 15 to 20 years from now. If they have lived in America, as I propose to have them live, for 1 year, then certainly they will thoroughly understand our people and how we think, and I feel that this can do more to help toward an understanding between the Scandinavian countries and ourselves than any other program that I personally could adopt. Likewise, I'm interested in seeing that these boys return to their native countries, since, if they were to end up becoming American citizens, my money would have been thrown away.

In order to save everyone's time, we are having a short interview of 10 minutes, and, from this group will be selected those with whom Mrs. Brittingham and I want to have a longer half hour interview. Let me assure those of you who are not successful that there is nothing about which to feel bad. When one comes to picking out one's own children, there will just be certain characteristics that happen to appeal to us that obviously might not necessarily appeal to someone else. All I can say to the lucky two from each country is, "Congratulations."

Naturally, I can appreciate that you will be inclined to be nervous, but, for your own sake, please forget about the nervous side. Just be as natural as you can, and please try to come in to see us with the same atmosphere surrounding you when meeting some very close and dear old friends of your own fathers and mothers whom you have known for a long time. Those of you who will be selected for the longer interviews will be called by telephone.

The Chairman. Mr. Oakes, please. Mr. Oakes, identify yourself for the reporter, please.

STATEMENT OF CHARLES E. OAKES, PRESIDENT, PENNSYLVANIA POWER & LIGHT CO.

Mr. Oakes. Senators, my name is Charles E. Oakes. I live in Allentown, Pa., and I am president of Pennsylvania Power & Light Co.

I am appearing before you as chairman of the special tax policy committee of the Edison Electric Institute, which is a trade association representing 85 percent of the investor-owned electric companies of the Nation. These companies, their customers, their shareholders and the countless number of peoples whose savings have been invested in utility securities through insurance, pension funds, and similar trusts, have a vital concern in the revision of the internal revenue laws which you have under consideration.

Last summer I appeared before the House Ways and Means Committee in regard to the revision you now have before you. I am glad to say that the taxpayers received substantial consideration on a number of matters.

Right here I want to add my commendatory remarks—others have said the same thing—that your staff has done, in my opinion, a remarkable job in the bill that has come out of the Ways and Means Committee.

The Chairman. I am glad to hear you say so.

Mr. Oakes. It certainly is a fine job.

I do not intend to repeat to you my remarks, therefore, before the House Ways and Means Committee. I do, however, have a number of items on which I wish to present new material. Short statements have been written on each, and they are being furnished to you for the record.

Most of the points included in the statements are technical, and cannot be discussed in an adequate manner within the time alloted to me. Several of them, however, would have far-reaching effects upon the electric companies, and so I wish to comment briefly upon them.

Section 6016 of H. R. 8300 would, over a period of 5 years, place corporations on a pay-as-you-go basis in respect to 50 percent of their Federal income taxes. This change is equivalent to increasing our annual income tax payments by 10 percent for the next 5 years. The only way this extra tax can be recovered is by liquidation of the corporation. Public utility companies do not liquidate their corporate organizations, as others do. We must continue to render a necessary service to the public.

The total of these extra payments probably will amount close to $50 million during the 5-year period. Many companies will have to sell additional securities in order to obtain the necessary cash.

The electrical companies accrue taxes on their books, but as their tax payments are not made until the next year, the cash is used for working capital. The commissions, however, that regulate us take this into account in establishing the rate bases on which we can earn. They would, of course, have to increase the rate bases should this pay-as-you-go proposal go through, and this would mean somewhat higher rates for our customers for that period.

For these reasons we ask that these new sections be deleted or that companies regulated by governmental bodies be exempt from these pay-as-you-go provisions of the revised code.

Subchapter C has been extensively rewritten. Its new provisions will adversely affect the utility companies in a number of diverse fields. I would like to mention some of the most important.

First, the new law would change existing law by subjecting to tax, in many cases, exchanges of stock and mergers between utilities. The practical effect of this change will be to deter and prevent the consummation of such transactions even though approved by regulatory authority as being in the public interest.

Customarily, many small utilities companies are involved. Very often they have proved unable to meet increased demands for service. The integration of such companies into larger utilities is in the public interest because the result is to extend the availability of the comparatively low-cost power furnished by the modern and highly efficient large-size generating units of established utility systems.

Second, certain new provisions of subchapter C may block many utilities from taking advantage of favorable money markets to refinance preferred stock that may be outstanding. Preferred stock is generally callable at a relatively high premium. If it has not been outstanding for 10 years, the penalty tax is so high that a company could not afford to call the stock. In the long run, this would mean that our customers would have to pay higher rates than they otherwise would. The implications of many of the other new provisions could be very serious to us. Therefore, we ask that the effective date of this revision of subchapter C be postponed to January 1, 1956, to permit further study and possible changes to avoid unnecessary harm to our industry.

Section 1514 retains the 2 percent penalty on consolidated returns, and section 243 continues the taxing of 15 percent of dividends received by one corporation from another. In our industry State and Federal laws and franchise provisions make subsidiary corporations necessary. We can't avoid it. These two provisions are, in reality, multiple taxation.

We suggest that these inequities be alleviated by:

(1) Reducing the 2 percent rate to 1⅓ percent rate for 1954, two-thirds percent for 1955, and to zero for 1956 and thereafter.

(2) That a deduction for dividends received of 90 percent, be allowed for 1954, 95 percent for 1955, and 100 percent for 1956 and subsequent years.

Now, I want to talk for a moment about double taxation of dividends—that is, the taxing of corporate earnings, first, in the form of the corporate-income tax and, second, by a tax on the individual when such earnings are distributed as dividends. As a matter of principle, double taxation is wrong. It is essential that a start be made toward its complete elimination from our tax structure. But, beyond the correction of this inequity and equally important is the need to remove the barriers which today discourage countless citizens from making available venture-type funds.

A constructive and commendable step has been taken in H. R. 8300, in which sections 34 and 116 provide for substantial relief from this double tax.

Since the end of World War II, the Nation's industries have expanded at a rapid pace, which has necessitated unprecedented expenditures for electric-power facilities, from powerhouse to the customer's meter.

As an industry with earnings restricted by governmental regulation, it is not possible for us to obtain from our day-to-day operations all of the money we need for new construction. Over 60 percent of our requirements must be new money, obtained from willing investors. The electric industry forsees continuation of its growth and expects to spend over $30 billion on construction during the next 10 years. The problem of raising the money for such large scale expenditures is, as you will observe, a serious one.

It is important to the Nation's welfare that the financing of the expansion of the electric industry, and indeed all industry, be on a sound basis. This calls for a large part of growth capital to be in the form of equity securities. Yet, the postwar record shows that almost $4 out of every $5 raised by all industry were of debt type. If industry continues debt financing at such a rate, the result could be disastrous.

I believe that this unhealthy economic trend is due largely to double taxation of dividends. It was not until 1936 that dividends received by individuals became subject to full taxation. This feature has since reduced the market for common stock. The steps which have been taken in H. R. 8300 toward alleviating the deterrent to investment by individuals in venture type securities comes at an opportune time. There is evidence that we are in a period of declining business. Expansion of our industrial potential has been planned on an extensive scale. Business needs all the support that can be given to carry out this program. In the process it is important that capital investment be provided in adequate amounts. If the economy is to develop on a sound basis, sufficient equity money must be forthcoming from the nation's investors—now and in the coming years.

But the record shows a discouraging picture of interest in equity investments on the part of many individuals.

Here, I would like to show you a chart, to make it a little easier for you to follow by remarks.

According to the Treasury Department statistics, there were 27.6 million tax returns with yearly joint incomes below $4,500, as shown on chart 1. Out of this, only 1.3 million reported some income from dividends, leaving 26.3 million potential investors—95 percent of the families in this low-income group. From the $4,500 to $10,000 income group, there were 6.8 million returns of which 1.1 million reported dividend income, leaving 5.7 million potential family-group investors—84 percent of this income class. Just taking these two income classes alone, there are 32 million family groups who do not own corporate stock.

I believe that if the proper tax incentive is provided, a sizable number of these noninvestors could be induced to invest some of their savings in the equity securities of business over a period of years. It is apparent that if only a small percentage of these taxpayers became stockholders, the money so realized would provide ample funds for industrial expansion well into the future.

Let us see what may happen, and illustrate it by the next chart. If we assume that 5 percent of those not now owning securities, with incomes below $4,500 yearly, and 10 percent of those in the $4,500 to

$10,000 class would, over a period of time, make a nominal investment of $2,000 and $4,500 on the average, respectively, for these groups——

The CHAIRMAN. What are the present savings in those groups?

Mr. OAKES. I think the best indication is the growth in savings accounts in the bank. Some of those could easily be transferable to equity investment. I would say in our own company area, people in the group under $4,500 are saving $300 or $400 a year, at least. And in the group up to $10,000, something more than that, of course. A great body of people in that group are saving money. There is no doubt about it.

The CHAIRMAN. The question obviously is whether they are spending up to the limit of their present income. Or, to put it this way: Do they have savings to invest?

Mr. OAKES. I don't think there is any doubt about it, Senator, because the evidence is in the growing savings accounts, and in the growing amount of insurance. People do have savings to invest, and the amount is growing every year.

The aggregate of just these two classes, is $5.2 billion. This amount equals the total raised by the sale of corporate common stock in the past 5 years of record-breaking industrial expansion.

It would further seem reasonable to expect that under a plan which would provide for successive series of increases in the amount of dividends excluded from tax, additional numbers of investors would become purchasers of industrial securities, thereby making available amounts of capital substantially greater than the $5.2 billion I have quoted.

We are not unmindful of the importance of conserving tax revenues. In my opinion, however, the relief of double taxation would tend to produce offsetting factors to the tax loss incurred. First, with a stimulation in the availability of equity money, a greater amount of future financing would be in the form of equities, with a resulting smaller use of debt issues. This would increase tax revenues by reason of lowered interest deductions.

Second, it would also be reasonable to expect that the need to conserve cash for expansion would be lessened, resulting in more of industry's earnings being paid out to investors in the form of dividends. In 1953 the percentage of profits paid out as dividends was 47.5 percent, less than half of corporate earnings.

Any increase in the dividend pay-out would add to the dividend income of existing holders of securities and, to the extent they are taxable, would be an offsetting factor. It would not take much of an increase in the dividend pay-out to equal the loss in tax revenues under the proposal I have made. Calculations indicate that if the payout were increased only 13 percent, the portion of the additional dividends would result in increases in tax revenues about equivalent to the loss due to the exemption of dividends as proposed in H. R. 8300 which ultimately is expected to reach about $800 million.

This, I believe, is a very important point in the alleviation of tax dividends.

The CHAIRMAN. Do you have the breakdown of those figures, how you reach that conclusion?

Mr. OAKES. I can give that to you. I don't have it here. We will be delighted to do so, sir.

(The information requested follows:)

Calculation of percentage increase in dividend payout to produce an equivalent offsetting tax revenue to the $814 million estimated to be lost by exempting dividends from income tax as provided under H. R. 8300

1. Based on 1949 statistics of income of U. S. Treasury Department, the weighted average increment tax rate for individuals applicable to additional amounts of dividends is (percent) ---------- 48. 3
2. Assuming that a sum of $814 million is to be realized in taxes from an increase in dividend payout, the amount of increased dividends which would have to be paid out to individual stockholders would be $814,000,000 divided by 0.483 equals---------- $1, 680, 000, 000
3. Corporate dividends are paid out to trustees, other corporations, etc., as well as individuals. (See note.) Since individuals subject to income tax would receive only a portion of any increased dividend payout of corporate earnings, the total payout, based on 1949 conditions, would therefore be $1.68 billion divided by the fraction: Dividends reported on individual income-tax returns in 1949 equals $5,000,000,000, divided by total dividends of United States corporations in 1949 equals $7,500,000,000 equals $1,680,000,000 divided by 0.67 equals---------- $2, 500, 000, 000
4. The ratio of dividend payout to profits (or earnings) after taxes, as reported by Department of Commerce, for 1953 was $9,300,000,000 divided by $19,600,000,000 or (percent)--- 47. 4
5. An increase in dividends of $2.3 billion would require a dividend payout of $9,300,000,000 plus $2,500,000,000 divided by 19.6 equals $11,800,000,000 divided by 19.6 or (percent)----- 60. 2
6. Which is an increase in dividend payout of 60.2 percent minus 47.4 percent or (percent)---------- 12. 8

NOTE.—Obviously the $2½ billion of dividends not reflected in personal income-tax returns does generate some tax revenue. This additional tax revenue was not included in this study for lack of data. Therefore, the result of 12.8 percent increase in the dividend payout is considerably higher than the figure would be if full information was available.

Mr. OAKES. I ask your permission to file for the record the 15 briefs we have prepared on various subjects in connection with H. R. 8300. We have them here.

The CHAIRMAN. They will be included.

Mr. OAKES. I thank you gentlemen for your attention, and I will appreciate any questions you might have.

The CHAIRMAN. Thank you for coming.

(The 15 briefs referred to, plus tables, follow:)

TABLE 1.—*Extent of ownership of equity securities as shown by 1949 individual income-tax returns*

Income class (thousands)	Number of returns (thousands)	Number of returns reporting dividends (thousands)	Total amount of dividends (millions)	Investment to produce dividends shown		Number of returns not reporting dividends	
				total (millions)	Per return	Number (thousands)	Percent of returns in class
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$0.6 under $4.5----------	27, 642	1, 316	$676	$13, 528	$10, 276	26, 326	95
$4.5 under $10----------	6, 836	1, 118	829	16, 587	14, 833	5, 718	84
$10 and over----------	1, 150	630	3, 480	69, 590	110, 527	520	45
Total----------	35, 628	3, 064	4, 985	99, 705	----------	32, 564	91

Col. (1), (2), (3), (4)—U. S. Treasury Department, Statistics of Income for 1949, pt. I.
Col. (5) equals amount of dividends in col. (4) capitalized at 5 percent (col. (4) divided by 0 05).
Col. (6) equals col. (5) divided by col. (3).
Col. (7) equals col. (2) minus col. (3).
Col. (8) equals col. (7) divided by col. (2).

TABLE 2.—*Income groups under $10,000 are potential source of new capital*

Annual income class (thousands)	Number of tax returns not reporting dividends (thousands)	Assumed percent becoming investors	Number of new investors (thousands)	Assumed investment per new investor	Potential investment of new investors (billions)
$0.6 under $4.5	26,326	5	1,316	$2,000	$2.63
$4.5 under $10	5,718	10	572	4,500	2.57
Total	32,044		1,888		5.20

Sections 6016, 6074, 6154, and 6655: Corporate modified pay-as-you-go proposal.
Subchapter C: Corporate distributions and adjustments.
Section 1514: Computation of tax, elimination of 2-percent penalty.
Section 165 (g) (3) (A): Losses, worthless securities, securities in affiliated corporations.
Section 165: Losses, and section 1231, property used in the trade or business and involuntary conversians.
Sections 104, 105, 106: Sickness and disability benefits.
Section 171 (b) (1) (B): Amortizable bond premium.
Section 243: Dividends received by corporations.
Section 247: Dividends paid on certain preferred stock of public utilities.
Section 248: Organizational expenditures (Federal stamp tax and other capital-stock issuance expense).
Section 275: Nonparticipating stock.
Section 461: General rule for taxable year of deduction.
Section 1341: Computation of tax where taxpayer restores substantial amount held under claim of right.
Section 1505: Consolidated returns for subsequent years.
Section 1732: Consolidated returns—earnings and profits.

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SECTION 275—NONPARTICIPATING STOCK

This section provides that no deduction shall be allowed for any amounts paid with respect to nonparticipating stock as defined in section 312 (d). By following through section 312 (b) (c) and (d) it becomes apparent that interest paid on an instrument which calls for fixed interest payments only if earned would not be deductible in determining taxable net income. The code is silent as to the treatment of such interest upon receipt by another corporation. It would appear that such interest should be subject to the deduction for 85 percent of dividends received under section 243 (dividends received by corporations) although no specific reference is made thereto. If the payment is not interest it would appear that it should be classified as a dividend. It would, therefore, appear appropriate for section 243 "Dividends received by corporations" to provide for the inclusion of such interest payments as dividends.

SECTION 247—DIVIDENDS PAID ON CERTAIN PREFERRED STOCK OF PUBLIC UTILITIES

Under section 247 of H. R. 8300 a public utility is given a deduction for dividends paid on certain of its preferred stock. This deduction is the same as the credit for dividends paid on utility preferred stock now allowed under section 26 (h) of the 1939 code.

Under section 275 of H. R. 8300, however, no deduction—otherwise allowable—will be allowed for any amount paid with respect to nonparticipating stock. Inasmuch as preferred stock described in section 247 is nonparticipating stock within the meaning of section 275, the effect is to disallow under section 275 a deduction specifically allowed under section 247—a clear error in drafting.

Section 247 (a) of H. R. 8300 should be amended by inserting before the words "In the case of a public utility," the words "Notwithstanding the provisions of section 275,".

SECTION 171—AMORTIZABLE BOND PREMIUM

This provision continues the deduction allowed, at the taxpayer's option, for amortizable bond premium. An important change is a new provision that the premium on callable bonds may be amortized to the earliest call date only if such date is more than 3 years from the date of original issue. According to the committee report, if the earliest call date is a date less than 3 years from date of issuance, the premium must be amortized to the maturity date. This change was inserted to prevent a form of tax avoidance by which a bondholder could deduct in 1 taxable year the premium he paid over the call price for bonds with a call date within the taxable year. However, the change has the effect of discriminating against bonds issued by utilities for the following reasons:

Most such issues are callable on 30 days' notice in order to permit refinancing if market conditions dictate. The SEC disapproves of noncallable bonds as not in accord with the spirit of the Public Utility Holding Company Act. If the above change becomes effective, bonds with the earliest call date more than 3 years from date of issuance, will enjoy a greater desirability because of the ability of the holder thereof to amortize his premium over a period shorter than the period to maturity, whereas the utility bondholder will be required to amortize his premium over the period to maturity.

It is suggested that section 171 (b) (1) (B) should be modified so as to provide that where bonds are callable at any time within 3 years from date of purchase it shall be assumed that for purposes of amortization of bond premium, the earliest call date is 3 years from the date of purchase. In this way all bonds will receive equal treatment and all issuers will be on an equal footing when they come into the securities market for financing.

SECTIONS 104, 105, AND 106—SICKNESS AND DISABILITY BENEFITS

Most utility companies provide sick and disability pay for their employees. In some instances the sick pay is provided through accident or health insurance, with benefits paid to the employees and premiums paid by the employers. There has been no question as to the taxability of such benefits to the employees, and under section 22 (b) (5) of the Internal Revenue Code—these amounts are excluded from gross income subject to tax.

Other companies pay the sick benefits directly to their employees, without using an insurance company as an intermediary. In such cases, the benefits paid to employees have been held to be taxable by the Internal Revenue Service and the employer is obliged to withhold income tax on the sick pay as wages.

In the recent case of *Epmeier* v. *United States* (199 F. 2d 508, 1952), the Court of Appeals for the Seventh Circuit held that payments made directly to an employee because of sickness were equivalent to amounts received from health insurance as compensation for sickness, and as such were excludable from income under section 22 (b) (5). The Internal Revenue Service is not following the Epmeier decision and does not believe that the exclusion under the statute includes amounts received by employees as sick or disability benefits where such amounts are based in whole or in part on their regular wages.

In a growing number of States that now include California, Rhode Island, New Jersey, and New York, the legislatures have enacted disability-benefits laws. Generally, these laws provide for the payment of weekly benefits in lieu of wages during periods of disability caused by nonoccupational injury or sickness. In New Jersey, the disability-benefits law is part of the unemployment-compensation law; in New York, the disability-benefits law is part of the workmen's compensation law. Both of these laws give to the employer the option of providing for the payment of benefits to his employees in any 1 or more of 3 ways:

(1) Insuring with the State insurance fund;
(2) Insuring with an authorized private carrier; or
(3) Self-insurance.

The Internal Revenue Service holds that benefits paid through a State fund or through a private carrier are not taxable income. In I. T. 4000, 4015, and 4060, issued in 1950 and 1951, the Internal Revenue Service first held that benefits received under a self-insured plan as part of a State disability law were nontaxable. In 1952, however, the Internal Revenue Service in I. T. 4107 reversed its position and now holds that such payments under a self-insured plan may be taxable income to the beneficiaries.

In addition, some employers had received rulings from the Bureau prior to the issuance of I. T. 4107 holding that benefits received under their self-insured sick-benefits plans were nontaxable. Although the Bureau has been requested by some employers to inform them if their plans fall within the general policy laid down in I. T. 4107, the Bureau has not done so.

The results of these cross currents in the field of sickness and disability benefits are confusion and inequity. Some employers, on the basis of I. T. 4107, are withholding income tax on sick pay as wages where these payments are made under self-insured plans. In other instances, where individual rulings had been issued, the employer is not withholding. Likewise, the employees under these self-insured plans are confused and uncertain as to the tax status of their sick payments.

As matters now stand, employees receiving benefits under sick-pay plans or State disability laws are in an equivocal position, and as between the employees of different employers there is inequality of tax treatment with respect to sick payments. If the employer provides for the sick pay through an insurance company, his employees do not receive taxable income. If the employer provides the same payments through a self-insured plan, the employee may be taxable. We believe that the result should be the same whether the payment is made through a State fund or private carrier or under a self-insured plan.

The necessity to clarify the tax status of sickness and accident benefits, whether under an insured or noninsured plan, by providing a uniform set of rules was recognized by the House Ways and Means Committee and resulted in the inclusion of sections 104, 105, and 106 in the Internal Revenue Code of 1954.

However, certain provisions of section 105 require further clarification in order to eliminate discrimination between different sick plans of various employers and the increased administrative difficulties of the employer in connection with their withholding responsibilities. To eliminate such discrimination and for further clarification it is recommended that consideration be given to adopting the following suggestions:

1. Distinguish by definition, "compensation for personal injuries or sickness" and "payment of compensation for loss of wages during a period of sickness."

2. For the purpose of defining a qualified employer's accident, sickness, or health plan, adopt language similar to that contained in subsection 1426 (a) (2) of the 1939 code relating to the exclusion of such payments from the definition of wages for social-security tax purposes.

3. To avoid discrimination arising as a result of sickness and accident plans containing waiting periods of various duration, no waiting period provision should be a requirement in an employer's plan. However, if a waiting period provision is contained in an employer's sickness and accident plan, the proposed code should require a uniform waiting period during which the compensation for sickness or accident is to be deemed includible in gross income.

If suggestions 1 to 3 above are adopted, it is believed that the effect will not only be to further clarify this situation but will eliminate any inequity and discrimination between taxpayers and will keep to a minimum the administrative difficulties of employers in connection with their withholding responsibilities.

SECTION 165—LOSSES; SECTION 1231—PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS

The authority for deduction of losses resulting from fire, storm, theft, or other casualty in H. R. 8300 is contained in section 165 which allows a deduction of "any loss sustained during the taxable year and not compensated for by insurance or otherwise." A similar rule appears in existing section 23 (f).

However, section 1231 (covering existing section 117 (j)) requires the taxpayer to group these losses in a given year with gains or losses which arise from—

(1) sales or exchanges of property used in trade or business held over 6 months, and

(2) involuntary conversion of trade or business properties or of capital assets held over 6 months.

If the total of these items including losses from fire, storm, theft, etc., produces a net gain for the taxable year, such gain is taxable under present rates at 26 percent. Where the net result is a loss for the taxable year, such loss is fully deductible against ordinary income, reducing the amount taxable by 52 percent at present rates.

Accordingly if a corporation sustains a loss from a casualty, for example, a storm loss which normally would be deductible from ordinary income with appropriate tax benefit of 52 percent, it is compelled to apply such loss against any gains from sales or exchanges of property used in trade or business which happen to occur in the same year, thus reducing the tax benefit of the loss to 26 percent.

Fire, storm, and other losses are occurrences which by their nature should call for the fullest possible tax relief. Obviously the taxpayer cannot deliberately control the point of time they are incurred so as to obtain the maximum tax benefit. A storm for example, giving rise to a loss to a calendar-year taxpayer, should afford the same measure of tax relief whether it strikes on December 31 or January 1 and there is no reason why the tax result should be influenced by a wholly unrelated transaction which happens to have been consummated during the same year.

The inequitable result described may be remedied by amendment of section 1231 (a) (2) as follows:

Striking out the words "destruction, in whole or in part, theft or seizure" and adding the following:

"(3) Only the excess of gains over losses upon the destruction in whole or in part or theft or seizure of property used in the trade or business or capital assets held for more than 6 months shall be considered for the purpose of subsection (a) and

"(4) The excess of losses over gains upon the destruction in whole or in part or theft or seizure of property used in trade or business or capital assets held for more than 6 months shall be deductible under section 165."

This amendment would permit deductions for casualty losses to stand alone under section 165 as intended.

SECTION 165 (G) (3) (A)—LOSSES, WORTHLESS SECURITIES, SECURITIES IN AFFILIATED CORPORATIONS (CAPITAL GAINS AND LOSSES)

The present Internal Revenue Code contains an inequity with respect to the nondeductibility by corporations of net long-term capital losses when they are in excess of net short-term capital gains for the current tax year. The fact that capital losses may be carried forward for a period of 5 years as an offset to net capital gains in those years, does not relieve the inequity since public-utility corporations ordinarily do not have large amounts of capital gains.

Such net losses in the case of a public utility are usually the result of transactions which are an integral and essential part of the corporation's operations. Utility companies occasionally make investments in the capital stock of local industries with the object of promoting local employment and business activity which, in turn, will increase the utility's revenues and scope of operations. Also, two or more corporations may jointly invest in the stock of a new corporation for the purpose of promoting, in close collaboration with a governmental authority, the national-defense effort or for some other public purpose.

For example, a group of electric utilities has recently organized a separate corporation to develop electric resources for the Atomic Energy Commission. The electric industry is joining chemical companies in research in the development of generating electricity from nuclear energy. Also, investments have been made in corporations engaged in research for developing new products from natural gas and oil.

Such necessary exploratory and research undertakings are made, in many instances, through separate corporations with the knowledge that partial or complete failures may result in many instances.

In the cases mentioned, the corporate taxpayer will, in most instances, own less than 80 percent (present law 95 percent) of each class of the capital stock of the corporation and thus will not come within the requirements of section 165 (g) (3) (A)—H. R. 8300. This section provides that if 80 percent (present law 95 percent) or more of each class of stock of the corporation is held by another corporation, then any loss resulting from such investment is deductible as an ordinary loss.

In order to arrive at true corporate net income for any tax year it is urged that section 165 (g) (3) (A)—H. R. 8300 be amended so that all net losses of corporations in investments, when incurred as a result of a transaction entered into for the purpose of advancing their main business, and which is incidental thereto, should be allowed in full as an ordinary loss in the year the loss occurs and that such losses should not be limited to corporations owning 80 percent or more of the stock of the company as to which the loss is realized.

SECTION 461—GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION

Section 461 (c) (1) of H. R. 8300 requires a taxpayer who reports income and deductions on the accrual basis to accrue real property taxes ratably over the period to which such taxes are related. Section 461 (c) (2) provides that the foregoing rule does not, however, apply to any real property tax to the extent that such tax was allowable as a deduction under the 1939 code for any taxable year beginning before January 1, 1954. The operation of these two provisions may result in considerable inequity to some accrual-basis taxpayers for the year 1954. That inequity can be illustrated by the following situation.

In many areas in the State of New York, for example, real property assessments are made as of July 1. Under practice approved by the Commissioner of Internal Revenue for many years, an accrual-basis New York taxpayer may accrue real property taxes as of July 1, even though such taxes are for the succeeding calendar year. Hence, such an accrual-basis taxpayer can accrue on its 1953 Federal income-tax return real-estate taxes assessed as of July 1, 1953, even though the tax so assessed is in fact attributable to 1954.

Under section 461 (c) (2) of H. R. 8300, an accrual-basis taxpayer in New York who had accrued as of July 1, 1954, real-estate tax attributable to 1955 would be denied any deduction on its 1954 return for real-estate taxes. The reason for such a result is that the real-estate tax assessed as of July 1, 1954, could be deducted only in 1955 under section 461 (c) (1) inasmuch as such tax is attributable to that year. Unless, therefore, a deduction is allowed on the 1954 return for real-estate taxes, a heavy and inequitable penalty is inflicted on the taxpayer for 1954 merely because of proper accruals on the 1953 return under the 1939 code.

Relief from such a penalty is clearly indicated.

The relief suggested could be provided by amending section 461 to permit an election to be made by the taxpayer to continue the method heretofore used in accruing real-property taxes, the permissible election being limited to taxpayers whose real-property taxes accrue under the 1939 code in the year preceding that to which said taxes are attributable and who have used such accrual date in years prior to 1954 as the basis for deducting the real-property taxes.

Section 461, if amended as suggested, would then more fully accord with the intent of the House Ways and Means Committee report as indicated in the general comments thereon, item F, page 50, in which permissive language is used.

SECTION 243—DIVIDENDS RECEIVED BY CORPORATIONS

Section 243 of H. R. 8300 in effect continues the taxing of 15 percent of dividends received by one corporation from another domestic corporation.

Thus, H. R. 8300 fails to correct the inequity which was recognized by the President in his message to Congress on January 21, 1954, in which it was stated: "I also recommend that the penalty tax on consolidated returns and intercorporate dividends be removed over a 3-year period." The gradual elimination of this inequity, in line with the President's recommendation, could be accomplished by increasing the dividend-deduction allowance to 90 percent for the year 1954, 95 percent for the year 1955, and 100 percent thereafter.

Historically, payments of intercorporate dividends have been treated for Federal income-tax purposes as nontaxable transfers of funds from one corporation to another. Prior to the Revenue Act of 1936, a corporation receiving dividends incurred no tax thereon. Full recognition was given to the principle that a corporate tax had already been paid upon the earnings distributed as dividends.

Ever since the enactment of the Revenue Act of 1936, 15 percent of intercorporate dividends have been subject to tax.

In 1936, with a corporate income tax rate of only 15 percent, the effective tax rate on intercompany dividends was only 2.25 percent. Under the present 52 percent tax rate, the effective rate on intercompany dividends is 7.8 percent. Thus, the burden of this economically unsound tax has become much heavier than when first imposed.

The only asserted reasons and possible justification for taxing intercorporate dividends have long since disappeared. In a message to Congress by the President of the United States dated June 19, 1935, the President recommended the substitution of a corporate income tax graduated according to the size of corporation income in place of the then uniform rate of 13¾ percent. The President supplemented this recommendation with the following:

"Provision should, of course, be made to prevent evasion of such graduated tax on corporate incomes through the device of numerous subsidiaries or affiliates, each of which might technically qualify as a small concern even though all were in fact operated as a single organization. The most effective method of preventing such evasions would be a tax on dividends received by corporations."

Corporate tax on an extensive graduated scale has long since been discarded. Tax avoidance under the present division of the corporate tax rate into normal and surtax today is largely prevented by other provisions of law. Thus the penal motivation of this tax has been removed and therefore the tax itself should also be removed.

The burden of the tax is particularly onerous upon a public utility system. Legal and operating consideration, State laws, requirements of corporate charters and franchises, the operation of regulatory process and the like contribute to the necessity of separate corporations as a fully integrated and closely affiliated utility system operating in several States. The considerations named prevent the creating by merger of a single corporation, the 2 percent penalty imposed in the filing of consolidated returns forecloses relief in this direction and thus the intercorporate dividend tax in a very real sense is not only the triple taxing of the same income, i. e., to subsidiary—to parent—to stockholder—but is in fact a penalty tax.

The chain of taxation may be shown thus:

Corporation S with a net income before tax of $1,000,000 pays a tax of	$520, 000
S disburses its remaining net income in dividends to corporation P, the latter paying thereon a tax of 7.8 percent	37, 440
Total	557, 440

The income has been taxed at 55.7 percent and of course the effective rate increases progressively if the corporate chain is longer. Moreover when the income passes to the parent corporation's stockholders there is a further imposition of normal tax and surtax at high rates. The inclusion of a penalty tax in this chain of taxation is wholly without justification.

The inequity should be corrected by eliminating the present tax on dividends from one domestic corporation to another.

SECTION 1341—COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT

Section 1341 provides for an alternative computation of tax where a taxpayer restores a substantial amount which was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to the item of income.

The section is made inapplicable specifically to sales of stock in trade or property of a kind properly includible in inventory.

The report of the Committee on Ways and Means of the House of Representatives at page A294 indicates that the reason for such exclusion is that "an accrual basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462."

Regulated public utility companies are frequently in the position of collecting revenue for the sales of their service or products during a period in which their rates are under review by a regulatory authority and as the result of decision of the regulatory authority must refund to their customers amounts included in gross income in a prior taxable year.

Although the wording is not clear, it would appear that sales of electric energy and gas may fall within the scope of the exception provisions of subsection (b) (2) of section 1341. Utility companies of course are not in the position of making sales returns that would qualify for relief under section 462.

Since the general relief purposes of section 1341 are clearly pertinent to utility companies under the circumstances as explained hereinabove the inequity may be corrected by amending section 1341, subsection (b) (2), by changing the period at the end to a comma, and adding the following:

"unless the deduction arises out of refunds or repayments required to be made by a corporation whose rates are fixed by a State or political subdivision thereof, or by a public service or public utility commission of a State, or a political subdivision thereof, or of the District of Columbia, or by an agency or instrumentality of the United States."

SECTION 248—ORGANIZATIONAL EXPENDITURES (FEDERAL STAMP TAXES AND OTHER CAPITAL STOCK ISSUANCE EXPENSE)

H. R. 8300, at section 248—Organizational expenditures, has made a step in the right direction by providing that certain organizational expenditures of a corporation may, at its election (made in accordance with regulations prescribed by the Secretary or his delegate), be treated as deferred expenses in computing taxable income. Such deferred expenses would be allowed as a deduction ratably over a period of not less than 60 months, as may be selected by the corporation (beginning with the month in which the corporation begins business).

In section 248, the term "organizational expenditures" is defined to mean any expenditure which—

(1) Is incident to the creation of the corporation;

(2) Is chargeable to capital account; and

(3) Is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

The report of the Committee on Ways and Means to accompany H. R. 8300 states: "This treatment will conform tax accounting more closely with general business accounting for these costs." However, the same report of the committee goes on further to say: "This provision is not applicable to the professional fees and other expenses incurred in connection with stock issues or transfers of corporate assets in reorganization. As is now the generally accepted practice, these expenses are to be charged directly to the capital paid in to the corporation as a result of the transaction."

The proposed new code section 248, therefore, will continue to deny as a deduction from gross income certain expenses of organization of a corporation and issuance of its capital stock, such as: Attorneys and accountants fees, Federal, State and local taxes, filing fees, investment counsel fees, transfer agent and registrar fees, printing, engraving, advertising, and other administrative expenses connected with the issuance of stock securities. The theory for not permitting such expenses as deductions from gross income appears to be that such expenditures are a reduction of the amount received by a corporation upon issuance of its stock, and therefore, represent merely a reduction of the capital invested by the stockholders rather than an employment of such capital for the purposes of the business.

Expenses of issuance of stock, preferred or common, subsequent to original organization including Federal issuance taxes, are similarly treated as nondeductible capital items. The capital theory of such items has evolved over the years through court decisions which, in turn, have given rise to Bureau rulings resulting in the present rate is indicated.

This rule had its inception at a time when corporate financing and corporate organization were handled on a very different basis than exists under today's conditions. Accordingly, the rule should be reexamined in the light of the reorientation in financing of the utility business.

The raising of capital through issuance of stocks and bonds is one of the most important aspects of the utility industry. It is common knowledge that large amounts of new money are required continually in the development and expansion of the industry. On the average $4 invested in plant and equipment is required for every $1 of revenue, as compared with manufacturing industries which average $1 or less invested in property for every $1 of revenue. Moreover the utility industry faces a dual problem of heavy capital requirements in order to maintain growth, with a comparatively small amount of retained earnings with which to finance such expansion. As a consequence it is an entirely ordinary and necessary function of the industry to go repeatedly to the public money market to raise a major portion of the funds required to serve the public.

From an income-tax standpoint it would be more advantageous to the utility to raise money through bond financing since the expenses of such financing including the items referred to above are deductible pro rata over the term of the bond issue. However, public utilities cannot rely only on bond financing to meet their capital requirements. In their case because of the need to maintain credit rating and the necessity of complying with regulatory requirements there is a compulsion to maintain a balanced capital structure comprising approximately 50 percent debt and 50 percent or more preferred and common stocks.

Under the circumstances recited, the issuance of stock is a regular part of the utility's business and the recurring expenses associated therewith are just as much an ordinary and necessary expense as any other item of operating-expense nature. It is inequitable, therefore, that these expenses should be capitalized and not permitted as a deduction in the determination of the utility's net income when they are such an integral part of the year-by-year operations of the average utility.

The impact of these expenses under modern-day procedure is vastly greater than it was in the early years of the growth of the corporate form of business. Present-day laws very properly set up elaborate safeguards for the benefit of the investor in the issuance of securities, compliance with which is an expensive process. Issuance taxes long in the law were initially at a much lower rate than obtains at the present time. As these and other expenditures described herein have increased and multiplied in class and extent they have lost entirely whatever slight capital characteristic they once may have had under a theory of law initially developed at a time when such expenditures were relatively few in kind and nominal in amount.

The following items, which have every aspect of ordinary and necessary expense, are incurred every time an issue of stock is sold, and, therefore, should be allowed as deductions from gross income: Securities and Exchange Commission filing fees; State corporate filing fees; State regulatory filing fees; Federal, State, and local taxes; legal, engineering, and accounting services; investment counsel fees; transfer agent and registrar fees; printing; engraving; advertising; and other administrative expenses in connection with issuance of stock securities.

In any realistic concept of net income subject to tax the treatment of these expenditures as nondeductible is difficult to understand. By their very nature they are clearly essential, ordinary, recurring expenses of doing business and should be so treated, consistent with the overall statutory scheme of allowing all ordinary and necessary epenses of conducting a business, as deductions from the income of the business.

It is respectfully submitted, therefore, that section 248 of the proposed Internal Revenue Code of 1954 should be extended so as to allow the deduction of these expenditures.

SECTION 1505—CONSOLIDATED RETURNS FOR SUBSEQUENT YEARS

This section provides that if a consolidated return is made for a taxable year, consolidated returns must be filed for subsequent years unless the code has been amended subsequent to the election, thereby making the filing of consolidated returns substantially less advantageous than separate returns. Furthermore, the expiration of any provision in the code is considered an amendment. The report of the Ways and Means Committee, page A-298, indicates that the applicable year of the change is not to be considered. An example was cited to the effect that if an affiliated group filed a consolidated return for the calendar year 1953 subsequent to the date of enactment of the Internal Revenue Code of 1954, it is required to file a consolidated return for the taxable year 1954, even though the new code does not take effect until 1954, and even though the excess-profits tax provisions expired in 1953.

It is submitted that this particular provision of the section is inequitable and that a new election should be given in the first applicable year of any amendment to the code that makes it substantially less advantageous to file consolidated returns.

This correction of H. R. 8300 may be accomplished by striking the clause "regardless of the effective date of such amendment" from subsection (a) (2) of section 1505.

SECTION 1732—CONSOLIDATED RETURNS; EARNINGS AND PROFITS

This section provides for an election of a method for allocation of consolidated income-tax liabilities among the various members of the group for earnings and profits purposes in the first consolidated return to be filed for a taxable year beginning after December 31, 1953. Once an election is made, the particular method of allocation must be continued as long as consolidated returns are filed. The majority of utility companies filing consolidated returns allocate the consolidated return tax liabilities in accordance with rules prescribed by the Securities and Exchange Commission. It is possible that subsequent to the enactment of the proposed code that SEC might change its method of allocation of consolidated tax liabilities. The rules outlined in section 1732 do not provide for such a contingency with the result that one method of allocation would be used for Federal income-tax purposes and another method would be used for SEC purposes.

This objection to section 1732 would be obviated by providing that subsection (a) (4) thereof be changed as follows:

(4) The tax liability of the group may be allocated in accord with any other method selected by the group at any time with the approval of the Secretary or his delegate.

SECTION 1514—COMPUTATION OF TAX-ELIMINATION OF 2-PERCENT PENALTY

H. R. 8300 continues the present 2-percent penalty when consolidated returns are filed. The penalty tax was first imposed by the Revenue Act of 1932 largely because of the contention that in the filing of a consolidated return the loss of one corporation could be used to reduce the net income of another. At that time the corporate tax rate was 13¾ percent. Developments in the tax law over the intervening 22 years plus an increase of 38 percentage points in the tax rate have removed whatever reasons may have existed for the penalty. The alleged advantage in 1932 has been nullified by the 1-year carryback and 5-year carryover of net losses, allowing in all a 6-year period for application of losses of 1 year against profits of other years.

Not only have two congressional committees recommended that the penalty tax be abolished, i. e., the Senate Committee on Finance in May 1932 and the Committee on Ways and Means in February 1934, but the President of the United States in his budget message of January 21, 1954, also recommended its elimination.

The desirability of consolidated returns for closely affiliated corporations has long been recognized as such from the viewpoint of preventing tax avoidance as for any other reason. When a more accurate determination of taxable income thus is achieved the imposition of a penalty is anomalous and has no justification.

Especially is this true of the public-utility industry. Many public-utility systems are required to operate through the medium of subsidiaries because of State laws, franchise requirements, etc. Thus, some States require that a utility operating within the geographical limits of the State shall be incorporated in that State, even though the separate corporation is a part of an integrated utility system operating through closely affiliated corporations in several States. In other cases, the use of a subsidiary to supply part of the service or part of the facilities through which the service is rendered, may be necessary because of joint ownership of property, franchise requirements, or similar reasons over which the regulated public utility has no control. It is inequitable to require the payment of a Federal tax penalty because of the requirements of State or local law or other mandatory conditions.

SECTIONS 6016, 6074, 6154, AND 6655—CORPORATE MODIFIED "PAY-AS-YOU-GO" PROPOSAL

The Internal Revenue Code of 1954, as embodied in H. R. 8300, contains provisions (secs. 6016, 6074, 6154, and 6655) which would require certain corporate taxpayers to estimate, declare, and pay a portion of their normal tax and surtax (under sec. 11 or 1201, or subch. L of subtitle A) during the year in which the income giving rise to such tax is recognized. This plan, as embodied in the aforementioned sections, is hereinafter referred to as the "proposal."

Background of the proposal

The ideas embodied in the proposal originate from two events of tax legislative history:

(1) The placing of tax payments of individuals on a pay-as-you-go basis, which was accomplished by the Current Tax Payment Act of 1943.

(2) The speedup of corporation taxpayments, which was placed in the code by the Revenue Act of 1950.

To date, corporations have paid these taxes in the year subsequent to the year to which the taxes applied. Thus 1953 taxes will be paid during the year 1954. Of course, the companies accrued these taxes on their books in 1953 but used the cash for other corporate purposes. They probably are making the taxpayments in 1954 out of current revenues.

Prior to 1951, corporations made these taxpayments in equal quarterly payments. In that year, as noted in point (2) above, a progressive change in the proportion paid each quarter was initiated. In order to illustrate the proposal, assume a company paying $100,000 each year in Federal corporate income taxes.

Taxes paid in—	Payment of preceding year's taxes				
	Mar. 15	June 15	Sept. 15	Dec. 15	Total
1950	$25,000	$25,000	$25,000	$25,000	$100,000
1951	30,000	30,000	20,000	20,000	100,000
1952	35,000	35,000	15,000	15,000	100,000
1953	40,000	40,000	10,000	10,000	100,000
1954	45,000	45,000	5,000	5,000	100,000
1955	50,000	50,000	0	0	100,000

The increase in the amounts paid in the first two quarters has adversely affected working capital, but since it was gradual the change has not attracted much attention.

H. R. 8300, however, proposes to pay a progressively larger proportion of the current year's taxes each year until the corporation is back on the equal quarterly payment basis. Taxes paid would work out as follows (as to the assumed taxpayer):

Taxes paid in—	Payment of preceding year's taxes		Payment of current year's taxes		Total
	Mar. 15	June 15	Sept. 15	Dec. 15	
1955	$50,000	$50,000	$5,000	$5,000	$110,000
1956	45,000	45,000	10,000	10,000	110,000
1957	40,000	40,000	15,000	15,000	110,000
1958	35,000	35,000	20,000	20,000	110,000
1959	30,000	30,000	25,000	25,000	110,000
1960	25,000	25,000	25,000	25,000	100,000

Thus in a 5-year period the assumed taxpayer would pay $50,000 (10 percent) more than its payments would have been under the old system. As the electric utility industry is growing this proposal will cost the taxpaying electric utilities $50 million or more extra cash during the 5-year period.

There is no practical way to recover this cash from the consumer rate payers during the 5 years. A corporation would never catch up with the money unless it liquidated.

Objections to the proposal

The proposal, as embodied in H. R. 8300, is objectionable for several reasons the most important of which will be briefly enumerated below:

(1) H. R. 8300 provides, in section 11, that the present 52 percent maximum corporate rate be reduced as of April 1, 1955, to a maximum of 47 percent (both percentages represent the combined maximum normal and surtax rates).

It has often been said that corporations would be afforded relief from the present burdensome income-tax rates next year. We are forced to conclude that only the letter but not the spirit or substance of this assurance is reflected in H. R. 8300. It is exceedingly difficult to find the promised and deserved relief in a tax reduction from 52 percent to 47 percent when, in the year that such reduction goes into effect, a 5-year plan is effectuated which calls for an annual 10 percent increase in tax dollars paid. The cash payment speed-up is all the more objectionable because it represents a "back door," or concealed, method of accelerating the flow of tax dollars into the Federal Treasury.

For a corporation whose life expectancy extends far into the future the proposal would, for all practical and immediate purposes, be quite similar to a tax rate increase for the transition years on a non-pay-as-you-go basis.

(2) The operation of the proposal would, in some cases, result in the payment of tax on income which is not earned, or is indeterminate, as of the date of payment. A law is manifestly unjust if it forces a taxpayer, whether corporate or individual, to estimate income, which cannot be determined with finality until many months later, and then levy a penalty for failure to make a satisfactory estimate.

Although the penalty to be assessed by the proposal is only applicable to an underpayment, an overpayment, in effect, carries its own informal penalty, which is no less real as to detriment.

(3) One of the cornerstones of accounting theory is the periodic determination of income on the basis of the calendar or fiscal year. Taxable income is likewise so determined. Corporations should not, as a matter of principle, be forced to determine taxable income on a basis other than a completed taxable year, even though such requirement may be rationalized by the use of the word "estimate."

(4) The compelling reason for placing individuals on a so-called pay-as-you-go system was to enable the Government to collect the burdensome taxes which came into being with the Revenue Act of 1942. It was a matter of expediency. In fact, it was a matter of absolute necessity.

The corporate tax rate in 1955 will, presumably, be no higher than it has been in 1952 and 1953 (it is, of course, now proposed that it be reduced). During the past 2 years no unusual difficulty has been encountered in collecting income tax due from corporations. There is simply no justification in presuming that a modified pay-as-you-go system is needed to insure collection of income tax from corporations.

(5) When the pay-as-you-go plan was applied to individuals, under the Current Tax Payment Act of 1943, doubling up of payments was avoided by, in effect, "forgiving" 75 percent of the lesser of the tax for the years 1942 or 1943, and equally dividing payment of the remainder between the years 1944 and 1945. There are no "forgiveness" provisions embodied in the current proposal.

(6) It has been stated that: "The irregularity of tax receipts increases the problems in managing the public debt and is an unsettling influence in the money markets. The irregularity of tax payments also makes it harder for corporations to manage their own financing."

It is respectfully submitted that relevant problems of management of the public debt or of corporate finance are the result of accelerated payments of income tax and the cure does not lie in further acceleration which would result in annual 110 percent tax payments during the transition period.

Recommendation

It is, therefore, recommended that sections 6016, 6074, 6154, and 6655, pertaining to declaration and payment of estimated tax by certain corporations on a modified so-called pay-as-you-go basis, be deleted in their entirety from H. R. 8300.

SUBCHAPTER C—CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

The taxpaying public utility industries are operated impartially for customers, employees, and investors. The electric and gas industries in general are regulated as to operations, rates, and capital structure, all of which are in the public interest. Such public utility industries should be distinguished from unregulated corporate taxpayers which are not as rigidly bound by the requirements of various governmental bodies.

The restraints and restrictions of subchapter C designed to eliminate certain tax abuses with respect to securities will work unfair and burdensome hardships upon regulated industry. The various tax avoidance devices intended to be eliminated by subchapter C may have no relevance to an industry subject to close regulatory scrutiny. Nevertheless the restraints and restrictions proposed in subchapter C work an unfair hardship upon our regulated industries as hereinafter indicated.

Electric and gas utilities must expand with the growth of population and the economy. Construction expenditures during the next 10 years by the electric industry alone are estimated to be $32 billions. Expenditures for property additions during 1954–56 by both electric and gas industries are estimated at $10.7 billions, the estimate for gas amounting to $2.3 billions with the estimate for electric aggregating $8.4 billions. The great bulk of capital for such estimated expenditures must be obtained from investment sources.

Changing money market conditions frequently require refinancing of capital structures which must be balanced as to ratios of debt, preferred stock, and equity capital. In order, marketwise, to attract additional equity investment and maintain appropriate ratios of debt to equity it is frequently desirable to substitute a lower dividend rate on preferred stock for an existing higher rate issue to the benefit of consumer, employee, and investors. The provisions of subchapter C of H. R. 8300 interpose barriers to such refinancing. The "penalty transfer tax" provisions of section 309 were proposed ostensibly to prevent "preferred stock bail-outs" and distribution of corporate surplus taxable at capital gains rates to selected or preferred proprietors.

In equity and in fact there is no reason whatever why these "loophole closing" provisions should be applied to regulated utilities. Preferred stocks of public utilities are not issued as a tax-free bonus on common stock. It was not uncommon years ago for preferred stocks to be issued for cash or property at an average book figure of about $90 per share which was the then arm's-length going money rate of about a $7 preferred dividend rate with a call premium of $10. In cases where any of such stocks are still outstanding the money market rate at this time would dictate refinancing. Under the proposed provisions of section 309, a public utility would be penalized by a transfer tax and criticized if it did not refinance. The penalty to the utility for calling such preferred stock at $110 per share would be at an 85 percent tax rate applied to the excess of 105 percent of the amount paid in ($90) or $13.18 ($90×105%=94.50; 110−94.50=15.50; 15.50×85%=$13.18).

This, it is urged, is an unrealistic burden to impose upon an innocent corporate taxpayer solely in order to police the unregulated loophole-seeking corporation. Accordingly we urge that the following amendments be made to the H. R. 8300 provisions to exclude public utilities from the application of such loophole provisions.

That a new subdivision be added to section 309 (a), numbered subparagraph (6) to read as follows:

First recommendation (sec. 309)

"(6) SINKING FUND REACQUISITION AND REFINANCING.—If a redemption is by a public utility (as defined by sec. 247 (b) (1), a transportation company, or by a railroad corporation (as defined by sec. 77 (m) of the Bankruptcy Act (49 Stat. 922; 11 U. S. C. 205)) and is pursuant to a sinking fund provision or to a recapitalization or refinancing, required or approved by the Interstate Commerce Commission, Federal Power Commission, Securities and Exchange Commission, or by a public utility or public service commission or other similar body of the District of Columbia or any State or political subdivision thereof."

Second recommendation (sec. 309)

Section 309 (a) of H. R. 8300 levies a penalty transfer tax on a corporation which redeems its nonparticipating stock within 10 years from the date of its issuance. This is explained to have been inserted in the law to close the so-called preferred stock bail-out tax minimization scheme which some nonregulated corporations and their shareholders had adopted. If a 10-year holding period from January 1, 1954, closes the loophole it seems to us that 10 years prior to redemption is equally effective. Yet despite the obvious conclusion section 309 (c) would apply to our present preferred stock, outstanding fifteen to thirty-odd years, for another 10-year span. In order that full and consistent treatment be given equitably to all taxpayers, the entire subject matter of section 309 (c) in H. R. 8300 should be stricken.

Call options (sec. 305 (c) (1) (B))

The normal refinancing of a preferred stock often includes an offer of exchange of new preferred stock for presently outstanding preferred stock, with provision that any unexchanged stock will be redeemed pursuant to a call provision.

Under section 305 (c) (1) (B) these normal call provisions could be construed as options, with the result that although the transaction in fact is a tax-free recapitalization exchange it would be treated, and taxed to the holder, as a redemption.

Third recommendation (sec. 305 (c) (1))

It is respectfully suggested that section 305 (c) (1) be amended by adding at the end thereof "for the purpose of this subsection, an option shall not be deemed to be held by a shareholder by reason of the presence or exercise of a call or redemption provision."

Liquidation wholly owned subsidiary (sec. 331 to sec. 336)

The treatment proposed in H. R. 8300 in the case of the liquidation into the parent corporation of a wholly owned subsidiary raises serious questions. In public utility operations this type of transaction is quite frequently encountered.

Due cognizance is taken of the problems posed by the Kimbell-Diamond decision but such questions probably arise in less than 5 percent of all cases. There appears no real need in the solution of such problems for a departure as to 95 percent of the cases from the 1939 code section 112 (b) (6) and 113 (a) (15) procedure.

Under the present Internal Revenue Code, the liquidation of a subsidiary into the parent corporation normally results in no income or less to either the parent or the subsidiary corporation. Such a transaction is governed by section 112 (b) (6). Section 113 (a) (15) provides that the basis of the assets of the subsidiary in the hands of the parent shall be the same as it was in the hands of the subsidiary. The only instances in which gain or loss may be recognized as to either of the parties is (1) where a subsidiary is indebted to the parent and (2) where the subsidiary has acquired debt of the parent at less than the issue price. These situations need corrective treatment, but they are minor factors when set off against the major "market valuation" problem discussed below.

Section 112 (b) (6) has no precise counterpart in H. R. 8300. All corporate liquidations are covered by sections 331 through 336, inclusive.

Whether or not a liquidation result in gain or loss to the shareholder of the liquidated corporation under the new law would depend on the relationship to each other of the (1) fair market value of the assets distributed, (2) the adjusted basis of the assets distributed, and (3) the adjusted basis of the stock redeemed.

If both the adjusted basis and the fair market value of the assets distributed exceed the adjusted basis of the stock, then gain would be recognized to the extent that the lesser of such fair market value or adjusted basis exceeds the adjusted basis of the stock (sec. 331 (b)). The basis of the assets in respect of which gain is recognized would be the lesser of the fair market value or the adjusted basis of such assets to the distributing corporation (sec. 334 (a)).

If the adjusted basis of the stock exceeds the fair market value of the assets distributed loss would be recognized to the extent of such excess (sec. 331 (c)). The basis of assets with respect to which such loss would be recognized would be the fair market value of such assets at the time of distribution (sec. 334 (b)).

If the fair market value of the assets distributed equals or exceeds the adjusted basis of the stock, and the adjusted basis of the assets distributed is equal to or less than the adjusted basis of the stock, then no gain or loss would be recognized in respect of the liquidation (sec. 331 (d) (1)). The basis of the assets so distributed would be the adjusted basis of the stock, allocated to the various assets in accordance with the fair market value of such assets (sec. 334 (c)).

Thus it is seen that the determination of whether or not gain or loss is to be recognized on a liquidation, the extent of such gain or loss, if any, and the basis of the assets in the hands of the distributee shareholder all would require that the fair market value of the assets distributed, both individually and in the aggregate, be ascertained.

In the instance of a public utility this may prove to be highly controversial, particularly where the earnings experience is less than a fair rate of return on the net investment in assets. This difficulty will not be confined solely to the taxpayer. The administrative problems inherent in the ascertainment of fair market values will also present to the Commissioner of Internal Revenue a most difficult task which will contribute to delay in settling tax liabilities.

In the situation of the liquidation of the subsidiary into the parent, in which any recognized gain does not result in actual tax to the parent because of the 100-percent dividend deduction provision, it will be to the advantage of the parent to urge a higher valuation. The Government would, of course, contend for a lower fair market value and an attendant lower basis.

Only in those cases in which no gain or loss is recognized is the lever of fair market value not directly material. Even here, however, fair market value of individual assets is required to permit allocation of basis established as the adjusted basis of the stock for the aggregate of the assets.

Now we believe these facts point up the fundamental objection to the H. R. 8300 provisions. One must determine "fair market value" of assets in every case. And there is an inevitable conflict of interest—taxpayer will want a high figure, Government a low figure, and both will disagree on item allocations.

We would, therefore, urge that relief be given the taxpayer willing to abide the 112 (b) (6) and 113 (a) (15) result. To this end we suggest that there be added to sections 331, 332, 333, and 334 elective provisions in substance or effect as follows:

Fourth recommendation (sec. 331 through sec. 336)

"Notwithstanding the provisions of this section if the taxpayer elects under regulations prescribed by the Secretary of his delegate, within 6 months after the effective date of this act or the date of the liquidation, whichever is later, the transaction shall be given for all Internal Revenue purposes the effect it would have been given under the provisions of the Internal Revenue Code of 1939 as if this Internal Revenue Code of 1954 had not been enacted."

Corporate Organizations, Acquisitions, and Separations of subchapter C (pt. III) retains appropriate provisions of nonrecognition of gain or loss to corporations which exchange property and stock pursuant to statutory mergers or statutory consolidations with one or more publicly held corporations. Integration of business enterprise is essential in a free economy and no deterrent should be interposed where joining of going concerns is in the public interest. Existing tax law has long recognized the desirability of permitting on a tax-free basis the combining of the operations and ownership of 2 or more corporations into 1 unit either (*a*) through acquisition of 80 percent controlling interest of stock in a stock-for-stock exchange, or (*b*) by the process of statutory merger or consolidation.

Under H. R. 8300, section 359 (b), Corporate Acquisition of Stock, and section 359 (c), Corporate Acquisition of Property, are intended to facilitate such transactions. However, the provisions of these sections are of such a restricted nature that they can be utilized only by corporations reasonably alike in size.

The rules requiring the shareholders of a corporation, the stock or property of which is acquired to obtain an interest of 25 percent of each class of stock of the acquiring corporation will preclude most of the acquisitions of property or stock of smaller corporations by larger corporations which has been a normal course in the development of our economy.

Since business in many instances cannot be joined as a practical matter by statutory mergers or consolidations, it follows that the rules of section 359 (b) and 359 (c) should be modified and made more readily available to corporations in general.

Fifth recommendation (subch. C, pt. III)

Therefore, in the case of section 359 (b), Corporate Acquisition of Stock, the rule under (1) relating to the acquiring corporation obtaining control (80 percent) should be sufficient and 359 (b) (2) relative to ownership of stock in the acquiring corporation should be deleted.

In the case of section 359 (c), paragraph (1) should be deleted since acquisition by one corporation of at least 80 percent of the fair market value of the properties of another corporation should be sufficient requirement when coupled with paragraph (2) requiring liquidation of the corporation which transferred assets to the acquiring corporation.

Sixth recommendation (subch. C)

In view of the new tax philosophies to be brought into play by subchapter C, the utility industries suggest and recommend that the effective date of subchapter C be set ahead to January 1, 1956. Such a period of time will permit the review of the effect of subchapter C upon various transactions under these most complicated provisions of law.

The CHAIRMAN. Mrs. Davis. Sit down, Mrs. Davis, and be comfortable, and identify yourself to the reporter.

STATEMENT OF MRS. RANICE W. DAVIS, JOHNS HOPKINS SCHOOL OF MEDICINE

Mrs. DAVIS. I am Mrs. Ranice W. Davis. I have come to speak for myself, as a taxpayer, and for a group of people who are concerned about section 214, on child care expenses.

We are encouraged that the Ways and Means Committee saw fit to try to alleviate the financial strain——

The CHAIRMAN. May I ask what is your connection with the Johns Hopkins School of Medicine?

Mrs. DAVIS. I am employed by the Johns Hopkins School of Medicine.

The CHAIRMAN. What do you do?

Mrs. DAVIS. I am an assistant professor and director of the Department of Art as Applied to Medicine.

The CHAIRMAN. Tell me again. I didn't hear you.

Mrs. DAVIS. I am an assistant professor and director of the Department of Art as Applied to Medicine.

The CHAIRMAN. Thank you.

Mrs. DAVIS. And I am a working mother, separated, but not legally without any support, and I have an 18-month-old child that I provide for.

For this reason, I am concerned about the discrepancies and the unfair aspects of this section since, at the moment, I would not qualify for any deduction, since I am not legally separated.

I might say here that I think that stressing the point of legal separation might in many instances discourage reconciliation between separated people, and speed legal action so that these working mothers, who have no other means of support except their own income, could qualify for deduction.

We are aware that Secretary of the Treasury Humphrey testified before you that one of the reasons for revising the tax bill was to rectify some of the unjust and unfair provisions that existed in it, and we certainly want to urge you not to perpetuate any such unfair and unjust provisions.

We also feel, as he said, that the bill had reached the state where initiative was seriously stifled, and we want to tell you that we feel, as it stands now, that the initiative of some 19 million working women is very definitely being stifled.

The general rule, as it exists, provides for a deduction allowance for widows and widowers, legally separated, divorced women, and women whose husbands are incapable of self-support, being mentally or physically deficient.

We feel that this classification is definitely discriminatory against the mother who must work in order to help provide basic living requirements for her family. We also feel it discriminates against a deserted parent, either a wife or a husband, who perhaps because they are hopeful of a future marital status, delay any legal action.

The CHAIRMAN. What you are proposing is that we look through the legal formalities and take a look at the actual facts?

Mrs. DAVIS. Look at the actual conditions of these people who may not have a legal status that would qualify them for eligibility, as now stated. And this might include the separated parent who, for religious reasons, is hesitating to take legal action. And it also includes the separated parent who, if they live in a State that requires more than 12 months' delay for divorce, have missed a total taxable year's deduction, although they do have legal action started for a divorce. And, of course, I believe it ignores the unwed mother, who must be complimented on trying to provide a home and a future for her child.

We contend that the hardship cases of working mothers are not necessarily among those listed, but are among, also, the 2 million working mothers who have children under 6 years of age. I think it should be noted that of these 2 million mothers, some 22 percent are factory workers, 20 percent are farm workers, 18 percent are clericals, 8 percent are professionals, and 4 percent officials. It is obvious that the largest number are in the low-income occupations.

In regard to the low-income occupations, we feel that the ceiling of $600 that has been stated, regardless of the number of children, is inadequate. We hold that child-care expenses should be considered as ordinary and necessary costs of operation incurred in the earning of a livelihood and should, therefore, be wholly deductible, as those under section 162, for trade or business expenses.

For example, Mr. Lasser, in his book Your Personal Income Tax, says that for the actor there is no ceiling on fan-mail costs; for the businessman there is no ceiling on advertising costs or entertainment expenses, including dinners, flowers, lunches, parties, theater tickets, sporting event tickets, and so forth; for the professional man there is no ceiling on the gifts required by his profession or for the purchase and laundering of uniforms, or any unusual expense necessary to earning his professional income.

Mr. Lasser also states that for the farmer there is no ceiling on club or association dues, if this membership is for farm business purposes.

We cannot agree that the expenses as cited in these examples are as basically essential to earning a livelihood as child-care expenses are to the working mother. And we feel that if a $600 ceiling were imposed on any of those specific items, it would be most inadequate and that the professional and business men would object.

We also feel that the precedent of establishing a ceiling on the amount of child-care expenses deductible is unfair and discriminatory against one group of wage earners, creating an undue hardship.

The established figure of $600 is definitely inadequate for the majority of areas in the country. I am speaking for the Baltimore area. There, for a woman working 11½ months, which would be 50 weeks less legal holidays, on a 5-day working-week schedule, and paying $5.50, which is $5 plus carfare, for day care for her child, pays $121 per month, or $2,684 a year. And this does not include the cost of meals supplied or the required employer's social-security payment.

If the child is old enough to go to a nursery school, the charges per child are $45 a month, and up. If they go to a nursery school or a kindergarten for older children, with a school program, they have limited hours and sessions, and per child it is $100 and up. Under these conditions the child's care must be supplemented by after-school care, since the sessions are out in the early afternoon, and if the mother is employed full time, she has to pay for the extra care.

I happen to be a mother who is one of the 1 percent of the women's labor forces who earned in 1953 $5,000 or more. After my withholding tax was taken out, and for the first 5 months of my child's life, falling within the taxable year, I paid $700 in baby care, I was left with an operating salary of less than $4,000 for the year.

There are 80 percent of the 19 million workingwomen in this country who earn less than $2,500 a year. Those who are mothers simply could not exist on what would be left, following similar child care expenses, which were made necessarily inexpensive.

The CHAIRMAN. Nineteen million?

Mrs. DAVIS. Nineteen million workingwomen, and 80 percent of these earn less than $2,500.

I have had correspondence from the offices of several Representatives and Senators that intimated possible abuses of the child-care-expenses deduction by well-to-do working married mothers. We refer these Congressmen, as well as your own committee, to the United States Government Printing Office Bulletin No. 246, called Employed Mothers and Child Care, for detailed support of our figures.

The census shows here that the larger number of wives enter the labor forces where the husband's income is under $3,000 than $5,000 and over. In 1951 the figures show that when the husband's income was under $1,000, 28 percent of the wives entered the labor force.

Where the husband's income was $2,000, 29 percent of the wives had to go to work.

Where it was under $3,000, 28 percent went into the labor forces.

Where it was under $4,000, 27 percent.

Under $5,000, 21 percent worked.

Under $6,000, 17 percent.

Under $10,000, 11 percent.

And, $10,000 and over, only 12 percent worked.

In this 12 percent you will find professional women, entertainers, teachers and those people who we feel contribute to society and should be kept in their working positions.

I can cite the shortage of nurses, doctors, and teachers in this country. All of those holding such positions are urged to work, and of course that includes the women. You cannot say, "Stay home and take care of your children," when America is asking for nurses, teachers, and other professional women.

We hold that to exclude the working mother as eligible for deduction, especially those whose husbands' incomes are $3,000 or less, is penalizing the very needy majority for the questionable abuses by a very small minority.

Included in the report of the Committee on Ways and Means, to accompany this bill, was a section 214 for child-care expenses, which stated that if the taxpayer had a maid or a housekeeper who cares for the children, in addition to her other household duties of cleaning and cooking, the cost of the maid's salary must be prorated, and only that portion which is allocable to child care may be taken as a deduction.

We feel that this implies that child care is babysitting only, necessitating a salary prorating for those duties normally considered essential in maintaining children in a developmental and hygienic environment.

And we say that it is impossible to establish a regular prorating scale with prenursery school-age children, in view of their irregular and progressive behavior patterns.

The CHAIRMAN. What is your suggestion?

Mrs. DAVIS. I suggest that the ceiling be removed entirely; that the statement read as it does for businessmen, "a reasonable amount." In other words, a woman who has to find very inexpensive care for her child, because that is all that she can afford, is able to deduct that. A woman who can afford more expensive care, can deduct that—however, up to a reasonable amount.

I do feel that any stated ceiling is creating a hardship, and is a precedent that should not be established. We are aware of the amendment which Senator Kerr and Senator Smith have submitted, and we know that they have stated that these expenses are deductible if they are incurred by a taxpayer who would otherwise render such care personally. So that, naturally, would include the classifications which we have pointed out as having been discriminated against.

They choose to raise the child level to 14 years, which we had in mind, and I think is excellent, though it is not as important, I feel, as the limitation question, at the moment.

They also define the term "care" to include feeding, supervision, and attending of a dependent, which should be considered more favorably. However, they have selected to retain a limit of $600, which is not only I think a hardship and a precedent, but is an inadequate amount, no matter how you look at it.

The CHAIRMAN. What was the revenue lost on this subject, in the House provision?

Mr. SMITH. $40 million.

The CHAIRMAN. Had you considered the specific proposal of the witness?

Mr. SMITH. No, sir; but I might say that if all working wives and widowers were allowed a deduction for child care up to 25 percent of their income, the estimate would run about $700 million.

The CHAIRMAN. Please take a look at that.

Mrs. DAVIS. I might add, of course, we feel that every child-care attendant employed is increasing the employment in the country. We also feel that, in fairness, the general economy at the moment could be helped by putting a ceiling on some of the businessmen's deductions, either a percentage or a flat ceiling, if that precedent is to be considered among deductions.

Thank you very much.

The CHAIRMAN. Thank you very much.

(The prepared statement of Mrs. Davis follows:)

BILL H. R. 8300—SECTION 214—CHILD-CARE EXPENSES

The undersigned are pleased to have an opportunity to submit this statement regarding Section 214—Child-Care Expenses of bill H. R. 8300. We wish to thank Senator Eugene Millikin and the Senate Finance Committee for granting a hearing to Mrs. Ranice W. Davis of Baltimore, Md., so that she might speak for us in expressing some of the following opinions.

We are encouraged that the Ways and Means Committee saw fit to include some attempt to alleviate the undue financial strain befalling working mothers, but we beg the Senate Finance Committee to rectify the discrepancies and discriminatory phases of this section before offering it to some 5¼ million mothers in the American labor force.

Secretary of the Treasury Humphrey has testified before your committee that the revision bill was designed with three purposes in mind, one being to relieve millions of persons from unjust and unfair provisions in the existing law. We urge you to guard against perpetuating such unjust and unfair provisions in the revision. Secretary Humphrey also testified that the tax structure has reached a point "where initiative is seriously stifled." We urge you to guard against stifling the initiative of 19 million working women.

With your permission we wish to discuss two subsections of section 214 separately:

(a) General rule

There shall be allowed as a deduction expenses paid (for child care) during the taxable year by the taxpayer who is (1) a widow or widower, or (2) a mother whose husband is incapable of self-support because mentally or physically defective. (The term "widow" and "widower" also includes an unmarried person who is divorced * * * and a person who is legally separated from his spouse).

We hold that—

I. This classification is discriminatory in not providing for the following persons:

1. The mother who must work in order to augment her husband's income to provide basic living requirements for her family.

2. The deserted parent who, hopeful for his future marital status, delays legal action.

3. The separated parent who for religious, financial, or other reasons must delay legal action.

4. The separated parent awaiting a final decree of divorce who, if living in a State requiring more than a 12-month delay before granting a divorce, is deprived of the child care expenses deduction for a taxable year.

5. The unwed mother who is providing a home and future for her child.

II. The principal hardship cases are not among those eligibles listed in section 214 alone, but are among the 2 million working mothers with children under 6 years of age.

Of these women, 22 percent are operatives (factory workers, 20 percent farm workers, 18 percent clericals, and only 8 percent professionals or technicians, and 4 percent officials.

Note that the majority are in low-income occupations.

(*b*) *Limitations*

The deduction under subsection (a)-(1) shall not exceed $600 or any taxable year.

We hold that—

I. Child-care expenses should be considered as ordinary and necessary costs of operation incurred in the earning of a livelihood, and should be, therefore, wholly deductible as are those under section 162—Trade or Business Expenses.

For example, as stated in Lasser's Your Personal Income Tax:

1. For the actor there is no ceiling on fan-mail costs.

2. For the businessman there is no ceiling on advertising costs or entertainment expenses (including dinners, drinks, flowers, lunches, parties, tickets to concerts, sporting events, and theaters, etc.).

3. For the professional man there is no ceiling on gifts required by his profession or the purchase and laundering of uniforms or unusual expenses necessary to earn his professional income.

4. For the farmer there is no ceiling on club or association dues when such membership is for farm business purposes.

We cannot agree that such expenses as cited in these examples are as basically essential to earning a livelihood as child-care expenses are to the working mother. We feel that a $600 ceiling imposed upon these specific items would appear most inadequate to the business or professional man. The precedent of establishing a ceiling on the amount of child-care expenses deductible is unfair and discriminatory against one group of wage earners, creating an undue hardship.

We hold that—

II. The established figure of $600 is inadequate for the majority of areas in the country.

For example, in the Baltimore area:

1. The working mother with minor children or prenursery school infants working 11½ months (50 weeks less legal holidays) on a 5-day working week schedule, and paying $5.50 ($5 plus carfare) for day care of these children pays: $121 per month, or $2,684 annually. This does not include the costs of meals supplied or the required employer's social-security payment.

2. The day nursery school charges per child are $45 per month and up.

3. Nursery schools and kindergartens with limited hours and sessions charge per child $100 per month and up. Such child care must be supplemented by paid after-school care where mothers are employed full time.

Cheaper day care, if available, is generally not licensed and public pressure is being brought against such unlicensed care.

Correspondence from the offices of several Representatives and Senators has intimated possible abuses of the child-care expenses deduction by well-to-do working married mothers. We refer these Congressmen, as well as your committee, to the United Government Printing Office Bulletin No. 246, Employed Mothers and Child Care, for detailed statistical support of our above contentions.

Notice that less than 1 percent of the women's labor force earn more than $5,000 per annum, while 80 percent earn less than $2,500. (See Ladies' Home Journal, April, 1954.)

Notice that the census shows that a larger number of wives enter the labor forces where the husband's income is under $3,000 than $5,000 or over.

Figures for 1951 show the following:

Husband's income:	*Wives' participation in labor forces (percent)*
Under $1,000	28
Under $2,000	29
Under $3,000	28
Under $4,000	27
Under $5,000	21
Under $6,000	16
Under $10,000	11
Over $10,000	12

We hold that—

III. To exclude the working mother as eligible for deduction, especially those whose husbands' incomes are $3,000 or less, is penalizing the needy majority for the questionable abuses by a very small minority.

Also included in the report of the Committee on Ways and Means to accompany H. R. 8300.

Section 214.—Child care expenses: If the taxpayer has a maid or housekeeper who cares for the children in addition to her other household duties of cleaning and cooking, the cost of the maid's salary must be prorated and only that portion which is allocable to child care may be taken as a deduction.

We hold that—

I. It is implied that "child care" means "baby sitting" only, necessitating a salary prorating for those duties normally considered essential to maintaining children in a developmental and hygienic environment.

II. It is almost impossible to establish a regular prorating scale with prenursery school age children in view of their irregular and progressive behavior patterns.

Respectfully submitted by:

Mrs. Ranice W. Davis.
Mrs. William G. Cochran.
Eleanor Delfs, M. D.
Mrs. Margaret Desch.
Mrs. Thelma Blanchard.
Richard Marshall.

The Chairman. Mr. Banfield.

Mr. Banfield, sit down and be comfortable, and identify yourself to the reporter.

STATEMENT OF RICHARD W. BANFIELD, EXECUTIVE VICE PRESIDENT, NILES-BEMENT-POND CO., WEST HARTFORD, CONN.

Mr. Banfield. My name is Richard W. Banfield. I am executive vice president of the Niles-Bement-Pond Co., of West Hartford, Conn. As chairman of the subcommittee on tax policy of the National Machine Tool Builders' Association, I am appearing on behalf of the machine-tool industry of the United States.

First, our industry wants to commend House Ways and Means Committee and the staffs of the committee, the Joint Committee on Internal Revenue Taxation, and the Treasury Department on the monumental task they have completed in drafting H. R. 8300, the proposed Internal Revenue Code of 1954, which eliminates or reduces so many long-standing inequities of our tax law.

Our industry feels strongly, however, that certain provisions of H. R. 8300, although steps in the right direction, do not provide a satisfactory solution to the problems involved. I shall confine my remarks to three points: The improved, but still inadequate, provisions covering depreciation; the need for additional revisions relating to the surtax based on unreasonable accumulation of earnings: and the need for relief from double taxation of corporate earnings.

I should add, however, that our industry believes the corporate income tax rate should be reduced to 47 percent as of April 1, 1954, and should be reduced further as revenue needs permit, and that tax payments by corporations with estimated income tax liability in excess of $50,000 should not be accelerated.

Depreciation: As you know, section 167 of H. R. 8300 would permit taxpayers to use the declining-balance method of depreciation, with a rate not in excess of 200 percent of the straight-line rate. This is a step in the right direction, but it does not go far enough.

The CHAIRMAN. Would you hold up a minute? Senator Martin, I have to leave for a few minutes. Would you take over, please?

Senator MARTIN (presiding). Proceed, Mr. Banfield.

Mr. BANFIELD. It does not eliminate that great bottleneck to industrial modernization and expansion—bulletin F, with its arbitrary and unrealistic "useful lives" based on surveys of equipment in use in the depressed 1930's. Because bulletin F and the useful-life concept remain as a guide for depreciation rates, I do not believe section 167 will have the far-reaching economic effect hoped for by the Ways and Means Committee.

We are convinced that only a system of "optional depreciation" for durable, productive equipment acquired after December 31, 1953, will give the necessary impetus to American economy. By "optional depreciation" we mean the method adopted in other countries under which management in the exercise of sound-business judgment, having regard to plant activity in cyclical businesses, technological improvements, cost savings, and all other factors, has discretion to write off the cost of facilities over the foreseeable period during which management believes the investment can be recouped out of the earnings produced with the facilities. "Optional depreciation" does not mean arbitrary or unreasonable writeoffs which would distort annual income or do violence to accepted accounting concepts.

Our proposal for "optional depreciation" is limited initially to durable productive equipment, because the need for a system of depreciation which will foster modernization is felt most keenly in connection with productive equipment. Eventually, and by an orderly transition, optional depreciation should be extended to all depreciable business property.

Because of immediate revenue needs to bring the national budget in balance, we have limited the percentage of cost which can be deducted in the first year to 50 percent, but after this transition period there should be no flat-percentage limitation and the amounts to be deducted should be based on sound business judgment by management.

We are convinced that the greatest single deterrent to industrial modernization and expansion to increase the national income and the tax base has been the so-called bulletin F concept that facilities must be written off as long as they last without regard to their utility or the cost of replacement.

Because machine tool builders are both sellers and users of machine tools, they are doubly affected by the useful life concept of the present law. As sellers, they get sales resistance from prospective customers experiencing the deterrent effects on replacements and modernizations exerted by bulletin F and its useful life standard. As users, they are faced with the same deterrents as anyone else in regard to replacement of their own productive equipment. Depreciation policy was largely responsible for the definite trend toward obsolescence in the productive equipment of machine tool builders and others in the critical period following World War II.

The enactment of section 124 and section 124A in 1940 and 1950 was a recognition that industry cannot expand under the straitjacket of bulletin F.

The useful life concept and bulletin F are particularly unsound in the case of machine tools because of rapid technological advances. In the 1920's, the industry progressed from belt-driven machines designed for use with mushet steel to electrically driven machines for use with high speed steel. In the 1930's sintered carbide cutting tools were introduced, and machine tools were redesigned around them.

During and after World War II, there was continued progress, both in electrical operating devices and in the growing substitution of cemented carbides and abrasives for sintered carbides and high-speed steel. Many machines built for use with high-speed steel in the late 1920's and 1930's are now doubly obsolete, although their bulletin F life may not have expired. Many machines built in the 1940's are at least once obsolete, although under bulletin F they are supposed to be serviceable well into the 1960's.

Optional depreciation is neither new nor untried. Many industrial nationas have adopted it in one form or another and with great success and stimulus to industrial expansion and modernization.

In Sweden, corporations were permitted, until January 1, 1952, to depreciate capital equipment without any limit, and it was quite common to write off 100 percent in 1 year. For 1952 and 1953 annual maximum depreciation allowances have been limited to 20 percent of cost, but we are advised this was adopted merely as an interim restriction because of a temporary economic situation.

Because of its realistic approach to depreciation in the past, Sweden has moved ahead of other countries with the finest and most modern factories in the world.

Switzerland, Great Britain, and Canada have also used systems of optional depreciation with comparable results. These are discussed in the written statement filed by our association with the Ways and Means Committee on July 22, 1953, as is the recommendation for the adoption of a system of optional depreciation made in 1947 by a Special Tax Study Committee of the House Committee on Ways and Means.

Few people realize that the United States has been losing ground to these other countries and that a substantial part of our national plant is obsolescent, principally because the delay in creating reserves in the face of continuing inflation had made replacement difficult or impossible.

The declining balance depreciation method allowed under section 167 of H. R. 8300 also contains a serious defect which should be corrected if your committee decides that optional depreciation cannot be adopted at this time.

Under the declining balance method set out in section 167, there is no terminal date. This means that full depreciation on a machine will never be recovered and that a substantial undepreciated cost will be left at the end of the so-called useful life determined under bulletin F.

If H. R. 8300 is not amended so as to allow optional depreciation, section 167 should be changed so that it clearly allows a taxpayer the election to take depreciation under either the declining balance method or the sum-of-the-digits method. The latter method is a well-recognized decreasing charge accounting method which allows complete depreciation of property over its theoretical useful life and gets rid of the theoretical problem of carrying some residue ad infinitum.

Under this method, the depreciation allowable in a particular year is determined by comparing the remaining estimated useful life as of that year with the sum of the digits represented in the number of years in the estimated useful life. For example, where the estimated useful life is 5 years, the sum of the digits is 15: that is 1 plus 2 plus 3 plus 4 plus 5. For the first year, five-fifteenths of the cost would be allowable; for the second year, four-fifteenths, and so forth.

In some years, the depreciation allowable under the sum-of-the-digits method is in excess of that allowable under the declining balance method described in section 167, and this excess would not be allowable as depreciation under the limitation of section 167 (b) (3). Section 167 must therefore be amended for a taxpayer to make use of this sum-of-the-digits method if he so desires.

Surtax or retained earnings: As you know, sections 531 through 536 of H. R. 8300 would make needed and extremely worthwhile improvements in the provision concerning the surtax based on unreasonable accumulation of income. This is the penalty surtax imposed by section 102 of the present Internal Revenue Code. Two further changes in existing law are necessary, however, in order to minimize the stifling influence of this tax upon American business development.

First, the law should be amended so as to eliminate from accumulated earnings subject to surtax any earnings that are retained for reasonable business needs. Under H. R. 8300, as under present law, two corporations which retain the same dollar amount of earnings are subject to the same penalty surtax, although one corporation might have accumulated all its earnings unreasonable while the other might have retained a substantial amount of the earnings for recognized business needs. Such a result cannot be justified.

One other problem as to the surtax on unreasonable accumulation of earnings is not resolved under H. R. 8300. Because of certain court decisions and the position which the Revenue Service has taken in some cases, there remains a substantial doubt whether a corporation in one business may safely accumulate funds in order to expand into a new unrelated business. This problem is particularly important to members of the machine-tool industry.

As you know, the industry having been subject to severe fluctuations, many members of the industry are interested in diversification. H. R. 8300 should be amended to make clear that a corporation will not be subject to a penalty surtax on accumulated earnings if it retains earnings in order to enter another unrelated business.

This deterrent to small companies expanding into other fields must be removed.

Double taxation of corporate earnings: My final point will be brief. Section 34 of H. R. 8300 makes a long overdue change in the law by eliminating, to some extent, the double taxation of corporate earnings. Our country has lagged far behind Canada and other leading nations of the world in failing to recognize the inequity of double taxation on corporate earnings.

Probably this double burden of tax has done more to discourage the development, production, and manufacture of new products than any other factor. Those who do not like our profit system are encouraged to think that this double taxation will dry up our sources of equity capital.

As you know, double taxation of corporate earnings in this country is not only unjust to shareholders, but has had unfortunate effects upon business development. It has often led to use of a partnership or proprietorship where a corporate entity was really necessary under modern business conditions. It has also frequently caused corporations to issue debt securities, the interest on which is deductible, rather than using more flexible equity financing.

I wish to say that our industry supports fully the action taken by the House of Representatives as to the relief from double taxation of corporate earnings. We suggest, however, that the relief offered by H. R. 8300 is only a bare minimum and that serious consideration should be given to amendments which would increase the measure of relief from this burden of double taxation.

I appreciate this opportunity to appear before you.

Senator MARTIN. Are there any questions?

Senator WILLIAMS. Mr. Banfield, have you compiled any estimate as to the loss of revenue which would result from the adoption of your proposal?

Mr. BANFIELD. No, we have not prepared any figures in detail, but we would be glad to look into it and submit some data to you. I believe some figures have been prepared by other parties that might answer the question.

Senator WILLIAMS. Do you have any alternative plan for revenue raising, in the event the loss in revenue was more than could be afforded at this time?

Mr. BANFIELD. I have been speaking chiefly on the problem of depreciation. I believe that any revenue loss would be of a very short-term nature, and that revenue gains for a very short period would make up for that loss in a matter of a minimum number of years.

Senator WILLIAMS. I noticed that you recommended leaving the corporate rate at 47 percent, and that would result in $2 billion.

Mr. BANFIELD. That is correct. I am familiar with that.

Senator WILLIAMS. I didn't know whether you had any alternative proposal or not.

Mr. BANFIELD. No. I am laying before you the problem of depreciation as it affects the general economy and the health of the industrial nation.

Senator WILLIAMS. Thank you.

Senator MARTIN. You know, we are confronted with a situation desiring to reduce taxes, but the American public is demanding enormous appropriations. And then we have also confronting us, if we don't balance the budget, the raising of the debt ceiling, and I think Senator Williams' question there is most relevant. I think that when you are asking for a reduction some place, you either ought to suggest where we can replace that tax with some other tax, or where we can reduce the expenditures.

When I was governor of my State, a man would come in with a proposal that the State ought to do so and so, and I would say, "Well, that sounds very good, but I wish you would also suggest the taxes that would take care of that," because I have always believed in a government that is pay as you go.

Mr. BANFIELD. I personally agree with that belief, too, and I also believe that Government expenses can be reduced substantially so that the budget can be balanced.

Senator MARTIN. The unfortunate part about it, say, in my own State, one of the departments down here will suggest curtailing certain installations, and then I start to get letters and telegrams that it would just be ruinous to this particular district if that was done.

Now, we get here in America just what we want in the way of government, and if the people would become economically minded and appreciate that everything that is done by the Government must be paid out of the earnings of the people—it is unfortunate that we don't. I didn't intend to get into that, but I think Senator Williams' suggestion is mighty good, and folks like yourself can be mighty helpful to us.

You have a very fine statement there, and Senator Williams asked the question because he felt that you probably had access to information that you could make a suggestion for additional revenue. If this committee would determine the things that you have suggested are good, and we can't curtail the expenditures, then what can we replace it with? That is Senator Williams' idea, and I think it is sound and I think it is complimentary to you, because you have made a good statement, and he feels you are probably in the position to make it.

If there are no further questions, thank you very much.

Mr. BANFIELD. Thank you.

Senator MARTIN. Now, Mrs. Marie Jordan Munoz. Will you identify yourself and the organization you represent?

STATEMENT OF MRS. MARIE JORDAN MUNOZ, FOUNDER, GOLD STAR WIVES OF AMERICA, INC.

Mrs. MUNOZ. I am Mrs. Marie Jordan Munoz, the founder of the Gold Star Wives of America. Our national president was to have given this statement, but her father is seriously ill, and she had to fly quickly to Georgia, so I am here in her place.

(The prepared statement of Mrs. Sara J. Mulvey, national president, follows:)

STATEMENT BY MRS. SARA J. MULVEY, NATIONAL PRESIDENT OF THE GOLD STAR WIVES OF AMERICA, INC.

The Gold Star Wives of America is an organization for the widows and children of men who died in service or as the result of a service-connected disability. Our activities include the maintenance of a service and welfare office to help these dependents with their claims and personal problems; a summer-camp program for children of working mothers; a fund for educational assistance for Gold Star children; and a fund for emergency medical aid. The small sum that our members pay into the organization for their membership dues is not enough to adequately finance these projects. The success of our program, therefore, is dependent upon the contributions which we receive from private individuals who are interested in our work.

The Internal Revenue Service has ruled that our organization is exempt from paying income taxes under the Bureau of Internal Revenue Code, section

101 (8). However, persons contributing to us cannot, at present, deduct their contributions from their income tax, since, according to 23 (o) (4) of this section, exemption is given only to persons making contributions to post or organizations of war veterans, or auxiliary units or societies of any such posts or organizations.

Although we feel sure that it was the original intent for an organization such as ours to be included under this regulation, the wording of this section does not explicitly state this. We ask, therefore, that this section be amended so that it will definitely specify that contributions to organizations of the next-of-kin of deceased servicemen as well as contributions to organizations of war veterans will be tax-exempt.

Mrs. MUNOZ. First, I want to point out to you how much it will mean to the widows of the men who died in the service if they will be allowed in the future to deduct the cost of child care from their income tax. We have had many in the past who found it would cost them so much to have the children cared for——

Senator MARTIN. Senator Millikin, this is Mrs. Munoz, who represents the Gold Star Wives of America.

The CHAIRMAN. Go right ahead, Mrs. Munoz.

Mrs. MUNOZ. I was pointing out the fact that it would mean so much to the widows of the men who died in the service if they would be allowed to deduct the cost of child care from their income tax. In the past we have had a great number who have found that by the time they pay someone to mind their children and, on top of that, lose their social-security benefits, that they are better off financially by staying home. A situation like that is not very conducive toward improving themselves or their families for their future.

Of course, it would mean most to them if they could deduct the full amount of child care from their income tax, if that would be at all possible. But you can see, I am sure, the importance of this proposal.

Now, another point that is of vital concern to our organization, as such: As you know, the Gold Star Wives of America is an organization for the widows and children of men who died in the service, or as a result of service-connected disability. Our activities includes the maintenance of a service and welfare office to help these dependents with their claims and personal problems, a summer-camp program for children of working mothers, a fund for educational assistance for Gold Star children, and a fund for emergency medical aid.

The small sum that our members pay into the organization for their membership, in the form of dues, could never finance all of these projects. So, as a result, to carry on this program we are greatly dependent upon contributions which we receive from the general public, who know of what we are doing and would like to contribute to us.

The Bureau of Internal Revenue has ruled that our organization is exempt from paying income taxes under the Bureau of Internal Revenue Code, section 101 (8). Now, that is fine; however, persons contributing to us cannot at present deduct their contributions from their income tax, since, according to 23 (o) (4) of this section, exemption is given only to persons making contributions to "posts or organizations of war veterans, or auxiliary units of societies of such posts."

I imagine it was intended that an organization of dependents of deceased war veterans would be included under that, but it is not specifically spelled out in that manner. We cannot be an auxiliary of anything, since the men have long been dead. So, therefore, we are not actually named under this regulation. At the moment we are just not mentioned at all, which is a peculiar situation. As a result, the Bureau doesn't actually know what to do with us, unless we are spelled out some place in the law.

We would like to ask, therefore, if we could have this particular section amended so that it would actually say that people contributing to "organizations of next of kin of deceased servicemen," as well as to organizations of "war veterans," could deduct their contributions from their income tax.

The CHAIRMAN. Was this brought to the attention of the House Ways and Means Committee?

Mrs. MUNOZ. No; it was brought to the attention of the Joint Committee on Internal Revenue.

The CHAIRMAN. Has the joint committee reached any conclusion?

Mr. SMITH. No, sir, but we had a letter from them this week, and the matter is being studied.

Mrs. MUNOZ. At the time the Ways and Means Committee was studying this section we didn't actually realize the situation until we took it up with the Bureau, and they explained this clause to us.

Senator CARLSON. May I ask if your organization has a charter recognized by Congress?

Mrs. MUNOZ. We do not have a charter approved by Congress. We have a charter by the State of New York at the present time.

We do have a bill requesting a congressional charter introduced by Senator Butler of Maryland, that we hope to ask for action on soon.

The CHAIRMAN. Thank you.

Mrs. MUNOZ. Thank you.

The CHAIRMAN. Mr. Churchill. Make yourself comfortable, Mr. Churchill, and identify yourself to the reporter.

STATEMENT OF ARTHUR M. CHURCHILL, PORTLAND, OREG.

Mr. CHURCHILL. Mr. Chairman, may I ask one favor, first? My hearing aid does not tell me whether I am talking too loud or too low.

The CHAIRMAN. Talk as loud as you want to, and if you talk so we can't hear you, then we will let you know.

Mr. CHURCHILL. Thank you.

I have prepared my memorandum in two sections. I want to stay within the 10 minutes. The first three pages present the essence of the situation. Also, my voice may fail me and I might want to submit this for the record. The supplementary material is in the remaining five pages, in case the committee chooses to question me.

The CHAIRMAN. It will be put in the record.

(The prepared supplementary material of Mr. Churchill follows:)

SUPPORTING MATERIAL FILED BY ARTHUR M. CHURCHILL ON EXEMPTING FOREIGN AID AS CHARITY

HOW MUCH DO TAXPAYERS LOSE?

Only exhaustive computations from internal revenue records could reveal precisely how many millions of dollars are lost annually from this phenomenal deduction. But the Department of Commerce balance of payments tables on page 150, and those of the United Jewish Appeal and the Jewish Yearbook make it clear that the sums involved are very great.

It seems conservative to estimate that, in the 8 years from 1946 to 1953 inclusive, the average annual sums sent to Israel from American philanthropy were not far from $55 million. To this should be added a campaign and administration expense of 7 or 8 percent. The total over the 8 years would seem not far from $500 million.

Under our high income-tax rates, an income does not have to be very high before the Government takes 50 percent in taxes from the top bracket. If one's net income be over $200,000, the tax is 92 percent. Such a contributor would only be giving 8 percent out of his own pocket. The rest would be shifted to others. It seems conservative to conclude that 50 percent of these gifts to Israel, most of which were from "big givers," in reality came out of other taxpayers.

This would mean that, in the 8 years from 1946 to 1953 inclusive, 50 percent of some $500 million was thus diverted, or $250 million. And under the "Jerusalem plan," promulgated last October, $200 million is to be asked in "grants-in-aid," which are wholly paid by the taxpayer, plus perhaps $800 million in gifts from American Jews. If 50 percent of this latter sum can be passed on to other taxpayers, that would be another $400 million, over the next 7 years.

THE THEORY OF CHARITABLE DEDUCTIONS

In 1874, when taxes were still small, the late President Charles W. Eliot, of Harvard, reviewed at length the basic reasons for charitable exemptions. Of course he was speaking only of domestic charity. If philanthropy, he said, generously gives vast sums to meet social needs, the State is thereby relieved of a corresponding tax expenditure. It can therefore well afford, in turn, to relieve charitable property from taxes.

Gifts sent abroad were quite different. When it was first sought to have these included in "charitable deductions," there was grave doubt in the courts as to whether the principle applied. But, beginning with small missionary enterprises, the policy of exempting charitable contributions going abroad won out, though there were many misgivings. Never in human history, however, has there been any approach to the vast sums sent in American Jewish funds to the relatively few human beings gathered from the ends of the earth into Israel. This is a totally new phenomenon in human life. There is no precedent for it. By comparison, I am told, combined annual contributions to the several middle eastern colleges, which have made so great a contribution to the entire region, have been only a half-million dollars, compared with $55 million to 1,430,000 Jews in Israel.

ARE THESE GIFTS CHARITABLE AT ALL?

It is my firm belief that these exemptions have never been legal at all. I personally know that this question was gravely raised in Zionist circles in 1947–48. Distinguished counsel were in grave doubt. How the decision was arrived at in the Internal Revenue Department, which has cost the taxpayers all these millions of dollars, no one seems to know. I have been refused any information on this.

Let us look at the law and at the facts.

The law seems clear. Section 39.23 (n) (o) provides specifically that such corporation or fund must be "organized and operated *exclusively for* * * * *charitable* * * * *purposes* * * *no substantial part of the activities of which is carrying on *propaganda, or* otherwise *attempting to influence legislation* * * *"

1. Since a major part of the very soul of American Zionism is to influence legislation and to bring pressure on Senators and Congressmen, and since the intermeshed Zionist funds and corporations file few clear accountings and probably no human being knows where one leaves off and another begins, it would seem that an affirmative showing, at frequent intervals, should be so convincing that there would be no room for doubt. Otherwise any exemption should be refused on the ground of propaganda and legislative pressure alone.

2. The records of the Department of Justice disclose, beyond peradventure, that the major part of these funds, thus exempted, go to and are applied by *the agent of a foreign power*, registered and making a report as such twice a year. How, pray, can payments to the registered agent of a foreign power be "charities" within the American tax laws?

3. Nearly all of these sums were admittedly applied to migrants, to the "ingathering of the exiles," to building them homes, to transporting them to Israel, to building up agriculture for them. The Zionist appeals insist, and insist again, that this was imperative charity. But was it? *Actually it was military.* Mr. Ben-Gurion, in his recent book Rebirth and Destiny of Israel, is much more candid than the special pleaders. I quote the following from his book, with the page reference [italic mine]:

"That is why the Government follows, in regard to immigration, a policy without historical parallel—one that many observers at home and abroad, not wholly unreasonably, deem fraught with danger and disaster to the State. * * * There are other cogent reasons, but *primarily*, this daring, even dangerous, policy is imposed by our needs for *national security. If our Army is twice as strong today * * * we may thank this policy for it*" (387).

"The *colonization of the frontiers* * * * is scarcely less important for *security* than immigration. * * *" (368).

"Others plausibly criticize our colonizing methods. But *massive*, accelerated *colonization cannot wait* for the refined systems of the 'good old days' * * * *security bids us swiftly people the borders and the barren voids in new ways*" (389).

"No economic and such-like considerations can be allowed to slow down the rate of immigration any more than they braked the resistance to the Arab armies * * *" (404).

"*The immigration of today is* mainly from the East, the country of Islam in Asia and Africa. * * * There is nothing like this in any other army, but for us it is *a categorical imperative of security and existence* * * *" (409).

So Mr. James G. McDonald, on page 227 of My Mission to Israel, quotes his private diary of July 29, 1950, as follows:

"Eban, he (Ben-Gurion) said, was returning to the United States to sound out the practicability of *a plan to speed up immigration* so that Israel might have a population of 2 million within 2 years and to increase and reequip the Israel army. He knew that the huge sums necessary could not be raised unless our Government were sympathetic. A billion dollars from public and private sources would be required."

4. To call these Zionist funds "exclusively charitable" in the light of Mr. Ben-Gurion's expressions would seem utterly improper. But this is reinforced from many other sources. Maurice Samuel, a devoted Zionist and follower of Weizmann, in his recent book Level Sunlight, is still more frank. I quote:

"There was an indiscriminate piling in of immigrants which was neither Zionism nor rescue. *An artificial stampede* * * * swept along tens of thousands of Jews who did not have to come at this time, and without excessive provocation and cajolery would not have come (63). * * * We went out of our way to stimulate and overstimulate immigration. We paid for transportation * * * the immigrants could have waited with no harm to them. * * * (66) * * * We needed the maximum number of Jews in the minimum amount of time in order to discourage the Arabs from attempting a second round. * * * (68) * * * We had to get in the maximum number of Jews, helter-skelter, from everywhere and anywhere, fit or unfit, convinced or merely cajoled, because it was necessary to fill up without delay the areas vacated by the thousands of Arabs who had fled their homes * * * and it was part of the effort to give an appearance of necessity and inevitability * * *" (68, 69).

5. In the August 1953 number of the distinguished Jewish magazine, Commentary, is a very illuminating article by Schlomo Riemer, Israel economist, which makes a mockery of this charitable idea. Among other things, he says:

"We are shielded against the icy winds of economic reality by the magic phrase, the 'ingathering of the exiles' * * * now for the fifth year running, drawing forth hundreds of millions of philanthropic dollars * * * unrequited imports * * * Without any productive effort of their own, every Jewish man, woman, and child * * * commands a volume of goods and services * * * three times the total means of subsistence per head of * * * Egypt, Iraq, and Syria, and is well above the $100 figure at which more than half of the world's population are subsisting * * * (141).

"There exists only one force which * * * can cancel out the pressures * * * And that is the people who provide the Government with 85 percent of its annual imports. *If American Jewry could summon up the moral courage to assume the role not merely of paying the piper, but of calling the tune* * * * (145) they could exert the necessary influence."

Even Mr. Riemer does not seem to realize that, under our topsy-turvy tax system, American Jewry quietly passes on most of the load to helpless taxpayers. If American Jewry should "*call the tune*" why should not the American Congress and the Internal Revenue Department act instantly in the premises?

6. London's New Statesman and Nation of August 18, 1951, published a very luminous article from Samuel Rolbant of Tel-Aviv, which reduces to the ridiculous certain phases of this immigration as charity. I quote from this briefly:

"The recent wave of immigration has brought into the cities of Israel little of the idealism which went to mold Jewish Palestine into a progressive labor commonwealth, and many of the things which the Jewish National Home was meant to abolish.

"It brought to the country thousands of black marketeers from postwar Germany, smugglers from Damascus, horseflesh dealers and horsethieves from Turkey, professional Rumanians, toughs from Morocco, billiard boys from Casablanca, currency dealers from Shanghai, British subjects who could not solve their differences with His Majesty's Inspector of Taxes, embezzlers from all countries to which they could not be extradited * * * and thousands of others who simply embody the agelong Jewish tradition of living by avoiding productive labor."

If Mr. Rolbant's description be at all representative, that the cost of such a migration should be passed on to American taxpayers as "charity" would seem obviously illegal and absurd.

HAS IT ALL BEEN WASTED?

The official Jerusalem plan (227-page book is called Data and Plans) seems to me a confession of despair. After receipt of approximately a billion dollars from America, the tiny new state owes $376 million (100). Its annual adverse balance in consumption goods alone is $145 million (227). If it can receive in unrequited funds from abroad over the next 7 years a total of $1,710 million, it hopes to reduce its net annual deficit to $75 million.

Henry Montor, manager of the bond drive, is quoted in the Jewish Post of November 16 as saying that Israel is paying 8 to 15 percent interest on its short-term loans. Manifestly its credit is not high. His hope that the $130 million Israel bonds sold in America will not be "dumped" when they may be sold after May 1, 1954, is because "They bought Israel bonds out of a desire to help Israel." That does not express confidence in these bonds as an investment.

The chairman of the Leumi Bank, Mr. E. S. Hoofen, points out in the May–June 1953 number of the official Israel Economic Bulletin, that the policy pursued has created a rich man's agriculture in a poor man's country. The Minister of Commerce, Mr. Peretz Bernstein, seems of like opinion in the same bulletin of December–January. Last year our State Department sent Prof. Gardner Patterson of Princeton to Israel to make an economic survey. He describes his conclusions in the January 4 Foreign Affairs. He seems to find some hope, but his facts do not seem to differ widely from those of Messrs. Hoofen, Bernstein, and Riemer.

THE FATAL ESSENCE

Personally I can see no hope whatever. By births over deaths alone, the population is doubling every 27 years, quite apart from migration. Data and Plans estimates an increase in the Jewish population of Israel[1] since the Arab-Israel War of 147,000, and expects a further such increase of 300,000 (225) in the next 7 years. Our own Census Department made a report on Israel in 1952, calling its population one of the fastest growing in the world.

As if that were not enough, the 1953 Jewish Appeal notes that in that year they hoped to bring 40,000 more immigrants, 68 percent from North Africa and notably of children from the "mellahs," where the "birth rate more than exceeds the death rate and the departure rate."

The bills are being sent to the United States, by indirection to its taxpayers. By what type of reasoning is American charity obligated to rescue the excess fecundity of prolific squalor? The world's population is increasing 75,000 every morning, 25 million a year. Even the Perlman Commission said we could not help Asia by migration. In non-Communist Asia alone the increase is 10 million a year. Europe increases 3 million a year. Why are Israel and the mellahs of Africa the obligation of the American taxpayer?

Mr. CHURCHILL. Mr. Chairman and gentlemen of the committee, my name is Arthur M. Churchill. I am a retired lawyer of Portland, Oreg. I ask your attention to a very urgent question which was not discussed at all, I am told, before the House committee. As I see it, this is a vital part of the burning issue in the Middle East, which now threatens the peace of the world.

[1] By excess of births over deaths.

I am deeply interested in foreign affairs and have studied certain issues more exhaustively than is usually possible. I represent no one but myself, but I feel that you will welcome the views even of private citizens, if they seek, disinterestedly, to contribute to problems which those in responsible positions must meet.

To my mind, it is of the greatest importance, in present world crises, that the United States be impartial in its approach to the acute difficulties of less fortunate peoples. I bring to you this appeal because I fear that, without intending to do so, we have departed gravely from that ideal. I do not believe that even your committee realizes what vast sums we have sent, by indirection, into the Middle East controversy. I am concentrating today on the charitable clauses, not because they are our only lapse in fair dealing, but because of this moment your committee is reviewing these.

If you will restudy the subject of charitable exemptions, insofar as they have been applied to contributions sent abroad, I think you may be astonished. It is my opinion that such a review may accomplish three very important things:

(1) You may well save to the taxpayers, over a period of years, several hundreds of millions of dollars.

(2) You may correct a costly interpretation of the law, not intended by anyone, which has grown up gradually by accretion.

(3) You may remove distortions which contribute greatly to the present chaos in the Middle East. These distortions and the bitterness they produce may easily plunge the world into the war which humanity everywhere is seeking to avoid.

Fortunately, the figures you will require are at your hand. The Department of Commerce has tabulated international balances, roughly by causes, which will give you a fairly close picture of the totals. If you will add to these the records of the Department of Justice under the Foreign Agents Act and the parallel tables from the Jewish Yearbook and the annual brochure of the United Jewish Appeal, you will have the essence of the situation.

Zionist contributions to Israel have been amazingly generous. What has not been realized is that nearly all of this, as with all large funds, comes from big givers. I am reliably advised that 90 percent of the gifts to Jewish charitable funds comes from 19 or 20 percent of the givers. And under our high tax rates and the charitable exemption rules, these "big givers" are allowed to deduct such gifts from their top brackets, in figuring their income taxes.

The result has been a very distorted situation. Such deductions do not come out of the atmosphere. The Government must go on. You must find the tax money to finance, for example, the staggering costs of defense. If one group of big givers send their money abroad to a special community in which they have a special interest, and if they are allowed to deduct these sums from their taxable income, the load is merely shifted to other citizens, who may not even inquire about what causes the shift.

The administering of charitable deductions by the Internal Revenue Department appears to present unsuspected opportunities for favoritism or even fraud. The printed list of exempt institutions which I have in my briefcase covers some 30,000 names. Even spot checking it is no small matter. If a corporation applies to be placed on this list and is refused, it may appeal to the Board of Tax Appeals or to the courts. Then there is some chance of discussion of the proprieties. But if the application be acted on favorably, no one else knows anything about it. The record is secret. Other taxpayers must make up the loss, but have no access to the facts or figures.

Hence, if the bureau having this responsibility be misled or deceived, or is under political pressure, or even acting fraudulently, those who must pay the bills seem to have no recourse. In the Zionist case, some hundreds of millions of dollars seem involved. The scandals in certain fields of internal revenue are fresh in our minds. But the citizen is helpless. The multiplied and interlocking Zionist funds and their beneficiaries render no detailed public accountings, so far as I can learn, which differentiate these items.

If my view be correct, this is not merely an unjustified extension of the whole concept of charitable exemptions. Nor does it merely involve the loss of hundreds of millions of dollars. Far more important is that the reputation of the United States for impartiality is being jeopardized. Both Secretary Dulles and Adlai Stevenson have expressed this fear. In his June 1, 1953, broadcast, Secretary Dulles said, among other things:

> The atmosphere is heavy with hate * * * The United States should seek to allay the deep resentment against it that has resulted from the creation of Israel * * * Today the Arab peoples are afraid that the United States will back the new State of Israel in aggressive expansion. They are more fearful of Zionism than of communism, and they fear lest the United States become the backer of expansionist Zionism.

No recent statement has been more courageous than that of Governor Stevenson, in his "No Peace for Israel," in Look magazine of August 11, republished in the November Reader's Digest. He confirms Secretary Dulles:

> They—the Arab leaders—are quick to blame the United States and the Zionists for their woes, and American prestige and popularity—once so high—have fallen to a low estate.

It is generally accepted that Israel could not have been created, nor could presently survive without tremendous American support. In the Saturday Evening Post of December 24, 1949, Israel was described as having been masterminded in the White House. The late Secretary Forrestall, in his diaries, and Alfred Lilienthal, in his recent book, "What Price Israel," describe the creative manipulations in detail.

Part of the colossal sums sent from America have really come from private pockets. But most of them, it will surprise many to know, come ultimately from the taxpayers. The use of the "charities" clause is only a part of this. But it is the largest item. The loan of $130 million by the Export-Import Bank, out of all proportion, per capita, to any other loan, calls for investigation without fear or favor. And the so-called grants-in-aid are purely contributions by the taxpayer. The pressure on Congressmen and Senators has been very great. Said Senator Russell, of Georgia, chairman of the Foreign Relations Committee, on the Senate floor in 1951:

> All of us have had constituents who have appealed to us to support not only the increase—from $40 million to $50 million—but we have also had appeals made to us to introduce a bill such as these two Senators are sponsoring, to give Israel $150 million as a grant.

Altogether, it is my estimate that there has been sent to Israel, out of the American economy, close to a billion dollars. And it is proposed under the new "Jerusalem plan" of last October that we send another billion over the next 7 years. The greater part of these vast sums, without precedent in human affairs, come directly or indirectly out of the taxpayers. I commend this to your further study.

That is the end of my oral statement, Mr. Chairman, and the supplementary material is at the disposal of the committee.

The CHAIRMAN. What is your specific recommendation?

Mr. CHURCHILL. This is rather too involved a matter for me to suggest. I personally, as I pointed out on page 6 and following, of my supplementary material, feel that the present laws, if they were taken account of very carefully, might cover this. But I don't think the private citizen or anybody else can get into the question, under the present status, and I have been utterly baffled to know how to do it.

I think the records which are on file, as to these corporations, 30,000 of them, asking exempt status, should be available in some form to the public, so that we may know what led up to these decisions and not be utterly helpless. I think that technicians, perhaps the new Commissioner of Internal Revenue, if he would give it his personal attention, or Mr. Stam, might find techniques. How to do it is a rather technical question, which is somewhat beyond people like myself.

The CHAIRMAN. Well, what do you want to do?

Mr. CHURCHILL. Well, I should like this committee to study the situation exhaustively and see, as I can't—I don't even get a reply from the office. They say that this is a secret matter and we can't give it to you.

Personally, I have stated on page 5 and following, my reasons why I think this is not charitable at all under the present law. It would be merely a technical matter of requiring its review by the Department, by somebody who has authority. Certainly, I think the law should provide that these records in some form should be available and not be secret, so that we are utterly helpless.

The CHAIRMAN. Well, are you objecting to charitable contributions that find their way to Israel? Is that your point?

Mr. CHURCHILL. I haven't time to read the supplementary material here, but my idea is that these are not charitable contributions at all, in the sense of the statute. But there is no help for it. They have been decided by the Bureau to be, and I find no way to get at it.

The CHAIRMAN. Well, the present administration has a friendly interest in Israel. And are you making a blanket objection to any charitable contributions made to Israel, or to activities in Israel?

Mr. CHURCHILL. Not at all, Mr. Chairman. I think these are primarily, as I pointed out on page 5 and following, military and not charitable, in the sense of the law. The law says these must be exclusively charitable.

The law says further that they must not be used at all substantially for propaganda or in an attempt to influence legislation. In my judgment, and I quoted from Ben-Gurion's book, and numerous others, if you take time to go into these pages, these moneys that have been sent to Israel have not been essentially charitable. They have been essentially military, or otherwise. The matter is covered in greater detail there, in my statement and I will be glad to go into it in further detail if you wish.

The CHAIRMAN. Well, we will get what you said out of what you have filed. We have a very expert force of digesters and they will digest what you have had to say and bring it to the attention of the committee. But I am just trying for my own information, without rehashing what you have in your written statement, to find out what your point is.

Mr. CHURCHILL. Your question as to just how I would correct it, technically, Mr. Chairman, the drafting of legislation is a highly technical matter and I shouldn't presume to do that without consultation with those who know it thoroughly.

The CHAIRMAN. What I was wondering about was whether you were trying to bar all charitable contributions to Israel.

Mr. CHURCHILL. I am trying to bar from exemption all contributions to the United Jewish Appeal or other charitable things, the major part of which goes to Israel. I do not think in the main they are charitable. Without going into too much detail—they are to go to agricultural improvement or to transportation, or to home building, for the immigrants. Mr. Ben-Gurion himself says flatly that the bringing in of the mass of immigrants at this time has been military, not charitable.

I do not think, as I said in my statement, there is any possible charitable contribution from this country whereby they can ever achieve what they are after. But that is too long a story for me to take out of the record, unless you wish me to.

The CHAIRMAN. We are very glad to have your statement. I simply wish to repeat that as far as this administration is concerned, and I think the preceding administration, we have a very friendly interest in Israel.

Mr. CHURCHILL. I have no objection to that at all.

The CHAIRMN. And we are trying to bring the Israelis and the Arabs into a state of peace. I think that, just as a generality—we will ultimately get to the details of what you have to say—I doubt very much whether there would be any hindrance to a true charitable gift to activities in Israel.

Mr. CHURCHILL. Mr. Chairman, I think that is quite correct, and I would subscribe to that. My point is that these have not, when they are analyzed correctly, been charitable.

The CHAIRMAN. Thank you very much.

Mr. Churchill, I would just like to read to you the provision in the last Republican platform, on Israel:

> The Republican Party has consistently advocated a national home for the Jewish people, since a Republican Congress declared its support of that objective 30 years ago. In providing a sanctuary for Jewish people rendered homeless by persecution, the state of Israel appeals to our deepest humanitarian instinct. We shall continue our friendly interests in this constructive and inspiring undertaking. We shall put our influence at the service of peace between Israel and the Arab States and we shall cooperate to bring economic and social stability to that area.

I just wanted you to know what the policy of the present administration is, and I may say the policy of the previous administration was also a liberal one toward Israel.

Mr. CHURCHILL. I think, Mr. Chairman, if you will read my statement in detail, you will find I do not differ with that particularly.

The CHAIRMAN. Thank you.

Mr. Halperin, please. Mr. Halperin, be seated, please, and identify yourself to the reporter.

STATEMENT OF J. STANLEY HALPERIN, NEW YORK, N. Y.

Mr. HALPERIN. Mr. Chairman and gentlemen, I am J. Stanley Halperin, of 46 Cedar Street, New York, N. Y. I appear in opposition to section 171 (b) (1) (B), relating to amortizable bond premium. I request permission to file a formal statement.

The CHAIRMAN. It will be put in the record.

(The prepared statement of Mr. Halperin follows:)

STATEMENT OF J. STANLEY HALPERIN IN OPPOSITION TO SECTION 171 (b) (1) (B)—AMORTIZABLE BOND PREMIUM

Mr. Chairman and gentlemen, I am J. Stanley Halperin of 46 Cedar Street, New York, N. Y. I appear in opposition to section 171 (b) (1) (B).

This provision will disallow the deduction of amortization of bond premium from date of purchase to the earliest call date where a bond is issued after January 22, 1951, and is callable within 3 years from the date of issue.

The provision makes no distinction whatsoever between the case where an early call date was provided because of bona fide business reasons including the insistence on such a provision by the SEC and the Public Utility Holding Company Act of 1935 and the case where the Ways and Means Committee says "the call feature is nominal or inoperative."

But the provision does make a distinction based on date of issue. A bona fide callable bond issued after January 22, 1951, falls within the new provision, but a confessedly tax-motivated callable bond issued before that date falls outside the new provision and now receives legislative approval of its use for tax-savings purposes.

It is difficult to reconcile this House proposal, which admittedly was adopted on the recommendation of the Treasury Department, with the two basic fundamentals of policy which have always been followed in tax legislation, and especially by this committee, namely:

1. The bona fide conduct of business in the ordinary way shall not be impeded.

2. Retroactivity is to be avoided, especially where the practice has been known to and approved by the Treasury Department, and the corrective provision shall be made prospective only in its operation.

The Treasury has not cited any case where an immediate call feature in a bond was "nominal or inoperative." It has not shown why it is not "bona fide conduct of business in the ordinary way" to include such a provision.

On the contrary, it is fundamental that it is good business to insert an early call date in a long-term bond issue. Practically every utility bond financing for the past 20 years has provided for redemption at any time after issue on 30 days' notice, thereby enabling a refinancing of the issue when, as, and if a refinancing can be made at a lesser rate of interest.

The wave of refinancing which has taken place in the past few months is ample testimony that such practice is good business. The inability of railroads which issued noncallable bonds to take advantage of lower interest rates through a refinancing, and their attendant financial difficulties, is but further proof.

Lastly, the SEC disapproves of restrictions rendering such securities partially or totally noncallable, because such noncallability introduces a potential "lack of economies in the raising of capital" by an issuer utility and holds that partial noncallability may run counter to the spirit and intent and the policies expressed in the Public Utility Holding Company Act of 1935. (In re Arkansas Louisiana Gas Company, SEC file No. 70-3129.)

Nowheres has it been shown to be contrary to the bona fide conduct of business in the ordinary way where a bond contains an early call feature. The House bill will, in effect, impede this worthwhile and desirable practice, and will result in the following situations with regard to bonds of public utilities:

(*a*) The new provision will place a premium on bonds which contain a restriction against callability within 3 years and 1 day from the date of issue.

(1) Tax Service are already recommending such restriction on callability. For example: special memo from J. K. Lasser dated April 1, 1954, published by Business Reports, Inc., states:

"In financing with callable bonds, don't include a call date earlier than 3 years from issuance date, if practical. If you do, the investor will be required to amortize any premium he pays from time of purchase to bond maturity. You force him to spread ordinary deductions over a longer period—your bond loses attractiveness as an investment."

(2) If nonutilities follow the suggested policy of inserting a 3-year restricted-call provision in new financing, the marketability and attractiveness of immediate call utility bonds will be inferior to nonutility bonds; ultimately resulting in higher interest rates payable on utility bonds to make them equally attractive to nonutility bonds; and thus an interest rate higher than the going market rate will result in inability to reduce rates to consumers.

(*b*) If utilities insert a 3-year restricted-call provision in order to make their bonds as marketable and attractive as competitive nonutility bonds, they will run contra to the spirit and intent and policy of the Public Utility Holding Company Act of 1935 and endanger the present right (in the case of immediately callable bonds) to refinance at a lesser rate of interest by taking advantage of changes in the money market. Even assuming approval by the SEC of a restriction on callability, the money market 3 years from the date of issue is impossible to forecast and a utility with a restricted-call bond issue may be indefinitely restricted from refinancing at a lesser rate of interest.

(*c*) If, despite the inadvisability of including a restriction on call, prospective utility issuers do insert such a provision in order to make their bonds competitively marketable and attractive to nonutility issues, by including a provision that the bonds are callable at any time on 30 days' notice after the first 3 years, any premium paid on such bonds will be amortizable to the earliest call date, and a purchaser, after the first 3 years, will be permitted to amortize his premium over a 30-day period. Assuming this practice with regard to new issues becomes widespread, the situation in 1957 would be as follows with respect to bonds callable at any time on 30 days' notice in 1957 and thereafter:

(1) Date of issue prior to January 23, 1951—despite the fact that the bonds were callable at any time from date of issue—period of amortization wil be 30 days.

(2) Date of issue January 23, 1951 and thereafter——

(A) If callable at any time within 3 years from date of issue—period of amortization will be from date of purchase to maturity, even though there has been no call within the first 3 years from date of issue.

(B) If callable only after 3 years from date of issue—period of amortization will be 30 days.

(*d*) Utilities which issue bonds during the period January 23, 1951 to January 22, 1954 will have outstanding bond issues which will be the least attractive to investors in the securities market. Thus, the market price of these bonds will not be similar to those of competitive bonds whose premium can be amortized immediately, and thus, the market price will tend to remain at or near redemption value level. The goodwill and following of the utility in the securities market will be seriously damaged; making additional bond flotations and refinancing more difficult to market and thus requiring the utility to pay a higher rate of interest than competitive utilities.

Moreover, the Treasury Department has never questioned the "bon fides" of an early call date. It has issued many rulings on this very subject, to the effect that the bondholder may claim amortization to the earliest call date. This practice is not something new. The Treasury has been fully aware of it. Yet it now requests a provision which, in effect, states that the issuance of a bond with an early call date is not the bona fide conduct of business in the ordinary way. That being the case, then it would seem that this provision is more designed to regulate business than to close a possible loophole. We will have a situation where, although good business and the SEC dictate the insertion of an early call date, the Internal Revenue Code will penalize the bond which does have an early call date, and in effect compel the insertion of a later call date. This is regulation of business conduct. As such, it would be contrary to the policy which has always guided this committee. That policy has been to use the revenue laws only for the purpose of raising revenue and not for the purpose of reforming and changing the procedures and practices of business.

There is no justification for making the House provision retroactive to bonds which were issued after January 22, 1951, and before January 23, 1954. Obviously, such bonds cannot now be changed to alter the call features. Investors in such bonds, who invested prior to January 23, 1954, had no knowledge or notice that the law would be changed. No mention of any possible change had ever been made prior to January 22, 1954, by the Treasury, the staff, the Ways and Means Committee, or anyone else. The committee report recognizes that the new provision will result in retroactive application to such bonds. It specifically exempts pre-January 23, 1951, bonds from the retroactive application of the new provision because as to investors in pre-January 23, 1951, bonds it will constitute "unfair retroactive application." No reason is given anywhere why there is not equally "unfair retroactive application" to investors in post-January 23, 1951, bonds.

Under the committee's original announcement on January 22, 1954, no distinction was made between bonds already issued on that date, regardless whether the bonds were issued before or after January 22, 1951. It was only in the committee's announcement on February 25, 1954, that a distinction in treatment was made as to bonds already issued, which difference in treatment was dependent on whether the "date of issue" was before or after January 22, 1951. Certainly an investor prior to January 22, 1954, in a bond could not be expected to have foreseen on the day he acquired his bond that the date of issue of his bond would become of material importance in determining whether, when he came to sell his bond, his purchaser would or would not be able to charge off the premium to the earliest call date. Yet under the House provision, an arbitrary date now determines whether the retroactive application is "fair" or "unfair." There is no justification for a distinction in the treatment of bonds which were already issued on January 22, 1954, regardless of their "date of issue."

Nowhere else in H. R. 8300 is the closing of an alleged loophole made retroactive. Thus, in the case of section 264, dealing with disallowance of interest paid in connection with single premium annuity contracts, the interest deduction is denied only as to annuities purchased after March 1, 1954. Under section 274, relating to disallowance of rental payments to governmental units for use of manufacturing facilities, the rental deduction is denied only if the governmental unit issued its industrial development revenue bonds after the date of the committee's announcement, viz, January 21, 1954. In no case, other than this provision to which I object, has the proposed change in the existing law been made applicable to bonds or other contractual obligations which had been entered into on or before the date of the committee's announcement. This is the only case of retroactive application, and even then, a distinction is made in its retroactivity.

I submit that in conformity with the basic fundamental policy of your committee of avoiding retroactivity, especially where the practice has been known to and approved by the Treasury Department, the House provision should not be made retroactive to bonds already issued on January 22, 1954. Existing law should be made applicable to all such bonds and not just to those issued prior to January 23, 1951. On the contrary, if the provision is to be made retroactive, it should apply equally to all bonds already issued on January 22, 1954, regardless of date of issue.

The pushing up of the date from January 22, 1951, to January 22, 1954, so as to make the new provision effective only as to bonds issued after January 22, 1954, will result in no unfair retroactive application of the provision. However, while it will give equal treatment to all bonds already issued on January 22, 1954, it may still result in in inequality of treatment between bonds issued on or before January 22, 1954, and those issued after that date. Moreover, it will not accomplish the following objectives:

(*a*) The avoidance of business regulation by the Internal Revenue Code, since the new provision will induce new issuers to insert a "first callable date" of 3 years and 1 day from the date of issue.

(*b*) The avoidance of the quick chargeoff of bond premium for tax-savings purposes, both in the case of the pre-January 22, 1954, bond and the new type "callable-after-3-years" bond.

To achieve these objectives, and the major objective of equality of treatment of all bonds, regardless of their date of issue and regardless of their immediate callability, I suggest the House provision be changed as follows:

1. Where a fully taxable bond is callable within 3 years from the date of purchase, the earliest call date shall be assumed to be 3 years from the date of purchase. (Existing law should remain unchanged with respect to a fully tax-exempt bond.)

2. If such a bond is called within the 3-year period, the taxpayer shall be entitled to either—

(*a*) Deduct the balance of the unamortized premium as an ordinary deduction in the year of redemption; or

(*b*) Recompute his amortization over the shortened period and claim the revised amortization for the applicable years.

The above solution will result in—

(*a*) Equal treatment of all bonds, regardless of their date of issue.

(*b*) Accomplishment of the objective of the House provision to eliminate a possible tax-avoidance device.

(*c*) Noninterference with the good business conduct and practice of retaining the right to refinance a bond issue at a lesser interest rate.

(*d*) No conflict between a practice which might be otherwise encouraged by the House provision ("restriction on call") and the practice insisted upon by the Securities and Exchange Commission ("no restriction on call").

(*e*) Retention of the present statutory recognition that sound accounting practice requires that bond premium be amortized.

(*f*) The nonopening of the pre-1942 loophole in the case of tax-exempt bonds, where the unamortized premium was deductible as a capital loss although the interest was exempt from tax.

The CHAIRMAN. Do you appear for yourself, Mr. Halperin?

Mr. HALPERIN. I am appearing for myself.

Senator KERR. What is your business?

Mr. HALPERIN. I am an attorney.

Senator KERR. Are you appearing as a professional?

Mr. HALPERIN. No; I am appearing as a taxpayer.

Senator KERR. As a taxpayer?

Mr. HALPERIN. As a taxpayer.

Senator KERR. Aside from any clientele?

Mr. HALPERIN. Aside from any clientele, sir, because I am also personally affected by this provision.

Senator KERR. That makes it serious.

Mr. HALPERIN. I agree with you, sir.

Pursuant to your suggestion, I have discussed this matter with the staff and the Treasury, and Mr. Kenneth Gemmill has authorized me to state to you that he will submit a recommendation regarding this provision for your consideration in executive session.

The CHAIRMAN. What is the provision?

Mr. HALPERIN. Amortizable bond premium, section 171 (b) (1) (B).

Under existing law, bond premium may be amortized from the date of purchase to the earliest call date or to maturity, regardless of the date of issue of the bond and regardless of the fact that the earliest possible call date may be within 3 years from the date of issue.

Under the proposed section 171 (b) (1) (B), where the date of issue of a bond is prior to January 23, 1951, there will be no change from existing law. On the other hand, where the date of issue of the bond was January 23, 1951, or later, then if the earliest possible call date is within 3 years from the date of issue, the only period of amortization will be from the date of purchase to maturity. However, if the earliest possible call date is 3 years and 1 day later from the date of issue, amortization will be allowable from the date of purchase to the earliest possible call date, regardless of when the bonds were purchased.

It is difficult to reconcile this House proposal, which admittedly was adopted on the recommendation of the Treasury Department, with the two basic fundamentals of policy which have always been followed in tax legislation, and especially by this committee, namely:

(1) The bona fide conduct of business in the ordinary way shall not be impeded.

(2) Retroactivity, particularly discriminatory retroactivity, is to be avoided, especially where the practice has been known to and approved by the Treasury Department, and the corrective provision shall be made prospective, according to this committee, only in its operation.

Such a provision will interfere with the bona fide conduct of business in the ordinary way. It will place a tax premium not only on those 30-day callable bonds which were issued prior to January 23, 1951, but on all future 30-day callable bonds where the earliest possible call date is at least 3 years and 1 day from the date of issue.

It will induce future issuers to provide for a first call date which is 3 years and 1 day from the date of issue. Tax services are already recommending that such a restriction be included in new issues. For example, special memo from J. K. Lasser, dated April 1, 1954, states, and I quote:

> In financing with callable bonds, don't include a call date earlier than 3 years from issuance date if practical. If you do, the investor will be required to amortize any premium he pays from the time of purchase to bond maturity. You force him to spread ordinary deductions over a long period. Your bond loses attractiveness as an investment.

Such a provision in future issues will prevent issuing companies from refinancing at lesser rates of interest during the noncallable period, a restriction which is frowned upon by the SEC, and a restriction which will prevent the issuers from taking advantage of lower money-market interest rates and, in the case of utilities, restrict them from reducing rates to consumers.

I might add that the Edison Electrical Institute has filed a brief on this very point. I found out about it this morning.

Moreover, the Treasury Department has never questioned the bona fides of an early call date. It has issued many rulings on this very subject that the bondholder may claim amortization to the earliest call date.

The CHAIRMAN. Just a minute. What was the view of the committee on that?

Mr. SMITH. It was intended to operate as the witness said but since the bill was reported a number of complaints on this have been received.

The CHAIRMAN. Is it being reviewed by the staff?

Mr. SMITH. Yes, sir.

Mr. HALPERIN. This practice is not something new. The Treasury has been fully aware of it; yet it now requests a provision which in effect states that the issuance of a bond with an early call date is not the bona fide conduct of business in the ordinary way. That being the case, then it would seem that this provision is more designed to regulate business than to close a possible loophole. We will have a situation where, although good business and the SEC dictate the insertion of an early call date, the Internal Revenue Code will penalize the bond which does have an early call date and in effect compel the insertion of a later call date. This is regulation of business conduct. As such, it would be contrary to the policy which has always guided this committee.

In the second place, the House proposal is in conflict with the other basic fundamental policy which has always been followed in tax legislation, especially by this committee, namely, that retroactivity, particularly discriminatory retroactivity, is to be avoided especially where the practice has been known to and approved by the Treasury Department.

There is no justification for making the House provision retroactive only to those bonds which were issued after January 22, 1951. Obviously, such bonds cannot now be changed to alter the call features.

The CHAIRMAN. What was the purpose of that particular provision, Mr. Smith?

Mr. SMITH. Senator, I don't recall. Mr. Kraft of the legislative counsel's office is here.

Mr. KRAFT. I don't recall, sir.

The CHAIRMAN. Pay special attention to that.

Mr. SMITH. Yes, sir.

Mr. HALPERIN. Investors in such bonds who invested prior to January 23, 1954, had no knowledge or notice that the law would be changed. The committee report recognizes that the new provision will result in retroactive application to such bonds. It specifically exempts those bonds which were issued before 1951 from the retroactive application of the new provision, because as to investors in pre-January 23, 1951, bonds, it will constitute, and I quote, "unfair retroactive application."

No reason is given anywhere why there is not equally unfair retroactive application to investors in post-January 23, 1951, bonds. In no case in the new bill, other than this provision to which I object, has the proposed change in the existing law been made applicable to bonds or other contractual obligations which had been entered into on or before the date of the committee's announcement. In fact, the Treasury and the staff admit that this is the only provision in the bill which is retroactive, going back to 1951.

I submit that the House provision should not be made retroactive to bonds already issued on January 22, 1954. Existing law should be made applicable to all such bonds and not to just those issued prior to January 23, 1951. On the contrary, if the provision is to be retroactive, it should apply equally to all bonds already issued on January 22, 1954, regardless of date of issue. All bonds should be treated equally.

I suggest that the House provision be changed as follows:

(1) Where a fully taxable bond is callable within 3 years from date of purchase, the earliest call date shall be assumed to be 3 years from the date of purchase.

(2) If such a bond is then called within the statutorily assumed 3-year period, the taxpayer shall be entitled to either deduct the balance of the unamortized premium as an ordinary deduction in the year of redemption, or, in the alternative, recompute his amortization over the shortened period, and claim the revised amortization for the applicable years of his•ownership, similar to amortization of emergency facilities during the war.

The above solution will result in the following:

(1) Equal treatment of all bonds, regardless of their date of issue.

(2) Accomplishment of the objective of the House provision to eliminate a possible tax-avoidance device.

(3) Noninterference with the good business conduct and practice of retaining the right to refinance a bond issue at a lesser interest rate.

(4) No conflict between a practice which might be otherwise encouraged by the House provision, namely, to insert a "restriction-on-call"——

The Chairman. To insert what?

Mr. Halperin. To insert a provision in the bond indenture that the bonds may not be called before 3 years and 1 day. And, the practice insisted upon by the SEC, namely, that there be no restriction on call.

(5) Retention of the present statutory recognition that sound accounting practice requires that bond premium be amortized.

And, lastly, it will accomplish this result: There will not be reopened the pre-1942 loophole, in the case of tax-exempt bonds, where the unamortized premium was deductible as a capital loss, although the interest was exempt from tax.

I might add that the Federal Tax Forum and the Edison Tax Institute have both filed briefs in support of the solution suggested as filed by me.

The Chairman. Thank you. That was an admirable statement.

The Chairman. Now, Mr. "X." Mr. "X," make yourself comfortable and identify yourself to the reporter.

STATEMENT OF MR. "X"

(Because of the embarrassing personal nature of the following testimony the transcription of the remarks of the witness has been altered to remove identity of person. This is in conformity with the suggestion of the Chairman found at the conclusion of the testimony.)

Mr. "X". My name is "X". I am a lawyer from (deleted). I appear here in connection with Representative Bolton's bill, designed to incorporate an amendment to section 23 (x) of the present code, relating to medical deductions.

I appreciate the cordial letter that you sent me, Your Honor, inviting me to come here.

The Chairman. We are glad to have you.

Mr. "X". And it is on a very embarrassing matter. I would much rather speak hypothetically, or in the third person, because what I have to say affects me materially.

Senator Kerr. You can still speak in the third person.

Mr. "X". Shall I call the situation that of Mr. "X", or "he"?

The Chairman. Make it yourself.

Senator Kerr. If it were both first and third person, I would say make it "he."

Mr. "X". In any event, if I did try to gloss it over by speaking as though I were representing a client, the subterfuge would become apparent, so I might as well state that this is my case.

I represent not only myself, but a large body of taxpayers who are confronted with very serious and exhaustive medical expenses.

It is a well-known fact that the average citizen, if confronted with a serious illness in his family, will exhaust himself in many cases to the point of extinction not only of his earnings, but of his accumulated capital. I don't think that many doctors take advantage of them, in the majority of cases. They have expended large sums in preparing for their profession, and the acquisition of their skill. There is considerable demand for their services, and they may feel entitled to exact large sums.

In my case, my daughter, following the birth of her child, had what is called by the doctors, a post partem neurosis, a difficult thing for a layman to describe.

I read briefly the report of the Ford Hospital, under date of January 3, 1952:

> This patient has had psychiatric treatment at intervals since 1946 under a diagnosis of constitutional psychopathic personality, inadequate type. She was in the hospital in March 1946, following a suicidal attempt. She was here in June 1946, for a period of psychiatric treatment for depression, and she was treated here again in June 1947 for another suicidal attempt, and was treated at the Milwaukee Sanitarium in 1947 and 1948.

Now, four lines more:

> Her treatment during this present hospitalization was primarily psychotherapeutic. Within a few days after her admission here, her general behavior was much better, and she was cooperative, pleasant, and emotionally stable.

Now, this is the important part:

> A long period of sanitarium care was recommended for her.

When you talk to the psychiatrist in the Ford Hospital, in a case like this, as you may know, he will tell you that in these cases a good many parents have to face a dilemma. They have to abandon the patient, or perhaps get her committed to an institution. Or, they have to do their utmost to bring her back to normality, without putting her to the sacrifice that is generally assumed a patient endures, in our understanding, at least, who is committed to a public institution, and particularly one who is told, "We're through with you: We can't do anything more for you."

So, they told my wife and me that there were four institutions in the country that gave the best care to these types of cases. One, of course, is the well-known Menninger Institution.

The CHAIRMAN. Where is that located?

Mr. "X". I think that is in Kansas.

Then, there is one here, in the suburbs of Washington, and I am going out there this afternoon. That is at Rockville, and is known as Chestnut Lodge, a highly accredited institution. And there are probably 2 or 3 others in the same high-priced category.

Now, when section 23 (x) was enacted, medical fees weren't what they are now, in this type and class of treatment. They have gone up remarkably, and the standard rate now in the institutions mentioned is about $1,200 a month. I hesitate to say it, but our daughter has been there now for nearly 2½ years. Our medical expenses for our daughter from the year 1946 to date, according to the schedule I have, as shown on our income-tax record, amount to $72,260.99, with $1,208 still owing as of April 1, 1954, in addition.

Now, I am not a high-priced corporation lawyer. I don't get fees commensurate with these situations and, if I did, after paying my taxes and paying these extremely high medical expenses, I wouldn't have much of anything left anyhow. And maybe that isn't the point. I understand the tax laws are, to some extent at least, social vehicles, and maybe you aren't supposed to have too much left. Maybe that is all right—a good living, clothes, food, the necessities of life. But under situations such as are here presented, you have to work pretty hard to make the squirrel cage go around, including about 7 days a week, which I save been indulging in for some time. But I shouldn't stress that.

(The schedule of medical expenses referred to follows:)

Schedule of medical expenses paid by taxpayers "X" and wife from 1946 to date of April 1st, 1954, almost entirely in behalf of daughter for sanitarium care and treatment.

1946	$5,619.48
1947	6,901.95
1948	9,214.94
1949	7,855.37
1950	6,158.16
1951	3,621.72
1952	14,187.97
1953	15,848.02
1954 to date of Apr. 1, 1954	2,853.38
Total	72,260.99
Due as of Apr. 1, 1954	1,208.00
Total to Apr. 1, 1954	73,468.99

In addition to the foregoing the taxpayers have perforce expended large additional sums for support and maintenance of the patient, including rentals, nursing, automobile, clothing and miscellaneous expenses when intermittently out of sanitariums, including the patient's traveling expenses (as well as the taxpayers' and attendants') to and from hospitals and sanitariums.

Dated: April 1, 1954.

Now, I think that compatibly with present situations—and I might say that my daughter married a wealthy man, and I don't blame him very much, because it may be pretty hard to live with a psychiatric wife. Some husbands however have stood by their afflicted spouses and it expedites recovery, most people think, if the patient has someone other than the parents that stands by them. But perhaps you can't blame him for abandoning the situation, severing himself from responsibility and cutting himself loose from all continuing obligations, except the payment of a modest monthly stipend for the support of the child, although a man of considerable means and earning power.

And this embarrasses me considerably. I don't like to talk about it. The child is with us, and my wife is 60 years of age; of course he is a fine boy, but night and day treatment, and that sort of thing, is more readily imposed upon a woman in her twenties. I think they can take it a little better. But, we wouldn't part with him. He is, as I stated, a fine boy, and reasonably healthy except for asthma which keeps him uncomfortable some nights.

The CHAIRMAN. Don't worry about the clock, Mr. "X".

Mr. "X" I am also rather worrying about my own embarrased position here. But, as I see it, if this new bill were enacted—and, Mr. Chairman, as you asked the various speakers here what they have to recommend in connection with their respective espousals; I have a specific recommendation, in line with Representative Bolton's bill.

And that is that you ameliorate the burden that is placed upon us who work for a living, by giving us something more consonant with present medical charges in the way of medical exemption.

In our case, we have four dependents, and are limited to a $5,000 deduction each year, as there is a $1,250 deduction per dependent with a maximum total deduction of $5,000 under the present law. Now, when we paid around $16,000 last year, we had to first get over 5 percent of our adjusted gross; that, of course, was not deductible. Then we had a segment of $5,000, $1,250 for each dependent, before we got to the point where we couldn't deduct further.

Now, if the present section pertinent to the subject matter, that is, subchapter B, part VII, section 213, H. R. 8300, is enacted, we would have only to get over 3 percent of our adjusted gross, to enter the realm of deductibility. I hope I am clear in this reference.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Mr. X. In any event there would be some reconciliation of present medical costs to the present dollar and present taxes, if that segment is increased from $5,000 deductible as a maximum to $10,000, as proposed in the present compilation of H. R. 8300; that is, $2,500 for each dependent, which gives you up to a maximum of $10,000. So that in the case of our $16,000 bill last year, we would first eliminate from deductibility 3 percent of our adjusted gross, instead of 5 percent. And then we would have a segment of $10,000 which would, under the proposed law, be deductible, and suffer nondeductibility of the amount above that, but we now, under the presently existing law have a larger segment of nondeductibility.

Now, I don't want to speak entirely for myself. There are a great many people in the country who are similarly affected. A good many of them will put all their goods on the line, so to speak, to endeavor to rescue the member of their family that is afflicted. That is common knowledge. You would, perhaps, be surprised to find that there are a great many people who are paying these prices that can't afford it. Menninger's, I understand, has a waiting list. You can't get in there for quite a while. We had to keep our daughter in Ford Hospital, in their psychiatric department, for some time before we could get admission to one of the four recommended institutions, and we finally obtained her admission out here at Rockville, Md., in the Chestnut Lodge Sanitarium.

The CHAIRMAN. Is she getting along all right?

Mr. X. I think she talks better than I do, considerably, with less perturbation perhaps, and less emotion. She looks good. She is the best looking patient they have out there. She has been a very fine athlete, with national athletic honors. She attended Vassar. She was on the Daisy Chain, which connotes brains as well as beauty. And she was at the head of her class at [deleted] School in [deleted].

She was all right until her marriage. And, living in the [deleted] so-called exclusive section, with the type of people she was with, I don't think was a very beneficial situation. It might well have been better if she had gone to a country town, where they didn't have the same ideas, financially, socially, and so forth.

But I dislike seeing this go into the record——

The Chairman. If you wish, we will take this all out of the record. We will make a hypothetical case out of it.

Mr. X. Could you do that?

The Chairman. Yes, we will leave it all out of the record, and let the staff digest it and make a hypothetical case out of it.

Mr. X. I think it would be better.

Senator Frear. Is it your opinion now that the maximum you could get would be $10,000, above the 3 percent?

Mr. X. I understand that to be the provision in the present draft (H. R. 8300). Of course, if the human anatomy could be treated as a machine, you would get full deduction for repairs that are necessary to put it back into service. You have heard that argument many times, and maybe the human machine has equal values to the mechanical machine. Also it is even true that when a person's nonbusiness property suffers through casualty, full deduction for repairs is allowed.

Senator Frear. In the present bill, can you get up to $10,000?

Mr. X. That is in the amendment.

Senator Frear. I mean in H. R. 8300. You don't so interpret it, I understand.

Mr. X. Well, Representative Bolton's proposal seeks to establish full deductibility, which I favor naturally.

Senator Frear. I mean isn't section 213, which is the revised one, or the new section number to the old 23 (x), isn't it now in the bill as section 213?

Mr. X. Yes. It is up for consideration, is it not? Whether or not it will be left in the bill, or deleted, and subject to argument——

Senator Frear. That is what I am trying to determined for my own information. Is that your point, that you would like this left in H. R. 8300?

Mr. X. Perhaps I should be satisfied with that. I don't think I can ask for too much. It is a considerable improvement on the former situation. And after you practice law as long as I have, you lean toward acceptance of compromise, you know.

Of course, I would, like Representative Bolton, favor full deductibility, such as we have in the repair of machines and in the case of casualties. There is a good argument for it. However, this might be a reasonable translation of higher medical fees and higher taxes; a concession to the lower purchasing power of the dollar. At the present time I am unfortunately working almost exclusively for the government and the doctors.

The Chairman. Thank you very much. We are glad to have you.

Mr. X. Thank you, sir.

The Chairman. Will you see that this part of the record is turned over to the staff, and the staff will digest it and make it a hypothetical case, and then we will put it back in the record.

Mr. X. That is a very gracious comment, and I appreciate it.

The Chairman. We will meet at 10 o'clock in the morning.

(By direction of the chairman, the following is made a part of the record:)

SATTERLEE & BROWNE,
New York, April 15, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
Senate of the United States.

DEAR SENATOR MILLIKIN: Since because of temporary eye trouble I am unable to meet my appointment for today to testify orally before your committee with respect to H. R. 8300, I append the following statement in writing, of which I shall appreciate consideration by yourself and the other members of the committee.

Yours very sincerely,

HUGH SATTERLEE.

STATEMENT OF HUGH SATTERLEE ON CERTAIN FEATURES OF H. R. 8300

My name is Hugh Satterlee. I appear on behalf of myself as an individual lawyer, who has specialized in Federal tax law since 1918.

H. R. 8300, the proposed Internal Revenue Code of 1954, covering 820 pages of ordinary type, without the appendix and table of contents, is staggering to tax lawyers, to say nothing of ordinary taxpayers. Yet, after the bill was drafted and submitted to the House of Representatives, no opportunity was afforded to consider and criticize it before it was passed in the House. The previous hearings before the Ways and Means Committee and the fragmentary reports of its decisions on certain questions were no adequate substitute for examination of the bill itself. In more than 35 years of specialization in tax practice the writer has seen no similar situation.

The bill contains greatly needed provisions correcting certain anomalies and paradoxes, but it needlessly changes the language of many provisions which have been satisfactory to both the Treasury and taxpayers and has gone a long way toward enacting into law the Treasury regulations, thereby substituting rigid rules of law for expressions of administrative interpretation, policy, and procedure. It has taken the courts a good many years, in thousands of decisions, practically all since January 1, 1918, to pass on most of the provisions of the existing Internal Revenue Code, but the present bill with its revolutionary provisions and language is likely to incite litigation for another 40 or 50 years.

In the writer's opinion an enormous amount of future confusion and injustice could be avoided if enactment of the bill were deferred to the end of the year, thereby affording ample opportunity for study and improvement of its provisions. The next best course would be to enact the bill to become effective January 1, 1955, thereby affording opportunity for taxpayers to become familiar with and adjust themselves to its provisions. In any event the effective date of the bill should be a fixed date subsequently to its enactment, with no retroactivity as to the incidence of the taxes, but only, if desired, as to rates and credits. At the present time many business transactions, the effect of which is clear under the present code, are necessarily suspended because of the uncertainty as to whether they will be subject to the provisions of the new code and, if so, what those provisions will be as finally enacted.

The uncertainty is particularly stultifying in the case of corporate distributions and adjustments under subchapter C of chapter 1 of subtitle A. Under the present code it is fairly well known what the tax consequences will be. Under the proposed code the consequences may be quite different and so harsh as to preclude the transactions altogether. The following two examples are illustrative of possible situations affected by the distributions provisions:

(*a*) A corporation having for a number of years manufactured different products at different plants finds that the manufacture of one of its products is no longer profitable and that the market for its other products is no longer as wide as in previous years. The corporation accordingly sells the plant devoted to the unprofitable product and sells and discards part of its equipment for the manufacture of its other products. This readjustment in its business, the remainder of which it intends to continue, leaves the corporation with substantial unneeded capital, which it proposes to distribute to its stockholders in liquidation of a proportionate amount of its stock. This would represent a partial liquidation under the present code, and the stockholders would realize capital gain or loss dependent upon the cost basis of their surrendered stock.

Under the proposed new code such a situation would present no possibility of relief unless the facts fell within the narrow and arbitrary requirements of the statute, which include the separate operation for 5 years previously of the discontinued branch of the business, with separate books of account (sec. 336). Such a state of facts would rarely, if ever, occur. Otherwise a partial liquidation would involve the treatment as a taxable dividend of the entire distribution to the extent of the surplus accumulated from the profitable branches of the business. Since such an abnormal dividend might well result in a tax up to 91 percent, the effect would be to compel the retention in the corporation of unneeded capital, at an economic waste to it and its shareholders and a loss to the Treasury of taxes which would be payable in the event of profitable employment of such capital by the distributees.

The bill should be amended to permit a partial liquidation, taxable as such, when an actual contraction in a corporation's business and facilities occurs in circumstances which indicate that the contraction is not occasioned merely by normal fluctuations, but is expected to be permanent.

(*b*) A corporation many years ago organized with chiefly common stock and to a less extent preferred stock, for both of which it received full par value in cash or property, proposes to redeem its preferred stock, which for over 10 years has been held by none of the original stockholders, although largely by members of their families. The individual stockholders own preferred and common stock in widely varying proportions. Under the present code this would represent a partial liquidation, and the preferred stockholders would realize capital gain or loss dependent on the cost basis of their preferred stock.

Under the proposed code the distribution may be treated as a partial liquidation if, as now, it is disproportionate, but that term is drastically limited by complicated and arbitrary requirements which could seldom be met (sec. 302). Moreover, an individual stockholder is regarded as owning stock held by his spouse, his parents, and his descendants (sec. 301), except that this identification would apparently not apply if the individual has held his stock for 10 years and after the distribution has no interest in or connection with the corporation for a period of 10 years (sec. 302 (c) (2), (3)). Furthermore, the redemption may be subject to a transfer tax of 85 percent if occurring within 10 years from the date of issuance of the stock, which is the later of the actual date of issuance or January 1, 1954, thus penalizing the redemption before 1964 of preferred stock issued 20 years or more before 1954 (sec. 309).

At present the redemption of preferred stock may sometimes be treated as substantially equivalent to a taxable dividend, but rarely if the stock was not issued as a stock dividend. The proposed code has been designed, so it is said, to encourage investment in corporate enterprises through the acquisition of stock instead of bonds or other securities. Except in the case of large corporations whose stock is widely held and dealt in, the contrary is true of such provisions as have been mentioned. If an individual cannot subscribe for preferred stock in a corporation unless he is prepared to retain his investment so long as the corporation continues in existence, or to incur confiscatory taxes, he will naturally be more interested in acquiring its bonds, which will have a definite date of maturity.

Preferred stock is a form of investment which gives the holder a higher return than a bond, but with greater risk, and its issue should be encouraged by the Government because, unlike interest on bonds, the preferred dividends do not decrease the taxable income of the corporation. Like bonds, preferred stock is customarily issued to provide additional capital for a limited period, and not as a permanent part of the capital structure. While the preferred stock is outstanding, the Government taxes the income derived by the use of the capital paid in for the preferred stock, and the holders of the stock are taxed on their fixed dividends. Any net earnings from the preferred capital in excess of the preferred dividends having redounded solely to the benefit of the common stockholders, why should preferred stockholders, who have paid in capital to the corporation and have received and been taxed each year on the limited return due them, not be entitled to receive back their capital as such, if the corporation chooses to redeem its preferred stock? Why in that respect treat preferred stock differently from bonds that may be redeemed?

Again, the proposed code gives some recognition to the unfairness of double taxation of corporate earnings, but in the distribution provisions would tax not only the income derived by the corporation from the use of preferred capital, but also as dividends the capital itself when returned to the preferred stockholders. It is indefensible to place preferred stock issued for value in the same category for tax purposes as preferred stock issued as a dividend on or in exchange for common stock. Whether or not a preferred stockholder may also own common stock is irrelevant.

The proposed code should be amended to provide that preferred stock issued for value paid in, limited as to dividend rate and as to sharing in the proceeds of liquidation, may be redeemed at any time in partial liquidation at the issuing price, plus a small premium, without liability to tax to the corporaton, or to the preferred stockholders except for any capital gain. If it should be feared that corporations might be organized with nominal common stock and large preferred capital, the privilege of redemption as above might be restricted to issues of preferred stock not exceeding 50 percent of the total paid in capital of the corporation.

Since preparing the foregoing the writer has seen the First Report on H. R. 8300 of the committee on taxation of the Association of the Bar of the City of New York, dealing with corporate distributions and adjustments. He is thoroughly in accord with the committee's recommendation that subchapter C be supplanted by the corresponding provisions of the present code pending adequate study of the revolutionary provisions of subchapter C. The committee's detailed comments highlight the arbitrary and illogical nature of the provisions relating to corporate distributions, even while making helpful suggestions for correcting them in furtherance of their presumable objectives.

However, it is suggested that all such provisions, if implemented logically and their purpose approved, might preferably be condensed into a statement that all distributions by corporations in partial liquidation shall be regarded as dividends to the extent of the surplus of the corporation. Then, as a result which the distribution provisions of subchapter A seem intended to accomplish, stockholders could never get their capital out of a corporation without taxes which they could not afford to incur, and the Government would accordingly lose the taxes on ordinary income not earned and on capital gains not realized because of the uneconomic freezing of capital. This may sound frivolous, but it is unpleasantly close to the truth, for only in highly exceptional circumstances would taxpayers be free from the prohibitive taxes on distributions proposed in subchapter A.

Statement of R. W. Waskom, Controller, Magnolia Mining Co., Madisonville, Ky.

Mr. Chairman and gentlemen of the committee, the committee was unable to grant me time to testify in person, and therefore I hope that this statement will be made a part of the record of these hearings.

My name is R. W. Waskom. I am controller of the Magnolia Mining Co., Madisonville, Ky. The Magnolia Mining Co. produces bituminous coal. The company is comparatively small, with annual production in the neighborhood of 250,000 tons.

Prior to 1951 our percentage depletion computation was relatively simple, because percentage depletion for coal was limited to 5 percent of the gross income from the property, not to exceed 50 percent of the net income from the property and our net income was sufficient in the years immediately prior to 1951 to permit our depletion to be based on 5 percent of the gross income. Section 114 (b) (4) (B) of the Internal Revenue Code contains a definition of gross income from the property which makes the computation of the gross income relatively satisfactory and simple.

In the Revenue Act of 1951 the percentage depletion allowance for coal was increased to 10 percent of the gross income from the property, still limited, of course, to 50 percent of the net income from the property. Since that time the bituminous coal industry has entered upon a period of severely depressed prices and the industry has lost a substantial portion of its markets to imported residual oil, to domestic petroleum, and to natural gas. The industry's production in its peak year, 1947, was 630 million tons. This had dropped to 533 million tons in 1951. In 1952 the industry's production dropped to 465 million, and in 1953 the industry's production was only 453 million tons. Through March of this year the industry's production is running 16 percent below the production for the corresponding period of last year. Although many forecasts indicate that in 15 to 25 years the demand for bituminous coal will increase substantially, there is no indication that the present condition of the industry will improve during the next several years.

As a result of this economic condition, practically all coal-producing companies are forced to compute their percentage depletion under the limitation on the net income, because the net income is not sufficient to allow them to utilize 10 percent of the gross income. For practical purposes, therefore, the computation of the net income from the property governs the amount of the percentage depletion allowance in the bituminous coal industry.

When these conditions put the Magnolia Mining Co. into the bracket where net income, rather than gross income, governed the depletion allowance, we found ourselves faced with an unreasonable and inequitable situation. The 1939 code does not provide a definition of "net income from the property." Under the regulations issued by the Commissioner of Internal Revenue, the net income from the property must be reduced by the amount of State income taxes paid. These regulations have been upheld by the courts, since Congress did not see fit to define net income from the property.

The State of Kentucky, like a large number of other States, allows percentage depletion for natural resources, with the amount of the allowance determined under the same rules applied by the Federal Government.

Our company, as well as any other corporation in Kentucky, finds itself faced with this situation: The amount of the Federal income tax cannot be determined until the amount of the Federal depletion allowance is determined. The amount of the Federal depletion allowance cannot be determined until the amount of the State income tax is known, since the net income from the property must be reduced by the amount of State income tax. The amount of the State income tax cannot be determined until the amount of the State depletion allowance is determined. The amount of the State depletion allowance cannot be determined until the amount of the Federal income tax is known, since the State law (duplicating the Federal law) requires that the net income from the property, for depletion purposes, be reduced by Federal income tax.

We are advised that it is possible, through the application of principles of advanced mathematics, to compute the amount of these four unknowns and thereby determine the proper amount of tax to be paid. As a practical solution, after several conferences with Federal and State officials, our particular problem has been settled in the following fashion: After our respective State and Federal returns were filed, the State adjusted the amount of the State depletion allowance, and therefore the amount of the State tax, by reducing net income from the property by the initial figure for the Federal income tax. The Federal Government then adjusted the amount of the Federal depletion allowance, and therefore the amount of the Federal tax, by reducing net income from the property by the adjusted amount of Federal income tax. Fortunately, the Federal Government did not insist on continuation of the chain of adjustments, or we never would know the final amount of either State or Federal tax.

Incidentally, in this connection, there is nothing in the regulations to prevent a continuous chain of adjustments, namely, Federal to State and State to Federal, until the depletion factor would be reduced to infinity. This being the case, it would appear that the law must be amended to eliminate the possibility that this chain of adjustments could ever be imposed on a taxpayer as a "matter of law" rather than interpretation by the Department in the form of regulations.

Aside from the unreasonable difficulties which the treatment of State income taxes poses for the taxpayer, equity between competing taxpayers requires that the law be amended to eliminate the reduction of net income from the property by the amount of State income taxes. Coal companies from different States compete for the same markets, and many States do not have taxes based on income. As a result, the Magnolia Mining Co. pays higher Federal income taxes than would be paid by a competitor located in a State where there is no State income tax, even though all other circumstances (production, prices, and profits) were identical. There seems to be no logical reason why the amount of the Federal income tax should be higher for a taxpayer in a State which imposes a State income tax than it is for an identical taxpayer located in a State which does not impose a State income tax.

Even as to taxpayers located within the same State, the present regulations impose competitive inequities. For example, the State of Kentucky imposes an income tax on corporations but not on individuals or partnerships. Therefore, under present law the Magnolia Mining Co. receives a lower Federal depletion allowance, and pays a higher Federal income tax, than would be paid by an identical coal producer located in the same State but operating under a different form of ownership—individual or partnership. This discrimination in the Federal depletion allowance, based on form of ownership, appears to be unreasonable.

The phrase "net income from the property" has been replaced, in section 613 (a) of H. R. 8300, by the phrase "taxable income from the property." This change is referred to on page A184 of the Ways and Means report, as follows:

"As used in section 613, the term 'taxable income from the property' means the same as 'net income from the property' in existing section 114 (b) (3), (4) (A), and no substantive change is intended by the change in language. In computing taxable income from the property it is intended that there be taken into account all deductible items (other than depletion) including such items as administrative and financial overhead expenditures and taxes which, under sound accounting principles, are attributable to extraction or processes treated as mining."

The effect of this provision of H. R. 8300, therefore, is to enact into law the unreasonable provisions heretofore contained only in the regulations. I believe that neither financial overhead (interest on indebtedness) nor taxes based on income should reduce the Federal depletion allowance. The Federal depletion allowance granted to competing taxpayers should not be less for one than for the other merely because one is in debt or is located in a State which imposes taxes based on income. In computing the net income from the property State income taxes should not be considered an expense of producing such income—it is in the nature of a disposition of such net income, rather than an expense of producing such net income.

I ask, therefore, that the term "taxable income from the property" in section 613 (a) of H. R. 8300 be replaced by the term "net income from the property," and that a new subsection (d) be added to section 613, as follows:

"(d) DEFINITION OF NET INCOME FROM THE PROPERTY.—As used in this paragraph the term 'net income from property' means the gross income from the minerals from the property, less the allowable deductions directly attributable to the mineral property upon which the depletion is claimed and the allowable deductions directly attributable to the processes described in paragraph (c) of this section insofar as they relate to the products of such property, including operating expenses, development costs properly charged to expense, depreciation, property taxes, losses sustained, etc., but excluding any allowance for depletion. Such expenses or deductions shall not include expenses or deductions attributable to, or arising out of expenditures on, other property or assets, irrespective of whether such property or assets are income producing or active. Deductions not attributable to, or arising out of, particular properties, processes or assets, such as general overhead, shall be fairly allocated to all properties, processes, and assets whether active or inactive. The term 'general overhead' as used herein shall be deemed to mean the overhead relating to the property but shall exclude deductions and expenses of financial overhead of the taxpayer such as interest, taxes based on or measured by income, capital stock taxes and the like."

GARDNER, MORRISON & ROGERS,
Washington, D. C., April 15, 1954.

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

GENTLEMEN: We enclose herewith three copies of a memorandum covering suggested amendments to H. R. 8300. The enclosed memorandum deals with the qualification of widow's allowances for the marital deduction and concerns specifically sections 2056 (b) (7) and 7851 (a) (2) (A) of the bill. We respectfully request that the enclosure be incorporated in the record of the hearings presently being conducted by your committee relative to H. R. 8300.

Respectfully submitted.

THOMAS J. BEDDOW.

RE H. R. 8300—QUALIFICATION OF WIDOW'S ALLOWANCE FOR MARITAL DEDUCTION

Prior to the enactment of the Revenue Act of 1950, a widow's allowance (i. e., an allowance out of an estate for support of a widow during the period of settlement of the estate) was specifically deductible from the gross estate, for Federal estate-tax purposes, under section 812 (b) (5) of the Internal Revenue Code. This specific deduction was eliminated from the code by the Revenue Act of 1950, effective with respect to estates of decedents dying after September 23, 1950.

However, both the Senate Finance Committee and the House Ways and Means Committee explained, in connection with the elimination of this specific deduction, that thereafter (i. e., in respect of the estates of decedents dying after September 23, 1950) 'a widow's allowance would normally qualify for deduction under the marital deduction section of the code.[1] Despite the congressional purpose to have widow's allowances qualify for the marital deduction, the Internal Revenue Service, in Revenue Ruling 83 (I. R. B. 1953), announced a position which would deny such qualification to the widow's allowances of many States.[2] To eliminate the view announced by the Service, H. R. 8300, as passed by the House of Representatives, contains a provision (sec. 2056 (b) (7)) qualifying widow's allowances for inclusion in the marital deduction. There are, however, two respects in which the present provision of H. R. 8300 dealing with the matter are deficient.

In the first place, section 2056 (b) (7) limits the qualification to amounts paid to the surviving spouse within 1 year after the date of the decedent's death. There appears to be no good reason for any such limitation. There may have been some feeling that abuse might result from allowing the inclusion in the marital deduction of support payments made to the surviving spouse during the period of settlement of the estate.[3] Clearly, however, the limitation of the marital deduction to 50 percent of the decedent's adjusted gross estate is an effective deterrent to abuse, and any other limitation runs counter to the congressional policy to permit the tax-free passage of half of a decedent's estate to the surviving spouse. In any event, if any time limitation is considered necessary, the most appropriate such limitation would be one restricting the provision to allowances for the support of the spouse within the period of limitations for the assessment of estate tax, since it is the question of the amount of the estate tax due which normally prevents distribution of an estate and thus makes necessary the payment of support allowances to the surviving spouse.

In the second place, the provisions of section 2056 (b) (7) are made applicable, by section 7851 (a) (2) (A), only with respect to the estates of decedents dying after the date of enactment of the bill. Enactment of the bill in this form would mean that widow's allowances would clearly qualify for deduction in respect of the estates of decedents dying prior to the date of enactment of the Revenue Act of 1950 and after the date of enactment of H. R. 8300, but that, in view of the attitude expressed by the Service in Revenue Ruling 83, doubt would exist about the rule applicable in respect of the estates of decedents dying after September 23, 1950, and before the enactment date of H. R. 8300, and such doubt could probably only be resolved through long and costly litigation. The failure of H. R. 8300 to make section 2056 (b) (7) applicable to the estates of decedents dying after September 23, 1950, would possibly not only thwart the congressional purpose in respect of the estates of decedents dying after September 23, 1950, and before the enactment date of H. R. 8300, but also unfairly discriminate against such estates.

The aforesaid defects can be cured by the following amendments to H. R. 8300: Amend section 2056 (b) (7) by striking out the words "within 1 year after the date of the decedent's death," and by substituting therefor the following words: "within the period of limitations for the assessment of estate tax as provided in section 6501 (a) (determined without the application of section 6503)", and amend subtitle B, chapter 11, part IV, by the addition of the following section:

"SEC. 2057. EFFECTIVE DATE OF CERTAIN PROVISIONS.

"Section 2056 (b) (7) shall apply with respect to the estates of decedents dying after September 23, 1950."

[1] Both committee reports covering the Revenue Act of 1950 stated as follows:

"Under existing law amounts expended in accordance with the local law for support of the surviving spouse of the decedent are, by reason of their deductibility under sec. 812 (b), not allowable as a marital deduction under sec. 812 (e) of the code. However, as a result of the amendment made by this section, such amounts heretofore deductible under sec. 812 (b) will be allowable as a marital deduction subject to the conditions and limitations of sec. 812 (e)."

[2] Not only does Revenue Ruling 83 violate the congressional purpose, but, in addition, it seems clear that it is based on an incorrect construction of the terminable interest provision of the marital deduction section.

[3] While the only possible reason for inclusion of the 1-year provision was as an abuse preventative, the report of the House Ways and Means Committee indicates (at p. A319) that the provision (sec. 2056 (b) (7)) will cover "lump-sum cash payments * * * made within such 1-year period although the amount of such payments may represent an allowance for support for a longer period of time."

AMERICAN COUNCIL ON EDUCATION,
Washington 6, D. C., April 15, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: The committee on taxation and fiscal reporting to the Federal Government of the American Council on Education reviewed with considerable care the 40 topics on which the House Committee on Ways and Means held hearings last spring as a basis for the provisions of H. R. 8300. The council's committee then either submitted testimony for the record or informed members of the Ways and Means Committee by letter of their stand on certain issues directly affecting higher education. The following provisions of H. R. 8300 were approved by this committee, and we urge that they be retained by the Senate:

Section 151 (e) (1) (B)

Under the present law a dependent may not be claimed as a dependent if he earns as much as $600. Section 151 removes this earning test for children of the taxpayer who are not over 19 years of age, or, if older, are students attending school or college.

Section 151 (d) (2)

This section provides for the exclusion of scholarships in determining whether a taxpayer supplied more than half the support of his child where the child is attending school or college.

Section 673 (b)

Provides that income from a trust payable to certain charitable beneficiaries should be taxed to the person setting up the trust if he retains the right to take the principal or income back within 2 years.

The council's committee also submitted testimony against extending tax withholdings on dividends and interest, and we are glad to note that H. R. 8300 accepts this position. It is also gratifying to see that the charitable-contribution limit for individuals is raised from 20 to 30 percent if this extra 10 percent is contributed to religious orders, educational institutions, hospitals, and churches. This will be of considerable help to the many educational institutions that now find themselves in dire financial straits.

An issue which was discussed in letters to the members of the Ways and Means Committee and which, in our judgment, is not satisfactorily resolved in the House version of the bill has to do with section 170 (b) (1) (C) of H. R. 8300. Section 120 of the present Internal Revenue Code covering unlimited deductions for charitable and other contributions may be summarized as follows:

The 20-percent limitation on charitable contributions does not apply where the combination of the taxpayer's charitable contributions and income tax in the current year and in each of the past 10 years equal 90 percent or more of his taxable income.

The committee on taxation and fiscal reporting to the Federal Government of the American Council on Education advocates an amendment to this section of the code which would decrease from 10 to 5 the number of past years that the 90-percent test is necessary. Section 170 (b) (1) (C) of H. R. 8300 liberalizes this slightly by providing that the 90-percent test needs to be met in only 9 out of the last 10 years, but this provision is not, in the judgment of our committee, adequate to meet specific situations with which we are familiar. The council's committee realizes that the application is not broad. However, in decreasing the number of years to 5 for the 90-percent test, a few more individuals will qualify, and the advantages to such institutions as might benefit from their enlarged contributions would be of substantial significance.

We shall be glad to provide additional testimony on any of these issues if the Senate Finance Committee desires to receive it.

Sincerely yours,

ARTHUR S. ADAMS.

JEREMIAH S. BUCKLEY,
CERTIFIED PUBLIC ACCOUNTANT,
Bridgeport 3, Conn., April 15, 1954.

Re Estate tax, marital deduction, Internal Revenue Code, section 812 (e)

SENATE FINANCE COMMITTEE,
United States Senate,
Washington, D. C.

GENTLEMEN: I wish to call to your attention a serious inequity that exists in regard to the allowance of the marital deduction under section 812 (e) of the Internal Revenue Code. This inequity comes about because the law does not provide relief in instances where mental incompetency has prohibited the decedent from taking full advantage of the marital deduction.

The marital deduction first became a part of the estate-tax laws by the Revenue Act of 1948, enacted April 2, 1948. The general purpose of the marital deduction was to provide equality of estate taxation for all citizens. By taking advantage of the marital deduction when he makes his last will and testament, a person can obtain a substantial benefit for his estate and heirs in a reduction of the amount of estate tax on his estate. A person who is mentally incompetent of making a valid last will and testament does not have the opportunity to gain for his estate and heirs these benefits to the fullest extent. This is particularly applicable to an instance where a decedent made his last will and testament some years prior to the enactment of the Revenue Act of 1948 and since such enactment has been in a state of mental incompetency.

While it is true that instances such as this are unusual, I have had one come to my attention. Undoubtedly throughout the country there are and will be others which deserve relief. It seems only proper that in the interest of equity that the law provide relief and that such relief be made retroactive to the Revenue Act of 1948.

Very truly yours,

JEREMIAH S. BUCKLEY.

BRIDGEPORT 3, CONN., *April 21, 1954.*

Re estate tax-marital deduction, Internal Revenue Code, section 812 (e) (1) (F), revenue ruling 54–20, I. R. B. No. 2, January 11, 1954; proposed Revenue Code of 1954, H. R. 8300, section 2056 (5).

UNITED STATES SENATE,
Committee on Finance,
Senate Office Building, Washington, D. C.

GENTLEMEN: Section 812 (e) (1) (F) of the Internal Revenue Code has been interpreted by revenue ruling 54–20 as not allowing a marital deduction for any portion of a trust passing from the decedent for the benefit of his widow even though the decedent has given his widow the power to appoint a portion of the trust corpus.

Section 2056 (5) of H. R. 8300 corrects the inequity of section 812 (e) (1) (F) as applied to a case such as the one described in the above paragraph.

However section 2056 (5) of H. R. 8300 apparently does not provide relief in a retroactive manner. It seems to me that in this instance equity would be better served if such relief were made retroactive to the Revenue Act of 1948.

Very truly yours,

JEREMIAH S. BUCKLEY,
Certified Public Accountant.

LAW OFFICES GEORGE H. ZEUTZIUS,
Los Angeles 13, Calif., April 15, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR MILLIKIN: Reference is made to H. R. 8300, my letter to you of January 26, 1954, and your reply of February 1, 1954, concerning three items in connection with the proposed revenue revision bill.

I am particularly concerned with the failure of the House to take any intelligent action by way of modernizing tax levy exemption section 3691 (a) of the Internal Revenue Code, which has not been changed in 88 years. I think the other two items mentioned in my letter to you of January 26, also are deserving of serious attention and appropriate legislative action.

I understand that your committee now is conducting public hearings in connection with H. R. 8300. Please consider this, and my earlier letter to you, as substituting for my appearance as a witness before your committee. It is my earnest hope that you and your committee will put forth a real effort and completely modernize the section dealing with property exempt from levy for Federal taxes. The old section (3691 (a), I. R. C.) is set forth in H. R. 8300 as new section 6334. A published explanation of the new section indicates that the House merely has rewritten part of the old section but has not brought it up to date in any real or substantial sense. The House has explained this change of the section as exempting from levy wearing apparel and schoolbooks necessary for the taxpayer or for members of his household, without any specific valuation limits, since the intent, it is explained, is to prevent seizing the ordinary clothing of the taxpayer or members of his household.

The House explains the second exemption from levy as applicable only to so much of the fuel, provisions, furniture, and personal effects in the household as does not exceed $500 in value. The 88-year-old provision allows at least $375 for fuel, provisions, and household furniture, so the House, out of the goodness of its heart, now has seen fit to increase from $375 to $500 the value of these exempt items.

The third item of exemption is explained by the House as covering books and tools necessary for the trade, business, or profession of the taxpayer not in excess of an aggregate of $250 in value. Eighty-eight years ago, this was fixed at $100 .

Clearly, proposed section 6334 represents a grossly inadequate attempt by the House to modernize the antiquated property exemption provisions of section 3691 of the Internal Revenue Code. I, therefore, strongly recommend and urge the Senate Finance Committee to insert, in the section exempting property from distraint, a provision for a homestead exemption, or its equivalent, in the amount of $12,500 in the case of a married couple or head of a family, and a homestead exemption of $5,000 in the case of a single or unmarried person who is not the head of a family; also, a provision exempting, in the case of a married couple or the head of a family, 50 percent of their current earnings or wages, or $200 per month, whichever is greater, except that in no event shall the total monthly wages or earnings to be exempted exceed $250 per month. In the case of a single person, the wages or earnings to be exempted could be 60 percent of the exemption allowed a married couple or head of a family. There should also be a provision exempting one automobile or truck for use by a person in the earning of his livelihood, or in traveling to and from his work. The suggested exempt amount for such an automobile should be a sum not to exceed the fair market value of $750. These exempt valuations should be exclusive of encumbrances.

Naturally, schoolbooks, wearing apparel, arms for personal use, certain livestock, food, fuel, household furniture, books, and tools of a trade or profession, including tools and equipment for the business of farming, within limitations, should also be exempt from levy for Federal taxes. Household equipment such as an automatic washer, refrigerator, kitchen stove, radio, and television, not in excess of a total given value, should be added to or included as part of the exemption presently classified as household furniture. I suggest the exempt classification be changed to read "household furniture, furnishings, and equipment."

California, in the collection of all of its taxes (other than taxes on realty), recognizes all exemptions which are allowed by State law in respect of the claims of judgment creditors. These exemptions include a homestead exemption of $12,500. Section 1260, California Civil Code (Am. Stats., 1953, ch. 943, sec. 1).

If the Congress will adequately liberalize and modernize the archaic Federal tax levy exemption provisions, it will have achieved something worthwhile, and much progress will have been made by it toward preserving the natural and inalienable individual rights which our Founding Fathers sought to protect and preserve for posterity, when they agreed to adopt the first 10 amendments to the Constitution. The House's new section 6334 amounts to mere mockery, it doesn't even pay lip service to the principles included in the Bill of Rights. It is common knowledge among tax laywers and persons handling all types of tax matters, that many unfortunate individuals, unable to meet their tax bills, have been effectively economically and physically destroyed by the exercise of the power of the Treasury Department in the collection of delinquent and other taxes. As the law now stands, any taxpayer can be harassed and annoyed by the threat of use of the power to take everything of value, including his salary, in order to collect taxes claimed to be due from him.

The tremendous financial requirements of the Federal Government make it necessary for Congress to pause in the interest of the individual, to give him at least some measure of protection, to the end that individual rights are preserved and not lost in the shuffle of world events, for in the final analysis, no nation is any greater than the family units and individuals comprising the same. It, therefore, is important to see to it that neither the Treasury Department nor any other governmental agency shall have the authority to evict a man from his castle (his home), when he is down on his luck and perhaps cannot afford to employ adequate legal or tax assistance. The exemption of a roof over one's head, and of funds for food, should be just as important a phase of the President's housing policy as is the appropriation of tremendous sums to finance new housing, directly and indirectly.

Please, Senator Millikin, insist on the Senate Finance Committee giving this matter of adequate and modern exemptions from distraint for Federal taxes its most careful study and consideration from the standpoint of the individual. The Treasury, with its powerful lobby, financially supported by all of us, seems too long to have had its own way. Give the little fellow a break. The little fellow is any one of us who at some future time might be unable to pay his taxes through no fault of his own, and be unable to protect his home or be assured of his daily bread because of inadequate protective exemption-from-seizure provisions.

Let us not forget that the power to tax does include the power to destroy. If the Treasury Department's collection functions can be reasonably controlled by up-to-date tax levy exemptions, then the fear of the loss of our homes and ability to make our livelihoods, should misfortune befall any one of us, will be effectively removed at a time when taxation, as a whole, already has reached the realm of confiscation.

I would appreciate your keeping me informed with reference to this matter.

Respectfully submitted.

GEO. H. ZEUTZIUS.

STATEMENT OF PAUL E. HADLICK, GENERAL COUNSEL, NATIONAL OIL MARKETERS ASSOCIATION, WASHINGTON, D. C.

In view of the fact that I testified before the House Ways and Means Committee during hearings on its general revenue revision[1] and am thus precluded from presenting oral testimony to the Senate Finance Committee, I desire to submit this statement for the record.

The National Oil Marketers Association is an organization of independent oil jobbers throughout the United States, principally east of the Rocky Mountains. It was organized in 1933 and incorporated in 1935. The members do a domestic distribution business in the petroleum industry handling all types of refined petroleum products.

First of all this association endorses and urges the adoption of the amendment to H. R. 8300 offered by Senators John J. Williams and George D. Aiken, proposing to cut the oil and gas depletion allowance from 27½ to 15 percent. However, we do not feel that even this cut goes far enough. The need for this reduction and a further limitation to end depletion allowances when "cost" has been recovered, and the additional need for requiring that drilling and development costs of completed oil and gas wells be capitalized and not charged off as "expenses of operation" will be apparent to you as the facts are presented herein.

The position of the National Oil Marketers Association in both these matters can best be presented by calling your attention to a resolution which the association adopted on November 11, 1953. It reads as follows:

"Whereas the vast expansion of Government expenditures with its attendant deficit financing and inflationary peril makes it essential that all business and industry bear their fair share of the tax burden and that no portion of an industry enjoy a tax advantage that results in injury to another segment of such industry; and

"Whereas the producers of oil and gas and the minerals production industry enjoy certain special allowances for depletion over and above a true rate of depletion of their capital; and

[1] See pt. 3: General Revenue Revision, hearings before the House Ways and Means Committee, 1953, pp. 1992–2000.

"Whereas the producers of oil and gas also enjoy the special privilege of writing off as expenses of doing business their investments in drilling and development of oilfields; and

"Whereas such subsidies and special privileges accorded the oil and gas industries deprive the Federal Government of about $1 billion in needed revenue, to which could be added the depletion subsidies granted to sulfur and the other mining and natural resource industries, thereby increasing the tax burden on all the other taxpayers including those in the oil industry who are not engaged in production, and giving integrated oil companies disproportionate profits from production which are available to subsidize their marketing activities; and

"Whereas the acqusition of wholesale and retail properties by the integrated oil companies is proceeding rapidly because of the tax-free funds made available by the depletion subsidy and the special tax writeoffs and it is thus tending to promote monopoly in the oil industry: Now, therefore, be it

Resolved by the National Oil Marketers Association in meeting assembled at Chicago, Ill., this 11th day of November 1953, That:

1. The Congress of the United States be urged to eliminate the principle of "discovery" depletion from the tax laws, as well as all fixed percentage allowances for depletion (such as the 27½-percent depletion allowance for oil and gas) and, as to the oil, gas, and mining industries, prescribes that value for the purpose of computing true depletion shall be the value of the property as of March 1, 1913 (if acquired prior thereto), or "cost" if acquired thereafter; and that the depletion allowance be treated as is depreciation under the income-tax laws, i. e., when the depletion allowance thus authorized equals the capital originally invested (or in the case of purchase made prior to March 1, 1913, the fair-market value as of that date) no further allowance shall be made.

2. The Congress of the United States be urged to amend the income-tax laws so as to require drilling and development costs in the oil and gas industry to be capitalized in the same manner as such capital investments are capitalized in other industries."

DEPLETION IN THE OIL INDUSTRY

There certainly is no objection to permitting a true depletion allowance in the production of oil and gas, inasmuch as the effect on the capital structure of a company is the same as the principle of allowing depreciation on mechanical goods, buildings, etc. Deplete means to exhaust, hence depletion is the exhaustion of a capital asset. One authority has defined depletion as follows:

"Depletion is that deduction from operating income provided to cover capital consumed in the operation of a mine or an oil or gas well, forest, or natural deposit."

An annual depletion allowance for tax purposes is merely a method of allowing a credit for that portion of the capital assets that have been removed and sold. Annual depletion, like depreciation allowed on other capital equipment or properties should be permitted only to such an extent as to compensate the taxpayer for the exhaustion and wasting of wealth. But when the time comes that an oil or gas producer has taken depletion allowances on his tax return, whatever the rate, equal to his cost, then in that event no further deductions should be permitted.

Since only income is taxable under the Federal income-tax laws we take no issue with the proper allowance of depletion to oil and gas producers or other natural resource industries. The point we wish to make is that the percentage depletion method in the oil industry returns to the producer his capital over and over again and thus provides a tax loophole that should be plugged.

HISTORICAL DEVELOPMENT OF PERCENTAGE DEPLETION FOR OIL AND GAS

The history of how percentage depletion was adopted for the oil industry, while somewhat beclouded, is very interesting. When the income-tax law for the Federal Government first became effective on March 1, 1913, and until about the year 1918, the basis for computing depletion in the oil industry, as in the case of depreciation, was the "value" as of March 1, 1913, or the "cost" if acquired thereafter.

As late as the year 1916 in legislating with reference to depletion the Congress of the United States included safeguards against evasion beyond full recovery of cost by declaring:

"That when the allowance * * * shall equal the capital originally invested, or, in the case of purchase made prior to March 1, 1913, the fair-market value as of that date, no further allowance shall be made." [3]

[3] See conference report on revenue bill, H. R. 16763, 64th Cong., 1st sess.

That should have remained the basis for depletion in the oil industry—a method whereby a taxpayer in the natural resource industries avoided paying taxes on capital, and yet contributed its fair share of taxes on true income.

But here is what happened: The first error occurred in 1918 when the Congress provided for "discovery depletion" or the use of "discovery value" for the purpose of computing the capital investment, rather than the actual investment, and from this inflated value after discovery of oil, gas, or minerals, the depletion could thereafter be computed. Under this method when an oil and gas well was brought in, an engineering concept of the amount of oil that would be produced was set up on the books and thereafter this became the so-called capital subject to deletion.

At hearings before the Senate Finance Committee on the Revenue Act of 1926[3] Mr. L. C. Manson, counsel for the Senate Select Committee Investigating the Bureau of Internal Revenue, described the operation of "discovery depletion" as follows:

"The method followed by the Bureau of arriving at the depletion deduction is to divide the value to be depleted by the estimated number of units in the mine or in the oil or gas property. What I mean by that is to estimate the number of tons of ore, for instance, in a mine and divide the value to be depleted by that estimated tonnage of ore, which gives a depletion unit per ton. For instance, if they estimate a million tons of ore and have a value of $500,000 to deplete, the unit depletion would be 50 cents per ton."

The main point to remember about the system of "discovery depletion" is that the value or capitalization is placed upon the property after the discovery of the oil, gas or mineral. But even this was somewhat protected, for, Mr. Manson said further:

"The statute which provides for discovery value as it now stands provides that discovery value shall not be allowed; that is, discovery depletion shall not be allowed where the property falls within an area which was a proven area at the date of purchase or acquisition by the taxpayer."

At least "discovery depletion," while it operated as a sort of Federal subsidy or bonus to the wildcatter or prospector, had the merit that it was not a beneficial covenant running with the land to be used for the benefit of the purchaser for all time to come.

Despite the fact that "discovery depletion" had merits far and above the present percentage depletion allowance, Mr. Manson described it as:

"* * * the only case under the income-tax law where increment in value since March 1, 1913, escapes taxation."

Following this first error in 1918, the Congress in 1926 abandoned the "discovery depletion" principle—a principle which was bad enough in itself, yet at least providing an incentive bonus to the wildcatter without endowing the land with special tax advantages for all enternity—and to establish the principle of percentage depletion—and a high one—27½ percent—for oil and gas production.

The tax laws since 1926 have authorized an oil or gas company to deduct 27½ percent from the gross income from any property producing oil or gas. This 27½ percent depletion allowance or deduction is computed as a percentage of income from each property without regard to the amount of the investment or to the amount of prior depletion deductions. One saving condition was attached, namely: In no case may the deduction exceed 50 percent of the net income from the property—something that I do not believe happens very often.

Obviously, over the life of an oil or gas-producing property the depletion allowance will not only exceed the investment or cost, but it will go on and on and possibly exceed the value on date of discovery.

SIZE OF THE OIL DEPLETION SUBSIDY

The committee can, no doubt, secure accurate up-to-date figures from the Treasury Department on what the 27½ percent depletion allowance means to every company or individual taking this on tax returns. However, there is in existence some few pieces of information denoting its tremendous size. Recently I tried to secure from Standard and Poors Corp. reports the amount of Federal income-tax paid by Amerada Petroleum Corp. but I find this item is buried in a classification reading: "Operational, general expense, taxes, etc." It is quite obvious that Amerada pays little, if any, Federal income taxes, though in the year 1952 this company made net profit of $16,296,652. In the January 1946

[3] 69th Cong., 1st sess., on H. R. 1.

issue of Fortune magazine there appeared a long article on Amerada Petroleum Corp., which is a crude-oil producing company. The article stated in part:

"Amerada's tax situation is a businessman's dream. The corporation quite literally does not have to pay any Federal income tax if it does not want to. This is due to the highly reasonable provisions of the internal-revenue law designed for producers of crude oil. Amerada pays so little in Federal income taxes that it does not even segregate the tax item in its annual reports. In wartime, though Amerada's profits soared, it made no provision for excess-profits taxes, and from 1943 to 1944 its normal Federal income tax actually declined. In 1944, on a gross of $26 million, a gross profit of $17 million, and a net after all charges of $5 million, Amerada's allowance for its Federal income tax was only $200,000."

It is among these strictly producing companies that one can get an idea of the magnitude of the twin subsidy of depletion and writeoff of drilling and development costs. The major integrated companies benefit to the degree that they produce oil and gas, though they have other operations upon which taxes are paid.

In addition to Amerada Petroleum Corp., referred to above, here are a few other examples of companies producing oil and gas:

Argo Oil Corp.[4] for the year 1952 made net profit after taxes of $3,496,477 and paid Federal income taxes of $91,660.

Kerr-McGee Oil Industries, Inc., for the year ended June 30, 1952, had net income after taxes of $2,234,688 and paid Federal income taxes of $78,082. For that same period the 27½ percent depletion allowance for this one company amounted to $607,611. For the year ended June 30, 1953, this company had net income after taxes of $3,072,723. But in Standard and Poors there is just a line where the amount of tax is usually indicated so I do not know what Federal income taxes this company paid for that period. During this latter year its depletion allowance was $858,795.

The Superior Oil Co. (California) for the year ended August 31, 1952, had net income of $11,900,165 and paid Federal income taxes of $200,000. While no figure is given for this company on depletion allowance taken it would closely be computed from the figure of 78,046,162 barrels of oil produced in this period. In this period Superior Oil Co. deducted intangible development costs of $17,298,443. For the year ended August 31, 1953, Superior had net income of $12,000,382 and Standard and Poors indicates a tax credit of half a million dollars. In this period Superior produced $3,669,221 barrels and wrote off intangible drilling and development costs of $19,302,531.

I call the committee's attention to the table below showing the net income after taxes and the amounts of Federal income taxes paid by a group of 23 companies other than the 4 mentioned above.

Company	Net income	Federal income taxes paid
Atlantic Refining Co	$40, 476, 692	$16, 167, 516
Continental Oil Co	38, 087, 890	14, 400, 000
Gulf Oil Corp	140, 070, 932	103, 598, 058
Humble Oil & Refining Co	145, 292, 141	30, 500, 000
Lion Oil Co	10, 211, 425	6, 736, 600
Ohio Oil Co	39, 354, 021	14, 685, 000
Phillips Petroleum Co	75, 284, 261	16, 500, 000
Plymouth Oil Co	10, 295, 792	4, 645, 000
Pure Oil Co	27, 304, 373	12, 094, 732
Seaboard Oil Co. of Delaware	6, 425, 299	2, 900, 000
Shell Oil Co	90, 872, 834	52, 700, 000
Sinclair Oil Corp	86, 475, 303	17, 000, 000
Skelly Oil Co	28, 039, 692	10, 211, 600
Socony-Vacuum Oil Co	171, 091, 587	51, 000, 000
Standard Oil Co. of California	174, 030, 499	40, 700, 000
Standard Oil Co of Indiana	119, 981, 438	51, 422, 000
Standard Oil Co. of New Jersey	519, 981, 109	293, 000, 000
Sun Oil Co	43, 013, 063	13, 700, 000
Sunray Oil Corp	24 724, 411	8, 450, 000
The Texas Co	181, 242, 172	47, 200, 000
Texas & Pacific Coal & Oil Co	6, 846, 335	1, 255, 000
Tidewater Associated Oil Co	31, 116, 521	8, 219, 000
Union Oil Co. of California	27, 579, 759	4, 800, 000

[4] Figures on this company and following companies from Standard and Poors Corp. reports.

Closely akin to the oil industry is the sulfur-producing industry that enjoy a 23-percent depletion allowance. The figures for the two top sulfur companies indicate a similar tax favoritism for them. For the year 1952:

Company	Net income	Federal income taxes paid
Freeport Sulphur Co	$7,325,750	$1,836,000
Texas Gulf Sulphur Co	25,112,312	13,500,000

In July of 1953 the House Committee on Interstate and Foreign Commerce conducted hearings on Recent Price Increases of Gasoline and Oil.[5] This petroleum study was not released until this spring because of delay in the submission of data called for by the committee. For the first time rather complete data over a 3-year period on four large integrated oil companies has been published. It becomes clear from the testimony before the House Interstate and Foreign Commerce Committee, and the charts or tables therein, that this statutory allowance of 27½ percent enters into the calculation of their tax but that the general practice in the industry in keeping their books is to charge only cost depletion. A witness, Mr. W. W. Keeler of Phillips Petroleum Co., was asked in this hearing (p. 131) whether the depletion reflected in the published statements of the company represented the 27½ percent depletion allowance. Mr. Keeler submitted an answer as follows:

"No; the depletion reflected in the published statements is based upon the cost of the oil in the ground as reflected by the accounts of the company and bears no relationship whatever to the depletion deductions provided for in the income-tax laws."

And, before the House Ways and Means Committee in 1951[6] Mr. Swensrud of Gulf Oil Corp. was asked: "Do the statements that your company sends to its stockholders yearly or semiyearly on their face show anything with regard to depletion allowances at all?"

Mr. Swensrud's answer was: "No, sir; they do not show the statutory depletion. The statutory depletion enters into the accounting figures as a formula for calculating the tax that you have to pay."

DETAILS ON FOUR COMPANIES

Four of the major integrated oil companies submitted data in some detail to the House Committee on Interstate and Foreign Commerce in connection with that committee's Petroleum Study started in July of 1953 and only recently released. I shall refer to some of these facts to enlighten the committee on the magnitude of the depletion allowance and the writeoff of drilling and development costs.

PHILLIPS PETROLEUM CO.

At pages 159 to 161 of the above referred to Petroleum Study you will find the detailed data relative to Phillips Petroleum Co. for the years 1950, 1951, and 1952. Going over these tables you will note that many items are explained as charged "per books" and "for income-tax purposes." For example following the item of "depletion allowance" it states:

"For income-tax purposes: Depletion is based upon cost or 27½ percent of gross income limited to 50 percent of net income from each producing property, determined in accordance with the provisions of sections 23 (m) and 114 (b) of the Internal Revenue Code."

You will note that Phillips lists its depletion allowances for the 3 years as follows:

Year 1950	$28,242,000
Year 1951	31,779,000
Year 1952	33,033,000

[5] See Petroleum Study (Gasoline and Oil Price Increases), July 1953, House Committee on Interstate and Foreign Commerce, 83d Cong., 1st sess.

[6] Revenue Revision of 1951, House Ways and Means Committee, p. 1715.

When the representative of Phillips was on the stand he was asked a question as to the extent o fthe tax exemption thus taken. The answer submitted (p. 132) was as follows:

"The depletion claimed on the tax return for 1952 with respect to domestic crude-oil production was $28,477,000. The tax reduction by reason of this depletion was 52 percent, or $14,808,000 or $0.327 per barrel."

You will note that the figure given in the Phillips' table is higher than that used by their representative in giving testimony.

Again referring to the Phillips' tables on page 160 of the Petroleum Study you will find the entry for intangible drilling costs for productive wells. Of course, the writeoffs for nonproductive wells are about the same in the table for the company books and for tax purposes. But the writeoffs of drilling and development costs for productive wells are shown as follows:

Year	Per books	For income-tax purposes
1950	$9, 198, 000	$15, 227, 000
1951	11, 367, 000	29, 552, 000
1952	15, 083, 000	37, 965, 000

At the end of the table on page 161 you will find the totals of the differences in chargeoffs according to the Phillips' books and for tax purposes. Note the tax favoritism in these figures:

Year	Per books	For income-tax purposes
1950	$37, 899, 000	$68, 051, 000
1951	49, 011, 000	95, 771, 000
1952	62, 142, 000	118, 653, 000

And did Phillips ever pay any excess-profits tax? When asked the question by the House Interstate and Foreign Commerce Committee (p. 98) Mr. Keeler of Phillips said:

"No; we are not paying an excess-profits tax this year. I am not sure whether we have ever had an excess-profits tax or not. I understand we have had a small amount."

STANDARD OIL CO. OF CALIFORNIA

Figures covering this company's operations for the years 1950, 1951, and 1952 will be found at page 173 of the House Committee on Interstate and Foreign Commerce's Petroleum Study.

The tables for Standard of California show the following depletion allowances taken for income-tax purposes:

Year 1950	$60, 939, 809
Year 1951	66, 250, 915
Year 1952	64, 328, 151

The writeoff of dry holes is about the same on the company books as on the tax return. However, for productive wells the company shows the following deductions from its tax returns:

Year 1950	$23, 889, 490
Year 1951	23, 162, 916
Year 1952	28, 167, 689

And a comparison of the totals shows the following:

Year	Per books	For income-tax purposes
1950	$59, 650, 490	$120, 838, 663
1951	73, 365, 864	131, 764, 100
1952	97, 983, 245	155, 922, 775

SOCONY-VACUUM OIL CO., INC.

The Socony-Vacuum Oil Co., Inc., and its affiliates, supplied figures for the Petroleum Study (p. 268) which indicate their 27½-percent depletion allowances to be:

Year 1950	$37,232,000
Year 1951	45,488,000
Year 1952	45,184,000

Intangible drilling costs written off on productive wells amounted to the following:

Year 1950	$39,509,000
Year 1951	46,416,000
Year 1952	52,076,000

Comparing the totals for this company, you will note the following:

Year	Per books	For income-tax purposes
1950	$61,411,000	$120,536,000
1951	71,638,000	140,817,000
1952	88,362,000	157,604,000

Just how Socony-Vacuum treats the matter of exploration and development costs on its books and for tax purposes is explained on page 269 of the Petroleum Study. As to intangible drilling costs on productive wells this compilation shows (for purposes of the company's books):

"All intangible drilling costs of productive wells are capitalized and depleted by individual properties on the same basis as producing-property costs."

But for tax purposes it says:

"Tax treatment is in accordance with Internal Revenue Code and regulations. The company has elected for tax purposes to treat intangible drilling costs as current expense."

HUMBLE OIL & REFINING CO.

On pages 374 to 376 of the Petroleum Study by the House Committee on Interstate and Foreign Commerce will be found tables setting forth the figures for the Humble Co. In one of the explanations on page 376 this interesting comment appears:

"The only financial significance of allowable depletion is its effect on taxes. The measure of its effect on taxes is the difference between book depletion and allowable depletion multiplied by the effective tax rate."

Humble Oil, for tax purposes, was allowed the following depletion:

Year 1950	$72,510,455
Year 1951	89,123,222
Year 1952	88,480,000

The tables for this company also show a good comparison of the amounts written off on the books and that on the tax return for intangible drilling costs of productive wells. They are as follows:

Year	Per books	For income-tax purposes
1950	$18,016,000	$36,243,775
1951	24,660,200	61,162,926
1952	28,458,000	63,044,110

The totals for Humble Oil, comparing their deductions on their books and those on their tax returns, are given as follows:

Year	Per books	For income-tax purposes
1950	$81,909,827	$169,576,309
1951	101,054,164	219,999,717
1952	127,854,663	244,596,000

DRILLING AND DEVELOPMENT COSTS AS EXPENSE IN THE OIL INDUSTRY

The matters of percentage depletion and the write-off of drilling and development costs are so interrelated in the oil industry that they must be considered together to get a fair understanding of the tax subsidy thus given to oil producers. Hence, a more detailed explanation of its origin seems pertinent at this point, before tracing the history of recommendations for changes in the depletion allowance.

Under Treasury Department regulations, of doubtful legality in their origin, but later approved by the Congress, drillers of oil and gas wells have the option to deduct, as an expense, intangible drilling and development costs.

This twin subsidy to oil and gas production was described to the Ways and Means Committee in 1951 by the then Secretary of the Treasury as follows:

"In addition to the highly favorable depletion allowances, oil producers can immediately deduct for tax purposes a substantial part of their outlays for drilling and development. The amounts of capital investment thus written off at the outset have no effect on the future percentage depletion deductions. This results in a double deduction with respect to the same capital investment. The combined impact of percentage depletion and the privilege of deducting drilling and development costs as a current expense is to wipe out the tax liability on incomes running into millions of dollars."

As I have indicated, the inauguration of this Treasury Department regulation was of doubtful legality. In 1918 the Treasury Department, by regulation, provided that intangible development costs could be deducted as an expense provided an oil producer made a binding election to do so consistently. This regulation remained unchallenged until in 1945 when the fifth circuit court of appeals held said regulation invalid. The Tax Court on March 5, 1945, held that the Treasury regulations insofar as they purported to give taxpayers the option to treat drilling and development costs as an expense was contrary to law and that the amounts expended should be charged to capital.

Promptly thereafter the Congress (79th, 1st sess.) brought in and enacted House Concurrent Resolution 50 legalizing the procedure.

So far as I am aware the oil industry is the only industry that enjoys this particular type of tax avoidance. It should be eliminated as promptly as possible, and the oil-producing companies required to capitalize their drilling and development costs the same as other industries.

TIME FOR A CHANGE

I do not know what the position of the present head of the Treasury Department is with reference to the percentage depletion allowance for oil and gas and the writing off of drilling and development costs. The National Oil Marketers Association wrote the Secretary of the Treasury last fall, and under date of October 19, 1953, Assistant to the Secretary Dan Throop Smith acknowledged the communication and declined to express an opinion until the full program has been developed. I can only assume from their silence that the present Treasury Department heads oppose the change. And this, despite Mr. Folsom's comment to the Senate Finance Committee when he referred to the accounting provisions of H. R. 8300. He stated (at p. 15 of the mimeographed sheets):

"Bring tax rules into harmony with generally accepted accounting principles, thereby eliminating to a great extent necessity for taxpayers to maintain two sets of records."

Regardless of what the Treasury Department recommends it is up to the Congress of the United States to write the laws. The fact that the present head of the Treasury Department has made no recommendation should not be considered final any more than the fact that Congress ignored the positive recommendations of many of the former heads of the Treasury who recommended changes. A review of these previous recommendations is enlightening:

In 1933 the Acting Secretary of the Treasury aimed this criticism at the percentage depletion allowance:

"Our experience shows that the percentage depletion rates set up in the law do not represent reasonable depletion rates in the case of the designated properties, but are much higher than the true depletion to which the taxpayer is fairly entitled. Moreover, these provisions enable a taxpayer to obtain annual depletion deductions, notwithstanding the fact that he has already recovered the full cost of the property. The deduction is, therefore, a pure subsidy to a special class of taxpayers. For this reason the Treasury recommends that these provisions be eliminated, in order to put all taxpayers upon the same footing."

Since 1933 the Treasury Department has repeatedly urged the Congress to either remove or reduce the percentage depletion allowance. In 1942 the then Secretary of the Treasury stated to the House Ways and Means Committee (hearings, revenue revision of 1942):

"*Percentage depletion.*—A second example of special privilege is the allowance for depletion. At the present time the owners of mines and oil wells are allowed to deduct so-called percentage depletion or cost depletion, whichever is higher. Percentage depletion consists of a certain percentage of gross income (27½ percent in the case of persons having an economic interest in oil and gas properties), the deduction being limited to 50 percent of the net income from the property. Under this arrangement percentage depletion goes on even after 100 percent of the cost is recovered and may substantially exceed depletion based on cost.

"In 1937 the President and the Treasury recommended the elimination of percentage depletion, but no action was then taken. The war has intensified the necessity for eliminating any such special favor to one group of taxpayers. The removal of this special privilege would yield $80 million a year.

"One of the reasons asserted in behalf of percentage depletion for oil and gas properties is that it stimulates exploration for such properties. If this is a proper objective it would be better achieved by a special depletion allowance to those who do explore without indiscriminate extension of the same favor to all owners. At the convenience of the committee, we shall place before it a plan directed to this purpose."

Please note that at the time Secretary Morgenthau was speaking, crude oil was around a dollar a barrel whereas today with tax rates higher crude oil is three times that amount. It emphasizes the need for current figures on just what this tax handout to the oil producers amounts to at this time.

In 1951 the then Secretary of the Treasury stated:

"Fully as important as improved enforcement is the need for improving the tax structure in those areas which enable favored taxpayers to escape their fair share of the burden.

"One of the major structural defects is percentage depletion available to oil and mineral producers. This is costing the Government, and, therefore, taxpayers in general, hundreds of millions of dollars each year.

"Under the percentage depletion provisions, owners of mines and oil wells are allowed to deduct a specified percentage of their gross income without regard to the capital cost of the property. These arbitrary rates of deduction range as high as 27½ percent of gross income in the case of oil and may amount to 50 percent of the net income. Unlike other capital-recovery allowances, percentage depletion continues to be deductible even after 100 percent of the investment has been recovered tax free. Thus total deductions may eventually amount to many times the taxpayer's actual investment."

If the 27½-percent depletion rate, or any other percentage, is to remain there should be some provision made so that when the oil producer received back his "capital" or "cost" that depletion thereafter ends. Hence, a mere reduction in the percentage rate is not the final answer, although it is a start in the right direction.

It would be far better if percentage depletion in the case of oil and gas production were eliminated, and likewise the principle of discovery depletion and a return made to the income-tax procedure under the original tax laws prior to 1918 whereby no further allowance can be deducted when the depletion taken equals the capital originally invested.

From the scanty figures that are available publicly it is fair to assume that were this plan adopted the Federal Government would gain better than a billion dollars in taxes.

THE OIL MARKETER'S INTEREST

The interest of the oil marketer in the tax-avoidance schemes or tax subsidies provided oil producers by the 27½-percent depletion allowance and the special writeoffs of drilling and development costs, goes beyond that of the ordinary taxpaying citizen, who is hurt by having to pay higher taxes, because of the special privileges thus accorded to the major integrated oil companies that are also oil producers.

The oil marketer's interest goes to his very ability to stay in business and compete against the integrated oil companies who have these special tax privileges to provide the funds with which to buy them out or expand their facilities so as to drive them out of business. Such tax favoritism smacks of the old Rockefeller system of railroad rebates and drawbacks whereby he drove all of his competitors out of business until the Federal Government intervened. It can happen again if this tax subsidy to the integrated oil companies is not ended.

If the tax benefits accorded oil producers were kept in the producing end of the business and not allowed to be used to subsidize losses in marketing of oil, the integrated oil companies, from a competitive standpoint, would be no threat. But such is not the case.

When the House Committee on Interstate and Foreign Commerce was taking testimony in its petroleum study, Chairman Charles A. Wolverton raised the question as to the using of funds saved from taxes for expansion in marketing, refining, or other fields and pointed out that they were not earmarked for exploration. He stated (p. 157):

"But when you come down to the question of the difference between integrated and independent companies, that creates a different question because it does relate to free enterprise and the extent to which independent companies can be used in a disadvantageous position as a result of not being an integrated company.

"So as to eliminate that as was done in the moving-picture industry, that is where it most recently found expression that I can remember offhand, that they divorced the right to conduct theaters from the producing companies. There was a reason for it. And I am wondering if the same reason applies here."

The integrated oil companies have practically eliminated the independent refiner from the oil industry—large areas that used to be served by independent refiners are now wholly controlled by the integrated oil companies. Acquisition of wholesale and retail stations by the integrated oil companies have proceeded in a big way. In a 6½-year period Socony-Vacuum Oil Co. alone took over better than 600 independent filling stations from their former owners and over 200 wholesale bulk plants from jobbers. (See hearings, Senate Small Business Committee, pt. 20, 80th Cong., 1st sess., pp. 2241–2251.)

Tax subsidies, such as the 27½ percent depletion allowance and the privilege of writing off drilling and development costs, proration of oil to market demand (or below), pipeline and other transportation profits, fast writeoffs for so-called emergency facilities have removed the financial risk of integrated oil companies so that they can be said to operate in a preferred class. With all the bounties showered upon them even in wartime they seldom, if ever, paid an excess-profits tax. If there is any risk left in the operation of the integrated oil producers such risk has been largely assumed or underwritten by the Federal and State Governments. The only competition left is in a few remote places where there are some hardy independent refiners left or where a couple of dealers or jobbers get into a local disagreement and try to prove who has the longest pocketbook. But even these small remnants of a once hardy competitive oil-marketing industry are fast disappearing. The dealers are becoming more and more employees of the major oil companies, independent only so far as the assumption of liability to customers is concerned. And wholesalers cannot operate in many areas unless they sign up on a franchise—only a step removed from the next controlled operation: commission agency. Little wonder that the Senate Small Business Committee found that "the petroleum industry can be set down as definitely a monopoly." (See S. Rept. 25, 81st Cong., 1st sess., p. 13.)

CONCLUSION

In conclusion may I respectfully recommend that as a very minimum the Senate Finance Committee adopt the suggestion of Senator Williams and reduce the percentage depletion allowance for oil and gas from 27½ to 15 percent.

But I strongly urge the members to consider the data submitted herein with a view to correcting the inequity to the oil jobbers and dealers and the public generally at this time. This can be done by abolishing percentage depletion for oil and gas and placing this industry on true cost depletion; and, by requiring the drilling and development costs on producing properties to be capitalized and not written off as expense.

OREPS CO., INC.,
New York, N. Y., April 15, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SIR: We wish to state our position against automatic extension of section 15 (c) of the Internal Revenue Code as provided by section 1731 of H. R. 8300.

Internal Revenue Code section 15 (c) was introduced into the code as a companion measure to the excess-profits-tax law in October 1951. It provided an additional and final deterrent to those corporations seeking excess-profits-tax relief in excess-profits-tax years by splitting their enterprise into multiple entities. With the expiration of the excess-profits tax in December 1953, the raison d'être for Internal Revenue Code section 15 (c) no longer existed. For the true purpose of thwarting tax avoidance in corporate splitups, sufficient powers are already lodged in the Director of Internal Revenue under Internal Revenue Code sections 129 and 45. It would appear therefore that the main effect of reenactment of Internal Revenue Code section 15 (c) would be discriminatory rather than extension of necessary revenue powers.

We wish to point out that it is a regular and accepted practice for retail chain-store groups, for example, to adopt a multicorporate structure in their organization for many good business reasons. Section 15 (c) of the code would be discriminatory in that it would deny equal advantages of the tax laws to one such group of corporations which are currently eperiencing the business need for corporate division as against another group who are granted these advantages solely on the ground that it has already enjoyed such tax benefits over the last few years. This section of the code does not apply equally to all corporate groups faced with similar busines problems; instead it would create a privileged group of business entities that are recognized for tax purposes, and the outcast corporate groups whose only crime was that they were faced with similar business problems in a later cycle of business development. Granted the same business problems and the same facets of corporate division, then all corporate groups should either be granted the benefits of corporate surtax exemption, or else it should be denied to all, the fact that such existence predates January 1951 notwithstanding.

Section 15 (c) is unrealistic in that it purports that business reasons for corporate division can exist without any frank tax considerations. This is a contravention of business economics today, wherein tax expense is a major cost in business operation. To raise the situation, as reenactment of Internal Revenue Code section 15 (c) does, wherein one business enterprise will enjoy the tax advantage because it availed itself on such advantages prior to January 1951, and a competitor will be denied such benefits, injects a feature antagonistic to the American system of free and competitive enterprise, and is one certainly not contemplated or desired in our tax legislation.

Even more is the inequity of the proposed reenactment of section 15 (c) of the code established in the first few months of 1954. With the expiration of the unfair restrictions of Internal Revenue Code section 15 (c), business enterprises were able to give vent to natural and compelling business needs for corporate division and at the same time not raise the question of tax avoidance. Accordingly, expenses were incurred in the formation of a divided corporate structure compatible with modern streamlined business needs and conforming with all intents and purposes of Internal Revenue Code sections 45 and 129. Such business enterprises are now faced with retroactive legislation that will add to their costs of doing busines, and if translated into higher sales prices, could prove ruinous to that business in the highly competitive market existing today. At best, retroactive legislation is repugnant and inequitable. It is therefore requested that if Internal Revenue Code section 15 (c) is reenacted, then the repugnant, inequitable, and unfair retroactive feature be at least eliminated, and the effective date of the application of the section be the same as the effective date of the application of the section be the same as the effective date of the new revenue law.

In proffering such request, the contention that this section be entirely deleted from the Internal Revenue Code is no less abated.

Very truly yours,

S. F. SPERO, *President*

STEPTOE & JOHNSON,
Washington, D. C., April 21, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: In his statement to your committee on April 8, 1954, Mr. Thomas N. Tarleau, chairman of the section of taxation, American Bar Association, pointed to the inequities which will result from the March 1, 1954, effective date of certain provisions in subchapter C of chapter 1 of subtitle A of H. R. 8300. The Honorable Daniel A. Reed, chairman of the Ways and Means Committee of the House, has made several public statements recognizing that the effective date of these provisions may result in inequities with respect to transactions in process on that date. We desire to invite your attention to a specific case of such inequity involving a client of our firm.

On March 5, 1954, the Internal Revenue Service issued a ruling with respect to the acquisition of certain common and preferred stock of two other public utility companies by Pacific Gas & Electric Co. (Pacific Gas) of San Francisco, Calif. This latter company is one of the largest public utility companies in the United States. In this ruling, the Internal Revenue Service held that the acquisition by Pacific Gas of common and preferred stock of Pacific Public Service Co. (Pacific Public) in exchange for voting stock of Pacific Gas would constitute a reorganization within the meaning of section 112 (g) (1) (B) of the Internal Revenue Code (1939), provided that at least 80 percent of the total outstanding shares of Pacific Public were acquired by Pacific Gas. The Internal Revenue Service further ruled that in accordance with the provisions of section 112 (b) (3) of the code and subject to the reservation stated in the immediately preceding sentence, no gain or loss would be recognized to the shareholders of Pacific Public as a result of the exchange of their stock for the voting stock of Pacific Gas. In the same ruling, the Service also held that certain other proposed exchanges of Pacific Gas common or preferred stock for preferred stock of Coast Counties Gas & Electric Co. (Coast Counties) would not be tax-free. On March 9 and 13, 1954, the Service issued supplemental rulings on other phases of this matter.

The acquisitions of Pacific Public and Coast Counties stock by Pacific Gas were in accordance with a plan for the ultimate merger of Pacific Public and Coast Counties into Pacific Gas. This plan of merger had to be, and was, approved by various governmental regulatory bodies, including the Public Utilities Commission of California and the Securities and Exchange Commission. The authorization of the California commission was granted after public hearing on February 16, 1954. The authorization of the Securities and Exchange Commission was granted on February 24, 1954.

Upon receipt of the ruling dated March 5, 1954, and after receiving the necessary clearances from the Securities and Exchange Commission with respect to the contents of its "offer of exchange" letters, Pacific Gas on March 15, 1954, transmitted to the public shareholders of Pacific Public and Coast Counties its offers for the exchanges of stock. In the letters to the Pacific Public shareholders, it was stated that the Commissioner of Internal Revenue had ruled that the exchanges of Pacific Public stock for Pacific Gas stock would be tax-free under Federal income tax law if Pacific Gas obtained the requisite 80 percent of Pacific Public stock.

A substantial percentage of the common stock and all of the preferred stock of Pacific Public is publicly held. Since the exchange offers have been made, shareholders of Pacific Public have been sending in their shares for exchange pursuant to the offer. Of course, these shareholders have relied upon the ruling of the Internal Revenue Service in deciding whether to accept the offer. The exchange offers expire April 28, 1954.

Transmitted herewith for your information is the following material which pertains to this problem:

Exhibit 1: Copy of ruling of the Internal Revenue Service dated March 5, 1954.

Exhibit 2: Copy of supplemental ruling of the Internal Revenue Service dated March 13, 1954.

Exhibit 3: Offers of exchange dated March 15, 1954, to the holders of Pacific Public Service Co. common and preferred stocks.

Exhibit 4: Booklet dated March 15, 1954, describing the proposed mergers and exchange offers, which booklet was distributed with the offers of exchange of the same date (exhibit 3).

The material transmitted herewith describes in greater detail the terms and circumstances of the exchange offers and proposed mergers. These mergers will effectuate the policies and purposes of the Public Utilities Commission of California and the Securities and Exchange Commission.

Although the exchanges of Pacific Public stock have been ruled by the Treasury Department to be tax-free under the present law and the stockholders of that company are currently exchanging their shares in reliance on that ruling, it is believed that the transaction between Pacific Gas and the shareholders of Pacific Public will not qualify as "tax-free" under H. R. 8300. The reason for this is that the Pacific Public shareholders will not receive the 25 percent stock interest required by section 359 (b) of H. R. 8300.

As is apparent from the booklet (exhibit 4), approximately 742,000 common shares of the Pacific Public are outstanding whereas almost 16,000,000 Pacific Gas common shares are outstanding. Assuming, for the sake of discussion, that Pacific Public shareholders will receive Pacific Gas shares on a share-for-share basis of exchange, it is obvious that the Pacific Public shareholders will not attain the 25 percent interest required by section 359 (b) of H. R. 8300.[1] This anomalous result is reached even though the shares of Pacific Public are widely held by the public and Securities and Exchange Commission approved the acquisition of these shares by Pacific Gas. It is also believed that those shares are registered on several stock exchanges, although we have not undertaken to verify this point. The result is reached even though Pacific Public is a large company—the problem arises because the acquiring corporation, Pacific Gas, is so much larger. It is obvious that the House did not intend to impose unnecessary restraints on exchanges of this type.

We shall appreciate you and your committee giving attention to this problem in your consideration of this bill. We hope that your committee will find it possible to cure the obviously unintentional inequities of the bill, particularly with respect to transactions already in process at the time when the Ways and Means Committee reported the bill to the House.

Respectfully yours,

STEPTOE & JOHNSON.

EXHIBIT 1

UNITED STATES TREASURY DEPARTMENT,
COMMISSIONER OF INTERNAL REVENUE,
Washington, March 5, 1954.

PACIFIC GAS & ELECTRIC CO.,
San Francisco, Calif.

GENTLEMEN: We have received your letter of January 13, 1954, wherein a ruling is requested as to the effect for Federal income-tax purposes of certain proposed transactions whereby Pacific Gas & Electric Co. will acquire capital stock of Pacific Public Service Co. and Coast Counties Gas & Electric Co. in exchange for part of its voting stock. We have also received the enclosures submitted with your letter which were indicated as exhibits A, B, C, D, and E. Additional information with respect to this matter was furnished by the firm Steptoe & Johnson in letters dated February 2, 1954, along with exhibits marked F, G, H, I, J, and K.

The information submitted indicates that Pacific Gas & Electric Co. (hereinafter referred to as Pacific Gas) is a California corporation engaged in the business of furnishing electric and gas service throughout a large part of northern and central California. The issued and outstanding capital stock of Pacific Gas as of June 30, 1953, consisted of 11,677,519 shares of first preferred stock and 13,627,798 shares of common stock. Both the preferred and common shares have full voting rights.

Pacific Public Service Co. (Pacific Public) is a holding company organized under the laws of the State of California. It owns all of the outstanding capital stock of Natural Gas Corp. of California, Gas Lines, Inc., and Arrowhead & Puritas Waters, Inc. The latter corporation recently terminated its business operations. Pacific Public also owns all of the outstanding common stock, consisting of 308,480 shares, of Coast Counties Gas & Electric Co. (Coast Counties).

[1] For each share of common stock of Pacific Public there is offered in exchange 0.53 share of common stock of Pacific Gas. For each share of $1.30 cumulative first preferred stock of Pacific Public there is offered in exchange 1 share of 5 percent redeemable first preferred stock of Pacific Gas or 0.70 share of common stock of Pacific Gas.

In addition to the common stock, Coast Counties has outstanding 199,000 shares of fully voting preferred stock which are publicly held.

The outstanding capital stock of Pacific Public consists of 298,137.7 shares of preferred stock and 741,969.85 shares of common stock. The preferred shares are fully voting and are redeemable in whole or in part, at any time or from time to time. All of Pacific Public's outstanding preferred stock, and about 16 percent of its outstanding common stock are publicly held. The remaining outstanding common stock, representing 623,651 shares, is held by Blyth & Co., Inc. (Blyth) an investment-banking firm. This stock was acquired by Blyth pursuant to a permissive order of the Securities and Exchange Commission, dated June 1, 1953, which provides that Blyth shall dispose of such stock prior to June 1, 1954, unless the time is extended by the Commission.

It is stated that Pacific Gas has been interested for many years in acquiring and integrating Coast Counties' utility properties with its own. To accomplish this objective, Pacific Gas proposes to acquire all of the common stock of Pacific Public which is presently held by Blyth. On January 20, 1954, Pacific Gas and Blyth entered into an agreement whereby the former will acquire 623,651 shares of the common stock of Pacific Public from Blyth. In exchange for such stock, Pacific Gas will issue 330,535 shares of its common stock to Blyth which will thereafter dispose of this stock by sales to the public. The exchange of stock will be carried out as soon as possible, and in any event, not later than 3 days after the parties receive all requisite governmental authorizations, including (*a*) authorization of the Public Utilities Commission of California under the Public Utilities Code, and (*b*) authorization of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935.

On the assumption that an agreement with Blyth would be reached, Pacific Gas has formulated a plan of merger of Pacific Public and Coast Counties with itself. The plan contemplates that the merger will be effected, if possible, without a merger agreement. It would be impracticable to endeavor to acquire Blyth's stock in Pacific Public pursuant to a merger agreement because of the time factor alone since a merger agreement would have to be approved by the shareholders of each of the merging corporations, as well as by both the Public Utilities Commission of California and the Federal Power Commission. These requirements and the offers of exchange pursuant to a merger agreement could not be accomplished by June 1, 1954, the date by which Blyth is required to dispose of such stock.

With a view to acquiring all of the remaining outstanding shares of common stock of Pacific Public, and all of the outstanding preferred shares of both Pacific Public and Coast Counties, Pacific Gas will make the following offers of exchange:

(1) To the holders of the remaining common stock of Pacific Public, Pacific Gas will offer its common stock in exchange therefor in the same ratio as that employed in the exchange with Blyth.

(2) Pacific Gas will offer either seven-tenths of a share of its common, or 1 share of its 5-percent redeemable first preferred, for each share of outstanding preferred stock of Pacific Public, as such holders may elect.

(3) Pacific Gas will offer either seven-tenths of a share of its common, or eight-tenths of a share of its 5-percent redeemable first preferred for each share of outstanding series A 4-percent preferred stock of Coast Counties, as such holders may elect.

(4) Pacific Gas will offer either seven-tenths of a share of its common, or 1 share of its 4.80-percent redeemable first preferred for each share of series B 4.80-percent preferred stock of Coast Counties as such holders may elect.

Thereafter, the course to be followed in effecting a merger will depend on the results obtained from the proposed offers of exchange. If all of the outstanding stock of Pacific Public and Coast Counties is acquired by Pacific Gas, then the latter can accomplish a merger with its wholly owned subsidiary corporations by filing a certificate of merger with the California Secretary of State.

On the other hand, if all of the outstanding stock of Pacific Public and Coast Counties is not acquired by Pacific Gas through the exchanges, or by redemption, then the latter will cause those two corporations to enter into a merger agreement with itself. The remaining stock will then be acquired pursuant to the statutes governing mergers, or redeemed. It is stated that the proposed merger, however effected, will be a valid statutory merger under the laws of the State of California.

The exchange ratios in the offers of exchange of stock of Pacific Gas for stock of Pacific Public and Coast Counties will result in some shareholders being entitled to receive fractional shares of stock of Pacific Gas. Under the proposed procedure, the latter will issue nothing but certificates for whole shares. The shareholders of Pacific Public and Coast Counties who deliver their shares for exchange will indicate their desire to round their fractional share interest up or down to the nearest share. A bank or trust company appointed by Pacific Gas will balance the purchase and sale requests as they are received. After the exchange period closes, Pacific Gas will issue to the bank or trust company, whole shares equal to the aggregate of the fractional shares belonging to the exchanging parties. After giving effect to the previous purchase and sale requests, the bank or trust company will sell any unallocated whole shares and remit the proceeds to the shareholders in accordance with their proportionate interests.

A ruling is requested to the effect that the proposed exchanges by Pacific Gas of its voting stock for common stock and preferred stock of Pacific Public, and for preferred stock of Coast Counties, will be exchanges pursuant to a plan of reorganization (statutory merger) within the meaning of section 112 (g) (1) (A) of the Internal Revenue Code; and that no gain or loss will be recognized as a result of such exchanges. A further ruling is requested to the effect that the procedure, whereby shareholders of Pacific Public and Coast Counties who round their fractional share interests up or down to the nearest whole share by selling or purchasing fractional shares, will not conflict with the requirements of section 112 (b) (3) and section 112 (g) (1) (B) of the code, that the exchange by the acquiring corporation be solely for its voting stock.

Based solely on the information submitted, it is the conclusion of this office that the proposed exchanges whereby Pacific Gas will acquire capital stock of Pacific Public and Coast Counties in exchange for its voting stock, are separate transactions which will precede the adoption of the plan of merger, and therefore cannot be considered as constituting transactions which will be consummated pursuant to a statutory merger of Pacific Public and Coast Counties into Pacific Gas. For this reason, it is held that section 112 (g) (1) (A) of the Internal Revenue Code, referring to statutory mergers, is not deemed applicable to the proposed exchanges.

It is also held that the acquisition of common stock and preferred stock of Pacific Public by Pacific Gas in exchange solely for part of the latter's voting stock will constitute a reorganization within the meaning of section 112 (g) (1) (B) of the code, provided that at least 80 percent of the total outstanding shares of Pacific Public are acquired by Pacific Gas.

In accordance with the provisions of section 112 (b) (3) of the code, and subject to the reservation stated in the paragraph immediately preceding, no gain or loss will be recognized to the stockholders of Pacific Public as a result of the exchange of their stock of Pacific Public solely for voting stock of Pacific Gas on the basis described above.

The arrangement for the purchase and sale of fractional-share interests of Pacific Public stock, in the manner described above, will not prevent the application of sections 112 (g) (1) (B) and 112 (b) (3) of the code to the above exchanges.

The basis of the stock of Pacific Gas received by the stockholders in exchange for their stock of Pacific Public will be the same as the cost or other basis of the stock of Pacific Public surrendered (sec. 113 (a) (6) of the code). In determining the holding period for which a stockholder has held the shares of Pacific Gas received on the exchange, there will be included the period for which he held the shares of Pacific Public exchanged therefor (sec. 117 (h) (1) of the code).

Sales of fractional shares of the stock of Pacific Gas by the bank or trust company will constitute sales for the accounts of the stockholders of Pacific Public who otherwise would have been entitled to such fractional shares. Such stockholders will realize a gain or loss as a result of such sales measured by the difference between the amount of cash received and the basis of the fractional shares sold. Such gain or loss will constitute capital gain or loss subject to the provisions and limitations of section 117 of the code.

The acquisition by Pacific Gas of preferred stock of Coast Counties in exchange solely for voting stock of Pacific Gas will not constitute a reorganization as that term is defined in section 112 (g) (1) of the code. It is therefore held that this exchange will result in the recognition of gain or loss to the stockholders of Coast Counties. Such gain or loss will be measured by the difference between the fair market value of the stock of Pacific Gas received on the exchange, and the cost or other basis of the stock of Coast Counties exchanged therefor, in accordance with the provisions of sections 112 (a) and 111 of the code, and the applicable provisions of section 117 of the code relating to capital gains and losses.

The transactions described above will not diminish the accumulated earnings and profits of Pacific Gas available for the distribution of subsequent dividends within the meaning of section 115 (a) of the code.

Very truly yours,

H. T. SWARTZ,
Director, Tax Rulings Division.

EXHIBIT 2

MARCH 13, 1954.

PACIFIC GAS & ELECTRIC CO.,
San Francisco, Calif.

GENTLEMEN: This is in reply to a letter dated March 5, 1954, from Steptoe & Johnson in which reference is made to letters dated January 13, 1954, and February 2, 1954, requesting rulings as to the effect, for Federal income-tax purposes, of certain proposed exchanges of capital stock of your corporation for capital stock of the Pacific Service Co. and Coast Counties Gas & Electric Co. Rulings with respect to the proposed exchanges were contained in a letter dated March 5, 1954.

It is stated that under the terms of the exchange offer from your corporation (hereinafter referred to as Pacific Gas) to the stockholders of Coast Counties Gas & Electric Co. (hereinafter referred to as Coast Counties), the offer to the Coast Counties stockholders will remain open until the close of business on April 28, 1954. The stockholders of Coast Counties participating in the exchange will continue to be stockholders of record of Coast Counties until the end of April 1954, and will receive a dividend at the regular rate for the 4-month period ending April 30, 1954. The new shares of Pacific Gas will be issued to the exchanging stockholders of Coast Counties as of May 1, 1954. May 1, 1954, is a Saturday, and it is anticipated that the stock exchanges on which the stock of Pacific Gas is listed will not be open for business on that date.

In the letter dated March 5, 1954, it was held that the exchange by the stockholders of Coast Counties of their stock in such company for shares of the capital stock of Pacific Gas will result in the recognition of gain or loss to the stockholders of Coast Counties measured by the differences between the fair, market value of the stock of Pacific Gas received on the exchange and the cost or other basis of the stock of Coast Counties exchanged therefor, in accordance with the provisions of sections 112 (a) and 111 of the code, and the applicable provisions of section 117 of the code relating to capital gains and losses.

In determining the fair market value of the stock of Pacific Gas as of the effective date of the exchange and, therefore, the basis of such stock in the hands of Coast Counties stockholders making the exchange, the mean of the high and low prices on the exchanges on which the stock is listed should be used on the first day on which quotations are available following the effective date of the exchange. The effective date of the exchange will be May 1, 1954.

Very truly yours,

FRANCES B. RAPP,
Acting Chief, Reorganization and Dividend Branch.

EXHIBIT 3A

PACIFIC GAS & ELECTRIC CO.,
San Francisco 6, Calif., March 15, 1954.

To the Holders of Pacific Public Service Co. Common Stock:

OFFER OF EXCHANGE

On February 26, 1954 Pacific Gas & Electric Co. acquired 623,651 shares of common stock of Pacific Public Service Co. from Blyth & Co., Inc. in exchange for 330,535 shares of common stock of Pacific Gas & Electric Co. As a result of this acquisition Pacific Gas & Electric Co. owns approximately 60 percent of all voting shares of Pacific Public Service Co.

Pacific Gas & Electric Co. acquired this stock as the initial step of a plan under which Pacific Public Service Co. and its subsidiary Coast Counties Gas & Electric Co., will be merged with Pacific Gas & Electric Co. In the course of effectuating this merger all of the capital stock of Pacific Public Service Co. and Coast Counties Gas & Electric Co. will be eliminated.

To further this plan Pacific Gas & Electric Co. now offers to exchange fifty-three one-hundredths share of its common stock for each share of Pacific Public Service Co. common stock, the same ratio of exchange as that agreed to with Blyth & Co., Inc. This ratio of exchange was approved by the Public Utilities Commission of California by its order dated February 16, 1954, after a hearing upon the fairness thereof at which all interested persons had an opportunity to appear.

In order to accept this offer of exchange it will be necessary for the annexed letter of transmittal and acceptance, properly completed and accompanied by certificates for the stock being exchanged, to reach Pacific Gas & Electric Co., Attention A. W. Uhrich, transfer agent, 245 Market Street, San Francisco, Calif., before the close of business April 28, 1954. Mere deposit in the mail will not constitute acceptance.

No fractional shares or script will be issued. Each stockholder entitled by application of the exchange ratio to a fractional interest in a share of Pacific Gas & Elecirtc Co. stock is requested to give instructions at the time of acceptance either for the sale of such fractional interest or for the purchase of such additional fractional interest as will entitle him to an additional whole share. In all cases in which stockholders omit such instructions their fractional interests will be sold for their account. Purchases and sales of fractional interests will be executed at prices based on the closing price on the New York Stock Exchange on April 30, 1954, for Pacific Gas & Electric Co. common stock.

Receipt of shares tendered for exchange will be acknowledged promptly. Shares of Pacific Gas & Electric Co. common stock will be issued as of May 1, 1954, and will be delivered as soon as practicable after that date. Exchanging shareholders will continue to be stockholders of record of Pacific Public Service Co. until the end of April 1954.

Acceptance of this offer by stockholders will be irrevocable. Pacific Gas & Electric Co. will be obligated to effect the exchange with respect to all shares duly tendered to it in acceptance of this offer, and may, but shall not be required to, waive defects in the manner of acceptance.

In accordance with a letter addressed to members of the National Association of Securities Dealers, Inc., Pacific Gas & Electric Co. will pay a solicitation fee to members who are instrumental in effecting exchanges of Pacific Public Service Co. common stock pursuant to this offer.

According to a ruling of the Commissioner of Internal Revenue, exchanges made pursuant to this offer and a simultaneous offer to holders of Pacific Public Service Co. first preferred stock will be tax free under Federal income tax law if Pacific Gas & Electric Co. acquires at least 80 percent of all outstanding shares of Pacific Public Service Co. common and first preferred stock. Since Pacific Gas & Electric Co. already owns approximately 60 percent of such shares, acceptance of these offers by the holders of at least one half of the remaining outstanding shares of such preferred and common stock will be sufficient to establish the tax exemption.

INFORMATION CONCERNING THE COMPANIES

We assume that you have received, as a stockholder of Pacific Public Service Co., its recently released annual report giving results of operations for 1953 and a consolidated balance sheet as of the end of that year. If you have not received a copy of this report you may obtain one by writing to Pacific Public Service Co., 369 Pine Street, San Francisco, Calif. Similar information as to Pacific Gas & Electric Co. is contained in the enclosed copy of its annual report. In addition we enclose a booklet describing generally the plan of merger, of which this exchange offer is a part, and containing a brief description of the capital stock, the business, and the properties of Pacific Gas & Electric Co.

The following information with respect to market prices, earnings, and dividends has been compiled for convenient reference, but it should be recognized that other factors deserve consideration in evaluation of this exchange offer. In making comparisons the exchange ratio should be taken into account.

A comparison of market prices of the two common stocks for the year 1953, by quarters, is given in the following table:

	Pacific Gas & Electric (New York Stock Exchange)		Pacific Public Service (American Stock Exchange)	
	High	Low	High	Low
1st	40	37⅞	19⅛	17⅞
2d	38¾	34½	21¼	17
3d	38⅞	36	20¾	19¾
4th	40	36⅞	[1] 22½	[1] 22½

[1] San Francisco Stock Exchange transactions. There were none on the American Stock Exchange.

NOTE.—The above prices for Pacific Public Service Co. common stock relate to a period prior to the sale by Arrowhead and Puritas Waters, Inc , a subsidiary, of all of its business assets This sale on Dec. 31, 1953, for a net price of $1,572,175 resulted in an increase of $328,780 in the consolidated earned surplus of Pacific Public Service Co. and its subsidiary corporations after giving effect to income tax reductions incidental thereto. In January 1954 Pacific Public Service Co. paid an extra dividend on common stock of $1,743,352 ($2.35 per share).

Earnings per share of common stock for the last 5 years for Pacific Gas & Electric Co. and for Pacific Public Service Co. (as reported to stockholders, and after elimination of the earnings of Arrowhead and Puritas Waters, Inc.) are given in the following table:

	Pacific Gas & Electric [1]	Pacific Public Service [2]	
		As reported stockholders	Excluding Arrowhead & Puritas Waters, Inc.
1949	$2 10	$2.08	$1.82
1950	2.62	2.23	2.02
1951	2.14	1.47	1.18
1952	2 52	1.69	1.37
1953	3 12	1.67	1 24

[1] Based on average number of shares outstanding during each year.
[2] Consolidated basis.

Pacific Gas & Electric Co. has paid dividends on its common stock in every year since 1918. From 1936 to July 15, 1953, dividends were paid at the rate of $2 per share per year. The dividends paid in October 1953 and January 1954 were each 55 cents per share.

Pacific Public Service Co. has paid dividends on its common stock in every year since 1938. Since 1948 regular dividends have been paid at the rate of $1 per share per year. In addition to the above-mentioned extra dividends paid in January 1954, an extra dividend of 25 cents per share was paid in December 1953.

Your early acceptance of this offer is invited.

Very truly yours,

J. B. BLACK, *President.*

INSTRUCTIONS FOR ACCEPTANCE

1. To accept this offer of exchange, complete the letter of transmittal and acceptance on the reverse hereof and deliver it, together with the stock certificates, to Pacific Gas & Electric Co., attention A. W. Uhrich, transfer agent, 245 Market Street, San Francisco 6, Calif., before the close of business April 28, 1954. Use of the mail is at the risk of the sender.

2. The signature on letter of transmittal and acceptance must correspond exactly to that on the face of the certificates transmitted for exchange.

3. The letter of transmittal and acceptance includes a stock transfer power in favor of Pacific Gas & Electric Co. and no endorsement of the certificates is necessary. However, if the certificates are endorsed, they should be endorsed to Pacific Gas & Electric Co. to minimize risk of loss, and not endorsed in blank.

4. If the letter is executed by an attorney, executor, administrator, guardian, or other fiduciary, or by an officer of a corporation, the person executing must give his full title in such capacity and proper evidence of authority to act in such capacity must be furnished.

5. Where appropriate indicate by a mark in the proper box whether you wish (1) to sell the fraction of a share of Pacific Gas & Electric Co. common stock which would result from application of the exchange ratio, or (2) to buy an additional fraction of a share to make up one whole share.

LETTER OF TRANSMITTAL AND ACCEPTANCE

(To accompany certificates for common stock of Pacific Public Service Co. submitted for exchange)

_ _____________, 1954.

PACIFIC GAS & ELECTRIC CO.,
245 Market Street, San Francisco 6, Calif.
(Attention: A. W. Uhrich, transfer agent.)

DEAR SIRS: Submitted herewith are certificates for shares of common stock of Pacific Public Service Co. as follows:

Certificate No.	*No of shares*	*Certificate No.*	*No. of shares*	*Certificate No.*	*No. of shares*
____________	____________	____________	____________	____________	____________
____________	____________	____________	____________	____________	____________

The offer of Pacific Gas & Electric Co. to exchange fifty-three one-hundredths share of its common stock for each of the above described shares is hereby irrevocably accepted. The undersigned hereby irrevocably constitutes and appoints A. W. Uhrich, attorney, to transfer to Pacific Gas & Electric Co. the shares represented by the certificates submitted herewith on the books of Pacific Public Service Co. as of the end of April 30, 1954, with full power of substitution in the premises.

If by application of the exchange ratio, I am entitled to a fractional interest in a share of Pacific Gas & Electric Co. stock, I hereby request and authorize the Bank of California, National Association, as described in the offer of exchange,

□ to SELL such fractional interest and remit the proceeds to me, or
□ to BUY an additional fractional interest to make up a whole share and bill the cost to me.

as indicated by an X or checkmark opposite my choice.

If I failed to indicate my choice, said bank is authorized to sell my fractional interest and remit the proceeds to me.

____

____
(Signature(s) of stockholder(s))

If the name and address as shown below are not correct for mailing of stock certificate and remittance, if any, please indicate necessary changes or give instructions as to manner of delivery.

EXHIBIT 3B

PACIFIC GAS & ELECTRIC CO.,
San Francisco 6, Calif., March 15, 1954.

OFFER OF EXCHANGE

To the Holders of Pacific Public Service Co., $1.30 Cumulative First Preferred Stock:

On February 26, 1954, Pacific Gas & Electric Co. acquired 623,651 shares of common stock of Pacific Public Service Co. from Blythe & Co., Inc., in exchange for 330,535 shares of common stock of Pacific Gas & Electric Co. As a result of this acquisition Pacific Gas & Electric Co. owns approximately 60 percent of all voting shares of Pacific Public Service Co.

Pacific Gas & Electric Co. acquired this stock as the initial step of a plan under which Pacific Public Service Co. and its subsidiary, Coast Counties Gas &

Electric Co., will be merged with Pacific Gas & Electric Co. In the course of effectuating this merger all of the capital stock of Pacific Public Service Co. and Coast Counties Gas & Electric Co. will be eliminated.

To further this plan Pacific Gas & Electric Co. now offers to exchange either one share of its 5-percent redeemable first preferred stock, or, in the alternative, seventy one-hundredths share of its common stock, for each share of Pacific Public Service Co. $1.30 cumulative first preferred stock. These ratios of exchange were approved by the Public Utilities Commission of California by its order dated February 16, 1954, after a hearing upon the fairness thereof at which all interested persons had an opportunity to appear.

In order to accept this offer of exchange it will be necessary for the annexed Letter of Transmittal and Acceptance, properly completed and accompanied by certificates for the stock being exchanged, to reach Pacific Gas & Electric Co., Attention A. W. Uhrich, Transfer Agent, 245 Market Street, San Francisco 6, Calif., before the close of business April 28, 1954. Mere deposit in the mail will not constitute acceptance.

No fractional shares or scrip will be issued. Each stockholder electing to take Pacific Gas & Electric Co. common stock and entitled by application of the exchange ratio to a fractional interest in a share thereof is requested to give instructions at the time of acceptance either for the sale of such fractional interest or for the purchase of such additional fractional interest as will entitle him to an additional whole share. In all cases in which stockholders omit such instructions their fractional interests will be sold for their account. Purchases and sales of fractional interests will be executed at prices based on the closing price on the New York Stock Exchange on April 30, 1954, for Pacific Gas & Electric Co. common stock.

Receipt of shares tendered for exchange will be acknowledged promptly. The new shares of Pacific Gas & Electric Co. stock will be issued as of May 1, 1954, and will be delivered as soon as practicable after that date. Exchanging shareholders will continue to be stockholders of record of Pacific Public Service Co. until the end of April 1954, and will receive the regular quarterly dividend for the quarter ending April 30, 1954.

Acceptance of this offer by stockholders will be irrevocable. Pacific Gas & Electric Co. will be obligated to effect the exchange with respect to all shares duly tendered to it in acceptance of this offer, and may, but shall not be required to, waive defects in the manner of acceptance.

According to a ruling of the Commissioner of Internal Revenue, exchanges made pursuant to this offer and a simultaneous offer to holders of Pacific Public Service Co. common stock will be tax free under Federal income-tax law if Pacific Gas & Electric Co. acquires at least 80 percent of all outstanding shares of Pacific Public Service Co. common and first preferred stock. Since Pacific Gas & Electric Co. already owns approximately 60 percent of such shares acceptance of these offers by the holders of at least one-half of the remaining outstanding shares of such preferred and common stock will be sufficient to establish the tax exemption.

Information concerning the companies

We assume that you have received, as stockholder of Pacific Public Service Co., its recently released annual report giving results of operations for 1953 and a consolidated balance sheet as of the end of that year. If you have not received a copy of this report you may obtain one by writing to Pacific Public Service Co., 369 Pine Street, San Francisco 4, Calif. Similar information as to Pacific Gas & Electric Co. is contained in the enclosed copy of its annual report. In addition we enclose a booklet describing generally the plan of merger, of which this exchange offer is a part, and containing a brief description of the capital stock, the business, and the properties of Pacific Gas & Electric Co.

The following information with respect to market prices, dividends and redemption prices has been compiled for convenient reference, but it should be recognized that other factors deserve consideration in evaluation of this exchange offer. In making comparisons the exchange ratios should be taken into account.

Market prices

	Pacific Public Service $1.30 cumulative first preferred (American Stock Exchange)		Pacific Gas & Electric 5 percent redeemable first preferred (American Stock Exchange		Pacific Gas & Electric common (New York Stock Exchange	
	High	Low	High	Low	High	Low
1952	25⅝	22⅞	28¼	25½	39⅝	32⅜
1953	26⅛	24	28⅛	25⅛	40	34½

Dividends

Pacific Public Service $1.30 cumulative first preferred:

Annual rate	$1.30
Quarterly dividend	0.325

Quarterly dividend periods commence on first days of February, May, August, and November. Dividends are cumulative.

Pacific Gas & Electric 5 percent redeemable first preferred:

Annual rate	$1.25
Quarterly dividend	0.3125

Quarterly dividend periods commence on first days of February, May, August, and November. Dividends are cumulative.

Pacific Gas & Electric common:

Current quarterly dividend	[1] $0.55

[1] Pacific Gas & Electric Co. has paid dividends on its common stock in every year since 1918. From 1936 to July 15, 1953, dividends were paid at the rate of $2 per share per year. The dividends paid in October 1953 and January 1954 were each $0.55 per share. Based on the average number of shares outstanding during each year, the earnings per share of common stock for the years 1949 to 1953, inclusive, were as follows: $2.10; $2.62; $2.14; $2.52; $3.12.

It is the company's practice to pay dividends in January, April, July, and October.

Redemption prices

The redemption price for Pacific Public Service Co. $1.30 cumulative first preferred stock is $27.50.

The redemption prices for Pacific Gas & Electric Co. 5 percent redeemable first preferred stock are as follows: $27.75 on or before July 31, 1958; $27.25 from August 1, 1958, to July 31, 1963, inclusive; $26.75 after July 31, 1963.

Your early acceptance of this offer is invited.

Very truly yours,

J. B. BLACK, *President.*

INSTRUCTIONS FOR ACCEPTANCE

1. To accept this offer of exchange, complete the letter of transmittal and acceptance on the reverse hereof and deliver it, together with the stock certificates, to Pacific Gas & Electric Co., attention A. W. Uhrich, transfer agent, 245 Market Street, San Francisco, Calif., before the close of business April 28, 1954. Use of the mail is at the risk of the sender.
2. The letter of transmittal and acceptance must be signed in the column describing the exchange selected. Do not sign both columns. The signature must correspond exactly to that on the face of the certificates transmitted for exchange.
3. The letter of transmittal and acceptance includes a stock transfer power in favor of Pacific Gas & Electric Co. and no endorsement of the certificates is necessary. However, if the certificates are endorsed, they should be endorsed to Pacific Gas & Electric Co. to minimize risk of loss, and not endorsed in blank.
4. If the letter is executed by an attorney, executor, administrator, guardian or other fiduciary, or by an officer of a corporation, the person executing must give his full title in such capacity and proper evidence of authority to act in such capacity must be furnished.

5. Where appropriate, indicate by a mark in the proper box whether you wish: (1) To sell the fraction of a share of Pacific Gas & Electric Co. common stock which would result from application of the exchange ratio, or (2) to buy an additional fraction of a share to make up one whole share.

LETTER OF TRANSMITTAL AND ACCEPTANCE

(To accompany certificates for first preferred stock of Pacific Public Service Co. submitted for exchange)

PACIFIC GAS & ELECTRIC CO.,
245 Market Street, San Francisco, Calif.
(Attention: A. W. Uhrich, Transfer Agent.)

------------------------, 1954.

DEAR SIRS: Submitted herewith are certificates for shares of first preferred stock of Pacific Public Service Co., as follows:

Certificate No.	*No. of shares*	*Certificate No.*	*No. of shares*	*Certificate No.*	*No. of shares*
------------	------------	------------	------------	------------	------------
------------	------------	------------	------------	------------	------------

The offer of Pacific Gas & Electric Co. to exchange shares of its capital stock for the above described shares is hereby irrevocably accepted as indicated by signature below. The undersigned hereby irrevocably constitutes and appoints A. W. Uhrich attorney to transfer to Pacific Gas & Electric Co. the shares represented by the certificates submitted herewith on the books of Pacific Public Service Co. as of the end of April 30, 1954, with full power of substitution in the premises.

(Sign below the exchange elected; do not sign both)

For each share of $1.30 cumulative first preferred stock of Pacific Public Service Co. issue to the undersigned one share of 5-percent redeemable first preferred stock of Pacific Gas & Electric Co.

(Signature(s) of stockholder(s))

For each share of $1.30 cumulative first preferred stock of Pacific Public Service Co. issue to the undersigned (0.70) share of common stock of Pacific Gas & Electric Co.

If, by application of the exchange ratio, I am entitled to a fractional interest in a share of Pacific Gas & Electric Co. stock, I hereby request and authorize the Bank of California, National Association, as described in the offer of exchange,

□ to sell such fractional interest and remit the proceeds to me,

or

□ to buy an additional fractional interest to make up a whole share and bill the cost to me,

as indicated by an X or check mark opposite my choice. If I have failed to indicate my choice, said bank is authorized to sell my fractional interest and remit the proceeds to me.

(Signature(s) of stockholder(s))

If the name and address as shown below are not correct for mailing of stock certificate and remittance, if any, please indicate necessary changes or give instructions as to manner of delivery.

EXHIBIT 4

DESCRIPTION OF EXCHANGE OFFERS FOR CAPITAL STOCKS OF PACIFIC PUBLIC SERVICE CO. AND COAST COUNTIES GAS & ELECTRIC CO. AND INFORMATION CONCERNING PACIFIC GAS & ELECTRIC CO.

(March 15, 1954)

EXCHANGE OFFERS AND PLAN OF MERGER

GENERAL

By letters addressed to the stockholders of Pacific Public Service Co. and Coast Counties Gas & Electric Co. offers for exchanges of capital stock are being made by Pacific Gas & Electric Co. This booklet describes the overall plan of the offering and gives certain information concerning Pacific Gas & Electric Co., including descriptions of its capital stock, business, and properties. It should be read in connection with the accompanying offering letter and the annual report of Pacific Gas & Electric Co. for 1953, which contain important information for exchanging stockholders. Detailed instructions on how to accept the offer are contained in each offering letter and the form letter of transmittal and acceptance which accompanies it.

OFFERS OF EXCHANGE

Pacific Gas & Electric Co. is offering to the holders of Pacific Public Service Co. common and preferred stocks and to the holders of Coast Counties Gas & Electric Co. preferred stocks an opportunity to exchange their holdings for shares of stock in Pacific Gas & Electric Co. as follows:

For each share of common capital stock of Pacific Public Service Co.: Fifty-three one-hundredths (0.53) share of common capital stock of Pacific Gas & Electric Co.

For each share of $1.30 cumulative first preferred stock of Pacific Public Service Co.: One (1) share of 5 percent redeemable first preferred stock of Pacific Gas & Electric Co., or seventy one-hundredths (0.70) share of common capital stock of Pacific Gas & Electric Co.

For each share of series A, 4 percent preferred stock of Coast Counties Gas & Electric Co.: Eight-tenths (0.8) share of 5 percent redeemable first preferred stock of Pacific Gas & Electric Co., or seventy one-hundredths (0.70) share of common capital stock of Pacific Gas & Electric Co.

For each share of series B, 4.80 percent preferred stock of Coast Counties Gas & Electric Co.: One (1) share of 4.80 percent redeemable first preferred stock of Pacific Gas & Electric Co., or seventy one-hundredths (0.70) share of common capital stock of Pacific Gas & Electric Co.

As indicated above, holders of the preferred stocks of Pacific Public Service Co. and Coast Counties Gas & Electric Co. may elect to exchange their holdings either for preferred stock or common stock of Pacific Gas & Electric Co. The alternatives are not necessarily equivalent in value.

The offer of exchange terminates at the close of business April 28, 1954. Acceptance of the offer must be given on the form letter of transmittal and acceptance provided for that purpose and must be accompanied by the certificates for the shares tendered in exchange. The letter of transmittal and acceptance and the certificates must reach the Pacific Gas & Electric Co. by April 28, 1954, to be effective. Acceptance by exchanging stockholders of Pacific Public Service Co. and Coast Counties Gas & Electric Co. is irrevocable either by death or otherwise. Pacific Gas & Electric Co. is obligated to effect the exchange with respect to all shares duly tendered to it in acceptance of the offer, and may, but is not required to, waive defects in the manner of acceptance.

Exchanging shareholders will continue to be holders of record of stock in Pacific Public Service Co. or Coast Counties Gas & Electric Co., as the case may be, until the end of April 1951. Receipt of shares tendered for exchange will be acknowledged promptly by Pacific Gas & Electric Co. The new shares of Pacific Gas & Electric Co. stock will be issued in exchange as of May 1, 1954, and will be delivered as soon as practicable after that date.

Pacific Gas & Electric Co. will not issue any fractional shares or scrip certificates in lieu thereof but exchanging shareholders who would be entitled to a fractional interest in a share of stock of Pacific Gas & Electric Co. are given the option of rounding up or down to the nearest whole share. For this purpose each such shareholder should indicate on the form letter of transmittal and acceptance whether he desires to sell his fractional interest or purchase such additional fractional interest as will entitle him to an additional whole share. In all cases where stockholders omit to indicate their choice their factional interests will be sold for their account.

Pacific Gas & Electric Co. has appointed the Bank of California, national association, to handle the purchase and sale of fractional interests for the account of the exchanging stockholders. All purchases and sales of fractional interests will be executed as of April 30, 1954. Sellers will be credited and buyers charged for fractional interests on the basis of the closing prices on that date on the New York Stock Exchange for the common stock and the American Stock Exchange for the 5 percent redeemable first preferred stock.

To the extent possible said bank will match orders of exchanging stockholders to buy and sell. If the total amount of fractional interests to be sold exceeds the fractional interests to be purchased, Pacific Gas & Electric Co. will issue the necessary number of excess shares to said bank as agent for the exchanging shareholders concerned and said bank will sell such shares on the market for their account. In the event the amount of fractional interests to be purchased exceeds the amount of fractional interests to be sold said bank will buy on the market for the account of the shareholders concerned additional shares to cover the excess. In no event will Pacific Gas & Electric Co. issue more new shares than required to effectuate the exchange in accordance with the authorized exchange ratios.

Said bank will remit the proceeds from the sale of fractional interests directly to the exchanging shareholders who ordered such sales and will bill the cost of fractional interests purchased directly to the exchanging shareholders who ordered such purchases. Delivery of the certificate to a shareholder who ordered the purchase of a fractional interest may be withheld by Pacific Gas & Electric Co. until said bank has received remittance for the cost of his purchase.

PLAN OF MERGER

The presently outstanding shares of the capital stocks of Pacific Public Service Co. and the ownership thereof are given in the following table:

	Shares outstanding	Held by Pacific Gas & Electric Co.		Publicly held	
		Shares	Percent	Shares	Percent
Common stock	741,969 85	623,651	84	118,318.85	16
First preferred stock	298,137.7	-----	-----	298,137.7	100
Total voting shares	1,040,107.55	623,651	60	416,456.55	40

The presently outstanding shares of the capital stocks of Coast Counties Gas & Electric Co. and the ownership thereof are given in the following table:

	Shares outstanding	Held by Pacific Public Service Co.		Publicly held	
		Shares	Percent	Shares	Percent
Common	308,480	308,480	100	-----	-----
Preferred:					
Series A 4 percent	124,000	-----	-----	124,000	100
Series B 4.80 percent	75,000	-----	-----	75,000	100
Total voting shares	507,480	308,480	61	199,000	39

Pacific Gas & Electric Co. acquired its interest in Pacific Public Service Co. on February 26, 1954, as the initial step in a plan to merge the latter and Coast Counties Gas & Electric Co. into Pacific Gas & Electric Co. Pursuant to this plan the offers of exchange described herein are made to the owners of the publicly held shares tabulated above. Prior to completion of the merger some or all of the preferred stocks of Pacific Public Service Co. and Coast Counties Gas & Electric Co. may be called for redemption, but in no event will any redemption take place before expiration of the exchange period for preferred stock. After completion of the exchanges and following such redemptions, if any, Pacific Gas & Electric Co. intends to proceed with the corporate merger, terminating the separate existence of two subsidary companies and eliminating their capital stocks. The merger will be carried out in accordance with the Corporations Code of California and subject to such authorization of the California Public Utilities Commission and the Federal Power Commission as may be required.

Information Concerning Pacific Gas & Electric Co.

The following description of capital stock, business, properties, and other matters relating to Pacific Gas & Electric Co. should be read in connection with its annual report to stockholders for the year 1953, which gives financial, statistical and other information concerning the company.

DESCRIPTION OF CAPITAL STOCK

The company is authorized to issue 20 million shares of common stock and 20 million shares of first preferred stock, each of the par value of $25. All shares are nonassessable and have full voting rights, including the right to cumulate votes in the election of directors. No shares now outstanding or being offered in exchange have any conversion rights. The first preferred stock consists of 3 series of nonredeemable shares (a 6-percent series of 4,211,662 shares, a 5½-percent series of 1,173,163 shares, and a 5-percent series of 400,000 shares, all of which are now outstanding) and 14,215,175 authorized redeemable shares, of which 6,026,068 shares are now outstanding. The board of directors is authorized to issue the redeemable shares in one or more series, to fix the number of shares of such series, and, while each such series is wholly unissued, to fix or alter the dividend rate, the conversion rights, if any, the redemption price, and the distinctive designation thereof.

Holders of first preferred stock are entitled to cumulative preferential dividends out of surplus profits of the company at the annual dividend rates indicated in the title of each series. After payment or setting aside for payment of the dividends on first preferred stock, holders of common stock are entitled to dividends when and as declared out of surplus profits of the company.

Upon liquidation or dissolution of the company, holders of first preferred stock are entitled to receive out of undistributed profits the amount of unpaid dividends and out of any assets the par value of their shares. Holders of common stock are entitled to the remaining assets of the company in proportion to their shareholdings.

Holders of first preferred stock have no preemptive rights. Holders of common stock have preemptive rights to subscribe for or purchase additional issues of common stock, provided that common stock having a par value not exceeding $5 million may be sold to employees and persons actively engaged in the conduct of the company's business, other than its directors and principal officers, at a price not less than the par value thereof.

The redeemable first preferred stock may be redeemed in whole or in part at the option of the company at any time or from time to time upon payment of the redemption price plus accumulated and unpaid dividends to the date fixed for redemption. The redemption prices are set forth in the following table. The company's articles of incorporation do not restrict the repurchase or redemption of shares of first preferred stock while there is any arrearage in the payment of dividends.

5-percent issues

Redemption date	*Redemption price per share*
On or before July 31, 1958	$27.75
After July 31, 1958, through July 31, 1963	27.25
After July 31, 1963	26.75

4.80-percent issue

Redemption date	*Redemption price per share*
On or before Jan. 31, 1955	$28.75
After Jan. 31, 1955, through Jan. 31, 1960	28.25
After Jan. 31, 1960, through Jan. 31, 1965	27.75
After Jan. 31, 1965	27.25

CAPITAL SECURITIES

The capital securities of the company as of February 28, 1954, are shown below:

	As of Feb. 28, 1954	
	Amount authorized	Amount outstanding
First and refunding mortgage bonds	[1] $800,000,000	
Series I 3½ percent bonds due June 1, 1966		$927,000
Series J 3 percent bonds due Dec. 1, 1970		18,669,000
Series K 3 percent bonds due June 1, 1971		23,839,000
Series L 3 percent bonds due June 1, 1974		109,548,000
Series M 3 percent bonds due Dec. 1, 1979		77,975,000
Series N 3 percent bonds due Dec. 1, 1977		48,182,000
Series O 3 percent bonds due Dec. 1, 1975		10,300,000
Series P 2¾ percent bonds due June 1, 1981		24,088,000
Series Q 2⅞ per cent bonds due Dec. 1, 1980		67,434,000
Series R 3⅛ percent bonds due June 1, 1982		69,150,000
Series S 3 percent bonds due June 1, 1983		74,774,000
Series T 2⅞ percent bonds due June 1, 1976		77,475,000
Series U 3⅜ percent bonds due Dec. 1, 1985		47.650,000
Series V 4 percent bonds due June 1, 1984		63,040,000
Series W 3⅛ percent bonds due Dec. 1, 1984		60,000,000
Total	800,000,000	[2] 773,051,000
	Shares	Shares
Capital stock (par value $25 per share):		
First preferred stock:		
6 percent first preferred stock, cumulative	4,211,662	4,211,662
5½ percent first preferred stock, cumulative	1,173,163	1,173,163
5 percent first preferred stock, cumulative	400,000	400,000
5 percent redeemable first preferred stock, cumulative	[3] 2,806,680	2,806,680
5 percent redeemable first preferred stock, series A, cumulative	1,750,000	1,719,388
4.80 percent redeemable first preferred stock, cumulative	[3] 1,500,000	1,500,000
Redeemable first preferred stock, cumulative (unclassified in series)	[3] 8,158,495	None
Common stock	20,000,000	15,905,162
Total	40,000,000	27,716,055

[1] The board of directors of the company may from time to time authorize increases in this amount.

[2] Exclusive of $115,000 principal amount held in treasury.

[3] The additional shares of the 5 and 4.80 percent redeemable first preferred stock series required to complete the exchanges described herein will be authorized by the board of directors prior to May 1, 1954, from the balance of redeemable first preferred stock now unclassified in series.

DESCRIPTION OF BUSINESS

The company was incorporated in California in 1905. Its principal executive offices are located at 245 Market Street, San Francisco, Calif. The company is an operating public utility engaged, principally, in the business of furnishing electric and gas service throughout a large part of northern and central California, with properties located and operations carried on entirely in California.

For the year ended December 31, 1953, sales of electric energy and gas accounted for 69.4 percent and 30.1 percent, respectively, of the company's total gross operating revenues and the distribution of water and steam in various localities for the remaining 0.5 percent.

Territory served

The company's electric production and transmission system is interconnected and supplies distribution systems extending into 46 counties of the northern and central parts of California. The company distributes electric energy in 158 incorporated cities and towns, about 225 unincorporated communities (each having an estimated population of 250 or more), and an extensive rural area. The company distributes gas in 118 incorporated cities and towns, about 85 unincorporated communities (each having an estimated population of 250 or more), and a number of rural areas, in most of which electric energy is also distributed.

The cities having a population of 10,000 or over and the population of each, in which the company serves at retail gas, designated by G, or electricity, designated by E, or both, are:

	1940	1950		1940	1950
San Francisco EG	634, 536	775, 357	Merced EG	10, 135	15, 278
Oakland EG	302, 163	384, 575	Daly City EG	9, 625	15, 191
Sacramen to G	105, 958	137, 572	San Pablo EG	([1])	14, 476
Berkeley EG	85, 547	113, 805	San Carlos EG	3, 520	14, 371
Richmond EG	23, 642	99, 545	Hayward EG	6, 736	14, 272
San Jose EG	68, 457	95, 280	San Luis Obispo E	8, 881	14, 180
Fresno EG	60, 685	91, 669	Salinas EG	11, 586	13, 917
Stockton EG	54, 714	70, 853	San Rafael EG	8, 573	13, 848
Alameda G	36, 256	64, 430	Lodi G	11, 079	13, 798
San Mateo EG	19, 403	41, 782	Menlo Park EG	3, 258	13, 587
Bakersfield EG	29, 252	34, 784	Napa EG	7, 740	13, 579
San Leandro EG	14, 601	27, 542	Pittsburg E	9, 250	12, 763
Redwood City EG	12, 453	25, 544	San Bruno EG	6, 519	12, 478
Vallejo G	20, 072	26, 038	Chico EG	9, 287	12, 272
Eureka EG	17, 055	23, 058	Santa Clara G	6. 650	11, 702
Burlingame EG	15, 940	19, 886	Antioch E	5, 106	11, 051
South San Francisco EG	6, 629	19, 351	Madera EG	6, 457	10, 497
El Cerrito EG	6, 137	18, 011	Santa Maria E	8, 522	10, 440
Santa Rosa EG	12, 605	17, 902	Petaluma EG	8,034	10, 315
Albany EG	11, 493	17, 590	Redding G	8, 109	10, 256
Modesto G	16, 379	17, 389	Piedmont EG	9, 866	10, 132
Monterey EG	10, 084	16, 205			

[1] Unincorporated.

NOTE.—Population figures are according to census announcements published by the U. S. Department of Commerce, Bureau of the Census.

The company sells at wholesale to municipalities substantially all of the electric energy distributed and sold in Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, and Ukiah, which are located in the general territory served by the company. See caption "Central Valley Project" with respect to sales to Sacramento Municipal Utility District which is also in such territory. The company's subsidiaries, Vallejo Electric Light & Power Co., and Coast Counties Gas & Electric Co., purchase electric energy at wholesale from the company for distribution in Vallejo, Santa Cruz, Watsonville, and certain smaller communities. Other wholesale electric customers of the company include the California Oregon Power Co., and Sierra Pacific Power Co., which purchase energy from the company in California and distribute some of such energy in their respective service areas in Oregon and Nevada. The company sells gas at wholesale to its subsidiary Coast Counties Gas & Electric Co. (to augment its supply from other sources) which distributes gas in Santa Cruz, Watsonville, Pittsburg, Antioch, and certain smaller communities. The company also sells gas at wholesale to the city of Palo Alto and to corporations serving Needles, Barstow, and Victorville, which are located near the company's Topock-Milpitas pipeline.

Sources of electric energy

Of the total energy output of the company's electric system during the 12 months ended December 31, 1953, approximately 85 percent was generated in plants owned by the company. The relative amounts of electric energy generated in the company's hydroelectric and steam-electric plants vary from year to year, depending upon precipitation and other factors.

The maximum demand on the company's electric system up to December 31, 1953, occurred on July 21, 1953, when the system demand was 3,340,100 kilowatts. This power was supplied from the following sources: 1,190,900 and 1,551,800 kilowatts, respectively, from the company's hydroelectric and steam-electric plants, and 597,400 kilowatts from other sources, which include the Central Valley project and hydroelectric generating plants operated in connection with various irrigation, flood control, and municipal water supply projects. The total gross dependable capacity (estimated for the critical month of August with assumed water supply equal to that of 1931, the most adverse year in the company's experience) available to the company from its present plants and under present contracts with other producers is estimated to be 3,765,500 kilowatts, including 445,900 kilowatts available from other producers. The company also has interchange agreements with Southern California Edison Co., and the California Oregon Power Co., under which nonfirm power is purchased from time to time.

In 1952 the company entered into a long term contract with the Oakdale and South San Joaquin Irrigation Districts for the purchase of the output (estimated at 81,000 kilowatts) of three proposed hydroelectric plants to be built by the districts on the Stanislaus River. The districts plan to finance the development in 1954.

Sources of gas

During the year 1953 the company's peak day sendout of gas was 1,129,440 Mcf,[1] and the total volume distributed, including company use, was 297,424,701 Mcf, more than 99 percent of which was natural gas. Manufactured gas is used only to supplement the company's natural gas supply during periods of peak demand; propane-air gas is used for that purpose and to supply certain communities not connected to the company's natural gas system. During the 12 months ended December 31, 1953, approximately 59 percent of the company's total supply of natural gas was out-of-State gas purchased from El Paso Natural Gas Co., and approximately 41 percent was California gas purchased from others. The average price paid for natural gas by the company during this period was approximately 22 cents per Mcf.

The California gas is obtained almost entirely from gas or oil and gas fields located in the Sacramento and San Joaquin Valleys. The company has contracts with approximately 50 California producers for the purchase of this natural gas. These contracts run for various periods, in some cases from day to day and in others for the life of the field, and give the company certain priorities on gas produced. The company took delivery of approximately 25 percent of the estimated net production of California natural gas during the 12 months ended June 30, 1953. The California Department of Natural Resources, Division of Oil and Gas, estimates this total production at 552,636,117 Mcf, and the total natural gas reserves of the State as of June 30, 1953, at 9,089,122,301 Mcf, which is approximately 16 times the volume produced during the preceding 12 months.

The out-of-State gas purchased by the company is obtained primarily from the Permian Basin area of western Texas and southeastern New Mexico and in San Juan Basin area of northwestern New Mexico and southwestern Colorado. The gas is delivered to the company at the California-Arizona boundary. The company's present gas service agreement with the El Paso Co., dated October 1, 1953, obligates El Paso to deliver a maximum daily volume of 606,925 Mcf until November 1, 1954, and 708,079 Mcf thereafter. The company's obligation is to purchase 91 percent of the maximum daily volume on an annual basis. Deliveries from El Paso during the year 1953 averaged approximately 480,000 Mcf per day.

Facilities to increase the capacity of the company's Topock-Milpitas line are under construction pursuant to authorization granted by the Federal Power Commission in June 1953 and by the California Public Utilities Commission in September 1953. El Paso's obligation to deliver the maximum daily volume will continue on a firm basis for approximately 15 years. El Paso is obligated thereafter to deliver to the company gas from certain dedicated sources and, if this is insufficient to maintain deliveries at the maximum daily volume, to deliver such additional gas as it is able to acquire through its best efforts. Exhibits filed by El Paso with the Federal Power Commission show that El Paso will be able to deliver the total volume of 708,079 Mcf for at least 15 years. The extent to which El Paso may be able to deliver this volume beyond the present contractual term or to deliver a higher daily volume to satisfy the company's anticipated increased need for gas in the future and to sustain any such higher daily deliveries beyond the present contractual term will depend upon the acquisition of additional gas supplies by El Paso, competing demands for gas on El Paso's system, the course of governmental regulation of interstate deliveries of gas, and other factors not now determinable.

The Southern California Gas Co. and the Southern Counties Gas Co. of California are entitled by contract to receive in the aggregate approximately the

[1] Mcf means 1,000 cubic feet on a pressure base of 14.73 pounds.

same volume of out-of-State gas from El Paso as the company is entitled to receive under its service agreement. The service agreements of the three purchasing companies provide for the pooling of so-called dedicated gas in the event of a shortage of gas on the part of El Paso and a resulting proration of gas between the company and the southern California companies.

PROPERTY

The general location of the company's principal properties is indicated on the map included in the annual report. Substantially all of the properties of the company are subject to the lien of its first and refunding mortgage. The company maintains its properties in good operating condition, and insures them against fire and certain other risks in such amounts as it deems adequate.

The company's main electric and gas transmission lines are almost all located on rights-of-way owned in fee by the company, on perpetual easements across privately owned lands, or on United States lands pursuant to licenses or permits. The other transmission lines and the distribution lines are for the most part located on perpetual easements across privately owned lands or on public roads or streets pursuant to franchises. Franchises in territory from which the company derives more than 75 percent of its gross revenues extend beyond 1990.

In addition to the properties described below the company owns and operates 2 steam-heating systems and 10 water-distribution systems. The company owns 7 multistory office buildings, other smaller office buildings, warehouses, garages, repair shops, and other properties in various locations throughout the territory served.

ELECTRIC PROPERTIES

Generating plants

The company owns and operates 17 steam electric and 57 hydroelectric generating plans, as shown in the included table which lists separately each plant of 20,000 or more kilowatts of capacity.

Seventy-two percent of the capacity of the company's steam-electric generating units has been installed since 1947. Most of the steam-electric capacity is in high efficiency units which are operated regularly to supply varying proportions of the system load and to furnish standby capacity. Most of the older units are shut down and retained in reserve.

About 65 percent of the capacity of the company's hydroelectric plants has been installed since 1923, and 40 percent since 1940. Twenty-eight hydroelectric plants are covered by major licenses issued by the Federal Power Commission under the Federal Power Act. Each of the major licenses provides that the United States has the right, upon the expiration of such license, to take over and operate any project covered in whole or in part by such license, upon the condition that before taking possession it shall pay the net investment (as determined in accordance with the act) of the company in the project taken, not to exceed the fair value of the property taken, plus such reasonable damage, if any, to property of the licensee not taken as may be caused by the severance therefrom of the property taken. If, upon the expiration of such licenses, the United States does not exercise its right to take over said projects, the Commission is authorized to issue new licenses upon such terms and conditions as may be authorized or required under then existing laws and regulations.

Electric general plants

Name of plant	Gross normal operating capacity kilowatts [1]	Location	Remarks
Steam electric plants:			
Moss Landing	575,000	Moss Landing	
Contra Costa	575,000	Antioch	
Station P	262,000	San Francisco	
Kern	195,000	Bakersfield	
Station A	135,000	San Francisco	
Station O	116,000	Oakland	
Oleum	100,000	Oleum	
Martinez	45,000	Martinez	
Avon	42,000	Avon	Lease on site expires 1974.
Midway	25,000	Buttonwillow	
North Beach	24,000	San Francisco	
Bakersfield	22,000	Bakersfield	
5 plants each less than 20,000 kilowatts capacity.	61,800		
Total, 17 steam electric plants	2,177,800		
Hydroelectric plants:			License expires.[2]
Pit No. 1	57,000	Pit River	([3]).
Pit No. 3	70,000	do	1973.
Pit No. 5	152,000	do	1973.
Caribou	73,000	North Fork, Feather River.	1968.
Rock Creek	110,000	do	1982.
Bucks Creek	55,000	do	1968.
Cresta	70,000	do	1982.
Big Bend	70,000	do	([3]).
Colgate	25,000	North Fork, Yuba River.	([3]).
Drum	52,000	Bear River and South Fork, Yuba River.	1980.[4]
Dutch Flat	22,000	do	([3]).
El Dorado	21,000	South Fork, American River.	1972.
Salt Springs	41,000	Mokelumne River	1975.
Tiger Creek	58,000	do	1975.
Electra	92,000	do	1975.
Stanislaus	40,000	Stanislaus River	1986.
Melones	26,000	do	1977.[5]
Wishon	20,000	Willow Creek	1989.
Kerckhoff	38,000	San Joaquin River	1972.
Balch	34,500	Kings River	1972.
37 plants each less than 20,000 kilowatts capacity.	222,800		([6]).
Total, 57 hydroelectric plants	1,349,300		
Total, hydroelectric and steam-electric plants.	3,527,100		

[1] The term "gross normal operating capacity" as used herein means power generating capability rated on the basis of operating experience under favorable conditions.

[2] Unless otherwise indicated, hydroelectric plants are subject to Federal Power Commission major license

[3] Not subject to Federal Power Commission license.

[4] Minor part license.

[5] Minor part license; term conditional upon continuance of an agreement with two irrigation districts.

[6] Of these plants, 14 with a capacity of 87,000 kilowatts are subject to major licenses, 17 plants with a capacity of 110,100 kilowatts are subject to minor part licenses, and 6 plants with a capacity of 25,700 kilowatts are not subject to Federal Power Commission licenses.

Nineteen hydroelectric plants are under minor part licenses issued by the Federal Power Commission, each of which contains a waiver by the United States of the right to take over the project at the expiration thereof and also a waiver of certain of the other provisions of the Federal Power Act. These licenses cover certain cases where the powerhouses and parts of appurtenant works are located upon lands or under easements therefor owned by the company, but other parts of appurtenant works are located upon lands owned by the United States.

In connection with its hydroelectric plants, the company owns and operates 57 storage reservoirs having a total present effective capacity of approximately 1,460,000 acre-feet and, in addition, a number of regulating reservoirs. Some of these storage and regulating reservoirs are under Federal Power Commission licensees covering one or more plants to which they are appurtenant. The Lake Almanor storage reservoir on North Fork Feather River and the Lake Fordyce storage reservoir on South Fork Yuba River are covered by separate minor part licenses which expire in 1968 and 1974, respectively.

Electric transmission and distribution systems

The company owns and operates an extensive interconnected electric transmission system consisting of high voltage substations and approximately 11,700 circuit miles of transmission lines constructed for voltages of 60 kilovolts or higher. About half of these circuit miles are on steel towers. The average age of the investment in electric transmission facilities is approximately 11 years.

The company owns and operates electric distribution systems extending into 46 counties in the northern and central parts of California. The distribution ssystems as of December 31, 1953, consisted of approximately 53,000 miles of distribution lines supplied from approximately 700 substations. The average age of the investment in electric distribution facilities is approximately 10 years.

GAS PROPERTIES

The company operates an extensive gas-transmission system and a number of gas-distribution systems, located in 32 counties in central and northern California. The transmission lines form an integrated system for the transportation of natural gas from the gas fields and other sources of supply to the company's principal distribution systems. The largest unit of the transmission system is the pipeline, 34 inches in diameter, which extends the 502 miles from Topock to Milpitas, Calif., together with its 3 compressor stations, 1 of which is located at Kettleman Hills on land under lease until 1947. This line transmits all of the gas delivered to the company by El Paso Natural Gas Co. (see "Sources of Gas"). Certain of the other transmission lines (aggregating about 230 miles) are owned by Standard Pacific Gas Line, Inc., six-sevenths of the outstanding stock of which is owned by the company and its subsidiary, Coast Counties Gas & Electric Co.; one-half of the carrying capacity of such lines is reserved for the company's use. Transmission lines extending from Trico gas field are jointly owned by the company and Southern California Gas Co. All other lines are owned by the company. The company owns and operates gas-distribution systems serving about 16,900 customers in 7 communities which are not connected with the main gas-transmission system. Of these customers about 13,700, in 3 communities are served with natural gas obtained from a nearby gas field and the others are served with propane-air gas.

As of December 31, 1953, there were approximately 2,200 miles of gas-transmission lines and approximately 12,850 miles of gas-distribution lines solely owned by the company. The average age of the investment in gas-transmission lines and other transmission facilities is approximately 6 years. The average age of the investment in distribution lines and other distribution facilities is approximately 14 years.

The company owns and operates 12 standby gas-generating plants connected to the gas-transmission systems to serve during emergencies and to assist in meeting demands on peak days. They have an aggregate daily capacity of approximately 159,000 thousand cubic feet, of which 149,220 thousand cubic feet is in oil-gas plants and the rest in liquid petroleum gas-air plants. The oil-gas plants were reconstructed during the period 1925 to 1930. Most of the gas-air facilities have been constructed since 1948.

CONSTRUCTION PROGRAM

In order to meet the increased demands on the company's system and build ahead of anticipated growth, the company is continuing its long-range program to extend and enlarge its facilities for serving the public. The expenditures for construction amounted to $192,480,000 in 1949, $168,634,000 in 1950, $151,764,000 in 1951, $162,010,000 in 1952, and $196,780,000 in 1953. The company estimates that expenditures for construction during the period from January 1, 1954, through the end of 1955 will aggregate approximately $340 million, although actual expenditures may be substantially less or greater than this amount. This estimate includes allowance for certain expenditures prior to the end of 1955 on facilities to be completed thereafter which have not as yet been definitely selected.

The company's current construction program is as follows:

	Estimated completion date	Estimated gross normal operating capacity, kilowatts	Estimated total cost (including expenditures to date)
Steam electric-generating plants:			
Pittsburg	1954	600,000	$75,000,000
Morro Bay:			
First unit	1955	150,000	44,300,000
Second unit	1956	150,000	
Humboldt Bay	1956	50,000	9,600,000
Hydroelectric plants under construction: Pit No. 4	1955	84,000	25,200,000
Other facilities (1954 and 1955):			
Electric transmission lines and substation facilities			50,000,000
Electric distribution substations, lines, and related facilities			90,000,000
Gas transmission and distribution facilities			65,000,000
Miscellaneous facilities			15,000,000

Applications have been filed with the Federal Power Commission for licenses for the hydroelectric plants listed below. The Commission issued a license for the Poe project on October 26, 1953, and it is anticipated that construction on this project will commence before the end of this year. The Commission has also authorized licenses for the Kings River project by orders which require the company to reach an agreement with the United States Government on payment for storage space in Pine Flat Reservoir to permit reregulation for irrigation purposes of waters released from proposed power reservoirs and an agreement with the local irrigation interests providing for the use by the company of the waters of the Kings River for power purposes. Negotiations for such agreements are now under way and it is hoped that they will be consummated in time to permit the company to commence preliminary construction on the project this year.

	Estimated gross normal operating capacity killowatts	Estimated cost
Pit No. 6	60,000	$19,700,000
Pit No. 7	54,000	16,000,000
Feather River:		
Butt Valley and Caribou No. 2	145,000	35,600,000
Poe	106,000	40,500,000
Belden	113,000	37,600,000
Kings River (3 plants and enlargement of existing plant)	[1] 274,000	75,000,000
McCloud River (2 plants)	232,000	89,000,000

[1] Including capacity of existing Balch plant.

EMPLOYEE RELATIONS

The company has approximately 18,500 employees. All of its physical workers and most of its clerical employees are represented by the International Brotherhood of Electrical Workers (IBEW), affiliated with the American Federation of Labor. Contracts covering the working conditions of all union-represented employees are in effect.

On September 1, 1953, the wages of all employees were increased 3.5 percent and on January 1, 1954, a revision of the company's insured retirement plan became effective. It is estimated that if these adjustments had been in full effect for the 12 months ended December 31, 1953, the company's payroll and pension costs would have been approximately $4 million greater for that period, of which approximately 40 percent would have been chargeable to construction and capitalized.

Under a contract made in 1937 and amended January 1, 1954, between the company and the Metropolitan Life Insurance Co. and the Prudential Insurance Co. of America, employees of the company may receive retirement annuities supplementing the pension available to such employees under the Federal social-security law. All employees of the company and its subsidiaries are eligible to participate in the plan after 1 year of employment with the company. Under this plan both the company and the participating members make contributions for the purchase of such annuities. The amount of the annuity is dependent upon the amount of the employees' contributions. The payments (including amounts charged to construction) made by the company to the insurance companies for the year ended December 31, 1953, amounted to $3,982,836. As of December 1, 1953, 14,901 employees were participating in the plan.

To provide for the payment of pensions for employees for services prior to 1937 the company in 1945 established a trust fund under an irrevocable trust agreement with Crocker First National Bank of San Francisco, as trustee. The trustee holds all of the presently outstanding series O 3-percent bonds of the company.

REGULATION

Public Utilities Commission of the State of California

The company is subject to regulation by the Public Utilities Commission of the State of California, which has the power, among other things, to establish rates and conditions of service, to regulate security issues, and to prescribe uniform systems of accounts to be kept by public utilities.

Federal Power Commission

The company is subject to regulation by the Federal Power Commission under the Federal Power Act and the Natural Gas Act.

The company holds a number of licenses for hydroelectric plants and facilities issued under part 1 of the Federal Power Act (see Electric Properties). By reason of sales of electric energy at wholesale in interstate commerce to the California Oregon Power Co. and to Sierra Pacific Power Co., the company is subject to regulation as a public utility under part II of the Federal Power Act and the Commission has authority to regulate its rates for such sales. Under that act the Commission may also regulate dispositions of property and temporary interconnection of facilities during war emergency, and prescribe uniform systems of accounts, rates of depreciation and other matters.

The Natural Gas Act confers authority on the Commission to certificate facilities for the transmission of natural gas in interstate commerce, to prescribe a uniform system of accounts, and to regulate the rates charged upon sales of gas in interstate commerce for resale for ultimate public consumption. The sale by El Paso Natural Gas Co. to the company and the sales by the company to the city of Palo Alto and to corporations serving Barstow, Victorville, and Needles are regulated by the Commission. The Commission asserts the authority to allocate, after formal hearings, natural gas transmitted by interstate gas pipeline companies (such as El Paso Natural Gas Co.) to various consumers or distributors of such gas, without regard to the gas sales contracts of such pipeline companies.

In the opinion of counsel for the company, no approval of the Commission is required under either the Federal Power Act or the Natural Gas Act with respect to the issuance and sale of any of the company's securities or the mortgaging of its properties.

UTILITY OPERATIONS OF PUBLIC AGENCIES

For many years the constitution and statutes of the State of California have authorized municipal corporations and various districts and other public agencies to engage in certain public-utility activities, and to acquire the necessary works therefor by purchase, condemnation, or original construction. Such activities may be competitive with privately owned public utilities.

San Francisco-Hetch Hetchy Power

The City and County of San Francisco generates electric energy in two hydroelectric plants in connection with its Hetch Hetchy project. The generation and use of this energy is governed by an act of Congress known as the Raker Act (38 Stat. (1913) 242), which prohibits the city from selling or letting to any corporation or individual, except a municipality or a municipal water or irrigation district, the right to sell or sublet the water or the electric energy sold or given to it by the city. The city uses some of its power for its own municipal purposes and sells substantially all of the balance. The company receives power from the city at Newark substation and transmits and delivers power to various locations in San Francisco and vicinity for the city's use. The company has agreed to sell to the city any supplementary power that the city may require for its own use or for sale to its customers and to buy from the city any surplus energy generated at the city's plants which otherwise would be wasted. The agreements between the company and the city extend to April 30, 1962.

Central Valley project

The Central Valley project is an extensive system of works being constructed by the United States Bureau of Reclamation for the purposes of reclamation, flood control and navigation, and for the generation and sale of electric energy as a means of financially aiding and assisting such undertakings. The completed hydroelectric generating facilities at Shasta and Keswick dams, on the upper Sacramento River, have an aggregate rated capacity of 450,000 kilowatts. Additional hydroelectric generating facilities are now under construction at Folsom and Nimbus Dams, on the American River, with aggregate rated capacity of 175,500 kilowatts.

Project transmission lines completed by the Bureau consist of three 230-kilovolt circuits from Shasta powerplant to Tracy, where the principal project pumps are located, and a 69-kilovolt line from Tracy to serve project pumps along the Contra Costa Canal. Now under construction is a single circuit 230-kilovolt transmission line from Folsom powerplant to connect with the east side Shasta-Tracy line.

The company has furnished exchange service to the Bureau for its own use since 1945. Effective August 27, 1951, the company and the Bureau entered into a 10-year transmission and exchange service (i. e., power wheeling service) contract, under which the company accepts delivery of project power and delivers, at the request of the Bureau, for its account, an equivalent amount of power (adjusted for transmission losses) to Federal establishments, including the Bureau, and to certain customers entitled to preference under the Reclamation Law. At the end of 1953, the company was providing service to 16 Federal establishments and to 4 preferred customers under this contract. The maximum simultaneous firm demand of such customers in 1953 was 36,920 kilowatts. Most of these customers of the Bureau had been customers of the company.

Since January 1, 1954, Ames Aeronautical Laboratory has purchased its power from the Bureau, deliveries being made by the company under the power wheeling service contract. Prior to that time it purchased all its power from the company with a maximum demand of 67,200 kilowatts in 1953. The Sacramento Municipal Utility District expects to purchase all of its power requirements from the Bureau commencing July 1, 1954, under a contract made with the Bureau in 1952. Power deliveries will be made by the company under the power wheeling service contract. The district is presently receiving its power from the company under a contract which extends to June 30, 1954. The district's maximum demand in 1953 was 145,200 kilowatts.

From 1944 to 1951, inclusive, the company purchased substantially the entire output of the Shasta and Keswick powerplants. Effective December 17, 1951, the company and the Bureau entered into a 10-year contract under which the company purchases project power which the Bureau does not need for (1) project uses, (2) requirements under the power wheeling service contract, or (3) loads which may otherwise be served by the Bureau. The contract also provides for interchange of power so as best to meet the combined load requirements of the parties, and for sale by the company of power to supply certain deficiencies which may occur in the output of project plants to the extent required by certain Federal agencies and preferred customers.

Proposed State of California Feather River project

In June 1951 the California Legislature authorized the State water project authority to construct and operate a project consisting of the following principal works (subject to modification by the authority) : a dam and 3,500,000 acre-foot reservoir on the Feather River near Oroville; a 440,000-kilowatt powerplant; an afterbay dam and 25,000-kilowatt powerplant; facilities for power transmission to a switchyard near project pumps, at Bethany, Contra Costa County; and systems of canals and pumps to transport water to Alameda and Santa Clara Counties, to the southern San Joaquin Valley, and to southern California, including San Diego County. The authority has applied to the Federal Power Commission for a license authorizing the hydroelectric features of the project.

Total cost of the project was estimated in the State's 1951 feasibility report at $1,270 million. The State engineer estimates that approximately 8.7 billion kilowatt-hours of energy will be required annually for project pumping. The output of the Feather River powerplants is estimated at 1.7 billion kilowatt-hours per year.

The only financing authorized for the project is by means of revenue bonds. The State is now making engineering studies for the project.

LAW OFFICES, BALLARD, SPAHR, ANDREWS & INGERSOLL,
Philadelphia, Pa., April 27, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, and Members of the Finance Committee,
United States Senate, Washington, D. C.

GENTLEMEN: The time has been too short to permit an exhaustive study of H. R. 8300. Accordingly the primary purpose of this letter is merely to record certain basic objections to the bill in its present form, with appropriate recommendations for improvement. Also, reference will be made to a few instances of deficiencies in the bill which, being of relatively limited applicability, may not yet have been brought to the attention of your committee.

EFFECTIVE DATE

As written, H. R. 8300 would be generally effective on January 1, 1954, subject to a number of exceptions. In view of the complexity of the bill and the great number of substantive changes which it would effect, it is believed that the bill should not become generally effective until January 1, 1955 (i. e., with respect to taxable years beginning after December 31, 1954). This would not only permit tax practitioners and others to familiarize themselves with the bill before having to make decisions affected by the bill, but would also provide a period of time during which any seriously objectionable features which may have been overlooked might be brought to the attention of Congress and rectified.

Certain portions of the bill, subchapters C, J, and K of subtitle A, dealing with the application of the income tax to corporate distributions and adjustments, estates and trusts and partnerships respectively, constitute such a radical deparure from exising law and embody so many new concepts that it is believed that their effective date should be postponed at least an additional year. They should not, in other words, be made applicable to taxable years beginning prior to January 1, 1956. This is particularly true of subchapter C, which has been the subject of widespread criticism in a number of serious and fundamental respects and will no doubt undergo substantial revision prior to enactment. Tax practitioners will require an extended period of time in which to gain a working knowledge of subchapter C in the form in which it is finally enacted and to study the applicability of the subchapter to the particular situations within their area of responsibility.

Another provision the operation of which might well be postponed is the acceleration of corporate tax payments provided for in sections 6016 and 6154 of the bill. These sections, which will in effect increase the taxload on many corporations by 10 percent for 5 successive years, are scheduled to go into effect in 1955. It is suggested that they be not made effective until 1956 so that the affected corporations will have adequate time to make provision for the heavy and prolonged drain on their cash position which must be anticipated.

INCOME TAX—SUBCHAPTER C

1. Definitions

Section 312 of the bill defines the terms "participating stock," "nonparticipating stock" and "securities" in terms which would throw into the category of "nonparticipating stock" certain types of equity participations which are commonly regarded as common stock and certain types of corporate securities which are never thought of as stock at all. Under this definition a corporation with voting common stock and nonvoting cumulative preferred stock outstanding, the common being given preference in some minor respect (such as a limited secondary preference to receive assets on liquidation) would be regarded as having no participating stock at all, and would consequently be penalized by being ineligible to participate in a corporate acquisition of property as defined in section 359.

Even more inequitable than the foregoing example, a corporation with mortgage bonds outstanding under the terms of which a fixed rate of interest was payable in all events with additional interest payable on an if-earned basis, might be disallowed a deduction for any interest paid on the bonds since under one interpretation of section 312 (c) the bonds might be said to be nonparticipating stock and the interest accordingly treated as a nondeductible dividend.

It is submitted that the familiar terms "common stock" and "preferred stock" should be substituted for "participating stock" and "nonparticipating stock" and that they should be defined (if definition is required) in accordance with common understanding. This would eliminate bizarre results such as the examples given above.

2. Corporate mergers and acquisitions

Subchapter C would draw a sharp line between so-called publicly held corporations and other corporations, permitting the tax-free statutory merger or consolidation of the former as liberally as under existing law but sharply restricting the combining of corporations not publicly held.

It is submitted that the classification of mergers for tax purposes in terms of the relative size of the participating corporations, as section 359 of the bill would do in the case of other than publicly held corporations, is totally unwarranted and should be abandoned. With this feature eliminated, it would appear that there would be no substantial reason for retaining the distinction between publicly held and other corporations and that statutory mergers or consolidations should be accorded the same treatment in all cases. This would have the incidental merit of eliminating a very contentious definition under which many large corporations whose stock is widely held and actively traded in would be classified as other than publicly held merely because a small number of stockholders (who might be unrelated to each other) held in the aggregate more than half of the outstanding stock.

3. Corporate separations and partial liquidations

Under the scheme of subchapter C in its present form a corporation could not effect a partial liquidation or spin-off a portion of its business to its stockholders with tax impunity to the latter unless certain stringent conditions were satisfied. For example, separate books would have to have been maintained for 5 years for the portion of the business liquidated or spun off. In the case of partial liquidation the terminated portion of the business would have to have been itself a business operated separately from the corporation's other business or businesses over a 5-year period.

It is suggested that these tests discriminate unduly and unnecessarily against smaller corporations and in favor of large corporations able to afford complex accounting systems and having farflung, widely separated activities. Consequently it is submitted that these tests should be discarded.

In the case of spin-offs the penalty for qualifying under the above tests is that the stock spun off is classified as stock of an inactive corporation, with the consequence that for a period of years anything realized on the stock is taxable to the stockholder as ordinary income. It is submitted that this penalty is far too harsh to fit the crime. For example, if the stock were sold within the prescribed period the proceeds would be taxable in their entirety as ordinary income and the selling stockholder would apparently lose his basis for the stock. This goes far beyond anything in existing law and would appear to raise a grave constitutional question. At the very least the bill should be amended to allow the recovery of basis tax free.

4. Stock redemption

Sections 302–4 of the bill would replace the much-litigated section 115 (g) of existing law. The effort which has been made to clarify the uncertainties of section 115 (g) is highly commendable, but the result is open to at least two serious objections.

In the first place section 303, dealing with the redemption of stock to pay death taxes, clearly should but does not qualify section 304 (redemption through use of related corporation) as well as section 302, the section dealing with redemption by the issuing corporation. Presumably this is merely an error in the drafting.

In the second place section 302, in excluding disproportionate redemptions from dividend treatment, defines disproportionate redemptions in an unrealistic and potentially inequitable manner. Under section 302 the test of whether or not a stock reclamation is substantially disproportionate is cast entirely in terms of its effect on the stockholder's proportionate ownership of participating stock. Thus the redemption of nonparticipating stock from only one stockholder (who continued to hold 1 percent or more of the company's participating stock) would in the ordinary case be taxed as a dividend, notwithstanding it substantially reduced the stockholder's relative participation in the ownership of the company's equity. A test which may thus result in taxing as a dividend what is in substance a partial return of the stockholder's investment is not in harmony with the purpose underlying section 302 and the present section 115 (g). The uncertainties existing under present law would appear to be preferable to certainty at this price.

5. Tax on redemption of nonparticipating stock

The bill contains a novel provision embodied in section 309, which would impose a tax equal to 85 percent of payments in redemption of nonparticipating stock within 10 years of its issuance under certain specified circumstances. It is to be noted that this tax would not be imposed on the person who would presumably benefit from the redemption, namely, the stockholder whose stock was redeemed, but would be imposed on the redeeming corporation and would therefore indirectly be borne by the remaining stockholders. It is also to be noted that although the tax is directed at the practice of siphoning off earnings and profits at capital gains rates through the so-called preferred stock bail-out, the tax would be payable irrespective of whether the corporation had earnings and profits.

The proposed tax would appear to be extremely arbitrary and inequitable and it is therefore believed that it should be eliminated from the bill. At the very least, section 309 should be amended in the following respects:

(*a*) To impose the tax only to the extent of the redeeming corporation's earnings and profits.

(*b*) To eliminate the provision under which nonparticipating stock issued prior to January 1, 1954, would be assumed for purposes of section 309 to have been issued on that date.

(*c*) To liberalize the exemption contained in section 309 (a) (3) so that it would cover nonparticipating stock issued bona fide for money or property but where the stock was redeemed for more than 105 percent of such money or property.

It is interesting to note that under the definitions discussed earlier in this letter a corporation would apparently have to pay the 85-percent tax on the redemption of its mortgage bonds if they were redeemed within 10 years of issuance and were wholly or partially on an if-earned basis.

INCOME TAX, PARTNERSHIPS

1. Partner's distributive share

"In the interest of simplification" (according to the House committee report) section 704 of the bill contains a provision which would in all cases tax the gain on a partnership's sale of contributed property among all the partners in accordance with the division of profits under the partnership agreement. Thus where the taxable gain was attributable entirely to appreciation in value of the property occurring prior to the time when it was contributed to the partnership, the noncontributing partners would be taxed on a gain which they had in no real sense enjoyed. It is true that they would be entitled to a corresponding increase in their bases for their partnership interests, but the benefits from such an adjustment to basis would necessarily be remote and problematical.

It is submitted that the treatment of contributed property called for under section 704 should be put on an optional rather than a mandatory basis.

2. Payments to a retiring partner

Under section 736 payments of partnership profits to a retired partner or with respect to a deceased partner would be recognized as the payment of a distributive share for a period of 5 years but would thereafter be treated as a gift by the partners, not deductible by them and resulting in no increase in their bases for their partnership interests.

It is suggested that this provision is arbitrary in the extreme and would work a harsh result in those cases where partnerships are under an obligation, incurred at arm's length, to permit a retired partner or the representatives of a deceased partner to participate in the partnership profits for an extended period of time. It is submitted that the 5-year limitation should be dropped, the only requirement being that the payments be pursuant to an obligation incurred bona fide and at arm's length.

INCOME TAX—DEDUCTION FOR DIVIDENDS RECEIVED

Section 243 would allow an 85 percent dividends-received deduction equivalent to the dividends received credit under existing law. However, it would depart from existing law in that it would disallow the deduction (sec. 246) in the case of dividends received from an insurance company taxed under subchapter L.

Part I of subchapter L sets up special rules for the taxation of life-insurance companies. In view of the very liberal provisions in part I, it may be that the denial of the dividends-received deductions to corporate stockholders of stock companies in this category is warranted. However, part III, which deals with the taxation of stock companies other than life, provides for a scheme of taxation which differs in no material respect (including rates) from the taxation of ordinary business corporations. Consequently exactly the same considerations are present in favor of allowing a dividends-received deduction with respect to dividends paid by such insurance companies as are present in the case of dividends paid by ordinary business corporations. It is submitted, therefore, that the denial of the deduction in section 246 as to insurance-company dividends should be restricted so as not to apply to dividends of insurance companies taxed under part III of subchapter L.

Sections 34 and 116 of the bill, which would allow to individuals a partial exclusion from taxable income and a credit against tax with respect to dividends received, would similarly be inapplicable to all insurance-company dividends under the bill as passed by the House. The amendment suggested in the preceding paragraph would be equally appropriate here.

ESTATE TAX—ALTERNATE VALUATION

Probably the most objectionable single feature of H. R. 8300 is section 2032, which would permit the valuation of gross estate as of 1 year after the decedent's death only if the value of the estate had declined by one-third or more in the intervening period.

This provision is arbitrary in the extreme. It is submitted that such widely differing tax consequences should not be made to depend on valuation factors entirely outside the executor's control. Also, if the one-third limitation is permitted to remain in the bill, it may be anticipated that the volume of hotly contested valuation cases will constitute a formidable administrative burden in times of declining values.

It is therefore submitted that section 2032 should be amended at least so as to conform to existing law, which permits the election of alternate valuation without limitation, and preferably so as to eliminate the necessity of making a binding election.

Very truly yours,

Ballard, Spahr, Andrews & Ingersoll,
By William R. Spofford.

Arizona Farm Bureau Federation,
Phoenix, Ariz., April 26, 1954.

Hon. Carl Hayden,
Senate Office Building, Washington, D. C.

Dear Senator Hayden: There is now before the Senate Finance Committee a bill, H. R. 8300, which contains proposals for revisions in the internal-revenue laws relative to deductions for corporations for dividends received.

Under existing law a corporation, in general, is entitled to a credit against net income of 85 percent of the amount received as dividends from other domestic corporations which are subject to Federal income tax. Section 243 (a) of H. R. 8300 continues this treatment but as a deduction instead of a credit. However, section 246 (a) of the bill provides for a major change in the existing law by not allowing such deductions to corporate shareholders on dividends received from insurance companies which are subject to the tax imposed by subchapter L (sec. 801 and following).

The Arizona Farm Bureau is deeply concerned by this proposed revision.

By policy resolutions Farm Bureau members in several Western States expressed a desire for the organization of a life-insurance service within the structure of Farm Bureau. Since the potential volume of business available among

Farm Bureau members in any one of the States was considered insufficient for a sound life-insurance operation in 1952, we organized the Western Farm Bureau Life Insurance Co. which operates in 6 States in the western region. It is a legal reserve stock company with its capital stock owned by six service companies affiliated with the respective State farm bureaus. Each State farm bureau service company has sold its capital stock to Farm Bureau members in its State. The State Farm Bureau service company looks to the life-insurance company for dividends on its stock in the life company as the source of income it needs to meet its own dividend obligations to the Farm Bureau members who put up the money which made this service possible.

That there was a definite need for such a service to farm families is proved by the fact that the regional company sold over $22 million of charter business in less than 1 year. Arizona Farm Bureau members purchased $2,900,000 worth of charter life insurance in less than 9 months.

It is quite obvious that the proposed change in the internal-revenue laws which would take away the present 85 percent credit on intercorporate dividends would constitute discriminatory treatment and would present a serious financial problem to our State farm bureaus.

It does not appear to be in the public interest for Congress to take away from present holders of stock in insurance companies certain rights which they possessed at the time of such stock purchase, thereby adversely affecting their net return on such property, when they had no knowledge that the Federal Government had any intention of changing the rules in question.

We wish to respectfully request that you contact members of the Senate Finance Committee and urge the deletion of sections 34 (c) (1) and 246 (a) (1) of H. R. 8300.

Sincerely,

William C. Davis,
Executive Secretary.

P. S.—I greatly appreciate the manner in which you have kept us informed of progress on various issues such as the Mexican labor bill and the grazing bill.

Wilkinson, Boyden, Cragun & Barker,
Washington, D. C., April 27, 1954.

Hon. Eugene D. Millikin,
Chairman, Committee on Finance, United States Senate,
Washington, D. C.

Dear Senator Millikin: We enclose a memorandum discussing two important inequities in the proposed revision of the internal-revenue law, H. R. 8300, as passed by the House, and a proposed amendment to the House bill to eliminate these situations.

In revising present code section 107 (a) dealing with the taxability of the lump-sum compensation for services rendered over a period of 36 months or more, the House has used language which would provide that, where a person otherwise entitled to the relief provisions of section 107 (a) changes his method of doing business from an individual operator to that of a partnership, he would be denied the privilege of computing the tax on the lump-sum compensation as if he had received it ratably over the period. While the literal language of the House bill would require that result, we doubt whether it was intended to deny the relief of section 107 (a) to a taxpayer mereby by reason of his election to do business as a partnership.

Also, with respect to such lump-sum compensation, the House language would reintroduce an inequality between taxpayers residing in community-property States and other taxpayers.

We urge your committee to give this matter its usual careful consideration and to adopt the corrective language we suggest.

Sincerely yours,

Wilkinson, Boyden, Cragun & Barker,
By Robert W. Barker.

Memorandum Concerning Inequities in House Revision of Present Section 107 (a), Internal Revenue Code, and Proposed Amendment to H. R. 8300

In revising section 107 (a) of the present Internal Revenue Code, the House of Representatives in sections 1301 (c) and 1304 (c) of H. R. 8300 in an effort to plug certain so-called loopholes created by court decisions in the application of the present section, created two inequities which should be cofrected before H. R. 8300 is enacted.

BACKGROUND AND PURPOSE OF THE PROVISION

As is well known, section 107 (a) of the present code was enacted to alleviate the hardship created where a person works on an employment for several years but receives most of the compensation (80 percent under present and proposed law) in 1 year. It recognizes that two inequities would arise if all of the compensation were taxed in 1 year, instead of ratably over the period of services, viz, (1) only deductions, expenses, and credits of the final year would be chargeable against the compensation for the full period, and (2) under the graduated surtax the taxpayer is subjected to a considerably greater burden because of the aggregation of his compensation. (See S. Rept. 648, 76th Cong. p. 7).

The present section 107 (a) is designed to alleviate that condition by providing that where 80 percent or more of the compensation for services of 36 months or more is received in 1 taxable year, the tax attributable to any part thereof shall not be greater than the aggregate of taxes attributable to such parts had it been included in the gross income of the individual ratably over that part of the period which precedes the date of the receipt of the compensation.

The House recognizing the desirability of this provision has continued it in substance in H. R. 8300 as section 1301. However, in attempting to override certain court decisions as to the application of the present section 107, the House has created two significant inequities.

1. *Partnership versus nonpartnership.*—Frequently, an individual engaged in personal services finds it desirable or necessary to change his method of doing business from that of an indvidual operator to that of a partnership. Under present law, where an individual works on an employment over a period of time and then joins a partnership and continues to work on the employment or to share in the compensation of the employment by reason of his membership in the partnership, he is entitled to compute his income as if the compensation had been received ratably over the period from the beginning of the employment to the date of payment.[1] His change in method of doing business from that of an individual operator to a partnership does not affect his tax liability, nor should it. However, under the language of section 1301 (c) of H. R. 8300, a rule with respect to partnership is established which would penalize the individual who changes his method of doing business from an individual operation to a partnership, as opposed, for instance, to one whose circumstances as to services and receipt of compensation were the same, but who left the partnership just before his receipt of the fee. It is submitted that this was not the intent of the House committee or the House in adopting this language but that the language would literally have that effect.

Section 1301 (c) of H. R. 8300 is designed to plug a loophole under present law. Now, where a partnership receives lump-sum compensation for services over a period of 36 months or more, which qualifiies for relief under section 107 (a), an individual partner who receives a share of that income is entitled to the benefits of section 107 (a) even though part of the services were rendered prior to his admission to the partnership. The fact that he was not a member of the partnership for 36 months or more does ont deprive him of that privilege and he is entitled to allocate his share of that income over the entire period of services rendered by the partnership prior to its receipt of the compensation (G. C. M. 26993, I. R. B. 1951-22; *Elder W. Marshall*, 14 T. C. 90, aff'd 185 F. 2d 674; *Burnham Enersen*, 187 F. 2d 233; *Sigvald Nielson*, 50,025, Prentice Hall Memo T. C.). Conceivably, of course, this could be carried to the extreme that a partner could allocate computation, for purposes of computation of taxes, to periods prior to his birth. The House attempt to correct this situation is justified, but the language of section 1301 (c) does more than that.

The objective of the House could be accomplished by limting the benefits of section 1301 to an individual who has been engaged in the employment for a period of 36 months or more or who has actually been a member of the partnership during a period of at least 36 months during which the services were being performed. It is suggested that H. R. 8300 be amended as follows:

[1] Assuming 80 percent of the compensation were received in 1 year and the period of services was 36 months or more.

"Amend Subchapter Q, Part I, Section 1301, page 265 by deleting subsection (c) and inserting in lieu thereof the following:

" '(c) RULES WITH RESPECT TO PARTNERS.—An individual who is a member of a partnership receiving or accruing compensation from an employment of the type described in Subsection (a) shall be entitled to the benefits of that subsection only if the individual has engaged in the employment, or has been a member of the partnership during a time or times that the partnership was engaged in the employment, for a total period of 36 months or more. In such case, the computation of the tax of the individual shall not include in the period preceding the date of receipt or accrual any period in which (1) he was not a member of the partnership during the time or times it was engaged in the employment, or (2) he was not otherwise engaged in the employment'."

2. *Reversal of split-income policy of equalization with community-property States.*—It is well settled that under section 107 (a) (of the present code) that tax computations, although computed, as if parts of the long-term compensation had been received in earlier years, are computations of the tax for the year in which the long-term compensation is received (*George K. Ford* 18 T. C. 387, 391; *Hofferbert* v. *Marshall,* 200 F. 2d 648 (C. A. 4th, 1953)). Section 1304 (c) dealing with the computation of tax attributable to income allocated to the prior period is therefore objectionable because it would deny to taxpayers the privilege of income-splitting with respect to income subsequent to March 1, 1954, to the extent that income is taxed as if received prior to 1948—even though income-splitting is continued as to other income received subsequent to March 1, 1954, by individual taxpayers. Section 1304 (c) is even more objectionable, however, because despite the considered decision of Congress in 1948 to place taxpayers residing in community-property States and those residing in non-community-property States on an equal footing for tax purposes, section 1304 (c) would enable taxpayers of community-property States to take advantage of income-splitting with their spouses with respect to compensation allocable to period prior to 1948 for tax computation under section 1301 (a), but would deny taxpayers in non-community-property States the same privilege.

Under community-property law long-term compensation for personal services of one spouse is community property, one-half of which is the income of the other spouse for tax purposes. Under section 1301 and section 1304 (c) it would so be taxed as though one-half had been received by each in the earlier years, since their income is split by State—not Federal—law.

Viewed from the point of view of amount of revenue involved and from the point of view of equality between taxpayers, the results of the case of *Hofferbert* v. *Marshall, supra,* are more desirable than section 1304 (c) of H. R. 8300. In that case, the court held that income received after 1948 when income-splitting provisions were in effect could be split between husband and wife for income-tax purposes, even as to calculations of the amount of tax allocable to the years prior to 1948. The inequality which would be produced under section 1304 (c) of H. R. 8300 revives the former and repudiated policy of discrimination in favor of the community-property-State taxpayer.

It is, therefore, suggested that section 1304, p. 267 be amended as follows:

"Delete subsection 1304 (c) and insert in lieu thereof the following:

" 'COMPUTATION OF TAX ATTRIBUTABLE TO INCOME ALLOCATED TO PRIOR PERIOD.—In the event an individual entitled to the benefits of this part shall file a joint return under the provisions of Section 2, then for the purpose of computing the tax attributable to the amount of an item of gross income allocable under this part to a particular taxable year, the total tax for that year shall be computed, if the taxpayer was permitted to file a joint return in that year, on the joint income of both spouses in accordance with the provisions of Section 2, and the remaining tax attributable to that year shall be determined by deducting therefrom the tax paid by both spouses in that year.' "

COMMITTEE FOR ECONOMIC DEVELOPMENT,
NEW YORK, N. Y., *April 22, 1954.*

HON. EUGENE D. MILLIKIN,
Senator from Colorado, Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: In response to an invitation from Senator Ralph E. Flanders, I submit herewith, on behalf of the research and policy committee of the Committee for Economic Development, a statement of our views on H. R. 8300.

Sincerely yours,

J. Cameron Thomson,
Chairman, Fiscal and Monetary Policy Subcommittee.

Time for Tax Reform

Statement by J. Cameron Thomson, president, Northwest Bancorporation, and chairman of fiscal, monetary, and debt-management subcommittee, Committee for Economic Development

The proposals contained in the pending tax bill, H. R. 8300, are among the most important ever considered by the Congress. I am pleased to present this statement concerning these proposals on behalf of the Research and Policy Committee of the Committee for Economic Development.[1]

The essential feature of the current proposals is the deliberate attempt to promote economic growth in a world where government expenditures and taxes are inevitably high. This attempt is important because it recognizes that economic growth and efficiency are primary objectives today and that tax reform is one of the main ways to promote those objectives. The new provisions for depreciation, for the taxation of dividends, for the treatment of foreign income, and for the retention of corporate earnings all reflect this point of view.

These proposals are not designed to provide tax privileges for any group. They are not designed to meet the temporary requirements of the current economic readjustment or any other transitory situation. They are designed to make our tax system more equitable and more consistent with the long-range interests of our economy and our Nation.

The pending tax proposals are the result of intensive study in one of the most complex areas of public policy. The congressional committees, their staffs, and the Treasury are to be commended on the quality and quantity of work that underlies the bill. They would undoubtedly agree that the present draft is not perfect. While every effort should be made to improve it, we shall be deluding ourselves if we plan to wait until it is perfect. There are no perfect tax bills. With necessary corrections which can be made in certain sections, or with substitution of present law provisions where time does not permit of appropriate adjustments, the tax proposals contained in H. R. 8300 should be approved, and they should be approved this year.

A brief look at the background of the past 25 years will show that we have now reached a turning point in tax policy. Our present tax system is a residue of the thirties and forties—decades dominated by depression and by total war. We now face the problem of adapting our tax system to the requirements of the 1950's and 1960's.

In the thirties tax receipts fell off as the depression ate into the national income. Government expenditures for public works and relief increased. At the same time, an attempt was made to reduce the resulting deficits by raising taxes. The tax increases hardly made a dent in the deficit, but they left a mark upon our tax system that still persists.

The tax increases of the thirties bore most heavily upon higher-income taxpayers. Moreover, the tax structure was revised in many ways that must be considered anti-business and anti-investment. The freedom of businesses to decide how fast they would charge off their capital assets was restricted, and the rate of chargeoff reduced. In 1936, dividends were made fully taxable under both the individual income and corporate profits tax. Up to that date dividends were exempt from part of the individual income tax because they had already been taxed at the corporate level. Limits on the offsetting of foreign income taxes against the United States corporation tax were made more stringent. Tax penalties were imposed upon the retention of earnings by corporations.

[1] The Committee for Economic Development is a private, nonpolitical organization of businessmen formed to study and report on the problems of achieving and maintaining a high level of employment and production within a free economy. Its research and policy committee issues from time to time statements on national policy containing recommendations for action which, in the committee's judgment, will contribute to maintaining productive employment and a rising standard of living. A list of members of the CED research and policy committee is attached.

These tax developments of the thirties were rationalized by their supporters in terms of the prevailing depression philosophy. With so much productive capacity idle, the problem of getting it used at all seemed, erroneously, to overshadow the problem of getting capacity increased and used efficiently. Emphasis was placed on an increase of consumers' expenditures and Government expenditures which, it was felt, would automatically bring about as much private investment as might be expected anyway. Saving was viewed as a drag upon the economy.

When World War II came we piled on top of this tax structure a set of rates dwarfing anything previously known in the United States. There was little concern with the danger that taxes would depress private investment. Restraint of private spending and investment was needed anyway, to make labor and materials available for war production. If expansion of particular munitions capacity was required the Government could take care of it, directly or indirectly.

As the end of World War II drew near, a wave of interest in tax reform arose. The wartime-tax system obviously could not and would not last. At least, this seemed obvious in 1944. People began, for the first time in many years, to look at our tax system from the standpoint of its broad effects on the economy in order to see what pattern postwar tax reduction should take. And when we did this we saw that we did not want to return to a tax system based on a depression philosophy. This philosophy had failed in the thirties, and a more detached view had revealed how weak were its intellectual foundations.

Programs of tax reform developed in 1944 and 1945 reflected the view that abundant opportunities existed for private investment to contribute to high employment and economic growth. To make the most of these opportunities, discriminatory tax burdens on enterprise would have to be reduced. More flexibility would have to be allowed to business in deciding how rapidly to charge off its capital investment, or how much of its earnings to plow back, or how it should be organized. Corporate profits would have to be treated as nearly as possible like other incomes, not taxed twice while most other income is taxed once and some is not taxed at all.

The hope that such reform would be achieved as part of a grand postwar tax reduction and tax revision was disappointed. The postwar reduction of expenditures, and therefore the reduction of taxes, turned out to be much less than had been expected. Some of the tax cuts made in 1946 and 1948 had to be restored to finance the post-Korean defense buildup. Moreover, when tax reductions were made, priority was given to popular reductions of rates and increases of exemptions rather than to reform directed at fostering the long-run growth of the economy.

This is not to say that no progress has been made since the end of World War II. For example, the excess-profits tax is out, we hope permanently. The income-tax treatment of married couples in all States has been made uniform, by the income-splitting provision. Businesses have been allowed to carry operating losses forward for a period of 5 years.

But by and large our tax system is nearly as bad and nearly as burdensome as it was 10 years ago. The standard rate of corporate-profits tax is now 52 percent, as compared with 40 percent during the war. For corporations taken as a whole, the present overall burden of taxation is nearly as heavy as it was during the war when the excess-profits tax was on. Some excises are down, as a result of the recent legislation, but others are still higher than during the war. Moreover, the rigid depreciation, the double taxation of dividends, and other repressive features of our tax system still exist.

In the pending tax proposals we have the first serious and hopeful effort to reform the Federal tax system. What can be done now is limited, of course, because we cannot afford any substantial reduction in Federal revenues. In fact, the reforms now proposed are made possible only by keeping the corporate-tax rate at 52 percent, despite the provision in earlier law that the rate should decline to 47 percent on April 1, 1954.

Even with their necessary limitations, these are important proposals, presented at a crucial time. During the earlier postwar period a fairly high rate of investment was sustained by temporary forces strong enough to overcome the obstacle of the tax system. These temporary postwar forces seem to be wearing off. It becomes increasingly doubtful that with the present tax system we can keep up the high rate of investment necessary for steady economic growth and high employment.

Moreover, we have learned that opportunities for tax reform come rarely. History shows that efforts for long-range tax reform have been frustrated by the attraction of more popular, although less beneficial, tax cuts. Tax reform then returns to its usual status of something we would like to do but cannot afford.

Four provisions of the pending proposals are particularly important for removing tax obstacles to economic growth:

1. *Depreciation.*—The tax law has always recognized that in calculating the net income of a business a deduction from receipts must be made for the decline in the value of capital assets that results from the passage of time, wear and tear, obsolescence, etc. Present tax law and regulations strictly limit the rate at which these depreciation charges may be taken. The depreciation allowed in the early years of an asset's life is often much less than the actual or probable decline in its value. This has a number of serious consequences. Businesses are reluctant to replace existing equipment with new equipment when the old still has a large value not yet written off. Also a risk is created, especially for smaller businesses, that the new equipment will lose its value as a source of income before all the allowable depreciation has been taken. Moreover, the understatement of depreciation results in an overstatement of income and therefore of tax. In effect, the business is required to pay part of its taxes earlier than they would have been due if depreciation were more reasonably calculated. This reduces the funds available for business to invest.

The proposed provision would retain the limitation that total depreciation taken may not exceed the cost of the asset. It would also retain a limit on the rate at which this depreciation may be taken. However, it would substantially relax this limit for investment in new assets after January 1, 1954, allowing more of the depreciation to be taken in the early years of the asset's life.

2. *Taxation of dividends.*—Under the tax law as it has been since 1936 corporation profits paid out as dividends are generally taxed twice. The corporation pays the corporation income tax on the profits and the stockholder pays the individual income tax on the dividends that are part of the profits. To some extent the corporation's tax may be passed on to customers in higher prices, which is itself an undesirable feature of the present tax system. But this passing-on is not complete and a very substantial element of double taxation remains.[1]

The double taxation of dividends is unfair. It is not made less unfair by the fact that many dividend recipients have large incomes. We already have a steeply progressive income tax that taxes persons with high incomes much more heavily than persons with low incomes. But there is no reason why dividend income should pay more tax than income from some other source.

Discriminatory taxation of dividends is not only unfair but also economically harmful. First, it raises the cost of equity capital (obtained by selling stock) and therefore encourages corporations to borrow rather than sell stock. This makes the economy more vulnerable to recession. Second, some corporations should not or cannot borrow (at least without selling more stock) and therefore the increase in the cost of equity capital will prevent some investment opportunities from being exploited. Third, a heavy drain is placed upon one of the main sources of investment funds—corporate profits—whether in the hands of corporations or stockholders. Fourth, potential investors are encouraged to divert funds from private productive investment into uses that yield nontaxable benefits.

The proposed provision would provide a moderate amount of relief from double taxation of dividends. A taxpayer would be allowed to exclude dividends up to $100 from his taxable income. He would also be allowed to credit against his income tax 10 percent of any dividends received in excess of $100 (but not in excess of his taxable income after exemptions and deductions).

The Committee for Economic Development has recommended in the past a different method for giving relief from double taxation. This method—the withholding plan—seems to us more logical and to have certain other advantages. However, the method proposed in the bill is administratively simple, and so

[1] It is sometimes said that double taxation is not peculiar to dividend income but happens to other incomes as well. Thus the wage earner's income is subject not only to the Federal income tax but also to Federal excises if he buys tobacco, for example, and possibly to States income taxes and local property taxes. But the dividend recipient pays the Federal excises and State and local taxes too. No matter how many layers of tax most income is subject to, dividend income is subject to one more—the 52 percent corporate profits tax that no other income pays.

long as the amount of relief given is small the difference among alternative methods is not great.

3. *Retention of earnings.*—With distributed corporate profits taxed twice there is in some circumstances an incentive to avoid or postpone the second tax by not distributing profits. To prevent this the law provides a penalty tax when profits are retained for the purpose of avoiding income tax. However, the purpose is naturally difficult to prove. Therefore, the law provides that retention of profits shall be considered to be for the purpose of avoiding income tax if the amount retained is unreasonable for the needs of the business. The burden of proof is on the taxpayer to show that the retention is not unreasonable. But the reasonableness of the retention is a matter of business judgment, often difficult to demonstrate.

The result has been great uncertainty for the taxpayer. In addition it has tended to stimulate distribution of profits in some circumstances where their retention and subsequent investment would be beneficial.

The pending provision keeps the penalty tax on corporate accumulation of earnings for the purpose of avoiding income tax. However, if the corporation claims that the accumulation is reasonable for the needs of the business the burden of proof is placed on the Treasury to show that it is not reasonable. Moreover, the concept of reasonable needs is restated to make clear that it includes "reasonably anticipated" needs.

These changes will reduce uncertainty for the taxpayer. They will increase the freedom of business decisions in those cases in which honest judgments may differ about the reasonableness of retaining profits. At the same time, the penalty will be kept for cases in which intent to avoid tax is clear.

4. *Taxation of foreign income.*—Our present tax treatment of foreign income is based on the principle of neutrality. By means of a foreign tax credit we have tried to avoid subjecting income that has been earned and taxed abroad, and then brought back to this country, to a higher total tax than would be paid on the same amount of income earned from investments made in this country. However, there are reasonable questions about the extent to which the present law and regulations do achieve complete neutrality.

Moreover, it is recognized that the United States has an important interest, from the standpoint of both national security and economic welfare, in the economic development of friendly foreign areas. Insofar as possible our contribution to this development should come about through private investment abroad. One way to stimulate private United States investment abroad would be to liberalize taxation of the income from such investment.

The provision proposed would remove one of two partially overlapping limitations on the credit for foreign taxes. It would also extend to certain categories of investment outside the Western Hemisphere the more favorable treatment now provided for Western Hemisphere investment.

These are steps in the right direction. Questions have been raised about whether they are sufficient or the best steps. These questions should be considered, especially whether it may not be desirable to go farther than is now proposed in encouraging private foreign investment. But in view of the strong national interest in encouraging foreign investment, consideration should not be allowed to defer action. We will learn from experience, and if experience shows the need for changes in the future, they can be made.

We believe that the provisions proposed with respect to depreciation, taxation of dividends, retention of corporate earnings and foreign income are generally sound. With desirable improvements, they should be put into effect.

This long tax bill contains many other features than the four we have discussed. CED has not studied them and can only comment on them in a general way.

One large group of provisions is intended to provide relief to individual income taxpayers in particular hardship situations. The deduction of the costs of child care, and the liberalization of the deduction of medical expenses are examples. The objectives sought here are commendable, and assuming that they are consistent with the Government's revenue requirements, these provisions should be adopted.

A second major group of provisions is designed to clarify the tax law, remove inconsistencies, and prevent avoidance. Qualified and objective experts have raised questions about some of these provisions, particularly those relating to corporate reorganizations, partnerships, and fringe benefits, including pensions. We have not studied these questions in detail. However, it does seem that reasonable doubt has been raised at many points about whether the proposed changes would achieve their objectives. Some new uncertainties, inconsistencies, and opportunities for avoidance may have been created in the process of removing old ones.

These questions should certainly be considered carefully, as we understand is now being done, and corrections made where study indicates the need for them. Where possible, these corrections should be made in time for inclusion in the pending bill. In some cases time may be too short for the necessary study and corrections. Where this is true the sections or chapters in question should be held back for review and existing provisions of law retained. But technical revision should not impede approval of the main provisions, which are sound and urgent.

The provisions of the pending tax bill have been criticized as representing an application of the "trickle-down" theory of economic policy. This criticism implies that large tax privileges are being given to a few in the expectations that a few drops of benefit will trickle down to the population as a whole.

This is a mistaken view.

First, the proposals for tax reform now under consideration provide much relief from taxation for individual income taxpayers of small and moderate means. Moreover, this relief is made possible now by keeping the corporate profits tax rate at 52 percent, despite the provision of existing law that would have reduced it to 47 percent.

Second, these proposals do not change our existing highly progressive income tax rate schedule, which imposes much heavier tax burdens on those with higher incomes than on those with lower incomes. They do partially correct certain situations in which double taxation or overstatement of income results in even heavier burdens than the rate schedule implies. This is not the granting of a privilege; it is the reduction of an inequity.

Third, and most important, the "trickle down" criticism denies the principle on which the American economy is organized. This is the principle that every part of the Nation has much to gain from the effective operation of every other part of the economy. The city dweller gains from the efficiency of the farmer. The manual laborer gains from the imagination and insight of the scientist. Similarly, everybody gains from the vigor of the process of enterprise and investment. All American history, with its record of the highest and most rapidly rising standard of living ever known, testifies that the gains have been a flood, not a trickle. The stimulus that tax reform can provide to enterprise and investment will sustain and swell this flow of benefit for all.

The proposals for tax reform that are now under consideration were not intended as emergency measures to correct the current economic recession. They are timely proposals and will contribute to recovery. But they are basically long-run improvements in our tax system that will serve us well for a long time in periods of good business as well as in periods of readjustment.

Whether it may be desirable to make a special reduction of taxes, to increase purchasing power as an antirecession measure, and if so what form the tax reduction should take, are questions that should be considered separately. These questions were discussed in a policy statement recently issued by CED, entitled "Defense Against Recession." It was our conclusion that in situations of serious economic decline, although not in moderate recession, a temporary tax reduction would be helpful. We suggested that if a temporary tax cut is called for as a recovery measure, an across-the-board cut in income taxes would be the most appropriate step.

We believe that the problem of antirecession tax policy deserves attention, so that we may be prepared to act if a situation arises in which such action is desirable. But it would be a serious mistake to mix up the questions of tax reform and antirecession tax reduction. This could only distract attention from the serious and difficult problems of reform and would not improve the possibility of developing a timely stabilization program.

The tax proposals now before your committee represent a mature and responsible approach to difficult questions. The economic and political problems we face in the United States have become enormously complicated, for reasons too well known to enumerate. In the solution of these problems not only progress but survival itself is at stake. We have no room left for those common features of tax discussions—dogmatism and demagoguery. Our ability to act constructively on the proposed tax reforms will be critical evidence of our ability to deal with the problems of the midtwentieth century.

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(Supplemental letter referred to on p. 778.)

NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES,
Washington, D. C., April 30, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate.

DEAR MR. CHAIRMAN: This association through my letter to you of March 30, 1954, and the statement of Marcellus C. Sheild, chairman of our legislative committee, to your committee at the hearings on April 12 last, has conveyed to you its interest in relief from the 30-percent tax on nonresident alien individuals of retired civil employees of the United States Government who are citizens of the Philippines.

Our request to your committee lies in the amendment of section 871 of H. R. 8300, or some other appropriate section of the bill, to bring relief to these alien employees retired from service of the United States who became aliens through Philippine independence which was brought about with the aid and consent of the United States.

Supplementing the letter and testimony referred to, I enclose herewith a copy of a note which has been transmitted to the Department of State on behalf of the Philippine Government in the interest of these retirees.

With assurances of my esteem and appreciation for your interest in the matter, I am

Sincerely yours,

FRANK J. WILSON, *President.*

The Chargé d'Affaires ad interim of the Philippines presents his compliments to His Excellency the Acting Secretary of State and has the honor to refer to the Embassy's note of March 6, 1953, and His Excellency's reply dated April 3, 1953, concerning the income tax imposed upon the annuities under the Civil Service Retirement Act of the nonresident, alien, retired employees who are Philippine citizens.

In the aforementioned note of the Embassy it was stated that the imposition of the Federal income tax of 30 percent on the annuities received by the Federal civil service retired employees who are Filipino citizens would work a serious hardship on them and their families.

The Chargé d'Affaires is informed that the total number of 3,052 nonresident, alien, retired employees under the Civil Service Retirement Act, 2,020 are residents of the Philippines; and of the total number of 586 survivor annuitants outside of the United States, 333 are residents of the Philippines. The average annuity of a retired employee in this category is a little over $600 a year before tax, and the average annuity for survivors is $250 a year before tax. It can readily be seen that the imposition of the 30-percent tax on these meager amounts constitutes a very heavy burden on those former employees of the United States Government and their families.

Undoubtedly the motive behind the policy to grant retirement annuities to these persons is to give partial recognition in terms of tangible benefits to their long and faithful service to the United States Government. To withhold almost one-third of the amounts authorized by law, in the form of income tax, is to that extent tantamount to defeating the very purpose of the retirement law.

Furthermore these retired employees earned the right to the retirement annuities during the time when they were not aliens to the United States.

The note of the Embassy referred to above sought the good offices of the Department of State to the end that appropriate legislation might be enacted to grant the retired employees concerned relief from the income tax of 30 percent under reference.

The Department of State evidently convinced of the merits of the case of the Filipino retired employees stated in its note of April 3, 1953, referred to above, that:

"The Department is pleased to inform the Ambassador that it is in favor of legislation similar to H. R. 8465, introduced in the 82d Congress, which would grant such former alien employees of the United States Government annual exemption of $600, if under the age of 65, and an additional $600, if age 65 or over, before application of the tax rate to the annuity income. The appropriate Department of this Government has been requested to seek reintroduction on a priority basis of the necessary legislation."

However, no bill to this effect has been introduced in Congress.

The Chargé d'Affaires would like to solicit again the assistance of His Excellency in this matter. It is believed that the desired relief could be accomplished by amending section 871 (tax on nonresident alien individuals) of H. R. 8300 now pending in Congress by exempting the Filipino retired civil-service employees of the United States Government now residing in the Philippines from the tax provided therein.

The Chargé d'Affaires would be grateful if His Excellency could see his way clear to recommending to the appropriate authorities this proposed relief.

EMBASSY OF THE PHILIPPINES,
Washington, 22, April 1954.

(Supplemental letter referred to on page 986:)

DRESSER INDUSTRIES, INC.,
Dallas, Tex., April 16, 1954.

Re Revenue Code of 1954, H. R. 8300

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee of the Senate,
Senate Office Building, Washington D. C.

DEAR SENATOR: I recently wrote you concerning changes being made in the above law which I believe are inequitable. In addition to those changes, I cannot help but feel that the proposed changes in H. R. 8300 covering the liquidation of a subsidiary (sec. 331 et seq.) are a step in the wrong direction.

I think the business of our company is representative of many companies doing business in various States and with different lines of products. As such, it has been found necessary to conduct much of our business through various wholly owned subsidiary corporations. The use of such subsidiary corporations is necessitated by various legal and practical considerations, but it is our desire, wherever and whenever practical, to liquidate these subsidiaries and thereby simplify our organizational structure. Heretofore, by virtue of section 112 (b) (6) of the Internal Revenue Code, we were able to so liquidate wholly owned subsidiaries without any gain or loss or without any change in basis of the assets. In other words, the present law recognizes that there has, in fact, been no change of any significance insofar as taxes are concerned. This should continue to be the case, for such liquidation of a wholly owned subsidiary is of no economic effect insofar as Dresser Industries or its shareholders are concerned.

Under the proposed new code, however, this simple transaction has been drastically changed. The proposed rules covering the transaction are extremely complicated. It appears, however, that, while no tax will be collected when a subsidiary is liquidated (for any gain is considered a dividend and a 100 percent dividend received credit is allowed), under some circumstances there may be a reduction in the basis of the assets arising out of the transfer. To this extent, the provisions of section 112 (b) (6) have been changed to the disadvantage of the taxpayers.

While the possibility of having a reduction in basis result from a liquidation of a subsidiary into a parent is serious, perhaps a far more serious drawback is the injection of the concept of the fair market value of the assets into the problem. Heretofore, when a wholly owned subsidiary was liquidated, no necessity was presented for establishing the fair market value of the assets. This was very important to the taxpayers for in manufacturing concerns like ours such a valuation is not easily established. Such concerns do not have a ready market, and the value thereof is a matter of opinion where experts can, and frequently do, differ. It will thus always be difficult to establish the fair market value of the assets of an operating subsidary. However, unless this can be done, it will be impossible to determine whether the fair market value of the assets is greater than or less than the adjusted basis of stock. Therefore, an area of dispute will exist as to whether a gain or a loss is to be recognized. Furthermore, in cases where gain is recognized under section 331 (b), uncertainty will exist as to the basis of the assets in the hands of the parent, for the basis will depend on whether the value of the assets exceeds the adjusted basis thereof.

The above complications are compounded when the rules with respect to appreciated inventory are considered. Here again the tax consequences depend upon the fair market value of the inventories and the fair market value of the other assets. Who can say what is the fair market value of inventories of a manufacturing concern where such inventories consist largely of work in various stages of manufacturing? I am very much afraid that the uncertainty which will be engendered if this new law is not changed will result in instances where the valuation of assets will be litigated many years after the liquidation has taken place. You may recall that under the reorganization provisions of the 1932 act the market value of the assets was a criterion in determining whether or not the reorganiaztion was tax free. We have recently experienced a situation where such a reorganiaztion took place in 1933, and both the taxpayer and the Bureau considered the value of the assets such that for 17 years thereafter both parties considered the transaction as a tax-free transaction. In 1950 the Bureau changed its mind concerning this valuation, and we thus found ourselves in 1953 engaged in Tax Court litigation, attempting to prove the value of the assets as of 1933. Such a situation is, of course, grossly inequitable; and laws which tend to create such situations serve neither the ends of justice, nor do they solve the need for revenue.

Our experience with section 112 (b) (6) of the old law leads us to the belief that it was a simple, straightforward, and equitable method of handling the problem of the liquidation of a subsidiary. The proposed new law has changed this so that in place of section 112 (b) (6) we have many highly complicated provisions which, as stated above, cannot help but spawn litigation. We therefore respectfully urge that H. R. 8300 be changed to restore the provisions of section 112 (b) (6).

We will deeply appreciate your efforts in this regard.

Very truly yours,

R. E. Reimer, *Vice President.*

Supplemental Statement Submitted by E. L. Grimes, Executive Vice Presi-
INCOME TAXES, SECTIONS 1035, 166 (F), 1221, H. R. 8300

INCOME TAXES, SECTION 1035, 166 (F), 1221, H. R. 8300

This brief is directed to and is an objection to the changes made by the above as they apply to bad debts on the foreclosure of liens of personal property.

FACTS

1. Section 1035 provides in effect that no bad-debt loss to a creditor is available where he acquires title to property previously held as security. Such bad-debt loss is postponed until ultimate disposition of the property.

2. Section 166 (f) denies a bad-debt deduction or an addition to a bad-debt reserve on all transactions above referred to under section 1035.

3. Section 1221 in defining capital assets excludes accounts and notes receivable generally but apparently makes an exception of installment obligations to which section 453 (d) applies and other obligations to which section 1035 applies (accounts and notes receivable secured by property). Under section 1035 the character of the indebtedness foreclosed upon governs as to whether the gain or loss is to be treated as a capital or ordinary gain or loss.

4. The exact extent of section 1035 as to when it does and when it does not allow a loss is unknown.

5. From the committee report accompanying H. R. 8300, it appears that section 1035 is primarily directed at property applicable to real estate involving mortgage transactions where that property is bid in at a foreclosure sale at a nominal value and a substantial bad-debt loss is taken by the creditor. The creditor then holds the property for more than 6 months, when it is sold at a figure at the equivalent of the fair value or more at that time or time of foreclosure and is, according to the decisions, treated as a capital gain.

6. Commercial Credit Co. and its banking subsidiaries, in company with other finance companies, make loans which are secured by tangible personal property pledged as collateral. Various types of instruments are used, such as conditional sales contracts, chattel mortgages, lease agreements, and trust receipts.

7. There may be several remedies available, one of which is foreclosure on property securing the contract. Would foreclosure remedy have to be employed under section 1035?

8. Because we deal in loans secured by tangible personal property, it is not always economically possible to repossess and foreclose. Does section 1035 deny loss unless such property is foreclosed upon, or, in the alternate, to take a bad-debt writeoff, do we just repossess and not commence any foreclosure proceeding in those States that allow an election of remedy for default on the contract?

9. Because of the nature of the property securing the contract which may be easily moved from place to place, it is not always possible to repossess and foreclose on the property. For example, a debtor may skip with an automobile and the finance company is unable to locate him. Because the loan is secured by a chattel mortgage would the finance company have to defer taking its loss under section 1035 until the car is located, repossessed, and disposed of?

10. Because of some legal technicality considerable time may elapse before the collateral may be disposed of, would section 1035 prohibit deducting a known loss until such collateral is disposed of?

11. The finance business does not follow the practice of bidding in property at a foreclosure sale at a nominal value to increase a bad-debt writeoff for tax purposes, then hold the property for more than 6 months and sell it at a figure greatly in excess of the bid price. This has never been available to the finance companies and is not now a practice. No finance company will hold a chattel acquired by foreclosure for as long as 6 months if at all possible before selling it.

12. As a matter of practice, except where market conditions are so depressed, the tangible property is sold almost simultaneously with the foreclosure and the amount of bad debt is determined as a writeoff at that time.

13. Any subsequent recoveries by finance companies at whatever time received in the form of salvage realized from deficiency judgments, etc., is applied to reduce the ordinary losses, or treated as ordinary income.

14. Section 166 (f) is not clear. There appears to be an implication that the reserve method for bad debts is not available on accounts and notes receivable which are secured by property.

15. Would a company dealing in loans secured by personal property, currently on the reserve method be required to change to the charge-off method?

16. Section 1221 in defining "Capital assets" excludes accounts and notes receivable generally (par. 4), but makes an exception of obligations to which section 1035 applies (accounts and notes receivable secured by property).

17. Section 1221, paragraph 4, is a new provision which excepts from the definition of capital assets accounts or notes receivable acquired in the ordinary course of trade or business for services rendered, or from the sale of property (inventory) held by taxpayer primarily for sale to customers in the ordinary course of his trade or business.

18. This section is not clear, and it appears to be rather restrictive as to the notes and accounts receivable that are to be excluded. Would notes and accounts purchased by a finance company be considered as coming under this exclusion clause?

CONCLUSION

Section 1035 should be amended by including a provision permitting a deduction for losses on notes and accounts receivable at the time a loss is ascertained without first having to dispose of the property securing the debt, when the following conditions are met:

(*a*) Accounts and notes receivable must be acquired in the ordinary course of business.

(*b*) Property securing the debt must be tangible personal property.

(*c*) Income from the accounts and notes receivable must have been treated by taxpayer as ordinary income.

(*d*) Sale of the property and any salvage or recoveries on the debt must be treated as a reduction of the loss from bad debts or as ordinary income.

Section 1221, paragraph 4, should be amended so as to broaden the accounts and notes receivable to be excluded from the definition of capital assets, to include such notes and accounts acquired in the ordinary course of business, the income from which has been treated as ordinary income, and any salvage or recovery on bad debts treated as a reduction of losses or ordinary income.

Similarly an amendment to section 166 (f) should be made permitting a provision for reserve for bad debts on accounts and notes receivable meeting the four conditions enumerated above under section 1035.

Dated at Baltimore, Md., the 26th day of April 1954.

Respectfully submitted.

Commercial Credit Co.,
By E. L. Grimes, *Executive Vice President.*

State Finance Co.,
Des Moines, Iowa, April 21, 1954.

Hon. Eugene D. Millikin,
Senate Office Building, Washington, D. C.

My Dear Senator: Enclosed I am sending you two proposed revisions of section 312 (c) of H. R. 8300 relating to the deductibility of interest on subordinated bonds.

I am enclosing a pamphlet[1] which points out the need for a change in present language of the bill in order to avoid certain hardships and inequities that would occur under sections 275 and 312 (c) and (d) as now drafted.

[1] The pamphlet referred to appears in Mr. Peterson's prepared statement, p. 1017.

The enclosed revisions would deny an interest deduction on subordinated notes held by persons who own 25 percent of more of the common stock if the total amount of subordinated notes so held exceeds 75 percent of the net worth of the corporation. This would mean that the interest on such obligations would be disallowed in all cases where the corporation is undercapitalized (sometimes referred to as "thin incorporation"). This change would prevent any interest deduction in all cases of this kind unless the stockholders have a substantial stock equity in the business equal to 133 percent of the total subordinated notes held by persons who own 25 percent or more of the common stock.

Yours very truly,

JOHN E. PETERSON.

REVISION A

Proposed revision of subsection (c) of section 312 of H. R. 8300 relating to deduction of interest on subordinated bonds if clause (2) relating to income debentures remains in the bill:

"SECTION 312. DEFINITIONS RELATING TO CORPORATE DISTRIBUTIONS

"(c) SECURITIES.—The term 'securities' means an instrument representing an obligation (or obligations) of a corporation to pay a sum certain in money on a definite maturity date or dates other than open account indebtedness—

"(1) which in the case of obligations held by persons who together own 25 percent or more of the participating stock is not subordinated to the claims of trade creditors generally;

"(2) payments, if any, for the use of the principal amount of which are not dependent in amount upon the earnings of the corporation and are unconditionally payable not later than the maturity date of the principal amount.

"(3) The provisions of (1) and (2) of this subsection (c) shall not apply to obligations which are subordinated to the claims of trade creditors generally if the total principal amount of such subordinated obligations held by persons who together own 25 percent or more of the participating stock does not exceed 75 percent of the total amount of surplus and outstanding capital stock of all classes of the corporation.

"(4) For the purpose of this subsection (c), in determining the ownership of stock and debt, section 311 shall be applicable."

REVISION B

Proposed revision of subsection (c) of section 312 of H. R. 8300 relating to deduction of interest on subordinated bonds if clause (2) relating to income debentures is to be completely eliminated.

"SECTION 312. DEFINITIONS RELATING TO CORPORATE DISTRIBUTIONS

"(c) SECURITIES.—The term 'securities' means an instrument representing an obligation (or obligations) of a corporation to pay a sum certain in money on a definite maturity date or dates other than open account indebtedness. The term 'securities' does not apply to or mean an instrument representing an obligation (or obligations) which are subordinated to the claims of trade creditors generally and held by persons who together own 25 percent or more of the participating stock if the total principal amount of such subordinated obligations held by persons who together own 25 percent or more of the participating stock exceeds 75 percent of the total amount of surplus and outstanding capital stock of all classes of the corporation. For the purpose of this subsection (c), in determining the ownership of stock and debt, section 311 shall be applicable."

Prepared by John E. Peterson of the Iowa Bar, 207 Ninth Street, Des Moines, Iowa.

(Whereupon, at 12:10 p. m., the committee recessed, to reconvene at 10 a. m., Friday April 16, 1954.)

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