TAX REFORM ACT OF 1975

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

H.R. 10612

AN ACT TO REFORM THE TAX LAWS OF THE UNITED STATES

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

PART 5

(APRIL 7, 8, 9, AND 13, 1976)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

69-460 O WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $3.60

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TAX REFORM ACT OF 1975

WEDNESDAY, APRIL 7, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met 10 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Gravel, Bentsen, Fannin, Hansen, and Packwood.

The CHAIRMAN. This hearing will come to order.

I will call the first witness, Hon. Dewey F. Bartlett, U.S. Senator from Oklahoma.

We are happy to have you here before our committee today and we will be glad to hear your suggestions.

STATEMENT OF HON. DEWEY F. BARTLETT, A U.S. SENATOR FROM THE STATE OF OKLAHOMA, ACCOMPANIED BY THOMAS BIERY AND LEE ROOKER, PROFESSIONAL STAFF ASSISTANTS

Senator BARTLETT. Thank you, Mr. Chairman.

I have Mr. Thomas Biery and Mr. Lee Rooker of my staff with me, if that is permissible.

Mr. Chairman, I seem to be doing a lot for the paper industry. I know you have a lot of trees in your State, Senator Packwood does, I know. However, I will confine myself to the summary remarks which are only about 8 pages.

I will summarize the first page which mentions information you, Mr. Chairman, and members of the committee are very familiar with. Two major energy bills enacted during the first session of this Congress, the Tax Reduction Act of 1975 and the Energy Policy and Conservation Act of 1975 have removed substantial capital from the petroleum industry, about $4.5 billion annually. This has resulted in reduced activity.

Our reserves are dropping off; production is dropping off. Therefore, now is not the time to reduce further the availability of capital in the petroleum industry. It is time to produce new means of capital formation which will not only offset the effects of the two damaging recent laws, but also result in sufficient additional capital to provide for our future energy needs.

Mr. Chairman, I am on page 2, about halfway down now. I am talking about intangible drilling costs.

Under existing law intangibles may be expressed for Federal income tax purposes in the year spent. The House bill proposes to limit for independent producers the intangible drilling cost deduction in any year to the net related income from a property.

This would have negative effects on domestic oil and natural gas production.

It would severely hamper the ability of independent producers to acquire investment capital from outside sources.

It would encourage the abandonment of marginal wells on new or low-income properties.

It would cause active oil and gas operators to lengthen normal drilling schedules.

If the House IDC proposal is enacted, fewer oil and gas wells will be drilled and hence there will be less production. These negative effects of the House IDC provisions would be magnified if more restrictive language is adopted, for example, if intangible expenses are to be capitalized entirely.

Current expensing of intangible drilling costs is the sensible way to encourage expenditures which would ultimately benefit the Nation. Rather than reduce the incentive for oil and gas production I suggest to the committee that it expand the IDC concept to include other types of oil and gas expenditures, like geological and geophysical expenditures.

MINIMUM TAXABLE INCOME

Expansion of the minimum taxable income concept to include intangible drilling expenses in the list of preference items to be subject to a minimum tax would be counterproductive to our Nation's energy goal, because it would encourage producers not to make drilling expenditures which would be subject to the minimum tax. If producers are willing to make expenditures which could result in increased domestic oil and gas production, we should encourage them by so designing our tax laws. Expanding the MTI, minimum taxable income, to include intangible drilling expenses would be a step backward.

PERCENTAGE DEPLETION

Congress voting last year to eliminate the oil and gas percentage depletion allowance for major oil companies was inadvisable and counterproductive. Reinstating percentage depletion for all oil and gas producers would be a big step toward energy independence.

Even though depletion was repealed for the majors, Congress did vote to retain it for independents and landowners. Because of technical problems in the independent producer exemption, however, a number of independents also lost the percentage depletion allowance. I do not believe this was Congress' intent.

The troublesome provisions involve the 65 percent of taxable income limitation, the retailer provision and the transfer of property provision.

The text of a bill I shall soon introduce, which addresses these problems, is attached to my statement. I will probably introduce this tomorrow.

Under current law percentage depletion is limited to 65 percent of taxable income. This is a disincentive to the active driller because he loses depletion if he drills enough wells—either exploratory or development—to reduce taxable income below about one-third of gross. Our energy tax laws should be designed to encourage drilling expenditures.

I suggest, therefore, that the limitation be retained but that taxable income for the purposes of applying the 65 percent be computed without deducting dry hole and intangible drilling expenses.

The "retailers excluded" provision was intended to prevent major oil companies from retaining depletion. However, it has actually caused many independents to be denied depletion also. I do not believe this was Congress intent. I suggest combining the "certain refiners excluded" and the "retailers excluded" provisions so that a producer would retain depletion to the extent permitted in the statute unless he was both a refiner and a retailer.

The "transfer of property" provision prohibits the transfer of an oil or gas property from receiving depletion even if the owner was otherwise qualified under the exemption. It discourages transfers which have historically helped independents in their drilling and production efforts. I believe Congress intent with this provision was to prevent a producer from circumventing the exemption by transferring properties so that he could receive more depletion than permitted.

I, therefore, suggest that the transfer provision be written so that transfers for bona fide business purposes can take place and that only those transfers which have the effect of circumventing the exemption would lose depletion.

We come now to capital formation.

This country desperately needs to institute new methods of capital formation for energy. The most direct way to provide for this is to decontrol the prices of both crude oil and natural gas, and I know this committee is well aware of that.

This would have the dual advantages of decreasing demand for energy and increasing supply. As long as crude oil and natural gas prices are controlled, our producers will be selling their reserves at prices below what is required to replace them. This can only result in a continual decline in our crude oil and natural gas production.

As we all know, however, all crude oil prices are controlled, and natural gas deregulation remains doubtful.

Absent decontrol of prices, other methods of capital formation will have to be implemented soon to prevent further deterioration of our domestic energy supplies. A reasonable way to do this is through our tax laws.

I would like to suggest for the committee's consideration a new procedure in which a portion of the income from oil- and gas-producing properties would be taxed as capital gains. This would have several advantages. One, it would tend to encourage a producer to be successful and efficient. Two, it would not only provide more capital for future investment, but would also attract capital to energy development projects. Three, it would encourage producers to develop and produce properties rather than to sell them as capital gains.

Other methods to provide more capital for energy development would be to permit exploratory and development drilling, geological and geophysical, and lease acquisition costs to receive the investment tax credit, or to provide for a more rapid writeoff of currently depreciated and cost-depleted items.

The need for additional capital in the energy industry is clear, not to benefit the industry, but to enable the industry to find and produce energy for the good of the country.

I sincerely hope this committee will address this problem and propose an innovative tax procedure which will increase, not decrease, the capital and incentives for oil and gas and other energy development.

Next, I would like to discuss the necessity for major reforms in the Federal estate tax.

ESTATE TAXES

On January 27 of this year I introduced S. 2885, legislation designed to increase the current estate tax exemption of $60,000 to $400,000.

In real terms $400,000 today is approximately the equivalent of the $100,000 exemption Congress voted in 1939. I think that is rather amazing. It came out $399,000-plus. We arrived at the current, completely inadequate $60,000 figure in 1942 when Congress temporarily reduced the $100,000 exemption in order to produce more income during World War II. To retain the $60,000 exemption of the 1942 act is, in 1939 dollars, equivalent to reducing the original $100,000 exemption to $15,000 as of the end of 1975.

ALTERNATE VALUATION OF FARMLANDS

Our current estate tax laws also force many acres of useful farmland out of production each year by appraising the value of that land at its anticipated market price—rather than on its ability to produce crops or livestock. Such as appraisal formula is blatantly unfair, and year after year costs this Nation more of its productive farmland.

S. 2885 would change the method for evaluating family farms from potential to actual use, based on the continual use of the land during the preceding 60 months.

WIDOW'S TAX

Another major problem with our estate tax system is that it is one of the most discriminatory in the entire Tax Code, particularly in relation to what is commonly called the "widow's tax." If an estate is held in joint tenancy by a husband and wife and the wife dies first, the tax imposed on her estate is based on an arbitrary decision that she has contributed very little to the actual fair market value of the property.

However, if the husband dies first, the Code works in reverse. That is to say, a major portion of the contribution is attributed to the husband and, therefore, the estate is determined to include an amount far in excess of 50 percent of the fair market value of the property.

The Code does not recognize that the wife, even though contributing labor and other necessities for a household, has contributed anything to the value of the jointly held property. This is particularly true with regard to the farm wife.

I have prepared for introduction legislation which would make three major changes:

First, it will provide a marital exemption of $100,000.

Second, it will add an off-the-top exemption of the principal residence of the couple.

Third, it provides a grace period of 5 years with no interest before the surviving spouse must begin to pay the taxes.

Mr. Chairman, I thank you.

The CHAIRMAN. Senator, I agree in the main with what you had to say about the energy industry. I know for the large companies the rule of thumb seems to be that for every dollar of cash flow that they have after taxes they tend to plow $2 back into trying to produce more energy and to refine it and get it to the public.

Now, you have referred to a situation regarding the major companies which was not as high a figure as you mentioned, that indicated the Congress reduced their cash flow by $2.5 billion.

Now the rule of thumb in that respect means then that that would reduce their activities of bringing the public more energy by $5 billion. That is very, very counterproductive and that, as much as any single thing, helps to explain why our situation gets worse and worse. If there had been no Congress here, and the price of the foreign oil went up, the domestic oil would have gone up. It would have been profitable to be in that business; everybody would have wanted to get into it. Those not in it would have tried to get into it, and those making money would have been seeking to plow it back in order to make more.

That is what is known as the free flow of capital, which is sophomore economics. Without the aid of Congress, just by the natural law of economics, the free flow of capital would have solved the problem for us within 10 years at the outside.

As it is, however, after the 10 years is over with, we will have succeeded in making this country almost completely hostage to the OPEC cartel, completely at their mercy, making the situation worse and worse, first by doubling their tax; second, by rolling back their price—the foreigners get their price because this Government can't control that price—and third, by passing a law to force the automobile companies to build smaller automobiles that they can't sell.

Why would anybody want to buy a small automobile and do without the air-conditioning, the power seats, the power windows, the power——

Senator BENTSEN. Ashtrays.

[Laughter.]

The CHAIRMAN. Yes, ashtrays.

Why would they want to do that facing the prospect of 51-cent-a-gallon gasoline?

Senator BARTLETT. I certainly agree with the chairman and I think it is important. I think all of us have had people ask us about how you break the OPEC cartel if it doesn't fall apart of its own weight. I personally don't think there is a chance of that with our current policies; but the only way I think we can do it is by concerted effort in this country and elsewhere with the American companies to expand their operations domestically and worldwide.

The large companies drill about one-quarter of the wells and find half the oil. The independents drill three-quarters and they find the other half. We need to go all-out in all directions and the tax laws that affect this rate of drilling and exploration, of course, are before this committee. They affect our American companies, domestically and worldwide both. This is something the chairman knows better than I.

So I think the opportunities of this committee are tremendous and I hope you will provide what is needed in the way of leadership in energy.

The CHAIRMAN. I will do whatever I can in my capacity as one Senator, but I must admit, while I have to try to provide leadership toward energy sufficiency, I am frustrated by those that want to nationalize that industry, Senator. That is the only explanation I can give to the course of events that has transpired, assuming that if we would like to see us be self-sufficient, I don't see how you can double the tax, roll back the price and do the things that have been done to the industry if you expect the industry to double or even make a major increase in its production.

It will have to be more profitable rather than less profitable to be able to do that.

Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. I have no questions, Mr. Chairman.

Thank you, Senator Bartlett, for a very perceptive presentation this morning. I have an idea that in this election year your advice and your observations are going to fall on ears that are not tuned into your voice, but rather the voices of other people around the country because it is a popular thing these days to play the role of Robin Hood, to find first some strawman, you know, that is the rich guy, and corporations obviously are such targets, and to tell the people that you think may be persuaded by your rhetoric that there are great things in store for them. That you are going to pay for all these deals by closing up so-called tax loopholes. As the chairman has implied, the Congress has allowed this to occur by making absolutely essential the transfer of more and more dollars to foreign countries, which as you say have their hands around our throats and could shut off our wind any moment.

I am deeply concerned about this, as I know the chairman is. It is just too bad that that is the way it is, but the desirability of being elected and saying appealing things to people and putting up straw men that can be struck at and struck down while you are championing the role of the guy who by comparison feel's himself to be underprivileged or disadvantaged, is an appealing one.

Thank you for coming.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. As to what the Senator from Wyoming has said, I would agree with him. I would just like to ask one question.

I first want to commend the Senator from Oklahoma for an excellent statement, for the recommendations that he has made and for the great work he has done in preparing the legislation that will be introduced.

I would like to discuss one subject on the estate tax exemptions. You recommend going to $400,000. This is quite a jump, going from $60,000 to $200,000, and it would cost $2.1 billion, I understand. Would the Senator feel that maybe this could be phased in over a period of several years rather than trying to take that much revenue out at one time?

Senator BARTLETT. Yes, I think that that would be a sensible way to approach it. I think it would take about $3.1 billion at the $400,000 level.

The reason we did this, I would say to the Senator from Arizona, is that this is just what it figures out, with inflation going back to the original $100,000. It came to $399,000-plus, so I agree with the Senator that it would be important to phase this in.

Senator FANNIN. Well, I am not disagreeing with the equity that is involved in the recommendation, but I am concerned about what we do as far as that loss of revenue. You have made an excellent presentation and certainly you have brought out the legislative history of this area of the Nation's tax laws. At one point the estate tax exemption was $100,000 but was "temporarily" reduced to $60,000 and has remained at that figure ever since.

Thank you, Senator.

Senator BARTLETT. If I could have 15 seconds, Mr. Chairman. The equity on the other side is more than dollars. I think it is in the loss of the family farm and family ownership generally.

Senator FANNIN. Certainly, the Senator from Arizona understands and wholeheartedly agrees. It has been unfair, it has been disastrous to many families for many years throughout this Nation. Certainly with the inflation that we have had it continues to even worsen and if we don't take action, it is going to be even more difficult.

Thank you, Senator. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. I share Senator Bartlett's concerns. You are carrying coals to Newcastle as far as I am concerned. I want to commend you for this effort.

Senator BARTLETT. Thank you.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Thank you.

I share the Senator's concern as do other members of this committee. Out of the energy legislation this Congress has passed in the past couple years, about the only shortage involved has been the drilling rig shortage, and drilling pipe shortage.

[Laughter.]

Senator BARTLETT. Yes, I think there are about 500 drilling rigs stacked now, 450 to 500.

Senator BENTSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Before this group here you are sort of like the preacher who was upbraiding his congregation for the fact that many people stayed home and didn't come to church. The people he was talking to were the ones who came, so that I would hope that you would direct your endeavor to some of those who don't share your views because we need to convert a few more to the position you are expressing here. I find great sympathy for it.

Thank you.

Senator BARTLETT. I will try to talk to them, too.

Thank you, Mr. Chairman.

[The prepared statement of Senator Bartlett follows. Oral testimony continues on p. 2038.]

TESTIMONY BY SENATOR DEWEY F. BARTLETT

I appreciate this opportunity to comment on some of the important tax issues before this Committee. My statement today will concern energy taxes and estate taxes.

ENERGY TAX LEGISLATION

This statement on energy tax matters concerns the intangible drilling cost deduction, the minimum taxable income proposal percentage depletion, and other methods of capital formation for energy.

BACKGROUND

Before I address specific energy tax issues, I would like to reflect generally on what recently enacted energy legislation is doing to our country's efforts to increase domestic oil and gas production.

Two major bills affecting oil and gas producers were enacted during the First Session of this Congress. One, the Tax Reduction Act of 1975, repealed percentage depletion for all integrated producers and either limited it or eliminated it for the independents. Because of this bill, investment capital of oil and gas producers was reduced about 2.5 billion dollars annually. Two, the Energy Policy and Conservation Act of 1975 placed all crude oil prices under controls and rolled back the prices of the 40 percent of domestic production which had previously been sold at free market prices. Like the Tax Reduction Act, the EPCA removed substantial capital from the petroleum industry, about 2 billion dollars, and simultaneously, because of the nature of the composite pricing scheme, placed an inflexible upward limit on the total revenues to be generated from domestic crude oil production.

Exhibits I and II, attached to this statement, were prepared by the Federal Energy Administration and show recent trends in drilling rig activity and geophysical activity and also the timing of recent changes in energy price and tax laws.

After 16 years of continual decline, drilling activity began to increase in 1971 when crude oil prices increased slightly. The rate of increase became more rapid in late 1973. Normally there is a noticeable surge in activity at year-end followed by a drop at the first of the new year. However as shown on Exhibit I, in the 1973–1974 and 1974–1975 periods this did not occur, presumably because of the strong demand for rigs resulting from the uncontrolled price for "new" crude.

In fact, in early 1975 there were indications that drilling activity would not drop much after the first of the year. It was as high in March as it was the previous December. But with the passage of the Tax Reduction Act, drilling activity dropped and remained realtively constant for much of the year below what it would have been had the percentage depletion allowance not been eliminated.

Since the Energy Policy and Conservation Act became law last December, there has been a rapid and continual decrease in drilling activity. At about the time the EPCA was signed there were over 1800 rigs actively drilling; the figure for last week was 1526. Currently, fewer rigs are operating than at any time in 1975. Considering that there are now over 2060 drilling rigs available, it is clear that our current efforts are falling far short of what they could be if all available equipment were employed. The simple facts are obvious: Congress has shut down rigs that could be out searching for oil and gas; Congress has seriously shackled the oil industry, limiting its efforts to achieve energy independence; and Congress has prescribed an insidious energy plan of greater dependence on the OPEC nations.

The seismic crew count on Exhibit II shows a similarly alarming trend. The number of active crews has declined continuously since the peak in mid-1974. Because seismic activity is necessary to develop the exploratory prospects to be drilled several years hence. This means that our inventory of well-defined exploratory prospects which could be drilled in the future is becoming smaller and smaller. Seismic activity is a glass ball look at future exploratory successes.

All this portends a dismal future for our country's oil and gas supplies. Our nation's natural gas producing rate has dropped 12 percent since the peak in 1973, and our oil producing rate has declined 15 percent since the peak in 1970. These production declines and an expanding economy have precipated since 1971 an increase in imports of approximately 100 percent to an average of 40 percent of consumption. Several weeks ago petroleum imports exceeded domestic crude oil production for the first time in our history.

Our crude oil producing rate and our natural gas producing rate continue to decline and show no signs of even leveling off. The United States is more vulnerable to an oil embargo now than in 1973. Our imports from OPEC have increased 20 percent since 1973.

For the United States to be even 40 percent dependent on foreign petroleum is bad from a national security standpoint. Not too many years ago, at a time when there was excess domestic productive capacity, we limited imports to 10 percent for national security reasons; now we blindly accept 40 percent and seem to be steering ourselves to even greater dependence. Most of our NATO allies are more vulnerable than we are. Previously we had the ability to help them out if petroleum supplies were cut off; now we could not even supply all our own needs let alone some of theirs. Consider, for instance, how a limited scale war in the Middle East or another protracted embargo could affect the supply of petroleum to meet the needs of the United States, European nations and the NATO defenses. We find ourselves in a precarious situation; fortunately, with time and proper federal energy policies, it does not have to be permanent.

When Congress passed the EPCA, an upward limit on the revenue generating capacity for the producing segment of the petroleum industry was established for at least 40 months, and probably longer than that. I refer to an upward limit because the EPSA places no controls on costs and because recent inflation in the petroleum industry has been much greater than for the economy as a whole—averaging about 30 percent per year. Producers are therefore unable to recover in the market place the higher costs of operation. The resultant level of capital generation is neither adequate to utilize fully all available drilling and seismic equipment nor to spawn an increase in the population of that equipment which would be necessary to support a drilling effort of the magnitude capable of solving our energy problems.

It is in this environment that I believe this Committee should consider energy tax legislation. This is not the time to reduce further the availability of capital for the petroleum industry. Rather it is the time to develop new means of capital formation which will not only offset the effects of the two damaging recent laws, but also result in sufficient additional capital formation to provide for our future energy needs.

What are the future needs for capital in the domestic petroleum industry and what is the industry's present ability to acquire that capital?

The Chase Manhattan Bank has recently completed an analysis indicating that for the period 1975–1985, if this nation is to be 40 percent dependent on foreign oil in 1985, domestic investments totaling $240 billion in non-inflated 1975 dollars would be required. At 5 percent inflation this figure is $315 billion, and at 10 percent it is $430 billion. Based on historical capital investment patterns, recent domestic profits and current price and tax laws, it would seem that under current restrictions, an annual capital spending level of about $14 billion could possibly be sustained. I consider this an optimistic spending estimate because prices are controlled and costs are not and because oil field inflation has been in excess of 5 or 10 percent per year. If this spending level can be maintained during the next 10 years, total expenditures would be $140 billion, far short of the $240 required to keep us only 40 percent dependent if there is no inflation at all.

This Committee has an opportunity, and I believe a responsibility, to propose tax legislation which would truly serve our nation's future best interests. Increasing capital availability and hence expenditures for oil and gas exploration and development are essential to our future.

If this is a desirable goal, the proposals to limit the intangible drilling cost (IDC) deduction and to expand the minimum taxable income (MTI) concept taken in H.R. 10612 are counter productive, jeopardize our ability to survive as a free nation, and should go no further than this Committee.

INTANGIBLE DRILLING COSTS

Under existing law an intangible is identified as any cost incurred which in itself has no salvage value and which is necessary for the drilling and the preparation of wells for the production of oil and gas. Intangibles may be expensed for Federal income tax purposes in the year spent.

Basically the House bill would limit for independent producers the intangible drilling cost deduction in any year to the net related income from a property.

This would have several negative effects on domestic crude oil and natural gas production.

For those independent producers who normally attract investment capital from sources outside the oil industry, it would severely hamper the ability of those operators to acquire investment capital.

Investors who would want to invest in an exploratory drilling venture are generally in high incremental tax brackets. They are willing to make the investment because some tax shelter is provided regardless of whether or not the exploratory well is successful. By limiting the IDC deduction for a successful well to the income from the property, much of the tax advantage for making the oil and gas investment is lost. The likely result is to dry up outside sources of capital for oil and gas investment and hence to reduce drilling.

For those independent operators who do not use outside capital, the proposed changes in the IDC deduction would have other adverse effects.

For example, the proposed limitation would encourgae the abandonment of marginal wells on new or low income properties because the tax savings from writing off a dry hole could be of greater value to the producer than completing the well and receiving little or no profit and no tax savings. If producers abandon marginal wells because of the IDC "reforms," millions of barrels of reserves could remain in the ground.

The House-passed language would cause active oil and gas operators to lengthen normal drilling schedules, especially near the end of the tax year. If an operator had planned to develop a property which had little or no current income, he would be encouraged to postpone his development operations until the first of the next year so that the intangible develoment expenses could be written off against the income derived from the wells drilled. Again, if we are trying to maximize domestic oil and gas production, changes in the IDC taxation are counter-productive.

There are other problems with the House-passed language. The deduction is permitted on a successful exploratory well if it is more than two miles from the nearest producing well or if it is closer than two miles and the producer can prove that it penetrates a new reservoir. Presumably this would apply both horizontally and vertically. Because a producer does not know if a new reservoir would be discovered until after he drills and tests a well, he would tend to make investment decisions assuming the well would, in the end, not qualify as an exploratory well. A study by a Dallas consulting firm indicates that 92 percent of all exploratory wells drilled in Texas in 1974 were within two miles of the nearest field. Thus in the vast majority of cases the producer would not know prior to drilling whether he would be able to deduct IDC expenses if his exploratory well was successful. Other technical problems with the House provision and their likely ramifications are detailed in a letter from Mr. Lee Keeling, a well respected petroleum consultant from Tulsa, Oklahoma. This letter is attached as Exhibit III.

Of course, the negative effects of the House IDC provisions would be magnified if more restrictive language is adopted, for instance, if intangible expenses are to be capitalized entirely.

If this occurs, I believe many independents would be taxed out of business. It has been argued that capitalizing normal IDC expenditures would only postpone the receipt of tax benefits because once the unamortized IDC base is built up the total tax deductions would be the same as now. In the meantime, producers could borrow the deficit to make up the difference. There are several problems with this argument.

First, during the period when the IDC base is being accumulated, much of the income from current production which producers would normally use to build up the IDC base would be taxed away. Wells would therefore not be drilled that could be drilled.

Second, the present value of an immediate tax deduction offsetting income from other properties is better than that of an extended tax deduction. Thus, drilling ventures which are marginal under the existing tax laws would very likely become uneconomic under the new system.

Third, outside sources of equity capital would become even more limited than previously described.

Fourth, I do not believe banks would be inclined, in the majority of development situations, to lend money because of the high risk associated with many oil field development projects. Banks do not lend money until a significant number of reserves have been proved and normally require development wells to be drilled to prove the reserves.

Because of each of these there would be reduced investment in oil and gas drilling at a time when a sharp increase of investment is needed. Current expensing of intangible drilling costs is a sensible way to encourage expenditures which would ultimately benefit the nation. The producer is not permitted to deduct more than he spends. If he makes drilling investments, he is permitted only to recover that expenditure quickly by rapid write-off.

Rather than reduce the incentives for oil and gas drilling, I suggest to the Committee that it expand the IDC concept to include other types of oil and gas expenditures. Specifically, geological and geophysical expenditures which are normally capitalized would be a reasonable extension of the IDC tax concept. An immediate deduction of geological and geophysical expenses would encourage these expenditures and help to reverse the declining trend in seismic activity to which I previously referred.

MINIMUM TAXABLE INCOME

Expansion of the minimum taxable income concept to include intangible drilling expenses in the list of preference items to be subject to the minimum tax would again be counterproductive to our nation's energy goals because it would encourage producers not to make drilling expenditures which would be subject to the minimum tax. The reason why these expenditures would not be made is that the producer, in many cases, would not be able to fully deduct his total expenditure. Thus, through the minimum tax, the assets of the producer would be confiscated.

I want to emphasize that increasing the tax burden of oil and gas producers so that oil and gas producers would pay more tax is an illogical way to approach our energy problems. If producers are willing to make expenditures which could result in increased domestic oil and gas production, I think we should encourage them by so designing our tax laws. Expanding the MTI to include intangible drilling expenses would be a step backward.

PERCENTAGE DEPLETION

I recognize that Congress voted to eliminate the oil and gas percentage depletion allowance for major oil companies when the Tax Reduction Act was passed. In my opinion, this action was inadvisable and counterproductive; and if percentage depletion were reinstated, it would be a big step toward energy independence. This Committee should reinstate the depletion allowance or pass similar legislation.

Even though depletion was repealed for the majors, Congress voted to retain it for independents and landowners. Unfortunately because of the technical problems of quickly drafting complex tax legislation, a number of independent producers also lost the percentage depletion allowance. I do not believe this was Congress' intent.

The troublesome provisions involve the 65 percent of taxable income limitation, the retailer provision, and the transfer of property provision.

Attached to this testimony as Exhibit IV is the text of a bill I shall soon introduce which addresses these problems. My rationale behind its major provisions is as follows:

LIMITATION ON TAXABLE INCOME

Under current law, percentage depletion is limited to 65 percent of taxable income. This is a disincentive to the active driller because he loses depletion if he drills enough wells (either exploratory or development) to reduce taxable income below about one-third of gross. Our energy tax laws should be designed to encourage drilling expenditures. I suggest, therefore, that the limitation be retained but that taxable income for the purposes of applying the 65 percent be computed without regard to dry hole expenses and intangible drilling expenses.

RETAILERS EXCLUDED

The "Retailers Excluded" provision was intended to prevent major oil companies from retaining depletion. However, it is written very broadly and has actually caused many independents to be denied depletion also. I do not believe this was Congress' intent. Although there may be other acceptable solutions, I suggest combining the "Certain Refiners Excluded" and the "Retailers Excluded" provisions so that a producer would retain depletion to the extent permitted in the statute unless he was both a refiner and a retailer.

TRANSFER OF OIL OR GAS PROPERTY

Finally, the "Transfer of Property" provision prohibits the transferee of an oil or gas property from receiving depletion even if he was otherwise qualified under the exemption. I believe Congress's intent with this provision was to prevent a producer from circumventing the exemption by transferring properties so that he could receive more depletion than permitted. Congress's intent was not to discourage transfers of oil or gas properties which have historically taken place for estate planning, financing, and other normal business reasons other than percentage depletion taxation. I suggest that the transfer provision be written so that normal transfers can take place and that only those transfers which have the effect of circumventing the exemption would lose depletion.

CAPITAL FORMATION

In the first part of my statement I endeavored to show why this country desperately needs to institute new methods of capital formation for energy.

Notwithstanding recent Congressional action, the most direct way to provide adequate capital for energy development is to decontrol the prices of both crude oil and natural gas. This would have the dual advantages of decreasing demand for energy and increasing supply. There is no logical justification for an energy policy in which foreign producers are paid more than are domestic producers. As long as crude oil and natural gas prices are controled, our producers will be selling their reserves at prices below what is required to replace them. This causes a deterioration of our reserve base to a point where production rates decline. We reached that point three years ago with natural gas and six years ago with crude oil.

We have done absolutely nothing to correct this situation. As we all know, all crude oil was placed under price controls with the passage of the EPCA last December, and the fate of legislation to deregulate new natural gas remains doubtful.

Absent decontrol of prices, other methods of captal formation will have to be implemented soon to prevent further deterioration of our domestic energy supplies. I am extremely concerned that Congress's failure to deal effectively with this problem will have serious negative repercussions on our domestic economy and national security.

Because producer incomes are controlled under present law while operating costs are not, a reasonable and perhaps the only way to provide additional capital is through a tax reduction. In designing a tax system which would provide more capital for investment in oil and gas and other resource development, this Committee should keep in mind that the desired objective is greater domestic oil and gas production.

I would like to suggest for the Committee's consideration a new procedure in which a portion of the net income from oil and gas producing properties would be taxed as capital gains. This would have several advantages: One, it would tend to encourage a producer to be successful and efficient. Two, it wou'd not only provide more capital for future investment but would also attract capital to energy development projects. Three, it would encourage producers to develop and produce properties rather than sell them as capital gains.

At any time after a discovery is made on a property and the reserves proven, a producer has the option to produce it or to sell it to someone else. If he holds the property for more than six months, the gain on the property (sales price less costs) would be taxed as capital gains. The purchaser of the property would in turn be able to capitalize the purchase price of the property and deduct it as cost depletion. A producer should be encouraged to continue to develop and to produce rather than to sell to benefit from capital gains tax treatment.

Further, considering that the producer could sell the property as a capital gain, it would seem that a portion of the income derived from the sale of oil or gas from the property, if he chose to produce it, should be considered the sale of his capital asset and thus should not be taxed as normal income.

Another plus for this proposal is that it does not involve a deduction. It merely provides consistent tax treatment for the portion of a producer's revenue which is in reality the sale of an asset.

There are methods other than this capital gains procedure which would provide more capital for energy development. Including exploratory and development drilling, geological and geophysical and lease acquisition costs, as expenditures receiving the investment tax credit is one possibility. Providing a rapid write-off of currently depreciated and cost depleted items is another.

The need for additional capital in the energy industry is clear, not to benefit the industry, but to enable the industry to find and produce energy for the good of the country. I sincerely hope this Committee will address this problem and propose an innovative new tax procedure that will increase, not decrease, the capital and incentives for oil and gas and other energy development.

ESTATE TAXES

I am pleased to note that the Administration has emphasized the need for farm estate tax relief. This is a matter which deserves the immediate attention of this Congress.

On January 27 of this year I introduced S. 2885, legislation designed to increase the current estate tax exemption of $60,000 to $400,000. This would be the first upward readjustment of the estate tax since 1939. It is time we acted to stem the tide of the ravaging effect of inflation on farmland prices which has been allowed to force the sale of small family farms in order to pay these taxes.

My basis for proposing this legislation is as follows. In real terms $400,000 today is approximately the equivalent of the $100,000 exemption Congress voted in 1939. We arrived at the current, completely inadequate, $60,000 figure in 1942 when Congress temporarily reduced the $100,000 exemption in order to produce more income during World War II. As with so many other temporary governmental actions, it is still in effect some 34 years later. To retain the $60,000 exemption of the 1942 Act is, in 1939 dollars, equivalent to reducing the original $100,000 exemption to $15,000 as of the end of 1975. This is totally inadequate and should be corrected. (See appendix I)

ALTERNATE VALUATION OF FARMLANDS

Our current estate tax laws also force many acres of useful farmland out of production each year by appraising the value of that land at its anticipated market price—rather than on its ability to produce crops or livestock. Such an appraisal formula is blatantly unfair, and year after year costs this nation more of its more productive farmland.

S. 2885 would change the method for evaluating family farms from potential to actual use, based on the continual use of the land during the preceding 60 months. Land on the edge of Oklahoma City, Minneapolis, Omaha, or any other metropolitan area which is being farmed should not be appraised for estate tax purposes on its value as a new housing subdivision. Passage of S. 2885 would prevent this from happening in the future.

WIDOW'S TAX

Another major problem with our estate tax system is that it is one of the most discriminatory in the entire Tax Code, particularly in relation to what is commonly called the "widow's tax." If an estate is held in joint tenancy by a husband and wife and the wife dies first, the tax imposed on her estate is based on an arbitrary decision that she has contributed very little to the actual fair market value of the property. However, if the husband dies first, the Code works in reverse. That is to say, a major portion of the contribution is attributed to the husband, and therefore, the estate is determined to include an amount far in excess of 50 percent of the fair market value of the property. The Code does not recognize that the wife, even though contributing labor and other necessities for a household, has contributed anything to the value of the jointly held property. This is particularly true with regard to the farm wife.

The farm wife not only cooks the meals and runs the household, but also drives the truck or tractor, helps with the care and feeding of the livestock, assists in the plainting and harvesting of crops and, as such, is indispensible in the successful operation of the farm. Unfortunately, none of this is considered a contribution to the farm as far as estate taxes are concerned. If the husband performs these functions, it is considered a contribution, but not so with the wife. Gentlemen, this is rank discrimination, and it has no place in our laws.

I have prepared for introduction legislation which would make three major changes:

First, it will provide a marital exemption of $100,000.

Second, it will add an off-the-top exemption of the principal residence of the couple.

Third, it provides a grace period of 5 years with no interest before the surviving spouse must begin to pay the taxes.

Because estate tax revision is long overdue, this Congress should significantly correct the existing inequities.

Mr. Chairman, I appreciate the opportunity to appear before the Committee today. I am submitting a written statement which elaborates the arguments I have made here and presents, for your consideration, a discussion of other problems.

TAX ON PRIVATE CHARITABLE FOUNDATIONS

In 1969, Congress enacted a 4 percent tax on private foundations. The tax was proposed as an estimated offset to the cost of the Congressionally mandated auditing and review of private foundations.

As many members of the Committee are aware, the 4 percent tax has been raising much more money than is necessary to offset the cost of the audits. At the same time, it is proving to be a substantial hardship for a sector of the economy which is attempting to solve problems through private initiative. Congress should be doing everything possible to promote private leadership in the areas of health, education, and concern for fellow human beings; instead, we are burdening these efforts with a tax. I urge the Committee to adopt legislation similar to that which both Senator Hartke and I have introduced to reduce the auditing tax to 2 percent.

Also, I would like to bring to the Committee's attention a problem faced by the Sand Springs home, of Sand Springs, Oklahoma and I'm sure by many similar institutions throughout the country. The Sand Springs Home is operated by the Oklahoma Masons. Because it is operated by a fraternal organization, the home is classified as a private foundation, and it must pay the auditing tax I have just discussed, whether it is 4 percent or 2 percent. Now, if this home were operated, instead, by a labor union or a civic club, it could qualify as a charitable organization and be exempt from the requirements imposed on private foundations.

I bring to the Committee's attention the request by the Sand Springs Home that this Committee adopt legislation to allow similar institutions which are operaed by fraternal organizations to be classified as charitable institutions. Presently pending in the House of Representatives is H.R. 5815. This bill is identical to H.R. 2258 of the 93rd Congress, which received the approval of the administration on December 10, 1973. I refer the Committee to Exhibit 5 (attached). Exhibit 5 is a letter from Mr. William J. Lehrfeld, Attorney for Sand Springs Home, explaining the history of the Home and their present situation. I commend this to the Committee's consideration.

HOUSEHOLD EQUITY

It is time that we examine the equity in our tax structure as it relates to the household. I have received many complaints, and I'm sure that my colleagues on the Committee are all aware of the dissatisfaction, from taxpayers who are single, or who are one of two working spouses. In fact, these categories of taxpaying Americans are rapidly increasing in number.

The effect of the tax code is an ironic set of complaints. On the one hand, single taxpayers believe that they are discriminated against because they are not married, and yet I often hear the complaint from couples who both work that they would save money on their taxes if they got a divorce. Admittedly, once Congress changes the tax rate, structuring the new rates to different types of households is difficult. But the results must reflect some sense of equity in changing times, and the trend to more working singles and couples is a result not only of changing lifestyles, but also of the pressures of inflation. I hope that this Committee will take the initiative in correcting unnecessary or outdated disparities.

CAPITAL FORMATION

Finally, I urge the Committee to examine all of its recommendations in light of their effects on capital formation. Since World War II, the United States has had a rate of new capital formation worse than every other major industrialized country except Great Britain. The circumstances during 1973 show that failure of the U.S. economy to be able to provide adequate productive capital leads to a double threat of inflation and recession.

Capital investment means jobs; capital investment means less inflation; capital investment means a strong private sector with a reduced need for government intervention.

Yet, our tax code in many places displays what Treasury Secretary William Simon calls a "bias against capital." A primary example of this is the discriminatory double taxation of dividends. This Committee has before it several different proposals to end this practice, and I urge you to examine them closely and choose the best from among them.

As with the proposals by the House of Representatives concerning the petroleum industry, the actions taken by a tax writing Committee can have tremendous side effects as far as capital formation is concerned. The amount of capital which will be required by American business over the next ten years is staggering. Chase Manhattan Bank estimates that, without substantial changes in our tax code, the shortfall from the amount necessary to reach some kind of full employment could be one and one half trillion dollars. So I hope that this Committee will address the problem in two directions. First, by examining the impact on capital formation of all related tax measures, and second by adopting positive recommendations to improve directly the climate for capital formation in the United States. If we don't want to watch our productive base dwindle as has been the case in the United Kingdom, we must act now.

CONCLUSION

Again, I thank the Committee for the opportunity to testify and elaborate my recommendations. The issues facing the Committee are overwhelming, as will be the complexity of their task. However, I am confident that their recommendations will be far superior to those proposed to us by the House of Representatives, which ignored the vital issue of energy independence, and yet found the opportunity to confront the pressing question of tax deduction for home garden tools. It is perhaps wise that the House included the garden tool title in their legislation, for if the House's philosophy is enacted, we will all be getting our fuel with shovels and saws in the near future.

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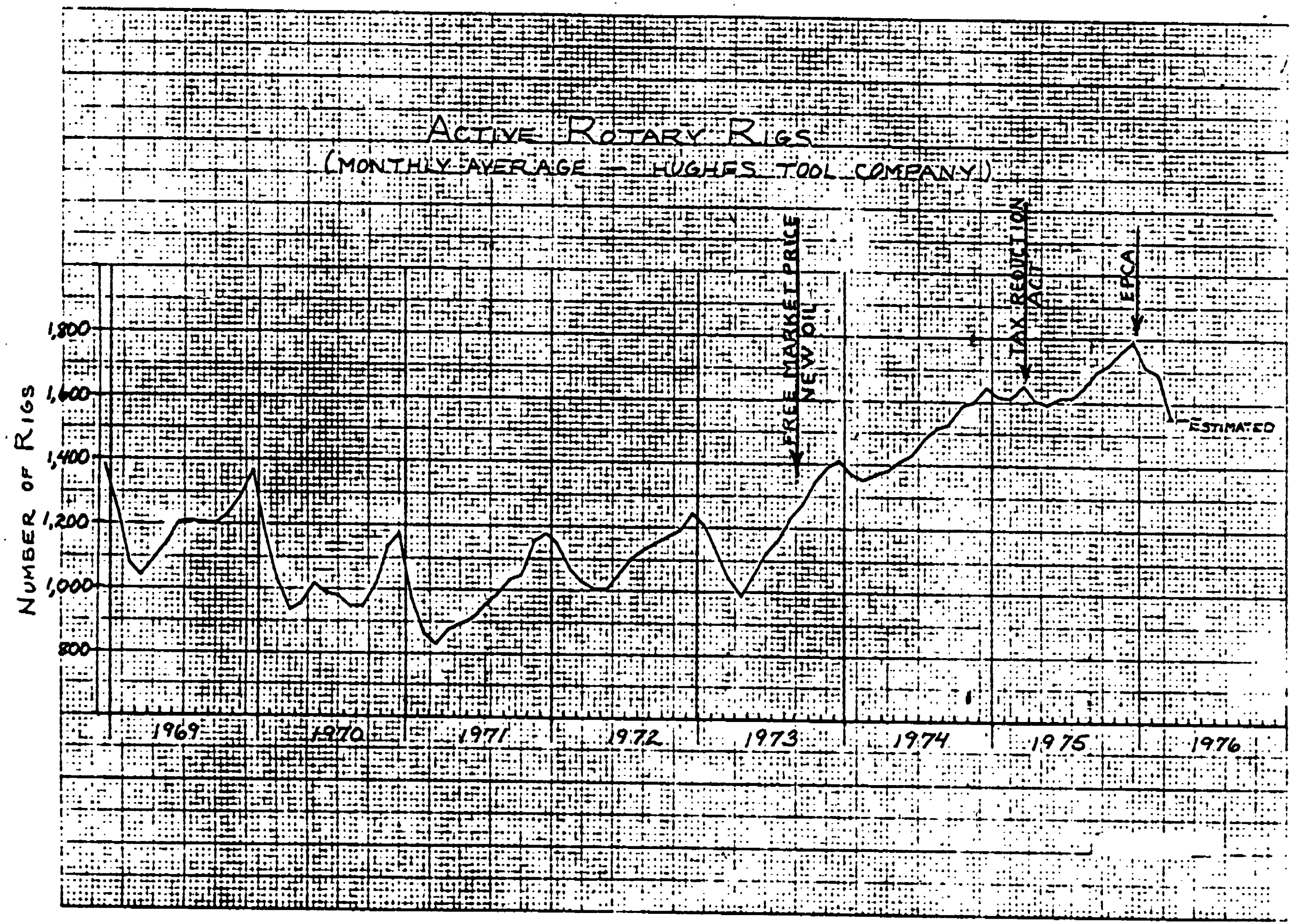
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(MONTHLY AVERAGE — HUGHES TOOL COMPANY)
NUMBER OF RIGS
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1,600
1,400
1,200
1,000
800
FREE MARKET PRICE NEW OIL
TAX REDUCTION ACT
EPCA
ESTIMATED
1969
1970
1971
1972
1973
1974
1975
1976

EXHIBIT I

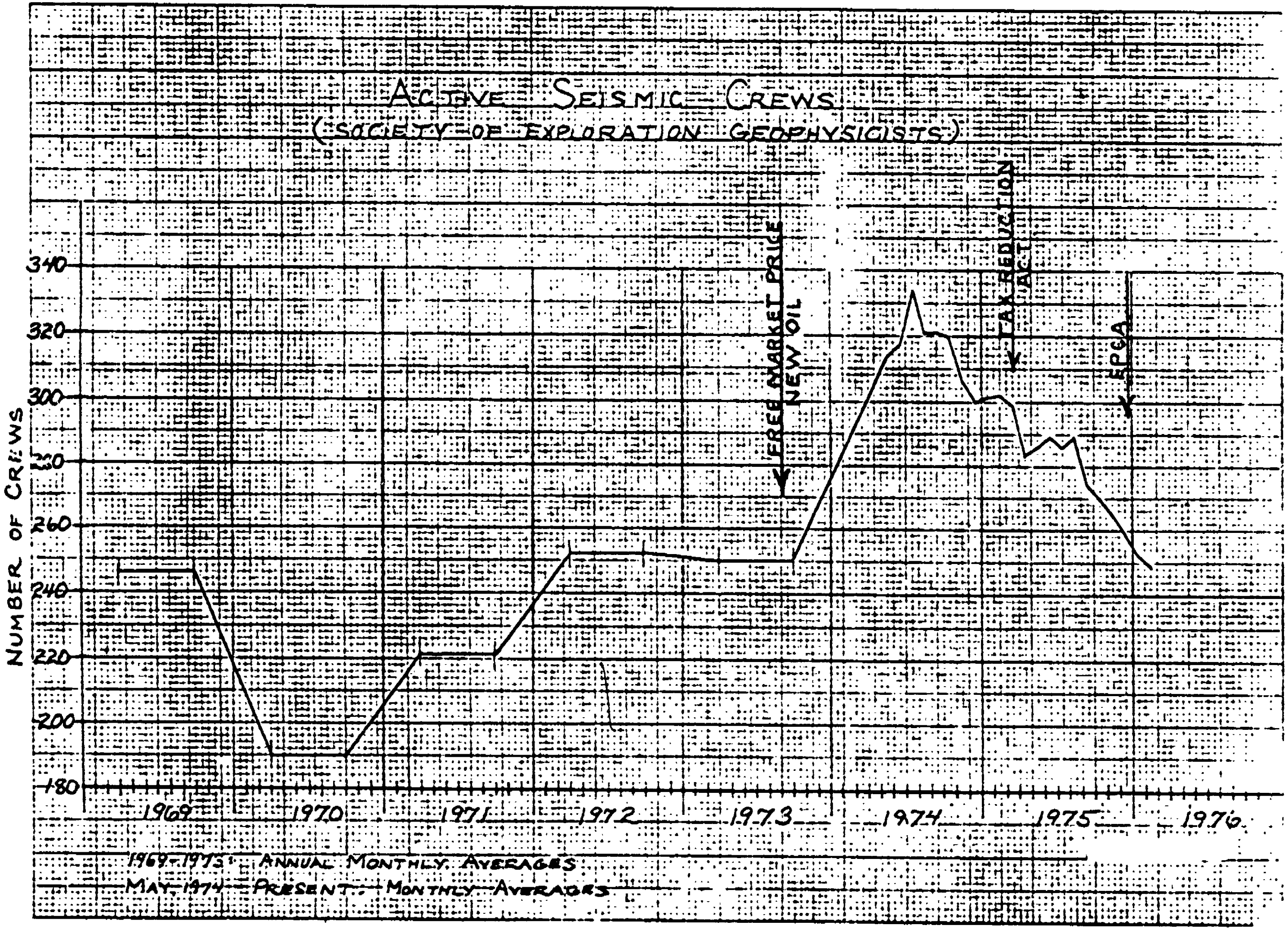
ACTIVE SEISMIC CREWS
(SOCIETY OF EXPLORATION GEOPHYSICISTS)
NUMBER OF CREWS
340
320
300
280
260
240
220
200
180
1969
1970
1971
1972
1973
1974
1975
1976
FREE MARKET PRICE NEW OIL
TAX REDUCTION ACT
EPCA
1969-1973: ANNUAL MONTHLY AVERAGES
MAY, 1974 - PRESENT: MONTHLY AVERAGES

EXHIBIT II

EXHIBIT III

LEE KEELING AND ASSOCIATES,
Tulsa, Okla., March 22, 1976.

Hon. DEWEY F. BARTLETT,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BARTLETT: This letter is being written in response to your request for my comments relative to House-passed legislation (H.R. 10612), and the effect this legislation will have on our efforts to develop additional oil and gas reserves in the United States. Most of my thoughts and opinions were presented to Dr. Lawrence N. Woodworth, Chief of Staff, Joint Commission on Internal Revenue Taxation in a letter dated November 6, 1975.

I have read the House bill passed by the House Committee on Ways and Means tax reform legislation and noted particularly their statement that the Committee did not want to discourage continued exploration for new oil and gas resources. However, it is apparent to me that the Committee members do not understand the need for outside capital in a very risky industry, nor are they aware that many oil and gas wells will never be drilled if the intangible deduction is eliminated or confined to exploratory tests as defined in the House bill. The consumer will be the ultimate loser—along with other members of the industry.

For your convenience and assistance in understanding my criticism of the definition of an exploratory well, the definition has been extracted from the bill and summarized as follows:

"(5) EXPLORATORY WELL.—The term 'exploratory well' means any well—

"(A) each point on which, at the time such well is completed, is more than 2 miles from the nearest point on the nearest producing well, or

"(B) which—

"(i) is completed 2 years or more after the completion of the last producing well which does not meet the requirements of subparagraph (A), and

"(ii) the taxpayer establishes (in the manner provided in regulations prescribed by the Secretary) by maps and other evidence that the well will not tap any reservoir from which there has been significant oil or gas production.

Subparagraph (B)(ii) shall be treated as not having been met with respect to any well, if on completion of such well, the bottom hole pressure or any other evidence indicates that there has been significant oil or gas production from any reservoir tapped by such well."

The definition of an exploratory well is ill conceived and, in my opinion, the house-passed version will affect our search for oil and gas in several ways, a few of which are summarized as follows:

(1) Discourage exploration in marginal areas.

(2) Eliminate development of many edge wells.

(3) Encourage the abandonment of marginal wells requiring remedial work.

(4) Encourage drilling during the first of the year and postpone year-end drilling until the first of the next tax year.

(5) Destroy many small companies that depend on risk capital to explore for oil and gas. The legislation will have little, if any, effect on the large oil companies because they capitalize a large portion of the drilling cost. However, the large oil companies are not drilling as many wells in the United States as the small companies.

(6) Contribute to the decline in drilling that has come about since the first of 1976. The rig count is down 150 rigs which means we have idle equipment that would be working if the investor climate were friendly. Investors will not take the high risks associated with drilling unless they can deduct their intangibles.

(7) Introduce a heavy burden on the judicial system—the delineation of specific oil reservoirs within the limits of a so-called field or pool are subject to interpretation. Internal Revenue agents and many oil and gas experts would be required to clarify the size and shape of a specific reservoir.

In my humble opinion, the two-mile limit used in the House bill definition of an exploratory well has no basis whatsoever. If nothing else, it discriminates against all oil wells and shallow-to-medium depth gas wells in favor of deep gas wells. It appears to me that they are trying to delineate reservoir size in an arbitrary manner that penalizes one segment of the same industry in favor of another.

Most tests, regardless of depth, drilled on a location outside the last row of producing wells should be classified as exploratory because of the multitude of unknown geological conditions encountered in the subsurface formations. Edge wells are usually marginal wells and edge wells will not be drilled if the House bill is passed.

Perhaps the only true development well is one that is drilled on an inside location, offset in four directions by commercial producing wells. However, this definition is not always true because there are areas in which dry holes have been drilled in the very center of existing oil and gas fields.

As an example, let us assume that a small operator has discovered a shallow marginal oil field producing from zones that are 10 feet thick at a depth of 500 feet. Each well is drilled in the center of 10 acres which would require 8 wells per mile. If your rule applied to this field, the operator would have to drill 16 locations in each direction from the last oil well to receive intangible credit. Without intangible support, these marginal-edge wells would not be drilled. The same principle applies to wells drilled on salt domes along the Gulf Coast where there is absolutely no assurance that the next location only 330 feet away from the last producing well would be productive. Other examples are the small pinnacle in Michigan, many of which contain no more than two wells and are surrounded by dry holes.

Obviously, very few tests can be classified as a true development well. Each step-out from a producing well is exploratory in nature and bears a significant amount of risk because all geological interpretations are just that—an interpretation and not a certainty.

(1) Geological interpretations are questionable because any one of the following conditions may exist below the surface in the target area:

(A) Splinter Faulting and Fracturing. Example: South Louisiana Acre Salt Domes.

(B) Small Reservoirs. Example: Reef Fields—Northern Michigan.

(C) Porosity Traps. Example: Medina Sands—Pennsylvania and New York.

(D) Questionable Oil—Water Contacts.

(E) Tilted Water Tables—California.

(F) Variable Permeability Zones—Morrow, West Oklahoma.

(G) Semi-Permeable Membranes.

Experts have many varied opinions as to the actual size, shape and character of oil and gas reservoirs. This fact should be fairly obvious to the Congress since the various companies, societies and agencies cannot agree on the total oil reservoirs remaining in the United States.

The Committee should be aware that many sizeable delineation and drainage lawsuits have been tried over the years which have burdened the courts and cost the United States many millions of dollars. The possibility exists that the same type lawsuits would be filed everytime someone drills an offset well—especially a marginal one. The SOCAL-Navy drainage case at Elk Hills is a prime example of how expensive a trial can be. You can hire many experts with opposite opinions—just as you can hire respected doctors that have opposite opinions as to the damage resulting from a back injury case. In each case, the specialists are working in an unknown area that cannot be evaluated visually. In the SOCAL-Navy case, the development of Elk Hills was held up for many years by an engineering committee that refused to admit that the field was larger than reported by the committee. This case is still in the courts and the structural configuration of the reservoir has yet to be resolved. Costs are accumulating every day.

I am hopeful that you receive my comments in the spirit in which they are given. I cannot take the risks associated with drilling for oil and gas; consequently, I am looking at the problem through the eyes of an interested citizen.

As yo umay know, I am a petroleum consultant and my clientele includes, in addition to the Internal Revenue Service, the Army, Corps of Engineers, Navy (Naval Petroleum Reserves), Justice Department, State of New York and many other federal and state governmental and regulatory agencies. I have also performed consulting services for many individuals, banks, estates, oil companies and utilities. The diversity of my clientele illustrates clearly that I look at our energy problems with an unbiased eye.

Yours very truly,

LEE A. KEELING.

EXHIBIT IV

[H.R. 10612, 94th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. Bartlett

H.R. 10612, an Act to reform the tax laws of the United States.

viz: At the appropriate place insert the following new section:

SEC.—. ELIMINATION OF CERTAIN INEQUITABLE PROVISIONS OF SECTION 613A.

(a) Transfers of Property.—Section 613A(c)(9)(B) (relating to transfer of oil or gas property) is amended—

(1) by striking out "or" at the end of clause (i),

(2) by striking out the period at the end of clause (ii) and inserting in lieu thereof a semicolon and the word "or", and

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

"(iii) any other transfer of property the principal purpose of which is not the avoidance of income tax liability, including, but not limited to, transfers in connection with estate planning, financing arrangements, or other bona fide business purposes.".

(b) Limitation Based on Taxable Income.—Section 613A(d)(1) (relating to limitation based on taxable income) is amended—

(1) by striking out "and" at the end of subparagraph (B),

(2) by striking out the period at the end of subparagraph (C) and inserting in lieu thereof a semicolon, and

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

"(D) any expenses paid or incurred in connection with the location, exploration, and development of oil and gas wells which are incapable of producing oil and gas in quantities which are sufficient to justify operating the wells for production purposes, and

"(E) expenses deductible under section 263 (c) (relating to intangible drilling and development costs in the case of oil and gas wells).".

(c) Exclusion of Retailers and Refiners.—Section 613A(d) (relating to limitations on application of subsection (c)) is amended—

(1) by inserting after "taxpayer" the first time it appears in paragraph (2) the following: "described in paragraph (4)", and

(2) by striking out "the taxpayer" the first time it appears in paragraph (4) and inserting in lieu thereof the following: "a taxpayer described in paragraph (2)".

(d) Effective Date.—The amendments made by this subsection apply to taxable years ending after December 31, 1974.

WEBSTER, KILCULLEN & CHAMBERLAIN,
Washington, D.C., March 24, 1976.

Attention: Mr. Mark Isaac.

Re Sand Springs Home, Tulsa, Okla.

Hon. DEWEY F. BARTLETT,
U.S. Senate,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BARTLETT: This letter represents a request on behalf of the Sand Springs Home, Tulsa, Oklahoma, for assistance in enacting a legislative change in the Internal Revenue Code. Basically, we are asking that you request Senator Carl Curtis that he raise, in executive session of the Finance Committee, a pending House bill (H.R. 5815) during consideration of tax reform (H.R. 10612). H.R. 5815 (94th Congress) is the same as H.R. 2258 (93d Congress) on which testimony was received by the Ways and Means Committee in 1973.

I. INTRODUCTION

The Sand Springs Home was founded by the late Charles Page in 1908 and incorporated in 1912. It was originally formed to care for orphans, but thereafter, because of the need to take care of widows and their children, the Home enlarged its activities to include these needy individuals. It was funded entirely by an endowment granted by Mr. Page and has never received any Federal support in connection with its charitable activities.

Orphans are committed to the home by order of the Oklahoma State District Court which charges the Home with the duty of care, maintenance and education of the children. Widows and their children are admitted to the widows' colony under rules and regulations authorized by the Sand Springs Home, but the children remain under the jurisdiction of their mother.

II. TAX CONSIDERATIONS

Since the enactment of the Tax Reform Act of 1969, Sand Springs Home has been treated as a "private foundation" because it supports its charitable activities entirely through its endowment. In brief, this means it must pay out a four percent audit free tax, it must distribute the greater of its income or a fixed percentage of its assets (now six percent), it must sell or otherwise dispose of certain of the business enterprises originally bequeathed to it in 1908 and otherwise comply with the onerous excise taxes affecting all "private foundations."

Certain charitable organizations which are fully endowed, and which receive no public contributions, may be exempt from private foundation calssification, including (1) churches, (2) schools, (3) hosiptals, (4) medical research organizations, (5) a "support" organization. Under existing law, a charitable organization which supports a public charity either by carrying on activities for the benefit of the public charity or by making grants to the public charity itself is not treated as a private foundation despite the fact its entire income is from an endowment. If the support organization is controlled by a civic league, a labor union, or a trade association, it too is exempt from private foundation classification. See, IRC Sec. 509(a)(3). The thrust of H.R. 5815 is to exempt from private foundation classification an organization controlled by a fraternal organization described in IRC Secs. 501(c)(8) (fraternal, insurance) or 501(c)(10) (fraternal, no insurance). Because Sand Springs Home is controlled by the Grand Master of the Oklahoma Masons, enactment of H.R. 5815 would exclude Sand Springs Home and any other support organization of fraternal societies from private foundation classification.

III. TREASURY SUPPORT

The Treasury Department approved H.R. 2258 in a bill report dated December 10, 1973. No bill report has been issued to date on H.R. 5815, but we do not believe the Treasury Department will change its opinion.

IV. GENERAL TESTIMONY

We asked on February 27 that the Senate Finance Committee give the Home the opportunity to testify further on this bill during its general consideration of tax reform. General testimony was taken by the Committee on Ways and Means during its 1973 hearings on tax reform and a copy is enclosed for your information. It is our understanding that the Senate's version of tax reform (H.R. 10612) will contain some foundation provisions although the House chose to defer until its consideration of Phase II tax reform foundation matters until later this year.

As you may surmise, there are literally hundreds of national, regional, state or local fraternal units whose charitable funds could benefit from this particular provision. It is not special interest legislation in any sense. It is our understanding that the Treasury Department would have approved this provision in 1969 had the matter been brought to their attention then. Our bill gives charitable funds of a fraternal organization the same benefits which today accrue to the charitable funds of (1) civic leagues, (2) labor unions, and (3) trade associations. We see no economic, logical or tax policy reason for excluding fraternal charitable funds from the existing exclusions from the private foundation provisions.

Sincerely,

WILLIAM J. LEHRFELD.

Enclosure.

APPENDIX I

The figure of $400,000 contained in S. 2885 is derived as the approximate value in January 1, 1976, dollars of the $100,000 exemption voted by Congress in 1939.

The calculation involves multiplying $100,000 by the ratio of the price indices for the two appropriate time periods:

$$100{,}000 \times \frac{166.3}{41.6} = 399{,}759.61$$

The CHAIRMAN. Next we will call Senator Daniel Inouye, U.S. Senator from Hawaii.

Senator, what is the word from those beautiful islands?

STATEMENT OF HON. DANIEL K. INOUYE, A U.S. SENATOR FROM THE STATE OF HAWAII

Senator INOUYE. Oh, I have some beautiful words, Mr. Chairman.

I wish to thank you and the members of the committee for permitting me to express my views on H.R. 10612, the legislation now under consideration before your committee. This morning I wish to address myself to that provision of the bill which restricts reasonable expense deductions for business or trade-related conventions held outside the United States, its possessions and trust territories of the Pacific.

Mr. Chairman, I am opposed to this provision because I believe it has the potential to do substantial harm to the American economy. Moreover, the abuses the provision is intended to eliminate can readily be corrected by enforcing existing laws and regulations.

Mr. Chairman, very simply, if the present restriction in H.R. 10612 is enacted into law, the United States will most assuredly invite reciprocal treatment from other nations. Unfortunately existing data does not indicate the amount of money spent by Americans going abroad to foreign conventions vis-a-vis the amount of money spent by foreign convention attendees in the United States. Nevertheless, as chairman of the Senate Subcommittee on Foreign Commerce and Tourism, and director of the National Tourism Policy Study, I am more than somewhat familiar with the economic dimensions of the tourist industry in the United States which, of course, includes convention business.

According to the latest statistics of the U.S. Travel Data Center tourism expenditures in the United States exceed $70 billion annually. These expenditures sustain over 5 million jobs. Not surprisingly, tourism is among the top 3 industries in 46 of our 50 States. Although we do not know the exact dollar value of foreign convention business to the cities throughout the United States, we do know that convention business per se in the United States is substantial.

Most recent estimates place annual convention expenditures in the United States at over $3 billion; and it may well be that the total amount spent by foreign convention attendees exceeds amounts spent by Americans attending conventions abroad.

I might mention at this juncture, Mr. Chairman, that the Pacific Area Travel Association is holding its 25th annual conference in Honolulu later this month. Over 2,000 delegates from countries throughout the Pacific Basin and Europe will attend. Later this year the American Society of Travel Agents will be holding their annual conferences in New Orleans, and over 6,000 delegates from 110 countries will attend.

In any event, if foreigners are deterred or discouraged from attending conventions in the United States, the economic impact on our cities will, in my judgment, be substantial.

Everyone will, I believe, agree that this is no time to be playing economic roulette with our cities. The threat of economic harm in that provision of the bill is, therefore, very real and quite substantial.

On the other hand, Mr. Chairman and members of the committee, I have yet to see any estimate on how much additional tax revenue will accrue to the Treasury if this provision is enacted.

My estimate is that the amount would nowhere near approach the amount of lost revenues to the cities, nor the lost tax revenues which accrue to the Federal, State, and local governments as a consequence of those expenditures by foreigners attending conventions in the United States.

Moreover, to the extent the provision does deter foreigners from attending conventions in the United States, it is contrary to the express policy of the Government to promote tourism in the United States from abroad as embodied in the International Travel Act of 1961 as amended.

Mr. Chairman and members of the committee, in and of themselves these reasons should be sufficient for committee to strike section 602, but there is yet another reason why it should be eliminated. All the Internal Revenue Service need do is rigorously enforce its existing regulations to determine if expenses claimed as business- or income-producing expense deductions are indeed incurred at a convention which satisfies the requirements of the agency's rules and regulations.

The IRS should be doing this now if the integrity of our tax system is to be maintained and the United States is to receive the tax revenues to which it is entitled under the law.

When faced with abuses or problems, the easy answer is to legislate more restrictions. More often than not this is also the wrong answer.

Mr. Chairman and members, plainly and simply, section 602 puts a restraint on travel by Americans abroad without any corresponding justification.

Thank you very much.

The CHAIRMAN. Thank you very much, Senator Inouye, for a very thoughtful statement.

Are there any questions?

Senator PACKWOOD. What is the House driving at? What kind of unethical business expenses are people taking now?

Senator INOUYE. I must agree with the proponents of this section that there have been abuses. There is on example that many cite.

About 2 years ago, ostensibly for business convention purposes, a group of men and women chartered a cruise ship going to the Caribbean. About an hour after the ship left U.S. shores, the chairman of the conference convened the meeting, looked around and said, "You received your minutes. Without objection, the minutes have been approved.

"This is the report of your nominating committe. All in favor say 'aye.' "

Then the ayes were heard.

"Is there further business?", asked the chairman.

"I hear none. The convention is adjourned." And he banged the gavel.

All this took less than 15 minutes. On that basis they took business deductions for income tax purposes.

My position is that the Internal Revenue could have very rigorously enforced existing law to reach that abuse. But why punish—it is a trite saying—why throw the baby out with bath water? Convention business is big business for the United States. I would hope that the committee will not only look at the abuses, but look at the benefits that would accrue to the United States not only to the Treasury, but to the Nation as a whole. And so, if we are addressing ourselves to abuses, let's do that; but not in this fashion.

Senator PACKWOOD. Thank you. No other questions, Mr. Chairman.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Senator Inouye, I understand that the provision on foreign conventions in the House bill would allow a business deduction for only two such conventions per year, and the Joint Committee, I am told, has estimated this provision will raise $5 million.

It is my understanding that you contend that this $5 million might be lost several times over if additionally this country could be subjected to the recriminations of foreign countries?

Senator INOUYE. Absolutely, sir. It is estimated at the present time that the expenditures by international visitors resulted in $434 million in Federal, State, and local tax receipts in 1975. The convention business share of this is, by any measure, substantial.

Senator HANSEN. Well, I think it is important to note, Mr. Chairman, that one simple illustration of what the offsets are, and I appreciate your testimony.

Senator INOUYE. Thank you very much, sir.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

I certainly commend the Senator from Hawaii for bringing out the other side of the story. I think that the House was talking about the exceptions to the rule, and they can happen in this country just as they can happen abroad. They can happen in the Greenbriar, Palm Springs, or Hawaii, or wherever it might be.

Certainly we have IRS regulations that should take care of those abuses. But I would think that—wouldn't the Senator agree—that promotion of good will and trade relations is an important factor of these conventions?

Senator INOUYE. Absolutely, sir.

Senator FANNIN. I know that you mentioned other countries. In my State of Arizona we are bordering on Mexico, and we have benefited greatly in trade relations by the conventions that we have had businessmen and others attending, professional people attending in Mexico. They have been tremendously beneficial to us.

I can think of some that I attended myself that led to later business that developed that would not have come to our State or come to the United States otherwise.

Senator INOUYE. You are absolutely correct, sir.

Senator FANNIN. Well, thank you, Senator.

Senator INOUYE. Thank you, Senator.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. On the surface it appears that the House may have done a very good thing, but when it is probed, we find that perhaps it was a tragic mistake. My own thinking tells me, and I will probably seek counsel from the Senator from Hawaii, that if we organized a trade mission to go from Japan to Alaska, that would obviously be a good thing from the business side and would have some pleasures attached to it as well.

The deduction is a small incentive to get the people to acquire some degree of knowledge about another area. The end product would be very beneficial to both communities. And obviously, the House provision would jeopardize this type of activity, which I believe to be so vital.

So I just wanted to add my voice. This certainly would have been one of the items overlooked had you not come forward and brought it to our attention. Thank you very much.

Senator INOUYE. Thank you.

Senator GRAVEL. I will seek your counsel on this trade question.

Senator INOUYE. Thank you.

The CHAIRMAN. Just one thought occurs to me, Senator. A considerable number of foreign countries have restrictions on their people coming here. I can recall quite a few years ago when some people wanted to bring that ship *La France* over here to have a convention in New York; the French Government would not permit them to bring the money out of the country to bring their people here.

They were going to bring people who knew all about making wine and liqueurs and things like that over here, and they would like to have visited the United States on a goodwill mission and hold a convention over here for the anniversary of their group. Their government's policies would not permit that.

I think Britain has been pretty much the same way. It seems we ought to consider if we are going to let our people go over there and use their airlines and spend money with them, that we ought to have a condition of reciprocity to it.

I woudl like to have a provision say if you are going to get the benefit of this, you will have to use American carriers coming and going, and you won't get this favorable tax treatment holding your convention in France, England, or wherever it happens to be unless those people have a reciprocity agreement toward the United States to let their people come here or have policies that encourage tourism of people coming this way.

That couldn't help but be beneficial to Hawaii. I would just like to see some of those friends from the Orient, from Japan, Taiwan, and elsewhere, attending some conventions in Hawaii. What is your reaction to that? That is, the idea of saying, "All right, if you want this advantage, fine," provided the other country reciprocates.

Senator INOUYE. According to our information, sir, these restrictions have been for the most part temporary in nature. They usually relate to the financial condition of that country. For example, in the case of Japan, right after World War II when that country was trying to revive itself economically, they had very severe restrictions on the outflow of yen. They limited, I think, each outgoing citizen to an amount something less than $100; and they limited the amount that could be spent on travel as such.

As the economy improved in that part of the world, these restrictions have been set aside. So today there are no restrictions in Japan and I think tourism from Japan is now a major source of income, at least along the west coast of the United States.

It is the same with France. I am certain if your staff looks into the French situation, that restriction you referred to has been partially lifted.

In the case of the United States, although specific data is not available, I think it would be safe to say that only a small number of conventions are being held abroad and so I don't think we can make simple comparisons on reciprocity, sir.

The CHAIRMAN. Well, I understand your position, but it does irritate me to see the American Bar Association holding a convention in London and seeing Britain, if they proceed to deny their citizens the right to hold a convention over here.

After all, Americans tend to be the big spenders. When they hold a convention over there Britain benefits a great deal more from it than we would if some of their people attended a convention over here.

I am sort of tired of turning the other cheek to those people when they keep engaging in restrictive practices that give us the worst of it, and they take all the advantage of our open policies to see that people ride their airline rather than ride our airlines, and they keep discriminating in favor of their own and against us.

I don't know how to make them stop that unless you just say, "Well, if that is how you are going to do business, you won't have the benefit of laws that we pass for the purpose of encouraging free trade, free movement of people, tourism." If you do not let them get the best of it and deny us our share, which is often the short end anyhow, after a while I think it sort of encourages that sort of nationalism—"just kick Uncle Sam, he never kicks back."

When they find out that you do kick back, I think they might give you more reasonable and fair treatment.

Senator INOUYE. Mr. Chairman, I share your frustrations, but I think I can understand why the British Government is doing this in view of its present fiscal condition. They are on the verge of bankruptcy.

So I would hope the committee will give this matter some thought, I believe that after giving it thought, you will agree that the restriction in section 602 is not in the best interests at this time.

The CHAIRMAN. Thank you very much, Senator. We appreciate your statement.

Senator INOUYE. Thank you, sir.

The CHAIRMAN. Next we will call Mr. Tom Scott, chairman of the Legislative Committee of the U.S. League of Savings Associations.

STATEMENT OF TOM SCOTT, JR., CHAIRMAN, LEGISLATIVE COMMITTEE, U.S. LEAGUE OF SAVINGS ASSOCIATIONS, ACCOMPANIED BY WILLIAM PRATHER AND JOHN SAPIENZA

Mr. SCOTT. Thank you, Mr. Chairman.

My name is Tom Scott, Jr., president of the Unifirst Federal and Loan Association of Jackson, Miss., and chairman of the Legislative Committee of the U.S. League of Savings Associations. I have with me Mr. William Prather and Mr. John Sapienza.

I appreciate the opportunity to appear before the committee on the subject of tax reform and I would ask that my complete written statement be made a part of the record.

The CHAIRMAN. Without objection it is so agreed.

MINIMUM INCOME TAX

Mr. SCOTT. Savings and loans allocate portions of their income to a bad debt reserve, one of the tax preference categories subject to the minimum income tax. This bad debt reserve tax treatment is in recognition of our role as specialized lenders providing, almost exclusively, long-term mortgage credit for American home buyers.

This committee has received legislative recommendations which would make some significant changes in the minimum income tax formula for both individuals and corporations. One proposal would eliminate the present $30,000 exemption, discontinue the deduction for other taxes paid, and raise the minimum tax rate to 14 percent.

Such changes would raise the tax liability of savings and loan associations dramatically—by at least $150 million. The committee will recall that the 1969 Tax Reform Act already provides for annual increases—over a 10-year period—in the tax rate for savings associations through decreases in the permissible bad debt deduction. Some commentators have suggested that the additional liability resulting from the minimum tax of the 1969 act was certainly unanticipated and perhaps unintended.

A further tax burden at this time would have a very serious effect on thrift institutions and on consumers who are seeking to buy a home.

There very well may be inequities in the minimum tax system as now structured, particularly for some wealthy individual taxpayers. But the occasional abuses of our tax laws by individuals should not be allowed to jeopardize our home finance system. We support the decisions of the House to leave unchanged the minimum tax formula as applied to corporations.

We would recommend further that the committee reexamine whether it is appropriate to include our bad debt deduction among the items subject to MIT. In any event we urge the committee to refrain from imposing a new and crippling tax burden on savings associations.

MORTGAGE INTEREST TAX CREDIT

The committee recently received testimony in support of the mortgage interest tax credit proposal originally contained in S. 1267, the Financial Institutions Act of 1975. This proposal, which would permit a tax credit of 1.5 percent to 3.833 percent, has been a subject of considerable interest in our business.

The mortgage interest tax credit appeals to many of our member associations particularly in times, such as the last year and a half, when earnings have been under severe pressure. In addition, associations using this proposed method would no longer be exposed to the minimum tax. Some experts also feel that the mortgage interest tax credit would add stability to housing finance.

On the other hand, there appears to be a number of questions about this change in the tax treatment for thrift institutions. First of all, we are disturbed by the revenue loss estimates of the Treasury. While the tax bill of savings and loan associations might remain roughly the same under a mortgage interest tax credit system, the tax break for other investors in mortgages could be significant—creating a "windfall", particularly for the commercial banks which already enjoy a number of tax planning advantages over our institutions. It is also unclear how the market for tax-exempt obligations of State and local governments might be affected.

Finally, we would note that any change in the percentage levels of tax credit or the percentage for qualifying loan commitment would significantly alter the appeal and revenue impact of a mortgage interest credit proposal. The possibility that the credit percentage might be altered frequently to accommodate short-term priorities could be very detrimental to the planning of such long-term lenders as thrift institutions.

The U.S. League, therefore, supports the mortgage interest tax credit as structured in the FIA 1975 as an acceptable alternative to the existing section 593 bad debt reserve deduction, but not as a substitute for that provision. We suggest that savings associations be given the option on a year-to-year basis to choose between the FIA's mortgage interest tax credit and section 593 treatment. If structured in this manner, the tax system could help stabilize mortgage availability at our specialized institutions throughout the economic cycle.

TAX INCENTIVES FOR SAVINGS AND CAPITAL FORMATION

The U.S. League endorses a tax incentive for savings account holders in recognition of the need for capital for homebuilding and homeownership in coming years.

The administration and other witnesses have described the immediate need for capital formation incentives in our economy, and the Treasury has presented a plan to encourage common stock ownership. We believe that any capital formation program should recognize as well the potential for increasing savings among our Nation's 50 million accountholders at housing-specialized thrift institutions.

Senator Bentsen of this committee has recognized this goal as part of his innovative "savings for education" proposal in S. 666, and Senator Fannin's S. 2909, the Investment Incentives Act, cosponsored by Senators Curtis and Hansen, embodies this principle. In the 93d Congress our business recommended a $500 tax exclusion for the first portion of interest earned on savings accounts. More recently we have endorsed an optional $600 exclusion or $200 tax credit to stimulate personal savings.

LIMITATION ON THE DEDUCTION FOR NONBUSINESS INTEREST EXPENSE

The U.S. League strongly opposes the House-passed proposal (section 206 of H.R. 10612) which would impose a $12,000 a year limitation on the amount of personal interest, and investment interest in excess of investment income, that an individual may deduct.

This rigid and arbitrary dollar limitation seriously infringes upon the principle of deductibility of home mortgage interest and would constitute a basic change in our tax law regarding real estate acquisitions.

The proposal also creates an immediate problem for the multifamily housing market. Our economics department estimates that 85 percent of apartment buildings of 50 units and under are owned by individuals or small partnerships, and 10 percent to 20 percent of these owners would find at least a part of their interest expense above the $12,000 level. These owners—frequently smalltown professional people or businessmen—could be expected to turn to other types of investments if section 206 were enacted.

Their departure from the multifamily housing market would only aggravate the serious situation which today finds apartment production at its lowest levels since World War II. The victims, ultimately, are the middle- and lower-income portions of our population, particularly the new families and elderly, who must depend upon rental property for shelter.

I thank you, Mr. Chairman, for the opportunity to appear before the committee and present our views.

The CHAIRMAN. Thank you very much.

Senator Packwood?

Senator PACKWOOD. On page 12 you make reference to the employees under 501(c)(3) organizations and the limit on their investments to annuities and mutual fund shares. I agree with you, I don't know why it should be limited to that, but I am curious about the reason. Why were they initially limited to those kinds of investments?

Mr. SCOTT. Senator, I am not sure that I can answer the congressional intent there, I really don't know. However, we do know that it is certainly not in the interest of the participants, the schoolteachers, because in an insured savings account the safety is implicit and the yield is obviously superior to the investments presently permitted, certainly over the past 8 or 10 years.

Senator PACKWOOD. Certainly it is safer than mutual fund shares if you are talking about trying to guarantee a retirement account.

Mr. SCOTT. Oh, yes.

Senator PACKWOOD. Limited employee retirement accounts which allow employees with small pension plans to have limited individual retirement accounts. Would you be willing to extend that to Government employees also?

Mr. SCOTT. Yes.

Senator PACKWOOD. I think that is all the questions I have, Mr. Chairman.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Scott, I thank you for your excellent statement. I am very concerned about the limitation of deduction of nonbusiness expenses. I think that you brought out the detrimental effects that this would have. We have had considerable comment from different members about the nonallowance of a deduction for interest or the taxing on the second home. I could explain it to you this way: I think you are familiar in many States where the people from the colder climates, either for their health condition or for other reasons, comfort and all, will go to the warmer climates in the winter months. We have it in Arizona and they have it in Florida, and it is not a luxury. It is almost a necessity, but we have had different members argue that this should not be allowed.

I would like to have your thoughts in that regard.

Mr. SCOTT. Well, I don't agree with that position, that it should not be allowed, because it strikes philosophically at the very basic issue of this country making housing available to those who want it and need it. And if it is necessary as you suggest that people maintain two residences, I just can't agree that one should be treated one way and the other not treated differently.

Senator FANNIN. I am very concerned about that because I know it would be very detrimental to people not necessarily in the high-income brackets. Many people are retired and others have limited incomes that still, because of the weather in their particular areas, would like to at least have some comfort and be able to live the life to which they are entitled and go to the warmer climate in the winter months.

Mr. SCOTT. You are quite right.

Senator FANNIN. Thank you very much.

The CHAIRMAN. Thank you very much, gentlemen.

[The perpared statement of Mr. Scott follows:]

STATEMENT BY THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS

SUMMARY

(1) *Minimum tax.*—Changes contemplated in the Minimum Tax formula for individuals should not be extended to those corporations, such as savings associations, which are incurring increased effective tax rates each year; further, the Committee should reexamine whether it is appropriate to include the bad debt reserve of Section 593 as a tax preference item exposed to the Minimum Tax.

(2) *Mortgage interest tax credit.*—The U.S. League supports the mortgage interest tax credit as structured in the Financial Institutions Act of '75 as an acceptable alternative to Section 593 bad debt reserve reatment—but not as a substitute for that provision. The U.S. League recommends that savings associations be allowed to choose each year which treatment would be used.

(3) *Tax incentives for savings and capital formation.*—The U.S. League reaffirms its long-standing recommendaion that consumer savers receive a tax incentive for the first portion of interest earned on their deposits as part of a national program to encourage capital formation. An optional tax exclusion of $600 or a tax credit of $200 would encourage thrift by American families, stabilize funds for home purchasers, retard inflation, and provide other benefits for our economy.

(4) *Limitation on the deduction for non-business interest expenses.*—Section 206 of H.R. 10612 as passed by the House places a $12,000 limit on annual interest deductions by individuals. The U.S. League strongly opposes this provision since it infringes upon the long-standing principle of the deductibility of home mortgage interest. In addition, such a ceiling has severe implications for the multifamily housing market, and the individual investors needed to acquire land for building and development.

(5) *Investment tax credit parity for thrift institutions.*—The U.S. League asks the Committee to repeal the restriction in Section 46(e) of the Code which limits the allowable investment credit for domestic building and loan associations to half that permitted other corporations. This is an archaic provision inserted in the Code at a time savings associations had a minimal effective tax rate; the effective rate is currently 26% or higher and is climbing annually.

(6) *Extension of corporate tax reductions provided in the Revenue Adjustment Act of 1975.*—Like other businesses, savings associations are deriving significant benefits from these temporary Code changes and urge that they be made a permanent part of the Tax Code.

(7) *Application of 30% withholding tax to savings' interest income received from the U.S. by foreign persons.*—The U.S. League supports the provision in H.R. 10612 permanently repealing the 30% tax on interest paid to non-resident alien individuals.

(8) *Broadening permissible investments under section 403(b).*—We also recommend that the Committee add accounts in FSLIC-insured institutions to the eligible investment media for employee-beneficiaries of certain eleemosynary organizations utilizing tax-sheltered investments under Section 403(b) of the Code.

(9) *Tax credit for energy conservation.*—The U.S. League endorses the 30% tax credit (of the first $500) for insulation and similar improvements as contained in H.R. 6860.

(10) *John Doe summons.*—The League approves of the provisions adopted by the House in H.R. 10612 limiting the investigative authority of the IRS to carefully defined situations where the identity of the taxpayer is known and there is clear evidence of an unsatisfied claim.

(11) *Tax exemption for condominium and homeowners' associations.*—The U.S. League supports enactment of the provision in H.R. 10612 exempting from taxation the reserves of homeowners' associations.

(12) *Modifications in the Employee Retirement Income Security Act of 1974.*—The U.S. League recommends a number of changes in ERISA to encourage Americans to adequately plan for their retirement years. These include:

(*a*) An immediate increase in the $1,500 annual deduction to $2,500—with further increases over the next years so that IRA account holders can achieve parity with Keogh plan participants.

(*b*) Broadening the scope of the IRA plans to include individual employees in qualified plans where annual contributions amount to less than IRA limits.

(*c*) Clarification in the Code that excess contributions to IRA accounts may be returned at any time before the due date of tax returns without penalty.

(*d*) Permission for employees where a pension plan has been terminated to roll over their funds into an IRA account as a tax-free event.

(*e*) Clarification that an individual need not participate in a pension plan for five years before being eligible to rollover his funds.

(*f*) Clarification that an individual can roll-over funds at age 59½ from a qualified plan even if not yet retired.

(*g*) Amendment so that the 10% penalty tax for premature withdrawal does not apply to distributions of interest earned on excess contributions returned before the due date of the tax return.

(*h*) Keogh Plan participants should be allowed to deduct at least 100% of earned income or $750, whichever is less, notwithstanding the overall 25% limitation of Section 415(c).

STATEMENT

My name is Tom Scott, Jr. I am President of Unifirst Federal Savings and Loan Association of Jackson, Mississippi and Chairman of the Legislative Committee of the U.S. League of Savings Associations.[1]

I appreciate the opportunity to appear before the Committee on the subject of tax reform. I would ask that my complete written statement be made a part of the record.

MINIMUM INCOME TAX

Savings and loans and mutual savings banks allocate portions of their income to a bad debt reserve, one of the tax preference categories subject to the Minimum Income Tax. This tax treatment is in recognition of their role as specialized lenders providing, almost exclusively, long-term mortgage credit for American home buyers.

This Committee has received legislative recommendations which would make some significant changes in the Minimum Income Tax formula for both individ-

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[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,600 savings and loan associations, representing over 98% of the assets of the savings and loan business. League membership includes all types of associations—Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Robert Hazen, President, Portland, Oregon; John Hardin, Vice-President, Rock Hill, South Carolina: Tom B. Scott, Jr., Legislative Chairman, Jackson, Mississippi; Norman Strunk, Executive Vice President, Chicago, Illinois; Arthur Edgeworth, Director—Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 East Wacker Drive, Chicago, Illinois, 60601; and the Washington Office is located at 1709 New York Avenue, N.W., Telephone: 785–9150.

uals and corporations. One proposal would eliminate the present $30,000 exemption, discontinue the deduction for other taxes paid, and raise the Minimum Tax rate to 14%.

Such changes would raise the tax liability of savings and loan associations dramatically—by at least $150 million. This amounts to an increase of 30% or more in the taxes our institutions pay. Elimination of the $30,000 exemption is particularly serious for medium-sized institutions; discontinuing the offset for other Federal taxes paid is the more serious change for larger institutions. Of course, any increase in taxes paid by all savings and loan associations would seriously damage the mortgage market—where our institutions currently provide 75% of America's home loans.

The Committee will recall that the 1969 Tax Reform Act already provides for annual increases (over a ten year period) in the tax rate for savings associations—through decreases in the permissible bad debt deduction. Some commentators have suggested that the additional liability resulting from the Minimum Tax of the 1969 Act was certainly unanticipated and perhaps unintended. Indeed, an estimated 7% of the Federal tax bill of our savings associations—an amount estimated at $37 million—was attributable to the Minimum Income Tax in 1974. A further tax burden at this time would have a very serious effect on thrift institutions and on consumers who are seeking to buy a home.

Savings and loan institutions and mutual savings banks bore the brunt of the 1973–1974 credit crunch—a crunch which foreshadowed the recission from which we are only now beginning to recover. The impact of rampant inflation on our institutions resulted in a 21.6% decline in pre-tax income from 1973 to 1975. Despite this decline in earnings, our average effective tax rate increased from 24.7% in 1973 to 25.5% in 1975. By contrast, commercial banks have experienced a rapidly declining effective tax rate—reaching 15.6% in 1974, the latest year for which figures are available. Currently we estimate that our institutions are earning an average 7.8% on the mortgage loan portfolios which comprise 82% of our assets. Money costs have risen to 6.3%. This margin leaves little room for increased expenses and certainly would be seriously eroded by a $150 million or more increase in our tax bill.

There very well may be inequities in the Minimum Tax system as now structured—particularly for some wealthy individual taxpayers. But the occasional abuses of our tax laws by individuals should not be allowed to jeopardize or home finance system. We support the decision of the House to leave unchanged the Minimum Tax formula as applied to corporations. We would recommend further that the Committee reexamine whether it is appropriate to include our debt deduction among the items subject to MIT. In any event, we urge the Committee to refrain from imposing a new and crippling tax burden on savings associations—institutions which perform a public service that Congress has specifically recognized as deserving of specialized tax treatment.

MORTGAGE INTEREST TAX CREDIT

The Committee recently received testimony in support of the mortgage interest tax credit proposal originally contained in S. 1267, the Financial Institutions Act of 1975. This proposal, which would permit a tax credit of 1.5% to 3.833%, depending upon the degree of investment in qualifying residential property loans, has been a subject of considerable interest in our business since it was first advocated by the Hunt Commission five years ago. The FIA '75 would allow savings and loan associations a one-time option (to 1979) to switch from their present Section 593 bad debt deduction reserve to the mortgage interest tax credit. (Though this tax proposal was developed by the Treasury Department, we observed that it was not part of Secretary Simon's detailed testimony to your Committee three weeks ago.)

The mortgage interest tax credit appeals to many of our member associations particularly in times, such as the last year and a half, when earnings have been under severe pressure (since this method of taxation depends upon gross income rather than a deductible percentage of "profits"). In addition, associations using this proposed method would no longer be exposed to the Minimum Tax since, unlike the Section 593 bad debt reserve, this new tax credit would not be a "tax preference" item. Some experts also feel that the mortgage interest tax credit would add stability to housing finance, particularly during high interest periods when long-term lending institutions are at a severe economic disadvantage.

On the other hand there appear to be a number of questions about this change in the tax treatment for thrift institutions. First of all, we are disturbed by the upward revisions in revenue loss estimates of the Treasury for this proposal—with estimates rising from a net loss of $100 million (in 1973) to $544 million (in recent testimony before a House Budget Task Force). (Academic economists have projected a loss three times that amount). While the tax bill of savings and loan associations might remain roughly the same under a mortgage interest tax credit system, the tax break for other investors in mortgages could be significant—creating a "windfall", particularly for the commercial banks which already enjoy a number of tax planning advantages over our institutions. It is also unclear how the market for tax-exempt obligations of state and local governments might be affected. Would commercial banks, which currently purchase a sizeable percentage of municipal bonds, divert some of their funds to the new "tax exempt" mortgages, particularly in times of monetary ease, only to switch away from mortgages in periods of rapidly rising rates when municipals provide more lucrative after-tax yields? Then too, we were disturbed when the House Banking Commitee last fall issued its F.I.N.E. Discussion Principles. The FINE Study, now discarded, tied the privilege of the mortgage interest tax credit to housing loans for particular income classes—a "social" objective which could prove highly disruptive in the marketplace, and one which implies elaborate Government machinery. Finally, we would note that any damage in the percentage levels of tax credit or the percentage of qualifying loan commitment would significantly alter the appeal and revenue impact of a mortgage interest credit proposal. The possibility that the credit percentage might be altered frequently to accommodate short-term priorities could be detrimental to the planning of such long-term lenders as thrift institutions.

The U.S. League therefore supports the mortgage interest tax credit as structured in the FIA-'75 as an acceptable alternative to the existing Section 593 bad debt reverse deduction—but not as a substitute for that provision. We suggest that savings associations be given the option on a year-to-year basis to choose between the FIA's mortgage interest tax credit and Section 593 treatment. (Such tax planning alternatives are familiar in the Code, for example, in the three options of Section 593 itself, the choice given individuals to use the Standard Deduction to itemize etc.) If structured in this manner, the tax system could help stabilize mortgage availability at our specialized institutions throughout the economic cycle.

TAX INCENTIVES FOR SAVINGS AND CAPITAL FORMATION

The U.S. League endorses a tax incentive for savings accountholders in recognition of the need for capital for home building and home ownership in coming years.

The Administration and other witnesses have described the immediate need for capital formation incentives for our economy, and the Treasury has presented a plan to encourage common stock ownership. We believe that any capital formation program should recognize as well the potential for increasing savings among our nation's 50 million accountholders at housing-specialized thrift institutions. Senator Bentsen of this Committee has recognized this goal as part of his innovative "savings for education" proposal in S. 666. In the 93rd Congress, our business recommended a $500 tax exclusion for the first portion of interest earned on savings accounts. More recently, we have endorsed an optional $600 exclusion or $200 tax credit to stimulate personal savings.

A tax exclusion or credit to encourage savings at thrift institutions has much to commend it. Such a program would correct the bias of our tax code toward consumption rather than savings. It would give ordinarly families the type of tax incentive enjoyed today by wealthy individuals who invest in municipal bonds. (The median savings account size at our savings and loan associations is $2,250 and the midian family income of our customers is $13,200.) By limiting the tax free treatment to the first $600 (if excluded) or $200 (if a credit is used), the plan is restricted to modest-sized savings accounts—yet, would cover all the savings of a majority of our accountholders.

By raising the effective return on household savings, the incentive plan also promises long-term stability for the sources of funds for home building and home purchase. (Our institutions are currently providing 88% of the home mortgages made by depository institutions.) It is our view that the net increase in deposits at thrift institutions, and the resulting stimulus (jobs and building activity) for the housing sector of the economy, would more than offset—through increased revenues—any "first-blush" cost to the Treasury of the plan.

The incentive to save also has important anti-inflationary consequences for our general economy. Many Americans have abandoned the pattern of saving for future purchases and are relying heavily on high interest credit plans, with concern only for size of their monthly payments. Such "spend now" behavior removes the discipline on price rises and fuels the inflationary spiral. By adding to the flow of funds to financial institutions, the tax exclusion or credit will result in better terms and lower interest rates for borrowers, paricularly in the home lending market—giving further aid to the anti-inflationary goals of the Congress and the Government. Finally, this plan reaffirms the value of thriftiness in family financial planning. Inevitably, increased family savings pattern will reduce the need for elaborate and expensive social programs.

LIMITATION ON THE DEDUCTION FOR NON-BUSINESS INTEREST EXPENSE

The U.S. League strongly opposes the House-passed proposal (Section 206 of H.R. 10612) which would impose a $12,000 a year limitation on the amount of personal interest, and investment interest in excess of investment income, that an individual may deduct.

This rigid and arbitrary dollar limitation seriously infringes upon the principle of deductibility of home mortgage interest and would constitute a basic change in our tax law regarding real estate acquisition. Since there is no carryover permitted for unused personal interest, the $12,000 limit could result in permanent loss of home mortgage interest deductions for individuals. Indeed, given the interest rates of recent years, even middle-income families with median-priced houses purchased at today's prices, an automobile, sudden medical expenses, college-age children, etc., could find themselves bumping the $12,000 ceiling of Section 206.

The proposal also creates an immediate problem for the multifamily housing market. Our Research Department estimates that 85% of apartment buildings of 50 units or less are owned by individuals or small partnerships, and 10% to 20% of these owners would find at least a part of their interest expense above the $12,000 level. These owners—frequently small town professional people or businessmen—could be expected to turn to other types of investment if Section 206 were enacted. Their departure from the multifamily housing market would only aggravate the serious situation which today finds apartment production at its lowest levels since World War II. The victims, ultimately, are the middle and lower income portions of our population—particularly the new families and elderly, who must depend upon rental property for shelter.

Similarly, the proposal to limit investment interest deductions would be disastrous for the middle-income taxpayers willing to take the risks needed to acquire and hold land for future development. This is a role frequently taken by small town entrepreneurs and professional people. Their participation in the development process is essential if homebuilders are to preserve working capital for construction purposes. Yet, such investments often are speculative and involve years of waiting before investment income is realized—and deductibility as permitted under the present Section 163(d) of the Code is an important consideration in attracting such investors. Any project which does not promise immediate income will be shunned by these individual investors—possibly leading to greater concentration in the home construction and development industries, with adverse consequences for the less populous regions of our country.

INVESTMENT TAX CREDIT PARITY FOR THRIFT INSTITUTIONS

On another matter, the 1975 Tax Reduction Act temporarily increased the investment tax credit for businesses in general from 7% to 10% until December 31, 1976, with the President recommending that this change be made permanent. Numerous witnesses have explained the importance of this capital formation incentive. There is presently a special section in the Code—Section 46(e)—which restricts the allowable investment credit for domestic building and loan associations and mutual savings banks to half of that permitted other corporations. (This provision was inserted years ago at a time when thrift institutions had a minimal effective tax rate.) While this special limitation is of very minor importance in terms of revenue dollars, it does place thrift institutions at a considerable disadvantage in developing new customer services, particularly in the emerging area of electronic banking, where our chief competitors—the commercial banks—have no such limitation. We would ask that the Committee consider repeal of this specal restriction on use of the investment tax credit by thrift institutions.

EXTENSION OF CORPORATE TAX REDUCTIONS PROVIDED IN REVENUE ADJUSTMENT ACT OF 1975

The Revenue Adjustment Act of 1975 altered the threshold level for the imposition of the corporate income surtax from $25,000 to $50,000 until the middle of this tax year, while lowering the rate on the first $25,000 of corporate income to 20%. Like other businesses, savings associations—particularly the smaller institutions serving small communities and neighborhoods—are deriving significant benefits from these temporary Code changes. It would seem appropriate to us to make these modifications a permanent change in the Tax Code since the $25,000 level established 25 years ago is obviously out of date, and $50,000 is clearly a more realistic threshold under modern circumstances.

APPLICATION OF 30% WITHHOLDING TAX TO SAVINGS' INTEREST INCOME RECEIVED FROM THE U.S. BY FOREIGN PERSONS

We also support the testimony of other witnesses recommending the permanent repeal of the 30% tax on interest on financial institutions' deposits paid to non-resident alien individuals or foreign corporations, unrelated to a trade or business. The current exemption from the 30% tax (Section 861(c) expires on December 31, 1976. Our institutions, particularly those near the Canadian border, have significant deposits from foreign accountholders. A permanent repeal of the 30% tax, as approved by the House in H.R. 10612, will be a gesture in the interest of free flow of capital with our international neighbors.

BROADENING PERMISSIBLE INVESTMENTS UNDER SECTION 403(b)

We would also commend to the Committee's attention an amendment to the Internal Revenue Code to permit employees of certain Section 501(c)(3) eleemosynary organizations—for example, school teachers—to place their funds in Federal Savings and Loan Insurance Corporation-insured savings accounts so that they might shelter such investments from taxation until retirement under Section 403(b) of the Code. Presently such tax-sheltered investments are limited to annuity contracts and mutual fund shares—investment media which involve commission loads and offer lower yields for consumers than insured deposits. We consider the Federally-insured savings accounts offered at our institutions an even safer and higher-yielding investment media for such retirement accounts (see, e.g., a recent Library of Congress study *re* IRA account practices; House Ways and Means Oversight Subcommittee Print, dated 11/17/75). The long-term deposits generated at insured associations by this proposal would be particularly appropriate to support the long-term mortgages in which our institutions specailize.

TAX CREDIT FOR ENERGY CONSERVATION

In recent testimony before the Senate Commerce Committee, the U.S. League endorsed the use of tax system to stimulate public interest in energy conservation. One such incentive appears in the tax credit permitted individual taxpayers making insulation and similar improvements as contained in H.R. 6860 sent to your Committee last spring. Tax incentives do have the decided advantage of fast public recognition, with minimal need for bureaucratic involvement. The limited dollar credit (30% of the first $500 of qualifying expenses) is a modest cost to the Treasury considering the important national objective of energy conservation in residential dwellings.

JOHN DOE SUMMONS

The U. S. Supreme Court held last year in the case, *U.S.v Besciglia* that the Internal Revenue Service, by means of a "John Doe" no-name administrative summons, might examine a broad range of financial institution customer records as part of a Federal income tax investigation. In its decision, the Court interpreted Section 7601 and 7602 of the Code in a very broad manner. The decision is of considerable concern to our member associations and other financial institutions which are charged with the responsibility of preserving the confidentiality of their customers' records and their customers' banking transactions. We support the language adopted by the House in H.R. 10612 to protect the privacy of financial institutions' customers, and to limit the investigative authority of the IRS carefully defined situations where the identity of the taxpayer is known and where there is clear evidence of an unsatisfied Federal tax claim. We also agree with the recommendations you have recently received that prior to the issuance of a John Doe summons, a Federal Court should review the extent of the request to determine its relevance, and that the Federal Court should review the records obtained under the summons before they are submitted to the Internal Revenue Service to protect the rights of innocent taxpayers.

TAX EXEMPTION FOR CONDOMINIUM AND HOMEOWNER'S ASSOCIATIONS

The U.S. League fully supports enactment of the provision in H.R. 10612 granting tax exemption to reserves created through member assessments received by a homeowners' association, a condominium housing association, or a cooperative housing corporation. These organizations are formed for the sole purpose of maintaining common facilities in condominium, townhouse, and planned developments and clearly qualify for tax-exempt status. In 1974, however, the Internal Revenue Service altered its position on homeowner associations and through revenue rulings denied such treatment on accumulated reserves. The result of this change is that we now tax the revenue of an association of homeowners acting together in certain situations where an individual acting alone would not be taxed on the same activity. The revenue ruling constitutes a burden on proper planning for capital improvements, maintenance and replacement of common facilities, and should be remedied by the Congress.

MODIFICATIONS IN THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Two years ago, your Committee made a major contribution to encouraging all Americans to plan adequately for their retirement years through your work on the Pension Reform Act (the Employee Retirement Income Security Act of 1974). One provision of particular interest to the savings and loan business was the authorization of the new Individual Retirement Accounts (IRAs) which have proved to be a popular savings program for employees not participating in qualified pension plans. The widespread interest in IRAs, in our view, justifies an increase in the permissible annual contributions under the program so that employees may accumulate additional security for their retirement years. Further, we have found that IRA accounts, as long-term savings plans, are particularly appropriate for our institutions, which specialize in long-term mortgage loans. The U.S. League recommends an immediate increase in the $1,500 annual deduction permitted to $2,500—with further increases in the limits over the next five years so that IRA accountholders can achieve parity with Keogh plan participants.

We would also recommend legislation broadening the IRA program to include employees in qualified pension programs where annual contributions for the employees amount to less than the permissible IRA amounts; for example, if an employee in a qualified plan presently contributes $600 a year, he should have the opportunity to open an IRA account and tax shelter another $900 (assuming the present $1,500 deduction limit). We would also support legislation, such as S. 2732 introduced by Senator Roth of this Committee and others, allowing individuals to set up IRAs for their unemployed spouses.

In addition, as with any new program, a number of administrative problems have come to our attention which may call for statutory change. The Code should be amended to make it clear that excess contributions to IRA accounts may be returned at any time before the due date of the tax return without becoming subject to the excise penalty tax. We are also concerned about an interpretation by the IRS which prevents employee "victims" of an employer's pension plan termination from rolling-over their contributions into an IRA account as a tax-free event. This results from a highly restrictive ruling last year by the IRS of the ERISA provision on separation from service. Further, the Code should be amended to make it clear that there is no requirement that an individual remain in a pension plan for five years before being eligible to rollover his funds. And, we would recommend that the Code be amended to clarify that an individual can roll-over his funds at age 59½ from a qualified plan even if he has not yet retired from active employment. Finally, the Code should be amended so that the 10% penalty tax for premature distributions from IRAs does not include distributions of interest earned on excess contributions returned before the due date of the tax return.

In a related area, a legislative change is needed to make it clear that Keogh Plan participants may deduct annually the lesser of 100% of earned income or $750, notwithstanding the overall 25% limitation of Section 415(c).

The CHAIRMAN. Next we will call Mr. Gilbert Roessner, past president of the National Savings & Loan League.

STATEMENT OF GILBERT G. ROESSNER, PRESIDENT, CITY FEDERAL SAVINGS & LOAN ASSOCIATION, ELIZABETH, N.J., AND PAST PRESIDENT OF THE NATIONAL SAVINGS AND LOAN LEAGUE, ACCOMPANIED BY HENRY CARRINGTON, EXECUTIVE VICE PRESIDENT OF THE LEAGUE, AND LEONARD SILVERSTEIN, TAX CONSULTANT TO THE LEAGUE

Mr. ROESSNER. Good morning.

Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, my name is Gilbert G. Roessner. I am president of City Federal Savings & Loan Association in Elizabeth, N.J., and I am past president of the National Savings & Loan League.

I appear here today on behalf of the national league. On my left is Henry Carrington, executive vice president of the league; and on my right is Leonard Silverstein, tax consultant to the national league.

Mr. Chairman we have submitted detailed testimony and I will just summarize the essence of our statement which is before you.

Our testimony deals with four proposals in H.R. 10612 and three amendments to the bill which we believe should be adopted.

Mr. Chairman, the tax legislation you are considering at this time could have far-reaching effects on the tax structure of our Nation. From our standpoint, there are two key tax areas. If they are addressed in this legislation they would go far to improve conditions in the housing sector and would result in substantial aid to prospective homebuyers.

The first of these is the mortgage interest tax credit, and, Mr. Chairman, we believe this is among the most important tax reform proposals pending before the current Congress.

As you recall, this came to your committee through the Financial Institutions Act of 1975 which has passed the Senate. We urge that it not be left out of any tax reform package passed through the Congress this session.

As you may be aware, it is the savings and loan industry, more than any other, that has been locked into the home mortgage field. When our industry was in its infancy, Congress reasoned that in order to compensate the savings and loans for their commitment to housing—and low-yielding mortgage loans—there would be no taxes imposed on these institutions.

Over the years, this has been changed, and today the primary tax incentive for thrift institutions, which is designed to keep our commitment to housing at a high level, is the bad debt reserve allowance.

While the bad debt allowance, as an incentive, might have been valid in the 1960's, it is far from being a major incentive to keep our institutions in housing today.

Indeed, since the 1969 Tax Reform Act, our associations' taxes have been climbing steadily, and we are still locked into relatively low-yielding mortgage loans.

Mr. Chairman, members of the committee, the savings and loan industry does not really have an incentive to remain tied as we are to the housing market.

What's more, it is our view that unless an incentive is considered appropriate by the Congress, more and more thrift institutions are going to find ways to move into other, far more lucrative fields—not by choice, but by an instinct for survival.

We have seen our tax position over the years being eroded to the point where we can look across the street at our commercial banking competitor and see that savings and loans are paying an effective rate of taxation of about double that of the banks—even though the banks are not restricted in their lending and investment areas.

The National Savings and Loan League recognized the mounting inequity between banks and savings and loan associations, and commissioned the most in-depth study ever undertaken in the area of financial institution taxation. Copies of this 5-volume study, which was independently accomplished by two Georgetown University economists, Dr. Kenneth Biederman and Dr. John A. Tuccillo, have been made available to your committee, and the staff has it in your files.[1]

This study exploded the widely held myth that savings and loan associations somehow enjoyed a special tax benefit that was being perpetuated by the Congress, and, Mr. Chairman, that just is not so.

If housing is to be served in a meaningful way by a specialized financial institution, incentives are necessary. Indeed, they are imperative.

Without the assistance that incentives such as the mortgage interest tax credit provide, that family does not have a chance—and that worries us even more because the implication is that the Government will have to come in and take over the job of housing this Nation.

Mr. Chairman, we believe that Congress ought to provide tax equality as between savings and loans, which are largely restricted to the housing areas, and which wish to remain so, and commercial banks, which are free to invest their funds just about anywhere in the world in just about any area they choose.

Indeed, this was the commercial banker argument in the late 1960's, when savings and loan associations began to seek alternative investment areas. The banks at that time and the administration argued that if thrift institutions wanted increased lending and investment authority, they should pay the same taxes as banks.

Well, Mr. Chairman, we agree.

We believe that our effective tax rate ought to be on a par with the banks. This parity can be achieved by enactment of the mortgage interest tax credit which will also serve to keep thrift institutions in housing.

The National Savings and Loan League believes the tax credit for institutions heavily committed to housing should be 5 percent, rather than 3⅝ percent suggested in the Financial Institutions Act.

A 5-percent housing investment tax credit for 70 percent investment of assets in qualifying housing loans would make the effective tax rate

[1] The study referred to was made a part of the official files of the committee.

of savings and loan associations just about equal with commercial banks, at around 14 percent.

There would still be a percentage bias in favor of commercial banks, but not the drastic 100-percent differential that exists today.

At the same time we believe that those savings and loan associations which choose to remain with their present tax formula, the bad debt allowance, should be permitted to do so, and there should be a continuing option to compute taxes either way, as recommended by Mr. Scott.

You might suggest this is asking too much, Mr. Chairman, but, you know, we are talking about bringing money into the housing area, for families who for too long have not been able to get funds for homeownership at reasonable prices or interest rates. And, with that objective, I do not think that is asking too much; and, moreover, if we do not do something quickly in this area, we are going to wind up with far too little.

We strongly recommend that this proposal, a draft of which is attached to my statement as an addendum, be included as an amendment to H.R. 10612.

The National League favors one other amendment to the bill in the form of a tax incentive to encourage personal savings.

We have heard a great deal during the past 5 years about how the small saver is not getting a fair return on his savings account. This is the chief argument for abolition of regulation Q and savings rate differentials.

The National League believes the rate differentials are imperative in order to allocate funds from the public to the housing market, and so this should be retained.

At the same time, we recognize that the average saver does not secure any of the benefits that accrue, for instance, to the stock investor, who can deduct $200 of dividend interest from his tax return. The small saver does not share in many of the tax advantages that accrue to people with larger amounts to invest.

A tax incentive in the savings area could bring him into this arena, however, and at the same time provide individuals with an additional incentive to save.

This, in turn, would have an increase benefit to the housing market in the sense that the increased savings at thrift institutions would move into the home mortgage market.

We propose a credit against Federal income tax equal to 14 percent of the amount received as interest or dividends. Such a credit would be available up to a maximum of $250.

We set the credit at 14 percent to equate it with the lowest applicable tax rate. This, we submit, provides the greatest savings incentive to those persons in that bracket.

The tax credit, Mr. Chairman, gives the small saver a bonus for his thrift, and we believe that is in the public interest. It also means that his funds will go into the housing areas, which needs those funds, and that will generate increased tax revenues to offset the revenue loss from the tax credit.

Next I would like to touch on four other elements of this legislation, and the first is proposed in section 206, the nonbusiness interest deduction.

We, too, oppose this. We agree with Mr. Scott's testimony that it is contrary to the general concept of all interest, incidentally, being deductible on one's tax return. We share the view that it would also be detrimental to multifamily housing.

Second, section 1501 and 1502, dealing with individual retirement accounts, we support those provisions.

Section 1501 authorizes a free, rather a tax-free rollover of distributions from a terminated pension plan where the funds are transferred to an individual retirement account.

With respect to 1502, this authorizes a supplemental or limited employee retirement account. This simply means that a person participating in existing—in an existing pension plan can add to his own individual retirement account with the same tax benefits that presently exist so long as the corporate contribution is below the maximum that is already allowable for the individual retirement account.

We favor the limits on the 10 percent investment tax credit but strongly urge that savings and loan associations be given a full working partnership in this credit. We receive only 50 percent of the investment tax credit now. The reason for providing thrift institutions with half a loaf in this are gone because they were based on the notion that thrift institutions had a special tax break by way of the bad debt allowance.

Mr. Chairman, we have pointed out we believe the bad debt allowance is antiquated.

I have heard the bell, sir, and I conclude my summary with that note.

Thank you very much.

The CHAIRMAN. Thank you very much, sir.

Senator Packwood?

Senator PACKWOOD. Thank you, Mr. Chairman.

Everybody—and I almost share the desire—but everybody wants to have some incentive for savings, or for capital investment, or for whatever it might be. Now, there is only so much capital, period. It seems to me, the more it goes into S. & L.'s, the less it goes into stocks; the more it goes into stocks, the less it goes into S. & L.'s. Doesn't it seem we are almost chasing our tails on this situation?

I mean, I have sat through these hearings for 3 or 4 weeks and every single industry is coming in making the plea that they are the worst off, hardest hit, and have to have the biggest preference—and I don't say that in a negative way—but it seems to me we are going to end up with everybody having a preference, and, therefore, no one will have a preference.

Mr. ROESSNER. Senator Packwood, again speaking as an individual, I don't disagree with the points you have made. However, on the other hand, as long as preferences are issued to specific industries, we must speak up for the industry that we understand. And, honestly, in reviewing material in connection with tax reform over the years, I am persuaded by real reform, which is elimination of all preferences. But that is another road.

Until the country takes that road, and the Congress embraces that concept, I think it is incumbent upon us to point out to the Congress the needs as we see them for the thrift and homeownership aspects of tax legislation.

Senator PACKWOOD. Well, you know, I appreciate your answer, and your statement on this, because it does set forth very forthrightly how it would adversely affect your industry and you then leave it to us to determine whether that is in the public interest, as to your recommended amendments and so on. I am much more impressed by your coming in and your interests. So many have come in talking about this "public interest", and how it is in the "public interest" that we do what they ask; and really they are talking about their own interest.

Thank you for that.

Mr. ROESSNER. Well, we have a constituency, as you, and we represent them, actually.

Senator PACKWOOD. Most everyone that testifies says it is in the "public interest" and I see nothing wrong with an industry coming in, as you say, telling us "this adversely affects us, let us tell you how or why it does" and then leave it to us to see whether or not your case is in the public interest. I have to say, I think in your cases it is but then I suppose I have a double interest, coming from a timber producing State, the more homes we build the better off we would be economically.

Mr. ROESSNER. I would hope that those who have the same religion for energy that Senator Bartlett has, you know, would come forward with the same religion for the housing aspects of this.

Senator PACKWOOD. Thank you; I have no further questions.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

I am very concerned about your statement that the savings and loans do not have an incentive "to remain tied as we are to the housing market."

There has been, I know, a tendency to go into other fields. How much has the savings and loan industry drifted away from the housing market? What percentage of that sort has come about?

Mr. ROESSNER. I don't have the figures for you at this moment, Senator Fannin, but there has been a significant rise in investments that have occurred in tax exempt areas. I know in my own institutions for other reasons, and for a number of reasons, we are diversifying within the limits of the law our assets. It is a changing mix.

The other thrift institutions such as the mutual savings banks, I know of a number of specific instances, they have abandoned the bad debt allowance and we have that option under the present law.

Senator FANNIN. Well, the future of the housing industry depends upon adequate financing and certainly I know that members of this committee are vitally concerned as to what is happening and the trends surfacing, especially with what you have said in your statement on page 3, and then your caveat as to what is happening and why.

I know that we all appreciate your bringing this to our attention. We are aware of many of these problems that your statement brings forth, and that trend is very disturbing.

I was anxious to find out what percentage is involved in this change.

Mr. ROESSNER. Senator Fannin, I could just briefly outline a number of points. The Tax Reform Act of 1969 had a profound effect upon the savings and loan industry, I suspect to the degree that was not at that time intended by the Congress.

For example, the minimum tax credit on the bad debt allowance has had a great impact and you recall at that time that the principal motive seemed to be the wealthy people who "escaped taxation totally."

The erosion and reduction of the bad debt allowance established by the law at that time has put us in an entirely different position.

Senator FANNIN. If I could interrupt; I agree, that tax has created many problems. I understand the intent, and I know the feeling that existed that many people were not paying any tax, so they should pay their fair share and everyone should pay tax. So the tax was established.

It certainly worked out differently than what I think was anticipated for the minimum tax by the Congress when it was approved. I know your testimony helps to certainly prove that matter.

Thank you, sir.

Mr. ROESSNER. Thank you, sir.

The CHAIRMAN. Senator Gravel?

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

I am very sympathetic and we have trees, also, in Alaska. [Laughter.]

I don't want to be cut down by Oregon in that regard.

You make the statement that some of the capital is moving from home investment, mortgage investment into other areas.

I happen to know that we have had great lengthy testimony showing certainly it is moving into the fossil fuel area, for one thing. What are some of the areas where capital is moving?

Mr. ROESSNER. In the case of mutual savings banks, they have a broader investment option than we have and, therefore, they are going into certain preferred stocks and corporate bonds and things of that kind.

In the case of Federal savings and loan associations who are limited by the Congress to primarily housing loans plus some other Government bonds, or agency issues, FNMA's, GNMA's, and FRDMC, also the tax exempt area. I don't know that that is all bad, Senator Gravel, in that situation.

Senator GRAVEL. It broadens your portfolio, does it not?

Mr. ROESSNER. Yes; to that extent it is a benefit. The point we are making is really that with the erosion of the bad debt allowance, plus the minimum tax on the bad debt allowance, the incentive to maximize our investments in housing is waning.

Senator GRAVEL. You glossed over the point on interest. I assume your position is that we not limit the deduction?

Mr. ROESSNER. Yes, Senator Gravel. I did not mean to gloss over it in terms of its significance, but I felt that bell on my back and I wanted to move along.

Senator GRAVEL. Well, that's OK. I just wanted to underscore that. I think it is very important.

Mr. ROESSNER. Yes; particularly, you know, we must remember that all interest is presently deductible whether or not it is the interest for purchase of an automobile or for a boat or whatever, and when you start putting these limits on—particularly because of the housing aspects—we think it is a very dangerous precedent. Many people invest in multifamily housing and are not the richest people in the world and to now say that interest is not a legitimate operating expense is to me frankly mind boggling.

Senator GRAVEL. What you are saying then with respect to interest, if we were to alter existing law, we would be striking at the core of middle America.

Mr. ROESSNER. Yes, sir. Yes, sir.

Senator GRAVEL. Not the poor—not the rich. We would be striking at the people who carry the financial weight of the Government on their backs; they would be the ones that would be suffering economically from a change in the law?

Mr. ROESSNER. Yes, sir.

Senator GRAVEL. Thank you very much.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. No, Mr. Chairman.

The CHAIRMAN. You might be able to show us how we can help you. Here is the problem we are going to have if we do what you are asking and what a lot of others are asking with respect to the investment tax credit.

It is going to reduce the Government income and put us in conflict with what the budget resolution is going to be by the time it is voted on by the Senate.

The only way I see we can do that for you—and I would like to do it if we can find a way to fnd it on the revenue side—is to put forward the date of the allowance for the tax credit by a year, because if we do this for you we are going to have to do something similar for a lot of the other people who make equally good cases, such as the companies that are not earning enough money because of the 50 percent limitation in order to take their credits that they are earning.

Now, if we are going to let some of these through, I think you can make an equally good case that people should be permitted to use their unused credits as you can to help you with your problem. I think you have a meritorious case. But to do all of this, if we can do it at all, we will have to make it fit within the budget resolution which the Senate will be voting on shortly. I think we would have to either say that you wait a year before you get it, or else we can say that you earned it but that you can't take it for a year. If we did that, perhaps you could show us how we could do it so you could get the use of the money by saying that you earned it, and perhaps we can say you are then entitled to interest on what you have coming to you until you do get it. Then you could assign it to someone who could lend you some money, maybe assign it to the Federal Reserve, if they are going to be doing business with you, or just anybody willing to take the IOU and agree you have earned it and you are entitled to it and you will be getting it, but you won't be getting it until the next year or so. At that point you can borrow against it.

Can you folks who are the ones in the lending business show us how we can work it out so that we might give you the benefit of it in terms of some money you can get your hands on to expand your operations now, so that you can go down and pledge with somebody or assign it to them and get money for your expansion now?

Mr. ROESSNER. Senator Long, I would sure like to try.

Let me just say two quick things first of all.

One, I enthusiastically endorse the budget limitations concept with which the Congress is now working. It seems to me that that comes first and foremost because to maintain the fiscal integrity of the Nation is critical to housing and all the rest of the economic activity in our judgment.

Second, I would like to briefly point out that we are not the great users of the investment tax credit. We are discriminated against, in our situation, because of the 50 percent which presumaby got in there as a result of our having the bad debt allowance which was listed as a "preference" income.

Third, with respect to your point, if we were restored to full equality with the rest of the corporations, as we recommend, such things as deferring the credit for a year, receiving interest on the deferral, you know, if it were authorized as an investment for us we would be happy to lend people the tax credit they are entitled to if it means by that process maintaining revenues against the expenses that the Congress is trying to achieve, or at least a target.

The CHAIRMAN. Well, I would appreciate if your people would think about it and give us a memo as to how we might manage to do something of this sort. We are going to have the problem not only with respect to you but we are going to have it with regard to a lot of people who, if they could, would be doing more than they are doing now to help move this economy ahead. The railroads testified yesterday; that is one good example. The majority of these railroads need that investment tax credit. It was intended to benefit them to help modernize and improve those railroads and both with equipment and better roadbeds and better rails, but they are not able to use the credit.

They are losing interest on the money because they cannot take their credits. Eventually, if we are able to get them back on their feet, the time will come when they are able to get the credits. Now, it just occurs to me that if we cannot do any better, we ought to say if you cannot use the credit, at least you will be entitled to interest on the unused credit at such time as you can use the credit.

Mr. ROESSNER. Your point is well taken, Mr. Chairman. Again it reminds me that one modification you could make is that the investment tax credit would only go to the taxpayer who made the investment. In my judgment these tax credits have gone in the form of tax shelters to others that were not intended by Congress and the benefit is not going to the taxpayer you intended to provide for. Just as a personal notion, for example, I could imagine this being a kind of a negative income tax rather than passing it on to the bank presumedly in the form of reduced interest rates which are rarely the case, as you know some of the major banks are paying virtually no taxes at all and one of the major tax shelters has been the investment tax credit.

When Pan Am buys that 747 and it is losing money anyway, it gives that 10 percent tax credit to the Chase Manhattan Bank that carries the airplane on its books as a loan, I think is inconsistent with the fundamental objective here in the Congress in encouraging expansion of plant and equipment.

The CHAIRMAN. We could overcome that if we would just do what I had been suggesting, and say that the investment tax credit is a refundable tax credit.

Mr. ROESSNER. Yes, sir.

The CHAIRMAN. When we first started to get into the investment tax credit, I said that the whole thing was a big gimmick and a racket because you were giving a person a tax advantage for an expense that did not exist. But the investment tax credit has in my judgment proved its merit. It has proved to be a good idea.

Mr. ROESSNER. Yes, sir.

The CHAIRMAN. When it first went into effect I said if you took the credit for 7 percent, then you could not depreciate the whole 100 percent, you had to reduce the depreciation by seven points. I was persuaded to yield on that, on the theory it would be a more effective instrument and do more for the economy without the reduction in depreciation. Subsequently it has done a lot for the economy. I have been persuaded with time that when people earn it they ought to be able to take it and it should not depend on the fact they owe enough income tax to where the credit does not exceed 50 percent of the tax he owes. It should not be tied to a 50-percent ratio.

In fact the more I see of it the more I am convinced of this and so are more business people, too. They earn it when they buy the equipment or when they build the plant.

Now, once they earn it, they ought to be permitted to take it. We have two problems. First, some people do not understand this idea, and it takes a while to get used to the idea. In the second place we have a budgetary problem. So on the first point I think we will move, as far as we can persuade people to understand it, to remove that 50 percent limit so that you can at least take it to the extent you pay taxes—and I do not know why you should not include your social security taxes paid as part of the taxes. Maybe we can get them to understand that much of it.

But if we do that then we are outside the budget resolution.

Mr. ROESSNER. I agree with you, Mr. Chairman, 100 percent. Fiscal integrity is critical. Let me just add so there would be no confusion, our concern is that under the law because of our so-called preference income for bad debt allowance we only receive 50 percent by law of the investment tax credit and when we buy—it just drives me up the wall frankly—when I first learned upon buying electronic teller terminals, a $500,000 order, at that time it was a 7 percent tax credit, that we only got 3.5 instead of 7. I could not believe it. But that is the law.

The CHAIRMAN. Generally speaking, what would your people do with that additional money if they had it? Supposing we give you the benefit of what you are asking for. What would you do with the rest of the money?

Mr. ROESSNER. We are under earnings pressure now. It would help the bottom line. You may not appreciate that but the spread between income and expense has narrowed in the thrift industry primarily because of our being locked in on fixed rate mortgages. On the expense side we have the rising costs as a result of inflation but most importantly, the rising cost of the deposit money. So to that degree it would give us a little better improvement. I cannot honestly say that we get enough investment tax credit that plowing it back into the business would have some major economic impact. I just would not be honest with you if I said that. You know, we are a very small portion of this investment tax credit question.

The CHAIRMAN. If I understand your answer, you are saying that at the moment your industry is not competitive for capital because it is not making enough profit.

Mr. ROESSNER. Well, we are competitive but we are under great pressures with respect to the bottom line, yes, sir. We are also currently receiving strong deposit flow, you know, people are putting a lot of money in the thrift industry these days. So in that sense we are competitive.

The CHAIRMAN. With what you are taking in you are making housing loans and things like that?

Mr. ROESSNER. Yes, sir.

The CHAIRMAN. And that is helping the economy?

Mr. ROESSNER. It sure is.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Roessner follows. Oral testimony continues on p. 2074.]

STATEMENT OF THE NATIONAL SAVINGS AND LOAN LEAGUE

SUMMARY

The League supports the following proposals:

1. *The Mortgage Interest Tax Credit* should be adopted to encourage a steady flow of funds into the housing market by providing a 5.0 percent tax credit for institutions maintaining a total of 70 percent of its portfolio in residential mortgages.

The credit will replace the bad debt reserve allowance which, since 1969, has phased down from 60 percent to 43 percent in 1976 and will drop to 40 percent by 1979. The mortgage interest tax credit will equalize the comparative tax burden between savings and loans and commercial banks by providing a uniform tax treatment for mortgage interest.

The credit will reduce the cost of mortgage credit to the consumer, improve the ability of thrifts to compete for savings in periods of high interest rates, induce more flexibility into mortgage instruments and increase the ratios of loans to value of mortgage loans made by savings and loan associations.

2. *A Tax Incentive for Savers* should be approved in the form of a credit equal to 14 percent of the amount received as interest on savings accounts up to a maximum credit of $250.

The credit is set at 14 percent to equate the percentage of credit with the lowest applicable tax rate. Therefore, individuals in the lowest tax bracket will completely offset their tax on the interest income by using the 14 percent credit. Taxpayers in a higher market will receive the same 14 percent credit which will offset their tax on the interest income to a progressively lesser degree depending on their tax bracket. No taxpayer could receive a credit for more than the tax attributable to the interest income and the taxpayers in the lowest bracket receives the greatest incentive to save.

This incentive would encourage saving, lessen the burden on social programs such as social security and provide additional funds for capital investment.

3. *Non Business Interest Deduction* should not be limited. The proposed $12,000 limitation will surely have an adverse effect on the housing market particularly in large urban areas where housing prices have and will continue to rise.

4. *Individual Retirement Accounts.* The provisions regarding IRA5 in H.R. 10612 are greatly needed and will correct two gross inequities. Many retirement plans are terminated each year and a tax free transfer of these funds into another pension plan should be available. The supplemental IRA proposed will give every person an opportunity to have the maximum amount set aside for retirement.

5. *Investment Tax Credit* should be extended and amended to give all taxpayers the benefit of the full credit. Savings and loan associations receive only half of the credit. Banks are allowed a full credit. This should be equalized because the reasons for the limitation on savings and loans are no longer applicable and the need for expensive equipment has risen.

6. *Minimum Tax* should be amended to eliminate the bad debt allowance as a preference item. Savings and loan associations now pay an effective tax rate of almost double the rate of commercial banks. The reasons for the inclusion of the bad debt allowance as a base, preference item is no longer applicable.

STATEMENT

Mr. Chairman, members of the Committee, my name is Gilbert G. Roessner, Past President of the National Savings and Loan League. I am currently President of City Federal Savings and Loan Association in Elizabeth, New Jersey and I am here today representing the National League which is a nationwide trade organization for savings and loan associations.

We appreciate the opportunity to testify on H.R. 10612, a bill with far reaching effects on the tax structure of this country. Specifically, I would like to discuss generally four of the proposals in H.R. 10612, and two proposed amendments to this bill which we feel could have a profound effect on the housing and the thrift industries.

MORTGAGE INTEREST TAX CREDIT

The issue of the Mortgage Interest Tax Credit was referred to this Committee during consideration of the Financial Institutions Act of 1975, (S. 1267). We feel that this is one of the most important tax reform proposals presently pending in Congress and one that should not be left out of any tax reform package in this session.

The proposal as outlined in the Financial Institutions Act would amend present law to permit until 1979 an election by thrift institutions to credit against their taxes an amount equal to 3½ percent of the gross interest income from residential mortgages earned during a taxable year. The amount of the credit is set on a sliding scale encompassing a minimum tax credit of 1½ percent for an institution that maintains 10 percent of its portfolio in residential mortgages and increases to a maximum of 3½ percent for an institution with 80 percent of its fortfolio in such loans. In 1980, the mortgage interest tax credit would replace completely the present bad debt reserve allowance which is presently permitted under Section 593 of the Internal Revenue Code.

The chief purpose of the mortgage interest tax credit is to encourage thrift and other financial institutions to make the maximum possible commitment in residential mortgage loans.

As you are well aware, the present tax incentive for financial institutions designed to accomplish this commitment is the bad debt reserve allowance (based upon a percentage of income as provided in Section 593(b)(2) of the Internal Revenue Code). This deduction, by law, phases down in the following manner: 43 percent for the year 1976; 42 percent for the year 1977; 41 percent for the year 1978; and 40 percent for the year 1979 and subsequent years.

As the bad debt deduction has phased down since the Tax Reform Act of 1969, the effective tax rates of savings and loan associations have risen. During this same period, commercial banks have increasingly taken advantage of tax shelters which are unavailable to thrifts. The effect of this has been that commercial banks have been able to reduce their statutory Federal tax burden dramatically.

In other words, the major incentive established by Congress for savings and loan associations to maintain their heavy portfolio in residential mortgages has been eroded to a point where the savings and loan industry is now paying an effective tax rate of almost double that paid by commercial banks.

We feel that it is essential to keep mortgage interest rates as low as possible so that the greatest number of families can participate in home ownership. We believe a mortgage tax credit is the most effective and equitable means to achieve that end.

The mortgage interest tax credit is aimed toward four basic objectives: (1) to attract new mortgage lenders; (2) to encourage existing mortgage finance specialists to maintain a high proportion of their portfolios in home mortgages; (3) to promote a greater cyclical stability in mortgage lending, and; (4) to establish tax neutrality among financial institutions by providing a simple consistent tax treatment for mortgage interest.

The mortgage interest tax credit was first introduced as a housing and mortgage market recommendation in the Hunt Commission Report in 1971. It was later part of the Financial Institutions Act of 1973, and finally part of Title VII of the Financial Institutions Act of 1975 which passed the Senate in December of 1975. A proposal similar to that contained in the FIA was also included in the

"President's Legislative Tax Proposals" referred to in his State of the Union message of January 15, 1975, and was reproposed on January 21, 1976 in the budget message of the President for fiscal year 1977.

The Treasury Department estimates that the revenue effect of the proposed tax changes for financial institutions will result in a revenue loss of approximately $618 million in calendar year 1977. We would suggest, however, that such revenue estimates do not appear to take into account the revenue gains that would result from the full effect of the mortgage tax credit proposal in terms of housing stability.

On February 25, 1976, Mr. Edward P. Snyder, Director of the Office of Debt Analysis at the Treasury Department, testified before the Task Force on Tax Expenditures of the House Budget Committee. He stated that the present bad debt reserve allowance is essentially pro-cyclical and therefore, provides the greatest return on assets and the greatest incentive to make mortgage loans when total profits are high and the least incentive when profits are low. This, he said, builds the momentum of cyclical swings in the mortgage market and accentuates the volatility of mortgage lending.

On the other hand, he stated that the mortgage interest tax credit is countercyclical and is tied to gross mortgage interest income. It, therefore, provides mortgage lenders with an increase in effective after-tax yield when interest rates are highest and competition for funds is greatest, and it reduces this stimulus when interest rates are low and funds are plentiful for all purposes.

The instability in the housing market, which according to Mr. Snyder is enhanced by the bad debt reserve allowance, involves costs to consumers, construction workers, construction materials suppliers and many others involved with the housing industry. The mortgage tax credit with its additional stability for housing could have a significant impact on the whole housing industry and all those associated with it. It could also ameliorate the estimated revenue losses that are expected to occur as the credit is implemented.

The National Savings and Loan League recently completed a massive in-depth and totally independent study by two Georgetown University economists, Drs. Kenneth R. Biederman and John A. Tuccillo, copies of which have been made available to your Committee. This study entitled "The Taxation of Financial Intermediaries" is primarily a comparison of the bad debt allowance and the proposed mortgage interest tax credit. The study found that by 1979 nearly all savings and loan associations would find a 3.5 percent mortgage interest tax credit more reasonable than the reduced level of the bad debt allowance. The bad debt allowance is not as efficient in encouraging housing and mortgages as the mortgage tax credit because there is no relationship between reserve additions on which the bad debt reserve allowance is calculated and actual mortgage loan loss experience. Essentially, the retention of the bad debt deduction without the option of the mortgage interest tax credit is going to increase the cost of home mortgages because it will cost savings and loans progressively more in terms of higher taxes and a worsening of the competitive relationship vis-a-vis banks.

Naturally the mortgage interest tax credit would be more advantageous to some associations than to others depending on asset structure. The FIA proposal provides a one-time option to each taxpayer to maintain the use of the bad debt deduction or to change and use the mortgage interest tax credit. This option would be available through 1980, at which time the mortgage tax credit would become mandatory.

The National League favors an option provision but we urge that it should not expire in 1980. It is to the advantage of the mortgage borrower if the lender can choose between these tax formulas. As the bad debt deduction is phased down, the mortgage tax credit will become more and more desirable but if for some reason it is not, the option should be available.

Although it would be virtually impossible to completely eliminate the long-term tax equity issue, developments since the 1969 Tax Reform Act indicate that at least a periodic adjustment or correction on equity grounds is needed again, just as it was in 1969. This is particularly the case when a more complete view of taxation is taken within the context of regulatory differences. In this regard, our analysis has shown that the proposed 3½ percent mortgage tax credit would, at least partially, correct some of the differences which currently exist in the comparative Federal tax and regulatory burdens of banks and savings and loans. However, in light of the nature of the mortgage credit and its availability to banks, it is our policy that a similarly structured credit with a ceiling of 5.0 percent for a 70 percent investment in mortgage loans rather than the administration's proposed 3.5 percent would put the effective tax rates of savings and loans on par with those of commercial banks.

A 5 percent housing investment tax credit for 70 percent investment of assets in qualifying housing loans would make the effective tax rates of banks and savings and loan associations just about equal at about 15 percent. There would still be a percentage bias in favor of commercial banks but not the 100 percent differential that is being approached today.

Any mortgage subsidy should be sufficient to induce savings and loans as well as other financial institutions to hold heavy portfolios in residential mortgages without the added force and burden of further regulation, and according to the Treasury, their proposed 3½ percent credit would accomplish this. However, in light of the analysis in our study, we strongly question this contention. Such a 3½ percent credit would amount only to about a 50 basis point subsidy to home mortgages. In light of the deterioration of returns on home mortgages vis-a-vis alternative long term investment instruments which began around 1966, a 50 basis point boost for home mortgages will not place savings and loans in the same position that existed prior to that time. For this reason we hope this Committee will consider a 5.0 percent credit which, we contend, would re-establish the competitive relationship.

Commercial banks can take advantage of a miriad of tax shelters which are unavailable to savings and loans, but savings and loan associations have to depend on the deteriorating bad debt tax incentive, coupled with the minimum tax which does not maintain the bank-savings and loan competitive relationship but worsens a comptitive disadvantage in taxation that has existed since 1971.

The housing investment tax credit with a 5 percent maximum will make a significant contribution to the provision of housing credit. It will reduce the cost of mortgage credit to the consumer, improve the ability of thrift institutions to compete for savings in periods of high interest rates, induce more flexibility into mortgage instruments and increase the ratios of loan-to-value of mortgage loans made by savings and loan associations.

We urge that the competitive relationship be restored and we feel that the mortgage interest tax credit is the most effective means of accomplishing this. In doing so, we feel this will also better serve the housing industry, the mortgage industry and the nation's economy.

We strongly recommend that this proposal, a draft of which is attached to my statement as an addendum, be included as an amendment to H.R. 10612.

TAX CREDIT INCENTIVES FOR SAVERS

The National Savings and Loan League has long endorsed the establishment of tax incentives to encourage personal savings. Many legislative proposals have been introduced to achieve this goal, and in fact, Treasury Secretary William Simon endorsed a rather complex proposal to increase personal savings in his July, 1975, testimony before the House Ways and Means Committee. At that time Secretary Simon stated that a program was needed to encourage the small saver because it was he that needed to save the most and that if this source of funds could be tapped it could ease the burden on social programs, like Social Security, and also open new funds for capital investment. This was also included in his testimony at the start of these hearings.

In response to this need, the National League would propose a credit against Federal Income Tax equal to 14 percent of the amount received as interest or dividends on savings accounts. Such a credit would be available up to a maximum of $250.

The credit is set at 14 percent to equate the percentage of credit with the lowest applicable tax rate. This provides the greatest savings incentive to those persons in the lowest tax bracket. For every dollar earned as interest or dividend for which such taxpayer would be taxed as income at a rate of 14 percent, he receives a credit of 14 percent—completely offsetting the tax on this income.

For $100 of interest income every taxpayer receives a credit of $14. A taxpayer in the 14 percent tax bracket would pay no effective tax on this income at all because the 14 percent credit completely offsets his 14 percent tax. A taxpayer in the 30 percent tax bracket, however, would have a tax liability on his $100 of interest amounting to $30. By offsetting this tax with a 14 percent credit he would still have to pay an effective tax of $16 on this income, i.e. $30 tax minus $14 credit. This proposal, therefore, chiefly benefits the smaller saver.

Not only does the credit succeed in providing the strongest incentive for the small saver to invest money through a savings account but it is also in keeping with the spirit of the proposed limitation on artificial loss provisions contained in Title I of H.R. 10612. This is accomplished by the 14 percent limitation of the credit. A taxpayer in the 14 percent tax bracket would receive a tax break equaling only the amount he would normally pay in taxes for this income. Any percentage of credit allowed over and above the 14 percent would give the taxpayer a credit not only against the tax he would pay on the interest but also against other taxable income "unrelated" to savings or investment.

We feel that for these reasons this proposal is the most equitable means of encouragement for individual savers. It helps not only the individual who saves but also the nation's economy by increasing funds available for investment in capital. We urge this Committee to include this proposal in the tax reform bill under consideration.

LIMITATION ON NONBUSINESS INTEREST DEDUCTION

The proposed Section 206 limitation on nonbusiness interest deduction could have a significant adverse effect on home ownership. This limitation of $12,000 would include within its scope not only interest on home mortgages but also on installment purchases of consumer goods, finance charges on credit cards, as well as interest paid on vacation and student loans and any other nonbusiness-related financing.

The House Ways and Means Committee implied that the $12,000 limitation should not affect the goal of putting home ownership within the reach of as many people as possible. We feel, however, that in this day of extended use of credit cards with their financing charges and long term financing of almost every major purchase, it would not take long to accumulate a substantial sum in interest payments.

If an individual is a recent home buyer, nearly the entire sum of his mortgage payments in the early stages of repayment will consist of interest on his loan.

The substantial increases in home prices particularly in large urban areas bear heavily on any such limitation. The median price of a new home reached $37,500 in December, 1974, which is a 9.3 percent increase over the last three months of 1973. The sales of homes priced below $20,000 dropped 35 percent between 1970 and 1974, and the number of homes in the upper price range ($40,000 or more) increased to 36 percent of the total homes sold in 1974, compared to only 12 percent in 1970.

All of these trends indicate unequivocally that housing costs are not going to fall, and certainly the value of high priced homes will be affected in the future by the prospect of the nondeductibility of a portion of interest payments.

The National League strongly urges that no limitation be placed on the interest deduction. We all learned that dollar limitations are totally relative from our experiences with State usury limits. No one thought that a lending limit of 6.0 percent would ever be reached, yet only last year we were making 10.0 percent loans and many laws had to be revised.

Without careful consideration, a limitation of $12,000 could appear fairly insignificant but it is this appearance that makes it necessary to consider the full, long term effect of such a provision. We are certain this provision would be the beginning of trend that would eliminate home ownership from the grasp of many American families. We do not believe this is the intended goal of this Committee and we would hope that you would consider these ramifications before making any decision on this provision.

INDIVIDUAL RETIREMENT ACCOUNTS

The Tax Return Act of 1975 contains two provisions dealing with individual retirement accounts. Section 1501 authorizes a tax-free rollover of distributions from a terminated pension plan and Section 1502 involves a limited employee retirement account that would supplement an individual's pension plan up to a maximum contribution amount.

Unfortunately, a significant number of cases have occurred where employers have terminated pension plans and distributed their assets even though the employees continue to work for the same employer. This occurs often when a company is acquired by another corporation and becomes a subsidiary or where a company's profits are low for a year or two and the employer is not making a significant contribution to its employees' pension plans. As a result, employees receive large distributions and acquire tax liability on the full extent of the distribution. This provision would allow such a distribution to be placed in another pension plan or IRA without addition of tax consequences and thus retaining the full benefit of one's pension benefits to which he is entitled.

We feel that this provision is essential. In most cases employees have no control over the termination of their pension plan and without this tax free rollover, the individual is taxed to the full extent of the distribution as if it were income. In order to qualify for a tax free rollover, 100 percent of the distribution must be contributed to another plan or IRA within 60 days after it is received. Therefore, the employee would receive no immediate benefit from the termination of the plan and his full accrued benefits would be set aside until retirement, just as they were originally intended when the plan was established.

We believe that this result is completely consistent with the spirit of the present pension law and the inclusion of this provision would remedy a very inequitable situation that now exists. This inequity was recognized by the House and this rollover provision was made retroactive through July 4, 1976. We wholeheartedly support this retroactive effect and hope that this provision is enacted as quickly as possible.

Section 1502 authorizes a supplemental or limited employee retirement account. Under present law, no contribution deduction is allowed to an individual for a contribution to an IRA during a taxable year, if, for any part of the year, he was an active participant in a qualified pension plan. Even though the benefits provided by such a plan may be less than the maximum amount he could provide for himself under an IRA, the employee is not allowed to make up the difference by making deductible contributions to his own plan or to an additional IRA.

By allowing such additional contributions up to an aggregated maximum this provision would eliminate the problems employees face when employers make pension contributions dependent on profit levels or when contributions are less than the maximum amount contributable.

The additional flexibility that these provisions would allow through IRA rollovers and additional deductible contributions should provide a substantive increase in the motivation of individuals to establsh IRAs and to get the most out of available pension programs. We think this is an admirable goal and the effect of the inclusion of these two provisions should be better retirement financial planning for all individuals.

INVESTMENT TAX CREDIT

The National League strongly supports the four-year extension of the 10 percent investment tax credit. There is a clear need to provide a continuing stimulus to the economy by maintain the investment credit but just as there is a necessity to maintain the increased rate of credit on investment which was accomplished in the Tax Reduction Act of 1975 there is a similar need to make this credit available on an equal basis for all taxpayers.

Under present law, the amount of investment credit which a thrift institution may claim is 50 percent of the amount which is allowed for other taxpayers under comparable circumstances. This limitation is largely historic and the arguments cited at the time supporting the enactment of this discriminatory treatment in the Revenue Act of 1962 are no longer applicable.

Prior to 1962 the thrift industry received a bad debt allowance equal to 100 percent of taxable income. The Revenue Act of 1962 reduced this bad debt allowance to 60 percent of taxable income and Congress was concerned that with the inclusion of a full investment tax credit for thrift institutions would result in an inequitable tax savings to thrifts.

Thus under the law as it then existed, a savings and loan association which claimed the full bad debt allowance could conceivably eliminate much of its remaining tax burden through the application of the full investment tax credit. In contrast, other taxpayers which did not have the special bad debt allowance available to them, would, at least, be able to offset a smaller percentage of their tax burden through application of the investment tax credit. I would like to emphasize that no similar rule has been applied to commercial banks, even though these institutions have had the bad debt reserve allowance available to them over the years.

Circumstances have radically changed since 1962. The Tax Reform Act of 1969 drastically cut back the amount of the bad debt reserve deduction allowed to thrift institutions and reduced, in several respects, the base upon which the bad debt reserve allowance was calculated.

As I mentioned in my discussion of the mortgage interest tax credit, the bad debt allowance for 1975 will be 45 percent of taxable income and this amount will phase down to 40 percent by 1979 Thus thrift institutions are much more nearly on a parity with other taxpayers than in 1962 and only receive one half of the investment credit available to commercial banks who now pay almost one half the effective income tax of savings and loans.

Not only has the situation changed with respect to the bad debt allowance but the demand for expensive equipment has expanded since 1962.

Computers and other expensive equipment were not used extensively by thrift institutions in 1962. The need for these machines has grown at an exponential rate since that time. Indeed, the advent of Electrnoic Funds Transfer Systems (EFTS), suggests that the amount of the investment in tangible personal property by thrift institutions will constitute a formidable expenditure over the next decade.

During the same period from 1962 onward, the asserted differential in tax burden between banks and thrift institutions has been eliminated. In fact this differential has reversed. Banks, however, have available the full investment credit. Enactment of the proposed legislation which we have attached as an addendum to our statement would not only eliminate this gross inequity between banks and thrift institutions, but would also enable savings and loan associations to utilize the investment tax credit for the purpose for which it was intended—to purchase the equipment and thereby furnish employment and capital to the affected industries.

MINIMUM TAX

The minimum tax was enacted in 1969 as an attempt to close up tax loopholes enjoyed by wealthy individuals that were escaping taxation.

Savings and loan associations were brought into the legislation because it was widely assumed, even by the majority of savings and loan associations, that thrift institutions were escaping from having to pay their fair share of taxes due to the bad debt deduction.

The result was, of course, that the bad debt deduction became listed as preference income within the minimum tax law.

We strongly believe that Congress erred in 1969 by including the bad debt allowance in the base of computing the minimum tax, while at the same time leaving out tax exempt securities from that same base.

The consequence of this action was that the impact of the 1969 law created a serious inequity between savings and loans, on one hand, and commercial banks, which invest substantial sums in tax exempt securities. In that year, the minimum tax paid by savings and loan associations totaled $21.4 million. Commercial banks' minimum taxes totaled $1.7 million.

Thrift institutions do not have available, and do not seek, special allowance which reduce tax burdens such as leasing arrangements, large investments in municipal securities, or foreign tax credits. Thrift institutions, on the other hand, are the principal suppliers of mortgage credit in this country. Application of the minimum tax as presently constituted reduces the capacity of these institutions to fulfill this essential national function.

We feel the minimum tax should be revised to eliminate the bad debt deduction from the base, and I have attached as an addendum legislative language that will affect this. We hope the Commitee will make use of the information which we have supplied in formulating the future course of taxation for our industry and that of the nation's commerical banks.

ADDENDUM A

PROPOSED AMENDMENT RELATING TO MORTGAGE INTEREST TAX CREDIT

Section 1. Credit for interest from qualifying residential mortgage loans.

Subpart A of part IV of subchapter A of chapter 1 (relating to credits allowable) is amended by renumbering section 42 as section 43, and by inserting after section 41 the following new section:

"Section 42. Interest from qualifying residential mortgage loans.

"(a) Organizations to which section applies.—"(1) this section shall apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit which makes the election provided in paragraph 2. "(2) An election under subsection (a)(1) shall be made in such manner as the Secretary or his delegate shall by regulations prescribe.

"(b) Credit allowed.—There shall be allowed as a credit against the tax imposed by this chapter for a taxable year the amount determined under subsection (c).

"(c) Determination of amount:

"(1) General rule.—The amount of credit allowed by subsection (b) for the taxable year shall be equal to the allowable percentage of the interest received or accrued by the taxpayer described in subsection (a)(1) from a qualifying residential mortgage loan.

"(2) Allowable percentage.—In the case of a taxpayer described in subsection (a)(1), the allowable percentage for purposes of this subsection shall be 5 percent if, for the taxable year, at least 70 percent of the total assets of such taxpayer are qualifying residential mortgage loans. If, for the taxable year, the perctnage of assets of the taxpayer, which are qualifying residential mortgage loans, is less than 70 percent of the total assets of the taxpayer, the allowable percentage shall be 5 percent reduced by 1/10 of 1 percentage point for each 1 percentage point (or fraction thereof) of such difference; provided however, that the allowable percentage shall be zero if, for the taxable year, less than 30 percent of the total assets of such taxpayer are qualifying residential mortgage loans.

"(d) Limitations:

"(1) Section 593 shall not apply to an organization which makes the election provided in subsection (a). An institution which makes such election shall compute an addition to its reserve for bad debts in the manner provided in Section 585(b).

"(2) Application with other credits.—The credit allowed by subsection (b) for a taxable year shall not exceed the tax imposed by this chapter, reduced by the sum of the credits allowable under Section 33 (relating to foreign tax crredits), Section 35 (relating to partially tax-exempt interest), Section 37 (relating to retirement income), Section 38 (relating to investment in certain depreciable property), Section 40 (relating to expenses of work incentive programs), and Section 41 (relating to contributions to candidates for public office).

"(3) Verification.—The credit allowed by subsection (b) shall be allowed, with respect to interest from qualifying residential mortgage loans, only if such interest is verified in such manner as the Secretary or his delegate shall prescribe by regulations.

"(e) Qualifying residential mortgage loan defined:

"(1) Except as provided in paragraph (2), for purposes of this section, the term 'qualifying residential mortgage loan' means any loan evidenced by an agreement which constitutes a first lien against the real property in the jurisdiction in which such real property is located (provided such property is located in the United States or a possession thereof), which loan is either—

"A) a loan (including redeemable ground rents, as defined in Section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property, or a loan made for the improvement of residential real property, provided that for purposes of this clause, residential real property shall include single or multi-family dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis, or

"(B) a loan secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under Section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, or a loan made for the improvement of any such real property.

For purposes of subparagraph (A), if a multifamily structure securing a loan is used in part for non-residential purposes, the entire loan is deemed a qualifying residential mortgage loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of subparagraph (A), a loan made to finance the acquisition or development of land shall be deemed to be a qualifying residential loan if, under regulations prescribed by the Secretary or his delegate, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property.

"(2) For purposes of this section, the term 'qualifying residential mortgage loan' does not include—"(A) any loan evidenced by a security (as defined in Section 165(g)(2)(C); "(B) any loan, whether or not evidenced by a security (as defined in Section 165(g)(2)(C), the primary obligor on which is—"(i) a government or political subdivision or instrumentality thereof; "(ii) a bank (as defined in Section 581; or "(iii) another member of the same affiliated group;

"(C) any loan, to the extent secured by a deposit in or share of the taxpayer; or

"(D) any loan which, within a 60-day period beginning in one taxable year of the creditor and ending in its next taxable year, is made or acquired and then repaid or disposed of, unless the transactions by which such loan was made or acquired and then repaid or disposed of are established to be for bona fide business purposes.

For purposes of subparagraph (B)(iii), the term 'affiliated group' has the meaning assigned to such term by Section 1504(a); except that the phrase 'more than 50 percent' shall be substituted for the phrase 'at least 80 percent' each place it appears in Section 1504(a), and all corporations shall be treated as includible corporations (without any exclusion under Section 1504(b)).

"(3) For purposes of this section a qualifying residential mortgage loan shall include an instrument which during its term represents an interest in one or more qualifying residential mortgage loans. The payment terms, yields, maturities and other provisions of such instrument may be different from those of the underlying residential mortgages so long as the terms and provisions of such instrument reasonably reflect anticipated principal and interest payments on the underlying mortgages, including consideration for retirements or prepayments of the underlying mortgages.

"(f) Carryback and carryover of unused credits:

"(1) Allowance of credit.—If the amount of the credit determined under subsection (c) for any taxable year exceeds the limitation provided by subsection (d) for such taxable year (hereinafter in this subsection referred to as 'unused credit year') such excess shall be—

"(A) a credit carryback to each of the 3 taxable years preceding the unused credit year, and "(B) a credit carryover to each of the 7 taxable years following the unused credit year,

And shall be added to the amount otherwise allowable as a credit by this section for such years, except that such excess may be a carryback only to a taxable year ending after [effective date]. In the case of a bank described in Section 581(a)(2), (3), or (4) which did not make an election under Section 581(b) such excess may be a carryback only to a taxable year beginning after December 31, 1978. In the case of a bank described in Section 581(a)(2), (3), or (4) which made an election under Section 581(b), such excess may be a carryback only to a taxable year beginning with or after the first year to which such election applies. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 10 taxable years to which (by reason of subparagraphs (A) and (B)) such credit may be carried, and then to each of the other 9 taxable years to the extent that, because of the limitation contained in paragraph (2), such unused credit may not be added for a prior taxable year to which such unused credit may be carried.

"(2) Limitation.—The amount of the unused credit which may be added under paragraph (1) for any preceding or suceeding taxable year shall not exceed the amount by which the limitation provided by subsection (d) for such taxable year exceeds the sum of—

"(A) the amount of credit determined under subsection (c) for such taxable year, and "(B) the amounts which by reason of this subsection, were added to the amount allowable for such taxable year and attributable to taxable years preceding the unused credit year.

"(g) Credit disallowed.—The credit allowed by subsection (b) shall be denied a taxpayer that—"(1) is formed or availed of primarily for the purpose of obtaining such credit, or (2) issued obligations that are—

"(A) supported by an authority to borrow from the Treasury of the United States, and (B) approved, at issuance, by the Department of the Treasury of the United States.

The Secretary or his delegate may prescribe such regulations as he may deem necessary in order to carry out the intent of paragraph (1).

"(h) This section shall not apply to a bank (as defined in Section 581) to which Section 585 does not apply."

Section 2. Conforming and Clerical amendments. [comparable to Section 708 of the Financial Institutions Act of 1975].

MEMORANDUM IN SUPPORT OF A PROPOSAL FOR AN OPTIONAL MORTGAGE TAX CREDIT FOR FINANCIAL INSTITUTIONS INVESTING IN RESIDENTIAL MORTGAGES

The proposed legislation, herewith attached, would amend present law to permit thrift institutions (mutual savings banks, savings and loan associations and cooperative banks) an election to credit against tax an amount equal to 5 percent of the gross interest income from residential mortgages earned during the taxable year.

The bad debt reserve allowance permitted under Section 593 of present law would be eliminated in the case of a thrift institution which elected the mortgage tax credit. In the case of such an election, the full percentage allowance would be available if the assets of such institution (determined as of the close of its taxable year) invested in qualifying residential mortgage loans is 70 percent or more of its total assets. If the percentage amount of qualifying residential mortgage loan of an electing institution is less than 70 percent of its total assets (determined as of the close of its taxable year), the credit percentage available to the electing institution would be reduced by one-tenth of one percent for each point below 70 percent. An electing thrift institution would not be denied a bad debt reserve allowance, however, but would compute its additions to the bad debt reserve under methods now provided (in Section 585) for a commercial bank ("the percentage of eligible loan" method or the "experience" method).

If, on the other hand, a thrift institution does not avail itself of the residential mortgage tax credit election, such institution could continue to compute its bad debt reserve allowance under Section 593.

The purpose of the foregoing proposal is to encourage thrift institutions to make a maximum committment in residential mortgage loans. Under present law, the bad debt reserve allowance (based upon a percentage of income as provided in Section 593(b)(2) phases down as follows: 43 percent for the year 1976; 42 percent for the year 1977; 41 percent for the year 1978; and 40 percent for the year 1979 and subsequent years. It is believed that a mortgage tax credit of 5 percent of interest income from residential mortgages will, in most instances, provide greater stimulus than the bad debt reserve allowance authorized under Section 593(b)(2) for the years 1976 and thereafter.

ADDENDUM B

PROPOSED AMENDMENT RELATING TO TAX INCENTIVES FOR SAVERS

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That part IV of subchapter A of chapter I of the Internal Revenue Code of 1954 (relating to credits against tax) is amended by inserting after section 33 the following new section:

"Sec. 34. Interest on savings.

"(a) General rule.—In the case of an individual who has received dividends or interest on deposits or withdrawable accounts in a domestic building and loan association, bank, credit union, or similar thrift institution, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 14 percent of such interest or dividends.

"(b) Limitations.

"(1) Maximum credit.—The credit allowed under subsection (a) shall not exceed $250 for any individual for any taxable year.

"(2) Limitation with respect to accounts.—For purposes of subsection (a) the term 'deposits' or 'withdrawable accounts' does not include any account with respect to which interest or dividends are payable at a rate in excess of the generally applicable minimum rate of the institution described in subsection (a)."

Sec. 2. The amendments made by the first section of this Act shall apply only with respect to taxable years ending after December 31, 1975.

EXPLANATION

CREDIT FOR SAVINGS AND LOAN INTEREST AND DIVIDENDS

To stimulate greater investment in savings and loan associations and comparable thrift institutions, a credit against tax would be allowed equal to 14 percent of the amount received as interest or dividends. The aggregate amount of the credit available for any taxable year to any individual could not exceed $250. The credit is set at a 14 percent amount to equate the percentage of the credit with the lowest applicable tax rate. The credit is thus intended to be equitable with respect to all taxpayers and not to benefit specially any person whose income tax bracket is higher than the lowest bracket of 14 percent.

To provide an absolute ceiling on the amount of the credit, the rule of new section 34 authorizes the credit only to the extent of $250 for any individual for any taxable year. Thus, a married household could receive a credit equal to $500 per annum whether or not joint returns were filed.

ADDENDUM C

PROPOSED AMENDMENT RELATING TO INVESTMENT TAX CREDIT AND MINIMUM TAX

The Internal Revenue Code of 1954 is amended—

(a) By striking out the words "or 593" from the first sentence of Section 57(a)(7) (relating to inclusion of certain reserves in items of tax preference); and

(b) By striking out subparagraph (A) of Section 46(d)(1) (relating to investment credit limitations with respect to certain persons) and redesignating subparagraphs (B) and (C) thereof as subparagraphs (A) and (B), respectively.

(c) Effective date.—The amendments made by subsection (a) and (b) shall apply to taxable years beginning on or after January 1, 1975.

MEMORANDUM IN SUPPORT OF A PROPOSAL TO ELIMINATE TAX INEQUITIES AFFECTING THRIFT INSTITUTIONS

I—THE INVESTMENT CREDIT

Under present law the amount of an investment credit which a thrift institution may claim is limited to 50 percent of the amount which would be allowed to other taxpayers under comparable circumstances. Thus, if a bank purchases a computer, the investment credit is available to the bank with respect to the total amount paid. A savings and loan association (or mutual savings bank) which purchases the same computer for the same price, as an "organization to which Section 593 applies," may claim only one-half of the investment credit available to the bank. The difference in treatment is largely historic and is not justified by present economic circumstances. The investment credit was first enacted in 1962 as part of the same legislation which reduced the bad debt reserve allowance for thrift institutions to 60 percent of taxable income. Previously, such institutions received an allowance equal to 100 percent of taxable income. Congress, at that time, was concerned that the computation of a full investment credit, plus a 60 percent bad debt reserve allowance, would enable a thrift institution to compound the benefits of the investment credit in a manner not contemplated by the Congress.[1]

Thus, under the law as it then existed, a savings and loan association which claimed the full bad debt reserve allowance could conceivably eliminate much of the remaining tax burden through application of the full investment credit. In contrast, other taxpayers which did not have available the special bad debt reserve allowance, would, in theory at least, be able to offset a smaller percentage of the tax burden through application of the investment credit. No similar rule has been applied to banks, even though these institutions have had available over the years special bad debt reserve calculations.

Circumstances have radically changed since 1962. The Tax Reform Act of 1969 cut back dramatically the amount of the bad debt reserve deduction allowed to thrift institutions.[2] For 1975 the allowance is 45 percent of taxable income and this amount will phase down to 40 percent by 1979. Thus, thrift institutions are

[1] See S. Rept. No. 1881, 87th Cong., 2d Sess. 20 (1962), indicating that the limitation "cuts down the allowance of the tax credit in proportion to the special benefit received . . .," thus largely offsetting the "special deductions" allowed to thrift institutions.

[2] The 1969 Act also reduced, in several respects, the base upon which the bad debt reserve allowance was calculated.

much more nearly on a parity than in 1962. Moreover, computer and other costly "hardware" were not used extensively by thrift institutions in 1962. The need for these machines has grown at an exponential rate since that time. Indeed, the anticipated advent of Electronic Funds Transfer Systems (EFTS), suggests that the amount of the investment in tangible personal property by thrift institutions will constitute a formidable expenditure over the next decade.

During the same period from 1962 onward, the asserted differential in tax burden between banks and thrift instittuions has been eliminated. Banks, however, have available the full investment credit. Enactment of the proposed legislation would not only eliminate this gross inequity between banks and thrift institutions, but would also enable the latter to utilize the investment credit for the purpose for which it was intended; i.e., to purchase the equipment and thereby furnish employment and capital to the affected industries.

MINIMUM TAX

The minimum tax was applied to thrift institutions (and banks) as a reflection of Congress' belief that a bad debt reserve allowance in excess of the amount allowable on the basis of actual loss experience constituted a special preferential offset to tax burdens. Accordingly, as part of the general conception of the minimum tax legislation in 1969, that portion of the bad debt reserve allowance which exceeded actual loss experience was included in the minimum tax computation.

Thrift institutions do not have available, and do not seek other special allowances which reduce tax burdens, such as leasing arrangements, large investments in municipal securities, or foreign tax credits. Thrift institutions, on the other hand, are the principal suppliers of mortgage credit in the country. Application of the minimum tax as presently constituted reduces the capacity of these institutions to fulfill this essential national function.

ADDENDUM D

UNADJUSTED AND ADJUSTED EFFECTIVE TAX RATES FOR MAJOR DEPOSITORY INTERMEDIARIES, BY INSTITUTION SIZE, 1973

[In percent]

Asset size—Insured mutual savings and insured commercial banks ($1,000,000)	Asset size—Insured savings and loans ($1,000,000)	Insured commercial banks [1]		Insured savings and loan associations [1]		Insured mutual savings banks [4]	
		Unadjusted [2]	Adjusted [3]	Unadjusted [2]	Adjusted [3]	Unadjusted [2]	Adjusted [3]
Less than $1		15.8	14.0				
$1 to $2		22.8	21.0				
$2 to $5		22.9	21.1				
$5 to $10	$10	21.7	19.9	13.0	13.2	9.7	[5] 9.6–9.9
$10 to $25	10–25	20.4	18.6	18.2	17.9	18.0	17.7–18.2
$25 to $50	25–50	18.6	16.8	22.5	22.6	18.3	18.2–18.9
$50 to $100	50–100	15.5	13.8	24.7	25.1	16.6	16.6–17.3
	100–250			25.7	25.3		
$100 to $500	250	14.5	12.7	26.3	26.9	22.4	21.8–22.9
$500 to $1,000		16.4	14.5			19.8	19.2–20.3
Over $1,000		14.2	12.2			17.0	16.5–17.6

[1] Source: K. R. Biederman and J. Tuccillo, "The Taxation and Regulation of Commercial Banks," loc. cit., and, "Equity Issues", loc. cit.

[2] Effective rate using definition for economic income as employed in "Tax Reform Studies and Proposals." Essentially this amounts to taxable income plus (1) bad debt deductions in excess of experience; (2) tax-exempt interest; (3) net operating loss carryovers; and (4) 85 percent of domestic dividends received. Consequently, these figures have not bee. adjusted in order to reflect regulatory differences.

[3] Effective rates adjusted for regulatory effects.

[4] Source: Tables II-15 and II-6.

[5] See table II-15, footnotes 2 and 3, for explanation of range.

ADDENDUM E

BASIS POINT SUBSIDY OF VARIOUS MORTGAGE INTEREST TAX CREDITS FOR ALTERNATIVE PORTFOLIOS

Mortgage tax credit (in percent)	Average return on fully-qualified portfolio (in percent)	Subsidy on portfolio return (in basis points)	Mortgage tax credit (in percent)	Average return on fully-qualified portfolio (in percent)	Subsidy on portfolio return (in basis points)
3.5	7.0	47	4.5	7.0	61
3.5	8.0	54	4.5	8.0	69
3.5	9.0	60	4.5	9.0	78
4.0	7.0	54	5.0	7.0	67
4.0	8.0	62	5.0	8.0	77
4.0	9.0	69	5.0	9.0	87

The CHAIRMAN. Next we will hear from Mr. Oakley Hunter.

STATEMENT OF OAKLEY HUNTER, CHAIRMAN OF THE BOARD AND PRESIDENT, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. HUNTER. Mr. Chairman and members of the committee, my name is Oakley Hunter. I am chairman of the board and president of the Federal National Mortgage Association, more familiarly known as FNMA.

The corporation was once wholly owned and controlled by the Federal Government, but pursuant to legislation enacted by the Congress in 1968, it was spun off and the transition to private status was completed in May 1970.

So, today we are privately owned, but in accord with our Charter Act, we are subject to certain regulation by the Secretary of the Department of Housing and Urban Development and by the Secretary of the Treasury.

Yesterday and last night I agonized over what to say in the time allotted to me. I wrote out a short statement that points out our problem as it affects the housing and home finance industry. In a sentence, I would say that FNMA is treated differently from all other mortgage lenders to the detriment of homeowners.

I appreciate this opportunity to comment on Senate bill 2772 which provides for a mortgage interest tax credit. Before doing so, however, I would like to point out that FNMA is the largest and, I might brag a little bit in behalf of the employees of the corporation, the most successful mortgage lender in the Nation. We have a mortgage portfolio now of about $31 billion, and that involves about 1.5 million mortgages and represents financing for about 1.9 million families. In contrast to many other lenders, the bulk of our holdings has been used to finance homes for families of moderate- and middle-level incomes.

It has been a great puzzle to us, therefore, why as a matter of public policy the income tax laws discriminate against FNMA and thus against the home financing efforts of our customers, the originators of mortgages. These originators include mortgage bankers, the savings banks, S and L's, life insurance companies, et cetera, which sell mortgages to us in the secondary market.

Among all of the major mortgage lenders only FNMA pays taxes at the full corporate rate of 48 percent. Maybe that was because the Congress originally felt it was the best method of impressing upon us the fact that we were to be private rather than a Government-owned corporation.

The Federal Home Loan Mortgage Corp., sometimes referred to as "Freddie Mac," our cousin, or our brother as is sometimes said in jest, is a private entity chartered by Congress in 1970 possessing the same statutory authority as FNMA, and is totally tax exempt. That is a privilege we are not requesting. The savings and loan associations enjoy a special provision, their reserve for bad debts which in effect permits them to pay Federal income taxes at a rate of about 25 percent, or a little more than half of what FNMA pays. The commercial banks pay taxes at a rate of about one-third of what we pay, about 15 percent. The bulk of their lending is not in residential mortgages but is for other purposes, mainly commercial loans.

From the standpoint of public policy, the significant point about this discrimination in the tax law relates to its ultimate impact on home buyers and also on homebuilders. Since we must pay Federal taxes at the full 48-percent corporate rate, there are no tax benefits that we can pass on to homeowners in the form of reduced interest charges as can these other mortgage financing institutions.

This discrimination can be reduced in one of two ways. Passage of S. 2772 with an amendment including FNMA would help. But if the committee does not see fit to enact the mortgage interest tax credit at this time, parity with the thrift institutions could be achieved by providing FNMA with the same type of special bad debt reserves as that now enjoyed by those institutions. This tax treatment for FNMA would be prospective only. It would not apply to our existing portfolio of $31 billion.

As a result, the revenue impact would be $10 million for the year.

There have been three major arguments raised against this proposal. First, it is argued that FNMA's charter allows it to deal only in mortgages and being a captive, it needs no incentive to buy such instruments.

I think that this ignores the fact that there are others that are also captive who are not disadvantaged by the tax laws.

The Federal Home Loan Mortgage Corp., as I said, is fully tax exempt. In addition, the savings and loan associations must invest, as was stated by the previous witness, a certain stated percentage in mortgages and other qualified assets to receive the favorable tax treatment of their bad debt reserves.

Second, it is being suggested that the special tax treatment for the thrifts is related to the fact that they are depository institutions, that is to say, they have savings accounts, while FNMA does not. We raise our money in the capital market through the sale of debentures and short-term discount notes.

But I fail to see the relevance of this argument. The favorable tax treatment is to encourage home construction and ownership, not to increase the rate of return to the depositors. The home buyer benefits only if the favorable tax treatment is passed on to mortgage borrowers. Moreover, other nondepository institutions such as life insurance companies would be given the mortgage tax credit under the legislation proposed.

Third, it is said that FNMA would not pass on such benefit partly because we are privately owned and a profit-oriented corporation. Well, so are many other institutions which get special tax credits. Moreover, this argument ignores the fact that many savings and loan associations are stockholder-owned and their number is growing. There have been conversions from Federal mutuals to State stock companies.

In addition, unlike those institutions, one-third of our directors, 5 of the 15, are appointed by the President of the United States for 1-year terms to represent the public interest on our board. Our dividend payments to stockholders are subject to review by the Secretary of Housing and Urban Development. A proposed dividend can be vetoed by the Secretary if there is a determination that it is unreasonable.

Therefore, the pledge of our board of directors which was made April 25th last year, by resolution unanimously adopted, to pass on as much of any tax benefit as is consistent with our charter, because we have to be self-supporting and we have to operate with our own funds, would, in contrast with thousands of privately owned or managed thrift institutions, be under the constant surveillance of responsible Federal officials and public interest directors.

Senator GRAVEL (presiding). Thank you very much. Senator Packwood?

Senator PACKWOOD. Your charter requires you to invest in home mortgages?

Mr. HUNTER. Yes. We can also buy mortgages on hospitals, nursing homes, and so forth, where the mortgages on such facilities are insured by the Federal Housing Administration.

Senator PACKWOOD. What is the principal source of your capital? Who buys your stock?

Mr. HUNTER. Our stock is purchased in the first instance mainly by the institutions and individuals who sell us mortgages. We have had some public sales of our stock, but mainly the initial buyers are the institutions selling mortgages to us.

Senator PACKWOOD. Do they have to buy some of your stock?

Mr. HUNTER. Yes; there is a requirement that at the time of the sale of mortgages to us, they must purchase stock with a value roughly equivalent to one-quarter of 1 percent of the unpaid principal balance of the mortgage.

Senator PACKWOOD. You raise the argument that FHLMC is not taxed and in essense does the same thing you do, and the S. & L.'s do the same thing and they get the tax break. The argue, why should we give you a tax break, you are not like the S. & L.'s you cannot go someplace else even if you wanted to. You have responded to that. I guess the question is, why do we need you at all? [Laughter.]

Mr. HUNTER. That question has been asked before.

Senator PACKWOOD. What function do you fulfill that would not be fulfilled if you did not exist?

Mr. HUNTER. We are by our charter a supplemental source of mortgage credit. We provide liquidity in the secondary market. We act when traditional sources of mortgage credit are in short supply. We have been called upon continually, more heavily when there is a serious credit crunch.

But even in normal times we are called upon because the country is capital short as far as providing residential mortgage credit at interest rates which home buyers can afford to pay. Last year our purchases of mortgages, for example, ran about $4.2 billion. I think the fact that we now hold $31 billion in mortgages is the clearest evidence of the need for our services.

Senator PACKWOOD. Why are you of any help on interest rates? You are a private corporation, private stock, you have to maintain solvency. How do you manage to be any kind of a deterrent to higher interest rates or a help toward lower ones if you want to phrase it that way.

Mr. HUNTER. Well, I would say that both FNMA and FHLMC have done a great deal to improve, to build up, the national secondary mortgage market for FHA, VA, and conventional mortgages. We have been mainly responsible for the creation of what is now the beginning of a national secondary market in conventional mortgages.

I think that both institutions by reason of supply and demand, by reason of our availability, have had a downward effect or pressure nationally on mortgage interest rates.

Now, as far as the Federal National Mortgage Association is concerned, it has been our stated policy, and it is a policy to which we have adhered, that we do not maximize profits to the detriment of the national interest. We do not take advantage of the situation when mortgage money is short and exact the last dollar from the home buyer. We have throughout our history as a private corporation done everything we can to help the residential mortgage market even to the extent of buying to the greatest extent possible section 236 subsidized mortgages at preferential rates but at the same time maintaining the requirements of our charter that we remain a viable, sound business firm that can continue in the future.

And I think we have been successful in that regard.

Senator PACKWOOD. If you are a private corporation and you have stockholders, albeit in many cases the people that you loan money to or buy mortgages from, why does the Government have members on your board and why do you have to have Government approval before you declare dividends? What is your connection with the Government that requires that kind of nexus?

Mr. HUNTER. That is, of course, a part of our charter which is an act of Congress. The corporation by Charter has a public purpose which I think has been manifested in an important way. That is in the purchase of mortgages to finance the section 235 single-family and the section 236 multifamily subsidized programs for low- and moderate-income families. Of the 236 multifamily mortgages, we ended up purchasing 90 percent of all these mortgages. We did that at a time when they were offered for sale to any other lender in the United States on the same terms, and yet we bought 90 percent of them.

Senator PACKWOOD. Well, the answer to my question then——

Mr. HUNTER. On the dividend——

Senator PACKWOOD [continuing]. As to why you have five members appointed by the President, you are saying simply because the charter says to.

Mr. HUNTER. Yes; and that is determined to be in the public interest to make sure that the company acts beyond what an ordinary private company would do. We feel that we have fulfilled that.

Now, under our Charter Act, the Secretary of the Department of Housing may establish regulations to insure that the purposes of our charter are accomplished. Also, and dividend payments to stockholders are subject to review by the HUD Secretary. At the present time our dividend return to the investor is about 5 percent. Also, the fact that today the price of our stock, on the New York Stock Exchange, is only slightly higher than it was 3 years ago indicates that we are not in any way taking advantage of the situation, but that we are doing our best to be a supplemental source of mortgage credit. This, I think, is absolutely necessary if we are going to meet a national housing goal of more than 2 million housing starts a year, if we are going to keep up with the 1.5 million new household formations, plus replacing housing going out of inventory on account of obsolescence, public construction, et cetera.

Senator GRAVEL. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Hunter, one of the great reasons I understand for FNMA is to have volume of funds available and at reasonable rates. Those are two functions that we are looking for as far as the need exists today and has in the past and will be in the future.

Mr. HUNTER. Yes.

Senator FANNIN. Is that not the greatest reason for FNMA being in existence?

Mr. HUNTER. Correct. And we feel that with the mortgage-tax credit or the bad debt reserve, we would be in a position to reduce our yields on mortgages for the benefit of a home buyer and still make roughly the same bottom line.

Senator FANNIN. I share some of the concerns of the Senator from Oregon; you say that you loan about 90 percent when we talk about the low-income housing, and 236 mortgages and all. What about the position we are in today in relationship to those mortgages that you are discussing? Do we not have a tremendous number of those homes that you have had to foreclose on? What is our record now on 236 and the mortgages that have been in existence over the past few years?

Mr. HUNTER. I do not have in mind the exact default rates or foreclosure rates on these two programs. They are above the rates for nonsubsidized housing in most respects, although in certain areas—Metropolitan New York, Chicago, Philadelphia, in the inner cities—the default and foreclosure rates are running higher than ——

Senator FANNIN. Higher than——

Mr. HUNTER. [continuing]. Just as high as section 235 and section 236. It is more reflective of a social conditions than of the programs.

Senator FANNIN. I understand. I will state that we receive many stories about it, and usually they are giving the examples that may be the exceptions to the rule, I mean to your overall work, but there are some very deserving reports coming through regarding those mortgages. That is why I was anxious to ask the question.

One of the deterrents to purchases as far as complaints of buyers has been that it was not the interest rates necessarily, but the points charged. You say you pass on benefits and give favorable interest rates. Would this alleviate some of the problems you have on points charged for mortgages?

Mr. HUNTER. I think that is really another problem, but it is a part of the overall problem of the cost of housing. I can give you a brief example here of what could happen on a $35,000, 30-year mortgage if we were given either the tax credit or the bad debt reserve. Assume a mortgage interest rate of 8 percent. That could be reduced to 7.78 percent if we had the bad debt reserve, and could be dropped to 7.62 percent if we had the advantage of the tax credit. In terms of the payment of interest over the life of the loan, in the case of the bad debt reserve it could save the homeowner roughly $2,000 in the case of the bad debt reserve and about $3,300 in the case of the tax credit. That is assuming that we passed on the entire tax benefit.

Senator FANNIN, Yes.

Mr. HUNTER. It is the intention of the company, it is our established policy to do this to the greatest extent possible. We could suffer financial reverses and have to build up our equity again. We now have about a 34 to 1 debt-equity ratio. If we had serious reverses or because of some turn in the economy, we could not guarantee the pass-on, but on the other hand, and I made the point earlier, it has always been the policy of the company not to maximize profits not to take advantage of a particular situation but to maintain our profit at such a level as will maintain our viability and long-term soundness. Beyond that we do what we can to keep interest rates down.

Senator FANNIN. Thank you, sir.

Senator GRAVEL. Senator Byrd?

Senator BYRD. What is the effective interest rate now, Mr. Hunter?

Mr. HUNTER. In our April 5 biweekly auction, our average yield was 9.049. On the FHA-VA, 8.937. Most of these mortgages will have either 5 or 10 percent downpayments which, of course, means that the yields would be slightly above those on mortgages having a 25-percent equity. We buy from all over the United States. Offers to sell mortgages to us come in from all 50 States, from remote areas, from the inner city. Ours is a national average, and, of course, we have a situation where in a special case, a savings and loan association making a loan to a customer could come below that. I think maybe some mortgages are now being made around 8.5 or 8.75 percent.

Senator BYRD. Roughly 9 percent, say.

Mr. HUNTER. Yes.

Senator BYRD. Looking ahead now, how do you envision the interest rates 12 to 18 months from now?

Mr. HUNTER. Our forecast—and like everybody else we could be entirely wrong when the time comes—is that as the economy accelerates during the balance of this year and into 1977, with more demands for credit, and with more activity in all fields, there will be a slight increase in the mortgage interest rates and in long-term rates generally. I think it is estimated that our rate of inflation for 1976 will be about 6 percent; and perhaps the same amount, hopefully lower, in 1977. But with a 6-percent rate of inflation, it is difficult to get rates much below 8.5 on the average, but closer to 9 percent really.

Senator BYRD. So you foresee a slight increase in interest rates for, say, 1977?

Mr. HUNTER. Generally speaking, yes.

Senator BYRD. I would think so, and with the Government going into the money markets as heavily as it will be, even heavier than now, in the latter part of 1976 and 1977 and going on into 1978, will that not have an effect on interest rates, too?

Mr. HUNTER. Correct. By virtue of the law of supply and demand, as the demand increases, that, of course, creates an upward pressure on interest rates, both short term and long term.

Senator BYRD. As I visualize it, it is very unlikely that interest rates will be coming down, and indeed it is very likely that the rates will be going up to some extent. I assume that is your view also?

Mr. HUNTER. Yes; but we feel with the advantage of either the bad debt reserve or the tax credit which is now available to other institutions, we could be effective in reducing market interest rates.

Senator BYRD. Thank you.

Senator GRAVEL. Thank you very much, Mr. Hunter.

Mr. HUNTER. You are welcome.

[The prepared statement of Mr. Hunter follows:]

STATEMENT OF OAKLEY HUNTER, CHAIRMAN OF THE BOARD AND PRESIDENT, FEDERAL NATIONAL MORTGAGE ASSOCIATION

SUMMARY

1. FNMA asks the Senate Finance Committee to act favorably on legislation that will benefit home buyers and the housing industry by giving it tax equality with other long-term mortgage financing institutions.

2. FNMA seeks approval of and inclusion in mortgage interest tax credit provisions of the "Uniform Tax Treatment of Financial Institutions Act" (S. 2772) or the extension of the special bad debt reserve provisions of the Internal Revenue Code (Sec. 593) to it on the same basis as that now enjoyed by the thrift institutions.

3. FNMA, if granted tax equality it seeks, will, to the extent possible but consistent with its Charter Act, pass on this tax benefit to the homeowners whose mortgages it buys, thus reducing their costs and creating some downward pressure on residential mortgage market interest rates generally.

4. FNMA is a private company, chartered by the Congress, to purchase, service and from time to time sell residential mortgages.

5. FNMA now pays full corporate income taxes—the only secondary market facility to do so. The Federal Home Loan Mortgage Corporation, a federally chartered private corporation with the same statutory authority as FNMA, is tax exempt; the savings and loan associations pay federal income taxes at a rate about half that of FNMA; the commercial banks even less.

6. FNMA will experience further discriminatory tax treatment if the mortgage interest tax credit is enacted and it continues to be excluded. Also, FNMA will be at a competitive disadvantage with all other mortgage lenders and the home buyer will suffer. FNMA itself will suffer because its ability to raise equity and debt capital with which to buy mortgages will be impaired, and the Treasury will still suffer a loss on tax revenue because of the reduction in FNMA's business and income.

7. FNMA's present mortgage portfolio totals about $31 billion, one-fourth of which involves federally assisted housing for moderate income families. The average government-backed mortgage that FNMA bought in 1975 was about $26,000; the average conventional mortgage about $34,000.

8. FNMA contends that the legislative background of the special bad debt reserve supports its being extended to FNMA. With such a reserve, FNMA can make mortgage money available at a lower rate to the home buyer and this lower rate will have a downward effect on the mortgage market itself.

9. FNMA suggests that the special bad debt reserve be applied only to the mortgages it buys after December 31, 1975. FNMA estimates the impact on the Treasury at $10 million for calendar 1976, and $14 million in calendar 1977.

STATEMENT

Mr. Chairman, and Members of the Committee, I am Oakley Hunter, Chairman of the Board and President of the Federal National Mortgage Association (FNMA). I appear before you today to ask this Committee to act favorably on remedial legislation that will benefit home buyers and the housing industry by giving our company tax equality with other long-term mortgage financing institutions.

Specifically, FNMA urges this Committee to approve the "Uniform Tax Treatment of Financial Institutions Act" (S. 2772) containing a new mortgage interest tax credit that includes FNMA. FNMA feels that both legal and marketplace considerations dictate that it be treated the same as any other taxpayer and that it should be included along with all other taxpayers as eligible for the mortgage interest tax credit. As the legislation is now drafted, FNMA is the only taxpayer specifically excluded.

If the Committee does not act favorably on the mortgage interest tax credit, FNMA asks this Committee give it the same type of special bad debt reserve as that now enjoyed by the thrift institutions.

FNMA to pass on any tax benefits to home buyers

If FNMA is given either the mortgage interest tax credit or the special bad debt reserve, we will, to the fullest extent practicable but consistent with our Charter Act, pass this tax benefit on to the home buyers whose mortgages we purchase.

Simply stated, with either the tax credit or the special bad debt reserve FNMA can lower its yield requirements and thus better the price at which we commit on and buy mortgages. This will obviously benefit home buyers, particularly those of moderate income because this is the market that FNMA serves.

It is frequently argued that FNMA's yield requirements tend to serve as an indicator to other mortgage investors. If this is so, this legislation can have a beneficial effect on the entire mortgage market because our yield requirements and pricing can be improved in favor of the home buyer.

FNMA can and will, as I have said, pass the benefits of this tax change on to the home buyers. Our Board of Directors adopted a resolution to this effect on April 25, 1975. That resolution is still in effect and FNMA management is, of course, committed to this objective. FNMA has always in the past carried out not only the letter of its federally enacted Charter Act, but the spirit and intent of that legislation as reflected in legislative history.

In addition, the Secretary of HUD has general regulatory power over FNMA as is necessary and proper to insure that the purposes of our Charter Act are accomplished.

Explanation of FNMA—what it is and what it does

Since this is FNMA's first appearance before this Committee, it might be helpful if I were first to describe briefly what our company is and what it does, and then present our arguments for tax equity.

FNMA is a federal chartered, but privately owned and managed corporation. It purchases, services, and from time to time sells mortgages on residential properties. As of December 31, 1975, FNMA's net mortgage and loan portfolio totaled almost $31 billion, representing housing for approximately two million families.

FNMA does not make mortgage loans directly but rather purchases large blocks of mortgages originated by others when primary lenders are short of funds. It thus provides supplemental liquidity for the secondary market in residential mortgages. It is the nation's largest single supplier of funds for homes and apartments and during most years is the nation's largest borrower except for the United States Treasury. The corporation is entirely owned by private stockholders. Its stock is publicly traded and is listed on the New York and several of the regional stock exchanges.

Even though FNMA gets no Congressional appropriation or federal subsidy and is fully self-supporting, it is the largest single provider of funds for residential mortgage financing for low and moderate income families. We provide no subsidies. The Department of Housing and Urban Development does. We concentrate on buying mortgages on modest priced housing. Thus, we have bought as much as 90 percent of all the mortgages insured under HUD's so-called Section 236 moderate rental housing assistance program. Mortgages on government-assisted housing constituted one-fourth of FNMA's portfolio as of December 31, 1975, an important contribution to the provision of homes and apartments for moderate income families. The average government-backed single family mortgage (FHA-insured or VA-guaranteed) which FNMA purchased in calendar 1974 was about $22,500; in 1975 it was about $26,000. The average conventional mortgage FNMA purchased in 1974 was about $27,500, and in 1975 it was almost $34,000. In today's market, this dollar range makes it clear that we are a major source for financing housing of moderate cost.

FNMA pays full federal corporate income taxes—the only secondary market facility which does so. FNMA is owned by its stockholders and is privately managed but is subject to certain federal supervision and regulation. Our Charter Act provides, among other things, for the following:

1. Five of the fifteen members of the FNMA Board of Directors are appointed by the President of the United States.

2. Cash dividends on the common stock may not exceed a rate determined from time to time by the Secretary of Housing and Urban Development to be a fair rate of return after consideration of the current earnings and capital condition of FNMA.

3. Security issues by FNMA must be approved by the Secretary of Housing and Urban Development. Issuances of debt securities must also be approved by the Secretary of the Treasury.

4. The Secretary of Housing and Urban Development is granted general regulatory powers over FNMA with authority to promulgate rules and regulations to insure that the purposes of our Charter Act are accomplished.

FNMA tax status—a summary from 1938 to date

FNMA was organized in 1938 as a government corporation and thus was exempt from federal income tax. This tax exempt status remained until 1954 when FNMA was reorganized. In this reorganization FNMA became a mixed ownership government corporation and its Secondary Market Operations were begun. FNMA became obligated to make a so-called "tax equivalent" payment—the payment of an amount equal to the federal corporate income taxes on its Secondary Market Operations which it would have had to pay were it subject to federal income tax. In 1968, when FNMA's ownership became entirely private, it was treated for federal income tax purposes the same as any other non-specialized taxpayer. Thus, FNMA has no special income tax treatment such as the special bad debt reserve that is available to other mortgage investors, such as the thrift and banking institutions.

FNMA's non-specialized federal income tax treatment continues to the present time despite the fact that other entities performing functions similar to those at FNMA have a different tax status. FNMA is currently taxed at an effective tax rate of 48 percent, far in excess of the effective tax rate applicable to any other substantial residential mortgage lender. The Federal Home Loan Mortgage Corporation, a privately owned corporation created by the Congress in 1970 and whose stautory authority almost exactly parallels FNMA's, is exempt from all income taxes. The thrift institutions have an effective tax rate of about half that of FNMA.

Accordingly, if under S. 2772 all other taxpayers are given mortgage interest tax credit and FNMA continues to be excluded, the current discriminatory tax treatment will be further exacerbated.

If in the tax bill to be reported to the Senate by this Committee a mortgage interest tax credit is included, we contend that as a matter of equity and because of marketplace considerations FNMA should be included as a taxpayer eligible for the tax credit. An amendment to accomplish this objective is set out in Attachment No. 1.

The "Uniform Tax Treatment of Financial Institutions Act"—FNMA is excluded

The proposed "Uniform Tax Treatment of Financial Institutions Act" (S. 2772) was originally included as Title VII of the "Financial Institutions Act of 1975" (S. 1267) as that bill was introduced in and reported to the Senate.

Title VII of S. 1267 as proposed by the Administration and S. 2772 contain changes in the tax treatment of financial institutions. The Treasury, in its release of March 19, 1975, states the "purpose is threefold: (1) to assure a steady flow of funds into housing; (2) to achieve a tax neutrality by providing that the income from a given asset will be subject to the same tax provisions, regardless of the type of financial institution holding the asset; and (3) to place competing institutions on an equal footing." The proposed exclusion of FNMA from the mortgage interest tax credit would violate each of these aspects of the legislation's stated purpose.

Section 707 of S. 1267 and Section 7 of S. 2772 provide that the proposed tax credit shall be denied a taxpayer that issues obligations that are "(A) supported by an authority to borrow from the Treasury of the United States, and (B) approved, at issuance, by the Department of the Treasury of the United States." (S. 1267, p. 80, lines 14–15, 18–22; S. 2772, p. 24, line 25 to p. 25, line 4)

FNMA is the only taxpayer to which the exclusion would apply, and indeed, it appears that the exclusionary language was drafted with the intention of excluding this single taxpayer from a credit to be available generally to all other taxpayers.

Apparently FNMA was omitted because of an impression that its special status as a federally-chartered secondary mortgage market facility and its large size would enable it to absorb discriminatory tax treatment without a significant change in earnings or in its ability to provide liquidity for the residential mortgage market. This is not correct. There will be either a significant loss of income thereby reducing the income tax that FNMA pays, or a significant loss of effectiveness in serving the housing consumers, thereby undermining the very purpose of the legislation. I will return to the reasons why this is so.

FNMA's special status and its size are entirely irrelevant to the merits of this tax issue. This becomes apparent if each of the several differences between FNMA and other major mortgage lenders is examined in the light of economic realities. Although these differences are interrelated, for purposes of clarity they will be treated separately.

1. *FNMA's size.*—FNMA's net mortgage and loan portfolio totals almost $31 billion. There have been periods in the past, fortunately brief, when the gross yield from mortgages being purchased to support the market was less than the cost of the borrowings made necessary by those purchases. FNMA borrows in competition with the Federal Home Loan Bank System, among others, and must pay competitive rates. Further, despite its size, FNMA is not as large as some other mortgage investors that would be made eligible for the tax credit.

2. *Treasury borrowing authority.*—Subject to specific requirements, FNMA can borrow up to $2.25 billion from the Treasury. It has been suggested that this borrowing authority (often referred to as a "Treasury backstop") adequately compensates for the proposed discriminatory tax treatment in the pending legislation. The realities are to the contrary. In the past, when FNMA was much smaller, this backstop authority was very important to its standing. Thus, in 1957, when the borrowing authority was increased to $2.25 billion, FNMA's outstanding debt was only $1.1 billion as compared to December 31, 1975 almost $30 billion. The borrowing authority now provides only a minor contingent benefit, especially since it is available only at the discretion of the Secretary of the Treasury.

Also, this borrowing authority has not been used since 1969 when FNMA was still in transition to the status it achieved in May, 1970, as a privately-owned and privately-managed corporation. We have consistently so conducted our affairs as to make it unlikely that we will again actually use the Treasury borrowing authority.

Finally, any relevance of the $2.25 billion borrowing authority to the proposed discriminatory tax treatment is difficult to grasp in light of the fact that the savings and loan industry (which would be eligible for the mortgage interest tax credit) has access to a Treasury borrowing authority of $4 billion through the Federal Home Loan Bank System. In a very real sense, then, any addition to the already discriminatory tax treatment of FNMA would further discriminate against those home buyers, particularly those of moderate income, whose mortgages are sold to FNMA and against those mortgage originators who most heavily rely on FNMA.

3. *FNMA's Federal charter.*—As mentioned, FNMA is a federally chartered corporation, but this is in no way relevant to the proposed tax treatment. Our federal charter was granted for the express purpose of providing, including housing for moderate income families. For reasons I will explain in detail, our proposed exclusion from the tax credit would diminish our capacity to serve this public purpose. It seems to us that our status as a corporation chartered by the Congress and our public purpose would more logically justify favorable, rather than unfavorable, tax treatment.

4. *Treasury Department approval of FNMA debt issuances.*—The provision for Treasury Department approval of FNMA debt issuances does not convey any special benefit of FNMA and is not relevant to FNMA's income tax status. Because the U.S. Treasury and FNMA have in recent years been the first and second largest borrowers of funds in the domestic money market, it is desirable that their borrowings be coordinated. Accordingly, even in the absence of the approval requirement, FNMA would voluntarily coordinate its borrowings with those of the Treasury to the advantage of all borrowers who have a stake in maintaining an orderly credit market. But the legal requirement that we seek Treasury's approval extends no additional benefit to FNMA.

Consequences of discriminatory tax treatment

Once it is understood that FNMA's size, its Treasury borrowing authority, its Federal Charter and the Treasury Department approval of its borrowings are individually and collectively irrelevant to its tax treatment, it becomes more readily apparent why the proposed discriminatory tax treatment, like most discrimination based on irrelevant factors, is unjust and harmful.

FNMA now a privately owned corporation, borrows competitively and it buys and sells mortgages competitively. To offset the mortgage interest tax credit proposel for all other institutions but denied to us, FNMA would be placed at a competitive disadvantage compared with other lenders to the extent of a loss in our yield on mortgages of 0.54 percent on an 8 percent portfolio and a 0.61 percent on a 9 percent portfolio. Such a differential is simply not available in a competitive market and must come out of the pockets of the American homeowners who, in future years, will have their housing financed by FNMA. Accordingly, if FNMA continues to be excluded from the tax credit it would be at a considerable yield disadvantage in relationship to all other mortgage lenders.

One corporate response, in fairness to our stockholders, would be to seek a higher compensating average yiled by changing the mix of the types of mortgages we purchase. This would diminish our capacity to support that segment of the market that serves families of moderate income. More than any other major mortgage investor, FNMA has focused its efforts on financing housing for such families. To the extent that this response is succesfully made, the purpose of the legislation would be subverted.

Under another conceivable alternative, FNMA would suffer reduced earnings and the Treasury would suffer a related loss of income tax revenues. In the short run this would primarily affect FNMA, its stockholders and the Treasury. Before long, however, the housing consumer fould also be affected as our ability to participate in the mortgage market would be greatly reduced by the inevitable erosion, caused by reduced earnings, of our ability to raise equity capital and debt capital with which to purchase more mortgages.

Conversely, if FNMA were entitled to the same mortgage interest tax credit as is proposed for all other mortgage lenders, its position would be basically competitive. If we are made eligible, the benefits of the proposed mortgage interest tax credit would, through the intense competition that charactrizes the mortgage market, be passed on to the homeowners whose mortgages we purchase. This is as true of FNMA's mortgage investments as it is of the mortgage investments of those entities covered bythe legislation as now drafted.

The very rationale for the proposed mortgage interest tax credit, which justifies a loss of income tax revenues to the Treasury, should apply in the same way to FNMA as to all other mortgage investors who would be given this tax credit. The Treasury Department has approved the proposed credit and has lobbied hard for its passage. It estimates that the credit under S. 2772 will result in a reduction of tax revenues in 1976 of $544 million and in 1977 of $618 million. Treasury estimated that the inclusion of FNMA would involve an additional $70 million of reduced tax revenues. If FNMA suffers discriminatory tax treatment, either its taxable income or its effectiveness in carrying out its purpose must necessarily be correspondingly reduced. If its taxable income were to be reduced as a result of a lower spread between income and expenses or a lower volume of business, then the "$70 million" theoretically saved by FNMA's exclusion would be offset, at least in part, by a reduction in our taxable income and, therefore, in our tax payments.

Yet another possible loss of effectiveness may result during periods when interest rates rise sharply and residential mortgage credit is in short supply. During such periods, FNMA may simply be unable to compete in the market for all the needed borrowings because it is unable to pay a higher interest rate on its borrowings at the same time that it is suffering the .54 to .61 percent yield disadvantage mentioned above.

Let me illustrate, for the benefit of the Committee, our estimate of the impact of the proposed mortgage interest tax credit on FNMA.

ESTIMATED IMPACT OF PROPOSED MORTGAGE INTEREST TAX CREDIT ON FEDERAL NATIONAL MORTGAGE ASSOCIATION

	With credit	Without credit
Yield	8.00	8.54
Expenses at 90 percent of 8.00	7.20	7.20
Income before ta	.80	1.34
Tax at 48 percent	.38	.64
Credit (3½ percent of 8.00)	.28	
Net Tax	.10	.64
Net income	.70	.70

More than $120 million of the $544 million revenue loss which Treasury estimates to be the cost of the mortgage tax credit in 1976 would go to commercial banks and insurance companies. Yet when interest rates rise rapidly, diversified lenders, such as commercial banks and insurance companies, find it relatively easy, because of the diversity among their borrowers, to reduce the volume of their residential lending in favor of other, higher yielding types of loans. These are precisely the times when the thrift institutions usually suffer depost outflows thus preventing them from making a substantial volume of additional residential mortgage loans. These are also precisely the times when FNMA sharply increases the volume of its mortgage purchases. For example, during the residential credit shortage of 1969–70, FNMA's mortgage purchase activities accounted for a large portion of the increase in funds going into one- to four-family home mortgages—namely, one-fourth of the increase for 1969 and one-third for 1970. But even these figures for the two full years do not tell the whole story. The strain on the mortgage market was especially severe that winter. FNMA accounted for about half of the increase in home mortgage loans during the fourth quarter of 1969 and the first quarter of 1970.

It is ironic, in the light of this history, that eligibility for a mortgage interest tax whose financial justification is to assist the housing market, should be denied to the one private mortgage investor that most vigorously supports residential lending at the time of greatest need.

Special bad debt reserve—an alternative

If the judgment of this Committee is to defer acting on the provisions of S. 2772, FNMA asks this Committee to adopt an amendment to H.R. 10612 to give it the same type of special bad debt reserve as that now enjoyed by the thrift institutions. The text of such an amendment is set out in Attachment No. 2.

By its express provisions our proposal would apply only to those mortgages purchased by FNMA on and after January 1, 1976. Stated otherwise, this legislation would not be applicable to any part of the $30.8 billion net mortgage and loan portfolio held by FNMA as of December 31, 1975.

FNMA estimates the impact on the Treasury to be $10 million in calendar 1976 and $14 million in calendar 1977.

That home buyers will benefit is the basis for the tax treatment of the bad debt reserves of the thrift institutions. Those institutions have argued that the benefits are passed on to home buyers, and the Congress has agreed. Extending similar tax treatment to FNMA would have a similar beneficial effect as I pointed out earlier in this statement.

The mortgage yields required by FNMA in order to be viable as a privately owned corporation also have a major impact upon the national mortgage market. During periods of tight money, mortgage lenders, including thrift institutions and commercial banks, tend to utilize the FNMA Free Market System auction as an indicator for current mortgage yields. If FNMA can operate with lower yields and continue to be self-sustaining, the enactment of this legislation could put a downward pressure on the yields in the national mortgage markets when that pressure is needed most.

Legislative background of bad debt reserve

In recent years Congress has given and continued a special bad debt reserve for thrift institutions, not because of a correlation between the bad debt reserve and the "small saver," perhaps the principal source of money for the thrift institutions, but rather because of the type of investment undertaken by the thrifts.

Initially thrift institutions were tax exempt on the principle that a cooperative enterprise did not generate gross income subject to taxation. But in 1951 the tax exempt status of the thrift institutions was changed, and they were given a statutory bad debt reserve. In 1962 the Congress reconsidered the bad debt reserve and, though it was reduced in amount, the reserve was continued because of, among other things, "the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions." (H. Rept. No. 1447, 87th Cong., 2nd Sess., p. 38 (1962).)

Further legislative changes again reducing the amount of the bad debt reserve allowance were made in 1969. Again, however, the Congress refused to abolish the allowance "in light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions." (H. Rept. No. 91–413, 91st Cong., 1st Sess., p. 125 (1969).)

The pattern of both the 1962 and the 1969 changes clearly suggests a tax policy which should apply to FNMA.

I also want to emphasize the fact that FNMA is owned by its stockholders should not preclude the Congress from extending the special bad debt reserve to it. In the report (S. Rept. No. 1881, 87th Cong., 2nd Sess., p. 42 (1962)) which accompanied the Revenue Act of 1962 (H.R. 10650), this Committee noted the fact that the bad debt reserve would be available to "stock savings and loan institutions, (which) although having many of the same characteristics as the mutual savings and loan association are, nevertheless, commercial enterprises more nearly comparable to banking institutions than are the mutual associations generally."

Today we understand that 18.7 percent of the more than 5,000 savings and loan associations are stock companies and they hold about 21 percent of the aggregate assets of the savings and loan business.

In concluding, Mr. Chairman, I want to refer again to a report from this Committee in support of our argument for obtaining the special bad reserve. In the report (S. Rept. No. 91-552), 91st Cong., 1st Sess., p. 162 (1969)) this Committee said, "There is no reason for providing mutual savings banks and savings and loan associations a special tax benefit except for the fact that they are a major source of home mortgage loans, an activity which the Congress has indicated it desires to encourage."

Mr. Chairman, we submit that this argument is "on all fours" with the Federal National Mortgage Association.

Attachment No. 1

AMENDMENT TO S. 2772

(1) Beginning with line 22 on page 24, strike out all down through line 4 on page 25, and insert in lieu thereof: "subsection (a) shall be denied to a taxpayer that is formed or availed of primarily for the purpose of obtaining such credit.", and (2) On page 25, strike line 7 and insert in lieu thereof "this subsection.".

This amendment to S. 2772, the Uniform Tax Treatment of Financial Institutions Act, would permit the Federal National Mortgage Association to avail itself of the mortgage interest tax credit in the same manner and to the same extent as any other taxpayer.

Attachment No. 2

AN AMENDMENT TO H.R. 10612

On Page 661 of H.R. 10612, after line 16, insert the following new section:

"Sec. 1923. Section 593 of the Internal Revenue Code of 1954 (relating to reserves for losses on loans by mutual savings banks, etc.) is amended—

(1) by adding after the word "profit" in subsection (a) the following: "and to national mortgage associations".

(2) by adding at the end of clause (ii), as a part thereof, of subsection (b)(1)(B) the following sentence: "In the case of a national mortgage association referred to in subsection (a), the amount referred to in this clause shall be an amount which, when added to the amount determined under subparagraph (A), equals the amount by which 12 percent of the total debt obligations (whether or not subordinated, and including trust certificates of beneficial interest) of such national mortgage association at the close of such year exceeds the sum of the capital, surplus, and undivided profits of such national mortgage association at the beginning of such year."; and

(3) by striking out "and" at the end of clause (iv) of subsection (b)(2)(E), by striking out the period at the end of clause (v), and inserting "; and" in lieu thereof, and adding the following new clause:

"(vi) in the case of a national mortgage association referred to in subsection (a), by excluding the income from, and expenses attributable to, all qualifying real property loans acquired by the taxpayer before January 1, 1976. For purposes of the preceding sentence, the expenses attributable to such qualifying real property loans shall be an amount determined by multiplying a fraction, the numerator of which is the gross income realized during the taxable year from qualifying real property loans acquired by the taxpayer before January 1, 1976, and the denominator of which is the gross income realized during the taxable year from all qualifying real property loans, by the total expenses paid or incurred during the taxable year attributable to all qualifying real property loans."

(b) The amendments made by this section shall apply to taxable years beginning after December 31, 1975.

This amendment to section 593 of the Internal Revenue Code would grant the Federal Mortgage Association the same type of special bad debt reserve as that now enjoyed by the thrift institutions.

Senator Gravel. Our next witness is T. A. Dobrozsi, President, Employee Relocation Council.

STATEMENT OF T. A. DOBROZSI, PRESIDENT, EMPLOYEE RELOCATION COUNCIL, ACCOMPANIED BY JAY W. GLASMANN, TAX COUNSEL, AND H. CRIS COLLIE, EXECUTIVE DIRECTOR

Mr. DOBROZSI. My name is T. A. Dobrozsi. I am employed by Armco Steel Corporation, in Middletown, Ohio and am appearing before you today as president of the Employee Relocation Council. I have with me Mr. H. Cris Collie, executive director of the Employee Relocation Council, and Mr. Jay W. Glasmann who serves as our Tax Counsel.

Our membership consists of representatives of 435 corporations and governmental agencies. The individual member representative is responsible for the administration of his or her company's relocation policy and as such interfaces with his respective transferred employees.

My appearance before you today is not only on behalf of our member companies but also on behalf of all people who make job-related moves, whether they be employed by industry, by government, or are self-employed, or unemployed. Our latest information is that our members annually transfer to new job locations somewhere between 100,000 and 150,000 of their employees. Since approximately 1,800,000 individuals annually claim the moving expense deduction on their tax returns, it is apparent that the moving expense provisions of the Code are of considerable importance outside our membership.

Our studies indicate that the great bulk of job-related moves, probably 90 percent, involve individuals who are in the $10,000-$25,000 a year salary bracket. In my own company, for example, over 75 percent of the individuals who transferred in 1974 earned less than $20,000.

Until the enactment of the Tax Reform Act of 1969, the Internal Revenue Code, as interpreted by the IRS and supported by a number of court decisions in the sixties, treated as taxable income to the employee any amount reimbursed to him by his employer for the cost of his move, other than incidental transportation costs and subsistence while en route. No deduction was allowed for the expenses of job-related moves other than for the cost of transporting the worker, his family, and household goods to the new job location.

The unfairness of this approach was obvious to anyone who had ever been moved from one city an another by his employer.

In some companies, an employee can avoid a move suggested by his employer only by risking the loss of the job, or by jeopardizing possible promotions in the future. In any event, beginning about 1966, bipartisan groups in both Houses of Congress pressed for corrective legislation, which was finally enacted in compromise form as part of the Tax Reform Act of 1969.

The 1969 legislation generally liberalized the rules with respect to job-related moves by allowing the deduction of the following four expenses:

(1) expenses for premove househunting trips;

(2) temporary living expenses for up to 30 days at the new location;

(3) expenses related to the sale of the residence (or the settlement of an unexpired lease) at the old job location, and

(4) expenses related to the purchase of a residence (or the acquisition of a lease) at the new job location.

However, maximum dollar limits were placed on the new deductions; no more than $1,000 for the househunting trip and temporary living expenses, and no more than $2,500 for all four of the new deductible categories.

In addition, the Congress decided that all moving expense reimbursements had to be included in the employee's gross income, and it substituted a 50-mile requirement for the 20-mile test applicable under prior law in determining whether a move qualified for deduction.

The tax revision bill passed by the House last year, which is now pending before this committee, recognizes that the present mileage and dollar limits are out of date and are interfering with the mobility of labor in this country.

Among other changes, section 506 of the House bill would increase the $2,500 limit on expenses for househunting trips, temporary living expenses while awaiting occupancy of permanent quarters, and residence sale and purchase expenses by $500 to $3,000 and would reduce the mileage test for a qualified move from 50 miles to 35 miles. These two changes, while helpful, are woefully inadequate. This is particularly true of the small $500 increase in the overall dollar ceiling when the inroads of inflation justify at least a 100-percent increase.

The best illustration of the inadequacy of the overall dollar limit of $2,500 can be found by tracing the inflationary pressures on the prices of homes since the Tax Reform Act of 1969 was enacted. In 1969, the median selling price of a previously occupied home in this country was $21,790. According to an article in the Wall Street Journal this week, the median selling price in February 1976 was $37,200. This dollar increase, in combination with increased brokerage fees, as a percentage of sales price, has caused home sale costs to rise by 99.1 percent. Other costs incident to the sale of a home, such as maintenance costs, attorneys' fees, and closing costs have also moved sharply upward. These conservative cost estimates for a typical move support an increase of $2,500 to an overall limit of $5,000.

With respect to the mileage test, the House bill's reduction from a 50-mile to a 35-mile test seems to be a continued endorsement of very long commutes. This is clearly counter to the grave national concern over energy conservation. For example, a taxpayer could be faced with an increase of up to 70 miles in his daily commute without being eligible for deductions for a move closer to a new job. The need for conserving gasoline necessitates reducing the present 50-mile test beyond the 35-mile test, as incorporated in the House bill, to a more realistic 20 miles. This should be done even though the change from 35 miles to 20 miles for qualifying moves probably will not increase the number of moves which are entitled to the benefits of the moving expense deduction by more than about 1 percent.

It has been suggested that liberalizing the moving expense deduction is a "tax expenditure" that is not entitled to a very high priority. Such an assertion obviously does not come from a homeowner faced with skyrocketing prices of housing who is required to move from one job location to another at the convenience of his employer, or because he has lost his job and must find work elsewhere.

Some employers, including the Federal Government, reimburse transferred employees for all or part of the cost of their moves, even though the dollar ceilings for deductible items are exceeded. When this happens, the employee must pay a tax on the amount reimbursed in excess of the allowable ceiling. This is what happens, for example, to the Federal employee who is transferred from the Washington, D.C. area, where the average price of existing homes in late 1975 was almost $59,500. Under Federal regulations, such an employee would probably have to incur selling expenses in disposing of his house of around 8 percent, or $4,760. This amount would be reimbursed to him by the Government under its present Federal Travel Regulations.

Assuming the employee had no other moving expenses subject to the $2,500 ceiling, he would have a tax to pay on $2,260 of the reimbursed amount. Thus, the Federal Government gives with one hand and takes away with the other—and the employee is economically in the hole because he moves at the request of his Government.

To summarize, for the reasons earlier noted, section 506 of H.R. 10612 should be modified in two respects:

1. The overall ceiling of $2.500 should be further increased from the proposed $3,000 to at least $5,000 to take account of the 100 percent increase in job-related moving expenses for the average homeowner between 1969 and 1976.

2. The House bill would change the present 50-mile test for a qualified move to 35 miles. With the growing need for gasoline conservation, the mileage test should be returned to 20 miles as provided in the statute prior to 1969.

We thank you for the opportunity of appearing, sir.

Senator GRAVEL. Thank you.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator GRAVEL. I have no question. Thank you very much.

[The prepared statement of the Employee Relocation Council follows. Oral testimony continues on p. 2100.]

SUMMARY OF RECOMMENDATIONS OF EMPLOYEE RELOCATION COUNCIL ON TAX TREATMENT OF JOB-RELATED MOVING EXPENSES

A. IMMEDIATE ACTION NEEDED

1. Despite the substantial inflation between 1969 and 1976 and the skyrocketing prices for houses, there has been no adjustment of the $1,000 and $2,500 ceilings on moving expense deductions allowed for job-related moves under section 217 of the Code. Section 506 of H.R. 10612 would increase these ceilings to $1,500–$3,000. The $1,500 ceiling on temporary living expenses and house-hunting trips is probably reasonable at this time; however, the proposed increase of the overall ceiling to only $3,000 for these two categories of moving expenses plus the expense for sale and purchase of a residence or settlement of a lease is woefully inadequate.

2. The overall ceiling of $2,500 should be increased to at least $5,000 to take account of the 100 percent increase in job-related moving expenses for the average home owner between 1969 and 1976.

3. The House bill would change the present 50-mile test for a qualified move to 35 miles. With the growing need for gasoline conservation, the mileage test should be returned to 20 miles as provided in the statute prior to 1969. The impact of this change would be small, affecting an estimated 1 percent of job-related moves in this country.

B. LONGER RANGE PROPOSALS

Over the long run, to simplify and up-date the moving expense provisions of the Code, the following changes should be considered by the Finance Committee:

1. Increase the present dollar limits of section 217 of the Code to $1,500 and $5,000, with a biannual cost-of-living adjustment to the revised dollar limits. In the alternative, the limitation applicable to the purchase and sale of a residence

should be based on a percentage of the purchase and sales prices (Federal Travel Regulation rule: 5 percent of purchase price not to exceed $2,500 and 10 percent of selling price not to exceed $5,000).

2. Increase from 30 days to 60 days the meals and lodging deduction while occupying temporary quarters and apply to expenses incurred at both new and former places of work.

3. Exclude from tax all relocation allowances paid or furnished to Federal employees, and their dependents, with the possible exception of miscellaneous moving allowances available to Federal employees.

4. Exclude from gross income reimbursements for expenses which are deductible, provided the employee provides his employer with documentation of the expenses.

STATEMENT OF EMPLOYEE RELOCATION COUNCIL ON TAX TREATMENT OF JOB-RELATED MOVING EXPENSES

My name is T. A. Dobrozsi. I am employed by Armco Steel in Middletown, Ohio, and appear before you today as President of the Employee Relocation Council (ERREAC). I have with me Mr. H. Cris Collie, Executive Director of ERREAC, and Mr. Jay Glasmann, who has served as our tax counsel for many years.

My testimony today will be limited to a discussion of the need for simplification and liberalization of the moving expenses provisions of the Tax Code.

ERREAC was formed by representatives of private industry in 1963 to facilitate and promote the exchange of information among those responsible for the relocation housing programs of their respective companies. At present ERREAC's membership consists of approximately 430 U.S. corporations and government agencies, and includes many of the nation's major employers. Membership in ERREAC is open to all companies and Governmental agencies who transfer employees from one job location to another and who are interested in furthering the study and solution of the many problems encountered by relocated employees. Appendix A lists the present membership of the Employee Relocation Council.

For the past ten years, ERREAC has actively supported the efforts of a large bipartisan group of Congressmen and Senators to obtain corrective legislation dealing with the tax treatment of moving expenses.

The ERREAC membership is most appreciative of the efforts of several members of this Committee, as well as those of many other Congressmen and Senators who have taken an active interest in the moving expense problem.

INTRODUCTION

For many years private industry has recognized the desirability of being able freely to move employees to new locations where they are needed and their skills can be put to the best use. To achieve this desired mobility of labor (which obviously benefits the entire economy), private industry has long followed the practice of reimbursing such employees for the costs of their moves, including not only transportation costs and subsistence en route but also the cost of selling the old home, the cost of finding living quarters at the new location, the cost of temporary living expenses until such quarters are available, and the like.

In 1966, the Congress authorized the Federal Government to follow a similar practice with the enactment of P.L. 89–516. Thus, for example, civilian Government employees who are transferred in the interest of the Government are now reimbursed the costs of selling their homes at the old location up to 10 percent of the selling price of the home, or $5,000, whichever is the lesser. Similarly, the Governmnt pays their costs incurred in finding a residence at the new job location up to 5 percent of the purchase price, or $2,500, whichever is less. In addition, they are reimbursed for house-hunting trips, temporary living expenses, and a wide variety of miscellaneous expenses incurred in connection with relocating their homes. See Chapter 2 of Federal Travel Regulations (May 1973).

The Congressional intent with respect to the tax treatment of Federal relocation allowances is clearly revealed by the House Floor Debate on H.R. 10607 (which became P.L. 89–516) in the 89th Congress and by Senate Report No. 3583, 89th Cong., 2d Sess., on the same bill. Mr. Smith of California, speaking for the Rules Committee stated: "The aim is to get this bill passed and try to remove such payments to employees, both Government and private, from ordinary income for tax purposes". Cong. Record p. 6277, 89th Cong., 2nd Sess. In like fashion, Mr. Byrnes of Wisconsin summarized the inequitable tax situation then existing as follows: "Mr. Chairman, it seems to me it is inconsistent to recognize that these expenses are a legitimate expense of the employer, that they are incurred for the convenience of the employer, and then say 'yes; but if we reimburse the out-of-pocket and the actual expenses of the employee, he has received income as a result and he must pay income taxes on these funds.'?

"Mr. Chairman, if we take this attitude it just seems to me that we defeat the very purpose that we have in mind here." Finally, Mr. Erlenborn stated: I think we have also made a good record here as to the fact that it is the intention of this Congress, although we cannot do it through this vehicle, to make these reimbursements of expenses nontaxable. Certainly this can be done only by the passage of another substantive piece of legislation, several of which have been discussed during the debate here today. I hope that the Committee on Ways and Means will act favorably on one of those bills so that this bill may reach its fullest meaning and these reimbursemens expenses will not be counted as income to the employees, which v uld mean they would in fact receive only a portion of the benefit that we intend to give them by the passage of this bill."

The following excerpt from Senate Report No. 1357 is also indicative of a Congressional intent not to tax relocation allowances paid to Federal employees:

"The committee considered a proposed amendment to H.R. 10607 which would specifically have exempted the allowances and benefits authorized by this bill from taxation, unless, of course, the taxpayer should realize a gain from such reimbursement.

"The committee endorses the intent of this proposed amendment. However, in view of the jurisdictional problems which might be raised as a result of adding such language to this bill and in view of the fact that general legislation similar to the proposed amendment is currently pending before the Ways and Means Committee of the House and the Finance Committee of the Senate, the amendment was not adopted.

"The committee is of the view, however, that the general purpose and effect of H.R. 10607 would be seriously diluted if the benefits and allowances authorized thereunder are deemed taxable as income. In this regard the committee is in full accord with the following testimony given on this matter by John W. Macy, Chairman of the Civil Service Commission before the House Committee:

> "'* * * the basic philosophy behind this legislation would indicate that this is not compensation, this is not additional income. This is reimbursement, and therefore, should not be taxable.'"

Unfortunately, until the enactment of the Tax Reform Act of 1969, the Internal Revenue Code, as interpreted by the IRS and supported by a number of Court decisions in the sixties, treated as taxable income to the employee any amount reimbursed to him by his employer for the cost of his move, other than actual transportation costs and subsistence while en route.

The unfairness of this approach was obvious to anyone who had ever been moved from one city to another by his employer. A transferred employee can avoid a move suggested by his employer only by risking the loss of his job, and by jeopardizing possible promotions in the future. In any event, beginning about 1966, bipartisan groups in both Houses of Congress pressed for corrective legislation, which was finally enacted in compromise form as part of the Tax Reform Act of 1969.

The 1969 legislation generally liberalized the rules with respect to job-related moves by allowing the deduction of the following four types of expenses:

(*a*) Expenses for pre-move housing-hunting trips;

(*b*) temporary living expenses for up to thirty days at the new job location;

(*c*) expenses related to the sale of the residence (or the settlement of an unexpired lease) at the old job location, and

(*d*) expenses related to the purchase of a residence (or the acquisition of a lease) at the new job location.

However, maximum dollar limits were placed on the new deductions; no more than $1,000 for house-hunting trips and temporary living expenses, and no more than $2,500 for all four of the new deductible categories.

Also of significance is the fact that no deduction was provided for miscellaneous moving expenses of the type included in Federal relocation allowances under Chapter 2, Part 8, of the Federal Travel Regulations.

In addition, the Congress decided that all moving expense reimbursements had to be included in the employee's gross income, and it substituted a fifty-mile requirement for the twenty-mile test applicable under prior law in determining whether a move qualified for deduction.

Prior to the enactment of the Tax Reform Act of 1969, new employees were required to include in gross income all reimbursements for moving expenses, including transportation and meals and lodging en route, and they had to satisfy the twenty-mile distance and the minimum period of employment requirements of section 217 of the Code in order to deduct any portion of their moving expenses. On the other hand, old employees who were transferred were permitted to exclude from their gross income reimbursements received from the employers for so-called "direct" or "bare bones" costs of moving from one job location to another. Further, they were not subject to either a mileage test or the minimum employment period rule.

HOW HAVE THE 1969 PROVISIONS WORKED?

The $2,500 limit which found its way into the 1969 Act was first suggested in 1967 by Mr. Burke as a compromise measure in order to eliminate Treasury objection to his bill, H.R. 47, which merely provided that moving expenses to be deductible had to be reasonable. Nine years have passed since then and a rigid ceiling for the new deductible items which was far from generous in 1967 is at the present time for the average move more than 100 percent too low. That separate limit of $1,000 for house-hunting trips and temporary living expenses, as well as the thirty consecutive day limitation on temporary living expenses, has produced inequities and has tended to make compliance with the 1969 rules overly difficult for both employers and their transferred employees. Since there are considerably more than a million moves a year subject to the moving expense provisions of the tax law, the complications arising from the multiple limitations and conditions which are now in the Statute are a matter of real concern. Among other things, these complications have led to a temporary moratorium with respect to the appliction of the moving expense rules to members of the Armed Services. See, e.g., Sec. 2 of P.L. 93-490.

ERREAC believes that the provision in the present law which requires employees who are reimbursed for their moves by their employers to report such reimbursements as income, and then claim offsetting deductions for allowable moving expenses, has imposed unnecessary and burdensome paperwork on both the employee in preparing his return and upon his employer in furnishing the employee with moving expense information as required by the present Treasury regulations.

Under most moving expense plans—and this is true for both the Government and industry—the employee can obtain reimbursement for the costs of his move only if he accounts to his employer with supporting documentation showing the nature of the expenses and that they were actually incurred. To the extent such expenses otherwise qualify for deduction under section 217 of the Code, the present rules require the following steps that would be eliminated if the employee who fully accounts for his moving expenses to his employer could simply exclude the reimbursements from his gross income:

1. The employer on IRS Form 4782 (or on the employer's own form giving the same information), must supply the transferred employee with detailed information on moving expense payments to him, broken down into six different types of expense, and by the nature of the payment (i.e., cash directly to the employee, to a third party for the benefit of the employee, and the values of services furnished in kind). Also, the employer must record on a W-2 form for the employee the amount of reimbursed moving expense, broken down between that which the employer thinks is deductible by the employee and that which appears to be subject to tax. Much of the information simply duplicates that which the employee has had to submit to the employer to account for his moving expense costs in order to justify receiving reimbursement. Thus, a Federal employee applying for an employee relocation allowance must comply with all the rules of Chapter 2 of Federal Travel Regulations (May 1973), including submission of a special government form covering expenses incurred upon sale or purchase of a residence upon change of official station. Once this is accomplished, and the reimbursement has been approved and paid, the Federal Government is required to give the same information back to the employee on IRS Form 4782, except that the individual details must be supplied in a different form.

2. Once the employee receives the Form 4782, he must then transcribe the information on to another IRS form, Form 3903, which he must file with his return.

3. On his Form 1040, the long form individual income tax return, the employee then claims his moving expense deduction on line 40, which ultimately is carried over to line 14 of the form as a subtraction from gross income.

In 1972, the Service reintroduced the short Form 1040–A to simplify the income tax return filing for many individuals. Unfortunately, an individual claiming a moving expense deduction is not eligible to use the short form return, although he would be if reimbursed moving expenses which are fully accounted for to the employer were treated as an "exclusion" rather than having to go into the employee's gross income and come back out again as a deduction. As the great bulk of the individuals who have job-related moves each year earn less than $25,000 (more than 95 percent in 1971, according to IRS Statistics of Income), it is obvious that the present rules need revision to simplify the present burdensome compliance problems.

The change in 1969 from a twenty-mile to a fifty-mile rule for determining whether a move qualifies for deduction, in addition to being most unfair to thousands of employees who are unable to meet the unreasonable new standard, causes difficult compliance problems. The Federal Government, for example, will reimburse moves made in the interest of the Government where the new official station is more than ten miles farther from the employee's home than was his old official station. A ten-mile rule is also a practice followed by many employers in private industry. The fact that most moves which are reimbursed qualify for deduction, up to the present maximum limit, while many others do not because of the fifty-mile rule, causes those charged with the responsibility for withholding on nondeductible moving expenses payments to wonder whether all the complexities of the present law are really necessary. A 1971 ERREAC study indicates that approximately 2 percent of job-related moves are adversely affected by the fifty-mile rule.

Aside from the unnecessary complications resulting from the inconsistency between the fifty-mile rule and industry and Federal Government reimbursement practices, the question remains whether it is sound tax policy to discourage moves where a change in job location increases one-way travel distance by as much as fifty miles. This rule can add one hundred miles to an individual's round-trip daily travel pattern. ERREAC submits this is an unreasonable distance to add to an individual's present commuting pattern before moving expense deductions are allowable. This is particularly true in these days of high gasoline prices and Government pleas for adoption of energy conservation practices.

ERREAC RECOMMENDATIONS

A. Immediate action needed

1. Despite the substantial inflation between 1969 and 1976 and the skyrocketing prices for houses, there has been no adjustment of the $1,000 and $2,000 ceilings on moving expense deductions allowed for job-related moves under section 217 of the Code. Section 506 of H.R. 10612 would increase these ceilings to $1,500–$3,000 The $1,500 ceiling on temporary living expenses and house-hunting trips is probably reasonable at this time; however, the proposed increase of the overall ceiling to only $3,000 for these two categories of moving expenses plus the expenses for sale and purchase of a residence or settlement of a lease is woefully inadequate.

2. The overall ceiling of $2,500 should be increased to at least $5,000 to take account of the 100 percent increase in job-related moving expenses for the average home owner between 1969 and 1976.

3. The House bill would change the present 50-mile test for a qualified move to 35 miles. With the growing need for gasoline conservation, the mileage test should be returned to 20 miles as provided in the statute prior to 1969. The impact of this change would be small, affecting an estimated 1 percent of job-related moves in this country.

B. Longer range proposals

1. Because of complicated compliance problems, there are some who suggest that the moving expense provisions of the Code should be junked. ERREAC's position is that reimbursement for the expenses of moves which are incurred primarily for the business convenience of the employer should not result in the realization of taxable income to the employee. Accordingly, ERREAC would be opposed to the elimination of present section 217 of the Code unless something takes its place to keep our Government from collecting tax on the reimbursement of the costs of job-related moves.

2. As a practical matter, the administration of the moving expense deduction would be greatly simplified if the present rigid dollar limitations could be dropped or, in the alternative, increased to a level reflecting the present cost of job-related moves.

(a) Our first choice would be the complete removal of the dollar limitations, making the deduction depend upon whether the particular moving expense was ordinary and necessary under the circumstances.

(b) As a second choice, we would recommend that any limitation applicable to the purchase and sale of a residence should be based in large part upon the selling price or the purchase price of the residence, as is presently the case where the Federal Government reimbursed an employee moving at the request of the Government. The Federal limit, as set forth in Federal Travel Regulations (May 1973), is the lesser of 10 percent of the actual sales price of the residence of $5,000, and the lesser of 5 percent of the actual purchase price of the residence or $2,500.

(c) ERREAC's third choice would be to raise the present overall limitation of $2,500 to $5,000 and to increase the sublimitation of $1,000 applicable to house-hunting trips and temporary living expenses to $1,500, with a biannual cost-of-living adjustment to the limitation to keep it from getting out of date. The proposed increase in the sublimitation of $1,000 to $1,500 is incorporated in section 506 of H.R. 10612, now pending before the Committee. However, this bill would increase the overall $2,500 limitation by $500 to $3,000, a figure we believe to be quite inadequate.

The $2,500 limit of present law, which was first presented in 1967 and enacted in 1969, is obviously inadequate today. In 1967, for example, the median sales price for homes in this country was $19,350 and the prevailing real estate commission between 5 and 6 percent. In contrast, in August 1975 the median sales price was $36,750 and real estate commissions were up to 7 percent or more. In combination, this gives an increase for real estate commissions alone of more than 100 percent, with a dollar real estate brokerage cost at the median selling price of $2,243. Furthermore, a 1971 ERREAC study indicates transferred employees of its members on the average were eligible for fifty days of temporary living expenses while awaiting permanent quarters, at an average cost of about $30 per day. In 1971, temporary living costs and house-hunting travel included in the ERREAC study averaged $1,200 per move. The cost of living since 1971 has increased around 25 perecnt. Thus, it is apparent the average move today generates moving expenses in the categories subject to the present overall limitation of $2,500 far in excess of this figure.

3. As a major step toward simplification, reimbursed moving expenses should be excluded from gross income if the employee accounts to his employer with supporting documentation showing that the expenses were actually incurred, and that they would be deductible under section 217 if the reimbursed amounts were included in gross income. This full accounting to the employer concept is analogous to the exclusion rule now applied in the business travel and entertainment area, where reimbursements are not taxable to the employee who makes a full accounting to his employer.

4. The daily limit on allowance of expenses of occupying temporary living quarters at the new job location should be increased from thirty to sixty days, in line with the ERREAC study that the average eligibility under industry transfer plans at present is fifty days. In like fashion, the related deduction for so-called in-transit storage and insurance of household goods and personal effects should also be changed from thirty days to sixty days.

5. The present statutory rule applicable to temporary living expenses applies only to expenses incurred at the new job location. Frequently a family departing from the old job location must get out of its house at the old job location several days before the moving van is finally loaded and they leave an empty house. This problem is touched upon in the Treasury regulations under § 217 which allow a one-day temporary living allowance at the old job location. This one-day rule should be expanded to at least five days.

6. The fifty-mile rule should be reduced to no more than twenty miles and preferably ten miles. The proposed 35-mile test in section 506 of H.R. 10612 is a move in the right direction but needs further liberalization. Many members of ERREAC are concerned about the increase in 1969 to fifty miles in the mileage test for qualifying for deduction of moving expenses. For any major company with many individual business locations scattered throughout the country, the effect of this change is most undesirable. The net effect is that unlucky employees who may already be commuting a considerable distance to work are expected to increase the commute up to fifty miles each way every working day if their place of work is changed, rather than move closer to the new job location. It comes down to the question of what is a normal and reasonable commuting distance for the average

employee given today's clogged highways, high gas prices, and inadequate transportation facilities. Should a man living on the east side of Washington (say in Manassas or Gaithersburg) be expected to commute daily to Baltimore or Annapolis, regardless of the inconvenience, or would a reasonable man move his residence to reduce the time and distance of the commute? Based upon such standards, we believe the poposed fifty-mile test is completely unreasonable. A twenty-mile rule would more adequately recognize existing practice in both Government and industry and consequently would simplify the meshing of normal reimbursement allowances with the tax law.

7. A major move toward simplification would be to exclude from tax all relocation allowances provided for Federal employees. If this is done, a miscellaneous moving expense deduction, patterned after Chapter 2, Part 3, of Federal Travel Regulations, should be permitted for private industry employees and the self-employed. Attached as Appendix B is a copy of Chapter 2, Part 3, of these Government Regulations. Note, effective as of October 8, 1978, the maximum annual rate for GS13 was established at $26,878, or $516 per week. Under this limit, a miscellaneous moving expense deduction of a maximum of $516 would be allowed for a transferred employee not having an immediate family, and twice this amount would be allowed for a family man.

Appendix A

ERREAC Member Companies

AMF, Inc.
ARA Services, Inc.
A-T-O Inc.
Abbott Laboratories
Abex Corporation
Aerojet-General Corp.
Aetna Insurance Co.
Aetna Life & Casualty Co.
Agrico Chemical Co.
Air Products & Chemicals, Inc.
Airco, Inc.
Allegheny Ludlum Industries
Allendale Mutual Insurance Co.
Allied Chemical Corp.
Allstate Insurance Co.
Aluminum Company of America
Amerace Corp.
Amerada Hess Corp.
American Airlines
American Bureau of Shipping
American Can Co.
American Cynamid Co.
American District Telegraph Co.
American Enka Co.
American Hoechst Corp.
American Hospital Supply Corp.
American Metal Climax, Inc.
American Standard, Inc.
American Telephone & Telegraph
American Thread Co.
Ameron-Corrosion Control Div.
Anheuser-Busch, Inc.
ARINC Research Corp.
Armco Steel Corp.
Armour & Co.
Armstrong Cork Co.
Atlantic Richfield Co.
Atlas Powder Co.
Avis Rent-A-Car System, Inc.

Babcock & Wilcox Co.
Baker/Beech-Nut Corp.
Ball Corp.
C. R. Bard, Inc.
BASF Wyandotte Corp.
Battelle Memorial Institute
Bausch & Lomb Inc.
Bechtel Corp.
Becton, Dickinson & Co.
Bell System Center for Technical Education
Bell Telephone Laboratories
Bell Telephone Co. of Pa.
Bemis Co. Inc.
Bendix Corp.
Bethlehem Steel Corp.
Black & Decker Mfg. Co.
Blue Cross of Southern Calif.
Boehringer Ingelheim Ltd.
Boeing Co.
Boise Cascade Corp.
Borg-Warner Chemicals
Bristol-Myers Co.
Brockway Glass Co., Inc.
Brown & Root, Inc.
Brown & Williamson Tobacco
Brunswick Corp.
Bunker-Ramo Corp.
Burlington Industries, Inc.
Burlington Northern, Inc.
Burmah Oil & Gas Co.
Burroughs Corp.

Continental Can Co., Inc.
CPC International, Inc.
Cabot Corp.
Calspan Corp.
Campbell Soup Co.
Carborundum Co.
Cargill Inc.
Carter-Wallace, Inc.
Caterpillar Tractor Co.
Ceco Corp.
Celanese Corp.
Central Soya Co.
Cessna Aircraft

ERREAC MEMBER COMPANIES—Continued

Champion International Corp.
Chemetron Corp.
Chemplex Co.
Chessie System
Chesapeake & Potmac Tel. Co.
Chesebrough-Pond's Inc.
Chicago Bridge & Iron Co.
Chicago & North Western Transportation Co.
Chubb & Son, Inc.
CIBA-GEIGY Corp.
Cities Service Co.
Clorox Co.
Coca-Cola Co.
Columbia Broadcasting System
Columbia Gas System Service Corp.
Combustion Engineering, Inc.
Commercial Union Companies
Connecticut General Life Ins. Co.
Consolidated Natural Gas
Consolidated Papers, Inc.
Consumers Power Co.
Container Corporation of America
Continental Can Co., Inc.
Continental Casualty Co.
Continental Oil Co.
Control Data Corp.
Conwed Corp.
Coopers & Lybrand
Corning Glass Works
Crown Zellerbach Corp.
Curtiss-Wright Corp.
Cutler-Hammer, Inc.

Dames & Moore
Deere & Co.
DeLuxe Check Printers, Inc.
DeSoto, Inc.
Detroit Edison Co.
Diamond Shamrock Corp.
Digital Equipment Corp.
Dow Chemical Co.
Dow Corning Corp.
Dravo Corp.
Dresser Industries, Inc.
Duplex Products, Inc.

E.I. duPont de Nemours & Co.
ESB Inc.
Eastern Air Lines, Inc.
Eastman Kodak Co.
Eaton Corp.
Electronic Data System Corp.
Emery Air Freight Corp.
Emery Industries
Employers Insurance of Wausau
Envirotech Corp. Emission Control Division
Equitable Life Assurance Society of the United States
Esmark, Inc.
Ethyl Corp.
Exxon Co., U.S.A.
Exxon Corp.

FMC Corp.
Fieldcrest Mills, Inc.
Fireman's Fund Insurance Co.
Firestone Tire & Rubber Co.
Fluor Corp.
Foote Mineral Co.
Ford Motor Co.
Foremost-McKesson, Inc.
Fort Howard Paper Co.

GAF Corp.
GTE Service Corp.
GTE Sylvania Inc.
Gardner-Denver Co.
Gates Rubber Co.

General Accident Group
General Adjustment Bureau, Inc.
General Battery Corp.
General Cable Corp.
General Dynamics Corp.
General Electric Co.
General Foods Corp.
General Mills, Inc.
General Motors Corp.
General Service Administration
General Tire & Rubber Co.
Gibbs & Hill, Inc.
Gillette Co.
Globe-Union Inc.
B.F. Goodrich Co.
Goodyear Tire & Rubber Co.
W.R. Grace & Co.
Great Northern Paper Co.
Grumman Aerospace Corp.
Gulf Oil Corp.

Halco (Mining) Inc.
Hanes Knitwear Division
Hartford Insurance Group
Hartz Mountain Corp.
Hercules Inc.
Heublein, Inc.
Hewlett-Packard Co.
Hobart Manufacturing Co.
Hoerner Waldorf Corp.
Honeywell, Inc.
George A. Hormel & Co.
Howmet Corp.

ICI Americas
INA Corp.
IU International Management Corp.
Illinois Bell Telephone Co.
Illinois Central Railroad
Indiana Bell Telephone Co.
Industrial Nucleonics Corp.
Ingersoll-Rand Co.
Inmont Corp.
Interlake, Inc.
Internal Revenue Service
International Business Machines
International Foodservice Systems
International Harvester Co.

ERREAC MEMBER COMPANIES—Continued

International Nickel Co., Inc.
International Paper Co., Inc.
International Silver Co.
International Telephone & Telegraph

Johnson & Johnson
Johns-Manville Corp.

Kaiser Aluminum & Chemical Corp.
Kaiser Industries Corp.
Keebler Co.
Kellogg Co.
Kemper Insurance Companies
Kendall Co.
Kennecott Copper Corp.
Kimberly-Clark Corp.
Koppers Company, Inc.
Kraftco Corp.
Kroger Co.

Law Engineering Testing Co.
Levi Strauss & Co.
Libbey-Owens-Ford Co.
Libby, McNeill & Libby
Liberty Mutual Insurance Co.
Liggett & Myers, Inc.
Eli Lilly and Co.
Thomas J. Lipton, Inc.
Lukens Steel Co.

Manpower, Inc.
Manufacturers Life Insurance Co.
Marathon Oil Co.
Maremont Corp.
Marriott Corp.
Martin Marietta Corp.
Masonite Corp.
Massachusetts Mutual Life Insurance Co.
Massey-Ferguson, Inc.
Oscar Mayer & Co., Inc.
McCormick & Co., Inc.
McDonald's Corp.
McDonnell Douglas Corp.
McGraw-Edison
McGraw-Hill, Inc.
Mead Corp.
F.W. Means & Co.
Medusa Corp.
Merck & Co., Inc.
Metropolitan Life Insurance Co.
Michigan Bell Telephone Co.
Michigan Consolidated Gas Co.
Midas-International Corp.
Miles Laboratories, Inc.
Mitre Corp.
Mobay Chemical Co.
Mobil Oil Co.
Mohasco Industries, Inc.
Monsanto Co.
Moore Business Forms, Inc.
Morrison-Knudsen Co., Inc.
Motorola, Inc.
Murphy Products Co., Inc.

NCR Corp.
NL Industries, Inc.
Nabisco, Inc.
Nalco Chemical Co.
National Bulk Carriers, Inc.
National Can Corp.
National Distillers & Chemical Corp.
National Linen Service
National Railroad Passenger Corp.
Nationwide Mutual Insurance Co.
Natural Gas Pipeline Co. of America
Nestle Co.
NIBCO, Inc.
Norris Industries
North American Phillips
Northern Indiana Public Service Co.
Northwest Orient Airlines
Northwestern Mutual Life Insurance Co.
Norton Co.

Ohio Bell Telephone Co.
Olin Corp.
Otis Elevator Co.
Owens-Corning Fiberglas Corp.
Owens-Illinois, Inc.

PPG Industries, Inc.
Pacific Northeast Bell Telephone Co.
Packaging Corp. of America
Pan American World Airways
Parke, Davis & Co.
Peat, Marwick, Mitchell & Co.
Peavey Co.
Penn Central Co.
Pennwalt Corp.
Pfizer. Inc.
Phelps Dodge Corp.
Philip Morris U.S.A.
Phillips Petroleum Co.
Pinkerton's, Inc.
Pitney-Bowes, Inc.
Polaroid Corp.
Polysar Limited
Potlatch Corp.
Procter & Gamble Co.
Prudential Insurance Co. of America
Public Service Electric & Gas Co.
Pullman, Inc.

RCA Corp.
Ralston Purina Co.
Raymond International, Inc.
Raytheon Co.
Reliance Insurance Companies
Retail Credit Co.
Rexnord, Inc.
R. J. Reynolds Industries
Rheem Manufacturing Co.
Richardson-Merrell, Inc.
H. H. Robertson Co.
A. H. Robins Co.
Rockwell International
Rohm & Haas Co.

ERREAC MEMBER COMPANIES—Continued

Rohr Industries, Inc.
Royal-Globe Insurance Co.

Samsonite Corp.
Sandia Laboratories
Schering Corp.
Jos. Schlitz Brewing Co.
Schlumberger Limited
Scott Paper Co.
Scovill Manufacturing Co.
G. D. Searle & Co.
Sentry Insurance
Sherwin-Williams Co.
Singer Co.
Skil Corp.
SmithKline Corp.
Social Security Administration
Southern Bell Telephone Co.
Southern Railway System
Southwestern Bell Telephone Co.
Sperry & Hutchinson Co.
Sperry Univac
Sperry Vickers, Div. Sperry Rand
E. R. Squibb & Sons, Inc.
St. Regis Paper Co.
Standard Oil Co. of California
Standard Oil Company of Indiana
Standard Oil Company of Ohio
State Farm Insurance Companies
Stauffer Chemical Company
Steelcase Inc.
J. P. Stevens & Co., Inc.
Sun Chemical Corp.
Sun Oil Co.
Sunbeam Appliances
Sundstrand Corp.
Super Valu Stores, Inc.
Sybron Corp.

TRW Systems Group, TRW, Inc.
Target Stores, div. Dayton-Hudson
Tektronix, Inc.
Texaco, Inc.
Texas Eastern Transmission Corp.
Texas Gulf, Inc.
Texas Instruments Inc.
3M Co.
Time, Inc.
Timken Co.
Torin Corp.
Trans Union Corp.
Travelers Insurance Co.
Travenol Laboratories, Inc.
Travenol Laboratories International

UMC Industries, Inc.
Unigard Mutual Insurance Co.
Union Camp Corp.
Union Carbide Corp.
Union Pacific Railroad Co.
Uniroyal, Inc.
United States Coast Guard
U.S. Steel Corp.
United Airlines
Upjohn Co.

Varian Associates
Vetco Offshore Industries, Inc.

Wagner Electric Corp.
Walker Manufacturing Co.
Warner-Lambert Co.
Warner & Swasey Co.
Walt Disney World Co.
Welch Foods, Inc.
West Point-Pepperell, Inc.
Western Electric
Western International Hotels
Westinghouse Electric Corp.
Westvaco Corp.
Weyerhaeuser Co.
Wheeling-Pittsburgh Steel Corp.
White Motores Corp.
Wickes Corp.
Williams Companies
Wisconsin Telephone Co.

Xerox Corp.

Youngstown Sheet & Tube Co.

Zenith Radio Corp.

PART 3. ALLOWANCE FOR MISCELLANEOUS EXPENSES

2-3.1. APPLICABILITY

(a) *Purpose for allowance.*—The miscellaneous expenses allowances authorized by 2-3.2 and 2-3.3 is for the purpose of defraying various continent costs associated with discontinuing residence at one location and establishing residence at a new location in connection with an authorized or approved permanent chance of station.

(b) *Types of costs covered.*—The allowance is related to expenses that are common to living quarters, furnishings, household appliances, and to other general types of costs inherent in relocation of a place of residence. The types of costs intended to be reimbursed under the allowance include but are not limited to the following:

(1) Fees for disconnecting and connecting appliances, equipment, and utilities involved in relocation and costs of converting appliances for operation on available utilities;

(2) Fees for unblocking and blocking and related expenses in connection with relocating a mobile home, but not the transportation expenses allowed under 2–7.3;

(3) Fees for cutting and fitting rugs, draperies, and curtains moved from one residence quarters to another;

(4) Utility fees or deposits that are not offset by eventual refunds;

(5) Forfeiture losses on medical, dental, and food locker contracts that are not transferable; and

(6) Costs of automobile registration, driver's license, and use taxes imposed when bringing automobiles into certain jurisdictions.

(c) *Types of costs not covered.*—This allowance shall not be used to reimburse the employee for costs or expenses incurred which exceed maximums provided by statute or in these regulations; costs or expenses that he incurred but which are disallowed elsewhere in these regulations; costs reimbursed under other provisions of law or regulations; costs or expenses incurred for reasons of personal taste or preference and not required because of the move; losses covered by insurance; fines or other penalties imposed upon the employee or members of his immediate family; judgments, court costs, and similar expenses growing out of civil actions; or any other expenses brought about by circumstances, factors, or actions in which the move to a new duty station was not the proximate cause. Examples of these types of costs which are not reimbursable from this allowance are as follows:

(1) Losses in selling or buying real and personal property and cost items related to such transactions;

(2) Costs which are reimbursed under other provisions of these regulations or under any other regulations or under provisions of any statute;

(3) Cost of additional insurance on household goods while in transit to new official station or cost of loss of damage to such property;

(4) Additional costs of moving household goods caused by exceeding the maximum weight limitation for which the employee has eligibility as provided by law or in these regulations;

(5) Costs of newly acquired items, such as the purchase or installation cost of new rugs or draperies;

(6) Higher income, real estate, sales, or other taxes as the result of establishing residence in the new locality;

(7) Fines imposed for traffic infractions while en route to the new official station locality;

(8) Accident insurance premiums or liability costs incurred in connection with travel to the new official station locality, or any other liability imposed upon the employee for uninsured damages caused by accidents for which he or a member of his immediate family is held responsible;

(9) Losses as the result of the sale or disposal of items of personal property not considered convenient or practicable to move;

(10) Damage or loss of clothing, luggage, or other personal effects while traveling to the new official station locality;

(11) Subsistence, transportation, or mileage expense in excess of the amounts reimbursed as per diem or other allowances under these regulations;

(12) Medical expenses due to illness or injuries of the employee or members of immediate family while en route to the new official station or while living in temporary quarters at Government expense under the provisions of 2–5; or

(13) Costs incurred in connection with structural alterations; remodeling or modernizing of living quarters, garages or other buildings to accommodate privately owned automobiles, appliances or equipment; or the cost of replacing or repairing worn-out or defective appliances, or equipment shipped to the new location.

2–3.2. ELIGIBILITY

(a) *Coverage.*—A miscellaneous expense allowance will be payable to an employee for whom a permanent change of station is authorized or approved and who has discontinued and established a residence in connection with such change regardless of where the old or new official stations are located; provided that the applicable eligibility conditions in 2–1.5 are met and the agreement required in 2–1.5a(1) is signed.

(b) *Exclusions.*—The provisions of 2–3 do not apply for new appointees, including those covered under 2–1.5f, employees assigned under the Government Employees Training Act (see 5 U.S.C. 4109), or employees returning from overseas assignments for the purpose of separation.

2–3.3. ALLOWANCE AMOUNT

Employees eligible for a miscellaneous expense allowance shall be paid an amount under 2–3.3a or reimbursed an amount under 2–3.3b, but not both as follows:

(*a*) Allowances in the following amounts will be paid without support or other documentation of expenses:

(1) $100 or the equivalent of 1 week's basic pay, whichever is the lesser amount, for an employee without immediate family; and

(2) $200 or the equivalent of 2 weeks' basic pay, whichever is the lesser amount, for an employee with immediate family.

(*b*) Allowances in excess of those provided in 2–3.3a may be authorized or approved, if supported by acceptable statements of fact and either paid bills or other acceptable evidence justifying the amounts claimed; provided that the aggregate amount does not exceed the employee's basic pay at the time the employee reported for duty, for 1 week if the employee is without an immediate family or for 2 weeks if the employee has an immediate family. In no instance will the amount exceed the maximum rate of grade GS–13 provided in 5 U.S.C. 5339 at the time the employee reported for duty. The entire amount claimed under 2–3.3b (including the amount otherwise payable without such documentation under 2–3.3a) must be supported as required above.

2–3.4 ADVANCE OF FUNDS

No advance of funds is authorized in connection with the allowance provided in this part.

Senator GRAVEL. Our next witness will be Robert L. McMullen, president and chairman of the board, American Society of Travel Agents, Inc.

STATEMENT OF ROBERT L. McMULLEN, PRESIDENT, AMERICAN SOCIETY OF TRAVEL AGENTS, INC., ACCOMPANIED BY GLEN A. WILKINSON, GENERAL COUNSEL TO ASTA

Mr. McMULLEN. Mr. Chairman, members of the committee, my name is Robert L. McMullen. I am a travel agent from Grove City, Pa., and along with my wife, own and operate travel agencies in Grove City, Franklin, and Butler, Pa.

I am also president of the American Society of Travel Agents, Inc. (ASTA), the world's largest trade association in the field of travel and tourism, with more than 7,500 travel agent members throughout the United States and Canada. I am accompanied this morning by Glen A. Wilkinson, a partner in the Washington law firm of Wilkinson, Cragun & Barker, general counsel to ASTA.

It is a pleasure, Mr. Chairman, to appear before this committee today to testify with respect to section 602 of the pending Tax Reform Act of 1975. ASTA is unalterably opposed to any legislation which would curtail deductions of reasonable expenses incurred by taxpayers attending legitimate business conventions held outside the United States.

As passed by the House of Representatives, section 602 would limit the deductible transportation cost to and from a foreign convention to the lowest coach or economy fare; and it would improperly restrict legitimate business and professional and educational aspects of travel for thousands of our taxpayers.

ASTA believes that our present tax laws provide the basis for adequate protection against any possible abuse in the area of foreign conventions or meetings.

Section 602 also would limit the amount of transportation expenses allowable as a deduction to the lower coach or economy rate charged by any commercial airline for such transportation during the calendar month the convention is held. We believe this limitation would be discriminatory, arbitrary, and unnecessary. First-class travel, in and of itself, is neither exorbitant nor unreasonable. Indeed, in approving first-class fares, the Civil Aeronautics Board has determined that such fares, in fact, bear a reasonable relationship to the services rendered and are, therefore, in the public interest.

Section 602 also would limit the deduction of so-called subsistence expenses while at a foreign convention or traveling to or from the convention, to an amount not to exceed the dollar per diem rate for the site of the convention which has been established for U.S. civil servants.

I will deviate from the prepared text to state that we found out yesterday that, ironically, this limit does not apply to civil servants attending meetings and conventions abroad.

Like the proposed limitation of the economy or coach fare, the imposition of such a limitation would be absolutely arbitrary and would bear no relationship whatsoever to the legitimate needs of a convention participant in any given situation.

Certainly, we recognize that the Government per diem may in some instances be entirely reasonable and sufficient. Conversely, however, there are undoubtedly many more situations where such levels would be entirely insufficient to cover expenses incurred for legitimate business purposes. Here again, the House's recommendation ignores the real problem of assisting the IRS in eliminating illegitimate tax deductions. Instead, in hopes of curtailing some improper deductions, the committee proposal arbitrarily limits all deductions, without regard to their legitimacy. Furthermore, as I have indicated, under present law the expenses deducted must be reasonable, and therefore, there is no need to discriminate against taxpayers who choose to attend out of the country meetings.

Limiting deductible expenses by businessmen to the per diem rate established for Government employees is a classis case of mixing apples and oranges. Prescribing a fixed per diem rate of reimbursement for Government employees keeps down Government expenditures. If there were no such limit and Government employees were reimbursed in full for their expenses, Government employees would have no incentive to minimize their expenditures. A business expense deduction operates quite differently. As long as the Government employee stays within the per diem rate, the Government must reimburse him dollar for dollar for what he spends. If a businessman spends a dollar and treats it as a deductible business expense, the businessman is not reimbursed in full for the dollar expended.

Section 602 also limits the deduction in full of transportation expenses to foreign conventions to cases where more than one-half of the total days of the trip are devoted to business-related activities and limits the deduction of subsistence expenses to cases where at least 6 hours of business activities are scheduled during the day and the individual attends at least two-thirds of these activities. In line with its position of opposing abuses of our tax laws, ASTA has already gone on record as supporting the establishment of more specific standards to distinguish the legitimate foreign business convention from the foreign junket. These standards could specify the number of hours per day and/or the number of days per trip the taxpayer actually spends in meetings. ASTA, however, does not believe that the proposed statutory provisions are necessary to accomplish this result. ASTA believes that the IRS has the authority under present law to impose such standards by regulation. ASTA firmly believes that the IRS should exercise its authority under existing law to write new regulations to assure taxpayers do not improperly deduct expenses in connection with out-of-country conventions or meetings.

Mr. Chairman, as I have said, I am a professional travel agent. I am one of more than 11,000 independent businessmen located throughout the United States who has dedicated his life to the promotion of travel and tourism. As you may be aware, America is today the world's No. 1 host country in receiving foreign visitors. One of the reasons for this success is the substantial progress which we have made in developing outstanding facilities to host visitors both from within the United States and abroad. By the same token, other countries throughout he world have expended hundreds of millions of dollars to develop hotels, convention centers, and meeting facilities designed to attract tourists and businessmen to attend meetings and conventions. These conventions enhance the visitors' knowledge of those countries and promote a better understanding of their commercial and cultural achievements. In my view, it would be a tragedy for the United States to adopt restrictive provisions which would inhibit our citizens from taking legitimate trips abroad for the legitimate purposes mentioned. It could well result in similar retaliatory action by other countries. I would also like to say that we endorse Senator Inouye's statement of this morning.

I would like to leave you just briefly with a quick personal experience of last year when we had our World Travel Congress in Rio with more than 6,000 delegates. We spent $250,000 in educational seminars, 110 countries were represented and those programs today have been reproduced and will be used in countries throughout the world in the months and years ahead. Thus, the residual benefit of this meeting will not only be substantial, but long lasting.

This year, our 46th World Travel Congress will be held in New Orleans, one of the best known and most popular tourist destinations in the United States. New Orleans has another attractive feature for our World Travel Congress since it has some of the finest meeting and convention facilities found anywhere in the world. Without those facilities, it would not be possible to hold our World Travel Congress in New Orleans. Conversely, the success of maintaining and expanding those facilities depends upon the ability of New Orleans to attract conventions and seminars similar to ours not only from throughout the United States but from countries around the world. We therefore feel the Congress should not enact legislation to restrict legitimate expenditures by U.S. taxpayers to attend meetings and conventions out of the country, but should encourage such expenditures as a device to expand our own tourism facilities, promote two-way travel and tourism, improve international knowledge and understanding and further this country's image as a world leader in promoting free trade, travel, and tourism.

In conclusion, as a spokesman for thousands of small businessmen who have a respect for and comply with their obligations under this country's tax laws, we reiterate our strong support for the committee's effort to eliminate any abuses which might exist in connection with taxpayers improperly deducting travel expenses for what are not legitimate business trips. I believe that insofar as such abuses exist, they should be eliminated through more aggressive enforcement of present regulations or through the drafting and promulgation of new regulations similar to those mentioned above. However, as businessmen who understand and appreciate the importance of travel and tourism not only to the economy of the United States, but to the economies of countries throughout the world and have a keen understanding of the importance of legitimate seminars and conventions whether held in the United States or abroad, we finally believe that no unnecessary or unduly restrictive steps should be taken to discourage or eliminate such legitimate travel to our country.

Thank you, Mr. Chairman, for the opportunity to appear before you and your committee this morning.

Senator GRAVEL. Do you have any questions?

Senator PACKWOOD. You are going to London for a business-related convention?

Mr. McMULLEN. I am going for the board of directors meeting, yes.

Senator PACKWOOD. Does that count as a deduction under one of these provisions, too?

Mr. McMULLEN. Yes, I think it would and I am very concerned about it.

Senator GRAVEL. Were you here when Senator Inouye was here?

Mr. McMULLEN. Yes.

Senator GRAVEL. He cited the example about the Caribbean tour. Could the IRS under existing regulations have corrected that inequity?

Mr. McMULLEN. Yes, they could, sir.

We could even sit down with the IRS and help them, if they would like, to help write new regulations. We think it is in the law now that the abuses complained can be stopped.

Senator GRAVEL. So if that were the case it would be the inability of the existing bureaucracy to enforce what is presently enforceable.

Mr. McMULLEN. Correct.

Senator GRAVEL. And we would be correcting that by adding more power to that bureaucracy.

Mr. McMULLEN. Yes. It is interesting that in the Pacific Northwest that you have lead in the area of these meetings with Alaska people going over to Japan every year. I think Chuck West, one of my predecessors, used to go on the trade missions with everyone. I believe that Pacific Northwest had always championed this type of meeting. I also heard the question asked this morning regarding retaliation. I was also a member of the U.S. Government Trade Mission to Russia. We went over specifically to spend 1 week talking with them regarding their restrictions on meetings and conventions in our country and we are negotiating with them right now. I think this is the way we should go by saying to them, "What is good for us is good for you," and see if we cannot correct the misunderstandings and expand two-way tourism.

Senator GRAVEL. You are quite right. We are sensitive in the Northwest to this. In fact, the only ski area we have in Alaska of note, has about 40-percent attendance by Japanese.

Mr. MCMULLEN. Right. It is big business.

Senator GRAVEL. So they help make it quite viable for use. Do you have a branch within your organization—I am thinking of trying to work to develop a trade mission to Japan sometime next fall. Do you have anybody that can counsel somebody in Government in setting something up like that?

Mr. MCMULLEN. Yes; we do and they are in New York. I would take the privilege of addressing that to our headquarters in New York City, 711 Fifth Avenue, Richard C. Remalia, executive vice president. We will furnish that to you.

Senator GRAVEL. Thank you, I am going to go and I would like the benefit of your counsel.

Mr. MCMULLEN. We feel this is part of our association and we should be involved in working in behalf of that function. People say tourism is separate but it is not. Tourism and trade and industry do go hand in hand.

Senator GRAVEL. Well, it is obviously part of the process to get people to go there and hopefully there will be pleasures involved with the trip. If it is all pain they could stay home and enjoy the pain.

Mr. MCMULLEN. That is correct, sir.

Senator GRAVEL. Thank you very much.

Mr. MCMULLEN. May we include this in the record?

Senator GRAVEL. Yes. Thank you very much.

[The prepared statement of Mr. McMullen follows:]

STATEMENT OF ROBERT L. MCMULLEN, PRESIDENT AND CHAIRMAN OF THE BOARD OF THE AMERICAN SOCIETY OF TRAVEL AGENTS, INC. (ASTA)

SUMMARY

ASTA is the world's largest trade association in the field of travel and tourism representing more than 7,500 travel agents throughout the United States.

Section 602 of the Tax Reform Act of 1975—H.R. 10612—would severely restrict the amount of money which a taxpayer could deduct for attending out-of-the-country meetings and conventions. Those restrictions would result from a limitation that the taxpayer could not attend more than two foreign conventions a year; that the deductible transportacost could not be greater than the lowest coach or economy fare; that the subsistence cost of the taxpayer would be limited to the per diem rate allowed for U.S. civil servants; that at least half of the total days of the trip would have to be devoted to business related activities; and at least six hours of business activities would have to be scheduled during each day of the meeting and the taxpayer would have to attend two thirds of those activities.

This Section of the House passed bill should be rejected by the Senate for the following reasons:

1. The provision would add nearly six pages to the House bill and further complicate the Internal Revenue Code at a time when simplification is an objective of the Congress.

2. If abuses do exist in this area, they can be taken care of by the provisions of the Code as it is now written.

3. A great majority of foreign conventions, meetings and seminars are legitimate and further the interests of the taxpayer, his business or profession and the United States as well as the country in which the meetings are held.

4. Imposing these restrictions on a taxpayer who attends out-of-the-country meetings or conventions, assuming that the taxpayer's attendance is in furtherance of his profession or business as is required by existing law, would be highly discriminatory.

5. The limitation on two foreign conventions a year is arbitrary and without any foundation; the limitation on transportation costs is without precedent and is equally discriminatory since other businessmen are free to deduct the full cost of air transportation for a legitimate business trip; the limitation on subsistence allowance is also without precedent, discriminates against persons attending foreign meetings and conventions and fails to take into account that the taxpayer, even if he deducts the full cost of a legitimate business trip abroad, still pays a portion of the amount spent after taking a tax deduction, and the limitations with respect to number of days devoted to business on a trip and the number of hours per day devoted to business sessions can be written into IRS regulations under the existing law without the need to amend the Code.

6. Enactment of these restrictions would cause retaliation by other governments who, like the United States, have huge investments in meeting and convention facilities and hotels which are dependent upon meetings, conventions and seminars participated in by people visiting from other countries.

7. The United States has been the world's leader in promoting free trade, travel and tourism therefore adoption of the House passed provision would be inconsistent with that tradition at a time when we should be doing all we can do attract foreign visitors and conventions to our country and encouraging our citizens to travel broadly throughout the world in promoting world peace, understanding and greater business and professional opportunities for our citizens.

STATEMENT

Mr. Chairman, members of the committee, my name is Robert L. McMullen. I am a travel agent from Grove City, Pennsylvania, and along with my wife, own and operate travel agencies in Grove City, Franklin and Butler, Pennsylvania. I am also President of the American Society of Travel Agents, Inc. (ASTA), the world's largest trade association in the field of travel and tourism, with more than 7,500 travel agent members throughout the United States and Canada. I am accompanied this morning by Glen A. Wilkinson, a partner in the Washington law firm of Wilkinson, Cragun & Barker, general counsel to ASTA.

It is a pleasure, Mr. Chairman, to appear before this Committee today to testify with respect to Section 602 of the pending Tax Reform Act of 1975. ASTA is unalterably opposed to any legislation which would curtail deductions of reasonable expenses incurred by taxpayers attending legitimate business conventions held outside the United States.

As passed by the Hous of Representatives, Section 602 of the Tax Reform Act of 1975 would limit deductions of expenses incurred in attending foreign conventions in five basic ways:

(1) It would limit deductions by an individual to no more than two foreign conventions in one year;

(2) It would limit the deductible transportation cost to and from a foreign convention to the lowest coach or economy fare;

(3) It would limit the deductible subsistence cost during the attendance of any foreign convention to the per diem rate for United States civil servants;

(4) It would permit transportation costs to be deductible in full only if at least half of the total days of the trip were devoted to business related activities (otherwise it would limit deduction to the percentage of the days of the trip devoted to business related activities); and

(5) It would permit subsistence costs to be deducted only if at least six hours of business activities were scheduled during the day and the individual attended at least two-thirds of those activities.

Although I will comment separately on each of these individual provisions, I would like to first make a few general comments. At a time when the basic tax law of this country has grown so complicated that few taxpayers, not to mention tax lawyers, profess to understand it in all its parts, there is a rising chorus calling for simplification of the Internal Revenue Code. In light of that laudatory goal, the Congress should ask itself whether it serves the interest of good government to add a new subsection to the Code that takes up nearly six pages of the printed House bill and deals with a relatively minor problem like travel to conventions in foreign countries—a problem which has very little impact if any on taxpayers in general or on the Treasury of the United States. This is particularly true when the Congress has already given the Internal Revenue Service authority and responsibility to assure taxpayer compliance with the Code as I shall discuss. Secondly, the basic assumption underlying Section 602 appears to be a suspicion that most foreign conventions and meetings are, in reality, a sham and nothing more than junkets. We would strenuously disagree that such is the case. Most foreign conventions and meetings, like most conventions and meetings held in this country, are legitimate functions which serve to advance and promote important trade and business objectives. We strongly believe that, while some abuses may exist, as they probably do in all areas of tax laws, they are relatively few in number. I would now like to comment specifically on each provision of Section 602.

Limitation to two foreign conventions per year

The Internal Revenue Service alleges that many abuses are occurring in the area of foreign conventions. According to the IRS, many conventions and educational seminars which are held outside the country ostensibly for business and educational purposes are really vacations in disguise, held at foreign sites for recreational and sightseeing opportunities afforded by the foreign country. Section 602 seeks to curb this abuse, in part, by limiting the number of foreign conventions for which an individual may take deductions to two per year.

We believe that this limitation is both arbitrary and unjustified. To the extent that there is a problem, we believe that it can be remedied without adopting a provision which in order to punish a few guilty individuals improperly interferes with legitimate business and professional and educational interests of thousands of our taxpayers. ASTA believes that our present tax laws provide adequate protection against any possible abuse in the area of foreign conventions or meetings. Generally, to be deductible under present code provisions, traveling expenses must be reasonable and necessary to the conduct of the taxpayer's business and directly attributable to the trade or business. There has to be a sufficient relationship between a taxpayer's trade or business and his attendance so that he is benefiting or advancing the interests of his trade or business.

If a taxpayer's attendance at a foreign convention is reasonable and necessary to the conduct of the taxpayer's trade or business, it is difficult to see why he should be limited arbitrarily to being able to deduce the expenses of just two such conventions per year. The problem is not the number of conventions attended per year but the relationship of those conventions to the taxpayer's trade or business. We believe that the IRS can use present law to ferret out those individuals who abuse the present law without penalizing those honest individuals who do not.

Limitation of transportation costs to coach or economy fare

Section 602 also would limit the amount of transportation expenses allowable as a deduction to the lowest coach or economy rate charged by any commercial airline for such transportation during the calendar month the convention is held. We believe that this limitation would be discriminatory, arbitrary and unnecessary. First-class travel, in and of itself, is neither exorbitant nor unreasonable. Indeed, in approving first-class fares, the Civil Aeronautics Board has determined that such fares, in fact, bear a reasonable relationship to the services rendered and are therefore in the public interest.

ASTA has always maintained and continues to maintain that the decision whether to fly at first-class or coach fares—which may depend on any number of personal factors—should be left to the individual traveler. Furthermore, this proposal does nothing whatsoever to further the ultimate objective of the Committee—the elimination of illegitimate deductions for vacation and "junket" travel. The present proposal ignores the real problem of enforcement of present IRS restrictions and would serve no legitimate legislative purpose. In fact, the House Committee Report which accompanied the Tax Reform Act of 1975 fails completely to explain how this provision will in any way serve to correct the abuses which supposedly occur in the area of foreign conventions.

Limitation of deductions to per diem levels established for government employees

Section 602 also would limit deduction of so-called subsistence expenses while at a foreign convention or traveling to or from the convention to an amount not to exceed the dollar per diem rate for the site of the convention which has been established for United States civil servants. Like the proposed limitation of economy or coach fare, the imposition of such a limitation would be absolutely arbitrary and would bear no relationship whatsoever to the legitimate needs of a convention participant in any given situation. Certainly, we recognize that the government per diem may in some instances be entirely reasonable and sufficient.

Conversely, however, there are undoubtedly many more situations in which such levels would be entirely insufficient to cover expenses incurred for legitimate business purposes. Here again, the House's recommendation ignores the real problem of assisting the IRS in eliminating illegitimate tax deductions. Instead, in hopes of curtailing some improper deductions, the Committee proposal arbitrarily limits all deductions without regard to their legitimacy. Furthermore, as I have indicated, under present law the expenses deducted must be reasonable, and therefore, there is no need to discriminate against taxpayers who choose to attend out of the country meetings.

Limiting deductible expenses by businessmen to the per diem rate established for government employees is a classic case of mixing apples and oranges. Prescribing a fixed per diem rate of reimbursement for government employees keeps down government expenditures. If there were no such limit and government employees were reimbursed in full for their expenses, government employees would have no incentive to minimize their expenditures. A business expense deduction operates quite differently. As long as the government employee stays within the per diem rate, the government must reimburse him dollar for dollar for what he spends. If a businessman spends a dollar and treats its as a deductible expense, the businessman is not reimbursed in full for the dollar expended. Assuming the businessman is in the 50 percent tax bracket, the deduction would only reimburse him 50 cents in tax savings for every dollar spent. The other 50 cents would come out of the businessman's own pocket. Every taxpayer, whether an individual or a corporation, therefore, has an incentive to see that his expenses, or his employees' expenses, are minimized. There seems no need to establish any per diem limitation to accomplish this purpose.

Establishment of statutory standards

Section 602 also limits the deduction in full of transportation expenses to foreign conventions to cases where more than one-half of the total days of the trip are devoted to business related activities and limits the deduction of subsistence expenses to cases where at least six hours of business activities are scheduled during the day and the individual attends at least two-thirds of these activities. In line with its position of opposing abuses of our tax laws, ASTA has already gone on record as supporting the establishment of more specific standards to distinguish the legitimate foreign business convention from the foreign junket. These standards could specify the number of hours per day and/or the number of days per trip the taxpayer actually spends in meetings. ASTA, however, does not believe that the proposed statutory provisions are necessary to accomplish this result. ASTA believes that the IRS has the authority under present law to impose such standards by regulation. ASTA firmly believes that the IRS should exercise its authority under existing law to write new regulations to assure that taxpayers do not improperly deduct expenses in connection with out-of-country conventions or meetings.

Mr. Chairman, as I have said, I am a professional travel agent. I am one of more than 11,000 independent businessmen located throughout the United States who has dedicated his life to the promotion of travel and tourism. As you may be aware, America is today the world's number one host country in receiving foreign visitors. One of the reasons for this success is the substantial progress which we have made in developing outstanding facilities to host visitors both from within the United States and abroad. By the same token, other countries throughout the world have expended hundreds of millions of dollars to develop hotels, convention centers, and meeting facilities designed to attract tourists and businessmen to attend meetings and conventions. These conventions enhance the visitors' knowledge of those countries and promote a better understanding of their commercial and cultural achievements. In my view, it would be a tragedy for the United States to adopt restrictive provisions which would inhibit our citizens from taking legitimate trips abroad for the legitimate purposes mentioned. It could well result in similar retaliatory action by other countries. Accordingly, we would not only undermine the substantial investment which our foreign friends have made in building hotels and tourist facilities but we might undermine our own efforts to attract foreign vistors to utilize the splendid facilities which we have in this country.

I would like to give you a personal illustration of how the proper preparation, planning and execution of an international convention can have a tremendous impact not only on the location where it is held, but on the delegates who attend and on the countries where the delegates reside. Last year ASTA held its 45th World Travel Congress in Rio de Janeiro, Brazil. That Congress attracted more than 6,000 delegates from one hundred and ten countries representing all phases of the travel and tourism indusrty. Two hundred and fifty thousand dollars were spent on the preparation and production of professional training programs designed to make each of those delegates a more professional and proficient salesperson to promote the tourism product. Those seminars and workshops which were produced in Rio are being reproduced and will continue to be reproduced and used in countries throughout the world in the months and years ahead. Thus, the residual benefit of this meeting will not only be substantial, but long lasting.

This year, our 46th World Travel Congress will be held in New Orleans, one of the best known and most popular tourist destinations in the United States. New Orleans is another attractive feature for our World Travel Congress and has some of the finest meeting and convention facilities found anywhere in the world. Without those facilities, it would not be possible to hold our World Travel Congress in New Orleans. Conversely, the success of maintaining and expanding those facilities depends upon the ability of New Orleans to attract conventions and seminars similar to ours not only from throughout the United States but from countries around the world. We therefore feel the Congress should not enact legislation to restrict legitimate expenditures by U.S. taxpayers to attend meetings and conventions out of the country, but should encourage such expenditures as a device to expand our own tourism facilities, promote two-way travel and tourism, improve international knowledge and understanding and further this country's image as a world leader in promoting free trade, travel and tourism.

In conclusion, as a spokesman for thousands of small businessmen who have a respect for and comply with their obligations under this country's tax laws, we reiterate our strong support for the Committee's effort to eliminate any abuses which might exist in connection with taxpayers improperly deducting travel expenses for what are not legitimate business trips. I believe that insofar as such abuses exist, they should be eliminated through more aggresive enforcement of present regulations or through the drafting and promulgation of new regulations similar to those mentioned above. However, as businessmen who understand and appreciate the importance of travel and tourism not only to the economy of the United States, but to the economies of countries throughout the world and have a keen understanding of the importance of legitimate seminars and conventions whether held in the United States or abroad, we firmly believe that no unnecessary or unduly restrictive steps should be taken to discrourage or eliminate such legitimate travel.

Thank you, Mr. Chairman, for the opportunity to appear before you and your committee this morning.

Senator GRAVEL. We will recess until 2 p.m.

[Whereupon, the committee recessed at 12:14 p.m., to reconvene at 2 p.m.]

AFTERNOON SESSION

Senator GRAVEL. The hearings will come back to order now.

Our next witness is Warner McLean, tax manager, Hilton Hotels Corp.

STATEMENT OF WARNER H. McLEAN, TAX DIRECTOR, HILTON HOTELS CORP., BEVERLY HILLS, CALIF.

Mr. McLEAN. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, I will summarize my statement which has been filed for the record.

Senator FANNIN [presiding]. Your complete statement will be made a part of the record and you may summarize as you see necessary.

Mr. McLEAN. Thank you, sir.

I am Warner McLean, and I am tax manager for Hilton Hotels and I am appearing in behalf of the American Hotel and Motel Association.

In the area of capital formation generally, the amount which an enterprise can borrow or additional capital stock it can issue is limited by the profits it can generate in its business.

Because of tax burdens, business profits have been too low to generate sufficient investment capital. With the combined State and Federal tax rates, well over 50 percent of profits, net income after taxes have been barely sufficient to meet day-to-day operating needs.

While this committee can do nothing about soaring State income taxes, you can create a Federal tax environment which will help business to meet its capital formation needs.

We would propose the following tax changes in order to stimulate capital formation.

No. 1, in the area of taxation of capital gains and losses, the position of the American Hotel and Motel Association is that long-term capital gains should be kept at the current rate since the "gain" on the sale of producing assets held for a long period of time is, in large measure, merely an inflationary mirage.

The primary basis for a tax differential between ordinary income and capital gains is a recognition that the economic gain realized is less than the bookkeeping gain because of inflation.

In our industries chain business, proceeds from the sale of assets must be reinvested in other assets in order to maintain their competitive status. These new assets are much more costly. To further tax the proceeds on the sale of older assets would reduce the ability of hotels or motels to reinvest in assets at current market prices.

With the Tax Reform Act of 1969, the use of accelerated depreciation to convert ordinary income on capital gains has been largely curtailed. Because of the recapture rules, the amount of gain which will qualify as a capital gain on the sale of a building will arise primarily from the rising price level. This gain then, is illusory.

When the hotel or motel operator attempts to replace the property sold, he finds that the cost of the replacement property will exceed the selling price of the old building. Not only that, a portion of the selling price will not have been retained by the operator, but instead will have been paid as a capital gains tax. To now increase the capital gains tax rate or to do away with the capital gains provisions will compound the operator's problem in raising replacement capital.

There is a new Securities Exchange Commission requirement that all productive assets be shown in a footnote on the company's balance sheet at replacement cost. In addition, the SEC requires that the balance sheet disclose the depreciation on replacement cost.

Thus, the SEC has recognized the concept of recovery of economic value. Presently, however, the Internal Revenue Code's concept of depreciation is a recovery of original cost invested. Therefore, the code does not permit the use of price level depreciation which allows capital recovery in this world of inflation.

We request that this committee recognize the concept as does the SEC and allow price level depreciation.

TAX TREATMENT OF REAL ESTATE

The association wishes to emphasize to this committee that the major factor determining the life of a new hotel or motel is functional obsolescence and not physical deterioration.

We ask the committee to allow the hotel and motel industry to depreciate their physical plants over shorter periods of time than those now permissible in the Internal Revenue Code. It is imperative for the long-term health and growth of the hotel and motel industry that the tax laws reflect the hard economics of capital recovery of those industries and allow the short lives.

TREATMENT OF CAPITAL RECOVERY FOR TAX PURPOSES

The hotel and motel industry's major investment is in its building and real property, which does not currently qualify for the investment tax credit; whereas other industries' major investments are personal property which qualify for investment tax credit.

We believe that serious consideration should be given to expanding the benefits of the investment tax credit to a portion of hotel and motel real property, such as the cost of steel, or cost of labor included in the building, or a percentage of the original total cost of the building.

The real estate and hotel/motel property, which is the major portion of the investment by the hotel and motel entrepreneur, is currently denied tax relief which is granted other industries. It is estimated that a new hotel will spend only 20 percent of the total investment on equipment subject to the investment tax credit. Other industries such as airlines, transportation and machine tools receive a far larger benefit from the investment tax credit since a far larger proportion of their total individual investment is in equipment subject to the investment tax credit.

We propose to equalize the tax benefits currently enjoyed by other capital intensive industries to the capital intensive hotel and motel industry by expanding benefits of the investment tax credit to a portion of the hotel and motel real property.

DEDUCTIONS OF BUSINESS EXPENSES

The association is opposed to proposals which would prohibit a business deduction for the cost in excess of a certain class of expense and tax such excess as income to the individual.

In our opinion, the ordinary and necessary expense test should be continued as the criteria for determining whether an expenditure is dedutcible. This test has been in effect for many years and is more than adequate to curb potential abuses.

The last area I would like to touch upon is Revenue Ruling 75-400, reporting of charged tips.

On September 15, 1975, the Internal Revenue Service issued Revenue Ruling 75-400. This ruling purports to require employers to keep independent records of the amount of charged tips paid to each employee—as contrasted to cash tips—and to compare this amount with the amount of charged tips which are reported by employees pursuant to section 6053 of the Code. If the amount of charged tips as thus recorded by the employer exceeds the charged tips reported by the employee, this ruling would require the employer to reflect the larger amount on that employee's Form W-2.

Revenue Ruling 75-400 does not allow the employer to take into consideration the fact that some portion of the charged tips paid to the employee may be shared with other employees as the result of tip splitting or tip pooling arrangements. Revenue Ruling 75-400 requires the employer to reflect the entire amount of charged tips paid to the employee on his Form W-2 even if the employer is generally aware of the existence of tip splitting or tip pooling arrangements in his establishment.

Thus, Revenue Ruling 75-400 purports to require employers to knowingly report an incorrect amount of employee's income on their Form W-2's by reporting amounts—based on the employer's records—which are in excess of the amounts reported by employees.

Surely, the intent of our tax laws cannot be to require employers to create useless records and report amounts which have no relation to real income or wages.

In enacting the Social Security Amendments Act of 1965 it was made crystal clear by Congress that section 6051(d) would be the sole reporting requirement for employers regarding tip income. Now, 10 years later the Internal Revenue Service incorrectly asserts that it has residual authority under section 6041 to require employers to file different information returns under a general provision in the Code. The industry would like a clarifying amendment indicating that employers shall only be required to report tips which are reported to them under section 6053 of the Internal Revenue Code. Thank you.

Senator FANNIN. Thank you, Mr. McLean. You brought out some very essential items in your statement, one that I am very concerned about. Here we are trying to save on energy that is utilized, and of course trying to create jobs and trying to have our tax program where it will be most beneficial for the development of revenue and for development of jobs in the overall operation of a business that can go forward. The cost replacement is, I understand, quite a problem with you when you speak of inflation and the writeoff and all that is involved and how maybe it costs two or three times as much to replace equipment as the equipment cost originally.

Do you feel that there would be a great deal more of replacement equipment, for instance, inefficient heating equipment, water heating equipment, refrigeration and all if this tax incentive was more of an inducement?

Mr. MCLEAN. Yes, I do, Senator. I know in our company that they do put off expenditures for a longer period of time than I think would be necessary if they were allowed this extra depreciation to create a reserve for expenditure in the future, I think that is very true.

Senator FANNIN. Your industry went through almost a recession at the time that we had the shortage of fuel. I assume it has made a pretty good recovery since that time. I just wonder what has happened or is happening as far as the rehabilitation, improvements and all in your industry? What is taking place now?

Mr. MCLEAN. Well, I think at the present time, unlike a year ago, I think about a year ago is when we had our real problems, but I think things are starting to look up. Of course, we are a little concerned about the energy problem and we have furnished this committee with a statement previously on our feelings as far as the energy goes.[1]

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[1] See printed hearings entitled "Energy Conservation and Conversion Act of 1975," pt. 2, p. 815 ff.

But that certainly is a concern of ours.

Senator FANNIN. Capital formation is a problem in almost every industry. Since you are a highly capitalized industry, your investments are very large commensurate with the amount of volume of business done because you just have a certain turnover that can come about. We are vitally interested in having specifics if we could get them. Could you provide this committee with specific statistics to show how additional expansion of facilities in your industry would employ more of our unemployed people?

In recent years, since the energy shortage, when we had the embargo, have you a greater number of employees or fewer employees? What has been the trend?

Mr. MCLEAN. I really can't say. I am not familiar with that. I can furnish that to you, Senator. I would be glad to.

Senator FANNIN. Fine.

[The information referred to follows:]

According to the Bureau of Labor statistics total employment for hotels, motels, and tourist courts was:

	Thousands
1973	765.4
1974	791.6
1975	805.8

Although total employment increased each year the percentage income was smaller in 1974–75 because of the problems encountered as a result of the Arab oil embargo.

Mr. MCLEAN. I would think the trend is down but I can't say with any great authority.

Senator FANNIN. What this committee would like to do is have justification for either continuing an incentive program, or for adopting a new incentive program, something that would assist. After all, the unemployment situation in this country today is of tremendous concern to everyone and of course capital formation is one of the most serious problems we have in providing employment for people. That is especially keen in the energy field and one place where we can encourage it is in the saving of energy. I know that your companies are vitally interested in more efficient equipment, they are interested in the insulation and different ways in which they can save energy. Certainly that is a dual purpose as far as the committee is concerned.

Mr. MCLEAN. Let me just say this one thing about capital formation. As an example the investment tax credit, some people say why should we allow these different companies an investment tax credit because they are not at full capacity, cannot really sell what they have now even though we give them additional incentives they just don't produce more, they will not hire any more employees.

I don't think that is true in the hotel and motel business. I think that if we have the incentives we will build more hotels and motels and will employ additional people.

Senator FANNIN. Well, if you modernize you have a greater chance of being more fully occupied. You have a competitive situation in new facilities being built. So that is a problem, I know, as to keeping up to date with all the facilities and staying in competition. You must furnish many facilities, of course, that are quite expensive but are needed to meet that competition.

Well, thank you very much, Mr. McLean.

Mr. McLEAN. Thank you, Senator.

[The prepared statement of Mr. McLean follows:]

STATEMENT OF THE AMERICAN HOTEL & MOTEL ASSOCIATION

SUMMARY

Taxation of capital gains and losses

Long-term capital gain tax rates should be lowered or kept at their current rate since the "gain" on the sale of producing assets held for long periods of time is, in large measure, merely an inflationary mirage; a company, in order to maintain its competitive position, must reinvest the profits of the sale of those assets in much lower costing assets.

Tax treatment of real estate

The increasingly rapid functional obsolescence of hotel and motel properties makes it imperative that shorter lives be permitted for depreciation tax purposes. The limited return on investment on ownership of hotel properties has made ownership of such properties less attractive, especially to major corporations who have, in fact, been confining their hotel activities to management rather than ownership. We propose that the Committee liberalize allowable depreciation in order to again make ownership of hotel properties viable.

Treatement of capital recovery for tax purposes

The hotel-motel industry's major investment is in building and real property, which does not currently qualify for the investment tax credit; whereas, other industries' major investments are personal property which qualify for investment tax credit. We suggest expanding the benefits of the investment tax credit to a portion of hotel real property such as the cost of steel or the cost of labor included in building the building, or a percentage of the original cost of the building.

Deduction of expenses attributable to business use of homes and rental of vacation homes

The Association is opposed to legislation which would single out owners of dwelling units who use such units partially for personal use to totally restrictive tax treatment. Existing law is sufficient to prevent abuses.

Deduction of business expenses

The Association is opposed to proposals which would prohibit a business deduction for the cost in excess of a certain class of fare and tax such excess as income to the individual.

Unfair competition

The Association opposes any effort to allow "social clubs" (Sec. 501(c)(7)) to earn additional outside income and still retain their tax-exempt status. Our view is that social clubs should be operated exclusively for the benefit of their members.

Ten years after the Congress enacted the Social Security Amendments Act of 1965, the Internal Revenue Service is now asserting that it has residual authority over 6041 to require additional information and record keeping returns over and above those specifically set forth by the Congress in Section 6051 and 6053 of the code.

The industry would like a clarifying amendment indicating that employers ~~should~~ only be required to report tips which are reported to them under Section 6053.

STATEMENT

I am Warner H. McLean, Tax Director of Hilton Hotels Corporation, Beverly Hills, California. I am appearing today on behalf of The American Hotel & Motel Association.

The Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands having a membership in excess of 8,000 hotels and motels containing in excess of 900,000 rentable rooms. The American Hotel & Motel Association maintains offices at 888 Seventh Avenue, New York City, and at 777-14th Street, N.W., Washington, D.C.

GENERAL COMMENTS

First, let me say that members of the American Hotel & Motel Association are operators of businesses which employ thousands of workers. The hotel and motel business is in large part not operated by passive investors or speculators who are interested in short-term trading profits, but by operators of businesses who rely on an economic net increase for their reward in operating a business.

Second, we ask that the Committee keep in mind that hotels and motels are a capital intensive industry requiring a large investment in a single one-purpose asset. The risks are high because factors such as location, changing fads and changing modes of transportation may make the operation obsolete very quickly. Building and location, unfortunately, cannot be moved to an intersection of a new highway. Similarly, if the location happens to be near the old highway, it must stay there and suffer drastic reductions in revenue.

CAPITAL FORMATION

In order to continue long term economic growth, it is essential that hotel and motel operators have the means to accumulate sufficient capital to meet expected modernization and expansion costs. Hotels and motel operators have two basic methods of obtaining investment capital: (1) by borrowing, or issuing capital stock to outside investors, and (2), by internally generating profits.

Generally, the amount which an enterprise can borrow, or the amount of additional capital stock it can issue is limited by the profits it can generate in its business. Because of the tax burden, business profits have been too low to generate sufficient investment capital. With the combined State and Federal tax rates well over 50 per cent of profits, net incomes after taxes have been barely sufficient to meet day-to-day operating needs.

While this Committee can do nothing about soaring State income taxes, you can create a Federal tax environment which will help business to meet its capital formation needs.

We propose the following tax changes in order to stimulate capital formation:

1. Taxation of capital gains and losses

The position of the American Hotel & Motel Association is that long-term capital gain rates should be kept at their current rate or lowered since the "gain" on the scale of assets held of a long period of time is in large measure inflationary. The primary basis for the tax differential between ordinary income and capital gains is the recognition that the economic gain realized is less than the because of inflation.

To further illustrate our point, depreciation is currently calculated both for income tax purposes and for accounting purposes under the Accounting Principles Board rules, based only on historical, actual costs.

If we assume a rate of inflation of ten percent annually, by the end of ten years recovery of $1 million of original investment via depreciation will produce only $550,000 purchasing power. The ability to replace the equivalent dollar value of productive capacity will be reduced by $450,000. Furthermore, businesses must earn $900,000 to replace the lost purchasing power since these earnings are taxed.

In our industry's chain business, proceeds from the sale of assets must be reinvested in other assets in order to maintain their competitive status. These new assets are much more costly. To further tax the proceeds on the sale of older assets would reduce the ability of hotels or motels to reinvest in assets at current market prices.

With the Tax Reform Act of 1969, the use of accelerated depreciation to convert ordinary income on capital gains has been largely curtailed. Because of the recapture rules, the amount of gain which will qualify as a capital gain on the sale of a building will arise primarily from the rising price level. This gain then, is illusory.

When the hotel or motel operator attempts to replace the property sold, he finds that the cost of the replacement property will exceed the selling price of the old building. Not only that, a portion of the selling price will not have been retained by the operator but instead will have been paid as a capital gains tax.

To now increase the capital gains tax rate or to do away with the capital gains provisions will compound the operator's problem in raising replacement capital.

There is a new Securities Exchange Commission requirement that all productive assets be shown in a footnote on the company's balance sheet at replacement cost. In addition, the S.E.C. requires that the balance sheet disclose the depreciation on replacement cost.

Thus, the S.E.C. has recognized the concept of recovery of economic value. Presently; however, the Internal Revenue Code's concept of depreciation is a recovery of original cost invested. Therefore, the Code does not permit the use of price level depreciation which allows capital recovery in this world of inflation.

We request that this Committee recognize the concept as does the S.E.C. and allow price level depreciation.

2. Tax treatment of real estate

The Association wishes to emphasize to this Committee that the major factor determining the life of a new hotel or motel is functional obsolescence and not physical deterioration.

The moving of a highway from Point X to Point Y in many cases reduces the life of a hotel or motel from forty years to zero years. Another example of obsolescence involved those hotels and motels surrounding Midway Airport in Chicago. The day that O'Hare Airport opened, these hotels and motels became functionally obsolescent, even though their physical condition was excellent. Permissible lives over which hotels and motels can be depreciated must be reduced in order to allow for probable but unknown causes of obsolescence.

For hotel companies, these causes of obsolescence in the past 15 years have been the wide-spread growth of motels; and for hotel and motel companies, increased use of the automobile, changing patterns of transportation, reliance on airplanes versus trains and buses, changing interstate highway systems, the ability to travel longer distances within one day, jet airplanes which allow travelers to attend a business meeting and return all within the same day, increasing foreign travel, and the trend for luxury hotels and rooms.

We ask the Committee to allow the hotel and motel industy to depreciate their physical plants over shorter periods of time than those now permissible in the Internal Revenue Code. It is imperative for the long-term health and growth of the hotel and motel industry that the tax laws reflect the hard economics of capital recovery of those industries and allow the short lives.

3. Treatment of capital recovery for tax purposes

The hotel and motel industry's major investment is in building and real property, which does not currently qualify for the investment tax credit; whereas other industries' major investments are personal property which qualify for investment tax credit.

We believe that serious consideration by this Committee should be given to expanding the benefits of the investment tax credit to a portion of hotel and motel real property, such as the cost of steel, or cost of labor included in the building, or a percentage of the original total cost of the building.

The real estate and hotel/motel property, which is the major portion of the investment by the hotel and motel entrepreneur, is currently denied tax relief which is granted to other industries. It is estimated that a NEW hotel will spend only 20 percent of the total investment on equipment subject to the investment tax credit. Other industries such as airlines, transportation and machine tools receive a far larger benefit from the investment tax credit since a far larger proportion of their total investment is in equipment subject to the investment tax credit.

We propose to equalize the tax benefits currently enjoyed by other capital intensive industries to the capital intensive hotel and motel industry by expanding benefits of the investment tax credit to a portion of the hotel and motel real property.

We wish to point out to the Committee that in essence a hotel or motel property is a one-time, long-term capital investment which results in a recovery of investment plus profit over a long time. The risks associated with this investment must be high since the recovery of capital is over a relatively long period of time.

As pointed out previously, the investment in real estate is not a passive investment; it is an investment in an operating physical asset. This distinction between operating and investments combined with the substantial reduction in tax advantages available to real estate investments as a result of the Tax

Reform Act of 1969 warrants the extension of the investment tax credit to real estate used in the active operation of a hotel or motel.

DEDUCTION OF EXPENSES ATTRIBUTABLE TO BUSINESS USE OF HOMES AND RENTAL OF VACATION HOMES

The Association is opposed to legislation which would single out owners of dwelling units who use such units partially for personal use to totally restrictive tax treatment. The mere use of such a unit by an owner should not be the sole factor in the determination that it is an activity not engaged in for profit.

Several years ago, the Internal Revenue Service issued a new regulation [section 1.83-1(d)(3)] spelling out possible significant losses in deductions for an owner who rents out his home for part of the year. An effort to close alleged tax shelters should not bar a taxpayer who can establish that he has a reasonable expectation of showing a profit from his rental activities from taking all deductions attributable to the rental activities.

DEDUCTION OF BUSINESS EXPENSES

The Association is opposed to proposals which would prohibit a business deduction for the cost in excess of a certain class of expense and tax such excess as income to the individual.

In our opinion, the "ordinary and necessary expense test" should be continued as the criteria for determining whether an expenditure is deductible. This test has been in effect for many years and is more than adequate to curb potential abuses.

UNFAIR COMPETITION

Under present law, a social club's tax exempt status will not be disturbed by the Internal Revenue Service if the club's annual income from making its facilities or services available to the general public is not more than the higher of 2,500 or five percent of the total gross receipts of the organizaton.

A bill, H.R. 1144, which is pending in the House Ways and Means Committee would raise that limit to 15 percent retroactive for years, beginning after 1969, for the clubs which are exempt under Section 501(c)(7). Additionally, H.R. 1144, would change the language necessary to qualify for exempt status from . . . an organization operated "exclusively" for pleasure, recreation, and other non-profitable purposes to one that "substantially all" its activities are for the above stated purposes.

AH&MA strongly opposes any liberalization of the tax laws respecting the treatment of social clubs.

Our members simply cannot compete with tax-exempts for valuable banquet and catering businesses. It is not fair to us, who pay federal, state, and local taxes, to have to watch hopelessly as social clubs are permitted to earn additional sources of revenue at our expense.

We ask this Committee to reject any measure that permits social clubs to derive outside income from the general public in excess of the limits under present law. After all, the only legitimate reason for having a tax-exempt social club is to serve "its own members" not the public.

REVENUE RULING 75-400; REPORTING OF CHARGED TIPS

On September 15, 1975, the Internal Revenue Service issued Revenue Ruling 75-400. This Ruling purports to require employers to keep independent records of the amount of charged tips paid to each employee (as contrasted to cash tips) and to compare this amount with the amount of charged tips which are reported by employees pursuant to Section 6053. If the amount of charged tips as thus recorded by the employer exceeds the charged tips reported by the employee, this Ruling would require the employer to reflect the larger amount on that employee's Form W-2.

Prior to Revenue Ruling 75-400, the Internal Revenue Service, based on Section 6051 of the Internal Revenue Code, required the employer to include on the W-2 only the amount of tips reported to him by the employee.

Section 3402(k) requires income tax withholding only on tips reported to the employer by the employee. Revenue Ruling 75-400 asserts that although charged tips paid by the employer are not reported by the employee are not subject to withholding, they must be reported on the W-2 as wages pursuant to Section 6041.

Revenue Ruling 75-400 does not allow the employer to take into consideration the fact that some portion of the charged tips paid to the employee may be shared with other employees as the result of tip splitting or tip pooling arrangements. Revenue Ruling 75-400 requires the employer to reflect the entire amount of charged tips paid to the employee on his From W-2 even if the employer is generally aware of the existence of tip splitting or tip pooling arrangements in his establishment.

Thus, Revenue Ruling 75-400 purports to require empolyers to knowingly report an incorrect amount of employee's income on their Form W-2's by reporting amounts (based on the employer's records) which are in excess of the amounts reported by employees.

Surely, the intent of our tax laws cannot be to require employers to create useless records and report amounts which have no relation to real income or wages.

Under Section 6051, employers are required to prepare Form W-2 and Section 6051(d) requires these forms to be filed with the Internal Revenue Service as an information return and the amount of tips to be reported on Form W-2 is only the amount of tips required to be reported by employees under Section 6053.

In enacting the Social Amendments Act of 1965 it was made crystal clear by Congress that Section 6051(d) would be the sole reporting requirement for employers regarding tip income. Now, ten years later the Internal Revenue Service incorrectly asserts that it has residual authority under Section 6041 to require employers to file different information returns. The Industry would like a clarifying amendment to Section 6041 or Section 6051 indicating that employers shall only be required to report tips which are reported to them under Section 6053.

This has been the historical practice in the industry.

Senator FANNIN. The next witness is John F. McClelland, National Association of Retired Federal Employees.

It is the chairman's understanding you are Charles Merin and you are accompanied by Judith Park, legislative assistant. We welcome you both to the committee hearings. Thank you for coming here. You have been very patient in waiting all this time. Your complete statement will be made a part of the record and you may proceed as you deem necessary.

TESTIMONY OF CHARLES MERIN AND JUDITH PARK, LEGISLATIVE ASSISTANTS, NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES

Mr. MERIN. I am with the legislative staff of the National Association of Retired Federal Employees. I am accompanied by Miss Judith Park, also of the legislative staff, and as a result of the recess called this morning, John McClelland, president of the association, was unable to present this testimony, so I would like to present it on his behalf.

The National Association of Retired Federal Employees was founded 54 years ago, just several months after enactment of the original Civil Service Retirement Law. NARFE is composed entirely of retirees from the Federal Government, their spouses and survivors. With a current dues-paying membership of approximately 250,000 our association has long served as the major spokesman for civil service annuitants in the legislative field.

We welcome this opportunity to voice our position on several of the provisions of the tax reform bill approved by the House of Representatives in the last session of this Congress. In particular we want to address ourselves to the issues of: (1) Retirement income credit; (2) sick-pay exclusion; (3) continuation of certain current allowable deductions.

RETIREMENT INCOME CREDIT

Tax relief legislation for retirees in general, and Federal retirees in particular, has long been a major concern of our association. Runaway inflation over the past few years, coupled with ever-increasing taxes at every level of government in the past decade has served to deepen our concern and given more urgency to the need for legislation to ease the tax burden of retirees.

Currently, social security and railroad retirement benefits are tax free, but the same is not true of civil service annuity benefits no retirement income from other public and private pension plans of many retired teachers, policemen, firemen, and others. These retirees must depend upon the retirement income credit provision (section 37) of the Internal Revenue Code of 1954 for tax relief of their annuities. Such at least, was the intent of Congress when the retirement income credit provision was enacted—"to conform the tax treatment of all individuals to those who now receive tax exempt social security benefits."

Unfortunately, this intent has not been continually implemented, as the specified amount of retirement income credit has not been updated since 1962, during which period of time there have been eight benefit increases in social security. These eight benefit increases have increased social Security benefits by approximately 84 percent since 1962 and none of these increases has been reflected in the figures used for retirement income credit computation.

Under the current law, retirement income credit is computed on a base of $1,524 for a single person, or $2,286 for a married couple filing a joint return; these figures reflect social security benefits in 1962, the last time the provision was updated. But lamentably, they inadequately reflect today's social security benefits, and the constraints made upon the annuitant's disposable income after current taxation demands.

The time is long past for legislation to update the retirement income credit. In justice to our older citizens, it is imperative that the Congress act now to implement a tax relief provision aimed at the equalization of tax treatment of Federal retirees with that already extended to social security and railroad retirement beneficiaries.

The problem of inequitable tax treatment of Federal annuities has not gone unnoticed. I might add that the Civil Service Commission has indicated in reports to the Congress its belief that Federal retirees should be accorded equal type tax treatment on this annuity formula. A number of bills now pending in both Chambers of the Congress seek to alleviate this situation. Our association would recommend the adoption by the Congress of S. 2870, a bill sponsored by Senator Joseph Montoya of New Mexico. This bill seeks to treat Federal retirement system income the same as social security income, to the extent that the Federal income does not exceed the sum of the moneys to be received under title II of the Social Security Act. More simply stated, in attempts to make the retirement income of civil service annuitants tax exempt to a point commensurate with that of social security income. Our association approves of this approach to the tax problem because it provides an exemption rather than a credit for the annuitant. Adoption of this exemption mechanism will greatly simplify tax preparation for this group of older Americans; we encourage this approach because the complicated formula for determining the credit under current tax regulations precludes many retirees from taking advantage of it. In addition, it places no ceiling figure which would require future congressional adjustment to accommodate the inevitable changes brought on by the inflationary spiral.

We strongly oppose the House-approved restructuring of the retirement income credit. While it proposes an upward adjustment in the credit computation figures to $2,5000 and $3,750 for an individual and qualified couple respectively, it also establishes a phaseout of the credit gress would be negating the original intent of the retirement income (AGI) in excess of $7,500 for an individual or $10,000 for a couple.

By applying a phase-out based on adjusted gross income, the Congress would be negating the original intent on the retirement income credit: to equalize tax treatment of civil service annuities with social security's tax-free benefits. There is, after all, no consideration of the adjusted gross income of a social security beneficiary in determining degree of taxation of the benefits paid under that system.

SICK-PAY EXCLUSION

In addressing ourselves to section 105(d) of the Tax Code, commonly referred to as the "sick-pay exclusion," NARFE urges the committee to continue application of this benefit in its current form. Evidence suggests that it was conceived and established as a protective fiscal device to enable working taxpayers whose productivity and solvency are diminished by a substantial setback due to sickness of injury, to maintain their solvency.

The maximum limit of this exclusion was set in 1954 at $100 per week. On the basis of a 40-hour normal work week, this corresponded to an hourly rate of pay at $2.50 per hour, compared to the Federal minimum hourly rate at that time of 75 cents. In light of economic developments, increased wages, and increased consumer prices, especially in the area of medical care, it would appear that attention should be focused on maintaining the fiscal solvency of disabled taxpayers in today's economy, thus readjusting upward the current maximum limit of the sick-pay exclusion; we believe above all that it is imperative that this moderate and proven method of protecting the fiscal solvency of the disabled worker be retained in the Tax Code.

We find ourselves at odds with the House-adopted revision of the sick-pay exclusion. Currently this exclusion of $100 per wek ($5.200 per annum) is applicable to persons drawing disability annuities or pension until they reach the mandatory retirement age prescribed by their former employers. For the majority of Federal retirees, mandatory retirement is set at age 70, although an earlier age is mandated for those in certain occupational areas. The present exclusion is not dependent upon the adjusted gross income of the disabled worker.

The revised sick-pay exclusion provision approved by the House of Representatives last year would limit application of this particular tax benefit to those deemed "permanently and totally disabled" until age 65. In addition, it would reduce the allowable exclusion of $5,200 per year on a dollar-for-dollar basis for persons with adjusted gross incomes in excess of $15,000. Thus a person with an AGI in excess of $20,000 would be ineligible to utilize the sick-pay exclusion.

NARFE maintains that the sick-pay exclusion should continue to be applicable until one attains the mandatory retirement age established by his or her last employer, as we can only assume that a person would have elected to work until that mandatory retirement age had disability not eliminated this option. At the very least, mandatory retirement age criterion should remain as the standard for eligibility for those already on the disability retirement rolls as of the effective date of this provision; the 65-year-age standard applying only to future retirees.

We can support application of the provision solely to those deemed "permanently and totally" disabled after the provision's effective date, but again we urge that the "permanent and total" disability test not be applicable to those already utilizing the sick-pay exclusion. NARFE has publicly supported strict adherence to the Civil Service Retirement System's guidelines for granting "disability" retirement status. The record shows that the granting of disability status under the Civil Service Retirement System in the past has been almost a matter of "rubberstamping" disability applications, a practice which we recognize must cease.

Our association must go on record as strongly opposing any phaseout of the sick-pay exclusion based on the disabled retiree's gross income. A disabled person, by reason of his disability alone, is assumed to have certain medical care expenses above and beyond the average person. The Consumer Price Index statistics on medical cost items have increased almost 100 percent since the sick-pay exclusion was enacted in 1954, and these costs cut heavily into everyone's disposable income, but in particular that of the disable individual. We cannot justify a tax benefit based on adjusted gross income which does not make physical or mental impairment any less debilitating.

CONTINUATION OF CERTAIN CURRENT ALLOWABLE DEDUCTIONS

With medical care and drug costs spiraling more rapidly than almost any other consumer service and goods in the past few years, our association feels it is imperative that a tax deduction for financial outlay in this area be retained in the Tax Code.

We do, however, feel that this deduction feature of the tax laws could be simplified by combining all medical and drug expenses, and allowing for a deduction of all combined expenses above a floor of 4 percent of adjusted gross income.

Going a step further on this issue, we would also urge reinstatement of other now-deleted tax provisions which allowed for full medical deductions for persons age 65 and over, as well as drug expenses for this group of elderly citizens. This was an allowable deduction until 1967, and we should like to see it restored. It is well established that the medical and drug expenses of the elderly are far higher than those of the younger segment of the population, and consume a far larger proportion of their generally small, fixed incomes. We believe that with today's exorbitant medical costs, the full deduction of these costs for the aged is more direly needed than ever.

We, as fully as anyone, recognize the need for tax simplification. For senior citizens complicated tax laws are more frustrating than ever and as a result we find the highest percentage of tax overpayments being made by this group. They overpay their taxes, simply because they cannot understand or compute the benefits made available to them in the morass of provisions and instructions. We do not, however, feel that the only means of simplifying the various tax benefits now available is to simply repeal them. For millions of low- and middle-income taxpayers, the small deductions allowed for items such as medical and drug expenses, charitable contributions, gasoline taxes, and so forth, are the only methods available to them of reducing their tax burden. We would hope that in the course of these and future hearings this committee can find equitable ways to reduce the complexity of the tax situation, without eliminating tax benefits now available to the average worker and retiree.

We thank you for the opportunity to participate. If we can answer your questions we will be happy to.

Senator FANNIN. You had perfect timing. Very good [laughter].

Starting at the end of your statement, and I was very impressed with the equity involved where you make recommendations that would assist in alleviating some of the problems; at the same time you take consideration of the fact we are in a period of inflation and that you feel that inflation perhaps is the most serious factor involving the problems that you have discussed.

Mr. MERIN. Yes; we do, very much so.

Senator FANNIN. I am concerned about your statement about the senior citizens, that because of our complicated tax laws and not understanding them, they do overpay their taxes. In most instances do you try to, in your association, furnish assistance in this regard?

Mr. MERIN. In whatever way we can, yes.

Miss PARK. Yes, Senator, at the local level we try to have our people helping NARFE members in their locals with this and as well providing whatever instructions we can through the monthly periodical of the association.

Senator FANNIN. Very good. I think that is highly essential and my Arizona citizens, senior citizens and others, do not utilize the services available to them and it is regrettable they may overpay and it may be caught and they get a refund but on a percentage basis—we are always talking about percentages because we are working percentages—the percentage is probably against them of getting a refund of that sort.

Mr. MERIN. Exactly.

Senator FANNIN. I am also concerned about some of the recommendations that have been made that I am afraid would affect the retired people. There have been recommendations about second homes.

Now, you have people that retire and they may be in a cold climate and want to stay at home in a warmer climate. It is not always a wealthy person moving down there. I know we have places in Arizona where they have very convenient homes, not terribly expensive. Do you think it would be fair if we did as some have recommended, have legislation that would restrict the amount of deduction only to the home, the first home and they could not take their taxes or their interest paid in connection with the second home?

Miss PARK. I don't believe, Senator, that the association has taken a position on that particular issue. I would, therefore, in behalf of the association hesitate to answer that.

Senator FANNIN. Well, coming from a State where there are many retired people I know that this would be an extra burden on them. Frequently for health condition or just because of the idea of comfort they want to go into a warmer climate during the cold winter months and this would be a burden upon them to have——

Senator GRAVEL [presiding]. Would the Senator yield at that point?

Senator FANNIN. Sure, fine.

Senator GRAVEL. Is there any possibility of your looking into that?

Miss PARK. Yes; we can; and we can report to the committee on that.

Senator GRAVEL. Probably a good part of your membership would be hurt by this and your study would help us. The record will be open and you will have more than enough time to submit a statement.

Miss PARK. Fine, we would be happy to.

Senator FANNIN. Fine, Mr. Chairman, I think that is important and a very good idea.

[The information referred to follows:]

The National Association of Retired Federal Employees would not go on record as recommending that a restriction on deductions only on a first home be enacted, as we believe there are cases where the taxes and interest paid on a second home are justified deductions.

We do not believe, however, that allowable deductions on a second home is of primary importance to most of our Federal retirees, for the limited incomes of this group, along with similar limited incomes of the majority of the nation's retirees, makes the purchase of a second home itself an impossibility.

We have found that while a large number of retirees spend certain portions of the year in different locales because of climatic differences, it is seldom that a second home is purchased. In most instances the "second home" is rented for the duration of the visit in the warmer clime, or a mobile home is utilized to make the yearly shift of residence.

Senator FANNIN. In your statement you refer to a bill that Senator Montoya has introduced, S. 2870. I am not completely familiar with that bill. Do you recommend passage of that bill or do you recommend that we take into consideration the stipulations in that bill that would affect the tax program and incorporate them in this legislation?

Mr. MERIN. We advocate passage of the bill. The intent of the bill, we believe, complies with the original intent on this matter. What the Senator is seeking to do is put these benefits at the point commensurate with social security, which was the original intent of the retirement income credit. For reasons stated within the testimony, we feel that bill nicely meets those requirements.

Senator FANNIN. In your statement you say:

We strongly oppose the House-approved restructuring of the retirement income credit. While it proposes an upward adjustment in the credit computation figures to $2,500 and $3,750 for an individual and qualified couple respectively, it also establishes a phaseout of the credit available on the basis of $1 for every $2 of adjusted gross income (AGI) in excess of $7,500 for an individual or $10,000 for a couple.

Do you feel more of your members would be adversely affected than would be benefited by that change?

Miss PARK. We feel the majority of our members who are now able to utilize the retirement income credit would be adversely affected by the income phaseout, but more importantly, I believe, we feel that the use of the income phaseout negates the original intent of Congress in retirement income credit.

Because as stated here, there is no means test or adjusted gross incomes test in determining what percentage of social security benefits are tax exempt. All social security benefits are tax exempt regardless of the adjusted gross income of the individual.

Senator FANNIN. Well, thank you both very much.

Mr. MERIN. We thank you.

Senator FANNIN. Thank you, Mr. Chairman.

Senator GRAVEL. Thank you.

Thank you, Senator, for holding the fort.

Our next witness is J. Robert Brouse, president, Direct Selling Association.

You are the anchorman today, Mr. Brouse.

STATEMENT OF J. ROBERT BROUSE, PRESIDENT, DIRECT SELLING ASSOCIATION, ACCOMPANIED BY NEIL OFFEN, SENIOR VICE PRESIDENT AND LEGAL COUNSEL

Mr. BROUSE. Thank you, Mr. Chairman.

Mr. Chairman, Senator Fannin, my name is Robert Brouse. With me today is Neil Offen, senior vice president and counsel of the association.

We are here to express our concern with section 601 of H.R. 10612 relating to deductions for expenses attributed to business use of the home, and request consideration of an amendment thereto.

The Direct Selling Association is a national trade association composed of about 100 companies whose goods and services are offered directly to consumers through sales transactions conducted in the home, by more than 1½ million salespersons, most of whom are independent retailers. The association was created in 1910 and has, since that time, sought to protect and promote the rights of small business persons and individual entrepreneurs who have pioneered retailing in America. Over half the people in this business are women. For the most part, they work in the communities in which they live. They operate almost exclusively out of their homes, and their annual sales total something in excess of $6 billion annually.

Historically, if a portion of the residence is used in the taxpayer's trade or business, or is used in the production of income, a deduction may be allowed for an allocable portion of the expenses incurred in maintaining such personal residence. The taxpayer has to establish that the expenses were incurred in carrying on the trade or business, or for the production of income, or in other words, show that there is some relatively clear connection between the activities conducted in the home and trade or business, or the production of income. Typically, the expenses for which a deduction is claimed include an allocable portion of the depreciation or rent, maintenance, utility, and insurance expenses incurred in connection with the business use of the residence.

In determining the deductible amount attributable to the business use of the home, the general rule is that any reasonable method of allocation may be used. In all cases involving the dual use of the home, the allocation of expenses attributable to the portion of the residence used for business purposes will take into account the space used for those purposes; for example, a percentage of the expenses based on the square feet of that portion, compared to the total square feet of the residence. In addition, a further allocation based on time of use is required, when the portion of the residence is not exclusively used for business purposes.

It has been suggested that there was a need for more definitive rules to resolve the conflict existing between several recent court decisions and the position of the Internal Revenue Service as to the correct standard governing the deductibility of expenses attributable to the maintenance of an office or business in the taxpayer's personal residence. The IRS was concerned, for example, that expenses otherwise considered nondeductible personal, living, and family expenses, might be converted into deductible business expenses simply because, under the facts of the particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence. For example, if a university professor, who is provided an office by his employer, uses his den or some other room in his residence for the purposes of grading papers, preparing examinations, or preparing classroom notes, an allocable portion of certain expenses might be claimed as a deduction, even though only minor incremental expenses were incurred in order to perform those activities. Another example might be a trade association executive, like myself, who, although provided an office downtown, might use his den at home to write legal briefs or speeches or organization manuals, as well as for personal purposes.

Frankly, we have no objection to denying a deduction for such expenses, but in drafting language to curb those deductions, that authors, inadvertently, I think, infringed on the rights of salespeople, whose homes are the sole fixed location of their business and who need the deductions in order to make a profit and compete effectively in the marketplace.

The House of Representatives recognized this distinction, which we brought to its attention, and attempted to provide for it in section 280 (c) (2), relating to certain storage use. In that section, they said that the limitations regarding deductions "shall not apply to any item to the extent such item is allocable to space within the dwelling unit, which is used on a regular basis as a storage unit for the inventory of the taxpayer, or for use in the taxpayer's trade or business of selling products at retail, but only if the dwelling unit is the sole fixed location of such trade or business." That is a step in the right direction, since nearly all of the independent contractors seeking the deduction will use a portion of their home for storage purposes and do so on a regular basis.

Our real problem, Mr. Chairman, lies with the preceding language, section 280(c) (1), which states that the limitations on deductions.

> Shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis as "(A) the taxpayer's principle place of business, or (B) a place of business which is used by

patients, clients or customers in meeting or dealing with the taxpayer in the normal course of his trade or business. In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer."

Our concern here is with the word exclusive. If the individual salesperson was making $50,000 a year, he could afford to set aside a part of his home to use exclusively for his business. The fact is, most of the individuals in direct selling are very small business persons. They might use the telephone in the kitchen to make appointments, a portion of the bedroom to write invoices, or keep records, a part of the basement for storage, et cetera. More often than not, they are supplementing their husband's income, in order to educate their children or simply to keep up with inflation, and they are truly not in a position to meet this exclusive use test. Yet their home is their sole, independently operated place of business.

In addition, there are thousands of direct selling company managers, as opposed to individual retailers, who also use their home as their sole fixed location for business in order to recruit, train, supervise and assist those individual salespersons. The section dealing with storage use is inadequate to protect them also.

Mr. Chairman, the problem which we are addressing today, on behalf of the independent salespersons in America, may surely seem pale beside the great tax reform issues encompassed by this bill. After all, the deductions being sought by these individuals are undoubtedly very small and the effect of the changes I am about to recommend, may not make an iota of difference to the national budget. Unfortunately, we have not been able to obtain reliable statistics from IRS to be able to tell you exactly the amount of the presently allowable deductions being claimed, although we are convinced that the amount is minimal. But, whatever the amount, both the real and the psychological impact of your actions may be telling indeed to those individuals who badly need every deduction entitled to them by law and who cannot understand why a big business is given consideration and a small businessperson or individual entrepreneur is given short shrift. What we have here is not merely a question of tax liability, but also Government credibility. The issue may be small in importance on a national fiscal scale but great in the income earning opportunities Congress should protect in its role as champion of the people. One way to do that, I suggest, is to amend the bill by striking the language after section 280(c)(2) relating to storage use and substituting the following language:

Subsection (a) will not apply to any item to the extent such items are allocable to the space within the dwelling unit which is used on a regular basis in the conduct of:

(A) the taxpayer's trade or business of selling goods or services, but only if the dwelling unit is the sole fixed location of such trade or business, or

(B) the business of the taxpayer's employer, for which no other office or fixed location is provided by the employer.

This language would both allow the individual retailer and the direct selling manager, both of whom use their homes as the sole fixed location of their business, to continue to deduct a portion of that home for their business. At the same time, it would prohibit the use of this exemption for expenses that did not result in necessary additional or incremental costs incurred as a result of business use in the home—such as a lawyer, a teacher or a trade association executive. It would be fair and equitable and it would help preserve a system of retailing which helped pioneer this country 200 years ago and remains today the epitome of free enterprise.

That concludes my statement, Mr. Chairman. I would be happy to try to answer any questions.

Senator GRAVEL. You know I sympathize with your position. I was once in the direct selling business.

Mr. BROUSE. You were?

Senator GRAVEL. Yes. I think your comments are very much to the point on that section of the bill.

Senator Fannin, do you have any questions?

Senator FANNIN. Thank you, Mr. Chairman.

You did make a very precise presentation, Mr. Brouse, of your position. Most of your people are fulltime employees, are they not, full time on the job?

Mr. BROUSE. No, sir; most of them are part time and they are independent contractors.

Senator FANNIN. Now, they don't devote full time to the work that is involved, then?

Mr. BROUSE. No, we have no way of telling how much time the individual devotes to the work of selling. He can devote as much or as little time as he likes.

Senator FANNIN. How would you gage, then, the amount of utilization of the quarters that you were stating should be allowable for deduction? In other words, if this is their sole income, and they are using those quarters for that purpose, certainly it is much more justifiable if they have another job and this is just something that they do that doesn't really occupy the quarters during the complete day.

Mr. BROUSE. Well, I am not sure I can agree on the distinction you have made. I can see that if you work at it full time that that is absolutely essential. But at the same time perhaps you could also be making the kind of income that you could afford an exclusive portion of your home for that purpose. Also, as you know, the rate of two incomes in the family has increased substantially over the years as inflation has drained the resources of people and a second income is essential.

Senator FANNIN. If the wife is doing this full time, I know they have certain firms, Watkins, I remember that. And I do think that in that case—I am not arguing against what you present. All I am trying to do is justify what you are presenting and be in a position if it is argued, "Well, look, this is just a tax loophole," that they are really not utilizing those facilities for that purpose so they are not entitled to it.

Now, perhaps you could establish just exactly what it is that is done, or how we could provide that the person gets the advantage of the deduction by the recommended method to be used in this connection?

In other words, how do we explain if they are on a part-time basis that they are entitled to the deduction that you are referring to in your testimony?

Mr. OFFEN. Senator, these people have to meet the existing IRS standards and tests, which means that they have to maintain records and justify the actual business use of the facilities, the insurance, utilities, whatever specific deductions they are claiming on a time basis. When you referred to full-time people, one of the great benefits of the industry is that it offers supplemental-income-earning opportunities to many people as well as offering flexibility in terms of the amount of hours that can be worked. So we therefore don't have a specific 40-hour week that is going to be put in.

Senator FANNIN. Oh, I understand that; but in other words if there is a telephone bill of $20 a month, do you feel that 75 percent of that is used for business purposes?

Mr. OFFEN. They would have to maintain a log or records that would be satisfactory to the Internal Revenue Service under the present existing test.

Senator FANNIN. And IRS does require that?

Mr. OFFEN. Yes, sir. And they are meeting that. We are not asking for a change in that law. We want to see the law maintained vis-a-vis other salespeople.

Senator FANNIN. What specifically do you feel should be done in this legislation that would go the farthest to accomplish your objectives?

Mr. BROUSE. We would like very much, Senator, to have the amendment we suggest incorporated in the final bill to remove, as far as our people are concerned, that exclusivity test called for now in the new section 280.

Senator FANNIN. Fine. Thank you.

Mr. OFFEN. I guess what we are asking is in terms of our independent retailers, we are asking for the status quo under present law.

Senator FANNIN. In other words, you would like to see it stay as it is at present.

Mr. BROUSE. Yes, sir.

Senator FANNIN. Thank you very much.

Mr. OFFEN. Thank you.

Senator GRAVEL. Thank you very much, gentlemen.

Mr. BROUSE. Thank you, Senator Gravel, Senator Fannin.

[The attachments to Mr. Brouse's statement follow:]

facts about direct selling

Direct Selling, the Direct Selling Association and the Consumer

Contact: Mills C. Edwards, Jr.

PUBLISHED BY
THE DIRECT SELLING ASSOCIATION
1730 M STREET, N.W.
WASHINGTON, D.C. 20036
(202) 293-5760

JUST WHAT IS DIRECT SELLING?

Direct selling is a major form of retail distribution. It is seller-initiated merchandising and occurs in the buyer's home through an in-person sales contact. It may take the well-known door-to-door form or the popular party-plan approach.

The direct selling industry provides income opportunities to some three million Americans yearly and contributes some $6 billion annually to the nation's economy.

The direct seller is the country's smallest independent business person; many are minority group members, disadvantaged or retired persons, students, homemakers and husband-and-wife teams with family-run businesses.

WHAT IS THE DIRECT SELLING ASSOCIATION?

The Direct Selling Association (DSA) is a national trade association representing companies which manufacture and distribute products intended for sale to the consumer in his home. Formerly the National Association of Direct Selling Companies, DSA was founded in 1910 and currently represents some 90 direct selling firms.

HOW CAN DSA HELP THE CONSUMER?

DSA can help the consumer make wise purchases at home through its strict and highly effective code of ethics. The code is, in effect, a guarantee to the consumer that all DSA member companies are honor-bound to conduct business fairly and will take steps to correct any improper practices brought to their attention.

HOW IS DSA'S CODE EFFECTIVE?

This is one code of ethics with teeth -- it doesn't merely pay lip service to the consumer. It requires that: A MEMBER COMPANY promptly investigate any consumer complaints of improper presentation of its goods or services and take appropriate action to correct the situation; THE DIRECT SELLING ASSOCIATION, itself, through an independent code administrator, act on reported violations by members to correct actual violations. If such violations are substantiated, the complaint will be remedied and, where appropriate, violations are referred to government agencies.

HOW CAN YOU LEARN MORE ABOUT THIS DIRECT SELLING CODE?

Write the Direct Selling Association. A copy of DSA Opens the Door to Consumer Protection is yours -- free for the asking. Please enclose a self-addressed, stamped, business-size envelope.

Also available, on a two-week, free-loan basis, is "Personal Selling--Something Extra!" It's a ten-minute, audiovisual (slides and cassette) program on the code. Please write to reserve your dates.

IF YOU HAVE A COMPLAINT?

If you have any doubts about a direct sale, either in the making or already completed, contact either the company or the Direct Selling Association. If it's a member company, DSA's code of ethics will do the rest. Write the Direct Selling Association, Dept. FS2, 1730 M Street, N.W., Washington, DC 20036.

DSA Active Member List

ACTIVE MEMBER COMPANIES AS OF FEBRUARY 6, 1976
Published by the Direct Selling Association / 1730 M Street, N.W., Washington, DC 20036 / (202) 293-5760

A

ACT II JEWELRY, INC.
Orlando, FL

AMERICAN FUTURE SYSTEMS, INC.
Bryn Mawr, PA

AMWAY CORPORATION
Ada, MI

ANCI CORPORATION
Framingham, MA

ANNA ELIZABETH WADE
(Chap Stick Company)
Lynchburg, VA

APO INTERNATIONAL, INC.
Dallas, TX

ARNESON PRODUCTS, INC.
Corte Madera, CA

ARTCRAFT CONCEPTS, INC.
Ballston Lake, NY

ARTEX HOBBY PRODUCTS, INC.
Lima, OH

AVON PRODUCTS, INC.
New York, NY

B

BEAUTI-CONTROL, INC.
(Tri-Chem, Inc.)
Arlington, TX

BEELINE FASHIONS, INC.
Bensenville, IL

BESTLINE PRODUCTS, INC.
Elk Grove Village, IL

BLAIR QUALITY PRODUCTS
(Chap Stick Company)
Lynchburg, VA

BRANDEIS DECOR BOUTIQUE
Omaha, NB

C

CAMEO COUTURES, INC.
Dallas, TX

THE CATO CORPORATION
Charlotte, NC

CAROLINE EMMONS
(C.H. Stuart Inc.)
Newark, NY

CELEBRITY CHINA COMPANY
Shawnee, KS

CHAP STICK COMPANY
Lynchburg, VA

THE CLASSIC NORTHAMERICAN CORP.
Dallas, TX

COLONY HOUSE, INC.
(SMC Industries, Inc.)
Dallas, TX

CON-STAN INDUSTRIES, INC.
City of Industry, CA

COPPERCRAFT GUILD
Taunton, MA

D

DONCASTER, INC.
Rutherfordton, NC

DUDLEY'S BEAUTY & BARBER SUPPLY, INC.
Greensboro, NC

E

ENCYCLOPAEDIA BRITANNICA, INC.
Chicago, IL

F

FAMILY RECORD PLAN, INC.
Los Angeles, CA

FASHION FROCKS, INC.
Ft. Mitchell, KY

FASHION TWO TWENTY, INC.
Aurora, OH

F (cont'd)

FASHION WAGON
(Minnesota Woolen Company)
Duluth, MN

FIELD ENTERPRISES EDUCATIONAL CORPORATION
Chicago, IL

FIGURETTES, INC.
Los Angeles, CA

THE FULLER BRUSH COMPANY
Niles, IL

FUTURE ENTERPRISES, INC.
Indianapolis, IN

G

GATEWAY HOME DECORATORS
(C. H. Stuart Inc.)
Newark, NY

GROLIER INCORPORATED
New York, NY

GUARDIAN SERVICE SECURITY SYSTEMS
Los Angeles, CA

H

THE HANOVER SHOE, INC.
Hanover, PA

HEALTH-MOR INC.
Chicago, IL

HIGHLIGHTS FOR CHILDREN, INC.
Columbus, OH

HOME INTERIORS & GIFTS, INC.
Dallas, TX

HOMEMAKERS GUILD OF AMERICA
Denver, CO

J

JAFRA COSMETICS, INC.
Canoga Park, CA

K

THE KIRBY COMPANY
(The Scott & Fetzer Company)
Cleveland, OH

L

JOHN W. LEWIS ENTERPRISES, INC.
San Juan, PR

LISA JEWELS COMPANY
Orange, NJ

LOS ANGELES POLA COSMETICS
Los Angeles, CA

LUCKY HEART COSMETICS, INC.
Memphis, TN

LUZIER INCORPORATED
Kansas City, MO

M

MARJO, INC.
Ft. Wayne, IN

MARY KAY COSMETICS, INC.
Dallas, TX

MASON SHOE MANUFACTURING COMPANY
Chippewa Falls, WI

MASTERGUARD CORPORATION
(SMC Industries, Inc.)
Dallas, TX

McCONNON & COMPANY
Winona, MN

MILKMAID COSMETICS, INC.
Chaska, MN

MIRACLE MAID
(West Bend Company)
West Bend, WI

MOORMAN MANUFACTURING CO.
Quincy, IL

N
NATIONAL PHOTOGRAPHERS ALBUM COMPANY
Fort Worth, TX

NEO-LIFE COMPANY OF AMERICA
San Lorenzo, CA

O
OLDE WORLDE PRODUCTS, INC.
North Canton, OH

ORIFLAME CORPORATION
Santa Monica, CA

P
PACESETTER BUILDING SYSTEMS, INC.
Omaha, NB

PASSEPORT, A DIVISION OF TELMONT CORPORATION
St. Paul, MN

THE PENNYRICH CORPORATION
Garland, TX

PRINCESS HOUSE, INC.
North Dighton, MA

Q
QUEEN'S-WAY TO FASHION, INC.
Skokie, IL

R
THE W.T. RAWLEIGH COMPANY
Freeport, IL

REALSILK, INC.
Indianapolis, IN

REGAL WARE, INC.
Kewaskum, WI

RENA-WARE DISTRIBUTORS, INC.
Bellevue, WA

RENN ENTERPRISES, LTD.
Rural Hall, NC

RICH PLAN CORPORATION
Ottumwa, IA

RUBBERMAID SALES CORP.
Chillicothe, OH

S
SALADMASTER
(SMC Industries, Inc.)
Dallas, TX

S (cont'd)
SARAH COVENTRY, INC.
Newark, NY

SERVICEMASTER INDUSTRIES, INC.
Downers Grove, IL

SHAKLEE CORPORATION
Emeryville, CA

SHOPSMITH, INC.
Tipp City, OH

SOCIETY CORPORATION
Muncie, IN

THE SOUTHWESTERN COMPANY
Nashville, TN

SOVEREIGN HOUSE LTD.
North Dighton, MA

STANLEY HOME PRODUCTS, INC.
Westfield, MA

STARK BRO'S NURSERIES & ORCHARDS COMPANY
Louisiana, MO

THE STUART McGUIRE COMPANY, INC.
Salem, VA

STUDIO GIRL COSMETICS, INC.
(Beeline Fashions, Inc.)
Bensenville, IL

SYMBRA'ETTE INC.
Scotts Valley, CA

T
TAMMEY JEWELS, INC.
Indianapolis, IN

TIME-LIFE LIBRARIES, INC.
Palatine, IL

TRI-CHEM, INC.
Harrison, NJ

U
U. S. SAFETY & ENGINEERING CORP.
Sacramento, CA

V
VITA CRAFT CORPORATION
(Rena-Ware Distributors, Inc.)
Overland Park, KS

W
WATKINS PRODUCTS, INC.
Winona, MN

W (cont'd)
WEAR-EVER ALUMINUM, INC.
Chillicothe, OH

WEL-TRON, INC.
Noblesville, IN

THE WEST BEND COMPANY
West Bend, WI

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Senator GRAVEL. The hearing is adjourned until tomorrow morning at 10 a.m.

[Whereupon, at 2:55 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, April 8, 1976.]

TAX REFORM ACT OF 1975

THURSDAY, APRIL 8, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met 10:40 a.m., pursuant to other business, in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Hartke, Byrd, Jr., of Virginia, Curtis, Fannin, Dole, and Packwood.

The CHAIRMAN. For this morning, we will call first Mr. C. L. Haslam, counsel of Duke University.

STATEMENT OF C. L. HASLAM, COUNSEL, ON BEHALF OF DUKE UNIVERSITY

Mr. HASLAM. I am C. L. Haslam, counsel of Duke University, appearing this morning to present the testimony of Terry Sanford, president of Duke University, who unfortunately has sustained a back injury and is unable to be here this morning.

Mr. Sanford is extremely interested in the impact of the proposed legislation. I have been asked to convey his appreciation to the committee for the opportunity to present his views to you.

All legislation should have a central purpose. Tax and regulatory legislation relating to foundations should be for the enhancement of the ability to make creative additions to American society. The broader public purpose of such legislative action should be the enhancement of our unique American diversity.

Foundations, like other institutions, including Government, need to have periods of self-examination to assess their place and function in society. The Tax Reform Act of 1969 provided the impetus for this experience for foundations and the results have been quite healthy.

Foundations were already beginning to take a closer look at themselves, but with the help of Congress they have accelerated the process and are now potentially stronger and more vital than they were before the act.

Foundations are in many ways peculiarly appropriate to the society we have developed. There is great reassurance in the pluralistic character of our Government, our business, and our institutions, providing alternative and competing forces for creative development.

To keep our system free and pluralistic we must constantly fight against centralizing, unifying, homogenizing forces, forces that would reach the cold grey hand of uniformity and compliance into every corner of our activities and lives. To allow for individual expression, development, and participation in creating new ways to deal with the future, we must make sure we leave as many productive avenues open as possible.

The existence of private foundations reflects and reinforces the duality of the private and public sectors. It was not contemplated by our Founding Fathers that government at any level should have the duty or responsibility to provide all new ideas, all innovations, all criticisms of society. Should we ever arrive at the point when all these facets are not widely diversified, we will have drifted dangerously far from the principles upon which our country has grown strong.

Ours is a wide, diverse land, with many currents running simultaneously in differing directions. To expect the Government to heed or be responsive to all of these at once is unrealistic. To expect the Government to be its own best critic is naive, and since I doubt that the Government would wish to leave the function of providing criticisms of its programs and policies entirely to the media, criticism is a valuable function of foundations.

Even if all the money spent by foundations were otherwise to be in the Government's treasury, which would not be the case at all, I would argue that American society needs the creative influence of having these funds spent by widely scattered individual decisions. We get more for our money that way. All together this is not much money compared to Government expenditures, but it accomplishes a world of good because it can be spent in small amounts for worthwhile ideas that need not involve nationwide or even statewide efforts.

In 1963 the North Carolina Governor's office established, with money from foundations, the North Carolina Fund, an idea that brought about permanent changes in efforts to help break the cycle of poverty and to bring poor people into broader individual opportunities. It is not that the money was not available in State government. It was that the flexibility was not there, the possibility of trying something new in a limited segment on an experimental basis.

To have attempted the goal with State funds would have meant immediately changing the structure of Federal-State programs, an impossibility. The availability of private funds made a useful experiment possible.

At the same time, because of foundations, the North Carolina public school system was enabled to experiment in special programs for the retarded, the gifted, the neglected, that have become models for other programs across the Nation. Had the experiments not worked, the foundations would have been free to support other approaches, and the State would not have been off on the wrong track with its taxpayers' money.

There are innumerable other examples in which Government and foundations can work together like this to stimulate and try out new ideas; this speaks eloquently of the need for strong, experienced, and ongoing foundations.

If Congress had to put up such experimental money it would bring a different dimension to such trial efforts. The ability to start programs quickly and to stop them when necessary without all the red tape necessarily attendant in Government projects is one of the most important aspects of foundation work. The very existence of foundations, moreover, creates a stimulus for ambitious and idealistic individuals to develop their ideas and bring them to fruition—a condition not likely to persist if the only avenue for hope in a new project were Government funding.

The arts and the humanities are healthier today than at any time in our history because of the vision of Congress in supporting the National Endowment for the Arts, but the arts, the mark of a civilized society, are here, alive, and a refreshing influence in American life, because of private foundation support over the years, as well as their continuing support today. More money flows today to these endeavors from private sources than from the Government, and that is as it should be.

In my own field of endeavor, higher education, never has the private sector in higher education been more in need of the helping hand and influence of foundations. We are all well aware of the financial problems in private higher education brought on primarily by inflation.

A large percentage of foundations' expenditures go to higher education, and while this is not much money in absolute terms, it can mean the difference between a college or university barely holding its own and being able to develop new and creative programs which have their effects throughout society.

At Duke, with foundation help, we have initiated development of the family doctor, the special care of children with heart defects, the search for the secrets of cancer, the improvement of relations with Canada, the problems of urban transportation, the recording of the oral history from the post-Civil War period, to name a few important projects.

We have just completed a new medical library with foundation help. and our divinity school has proper facilities because of foundation grants. These are some of hundreds of examples of foundation help to just one university.

There is no need for Congress to retard the development of private foundations. Rather there should indeed be deliberate acts to promote vital, dynamic foundations. One retarding influence has been the excise tax. This may seem to be a negligible sum, but it is extremely important to the private sector of American institutions. For example, the revenue raised since 1969 by the 4 percent foundation tax in excess of the actual costs of auditing and supervision is not very large measured by sums in the Federal budget, but it amounts to more than the total permanent endowment of Duke University.

The foundation dollar is vital to private higher education. To remove or hamper the ability of foundations and individuals to contribute to and work with institutions of higher education, a partnership in which historically so much has been accomplished, would have a damaging effect on the quality of both private and public education in this country.

The arguments involving the creativity and flexibility of foundations can only hold, of course, if one believes that foundations and their work are both responsible and worthwhile.

As for the existence of foundations in general, a basic tenet of our culture, deeply embedded in our Judeo-Christian tradition, is the worthiness of charitable giving. This point need not be belabored, but it must be mentioned, for in all but a handful of instances this impulse stands behind the existence of charitable foundations.

The Tax Reform Act of 1969 has done much to straighten out whatever improprieties might have existed, but it should be noted that already 4 years before the act, the Treasury Department concluded in its study of foundations that "most private foundations act responsibly and contribute significantly to the improvement of our society."

And so, as we continue to reexamine and appraise the nature and role of foundations in the United States, I hope you will give close consideration to the specific suggestions of my colleagues with regard to strengthening and making more equitable the provisions of the 1969 Tax Reform Act. If we move judiciously now that some of the effects of the act have been studied and felt, I think we can arrive at a position which will benefit the government, the foundations, and most of all, the people of the United States, whom the first two exist to serve.

Specifically in this year, we will, I hope, attempt that following actions:

One: Pass S. 2348 for a reduction of the 4-percent excise tax on foundations.

Two: Pass S. 2475 to fix the annual distribution of funds for foundations at a flat 5 percent of principal, or actual income if higher than 5 percent.

Three: Preserve or perhaps extend that tax deductions that encourage charitable giving.

Four: Continue the unlimited estate tax deduction for charitable deductions, without special limitations on bequests to private foundations.

Thank you, very much.

The CHAIRMAN. Let me ask you this. If I have some money which I could give to Duke University, would you prefer I give it to the Russell Long Foundation and set that up so my heirs might later give it to Duke, or would you prefer that I give it to Duke now?

Mr. HASLAM. We would like for you to give it to Duke University, but we would not foreclose your option of giving it to us through the Long Foundation, and the funds given to the Russell Long Foundation might also benefit other institutions.

The CHAIRMAN. If it was put in the Russell Long Foundation would you give me the privilege of keeping it there forever without ever paying anything to Duke at all?

Mr. HASLAM. You need not pay it to Duke——

The CHAIRMAN. I mean without paying it to any charity, just keep it in the foundation and think about it forever?

Mr. HASLAM. We recommend that you pass the bill to require a 5-percent distribution. We think that is reasonable, we don't think it should be more than that. We think that foundations should have the ability to invest their funds wisely and get a reasonable rate of return.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Isn't it true that sometimes a businessman wishes to do good with his property, so he gives that which he has which may be a business, and if that business is of greater value if it continues to operate than if its sold and liquidated, and therefore he follows the foundation route, so he might turn over the earnings of his gift to good causes? I understand from your testimony you would like to preserve that right.

Mr. HASLAM. We would like to preserve that as an option to a businessman or to any other person who has personal assets which he would like to dispose of in a manner beneficial to charities.

He ought to be able to place those in the private foundations if he chooses.

Senator CURTIS. You mentioned the foundation in your State. What was the date of that creation?

Mr. HASLAM. The North Carolina Fund was created in 1963 under the leadership of then Gov. Terry Sanford and it was created for the express purpose of providing private funding for the execution of certain programs within the State, primarily directed toward poverty.

Senator CURTIS. You have some private foundations in your State too, don't you?

Mr. HASLAM. Yes, sir.

Senator CURTIS. Have there been any private foundations created since 1969 to your knowledge anywhere?

Mr. HASLAM. I don't know, but I have no doubt that there have been many.

Senator CURTIS. I don't think there have been any. I think these bills S. 2475 and S. 2348 are just two of the things that are very much needed. I think we have restricted the foundation field so much that there have not been any new ones.

That is all, Mr. Chairman.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. The only question I have is a furtherance of what the Senator from Nebraska stated that the North Carolina Governor's office established this North Carolina Fund.

Now, as I see it, the benefit that you have talked about is the flexibility that is involved, is that right?

Mr. HASLAM. That is true.

Senator FANNIN. Because the amount as to the overall is minute, is it not?

Mr. HASLAM. I believe the primary point with respect to the North Carolina Fund is that experiments within North Carolina were made possible where even if public funds were available, they should not have been used.

Senator FANNIN. In some purposes it could not have been utilized for that purpose, is that correct?

Mr. HASLAM. That is correct.

The CHAIRMAN. Senator Hartke.

Senator HARTKE. I just want to express my personal best wishes to President Sanford and I hope he gets well soon.

Mr. HASLAM. Thank you, very much. I will certainly pass that along.

Senator DOLE. I won't ask any questions. My wife is on the board at Duke.

The CHAIRMAN. One of my daughters went to Duke, so I feel kindly toward you. But I still think that if I am going to give some money it would be better to just give it to Duke rather than to the Russell Long Foundation.

I heard a speech by the president of the University of Texas in which she made a statement about the cost of HEW activities, and I am not sure whether it was the cost of the Federal Government or the cost to the university. I assume she meant the cost to the universities, to comply with all of these things that these HEW people are coming in for, exceeds a billion dollars a year. As a matter of fact the way I understand it, in most cases when they finally get through with all of this, they finally conclude that the university is complying with the HEW regulations.

There is a story about the two biggest liars on the campus. The first is the HEW inspector who says, "Hi, I am from HEW. I am here to help you." The second biggest liar is the president who says, "Hello, I am glad to see you."

While you are before the Finance Committee, I think you would be well advised, if your problem is the same as the University of Texas or the University of Louisiana or others, to bring up some suggestions of how we can relieve you of some of that billion-dollar expense of complying with all of these HEW regulations that are driving the university presidents wild and costing a fortune.

Does that sound correct to you, that the cost of complying with all these HEW regulations would exceed what the universities are getting from private giving?

Mr. HASLAM. I have several comments with respect to that.

The first would be that the American Council on Education is presently conducting a study to determine the aggregate cost for all of higher education directly attributable to compliance with the various Federal programs and Federal regulations.

I should like to make clear that it is not simply the Department of Health, Education, and Welfare. It also includes the Department of Labor and other agencies. I believes that the estimate, the aggregate cost to higher education, public and private, may well exceed $1 billion.

It includes such programs as the Occupational Safety and Health Act. It includes, to be sure, affirmative action and some of the other programs in Health, Education, and Welfare. I do know that at Duke University alone our costs to comply with all of these regulations are estimated as greater than $1 million a year.

In terms of recommendations. I would say one thing which clearly ought to be given serious consideration is to rationalize the number of agencies which have direct responsibility for institutions of higher education. For example, in the area of employment discrimination, certainly one where educational institutions claim no right to be exempt from the law, there are many different, sometimes conflicting, jurisdictional agencies—Equal Employment Opportunity Commission; the Department of Health, Education, and Welfare; and pursuant to the Executive order, the Department of Labor.

The Internal Revenue Service, although its final regulations were not nearly as burdensome as the proposed regulations, is also entering into enforcement of nondiscrimination.

There also exists the right of private action under title VII. Some legislation has only recently been extended to higher education, and we received a fully mature regulatory network which had been developed primarily with respect to industry.

In brief, it is extremely expensive. Colleges and universities have no opportunity to pass these costs on to students except within very narrow limits. We can't keep increasing tuition. Inflation has cut deeply into institutional resources. Nondiscretionary costs continue to go up. Then we have tax bills under consideration by this committee, which, by their potential impact upon charitable giving, might close the pincers movement from the other side and curtail our opportunities to generate revenue.

The next result is one of extreme fiscal pressure. Business routinely passes on the costs of compliance with the Federal regulations.

The CHAIRMAN. Why don't you send us a memo making your suggestions on action we might take to solve some of these problems.

Senator Hartke?

Senator HARTKE. Are you familiar with the Filer Commission report?

Mr. HASLAM. Yes, sir.

Senator HARTKE. We are going to hear from the Foundations Subcommittee, and I would hope we would go into depth on that matter. I was disappointed with that report which we had waited for so long with the hope it would give us something along the line the chairman is referring to; that is, how to handle money if you are going to give it. It appears to me that what we had anticipated the Filer Commission was going to do, turned out to be of no help to us whatsoever, unfortunately.

Would you think that is an example of the type of nongovernmental function which we should rely upon?

Mr. HASLAM. First of all, I would like to say there are other witnesses this morning who are far more familiar with the Filer Commission report and recommendations than I am. I think the committee can rely on external programs of research, study, data generation, and conclusions.

Of course, the committee can determine for itself whether it is getting what it asked for, what is wishes to act upon. In terms of the full recommendations of the Filer Commission, I think by and large they were beneficial to charity. But as to whether or not it assisted the committee in its determination of proposed legislation, I just don't know.

Senator HARTKE. They didn't deal with the fundamental issue. The fundamental issue is, how do you spend the Government's money? Foundation money is the Government's money.

Mr. HASLAM. One might take issue with that.

Senator HARTKE. How can you take issue with it? The benefits of it are a tax benefit. I am not saying it is a good benefit or a bad benefit. It is an avoidance of taxation, which is perfectly legal, but it is a determination of how do you use the Nation's wealth.

That is a legal determination made by the Government, and they didn't even talk about that. After all, that is the issue even Senator Long is talking about. What he is talking about is if you have some money, how are you going to use it?

How are you going to use it, and if it merely is a method of avoiding taxation, then I would find it very hard to defend mere tax avoidance simply because of the method in which you give it.

We are dealing with this whole question at a later date. The question of charitable giving is a very difficult problem and represents some fundamental decisions that this committee is going to have to ultimately deal with much better than we have in the past. It has been a somewhat neglected area, but it is a big area.

Charitable donations and foundation giving is one of the biggest tax avoidances of the Internal Revenue Code. I am not passing judgment. I would just hope that someplace along the line people who are in universities which depend so heavily on that type of giving, give some thought, not only to the technicalities. Don't just make the assumption, at least as far as this Senator is concerned, that I agree that all foundations are either good or bad, or that foundation giving is good or bad.

I think that is an assumption that has been made far too long.

Mr. HASLAM. I would say, first, we do make an assumption that it is in the national interest to encourage the support of charities, whether that be education——

Senator HARTKE. You might be just as well off if you simply give the money from the Treasury.

The CHAIRMAN. Thank you very much.

Next we will call Mr. Durward B. Varner, president, University of Nebraska, accompanied by Professor Julian Levi, chairman, committee on taxation, American Council on Education.

I know Senator Curtis wants to welcome you here, but I suggest you commence with your statement.

STATEMENT OF DURWARD B. VARNER, PRESIDENT, UNIVERSITY OF NEBRASKA, ACCOMPANIED BY JULIAN LEVI, CHAIRMAN, COMMITTEE ON TAXATION, AMERICAN COUNCIL ON EDUCATION

Mr. VARNER. Mr. Chairman and members of the committee, I am Durward Varner, chancellor of the University of Nebraska. I am accompanied by Professor Julian Levi of the University of Chicago, chairman of the American Council on Education's Committee on Taxation.

We are very grateful for this opportunity to appear before you on behalf of America's colleges and universities and its privately supported elementary and secondary schools. We are authorized to speak for the associations, noted on the cover sheet of this testimony, whose memberships include virtually all of the accredited, public and private, nonprofit colleges and universities, as well as nonprofit elementary and secondary schools which enroll approximately 90 percent of the Nation's private school children. While we are speaking for colleges and universities, public and private, for private schools and for associations of such institutions, what we are really talking about are some 13 million students served by those institutions.

While our comments will primarily bear on individual gifts and grants, we would not like to minimize the invaluable role played by the private foundations as far as education is concerned.

The American Council on Education has just completed a third indepth analysis of voluntary support of American colleges and universities showing the patterns of giving to those institutions in the 1973–74 fiscal year. The study is attached. In summary, the report indicates that: 22 percent of voluntary support was received by public colleges and universities. Some 47.5 percent of all voluntary support in 1973–74 consisted of gifts from individuals, alumni and nonalumni. Aggregate support from this category of donor was approximately $796 million, of which $564 million came in transactions of more than $5,000.

Higher education is dependent upon the large gift. Of all gift transactions by individuals (alumni and nonalumni) to higher education in 1973–74, 99.56 percent were for less than $5,000 and in the aggregate produce 29.16 percent of all voluntary support. The remaining 0.44 percent of all transactions (those over $5,000) produce 70.84 percent of all voluntary support by individuals.

Approximately 52 percent of gifts over $5,000 from individuals were received in the form of securities, real estate, or other property.

In 1973–74 voluntary support by bequest reached $267 million. Bequests of $5,000 or more amounted to approximately 98 percent of all bequest receipts, while bequests of securities, real estate and other property represented 41 percent of all bequest receipts.

Thus, higher education in 1973–74, as in prior years, was dependent upon large gifts, approximately half of which come from individuals; and approximately 40 percent of these gifts from individuals, both over and under $5,000, were in the form of securities, real estate, or other property.

We estimate that at least 75 percent of gifts to the University of Nebraska have come in the form of securities, real estate and other properties with appreciated values. We are persuaded that most of this would not have been available to us if appreciated values had been subject to taxation.

Private sources of support are essential to the continued existence of private institutions of elementary, secondary, and higher education and crucial to the quality of education provided by many public institutions. For that reason we urge this committee, in considering modification of the tax laws at this critical time, to carefully weigh the potential effect of any modification on charitable and educational institutions, particularly those which like private schools, colleges, and universities perform functions that would otherwise have to be financed for the most part by direct public budget outlays. In fact, we would hope that the committee could find ways to encourage charitable contributions and bequests which are so essential to the continuation of the system of education.

We feel certain that each member of this committee is sensitive to the critical condition of schools, colleges and universities and supportive of the crucial role which they play in the life of this Nation. On the other hand, we are genuinely fearful that, in making changes, which for other reasons may seem justified. Congress may inadvertently significantly damage the incentives to giving which are so important to the continued private support of all charities.

I should like now to turn to Professor Levi, who will speak to some of the specific proposals before the committee which would have an impact on voluntary support for higher education.

Professor Levi. I hope you will excuse a personal comment. I will express my deep pleasure and appreciation for the privilege of appearing here. This is the fourth time I have been here. Also I would like to express my own admiration for two of the staff persons you have here, Mr. Michael Stern and Dr. Lawrence Woodworth.

As an instructor of young lawyers, many of whom enter Government service, it is a privilege to know people whose very performance represents the best that we can hope for at any time.

Now because I realize that the committee is busy, I would hope that we could offer as evidence rather than reading into the record, first, our entire statement. Second, the analysis of Patterns of Giving to Higher Education III, which has just been released this morning; third, a series of reports prepared in connection with the Filer Commission.[1]

These particular documents were prepared in collaboration with the U.S. Treasury. We would like to offer them, if it would please the chairman and the committee, because we believe that this discussion ought to proceed on fact and not on theory. Between the materials presented in the Patterns of Giving and the Filer Commission reports it becomes possible to estimate what effect on the charitable contribution would result from changes in the law.

There are examples here where, for instance, for $1 of additional revenue the loss to charities, specifically higher education and hospitals as an example, would run as high $1.80. Obviously change, in the light of this information, is not something that I think the committee would undertake lightly.

Our purpose is to bring these matters before you in order that the judgments which have to be made in the public arena and have to be made by those who are entitled to make it are made with the utmost information and support.

I would like at this point to make just two other points. First, we do not subscribe whatsoever to the theory of the tax expenditure at all. Basic to the theory of the tax expenditure is the notion that Government somehow owns the income of any taxpayer and that when Government elects not to collect it it therefore expends its funds.

Now this particular theory has been celebrated as a new and novel one. The fact is it is neither new nor novel. Those who have advocated the tax expenditure theory ought to read something about feudal history. The lord of the manor always owned the income of any person who was on the manor.

You can read, if you will an article which will be appearing shortly in Duke University's "The Law and Contemporary Problems". It is based in part on the work of Maitland, in which he explains what the serf on the manor was excused from doing, including, for example, some types of charitable deductions. He was excused on religious festivals from providing certain kinds of work to the manor. So the notion of the tax expenditure is simply from our point of view a fallacy that does not exist.

Finally—and I can say that the comments of the chairman regarding the function of the budget were indeed important. The private gift is uniquely important. I am not aware of any private donor who will say to the college or the hospital or anyone else: "We have authorized a specific gift" and then calls up a little later and says, "I am sorry, we have appropriated a lesser amount" and then finally calls up subsequently and says, "I am sorry, part of it is impounded."

[1] These reports were made a part of the official files of the committee.

Ninety-five percent of the private pledges made to higher education, even though they are not legally enforcible, are collected.

Now, there is one other thing. It is completely appropriate that in the determination of the expenditure of public funds that the administrator of public funds has to look to a considerable extent to conventional wisdom, that he not provide appropriations for something which appears foolish and outlandish. But very often knowledge proceeds on exactly the investigation of what is thought very completely in error.

That occurs most often in the support of the private donor who does not have to respond to the kinds of issues that one has to respond to in the distribution of public funds.

I think the chairman really put his finger on it. What we are dealing with here in a very real sense in the private gift is the issue of freedom, the issue of variety, the issue of compassion.

Over the years this committee has been of enormous assistance to higher education. We hope the materials we asked to file with you will prove to be helpful to you in your deliberations.

The CHAIRMAN. Thank you very much.

Senator Packwood, you were the second man in the room. I will yield my turn to you.

Senator PACKWOOD. I am curious about the other name on here, Sheldon Elliot Steinbach—is that any relation to the former professor?

Professor LEVI. No, it is not.

Senator PACKWOOD. It is excellent testimony and I am very impressed with your history on tax expenditures. I don't think I have heard it phrased better than your phrase that there are those opposed to the theory that it basically belongs to the citizens and the Government will take it from us.

Professor LEVI. That, of course, is the precise issue. You may be somewhat amused at Maitland's description of the tax expenditure and subsidy which occurred in the last 6 years of Edward II's reign in England, running, as he put it, in the year from Michaelmas to Michaelmas. The reaper and the smith who rendered public services were excused from 58 works. There was a cottery owned by someone—he got seven and a half works off.

There was the first charitable tax expenditure, if that is what you want to call it, for religious purposes, excused on account of festivals, 58 works.

Finally—and this literally is there—carrying dung, 58 works.

Senator PACKWOOD. Is that in your statement we have here today?

Professor LEVI. No, I will be pleased to file it. This will be published in "Law and Contemporary Problems".

[Excepts from the item referred to follow:]

* * * * * * *

To correct these alleged inequities, those critical of the existing tax laws propose a variety of statutory changes which include elimination of the charitable deduction altogether (sometimes coupled with a proposal to substitute a matching grant system), identical treatment of all charitable deductions by means of a fixed credit against tax rather than by deduction from gross income (under this arrangement the taxpayer, regardless of income, would obtain a nonrefundable credit against tax), establishment of a floor under deductions akin to that provided with respect to medical expenses, and allowance of the charitable deduction only to the extent of the ratio between the taxpayer's "taxed" and "untaxed" income. Reform directed at gifts of appreciated property proposes either to treat the donation as a realization of the appreciation to be included in gross income, or to restrict the amount of the deduction to the basis of the donated property.

The view that a deduction for a charitable contribution represents a form of government spending called a "tax expenditure" has gained substantial acceptance in recent years as a result of the advocacy of Stanley Surrey and, as indicated, is now a term included in the official United States budget. With increasing pressures to reduce federal "spending," its acceptance probably presents the clearest danger that the deduction for charitable contributions may be further weakened by future legislation.

This analysis, however, has substantial shortcomings and rests on a form of logic that implies a financial obligation of citizens to the United States which is totally at odds with our fundamental concepts of freedom.

Irving Kristol with customary incisiveness has noted the peculiarity of the logic leading to the concept of a "tax expenditure."

Many economists and tax experts—Stanley Surrey, most notably— nevertheless do favor subsidies rather than tax incentives, and argue persuasively for them. But in the course of making these arguments, a very interesting rhetorical transformation takes place. They begin to think and talk as if the basic decision to subsidize had already been made—only, the subsidies are now incarnated in the tax system rather than in positive legislation. So they come quickly to refer to all exemptions and allowances in our tax laws as "tax subsidies" or even "tax expenditures." But note what happens when you make this assumption and start using such terms. You are implicitly asserting that all income covered by the general provisions of the tax laws belongs of right to the government, and that what the government decides, by exemption or qualification, not to collect in taxes constitutes a subsidy. Wheres a subsidy used to mean a governmental expenditure for a certain purpose, it now acquires quite another meaning—i.e., a generous decision by government not to take your money.

When a man makes a tax-deductible gift to charity, whose money has he given away? Traditionally, it has been thought that he gives away his own money, and that the tax deduction exists only to encourage him to give away his own money for such a purpose. Today, however, one hears it commonly said that he has only in part given away his own money—in actuality, he has also given away some "public" money. This "public" money consists of that sum which, were no such deductions permitted by law, he would have to pay in taxes. It is then said—indeed, it is now a cliche—that the object of his philanthropy (a museum, say) is "in effect" being subsidized by public monies.

What we are talking about here is no slight terminological quibble. At issue is a basic principle of social and political philosophy—the principle that used to be called "private property." The conversion of tax incentives into "tax subsidies" or "tax expenditures" means that "in effect" a substantial part of everyone's income really belongs to the government—only the government, when it generously or foolishly refrains from taxing it away, tolerates our possession and use of it. To put it another way, when you start talking glibly of some $70 billion of legal deductions and allowances as "tax subsidies," you have already in imagination socialized that amount of personal and corporate income.

The implicit assumption in the concept of "tax expenditures," that citizens owe their incomes to the United States, is reminiscent of the assumptions upon which feudal societies were organized. Consider, for example, how Harry A. Bigelow described the system of land holding in England during the time of Henry II:

"It may, roughly, be compared to a pyramid: At the summit of the pyramid was the king, who was, in legal theory, the owner of all land in England. Immediately under him were the great lords of the kingdom, holding the large tracts of land in the manner already mentioned. These tenants immediately under the king later received the name of "tenants in capite." Under the tenants in capite were various grades of intermediate or mesne tenants, and at the bottom of the pyramid may be said to be the tenants who were in actual occupation of the land, either personally or by their servants. . . . Thus it may be said that, except for the highest and lowest grades, each person occupied a double relation. With respect to the person under whom he was holding he was a tenant, owing fealty and faith and feudal services, and entitled to receive protection from his lord."

Assuming such a society, a "tax expenditure" budget is inescapable. F. W. Maitland's classic. The History of a Cambridgeshire Manor, demonstrates the point. Maitland had before him "a splendid line of court and account rolls which, though there were some gaps in it, stretched from Edward I to Henry VII." Thus he was able, as he put it, "to lay before the readers * * * a fairly continuous history of a particular English manor during the later Middle Ages * * *." The Manor of Wilberton formed part of the ancient estates of the Church of Ely. The court rolls maintained by the Bishop, the bailiff and reeve, account for the relations and services described by Bigelow. First, small money rents were collected. Second, collections accrue from particular transactions (comparable to an excise tax) including excuse from attendance at court, where the freeholder would "owe a heriot (best beast, or 32d.), a fine for marrying their daughters (32d.), leyrwite and tallage; the gersuma, or fine for marrying a daughter, is mentioned in the earlier extent." Third, tenants were required to provide labor described as "works." The assigned value of such works depended not only on the character of the work performed, but the season of the year.

Some works were excused because of public services performed by the reeve, the reaper, or the smith. Some works would be excused on account of festivals (perhaps an early form of the charitable deduction calculated on a tax expenditure basis). At any rate, the reeve in one of his accounts calculating upon a year running from Michaelmas to Michaelmas in the last six years of Edward II's reign produced the following tax expenditure budget, excusing performance of works in some cases (a tax subsidy), and assigning value (a tax expenditure) in others:

	Works
Excused to reeve, reaper, smith	58
Excused in respect of a cottary let at a rent	7½
Excused on account of festivals	58
Sold	246½
Reaping, binding, and stacking 128 acres at 2 works per acre	256
Carrying	96
Garnering[1]	22
Stacking pease	10
Carrying dung	58
	812

[1] In bladis mayand" in grangia. The word mayare is new to me. (See Baxter, Medieval Latin Word List, s.v. mela.)

Senator PACKWOOD. You make an excellent case. I have no other questions, Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Mr. Chairman. I was called to the phone when these witnesses were asked to take their places. At this point I want to welcome Dr. Varner to this committee. Both of you gentlemen have made an outstanding contribution. We are particularly grateful for the historical analysis of tax expenditures.

If I had hair, the term "tax expenditure" would make it stand on end. That is not an appropriate expression for me.

Seriously, I would like to ask each of you, are you in favor of legislation which would reduce the tax on foundations from 4 percent to 2 percent?

Professor LEVI. I would say that I am, for this reason, Mr. Chairman. That tax, as I understand it, was imposed for the effect of being an excise tax in order to defray the costs of audit and supervision. I will say that I am emphatically in favor of proper supervision of foundations, but it now appears that a tax at the rate that it is imposed is in excess of what is required to accomplish the results, and if that is the case, the tax ought to be reduced.

Senator CURTIS. I might say the proceeds of this tax have been used to supervise and enforce not only foundations, but all tax-exempt institutions, and the total bill can be paid from a 2-percent tax. I concur that should be borne by the tax-exempt institutions.

Professor LEVI. May I make one added comment, and this is, for instance, one of the places that I part company with some of the recommendations of the Filer study. Colleges and universities over the country at this moment are in receipt of full examinations by the Bureau of Internal Revenue.

From my point of view this is fine. There is no reason why colleges and universities should be exempt from such examinations. These examinations are costly. The costs to the University of Chicago of such an examination will be, I assume, in excess of $50,000 spent in legal and accounting fees.

Now if the normal discipline is applied, the Bureau is not going to come back for a long time because they will not find anything which will justify the expenditure of their time and their effort. If, on the other hand, there are funds set aside for continued examination of this sort where you do not have the discipline which applies on the examination of the ordinary taxpayer, and that you don't examine unless there is a reason to assume something, this will amount to a levy on scarce assets year after year for, I think, no purpose whatsoever.

Senator CURTIS. Thank you.

Mr. VARNER. May I just add, university presidents learn very early to rely on the expert commentary of their professors. In this case I am pleased to be identified with Professor Levi's comments.

I don't know the circumstances that prevailed in 1968 and 1969 because I was not directly involved in the consideration which led to some of the tax reform as it pertained particularly to foundations. I suspect that it might have been an environment or an era or a mood that prevailed in 1968 or 1969.

Whatever it was, it is my judgment working with and watching the functioning of private foundations that it might have been a case of overkill. These foundations clearly are making a serious effort to comply with the intent of the Congress and to respond in terms of good citizenship.

In my experience it seems to me there may have been some punitive measures which are not serving the public good. I would hope that would be reduced to 2 percent.

Senator CURTIS. Now if we tax foundations beyond what the necessary cost is of auditing, we are, in effect, taxing the beneficiaries of that foundation, are we not?

Professor LEVI. Yes, sir.

Senator CURTIS. Now I want to inquire about another bill, S. 2475, that would reduce the mandatory payout of foundations from 6 percent to 5 percent. Would you care to express an opinion on that, either one of you or both?

Professor LEVI. The purpose of the payout requirement, which again I am thoroughly in sympathy with, was in order to be sure that foundations were not used as the example which Senator Long described for the Long Foundation, which I hope will be long, long delayed because I would assume it is a testamentary foundation, and that is one foundation we don't ever want to see, Senator. You would not want capital to simply accumulate and no consideration given to the essential purpose of the foundation.

Now, when it becomes unreasonable in light of the behavior of money markets and income to assume that 6 percent can be paid out without disturbing capital, then I can understand the purpose in reducing the mandatory payout from 6 to 5 percent.

Senator CURTIS. Yes. I think this committee should also take into account that we are dealing with many different types of foundations; some of them have been established many years. They have a diversified portfolio. They can meet various requirements that are laid down.

There may be another foundation that has just existed a few years. It starts out rather small or even on paper it may be of considerable size, but the donor gives that which he has, which often is a portion of his business, and to make a mandatory payout on rather small newly formed foundations can be not only an unjust burden, but it can be a discouraging one for the donor to give in that manner. Is that correct?

Professor LEVI. There is no question about it.

Senator CURTIS. I will ask unanimous consent, they are both short, that S. 2475 and S. 2348 be printed in the record at this point. The latter one was introduced by Senator Hartke for himself, Senator Bentsen, Senator Curtis, Senator Fannin, Senator Hansen, Senator Mondale, Senator Roth, and Senator Thurmond; and S. 2475 was introduced by myself. They relate to the two matters which the witnesses have just testified to.

The CHAIRMAN. Without objection.

[S. 2475 and S. 2348 follow:]

[S. 2475, 94th Cong., 1st sess.]

A BILL To amend the Internal Revenue Code of 1954 to modify the charitable distribution requirements imposed upon foundations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 4942(e) of the Internal Revenue Code of 1954 (relating to the minimum investment return for purposes of the tax of failure to distribute income) is amended—

(1) by striking out subparagraph (B) of paragraph (1) and inserting in lieu thereof the following:

"(B) 5 percent.",

(2) by striking out paragraph (3), and

(3) by redesignating paragraph (4) as paragraph (3).

SEC. 2. The amendments made by the first section of this Act apply to taxable years beginning after December 31, 1975.

[S. 2348, 94th Cong., 1st sess.]

A BILL To amend section 4940 of the Internal Revenue Code of 1954 to change the excise tax on the investment income of private foundations from 4 percent to 2 percent

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 4940(a) of the Internal Revenue Code of 1954 (relating to excise tax based on the investment income of private foundations) is amended by striking out "a tax equal to 4 percent" and inserting in lieu thereof "a tax equal to 2 percent".

SEC. 2. The amendment made by this Act shall apply to taxable years beginning after December 31, 1975.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. I will congratulate you on your excellent statements. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Dole?

Senator DOLE. No questions.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. Let me ask you, is it your contention that if the tax were reduced from 4 percent to 2 percent, the additional money would be available so more could be given to charity?

Professor LEVI. Yes. It would be included and subject to the payout requirements.

Senator HARTKE. Is it also your contention that the payout requirements should be lessened?

Professor LEVI. The payout requirements in my judgment ought to be increased or lessened, depending upon how the money markets and the net income of foundations operate as a matter of practical performance. I am not sure at all, very frankly, whether the issue of accumulation is best handled with a percentage per se. I would, as a matter of fact, like to see the percentage reduced and then see at the same time included something which is similar to what is found in other provisions of the law as to unreasonable accumulations perhaps.

That is something that might have some consideration to it. I do not think that it is a good thing to have a foundation put in a position where it has to liquidate at any period of time. Personally, I subscribe to the philosophy that Mr. Julius Rosenwald and others had, that a particular foundation should have a mandatory liquidation after a certain period. I think that again is something that out to be left to the creative feeling of the donor.

The CHAIRMAN. Senator Byrd?

Senator BYRD. I may have several questions I would like to ask for the record, but I have none at the moment, Mr. Chairman.

The CHAIRMAN. I enjoyed your statement about tax expenditures. I will read the information you provided to us with great interest.

There was a member of this committee who insisted on advocating the theory that everybody owed a certain amount of taxes, whether the law said so or not, and anything that was less than that was a tax loophole or a tax expenditure.

I subscribe to your view of it, which basically is the view that the people of this Nation own the Government rather than the Government owning the people. Of course, it works the other way around in these Communist countries, just as it worked the other way around at one time in the history of the countries you made reference to.

You gentlemen, unfortunately, didn't come here prepared to testify on the bill that Senator Bentsen and I have introduced that would make the Government pay all the cost of paperwork entailed by the Government requiring you to provide information. The overall cost of the Government is estimated to be $50 billion, but it is believed that would actually save the Government money because that would force all of these Government departments to reduce the unnecessary paperwork and cut it into about one-quarter. If that were done, we would pick up revenue because most of the people who have to fill all this stuff out are business people who are entitled to deduct it as a business expense.

So by imposing a much lesser burden on the public, we would save a tremendous amount of money. We could even provide a university with a tax credit against the social security tax they pay for their employees, if we wanted to do so, to help cover the cost of all this burden of paperwork required by Government agencies, HEW being the prime example.

I hope your people look into that and give us some recommendations as soon as they can. We might do a lot more good toward finding you some money here than elsewhere at the moment.

Now tell me how much of the private giving that the universities receive is actually from the private foundations rather than the public ones.

Professor LEVI. I have the most recent report of the Council for Financial Aid—these figures as a matter of fact would indicate that foundations in 1973 and 1974 accounted for 23.9 percent of the total support which was received by all institutions reporting, amounting to $416 million. In 1974 and 1975 the figure had declined to $384 million, a 7 percent decline, and 23 percent of the total. Roughly speaking 50 percent (it will vary between 46 and 50 percent) comes from individuals, that is, individuals as distinguished from foundations, 16 percent from corporations, 5.2 from individuals, 7.6 to 8.9 from others, and 23 percent from foundations. This is what the anatomy of private universe looks like. None of this is public.

The CHAIRMAN. How much of it was actually from private foundations?

Professor LEVI. 23 percent.

The CHAIRMAN. I would submit to you that the pickup you would make if we could make some headway of making the Government pay some of the costs of complying with these HEW regulations and the various other Government activities that have been imposed in recent years, would vastly exceed whatever difference we might legislate in this particular area.

I hope that your people would get busy and see if you could not generate some support for the kind of thing Senator Bentsen and I are trying to do.

Professor LEVI. I wonder if you would permit a comment I would make, and again this is an expression of complete gratitude. One of the things that college and university presidents do when they meet one another, when they don't have medical schools and teaching hospitals, they congratulate one another that they don't have the same and when they do have the same, to commiserate.

If it had not been for your interest, Mr. Chairman, and the action of Mr. Stern, and your splendid people, at the last session of Congress, the teaching hospitals in the city of Chicago and in Illinois would be facing bankruptcy. It was due to your interest that we will be able (hopefully) to get the State of Illinois to properly disperse Federal funds which had been given to them for medicaid and welfare upon which they are sitting while at the same time the medical schools and the hospitals in Chicago are being obliged to absorb costs to the tune of $25 million a year.

So I can't tell you, Mr. Chairman, how grateful we are.

The CHAIRMAN. You know we still have a problem here. Thank you very much.

Senator CURTIS. I am surrounded, Dr. Varner, on this committee by boosters from Louisiana State and Arizona State. Do you have anything you want to say about the coming football season?

Mr. VARNER. We will open it in Baton Rouge, Senator Long. We hope very much Senator Long will be there and we would like to have a rematch with Arizona State.

I appreciate Senator Long's dilemma as to whether he establishes that Russell Long Foundation to give that money to Duke, and there is another alternative and that is to give it to the University of Nebraska.

The CHAIRMAN. I am willing to give something. I am just trying to find out the best way to do it.

[The prepared statement of the American Council on Education, and attachments referred to, and a statement of Dr. Edward J. Boling, president of the University of Tennessee, follows. Oral testimony continues on p. 2179.]

STATEMENT OF THE AMERICAN COUNCIL ON EDUCATION

The following associations join in this statement: American Association of Community and Junior Colleges; American Association of State Colleges and Universities; Association of American Universities; Association of Governing Boards; Association of Jesuit Colleges and Universities: Council for American Private Education; Council for the Advancement and Support of Education; National Association of State Universities and Land-Grant Colleges; National Catholic Educational Association, College and University Department; and National Council of Independent Colleges and Universities.

Mr. Chairman and members of the committee: I am Durward Varner, Chancellor of the University of Nebraska. I am accompanied by Professor Julian Levi of the University of Chicago, Chairman of the American Council on Education's Committee on Taxation.

We are very grateful for this opportunity to appear before you on behalf of America's colleges and universities and its privately supported elementary and secondary schools. We are authorized to speak for the associations, noted on the cover sheet of this testimony, whose memberships include virtually all of the accredited, public and private, nonprofit colleges and universities, as well as nonprofit elementary and secondary schools which enroll approximately ninety percent of the nation's private school children. While we are speaking for colleges and universities, public and private, for private schools and for associations of such institutions, what we are really talking about are some thirteen million students served by those institutions.

Over the course of the past several years, schools, colleges and universities have faced a critical financial plight that has resulted in a substantial curtailment of programs and limitation of activities. State institutions face increasing competition for funds. Private institutions, large and small, incur substantial operating deficits. One single factor—the increase in energy costs—shattered the expectations of many to balance their budgets. The anticipated increase in philanthropic support has not been realized. In fact, in the year 1973–74, for the first time in many years, there was no overall increase in contributions and bequests to institutions of higher education. In the same period, the expenses of providing education have substantially increased. Moreover, schools, colleges and universities, public and private, fortunate enough to realize income from endowment sources, have seen that income sharply reduced in many instances. As an inevitable result, the crucial share of support which educational institutions receive from private gifts and bequests (and the income from those contributions which are funneled into endowment) has been reduced.

Other than the fact that overall contributions to educational institutions did not increase in the 1973–74 year, there are few material changes in the patterns of giving to schools, colleges and universities.

The American Council on Education has just completed a third indepth analysis of voluntary support of American colleges and universities showing the patterns of giving to those institutions in the 1973–74 fiscal year. The study is attached. In summary, the report indicates that

a. Total documented voluntary support was found by the Council for Financial Aid to Education to be $1.746 billion, with an estimate of a probable $2.240 billion.

b. Twenty-two percent of voluntary support was received by public colleges and universities.

c. The 988 colleges and universities participating in the 1973–74 Survey reported $1.746 billion voluntary support. Of these institutions 961 reported $15.626 billion in expenditures for general education and student aid, and 863 of these institutions reported endowments with a market value of $10.827 billion. In 1973–74 estimated endowment yield was 4.93 percent. Thus, voluntary support reported by the institutions participating in the 1973–74 Survey was 11 percent of educational expenditures reported. Such voluntary support, if derived from endowment income, would have required an additional endowment of more than $35 billion in contrast to reported endowment of $19.827 billion.

d. Some 47.5 percent of all voluntary support in 1973–74 consisted of gifts from individuals—alumni and nonalumni. Aggregate support from this category of donor was approximately $796 million, of which $564 million came in transactions of more than $5,000.

e. Higher education is dependent upon the large gift. Of all gift transactions by individuals (alumni and nonalumni) to higher education in 1973–74, 99.56 percent were for less than $5,000 and in the aggregate produce 29.16 percent of all voluntary support. The remaining 0.44 percent of all transactions (those over $5,000) produce 70.84 percent of all voluntary support by individuals.

f. Approximately 52 percent of gifts over $5,000 from individuals were received in the form of securities, real estate, or other property.

g. In 1973–74 voluntary support by bequest reached $267 million. Bequests of $5,000 or more amounted to approximately 98 percent of all bequest receipts, while bequests of securities, real estate, and other property represented 41 percent of all bequest receipts.

h. The total amount of annuities, life contracts, insurance policies, and other forms of deferred giving amounted to $56.9 million in 1973–74, a decrease of 29 percent from the amount reported in 1972–73. Deferred giving transactions of more than $5,000 represented 98.5 percent of all deferred giving receipts.

Thus, higher education in 1973–74, as in prior years, was dependent upon large gifts, approximately half of which come from individuals; and approximately 40 percent of these gifts from individuals, both over and under $5,000, were in the form of securities, real estate, or other property.

Private sources of support are essential to the continued existence of private institutions of elementary, secondary and higher education and crucial to the quality of education provided by many public institutions. For that reason, we urge this Committee, in considering modification of the tax laws at this critical time, to carefully weigh the potential effect of any modification on charitable and educational institutions, particularly those which like private schools, colleges and universities perform functions that would otherwise have to be financed for the most part by direct public budget outlays.

In fact, we would hope that the Committee could find ways to encourage charitable contributions and bequests which are so essential to the continuation of the system of education. We feel certain that each member of this Committee is sensitive to the critical condition of schools, colleges and universities and supportive of the crucial role which they play in the life of this nation. On the other hand, we are genuinely fearful that, in making changes, which for other reasons may seem justified, Congress may, inadvertently, significantly damage the incentives to giving which are so important to the continued private support of all charities.

As a result of reforms enacted in 1969, a donor cannot incur financial benefit for himself or his family by means of a gift or bequest. The personal satisfaction that may accrue to a donor as a result of his directing a contribution to a recognized charity is small in comparison to the benefits which the charity and, directly and indirectly, the public received. With this in mind, we trust the Committee will give serious consideration to the potential detriment to private support that could result from particular changes, especially where the increases in tax revenues to the Federal government are minimal in comparison with the losses to educational institutions.

In this connection, we would like to call the Committee's attention to the Commission on Private Philanthropy and Public Needs' study of all aspects of philanthropy and philanthropic organizations in the United States. One of the Commission's most important acts was to sponsor the first comprehensive examination, based on econometric analyses, of the role which the Federal tax laws play in encouraging contributions and bequests. Studies conducted by Professor Martin Feldstein at Harvard and others confirm for the first time the significant role that the charitable contribution deduction plays in encouraging donations and, in the process, refute prior suggestions to the contrary. Studies conducted by Professor Michael J. Boskin of Stanford and the National Bureau of Economic Research, Professor Feldstein and others for the first time establish the even greater incentives to giving provided by the Federal estate tax deduction.

References are made to studies which will be included in a conpendium to be published in the near future. Martin Feldstein and Charles Clotfelter, "Tax

Incentives and Charitable Contributions in the United States: A Microeconometric Analysis"; Michael J. Boskin, "Estate Taxation and Charitable Bequests"; Martin Feldstein, "Charitable Bequests, Estate Taxation and Intergenerational Wealth Transfers."

These studies show that the income and estate tax deductions for charitable gifts are indeed "efficient" in that for every dollar of tax revenue foregone by the Treasury, substantially more than a dollar is gained by the beneficiary charitable institutions. In the case of gifts of property and bequests, the benefits to charity resulting from the deduction are even more important.

Foundations are funding sources of great significance to colleges and universities, providing 23 percent to 26 percent of their gift income in recent years. For 1973–74 foundation contributions to higher education amounted to some $535 million. But it is not only the volume of dollars that is important. Functioning as independent funding sources, foundations materially add to the flexibility and capacity of colleges and universities in meeting such needs as broadened educational opportunities among women and minority groups, the development of new curricula and lines of inquiry, and qualitative improvement within both public and private higher education.

We would now like to make specific comments on those subjects that have a major impact on educational institutions.

MINIMUM TAXABLE INCOME

Another proposal before this committee that could have an adverse effect on support of public charities is the proposal to impose a minimum tax on all individuals regardless of the validity of claimed deductions and exclusions if these result in an individual of substantial wealth paying little or no income taxes for a particular year. We understand the reasons for such a proposal. However, we believe that any examination of this problem requires a careful consideration of the nature of each deduction or exclusion. In particular, we urge that any proposal that the Committee adopts not impinge upon the charitable contribution deduction. A charitable gift is, unlike other deductions, the result of a voluntary decision, which may be made or not made at will. Imposing an additional or alternate tax on charitable gifts would, in our opinion, work a substantial reduction of contributions at little, if any, gain in revenue.

We support Title III of H.R. 10612, the Ways and Means Committee's minimum tax provision, which adds itemized deductions in excess of 70 percent of adjusted gross income as an item subject to the existing minimum tax. This does not impair the full deductibility for gifts to charity although there does seem to be an unintended effect in the case of estates and trusts. Because these entities are treated as conduits, they are provided deductions for distributions under Sections 651 and 661 and, in some circumstances, charitable contributions paid or set aside under Section 642(c). Thus an estate and trust is likely to have income subject to the minimum tax even though its only deductions are for amounts distributed to beneficiaries or charitable contributions. We urge that trusts and estates be excluded from the application of the "excess itemized deduction" concept. If complete exclusion is not possible, proposed Section 57(d) should be revised to permit a trust or an estate to exclude the deductions provided by Sections 642(c), 651 and 661.

The House rejected a proposal for an alternate minimum tax provision (MTI) which we estimated would cost total charitable giving at the outset $155 million yearly with $28.5 of this total lost to education. This loss would result from the decrease in tax incentive for charitable giving caused by the imposition of any MTI. Our estimate is vertified by projections done as an outgrowth of the National Commission on Private Philanthropy and Public Needs studies.

We would note that the Treasury's revised MTI proposal outlined in testimony Secretary of the Treasury William E. Simon before this Committee on March 17, 1976, has been carefully structured so as to "avoid completely all impact on charitable contributions."

We respectfully urge that, in considering the proposals with respect to modification of the present preference income tax or substituting alternate tax on economic income, the Committee pursue the course of action followed by the House and recommended by Secretary Simon, and treat the charitable contribution separately so that no direct or indirect tax is imposed which has a material impact on such contributions.

TAXATION OF GIFTS OF APPRECIATED PROPERTY

The proposal which could have the most far-reaching effect on the private support of education is that of changing the present rules with respect to gifts of appreciated property. The rules were modified in 1969 with respect to gifts of appreciated property to private foundations. Donors to private foundations of long-term appreciated property must reduce the fair market value by one-half of the unrealized appreciation. There are those who believe that it has virtually eliminated the support of private foundations through current gifts. We believe that the extension to public charities of a provision which would tax gifts of long-term appreciated property could result in eliminating the property gift which accounts for almost half of all individual donations and for more than one-quarter of the overall private support of higher education. The proposal that unrealized appreciation (and it is unrealized since the property, including the appreciation, passes to charity) be taxed at the time of gift to a public charity might well eliminate this form of giving, since it imposes a penalty on the donor who makes a contribution. This is a penalty that the donor can avoid by reducing the amount of his charitable contribution so that the real burden of the increased tax will be borne by the charitable institutions that are the dones.

We believe that the imposition of a tax at the time of gift would cause the donor to reduce or eliminate gifts of appreciated property. The Feldstein-Clotfelter studies indicate that for every dollar of revenue gained by taxation of the unrealized appreciation in property given to public charities, there will be a reduction in contributions to such public charities of nearly $1.60 and suggest that the burden of that reduction will be borne disproportionately by colleges and similar charities which perform a clearly public function which would otherwise have to be supported by Federal or state funds. The Filer Commission, after a careful examination into and spirited debate with respect to this issue, recommended that the "appreciated property allowance within the charitable deduction be basically retained but amended to eliminate any possibility of personal financial gain through tax-deductible charitable giving." (Giving in America—Toward a Stronger Voluntary Sector, Report of the Commission on Private Philanthropy and Public Needs, page 147. see discussion pages 143–147).

In this regard, it is important to note that the charitable contribution, unlike any other deduction, is a voluntary act. The donor's choice is to give or not to give, and many factors play a role in the decision. The present tax laws are relatively benign towards the donor who wishes to give appreciated property for charitable purposes, and it encourages such gifts or bequests by allowing tax deductions. A change that would place on the donor a burden, which in some cases he might be in no position to assume, would, in our opinion, cause him to choose not to give. In such a case, we do not see how there could be resulting benefit or revenue to the Government. In short, we believe that the effect of the proposed changes with respect to gitfs and bequests of property will not benefit the Treasury, but it will cause a substantial diminution of the support of public charities and in particular schools, colleges and in universities at a time of dire financial stress.

TAXATION OF APPRECIATED PROPERTY AT DEATH

There are a number of proposals with respect to the treatment of unrealized appreciation at death. The suggestion that basis be carried through at death would not affect public charities. Other proposals, however, could substantially inhibit gifts of property. The imposition of a tax on unrealized appreciation at death without an exception for property passing to charitable purposes would clearly impose a burden which the taxpayer would have to take into account in planning for charitable bequests. The extent of that burden may be suggested by the fact that over 40 percent of the value of estates bequeathed to colleges and universities is in the form of property. Since few people can anticipate the time of death, the problems associated with making judgments with respect to charitable gifts and bequests, if such a proposal were adopted, could be overwhelming. We believe that the effect wou'd be distressing even if a simplified version of this tax were adopted, such as an additional estate tax. (See Feldstein, "Charitable Bequests, Estate Taxation and Intergenerational Wealth Transfers" for an indication of the magnitude of the penalty which may be imposed.) We strongly urge that, if a tax on unrealized appreciation at death is imposed, there be an exception (as supported by President Kennedy in his initial tax message to Congress) for property passing to charity. In this connection, we would note that the American Bankers Association recommendation with respect to the adoption of an additional estate tax (AET) recognizes the propriety of including an exception for charitable bequests.

LIMITATION ON CHARITABLE DEDUCTIONS FOR ESTATE TAX PURPOSES

We find it difficult to understand the rationale of the proposal that there be a limitation on the estate tax deduction. In the case of a bequest, no individual benefits by reason of that deduction. All of the assets flow to a public or quasi-public entity. As indicated above, the Congress in 1969 ensured that those entities would either be public in nature, like schools, colleges and universities, or would operate strictly for the public benefit. Thus, it is incorrect to speak of the estate bearing its share of the tax burden. The burden will be borne by the charitable beneficiary or legatee. As indicated above, the Council for Financial Aid to Education survey indicates that private support of public and private charities for the sample of reporting institutions reached the total of over $1.7 billion the 1973–74 fiscal year. Over 15 percent, or $267 million, was in the form of bequests. If nearly 40 percent of the dollar value of these bequests were part of or constituted the residue, as the 1973–74 survey indicates, then the effect of a limitation on this form of support could be serious indeed.

Special examinations suggest that many of the residue bequests consist of virtually the whole estate. Clearly, the large bequest provides virtually all of this form of support. If even 50 percent of the bequests represent substantially more than half the testator's estate, then the taxes which would have to be borne by the recipient educational institutions would certainly be many millions of dollars. Equally important, we feel that testators, when faced by the imposition of a tax on half of their estate passing to charity would react to this disincentive by limiting their charitable bequests to 50 percent. In such case, the loss to the colleges and universities alone could well exceed $100 million annually in vital support.

The Boskin studies prepared for the Filer Commission indicate that the imposition of a 50 percent ceiling on charitable bequests would result in a maximum increase in revenue of $43 million in return for a loss in bequests to charitable institutions, particularly educational, scientific, health and social welfare organizations of between $189 and $338 million or that for a maximum gain in revenue of one dollar, charities can be expected to lose $4.40. This indicates that the charitable bequest is a significant incentive indeed. The same studies further indicate that, if the deduction were replaced with a 30 percent credit, for every dollar gained in revenue, there would be a loss of $1.60 in bequests to charities, virtually all of which will be borne by the educational, scientific, health and social welfare organizations. (Boskin, supra, Table 13.)

As in the case of the charitable gift, the fact that Congress has established a procedure for recognizing and supervising worthy charities and permits unlimited deductions for charitable bequests to them is itself an incentive regardless of the actual effect on the taxpayer's estate. In this regard, we note that after due deliberation the American Law Institute concluded that "The 100 percent charitable deduction in the field of transfer taxation should be retained, under either a dual tax system or a unified tax." (Federal Estate and Gift Taxation Recommendations adopted by the American Law Institute at Washington, D.C., May 23–24, 1968, page 23).

We would also note that the Filer Commission, after due deliberation, recommended that "the charitable deduction be retained in its present form." (Giving in America, supra, page 151, see discussion pages 147–151.)

INTEGRATION OF ESTATE AND GIFT TAXES

The joinder of the proposal to limit the charitable deduction with the suggestion that the gift and estate tax be unified could be most unfortunate. We do not understand exactly how the limitation might be reflected insofar as the gift taxes are concerned. However, if any limitation is imposed on the gift deduction, then support of education at all levels, and we suspect of many other public charities, could well be destroyed. As indicated, 70 percent of the money raised comes in gifts of $5,000 or more. If one-half these gifts are subject to a gift tax, then we suspect we simply would not receive them except in the most unusual circumstances. To impose a gift tax on a transfer to charity would be to discourage giving a charity, which seems directly contrary to the long-standing policy of Congress to encourage contributions through the income and estate tax deduction. Even if the change merely proposed that charitab'e contributions during lifetime be considered in determining the amount of charitable contributions deducted within the limitation discussed above, the effect would be most detrimental. Donors would be hard put at any time to know exactly what their charitable bequest deduction might be, and they would be even more likely to apply formula limitations on the charitable bequest.

Moreover, particularly in the case of a gift tax proposal, we cannot believe that any substantial revenue would be involved, simply because donors would be unlikely to continue their pattern of giving in the fact of substantial gift taxes. Since no individual benefits are involved, we seriously question whether the revenue resulting from all of these proposals would be substantial. Because, singly or together, they might destroy an important source of support for public charities, particularly colleges, universities, and schools, we would urge that any changes proposed provide suitable exceptions and reservations to preserve the present tax incentives to charitable bequests and not impose a burden, such as a gift tax, on donations.

DECLARATORY JUDGMENTS IN THE CASE OF TAX EXEMPT ORGANIZATIONS

We strongly support the proposal that there be provision for declaratory judgments in the case of a wide range of questions involving tax exempt organizations. On the recommendation of this Committee, Congress had already adopted a similar rule with respect to the Federal tax status of pension plans. The problem is even more critical in the case of the determination of the exempt status of a charitable organization. Denial or revocation of exemption is quite clearly an irreparable injury. However, the Supreme Court has reluctantly concluded that the antiinjunction statute (26 U.S. Code 7421(a)) denies an organization claiming exemption access to the courts in the event of an adverse Internal Revenue Service decision unless it can establish that "under no circumstance could the Government ultimately prevail" in its conclusion. (*Bob Jones University* v. *Simon, et al.*, 416 U.S.C. 725 (1974)). In the dissenting opinion in a companion case, ultimately, it modified the decision in part by advising that it would not impose that ruling retroactively. (Revenue Ruling 74-540). However, that advice relates only to that particular program. There is a wide range of loan forgiveness plans under Federal and state laws, as well as a few in connection with the private scholarship programs. We submit that the original Internal Revenue Service action was correct and urge the Committee to establish statutory guidelines under which student loan programs will be treated as excludable grants under Section 117.

In this connection, we would note that this experience with respect to the loan forgiveness program is only one of many similar problems faced by the colleges and universities in the administration of their scholarship and fellowship programs. Colleges and universities provide a major source of grant funds which make it possible for disadvantaged young people to attend institutions of higher education. Taking account of the statute, the regulations, decided cases, private and, in some cases, published rulings of the Internal Revenue Service, these institutions have treated a wide range of grants as coming within the purview of Section 117 and, therefore, not subject to withholding requirements either with respect to income tax or social security (FICA). Such institutions will be faced with substantial liabilities if the Internal Revenue Service adopts the position that payments under one or more of the programs represent taxable stipends as it did in the case of the loan forgiveness program.

A claim for withholding of income and social security taxes once finally asserted by the Internal Revenue Service may not be appealed to the Tax Court but must be paid and redress sought only through a refund suit. This circumstance is a nightmare for college and university administrators who may expose their institutions to substantial liability in the exercise of prudent and proper judgment. For this reason, we earnestly urge that the Committee consider providing a ready access to the Tax Court for a determination of the status of payments as scholarship or fellowship grants under Section 117, limited solely to the issue of whether or not the institution is required to withhold income and social security taxes.

CHARITABLE REMAINDER VARIABLE ANNUITY TRUST

The 1969 Tax Reform Act imposed serious restrictions on the kinds of remainder interests after trust which can qualify for Federal income, estate and gift tax deduction if contributed to a charitable entity. In essence, no deduction is available unless the remainder interest is in the form of a charitable remainder trust as defined in IRC Section 664 or to a pooled income fund as defined in Section

642(c)(5). Mr. Teitell, in his presentation on behalf of the American Associaiton of Presidents of Independent Colleges and Universities and other similar associations and charities, has recommended that the definition of charitable remainder trust be expanded to include a "variable annuity trust" in addition to the annuity trust and the unitrust. (See pages 44 through 49 of the testimony.) Because of inflation and the unusual condition of the market which has existed since shortly after 1969, this additional flexibility is essential if the viability of this important kind of gift is to be preserved. Under the proposal, the beneficiary could elect to have an annuity amount, namely, a fixed percentage (not less than 5) of the initial fair market value of the assets or, as an alternative to the fixed dollar amount, the percentage multiplied by the net fair market value of the assets determined annually. For the reasons set forth in Mr. Teitell's presentation, we urge the adoption of this proposal.

Mr. Chairman, I respectfully suggest that any combination of some of the proposals we have discussed today, for the reasons inherent in the patterns of giving to educational institutions, may virtually destroy important sources of private support for public and private educational institutions, all performing functions for which the state or federal government would otherwise have to assume financial responsibility. We believe that there is little evidence that the changes would be accompanied by any significant increase of revenue to the federal government. We further believe that the changes proposed would not produce a more equitable tax system, for there are no cases where an individual, alive or dead, benefits financially by reason of his gift or bequest. Thus, it is difficult for us to believe that the public purposes would be served by curtailing the present tax incentives to charitable contributions and bequests. Certainly there is no warrant for imposing burdens and disincentives. If there is no indication of increased revenue and no proof of financial advantage, the only real effect would be to reduce substantially private support of public and private educational institutions with no corresponding benefit.

Patterns of Giving to Higher Education III

An Analysis of Voluntary Support of American Colleges and Universities, 1973–74

(By Julian H. Levi and Sheldon Elliot Steinbach of the American Council on Education)

Summary

Since 1954 the Council for Financial Aid to Education has published surveys of Voluntary Support of Education. The present special study under the auspices of the American Council on Education supplements the CFAE material for fiscal 1973–74.

a. Total documented voluntary support was found by the Council for Financial Aid to Education to be $1.746 billion, with an estimate of a probable $2.240 billion.

b. Twenty-two percent of voluntary support was received by public colleges and universities.

c. The 988 colleges and universities participating in the 1973–74 Survey reported $1.746 billion voluntary support. Of these institutions 961 reported $15.626 billion in expenditures for general education and student aid, and 8?3 of these institutions reported endowments with a market value of $10.827 billion. In 1973–74 estimated endowment yield was 4.93 percent. Thus, voluntary support reported by the institutions participating in the 1973–74 Survey was 11 percent of educational expenditures reported. Such voluntary support, if derived from endowment income, would have required an additional endowment of more than $35 billion in contrast to reported endowment of $10.827 billion.

d. Some 47.5 percent of all voluntary support in 1973–74 consisted of gifts from individuals—alumni, and nonalumni. Aggregate support from this category of donors was approximately $796 million, of which $564 million came in transactions of more than $5,000.

e. Higher education is dependent upon the large gift. Of all gift transactions by individuals (alumni and nonalumni) to higher education in 1973–74 99.56 percent were for less than $5,000 and in the aggregate produced 29.16 percent of all voluntary support by individuals. The remaining 0.44 percent of all transactions (those over $5,000) produced 70.84 percent of all voluntary support.

f. Approximately 52 percent of gifts of over $5,000 from individuals were received in the form of securities, real estate, or other property.

g. In 1973–74 voluntary support by bequest reached $267 million. Bequests of $5,000 or more amounted to approximately 98 percent of all bequest receipts, while bequests of securities, real estate, and other property represented 41 percent of all bequest receipts.

h. The total amount of annuities, life contracts, insurance policies, and other forms of deferred giving amounted to $56.9 million in 1973–74, a decrease of 29 percent from the amount reported in 1972–73. Deferred giving transactions of more than $5,000 represented 98.5 percent of all deferred giving receipts.

Thus, higher education in 1973–74, as in prior years, is dependent upon large gifts, approximately half of which came from individuals; and approximately 40 percent of these gifts from individuals, both over and under $5,000, were in the form of securities, real estate, or other property.

CONTENTS

FOREWORD

In 1968 and 1973, the American Council on Education published analyses showing patterns of voluntary support to higher education. A third study, presented here, shows the patterns of giving in 1973–74, but with the focus on contributions from alumni and non-alumni ("individual donors") and only summary figures supplied for contributions from businesses, religious denominations, foundations, and other sources. Although total giving in 1973–74 is estimated at the same amount as in 1972–73, contributions from the latter sector increased, whereas voluntary support from individual donors declined by 6 percent.

In 1969 and 1974, the Congress debated issues of tax reform, with much attention devoted to tax treatment of individual donors. Inasmuch as the tax structure can encourage or can cause a severe decline in individual giving to colleges and universities, information and data about the individual donor and donor gifts should enter into policy determinations. Given the significance of private gift support, it is incumbent on all those concerned with the financing of higher education—in government, in the higher education enterprise, and elsewhere—to understand the amount, characteristics, and patterns of private philanthropy.

In 1973–74, alumni and non-alumni made 3,323,000 gifts to the 988 colleges and universities reporting in the aggregate amount of $830,174,000. In human terms these statistics mean that on more than three million occasions in this one year, men and women made decisions that collectively provided more than $800 million to colleges and universities to help those institutions carry forward the services for which they have the primary responsibility. To the institutions, individual donor gifts may well mean the difference between high-quality education, research, and services or mediocrity (in some cases, even survival).

Higher education in this nation owes its beginnings to the generosity of private benefactors. Even though the succeeding decades have seen increasing governmental support and funding, the contributions of private donors remain essential to the financial health of all colleges and universities, both public and private.

This report has been prepared by the Office of Governmental Relations and its Committee on Taxation.

ROGER W. HEYNS,
President, American Council on Education.

PATTERNS OF GIVING TO HIGHER EDUCATION III

In 1968 and 1973 the American Council on Education published an analysis of voluntary support to higher education under the titles "Patterns of Giving to Higher Education."

As the case with the prior publications, this study builds upon the reports of Voluntary Support of Education published by the Council for Financial Aid to Education. Nine hundred eighty-eight institutions of higher education participated in the fifteenth survey for the fiscal year 1973–74, and a total voluntary support of $1.746 billion was reported.

Congressional attention has recently focused on the tax treatment of individual donors. This study therefore is limited to patterns of giving by individuals. "Individual donors" are classified between alumni and non-alumni donors, which is consistent with the practices of the Council on Financial Aid.

As in the previous studies, the Council for Financial Aid to Education and its staff, together with officers and staffs at hundreds of colleges and universities throughout the United States, made additional data and information available. For this support and cooperation, the deepest gratitude and appreciation must be expressed.

I. THE SURVEY OF VOLUNTARY SUPPORT OF EDUCATION, 1973–74

The Survey Report, Voluntary Support of Education, 1973–74, stated certain highlights;

No change in total support

The total voluntary support received by the institutions of higher education is estimated at $2.240 billion, the same as in 1972–73.

Public institutions gain

The public colleges and universities reported nearly 5 percent more support in 1973–74 than in 1972–73. Although the private women's colleges and professional and specialized schools reported similar increases, the private institutions as a group received 1.5 percent less support. The two-year institutions reported a large decline in voluntary support.

Table 1. Total Support by Source, All Colleges and Universities Reporting (000 omitted)

	1972-73 (1,020 inst.)		1973-74 (988 inst.)		% Change
Foundations	$ 409,926	(23.4)	$ 416,924	+ (23.9)	+ 1.7
Non-Alumni Individuals	469,067	(26.8)	433,489	(24.8)	− 7.6
Alumni	418,018	(23.9)	396,804	(22.7)	− 5.1
Business Corporations	249,764	(14.3)	276,192	(15.8)	+10.6
Religious Denominations	78,131	(4.4)	90,511	(5.2)	+15.8
Other	126,066	(7.2)	132,879	(7.6)	+ 5.4
Total	$1,750,909	(100.0)	$1,746,851	(100.0)	− 0.2
Memo:					
All Individuals	$ 887,103	(50.7)	$ 830,355	(47.5)	− 6.4
		(100.0)		(100.0)	
Bequests	255,908	(28.8)	267,123	(32.2)	+ 4.4
Deferred Gifts	80,211	(9.0)	56,904	(6.9)	−29.1
Other Gifts	550,984	(62.1)	506,328	(60.9)	− 8.1

[1] *Voluntary Support of Education* (New York: Council for Financial Aid to Education, 1975), p. 8.

Major shift among donor groups

There was a decrease of 6 percent in voluntary support from individual donors, alumni and non-alumni alike. This was offset by a large increase in support from business corporations, foundations, religious denominations, and other sources. Alumni support of Annual Funds continued to gain.

Current giving up; Capital support down

Private gifts and grants for current operations gained about 4.3 percent, with support for faculty compensation up sharply. Voluntary support for capital purposes, including endowment, decreased 5.4 percent, with gifts for physical plant and for student aid down moderately.

Table 1. (a) Voluntary Support of Education
All Institutions Participating 1973-74

GROUP AND NUMBER OF INSTITUTIONS	VOLUME OF SUPPORT			SOURCES OF SUPPORT						FORMS OF GIVING	
	1. Grand Total of Support	2. Current Operations	3. Capital Purposes	4. Business Corporations	5. Religious Denominations	6. Alumni	7. Non-Alumni Individuals	8. General Welfare Foundations	9. Other Groups & Sources	10. Bequests (% of Total Gifts)	11. Annuities, Life Contracts, Insurance (% of Total Gifts)
Major Private Universities (68)	$ 701,160,297 (100%)	$364,137,722 (51.9%)	$337,022,575 (48.1%)	$ 91,360,708 (13.0%)	$12,642,009 (1.8%)	$185,850,097 (26.5%)	$167,749,861 (23.9%)	$205,786,496 (29.4%)	$ 37,771,126 (5.4%)	$141,877,284 (20.2%)	$22,254,346 (3.2%)
Private Men's Colleges (14)	26,670,537 (100%)	9,337,767 (35.0%)	17,332,770 (65.0%)	1,384,334 (5.2%)	1,523,240 (5.7%)	6,384,116 (23.9%)	11,767,039 (44.1%)	4,931,800 (18.5%)	680,008 (2.6%)	2,826,221 (10.6%)	1,081,483 (4.1%)
Private Women's Colleges (78)	68,291,281 (100%)	28,824,477 (42.2%)	39,466,804 (57.8%)	5,799,598 (8.5%)	3,051,976 (4.5%)	30,533,064 (44.7%)	18,875,323 (20.3%)	13,269,446 (19.4%)	1,761,874 (2.6%)	13,957,479 (20.4%)	2,358,822 (3.5%)
Private Coeducational Colleges (463)	461,116,570 (100%)	228,644,665 (49.6%)	232,471,905 (50.4%)	70,593,128 (15.3%)	59,437,194 (12.9%)	90,331,809 (19.6%)	140,931,465 (30.5%)	77,542,519 (16.8%)	22,280,455 (4.9%)	61,219,471 (13.3%)	20,500,701 (4.4%)
Professional & Specialized Schools (51)	84,365,300 (100%)	41,738,543 (49.5%)	42,626,757 (50.5%)	10,588,874 (12.6%)	10,156,450 (12.0%)	10,320,384 (12.2%)	22,838,169 (27.1%)	27,926,767 (33.1%)	2,534,656 (3.0%)	13,084,271 (15.5%)	4,170,431 (4.9%)
Public Institutions (206)	386,160,502 (100%)	283,646,841 (73.5%)	102,513,661 (26.5%)	94,006,771 (24.3%)	293,184 (0.1%)	70,674,348 (18.3%)	70,187,313 (18.2%)	84,852,671 (22.0%)	66,146,215 (17.1%)	33,026,066 (8.6%)	6,368,755 (1.6%)
Junior Colleges (108)	19,086,221 (100%)	12,700,948 (66.5%)	6,385,273 (33.5%)	2,458,280 (12.9%)	3,407,159 (17.9%)	2,771,451 (14.5%)	6,139,957 (32.1%)	2,614,671 (13.7%)	1,694,703 (8.9%)	1,353,134 (7.1%)	169,532 (0.9%)
Total (988)	$1,746,850,708 (100%)	$969,030,963 (55.5%)	$777,819,745 (44.5%)	$276,191,693 (15.8%)	$90,511,212 (5.2%)	$396,665,269 (22.7%)	$433,489,127 (24.8%)	$416,924,370 (23.9%)	$132,868,837 (7.6%)	$267,123,916 (15.3%)	$56,904,070 (3.3%)

Voluntary Support of Education (New York Council for Financial Aid to Education, 1975), p. 62.

Table 1. (a) — Continued

SUPPORT THROUGH THE ANNUAL FUND						TOTAL NON-ALUMNI PARENT SUPPORT		CORPORATION MATCHING GIFTS		VITAL STATISTICS	
12. Total No. of Alumni of Record	13. No. of Alumni Solicited Through Annual Fund	14. No. of Alumni Donors to the Annual Fund	15. Dollar Value Alumni Gifts to the A.F.	16. Dollar Value Non-Alumni Parents Gifts to the A.F.	17. Dollar Value Total Gifts to the A.F.	18. No. of Non-Alumni Parent Donors for All Purposes	19. Amt. of Contributions by Non-Alumni Parents for All Purposes	20. Amt. of Corporate Support from Corporation Matching Gift Programs	21. Total Number of Gifts Matched	22. Expenditures-Education & General & Student Aid	23. Endowment-Market Value
3,431,496	3,059,819	685,427	$ 63,020,241	$ 2,184,369	$ 90,063,758	31,459	$ 3,908,234	$ 3,905,732	30,572	$ 3,905,108,980 (64 inst.)	$ 6,121,863,813 (64 inst.)
104,909	95,031	32,541	2,854,721	225,276	12,413,550	2,569	349,458	294,203	1,638	64,817,883 (14 inst.)	197,681,033 (13 inst.)
595,140	534,402	164,849	13,943,719	1,114,616	22,931,453	14,524	3,150,630	678,752	6,130	248,029,836 (78 inst.)	556,993,058 (75 inst.)
3,596,283	3,138,313	612,963	37,450,105	4,962,581	99,843,713	71,984	8,633,749	3,400,777	25,508	1,844,880,607 (455 inst.)	2,200,585,385 (411 inst.)
367,243	294,148	48,167	3,240,020	128,050	6,825,448	1,622	253,874	382,381	2,271	345,785,979 (50 inst.)	592,946,918 (46 inst.)
7,102,025	5,732,077	722,550	35,416,906	373,872	57,600,969	15,224	381,127	1,308,091	17,891	8,828,238,730 (198 inst.)	1,128,104,360 (169 inst.)
411,342	250,957	31,023	1,288,589	860,742	4,540,949	6,201	1,271,399	104,590	741	389,362,231 (102 inst.)	29,290,826 (85 inst.)
15,608,438	13,104,747	2,277,520	$157,214,301	$9,849,506	$294,219,840	143,583	$17,948,471	$10,054,526	84,751	$15,626,224,246 (961 inst.)	$10,827,265,173 (883 inst.)

Bequests up; deferred gifts down

There was an increase of 4.4 percent in individual support in the form of bequests. However, deferred gifts, which had risen sharply in the two previous years, showed a 29 percent drop. College and university endowment funds were down in market value [illegible]espite a gain [illegible].

The number of colleges and universities participating in the Survey was 988, down 3 percent from 1972–73. The year-to-year trends and other comparative findings are derived primarily from an analysis of data supplied by 827 institutions that took part in both the 1972–73 and 1973–74 Surveys.

Voluntary Support of Education 1973–74 (New York: Council for Financial Aid to Education, 1975), p. 3.

II. GIFTS OF INDIVIDUAL DONORS, ALUMNI AND NON-ALUMNI

The issues of tax reform debated by the Congress in 1969 and again in 1974 centered on tax treatment of individual donors. Public Law 93–344 requires an analysis of tax expenditures defined as: Those revenue losses attributable to provisions of the federal tax laws which allow special, exclusion, exemption, or deduction from gross income, or which provide a special credit, or a preferential rate of tax, or a deferral of tax liability.

Accordingly, the fiscal 1976 budget of the United States includes special Analysis F–1, "Tax Expenditure Estimates by Function".

[In millions of dollars]

Description	Corporations			Individuals		
	1974	1975	1976	1974	1975	1976
Deductibility of contributions to educational institutions	155	160	155	355	405	435
Deductibility of charitable contributions (other than education)	290	295	285	3,820	4,485	4,840

Source: Special Analyses budget of the U.S. Government, 1976 (Washington: Government Printing Office), p. 109.

III. METHODOLOGY OF THIS STUDY

Patterns of Giving to Higher Education I, II drew upon samples selected from institutions participating in the Council for Financial Aid (CFAE) Survey of Voluntary Support of Education. Generally, both American Council studies included all institutions reporting more than $1,000,000 in gifts; 50 percent of all institutions in the $500,000 to $1,000,000 brackets; 10 percent of all institutions in the $250,000 to $500,000 brackets; and 5 percent of all institutions reporting less than $250,000 in gifts.

This study, based on the Voluntary Support of Education 1973–74, uses the same classification system. A questionnaire was then prepared and circulated to the sample institutions. Thus, the sample for this study consisted of 463 institutions of the original 988 participating in the CFAE report for 1973–74. Usable responses for this study were received from 306 institutions. The participating institutions are listed in Appendix A. The form of questionnaire is shown in Appendix B.

This study sought greater detail concerning the support reported in the Survey of Voluntary Support to Education 1973–74, but limited, as noted, to gifts made by individual donors. Respondents were requested to classify each gift received as support for current operations only or for capital purposes only; to classify gift transactions as more or less than $5,000; to classify gift transactions as to whether received in cash, securities, real estate, or other property; and to classify bequests and deferred gift transactions with regard to size and form of gift received. Support reported from individual donors by the institutions responding totals $513,868,004.

The total reported in the Voluntary Support of Education 1973–74 from individual donors was $830,355,000, as indicated by Table 1. Thus, the study response is equal to approximately 62 percent in this universe.

Table 2 tabulates the unweighted data provided by all institutions participating in this study related to individual donors, the number of transactions more or less than $5,000, whether received in cash, securities, or other property, and whether donated in support of current operations or capital purposes.

Table 3 further tabulates this unweighted data as between alumni and nonalumni donors, as more or less than $5,000 and whether donated in support of current operations or capital purposes.

Table 2: Voluntary Support: Individual Donors; All Colleges &Universities Reporting: ACE Study 1973-74 (Unweighted Data)

Under 5,000	Transactions	Cash	Securities	Real Estate	Other	Total
Current Operations	1,587,061	94,774,037 (92.92%)	5,696,632 (5.58%)	22,197 (0.02%)	1,517,736 (1.49%)	102,009,601
Capital Purposes	222,284	29,325,031 (87.70%)	2,981,943 (8.86%)	54,318 (0.16%)	1,097,702 (3.28%)	33,438,994
Total	1,809,336 *99.48%	124,099,068 (91.63%)	8,648,575 (6.39%)	76,515 (0.06%)	2,615,437 (1.93%)	136,438,595 *26.36%
Over 5,000						
Current Operations	4,044	55,654,837 (60.30%)	27,974,944 (30.31%)	4,049,836 (4.39%)	4,611,473 (5.00%)	92,291,092
Capital Purposes	5,453	123,168,067 (43.06%)	130,370,280 (45.56%)	16,760,823 (5.86%)	15,838,247 (5.54%)	286,137,407
Total	9,497 *0.52%	178,822,894 (47.25%)	158,345,224 (41.84%)	20,810,661 (5.50%)	20,449,720 (5.40%)	378,428,499 *73.64%
Grand Total	1,818,832	302,921,962 (58.95%)	166,993,799 (32.49%)	20,887,176 (4.06%)	23,065,157 (4.48%)	513,868,094

*Indicates % of Total to Grand Total

Table 3: Voluntary Support Received in 1973-74 by All Institutions Participating, Distinguishing Individual Donors between Alumni/Non-Alumni: ACE Study

Above & Under $5,000 (unweighted data)

Under 5,000	Transactions	Cash	Securities	Real Estate	Other	Total
Current Operations						
Alumni	1,245,776	$63,526,222 (93.20%)	$4,115,673 (6.04%)	$12,425 $0.02%)	$445,333 (0.65%)	$68,099,653
Other	341,275	31,247,815 (92.17%)	1,570,959 (4.63%)	9,772 (0.03%)	1,072,402 3.16%)	33,909,948
Total	1,587,061	$94,774,037 (92.92%)	$5,696,632 (5.58%)	22,197 (0.02%)	1,517,735 (1.49%)	102,009,601
Capital Purposes						
Alumni	155,772	17,220,348 (88.14%)	2,036,824 (10.42%)	29,979 (0.15%)	251,556 (1.29%)	19,537,707
Other	66,512	12,104,683 (87.06%)	926,119 (6.66%)	24,339 (0.18%)	846,146 (6.09%)	13,901,287
Total	222,284	29,325,031 (87.70%)	2,961,943 (8.83%)	54,318 (0.16%)	1,097,702 (3.28%)	33,438,994
Grand Total	1,809,336	124,099,068 (91.63%)	8,648,515 (6.39%)	76,515 (0.06%)	2,615,437 (1.93%)	136,438,595

Over 5,000	Transactions	Cash	Securities	Real Estate	Other	Total
Current Operations						
Alumni	1,863	$ 26,006,031 (64.33%)	$ 12,568,883 (31.09%)	$ 480,790 (1.19%)	$ 1,372,613 (3.40%)	$ 40,428,317
Other	2,181	29,648,806 (57.17%)	15,406,061 (29.71%)	3,569,048 (6.88%)	3,238,860 (6.25%)	51,862,775
Total	4,044	55,654,837 (60.30%)	27,974,944 (30.31%)	4,049,838 (4.39%)	4,611,473 (5.00%)	92,291,092
Capital Purposes						
Alumni	2,657	63,177,988 (46.71%)	63,931,146 (47.20%)	4,785,683 (3.54%)	3,374,144 (2.49%)	135,268,961
Other	2,796	59,990,069 (39.76%)	66,439,134 (44.04%)	11m975,140 (7.94%)	12,464,103 (8.26%)	150,868,446
Total	5,453	123,168,057 (43.06%)	130,370,280 (45.56%)	16,760,823 (5.86%)	15,838,247 (5.54%)	286,137,407
Grand Total	9,497	187,822,894 (47.25%)	158,345,224 (41.84%)	20,810,661 (5.50%)	20,449,720 (5.40%)	378,428,499

The procedures followed in preparation of Patterns of Giving I and II were applied to this study as well. Appendix C, Patterns of Giving II, describes the preparation and weighting of the data. Except where specifically noted, all data hereafter provided have had appropriate weighting procedures applied.

IV. QUALIFICATIONS GOVERNING THIS STUDY

1. The Council for Financial Aid to Education (CFAE), requires self-classification by participating institutions within the seven categories of institutions shown by Table 4.

2. CFAE surveys of individual support fall within two categories: alumni and non-alumni individuals. Determination of classification is made by reporting institutions. These procedures and classifications were accepted for the purposes of this study.

3. This study deals with consummated donor transactions rather than donors. Successive gifts by any one donor will appear as independent donor transactions rather than as an aggregate total from the single donor.

4. The data were sought with regard to consummated donor transactions in the 1973–74 study year. At many institutions recording of gifts may be handled by development officers and personnel, whereas the actual receipt of the gift will be dealt with by the treasurer. Accordingly, single payments by a donor may cover, on occasion, more than one donor transaction or may include payment on pledges from prior years.

5. Distinctions between current and capital support are made by the institutions concerned upon their application of the guideline that current operations include gifts earmarked for that purpose or placed there at the institution's discretion; support for capital purposes include gifts for endowment whether earmarked for that purpose or placed there at the institution's discretion.

6. Distinctions between bequests as specific or residuary were accepted as reported by the institutions. Responses about the character and the nature of the bequest were not complete throughout, and the two totals are not reconciled. Distinctions of nature of bequests as between cash, securities, real estate, or other property were accepted as reported by the participating institutions. It is assumed payment of bequests ordinarily will occur at the time of final distribution and accounting. The data as collected make no allowance for sale conversion of estate assets to cash by an executor or administrator during the course of administration.

V. THE IMPORTANCE OF VOLUNTARY SUPPORT

Of the 988 institutions reporting to CFAE, 981 reported the volume of expenditures for education and general student aid purposes, and 868 institutions reported the market value of their endowment. This material shown in Table 1 may be extrapolated with reference to voluntary support received by each class of institution and in the aggregate.

While, as noted, there is a discrepancy between the number of institutions reporting voluntary support and those reporting expenditures and endowment market value, the data available demonstrate:

1. The grand total of reported voluntary support ($1,746,850,708) is equal to 11 percent of the reported expenditures ($15,626,224,246).

2. The average yield on investment of colleges and universities during 1973–74 on endowment funds is taken to have been 4.93 percent.[1] The $1,746,850,708 is thus the rough equivalent of an added endowment to American higher education of $35 billion in contrast to the actual admitted endowment of $10.827 billion shown on Table 4.

3. In the ten years 1964–65 to 1973–74, voluntary support of public institutions increased from $195,286,000 (16 percent of all voluntary support to higher education) to $386,161,000 (22 percent of all voluntary support to higher education). See Table 5.

4. CFAE also summarizes the purposes of voluntary support of the past ten years, shown in Table 6.

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[1] *Results of the 1974 NACUBO Comparative Performance Study* (Washington, 1975), p. 8.

Table 4: Voluntary Support Received, 1973-74 and Endowment Market Value: All Institutions Participating: CFAE Report 1973-74

GROUP AND NUMBER OF INSTITUTIONS	Grand Total of Support	Endowment Market Value	GROUP AND NUMBER OF INSTITUTIONS
Major Private Universities (68)	$ 701,180,297 (100%)	$ 6,121,663,613 (64 inst.)	Major Private Universities (68)
Private Men's Colleges (14)	26,670,537 (100%)	197,681,033 (13 inst.)	Private Men's Colleges (14)
Private Women's Colleges (78)	68,291,281 (100%)	556,993,058 (75 inst.)	Private Women's Colleges (78)
Private Coeducational Colleges (483)	431,118,570 (100%)	2,200,585,365 (411 inst.)	Private Coeducational Colleges (483)
Professional & Specialized Schools (51)	84,385,300 (100%)	592,948,918 (46 inst.)	Professional & Specialized Schools (51)
Public Institutions (206)	388,180,592 (100%)	1,128,104,380 (169 inst.)	Public Institutions (206)
Junior Colleges (108)	19,108,221 (100%)	29,290,826 (85 inst.)	Junior Colleges (108)
TOTAL (988)	$1,746,850,708 (100%)	$10,827,265,173 (863 inst.)	TOTAL (988)
Private Secondary & Elementary Schools (313)	$100,956,486 (100%)	$529,471,123 (260 inst.)	
Institutions Outside U.S. (2)	$ 787,014 (100%)	$ 10,872,890 (1 inst.)	Institutions Outside U.S. (2)
GRAND TOTAL (1,303)	$1,848,594,188 (100%)	$11,367,609,186 (1,124 inst.)	GRAND TOTAL (1,303)

Voluntary Support of Education (New York: Council for Financial Aid to Education, 1975), pp. 62-63

The ten-year CFAE study, as well as the two prior Patterns of Giving, demonstrates: (1) Voluntary support, as related to expenditure and endowment values, is indeed essential to the future survival and excellence of higher education. (2) Public institutions are increasingly benefited by private voluntary support. Such support, although a significantly smaller percentage of reported expenditures as contrasted to that of private institutions, is twice as beneficial in relation to endowment market value. This voluntary support is the one counterbalance to total dependence upon the state legislature and the federal government. (3) The designated purposes of voluntary support are at the core of the educational enterprise. More than one-third of all giving is unrestricted and thus may be spent for those objectives seen as most urgent by higher education itself: in 1973–74, 18 percent for basic research, 18 percent for student financial aid, and 6.2 percent for faculty compensation.

VI. THE DEPENDENCE OF HIGHER EDUCATION ON THE LARGE GIFT

Table 7 tabulates the weighted data as between individual alumni and non-alumni donors, as more or less than $5,000, and whether donated in support of current operations or capital purposes.

Table 8 applies the data obtained from the participating institutions to classification of voluntary support of individuals by class of individual donor, size of gift (as more or less than $5,000), and designation.

Thus 3,308,648 transactions (each less than $5,000) produce an aggregate of $232,221,801, while 14,490 transactions (each over $5,000) produce an aggregate of $564,160,744 in voluntary support. Accordingly, 0.44 percent of all transactions (more than $5,000) produce 70.84 percent of individual support.

VII. THE IMPORTANCE OF GIFTS OF PROPERTY

Gifts of securities, real estate, and other property may be distinguished from gifts of cash and also between more or less than $5,000, all as shown by Table 8. Gifts of securities, real estate, and other property account for less than 8 percent of all gift transactions under $5,000. Gifts of securities, real estate, and other property account for more than 51 percent of all gift transactions over $5,000.

It may be concluded that dependence on the large gift and the importance of gifts of securities, real estate, and other property are applicable to all classes of higher education.

Table 5. Voluntary Support of Higher Education, By Type of Institution
(including percentage of Grand Total, and average per institution)
(dollar totals and averages in thousands)

Group[1]	1964-1965	1965-1966	1966-1967	1967-1968	1968-1969	1969-1970	1970-1971	1971-1972	1972-1973	1973-1974
Major Private Universities	$ 477,743 (38.4%) (53) Av. $9,014	$ 444,201 (36.1%) (56) Av. $8,876	$ 481,385 (37.9%) (55) Av. $8,752	$ 605,368 (44.1%) (61) Av. $9,924	$ 615,249 (42.1%) (61) Av. $10,086	$ 638,927 (43.4%) (61) Av. $10,474	$ 604,485 (40.2%) (58) Av. $10,421	$ 685,807 (41.7%) (62) Av. $11,061	$ 709,409 (40.5%) (65) Av. $10,913	$ 701,160 (40.2%) (68) Av. $10,311
Private Coed Colleges	304,220 (24.4%) (365) Av. $ 833	276,770 (22.5%) (369) Av. $ 750	289,427 (22.8%) (375) Av. $ 772	277,439 (20.2%) (372) Av. $ 746	343,409 (23.5%) (354) Av. $ 970	331,034 (22.5%) (422) Av. $ 784	345,384 (22.9%) (439) Av. $ 787	409,389 (24.9%) (469) Av. $ 872	442,598 (25.3%) (433) Av. $ 1,022	461,117 (26.4%) (463) Av. $ 995
Public Institutions	195,286 (15.7%) (191) Av. $1,022	242,892 (19.8%) 191) Av $1,271	243,785 (19.2%) (193) Av. $1,263	241,580 (17.6%) (203) Av. $1,190	269,565 (18.5%) (185) Av. $ 1,457	291,701 (19.8%) (197) Av. $ 1,480	(325,640 (21.6%) (231) Av. $ 1,409	358,253 (21.8%) (222) Av. $ 1,604	383,276 (21.9%) (217) Av. $ 1,766	386,161 (22.1%) (206) Av. $ 1,874
Professional & Specialized Schools	99,285 (8.0%) (83) Av. $1,196	118,338 (9.7%) (78) Av. $1,511	114,289 (9.0%) (75) Av. $1,524	99,068 (7.2%) (77) Av. $1,287	78,179 (5.4%) (71) Av. $ 1,101	89,004 (6.0%) (75) Av. $ 1,186	118,247 (7.9%) (80) Av. $ 1,478	82,643 (5.0%) (73) Av. $ 1,132	106,413 (6.1%) (71) Av. $ 1,498	84,365 (4.8%) (51) Av. $ 1,654
Private Women's Colleges	75,046 (6.0%) (140) Av. $ 536	66,594 (5.4%) (142) Av. $ 469	65,233 (5.1%) (143) Av. $ 456	69,966 (5.1%) (136) Av. $ 515	76,194 (5.2%) (132) Av. $ 577	58,481 (4.0%) (106 Av. $ 551	58,772 (3.8%) (94) Av. $ 603	60,944 (3.7%) (89) Av. $ 684	61,567 (3.5%) (85) Av. $ 724	68,291 (3.9%) (78) Av. $ 875
Private Men's Colleges	75,455 (6.1%) (67) Av. $1,126	59,521 (4.8%) (63) Av. $ 945	57,154 (4.5%) (64 Av. $ 893	58,802 (4.3%) (57) Av. $1,030	57,329 (3.9%) (53) Av. $ 1,081	37,200 (2.5%) (35) Av. $ 1,066	31,382 (2.1%) (28) Av. $ 1,121	28,574 (1.7%) (20) Av. $ 1,428	22,437 (1.3%) (14) Av. $ 1,602	26,671 (1.5%) (14) Av. $ 1,905
Junior Colleges	17,861 (1.4%) (165) Av. $ 108	20,486 (1.7%) (134) Av. $ 137	18,745 (1.5%) (137) Av. $ 137	19,423 (1.5%) (137) Av. $ 142	20,963 (1.4%) (157) Av. $ 133	25,873 (1.8%) (149) Av. $ 173	22,228 (1.5%) (151) Av. $ 173	23,017 (1.4%) (158) Av. $ 146	25,288 (1.4%) (136) Av. $ 187	19,086 (1.1%) (108) Av. $ 176
Grand Total	$1,244,815 (100%) (1,064) Av. $1,170	$1,229,794 (100%) (1,033) Av. $1,191	$1,269,968 (100%) (1,042) Av. $1,219	$1,371,557 (100%) (1,043) Av $1,315	$1,460,878 (100%) (1,013) Av. $1,442	(1,472,300 (100%) (1,046) Av. $1,408	$1,503,837 (100%) (1,088) Av. $1,382	$1,646,907 (100%) (1,083) Av. $1,506	$1,750,986 (100%) (1,020) Av. $1,716	$1,748,851 (100%) (969) Av. $1,768

Voluntary Support of Education (New York: Council for Financial Aid to Education, 1975), p. 66.

[1] In every Survey, each institution is classified in the category appropriate to its status in that year. Since the status of many institutions has changed over the years, the data by category is not strictly comparable from one Survey to another.

Table 6. Voluntary Support Received in 1973-74, Distinguished by Purpose, by All Participating Institutions

Purpose	1964-1965 (1,064 inst.)	1965-1966 (1,033 inst.)	1966-1967 (1,042 inst.)	1967-1968 (1,043 inst.)	1968-1969 (1,013 inst.)	1969-1970 (1,046 inst.)	1970-1971 (1,000 inst.)	1971-1972 (1,003 inst.)	1972-1973 (1,020 inst.)	1973-1974 (908 inst.)
Unrestricted	$ 407,970 (32.0%)	$ 370,069 (30.0%)	$ 300,770 (30.0%)	$ 400,020 (33.5%)	$ 424,570 (29.1%)	$ 461,021 (31.3%)	$ 481,060 (32.0%)	$ 552,062 (33.0%)	$ 584,542 (34.0%)	$ 579,986 (33.2%)
Physical Plant	333,902 (26.8%)	311,906 (25.4%)	312,537 (24.0%)	318,368 (23.3%)	308,230 (25.2%)	323,534 (22.0%)	311,064 (21.0%)	322,576 (19.0%)	322,830 (18.4%)	302,336 (17.3%)
Basic Research	138,581 (11.2%)	176,718 (14.4%)	158,733 (12.4%)	171,738 (12.5%)	182,578 (12.5%)	177,494 (12.1%)	208,823 (13.3%)	218,506 (12.0%)	228,447 (13.0%)	227,967 (13.0%)
Student Financial Aid	143,912 (11.0%)	149,544 (12.2%)	174,826 (13.7%)	170,020 (12.9%)	171,707 (11.0%)	202,001 (13.7%)	206,156 (13.5%)	214,741 (13.0%)	251,400 (14.4%)	227,832 (13.0%)
Faculty Compensation	63,423 (5.1%)	75,700 (6.1%)	84,400 (6.0%)	75,241 (5.5%)	78,263 (5.2%)	78,191 (5.3%)	68,500 (4.0%)	80,903 (4.9%)	88,901 (5.1%)	107,400 (6.2%)
Other Purposes	156,007 (12.5%)	136,066 (11.1%)	161,400 (12.7%)	168,374 (12.3%)	236,441 (16.1%)	228,900 (15.0%)	238,150 (15.0%)	206,070 (18.1%)	264,002 (15.1%)	301,251 (17.2%)
Grand Total	$1,244,015 (100%)	$1,229,794 (100%)	$1,200,900 (100%)	$1,371,567 (100%)	$1,400,070 (100%)	$1,472,300 (100%)	$1,503,837 (100%)	$1,646,007 (100%)	$1,750,900 (100%)	$1,746,061 (100%)

Voluntary Support of Education (New York: Council for Financial Aid to Education, 1975), p. 66

Table 7: Voluntary Support: 1973-74; Alumni, Non-Alumni Individuals; All Colleges and Universities Reporting ACE Study (Weighted)

	Transactions	Cash	Securities	Real Estate	Other	Total
Under 5,000						
Current Operations	12,919,918	165,351,690 (93.60%)	8,674,391 (4.91%)	61,369 (0.03%)	2,408,846 (1.36%)	176,496,339
Capital Purposes	388,730	49,161,699 (88.22%)	4,636,558 (8.31%)	76,391 (0.13%)	1,851,855 (3.32%)	55,725,462
Total	3,308,648 *99.56%	214,513,389 (92.37%)	13,300,949 (5.73%)	137,760 (0.05%)	4,260,323 (1.83%)	232,221,801 *29.16%
Over 5,000						
Current Operations	6,260	87,794,037 (61.00%)	40,726,300 (28.66%)	6,358,055 (4.40%)	7,172,799 (5.06%)	142,052,253
Capital Purposes	8,230	184,312,926 (43.66%)	188,569,972 (44.67%)	25,831,404 (6.12%)	23,394,063 (5.54%)	422,108,491
Total	14,490 *0.44%	272,106,963 (48.23%)	229,296,272 (40.64%)	32,190,459 (5.71%)	30,566,862 (5.42%)	564,160,744 *70.84%
Grand Total	3,323,138	486,620,352 (61.10%)	242,606,221 (30.46%)	32,328,209 (4.06%)	34,827,185 (4.37%)	796,382,545

Table 8. Voluntary Support Received in 1973-74: All Institutions Participating: Distinguishing Individual Donors between Alumni—Non-Alumni: ACE Study (Weighted)

Part A	Under 5,000				Current Operations	
	Transactions	Cash	Securities	Real Estate	Other	Total
Alumni Individuals	2,321,069	106,246,929	6,120,353	17,778	711,982	113,097,149
		(93.94%)	(5.41%)	(0.02%)	(0.63%)	
Non-Alumni Individuals	596,859	59,104,761	2,554,036	43,583	1,696,866	63,399,190
		(93.23%)	(4.03%)	(0.07%)	(2.68%)	
Total	2,918,918	165,351,690	8,674,391	61,359	2,408,868	176,496,339
		(93.89%)	(4.91%)	(0.03%)	(1.36%)	
					Capital Purposes	
Alumni Individuals	274,772	28,819,863	3,039,123	42,484	363,634	32,265,125
		(89.32%)	(9.42%)	(0.13%)	(1.13%)	
Non-Alumni Individuals	113,958	20,341,896	1,596,436	33,907	1,488,021	23,460,337
		(86.71%)	(6.80%)	(0.14%)	(6.34%)	
Total	388,730	49,161,699	4,635,558	76,391	1,851,655	55,725,462
		(88.22%)	(8.32%)	(0.14%)	(3.32%)	
Grand Total	3,306,648	214,513,389	13,309,949	137,750	4,260,323	232,221,861
		(92.37%)	(5.73%)	(0.06%)	(1.83%)	
Part B	**Over 5,000**				**Current Operations**	
	Transactions	Cash	Securities	Real Estate	Other	Total
Alumni Individuals	2,686	38,736,669	18,099,965	776,877	2,200,155	59,813,813
		(64.76%)	(30.26%)	(1.30%)	(3.68%)	
Non-Alumni Individuals	3,574	49,067,348	22,626,335	5,582,078	4,972,644	82,238,440
		(59.65%)	(27.51%)	(6.79%)	(6.05%)	
Total	6,260	87,794,037	40,726,300	6,359,065	7,172,799	142,052,263
		(61.80%)	(28.66%)	(4.48%)	(5.05%)	
					Capital Purposes	
Alumni Individuals	3,941	93,347,595	91,236,466	7,874,581	5,032,732	197,491,426
		(47.27%)	(46.20%)	(3.99%)	(2.55%)	
Non-Alumni Individuals	4,289	90,965,331	97,333,512	17,956,823	18,361,331	224,617,005
		(40.50%)	(43.33%)	(7.99%)	(8.17%)	
Total	8,230	184,312,926	188,569,972	25,831,404	23,394,063	422,108,461
		(43.66%)	(44.67%)	(6.12%)	(5.54%)	
Grand Total	14,490	272,106,963	229,296,272	32,190,469	30,566,862	564,160,744
		(48.23%)	(40.64%)	(5.71%)	(5.42%)	

Table 9 details and distributes the data shown in Table 8 among the institutional classifications of higher education. Table 10 analyzes the dollar statisics in percentages of applicable totals.

The generosity of donors is by no means limited to the so-called major institutions. In the case of the public institutions for example, 19.82 percent of all non-alumni gift transactions over $5,000 accounted for 52.14 percent of all receipts.

VIII. BEQUESTS

The Council for Financial Aid to Education reported in 1973-74 that bequests rose to $267,123,916, 32.2 percent of all voluntary support obtained from individual donors. The ACE study sought to differentiate between specific bequests and residuary bequests, as well as between cash, securities, real estate, and other property. The total for the category and designation of the bequests are not reconciled, nor does the study take into account sale and conversion of estate assets to cash during the course of administration.

Character of bequest responses total $176,200,000; nature of bequest responses total $193,900,000. The bequest responses of the CFAE 1973–74 Response Survey Report are $267,123,916. Thus, the ACE study responses on character of bequests is 65.9 percent and on the nature of the bequest are 72.6 percent. Under these circumstances, preparation of a weighted table would add little to the results, so this study proceeds from the sample data.

Certain conclusions are evident:

1. Voluntary support by bequest was found by the Council for Financial Aid in 1973–74 to represent 15.3 percent of all gifts, varying from 7.1 percent of all gifts to junior colleges to 20.4 percent of all giving to private women's colleges. (See table 1a).

2. Bequests of $5,000 or more represent 98.28 percent of all bequest receipts (Table 12). Again, higher education is dependent upon the large donor.

3. Bequests of stock, real estate, or other property represent 41.47 percent of all bequest receipts (Table 11). Again, gifts of property are most significant to higher education.

Table 9: Voluntary Support: Alumni/Non-Alumni, Under and Above $5,000

Number of Transactions, Subject Matter of Gift and Type of Institution, in actual dollars: 1973-74 ACE Study

Source			Cash		Securities		Real Estate		Other		Total Dollar Value
			Transactions	Dollar Value	Transactions	Dollar Value	Transactions	Dollar Value	Transactions	Dollar Value	
Private Universities	Alumni:	Under 5,000	667,653	$ 46,460,202	4,321	$ 4,355,334	15	$ 20,158	986	$ 267,408	$ 51,103,094
		Above 5,000	1,863	77,780,831	1,131	68,701,111	32	2,396,125	34	1,421,538	150,299,405
	Non-Alumni:	Under 5,000	131,424	15,440,812	825	1,215,800	3	1,521	1,616	453,839	17,111,972
		Above 5,000	1,876	61,947,289	519	57,956,856	23	2,925,754	98	8,259,105	131,089,004
	Total		802,816	201,628,934	6,796	132,229,101	73	5,343,550	2,714	10,401,890	349,603,475
Private Men's Colleges	Alumni:	Under 5,000	42,678	2,010,463	141	115,908	0	0	25	44,696	2,171,067
		Above 5,000	27	288,861	11	626,347	0	0	0	0	915,208
	Non-Alumni:	Under 5,000	5,341	625,137	28	40,237	1	4,795	6	903	671,027
		Above 5,000	42	771,049	19	379,118	11	667,690	1	30,140	2,207,997
	Total		48,088	3,695,510	199	1,521,610	12	672,485	32	75,739	5,965,344
Private Women's Colleges	Alumni:	Under 5,000	139,003	9,525,507	936	1,010,528	0	0	3	883	10,536,918
		Above 5,000	387	7,088,215	140	7,178,110	3	132,930	0	0	14,399,255
	Non-Alumni:	Under 5,000	24,192	3,022,476	267	331,755	6	18,160	130	97,468	3,469,859
		Above 5,000	226	3,973,346	80	2,278,450	1	499,708	2	155,769	6,907,345
	Total		163,808	23,609,544	1,413	10,798,843	10	650,870	134	254,120	35,313,377
Private Co-educational Colleges	Alumni:	Under 5,000	802,716	43,747,447	2,429	2,715,608	16	29,608	1,554	296,181	46,788,244
		Above 5,000	1,133	28,757,234	646	19,594,201	57	3,023,432	37	845,541	50,220,318
	Non-Alumni:	Under 5,000	339,871	34,594,720	1,051	1,572,682	30	48,576	1,997	514,981	36,730,959
		Above 5,000	2,205	41,996,209	659	35,525,571	80	10,049,609	104	5,849,894	93,421,283
	Total		1,145,385	147,095,610	4,785	59,408,062	183	13,150,625	3,692	7,506,507	227,159,804
Professional and Specialized Schools	Alumni:	Under 5,000	39,026	2,384,954	89	105,764	0	0	7	17,259	2,507,977
		Above 5,000	59	3,238,924	43	2,430,811	3	47,226	13	1,276,251	6,993,212
	Non-Alumni:	Under 5,000	15,771	3,985,508	131	243,748	0	0	137	61,950	4,291,206
		Above 5,000	524	11,985,857	103	8,432,849	5	1,249,274	10	486,987	22,154,967
	Total		55,380	21,595,243	366	11,213,172	8	1,296,500	167	1,842,447	35,947,362
Public Institutions	Alumni:	Under 5,000	834,031	28,122,498	580	751,184	2	11,102	736	449,189	29,333,961
		Above 5,000	565	14,568,868	211	10,379,446	22	3,051,845	113	3,689,647	31,689,806
	Non-Alumni:	Under 5,000	189,002	18,974,283	225	414,500	6	4,438	2,819	2,040,208	21,333,489
		Above 5,000	697	18,419,856	182	14,438,096	44	7,995,609	229	8,436,099	49,389,660
	Total		1,004,295	80,085,473	1,178	25,983,226	76	11,062,994	3,897	14,617,143	131,748,836
Junior Colleges	Alumni:	Under 5,000	59,304	2,815,573	161	106,150	0	0	0	0	2,920,823
		Above 5,000	66	2,361,551	31	426,399	0	0	0	0	2,787,950
	Non-Alumni:	Under 5,000	17,050	2,803,741	291	331,751	0	0	7	15,358	3,150,850
		Above 5,000	84	929,073	31	588,907	2	141,185	6	115,981	1,775,146
	Total		77,140	8,910,838	514	1,452,207	2	141,185	13	131,339	10,634,769
	Grand Total		3,296,876	486,620,352	15,251	242,606,221	362	32,318,269	10,849	34,287,185	796,371,987

Table 10. Voluntary Support: Alumni/Non-Alumni, Under and Above $5,000, Percentages of Transactions to Subject Matter of Gifts, in the Eight Institutional Types 1973-74

Source			Transactions	Cash	Transactions	Securities	Transactions	Real Estate	Transactions	Other	Total
Private	Alumni %	Under 5,000	83.16%	23.04%	63.58%	3.29%	20.54%	.37%	35.80%	2.57%	58.72% 7.32%
Universities		Above 5,000	.23%	38.57%	16.64%	51.95%	43.84%	44.84%	1.25%	13.66%	15.58% 37.25%
	Non-Alumni %	Under 5,000	16.37%	7.86%	12.14%	.92%	4.10%	.03%	59.54%	4.38%	23.04% 3.24%
		Above 5,000	.23%	30.72%	7.64%	43.83%	31.50%	54.75%	3.61%	79.40%	10.75% 52.10%
	Total		802,816	$201,628,934	6,796	$132,229,101	73	$6,343,560	2,714	$10,401,800	
Private	Alumni %	Under 5,000	88.75%	54.40%	78.85%	7.62%	0.0%	0.0%	78.12%	58.01%	58.43% 38.50%
Men's		Above 5,000	.80%	7.82%	5.52%	41.10%	0.0%	0.0%	0.0%	0.0%	1.40% 12.24%
Colleges	Non-Alumni %	Under 5,000	11.10%	16.92%	14.07%	2.64%	8.33%	.72%	18.75%	1.19%	13.00% 5.30%
		Above 5,000	.08%	20.80%	9.55%	48.57%	91.60%	98.20%	3.12%	39.79%	26.10% 52.12%
	Total		48,088	$3,885,510	199	$1,521,610	12	$872,485	32	$75,730	
Private	Alumni %	Under 5,000	84.88%	40.34%	88.24%	9.38%	0.0%	0.0%	1.50%	.35%	38.15% 12.50%
Women's		Above 5,000	.24%	30.02%	9.90%	86.47%	30.00%	20.42%	0.0%	0.0%	10.00% 29.22%
Colleges	Non-Alumni %	Under 5,000	14.70%	12.80%	18.18%	3.07%	60.00%	2.79%	97.00%	38.35%	47.48% 14.25%
		Above 5,000	.14%	16.82%	5.60%	21.10%	10.0%	76.78%	1.50%	61.30%	4.32% 44.08%
	Total		163,808	$23,609,544	1,413	$10,798,843	10	$850,870	134	$254,120	
Private	Alumni %	Under 5,000	70.03%	29.74%	50.76%	4.51%	8.74%	.22%	42.08%	3.94%	42.90% 9.80%
Coed		Above 5,000	.10%	18.19%	13.50%	32.98%	31.14%	22.99%	1.00%	11.20%	11.44% 21.35%
Colleges	Non-Alumni %	Under 5,000	29.67%	23.52%	21.98%	2.64%	16.40%	.37%	54.08%	6.80%	30.52% 8.35%
		Above 5,000	.20%	28.55%	13.77%	59.80%	43.72%	76.42%	2.82%	77.93%	15.12% 60.68%
	Total		1,146,385	$147,085,610	4,785	$58,408,082	183	$13,150,625	3,682	$7,508,507	
Professional	Alumni %	Under 5,000	70.47%	11.04%	24.32%	.94%	0.0%	0.0%	4.20%	.94%	24.75% 3.23%
& Specialized		Above 5,000	.11%	15.10%	11.75%	21.68%	37.50%	3.64%	7.78%	68.28%	14.28% 27.42%
Schools	Non-Alumni %	Under 5,000	28.48%	18.45%	35.80%	2.18%	0.0%	0.0%	82.04%	3.38%	36.58% 6.00%
		Above 5,000	.94%	55.50%	28.14%	75.20%	62.50%	96.38%	5.98%	28.43%	24.39% 63.37%
	Total		55,380	$21,585,243	388	$11,213,172	8	$1,298,500	167	$1,842,447	
Public	Alumni %	Under 5,000	83.04%	35.12%	47.53%	2.90%	2.64%	.10%	18.88%	3.07%	38.02% 10.30%
Institutions		Above 5,000	.08%	18.19%	11.91%	39.94%	28.94%	27.58%	2.90%	25.24%	12.27% 27.74%
	Non-Alumni %	Under 5,000	16.80%	23.63%	18.10%	1.60%	7.90%	.04%	72.34%	13.98%	29.04% 9.80%
		Above 5,000	0.07%	23.00%	15.45%	55.56%	57.90%	72.27%	5.88%	57.71%	19.82% 52.14%
	Total		1,004,295	$80,085,473	1,178	$25,983,226	76	$11,082,994	3,897	$14,617,143	
Junior	Alumni %	Under 5,000	76.90%	31.60%	31.32%	7.24%	0.0%	0.0%	0.0%	0.0%	27.05% 9.71%
Colleges		Above 5,000	.08%	26.50%	6.03%	29.36%	0.0%	0.0%	0.0%	0.0%	1.52% 13.90%
	Non-Alumni %	Under 5,000	22.90%	31.48%	56.81%	22.84%	0.0%	0.0%	53.85%	11.70%	33.34% 16.50%
		Above 5,000	.11%	10.42%	6.03%	40.55%	100.00	100.00	46.15%	88.30%	38.07% 59.82%
	Total		77,104	$8,910,038	514	$1,452,207	2	$141,185	13	$131,339	

1. Transactions and gifts %'s are determined by their relationship to the total shown in the fifth line of the individual columns, i.e.: 83.16 percent shown in column one demonstrates that of the cash transactions, 83.16 percent were given in gifts under $5,000 by alumni; that 83.16 percent in transactions yielded 23.04 percent of the total cash received.

Table 11: Character and Nature of Bequests Received 1973-74 by All Institutions Participating in ACE Study. (Unweighted Data)

Character of Bequest	Size	# of Bequests	Dollar Total	% of Beq.	% of Dollars
Specific Bequests	Less than 5,000	1,256	1,476,920	8.34	0.84
	5,000 or more	1,068	88,468,608	7.09	50.19
Residuary Bequests	Less than 5,000	363	559,323	2.41	0.32
	5,000 or more	568	71,229,816	3.77	40.41
Unclassified	Less than 5,000	11,616	979,234	77.14	0.56
	5,000 or more	187	13,540,171	1.24	7.68
Total		15,058	176,254,072	100.00	100.00
Nature of Bequests	**Size**	**# of Bequests**	**Dollar Total**	**% of Beq.**	**% of Dollars**
Cash	Less than 5,000	14,327	3,208,866	87.37	1.65
	5,000 or more	1,510	110,315,530	9.21	56.88
Securities	Less than 5,000	86	153,323	0.52	0.08
	5,000 or more	360	74,310,645	2.20	38.31
Real Estate	Less than 5,000	6	7,585	0.04	0.02
	5,000 or more	49	5,142,413	0.30	2.65
Other Property	Less than 5,000	40	45,966	0.24	0.02
	5,000 or more	20	762,761	0.12	0.39
Total		16,398	193,947,089	100.00	100.00

Table 12: Character & Nature of Bequests: Unweighted (1973-74 ACE Study)

Character*		Total Dollars	%	Transactions	%
1. Specific 2. Residuary 3. Unclassified	Under $5,000	$ 3,015,477	1.72%	13,235	87.90%
1. Specific 2. Residuary 3. Unclassified	Above $5,000	$173,238,595	98.28%	1,823	12.10%
		$176,254,072	100 %	15,058	100 %
Nature*		**Total Dollars**	**%**	**Transactions**	**%**
1. Cash 2. Securities 3. Real Estate 4. Other Property	Under $5,000	$ 3,415,740	1.76%	14,459	88.20%
1. Cash 2. Securities 3. Real Estate 4. Other Property	Above $5,000	$190,531,349	98.24%	1,939	11.80%
		$193,947,089	100 %	15,058	100 %

*Character: 1) Total dollars given; by conditions, number of transactions lesser than, greater than $5,000
2) Determines percentages of dollars/transactions.
*Nature: 1) Totals dollars given; less than, greater than $5,000, transactions.
2) Determines percentages of dollars to transactions.*

Table 13: Forms of Individual Giving as a Percentage of Voluntary Support by Individuals

Year	Bequests	Deferred Giving	Year	Bequests	Deferred Giving
1964-65	31.4%	6.7%	1969-70	27.3%	5.0%
1965-66	30.1%	6.8%	1970-71	34.9%	3.9%
1966-67	25.5%	6.1%	1971-72	32.0%	6.4%
1967-68	25.1%	7.1%	1972-73	28.8%	9.0%
1968-69	28.8%	5.4%	1973-74	32.2%	6.9%

Voluntary Support of Education 1973-74 (New York: Council for Financial Aid to Education, 1975), p. 60, table 8

Table 14: Types and Size of Deferred Giving Received 1973-74 by All Institutions Participating ACE Study (Unweighted Data)

Deferred Gifts	Size	# of Gifts	Dollar Total	% of Gifts	% of Dollars
Charitable Remainder	Less than 5,000	42	78,523	3.73	0.19
Annuity Trusts	5,000 or more	138	6,909,797	12.26	17.04
Charitable Remainder	Less than 5,000	25	55,692	2.22	0.14
Unitrust	5,000 or more	194	17,062,370	17.23	42.07
Pooled Income Fund	Less than 5,000	147	180,012	13.06	0.89
Contracts	5,000 or more	274	6,569,531	24.33	16.20
Other	Less than 5,000	127	173,435	11.28	0.43
	5,000 or more	179	9,429,790	15.90	23.25
Total		1,126	40,559,150	100.00	100.00

IX. DEFERRED GIVING

CFAE reported that in fiscal 1973–74 deferred giving amounted to $56,904,000. The ACEE study sought to differentiate between forms of deferred giving in more precise legal classifications and also to learn of the distribution of such support between gifts or more or less than $5,000.

The gross sample response is $40,559,150, in contrast to the CFAE total of $56.904,000. Study response represents 71.2 percent of the CFAE total giving.

Under the circumstances, preparation of a weighted table would add little to the results and the study proceeds from sample data. As shown by Table 15, deferred giving transactions of more than $5,000 represent 98.55 percent of all deferred giving receipts.

X. LIFE TIME GIFTS VS. BEQUESTS

The Council for Financial Aid in its reporting includes gifts by bequest within the totals shown as received from alumni and non-alumni individuals (see Table 1). Thus, alumni and non-alumni totals will include both intervivos and bequests. Council for Financial Aid Reports do not, however, analyze support between cash, securities, and real estate. The ACE study makes this analysis (Table 11).

Evident cautions must be noted:

1. The year 1973–74 was a year of high bequest support (see Table 18).
2. As noted, this study deals with consummated donor transactions. Bequests are ordinarily paid at the time of final distribution and accounting.
3. The statistics reported make no allowance for conversion of estate assets to cash by the executor during the period of administration.

Table 15: Deferred Gifts: Unweighted All Colleges & Universities Participating in ACE Study 1973-1974

Type	Size	Total Dollars	%	Transactions	%
Charitable Remainder Annuity Trusts Charitable Remainder Unitrust Pooled Income Fund Other	Under $5,000	$ 587,662	1.45%	341	30.28%
Charitable Remainder Annuity Trusts Charitable Remainder Unitrust Pooled Income Fund Other	Above $5,000	$39,971,488	98.55%	785	69.72%
		$40,559,150	100.00%	1,126	100.%

Table 16: Life Time Gifts vs Bequests (Unweighted Gifts over $5,000: Dollars/Percent)

	Cash	%	Securities	%	Real Estate	%	Other	%
Bequests	110,315,530	61.7	74,310,845	46.9	5,142,413	24.7	762,761	3.7
Intervivos Gifts	68,507,364	38.3	84,034,579	53.1	15,668,248	75.3	19,686,959	96.3
Total Giving	178,822,894	100.0	158,345,224	100.0	20,810,661	100.0	20,449,720	100.0

APPENDIX A - RESPONDING INSTITUTIONS

ALABAMA

Birmingham-Southern College
Tuskegee Institute

ARIZONA

University of Arizona

ARKANSAS

Arkansas College
John Brown University
University of Arkansas, Little Rock

CALIFORNIA

Art Center College of Design
Biola College
California Institute of Technology
California Institute of the Arts
Chapman College
Claremont Graduate School
Claremont Men's College
Claremont University Center
Harvey Mudd College
Immaculate Heart College
Loma Linda University
Mills College
Occidental College
Pitzer College
Pomona College
Scripps College
Stanford University
University of California – Summary
University of Redlands
University of San Francisco
University of Santa Clara
University of Southern California
University of the Pacific

COLORADO

Colorado College
Colorado State University
University of Denver

CONNECTICUT

Albertus Magnus College
Connecticut College
Fairfield University
Trinity College
University of Bridgeport
University of Connecticut
University of Hartford
Wesleyan University
Yale University

DELAWARE

University of Delaware
Wesley College

DISTRICT OF COLUMBIA

Catholic University of America
Georgetown University
Trinity College

FLORIDA

Bethune Cookman College
Eckerd College
Florida Southern College
Rollins College
St. Petersburg Junior College
University of Florida
University of Miami
University of South Florida
University of Tampa

GEORGIA

Agnes Scott College
Berry College
Columbus College
Emory University
Mercer University
Morris Brown College
Shorter College
University of Georgia

HAWAII

University of Hawaii

ILLINOIS

Augustana College
Central YMCA Community College
Concordia Teachers College
DePaul University
Elmhurst College
George Williams College
Illinois Institute of Technology
Illinois Wesleyan University
Knox College
Lake Forest College
Loyola University of Chicago
Millikin University
North Park College & Theological Seminary
Northwestern University
Rockford College
Roosevelt University
University of Illinois
University of Chicago

INDIANA

Anderson College
Ball State University
DePauw University
Hanover College
Indiana State University
Indiana University
St. Mary's College
Tri-State College
University of Evansville
Valparaiso University

IOWA

Briarcliff College
Coe College
Cornell College
Drake University
Grinnell College
Iowa State University of Science & Technology
University of Dubuque
University of Iowa

KANSAS

Friends University
Kansas State University
Ottawa University
University of Kansas
Wichita State University

KENTUCKY

Alice Lloyd College
Asbury College
Centre College of Kentucky
Union College
University of Kentucky

LOUISIANA

Dillard College
Tulane University
Xavier University of Louisiana

MAINE

Bowdoin College

MARYLAND

Goucher College
Johns Hopkins University & Hospital
University of Maryland
Western Maryland College

MASSACHUSETTS

Amherst College
Boston College
Clark University
College of the Holy Cross
Dakota Wesleyan University
Gordon College
Harvard University
Massachusetts Institute of Technology
Mount Holyoke College
Northeastern University
Pine Manor Junior College
Radcliffe College
Smith College
Wheaton College
Williams College
Worcester Polytechnic Institute

MICHIGAN

Albion College
Alma College
Calvin College
Hope College
Kalamazoo College
Michigan Technical University
Oakland University
University of Detroit
University of Michigan
Western Michigan University

MINNESOTA

Augsburg College
Carleton College
College of St. Thomas
Concordia College
St. Johns University
St. Olaf College

MISSISSIPPI

Mississippi College
University of Southern Mississippi

MISSOURI

St. Louis University
Stephens College
University of Missouri
Washington University

NEBRASKA

Concordia Teachers College
Nebraska Wesleyan University

NEVADA

University of Nevada, Reno

NEW HAMPSHIRE

Dartmouth College
Keene State College
St. Anselm's College

NEW JERSEY

Drew University
Fairleigh Dickinson University
Monmouth College
Princeton Theological Seminary
Princeton University
Stevens Institute of Technology

NEW MEXICO

College of Santa Fe

NEW YORK

Alfred University
Bank Street College of Education
Barnard College
Bennett College
Canisius College
Clarkson College of Technology
Colgate University
Columbia University
Cooper Union
Cornell University
Fordham University
Hartwick College
Hobart & William Smith Colleges
Hofstra University
Houghton College
Kirkland College
Le Moyne College
New York University
Pace University
Rensselaer Polytechnic Institute
Rochester Institute of Technology
Rockefeller University
Rosary Hill College
Sarah Lawrence College
Skidmore College
St. John's University
St. Lawrence University
Suny-Buffalo State University
Suny-Albany
Suny-Upstate Medical Center
Syracuse University
Teachers College, Columbia University
Union College
Vassar College
Wagner College
Wells College

NORTH CAROLINA

Bennett College
Campbell College
Davidson College
Duke University
Guilford College
Lenoir Rhyne College
North Carolina State University, Raleigh
St. Andrews Presbyterian College
University of North Carolina, Chapel Hill
Warren Wilson College

NORTH DAKOTA

University of North Dakota

OHIO

Baldwin-Wallace College
Bowling Green State University
Capital University
Case Western Reserve University
College of Wooster
Denison University
Heidelberg College
John Carroll University
Kent State University
Kenyon College
Marietta College
Miami University
Oberlin College
Ohio Northern University
Ohio State University
Ohio Wesleyan University
University of Akron
University of Cincinnati
University of Dayton
University of Toledo
Wilberforce University
Wittenberg University
Xavier University

OKLAHOMA

University of Tulsa

OREGON

Lewis & Clark College
Oregon State University
Reed Institute

PENNSYLVANIA

Albright College
Allegheny College
Carnegie-Mellon University
Chatham College
Dickinson College
Franklin & Marshall College
Geneva College
Gettysburg College
Juniata College
Lafayette College
Lehigh University
Moravian College
Susquehanna University
Swarthmore College
Valley Forge Military Academy & Junior College
Villanova University
Westminster College
Wilkes College

RHODE ISLAND

Brown University
Providence College
Rhode Island School of Design
University of Rhode Island

SOUTH CAROLINA

Clemson University
Converse College
Erskine College
Furman University
Newberry College
Presbyterian College
Wofford College

SOUTH DAKOTA

Augustana College

TENNESSEE

Carson-Newman College
Fisk University
University of Tennessee
Union University
University of the South
Vanderbilt University

TEXAS

Abilene Christian College
Baylor College of Medicine
Baylor University
Howard Payne College
Huston-Tillotson College
Rice University
St. Mary's University
Texas Christian University
Trinity University
University of Houston

VERMONT

Bennington College
Middlebury College
Norwich University

VIRGINIA

College of William & Mary
Emory & Henry College
Ferrum College
Old Dominion University
Roanoke College
Sweet Briar College
University of Richmond
University of Virginia
Virginia Military Institute
Virginia Polytechnic Institute
Virginia Union University

WASHINGTON

Gonzaga University
Seattle University
University of Puget Sound
Walla Walla College
Washington State University
Whitman College

WEST VIRGINIA

Davis & Elkins College

WISCONSIN

Beloit College
Carroll College
Concordia College
Marquette University
Medical College of Wisconsin
Milwaukee School of Engineering

WYOMING

University of Wyoming

APPENDIX B—SURVEY QUESTIONNAIRE

Please return one completed copy of the inquiry form to the
AMERICAN COUNCIL ON EDUCATION
1 Dupont Circle
Washington, D.C. 20036

Branches included in the report

____
Name of Institution

____
Address

____
Name of President

____
Name and Title of Reporting Officer

____
Date

Report for latest fiscal year beginning ______________, ending ______________

- PRELIMINARY INFORMATION

1 Classification (check one)

Private University (Ph.D., 3 or more professional schools)
____independent
____church
____church-related

Private Men's College, 4-year
____independent
____church
____church-related

Private Women's College, 4-year
____independent
____church
____church-related

Private Coeducational College, 4 year
____independent
____church
____church-related

Private Professional or Specialized School
____independent
____church
____church-related

Public Institution
____state university
____other state institution
____municipal institution
____Federally supported (i.e. West Point)

Junior College
____independent
____church
____church-related
____public

(DO NOT WRITE IN THIS SPACE)

INST ID NO. SEQUENCE NO.

3 4 5 6 7 8 9 10 11 12 13 14 15 16 NAME OF INST (17-80)

Survey of Patterns of Giving to Higher Education, 1973-74

Sponsored by the American Council on Education

This survey is designed to obtain information supplementary to that reported in the "Survey of Voluntary Support of Education, 1973-74" conducted by the Council for Financial Aid to Education, American Alumni Council-American College Public Relations Association, and the National Association of Independent Schools. The additional information relates to the size and substance of gifts from individuals to higher education in fiscal 1973-74. Thus, the respondent should first refer to the 1973-74 CFAE questionnaire and supply information consistent with that form.

GENERAL INSTRUCTIONS

1. Please *include* as voluntary support to your institution and/or its foundation

- actual cash received and recorded in the form of contributions, gifts and grants,
- additions to endowment made during the year, but *not* income from these additions or from any previously established endowment,
- bequests actually received during the year,
- securities, real estate, or other property, including gifts of art, books, boats etc., to be evaluated at the sum to which support is carried on your books, not the cash income therefrom,
- book value of annuity trusts and unitrusts, life income contracts, and other deferred giving arrangements entered into during the year,
- cash value of life insurance contracts,
- cash payments returned as contributions from salaried staff

2. Please *exclude* from voluntary support

- pledges of financial support from any source made but unpaid during the fiscal year,
- unpaid balances at the close of the fiscal year, on all commitments,
- contributed services of clergy,
- all support from government sources, corporations, religious denominations, foundations, other groups and organizations.

3. Please round figures to the nearest dollar, omit cents

The following part of the questionnaire is designed to obtain further information with regard to bequests and deferred gifts. In sections A & B, below, the figures furnished should agree in total with the sum of the figures reported in Part V, line 2 of the CFAE questionnaire. In section C, the figures should agree in total with Part V, line 3 of the CFAE form.

PART I

A. Source of Bequest	Size	Number of bequests	Dollar total
1. Specific Bequests	Less than $5,000		
	$5,000 or more		
2. Residuary Bequests	Less than $5,000		
	$5,000 or more		
3. Unclassified	Less than $5,000		
	$5,000 or more		
TOTAL			*

B. Nature of Bequest	Size	Number of bequests	Dollar total
1. Cash	Less than $5,000		
	$5,000 or more		
2. Securities	Less than $5,000		
	$5,000 or more		
3. Real Estate	Less than $5,000		
	$5,000 or more		
4. Other property	Less than $5,000		
	$5,000 or more		
TOTAL			*

C. Deferred Gifts	Size	Number of transactions	Dollar total
1. Charitable remainder Annuity Trusts	Less than $5,000		
	$5,000 or more		
2. Charitable remainder Unitrust	Less than $5,000		
	$5,000 or more		
3. Pooled Income Fund Contracts	Less than $5,000		
	$5,000 or more		
4. Other	Less than $5,000		
	$5,000 or more		
TOTAL			**

*This total should agree with the sum of the amounts shown in Part V, line 2 of the 1973-74 report to the CFAE. If it does not, please explain the difference in the space provided on the right.

**This total should agree with the amount shown in Part V, line 3 of the 1973-74 report to the CFAE. If it does not, please explain the difference in the space provided on the right.

SPECIAL INSTRUCTION FOR PART II

The Sources of Voluntary Support for Current Operations Only are to agree with lines 3 and 4 of Part II of the 1973-74 CFAE Report.

1. As to each source of support, report all transactions under $5,000 in columns 1-5 and all transactions of $5,000 or more in columns 6-10. In columns 1-5 and 6-10 show the total dollar value of the number of transactions reported.

2. Add the totals as shown in column 5 (Gifts Under $5,000) to the totals as shown in column 10 (Gifts Over $5,000) and enter in column 11. These totals should agree with the amounts shown in Part II, Column 7, 1973-74 CFAE Report. If it does not, please explain the difference.

3. Donor transactions are as shown by receipts issued by recipient institution, i.e., if one individual makes *three* gifts within the 1973-74 period for which *three* receipts are issued, show *three* donor transactions.

SPECIAL INSTRUCTION FOR PART III

The Sources of Voluntary Support for Capital Purposes Only are to agree with lines 3 and 4 of Part III of the 1973-74 CFAE Report.

1. As to each source of support, report all transactions under $5,000 in columns 1-5 and all transactions of $5,000 or more in columns 6-10. In columns 1-5 and 6-10, show the total dollar value of the number of transactions reported.

2. Add the totals as shown in column 5 (Gifts Under $5,000) to the totals as shown in column 10 (Gifts Over $5,000) and enter in column 11. These totals should agree with the amounts shown in Part III, Column 7, 1973-74 CFAE Report. If it does not, please explain the difference.

3. Donor transactions are as shown by receipts issued by recipient institution, i.e., if one individual makes *three* gifts within the 1973-74 period for which *three* receipts are issued, show *three* donor transactions.

Explanations

UNDER $[illegible].

SOURCES OF VOLUNTARY SUPPORT	NUMBER OF TRANSACTIONS	1 CASH	NUMBER OF TRANSACTIONS	2 SECURITIES	NUMBER OF TRANSACTIONS	3 REAL ESTATE	NUMBER OF TRANSACTIONS	4 OTHER	5 TOTAL COL. 1 THRU 4
1. Alumni. Support from individual alumni, alumni groups (associations, regional clubs, etc.), annual alumni funds, special alumni endowment funds, alumni insurance plans, alumni family groups (i.e., alumni families giving as a unit), and individual alumni, including alumni members of the Governing Board		$		$		$		$	$
2. Other Individuals and/or Families. Support from non-alumni, including non-alumni members of the Governing Board and non-alumni parents.		$		$		$		$	$
									TOTAL $

UNDER $[illegible].

SOURCES OF VOLUNTARY SUPPORT	NUMBER OF TRANSACTIONS	1 CASH	NUMBER OF TRANSACTIONS	2 SECURITIES	NUMBER OF TRANSACTIONS	3 REAL ESTATE	NUMBER OF TRANSACTIONS	4 OTHER	5 TOTAL COL. 1 THRU 4
1. Alumni. Support from individual alumni, alumni groups (associations, regional clubs, etc.), annual alumni funds, special alumni endowment funds, alumni insurance plans, alumni family groups (i.e., alumni families giving as a unit), and individual alumni, including alumni members of the Governing Board		$		$		$		$	$
2. Other Individuals and/or Families. Support from non-alumni, including non-alumni members of the Governing Board and non-alumni parents.		$		$		$		$	$
									TOTAL $

PART II
SUPPORT FOR CURRENT OPERATIONS ONLY

OVER $5,000.									
NUMBER OF TRANSACTIONS	6 CASH	NUMBER OF TRANSACTIONS	7 SECURITIES	NUMBER OF TRANSACTIONS	8 REAL ESTATE	NUMBER OF TRANSACTIONS	9 OTHER	10 TOTAL COL. 6 THRU 9	11 TOTAL SUPPORT FOR CURRENT OPERATIONS COL. 5 PLUS 10
______	$______	______	$______	______	$______	______	$______	$______	$______
______	$______	______	$______	______	$______	______	$______	$______	$______
								TOTAL $	GRAND TOTAL $

PART III
SUPPORT FOR CAPITAL PURPOSES ONLY

OVER $5,000.									
NUMBER OF TRANSACTIONS	6 CASH	NUMBER OF TRANSACTIONS	7 SECURITIES	NUMBER OF TRANSACTIONS	8 REAL ESTATE	NUMBER OF TRANSACTIONS	9 OTHER	10 TOTAL COL. 6 THRU 9	11 TOTAL SUPPORT FOR CURRENT OPERATIONS COL. 5 PLUS 10
______	$______	______	$______	______	$______	______	$______	$______	$______
______	$______	______	$______	______	$______	______	$______	$______	$______
								TOTAL $	GRAND TOTAL $

STATEMENT OF DR. EDWARD J. BOLING, PRESIDENT, UNIVERSITY OF TENNESSEE

I am Edward J. Boling, President of the University of Tenessee and a member of the Committee on Taxation of the American Council on Education. I am submitting written views in lieu of a personal appearance before this distinguished committee. Professor Julian Levi of the University of Chicago and chairman of the American Council on Education's Committee of Taxation will appear before you on behalf of America's colleges and universities and its privately supported elementary and secondary schools. You will also receive a consolidated statement representing the views of that group. I have reviewed that statement, and we at the University of Tennessee wholeheartedly concur with the views presented. Therefore, in this brief statement, I shall confine my views to the importance of private giving to public institutions and more specifically to the University of Tennessee, a publicly assisted state University-system composed of five major campuses.

While the University of Tennessee is a publicly aided institution, for the past several years, less than 40.0 percent of our operating budget has been provided from state tax dollars. Moreover, our current state budgetary situation is more critical than it has been at any time since I first became a university administrator. For example, in this current fiscal year, faculty and staff annual salary increases have been limited by the state legislature to 2.5 percent. Currently, we are unable to replace a number of vacant positions due to a lack of funds. This lack of state appropriated funds coupled with unusual cost escalation due to inflation makes it difficult, if not impossible, for us to continue to provide quality programs of higher education and public service without additional sources of revenue. Therefore, private giving is essential to the University of Tennessee. This has always been true for private institutions. However, as we have noted, we foresee private contributions as becoming even more essential in the future not only to private institutions but also to public universities such as ours, if we are to continue to build and maintain high quality programs.

Specifically, charitable gifts from private sources to the University of Tennessee have accounted for over 4.0 percent of our total annual operating budget for the past four years. These funds come both from donors who contribute from $5 to $1,000 on an annual basis as well as those who make less frequent, but much larger gifts of sometimes more than one million dollars. While we believe people give because they are charitably motivated. We know from our experience in fund-raising and development work that they also can and do give more because of tax incentives. Therefore, we submit that <u>any</u> changes in current tax laws that would limit the tax incentives to charitable giving would severely decrease this important source of funds and thereby reduce or limit our overall effectiveness. Both lifetime and testamentary gifts would be adversely affected by further reducing incentives and imposing further limitations on charitable giving.

Virtually every university, whether public or private, can cite a number of significant gifts of an entire estate or a substantial portion of an estate. A large portion of our total private support comes in the form of bequests. As President and former Chief Development Officer for the University of Tennessee, I have had the pleasure of accepting a number of such gifts. For example, in October of 1972 I had the honor of announcing a 1.6 million dollar bequest from the Cecil M. Gooch estate. The purpose of the bequest was to establish a scholarship endowment fund for the benefit of undergraduate students attending the University of Tennessee at Martin and for medical students attending the University of Tennessee Center for the Health Sciences in Memphis. The University of Tennessee was not the only charitable beneficiary of this donor's will. In fact, more than 70.0 percent of the decedent's estate was given to charity. Both Mr. and Mrs. Gooch had a long established record of lifetime giving as well. Under our current estate tax laws, the entire 70.0 percent of this estate was deductible as a charitable contribution deduction. What this means to the University of Tennessee is that deserving and qualified students who might not otherwise achieve the goal of a college education would be afforded that opportunity.

How would taxation of appreciated property at death, or a limitation on charitable deductions as currently proposed by some, affect such gifts? We submit that one such proposal, an imposition of a tax on unrealized appreciation at death without an exception for property passing to charity would clearly impose a burden which taxpayers such as Mr. Gooch, though charitably motivated, would have to take into account in planning for charitable bequests. Also, any limitation ceiling on charitable deductions for estate tax purposes, which has been proposed, would obviously substantially reduce these types of gifts. Even assuming such gifts would be made, the total amount would still be substantially reduced. Thus, in effect, the tax burden would be borne by the charitable beneficiary.

Other examples include a recent bequest in a charitable unitrust of 70 percent of the late U.S. Senator Herbert S. Walters estate. The estate has been valued at substantially over a million dollars. We have also recently received a copy of the will of a prominent New Jersey attorney and alumnus which leaves his entire estate to the University of Tennessee. This estate also is expected to be substantially more than a million dollars. This gentleman, recognizing the importance of hard work in achieving educational goals as a result of having worked to put himself through school, directs that his bequest be used primarily for the purpose of educational loans to students who might not otherwise qualify for financial aid.

Student aid is not the only purpose for which both testamentary and lifetime gifts have been made to the University of Tennessee. We have received major gifts for almost every program and activity in which we are involved. For example, one program of the University which has now achieved a national reputation is our theatre program. This has been achieved as a direct result of gifts totaling over a half million dollars from former MGM movie director Clarence L. Brown. We now have a theatre facility which is unexcelled by any institution in the country. Earlier this year our theatre and its excellent staff including Mr. Anthony Quayle, world renowed actor, presented a premiere performance of RIP VAN WINKLE at the Kennedy Center in Washington, D.C. The early success of this program led to unprecedented National Endowment for the Arts grants to the University totaling more than $100,000. These grants coupled with matching private dollars have helped to establish the first professional touring theatre company from a public university in the United States. This might have been expected from some of our more prestigious private universities, but we consider this an outstanding and major achievement for a southern publicly aided university. All this was made possible by private giving.

The University of Tennessee receives many other gifts which enables us to add "dimensions of excellence" to our programs throughout our system beyond what our operating budget would normally permit. Some of those received in recent years include:

1. A $500,000 bequest from the estate of Mr. Fred Mason Roddy. The purpose of the bequest was to establish an endowment fund "to provide scholarships for worthy students of high scholarship and character and for such other purposes as the Trustees of the University may deem essential to the University's development." The income from Mr. Roddy's bequest each year provides approximately 150 scholarships to students in all colleges of the University of Tennessee at Knoxville. Any student on the Knoxville campus may qualify depending upon financial need.

In addition to Mr. Roddy's bequest, as a result of their association with the University of Tennessee in administering the trust, the Roddy Trustees have themselves made generous gifts which provide additional scholarships.

2. Another of the University's most generous benefactors, Mr. Clayton Arnold, a retired rural mail carrier, has given the University more than a million dollars in appreciated securities to establish charitable remainder unitrusts. We currently receive 10.0 percent of the income from the trust which provides 23 scholarships per year from prospective teachers. After Mr. Arnold's death, the entire income from the trust is expected to provide such scholarships for 153 students per year.

3. A gift of $750,000 in appreciated securities from William B. Stokely, Jr., has made possible the Stokely Athletics Center, a much needed athletic facility. Since Mr. Stokely's death in 1966, a private foundation bearing his name has given more than a million dollars to the University in support of academic programs making possible among other things the first endowed chair at the University, the Stokely Chair of Management in the College of Business Administration.

4. Another donor, Mrs. Charles B. Stout, gave $250.000 in honor of her late husband to establish the laboratory for neuroscience at the University of Tennessee Center for the Health Sciences.

5. An additional gift which will perhaps best illustrate the urgency of our statement is a gift of farm real estate to the University. The farmer donor was of retirement age and unable to continue a farming operation. While he was interested in doing something for the benefit of higher education, the donor also

felt he needed additional income. However, his current income was down substantially due to his inability to continue to manage the operation. After the charitable remainder unitrust was explained he decided to give the property, appraised at over $400,000, to the University to establish a unitrust, the remainder going to the University's Institute of Agriculture to esablish an endowment fund which would provide scholarships and professorships in Agriculture. Donors of this type of gift would not likely be motivated nor in a position to make such a gift if the tax incentives were not available or limited.

We are currently working with a potential donor who is capable of and hopefully motivated to give the University over a million dollars in a combined gift of cash and appreciated property. Needless to say, any additional or alternate tax imposed on charitable gifts would likely result in a substantial reduction of such gifts. We submit that the minimum taxable income proposal (MTI), along with other proposals before this committee would have a direct and adverse effect on private support of public educational institutions such as ours. Gifts of appreciated property are a major source of private support for our institution. Therefore, subjecting such gifts to further limitations and uncertainties of MTI or otherwise changing the present rules with respect to gifts of appreciated property would have a most far-reaching detrimental effect on the University of Tennessee.

We respectfully submit that any proposals establishing ceilings or limitations on charitable deductions or any combination of such of the proposals before you, if enacted, would drastically decrease if not destroy the critically important source of private support for public and private educational institutions, all of which perform many functions for which the state or federal government would otherwise have to assume financial responsibility. Every deductible dollar that is paid to charity is devoted to public purposes. In the case of colleges and universities, such transfers of funds may be used for programs and activities which benefit the public, but which public funds would not fund. Any change in the estate tax laws which reduces the funds available for charity will result in diminishing the private sectors ability to sustain eleemosynary institutions.

We strongly support the American Law Institutes position related in its federal estate and gift tax recommendations adopted at Washington, D.C. May 23–24, 1968, and as again submitted in a paper to the House Ways and Means Committee in 1973. The recommendations stated the general proposition that "the 100 percent charitable deduction in the field of transfer taxation should be retained either under a dual tax system or a unified system." Therefore, we respectfully urge that this committee give serious consideration to allow current law to remain unchanged; but if changes are made that no limitations be imposed that would further reduce the tax incentives to charitably motivated people. Otherwise, a loss of this major source of support to institutions such as ours could mean the difference between mediocrity and greatness. A removal of tax incentives to charitable giving would be a stragic loss to this institution, as well as to colleges, schools, hospitals and other charitable organizations throughout our country.

The CHAIRMAN. Next we will call Mr. Robert Goheen, chairman of the Council on Foundations.

STATEMENT OF ROBERT F. GOHEEN, CHAIRMAN, COUNCIL ON FOUNDATIONS, INC.

Mr. GOHEEN. My name is Robert F. Goheen. It is a pleasure to be able to testify today on behalf of the Council on Foundations.

Thanks to hearings conducted over recent years by your Subcommittee on Foundations under Senator Hartke's chairmanship this committee has a considerable record on foundations; so, my testimony will be very brief.

I wish to urge the two specific changes in the 1969 private foundation legislation represented in the two bills Senator Curtis has introduced at this hearing. But, first, I wish to make three general points that speak to the good sense and the propriety of these changes.

First, as independent sources of funding and initiative, foundations contribute to the strength and flexibility of America's many voluntary not-for-profit service organizations. The testimony prepared by Governor Sanford and delivered for him by Mr. Haslam this morning gives eloquent witness to that fact. Other varied illustrations are in my written testimony, so, I shall pass by illustrations, but only say that in many, many cases—both in local situations and in facing broad national needs—foundations today provide the other door on which to knock, without which many voluntary activities could not be initiated and others could not be sustained.

Foundations, of course, are not immune to criticism, but their overall record, I submit, is a good one. Apparently the general public shares that view. A Gallup Survey conducted last month shows a high level, 65 percent, of opinion favorable to foundations with only 9 percent expressing negative views.

I would be glad to make a summary of that Gallup Survey available for the record should the committee wish it.[1]

My second general point is that current law very specifically requires private foundations to operate in the public interest. The foundation rules of the 1969 Tax Reform Act prevent the use of assets for personal benefit, preclude prolonged retention of closely held business interest, regulate investments, prohibit partisan political activity, compel substantial and continuing distributions for charitable activities, and require detailed annual reports to IRS, State authorities and the public. In no other category of charitable organizations is there such thorough regulation to insure commitment of resources to bona fide charitable purposes.

My third general point is that the post-1969 record of foundation compliance with these regulatory provisions is excellent. The IRS has recently completed a 5-year audit program unprecedented in scope in which every private foundation was audited at least once and many of them more than once.

Based on this close inspection, both Commissioner Alexander and Assistant Commissioner Lurie have recently praised foundation compliance. The Assistant Commissioner's word was "superb".

Given, then, the record of usefulness, the regulatory framework, and the record of compliance, it is now more than ever proper to recognize and to treat foundations as valid and respectable philanthropic enterprises. Indeed, what is needed now is attention to the continuation of their capacity to make important commitments to the advancement of education, science, culture and other critical aspects of the public welfare. It is for such purposes that we advocate the changes mentioned earlier.

Specifically, we urge the committee to approve S. 2349 introduced by Senator Hartke and cosponsored by a number of other members of this committee. This bill would reduce the 4-percent excise tax on the net investment income of private foundations to 2 percent.

As you know, the revenue raised by the current tax is far in excess of what is required for effective auditing and supervision of foundations. In fiscal 1975 the tax collected more than $56 million above what IRS expended to audit foundations.

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[1] This summary was made a part of the official files of the committee.

As has already been noted, year by year this excess collection is a direct loss to the colleges, hospitals, welfare organizations, and other service agencies to whom foundations would have otherwise had to direct these sums.

We equally urge approval of S. 2475 introduced by Senator Curtis with a number of cosponsors. This bill, as he has said, would set the payout requirements as a percentage of assets—that is, the MIR—at 5 percent. As you will remember, this bill represents the position which this committee took in 1969. It is the position recommended by the Treasury both in 1969 and again just a few months ago.

A 5 percent of assets rate is in line with the long-term experience of funds broadly invested in American capital markets, a fact now established by a number of economic studies. A recent one by Prof. J. Peter Williamson of Dartmouth is attached to my written testimony.[2] The evidence that Williamson has marshaled makes clear that any MIR requirement in excess of 5 percent will necessitate recurring invasions of the foundation principal greater than can be expected to be made up through capital appreciation.

So, in order to prevent a progressive forced reduction in the capacity of foundations to support the work of educational, medical, and other charitable organizations, a reduction of the MIR requirement to 5 percent is of high importance.

I would like finally now, if I may, to say a few words about charitable giving in relation to minimum income tax proposals and to gift and estate taxes. I understand that these subjects will be coming before the committee, if indeed, they have not already done so.

First, with respect to minimum tax proposals, we share the view that no one should be able completely to avoid income tax liability through a combination of tax preferences. We urge, however, that that objective be pursued in ways that will not discourage the large gifts on which so many educational and other charitable organizations depend.

With respect to estate taxes, the evidence is that the disincentives enacted in the income tax in 1969 have substantially deterred the flow of new money to foundations, so that the field is now more than ever dependent on bequests for sources of new funds.

Confirmation of this fact emerged in a study of 1973 data, drawn from IRS records which is reported in my written testimony. Briefly, it shows that 30 out of the 36 largest gifts made to private foundations in 1973 were testimentary, and 90 percent of the dollars in these gifts were testimentary rather than of an *inter vivos* nature.

As previous witnesses have indicated, Professor Levi particularly, studies done for the Filer Commission have demonstrated that charitable deductions for estates are efficient in the sense that they increase funds committed to charitable purposes more than they reduce taxes. In addition, these deductions help to disperse wealth more widely than would be the case were these deductions not operative.

On the ground, then, first, of the significance of charitable contributions to all charitable organizations including foundations, and, second, of the efficiency of the charitable deductions in our tax system in stimulating such giving, we believe not to be in the public interest

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[2] See p. 2190.

changes in the deduction rules which would materially discourage or impair the flow of funds to the Nation's voluntary, not-for-profit organizations.

Thank you for the opportunity to express these views.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. I have read all of the statements that were to be presented today. Through all of them runs the thread that most of these come from very large donors. Is it a fair statement to say that anything we might do to limit their tax preference is going to have some adverse effect on charity?

Mr. GOHEEN. I don't think that I understand the import of your phrase "anything you might do."

Senator PACKWOOD. The less loose change they have, the less likely they are to give?

Mr. GOHEEN. That's right.

Senator PACKWOOD. And these changes that were proposed on the floor of the Senate are going to limit the amount of loose change they will have, and in some cases the corporations.

Mr. GOHEEN. If people don't have money, they can't give it away. That is certain.

Senator PACKWOOD. I don't think I have any other questions Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Why is the 4-percent tax on foundations income really a tax on the beneficiaries?

Mr. GOHEEN. The way the statute is written, money paid into the tax is a credit against the required distribution, so that any dollar taken out of the tax is a dollar added to the required distribution. If you do not pay it to the Federal Government, it would have to go to the University of Nebraska and places of that sort.

Senator CURTIS. And also the foundation has less money to give, totally disregarding the mandatory payout?

Mr. GOHEEN. That is true. But if you believe, as I do, that a primary function of foundations is to help the many voluntary agencies function well, it is the damage to those agencies that is more important.

Senator CURTIS. Do you agree that a private foundation cannot accumulate income except for the fact that IRS approve in advance?

Mr. GOHEEN. We support your bill.

Senator CURTIS. Neither the existing law nor this bill or the both of them, rather, provide private foundations cannot accumulate income except to the extent the IRS gives them——

Mr. GOHEEN. Certain set-aside provisions. Yes, it is impossible for a foundation to aggrandize its wealth with a 5-percent payout.

The CHAIRMAN. Senator Hartke?

Senator HARTKE. I have introduced a bill reducing it from 4 to 2 percent. At the present time that so-called auditing fee goes into the general treasury and then the ultimate decision when they cut the budget, they go back and cut the auditing out. Would there be any advantage in going ahead and providing that whatever the audit fee is that it be specifically earmarked by Treasury for the auditing of foundations only?

Mr. GOHEEN. May I make a two-part answer to that?

As you know, Senator Hartke, in an ideal situation we would much prefer that the tax be redesignated as an auditing fee and scaled to the real costs of auditing rather than to a fixed percentage. We don't live in an ideal world, however, and we are happy to endorse your bill fully.

On the other part of your question, I understand that many of the people who know much more about Federal taxation than I do are very leery of the notion of earmarking taxes. Personally, I am not in a position to say whether that is good or not.

Senator HARTKE. Let me ask you one other thing. Don't we find ourselves in sort of a contradictory position, when we say that we propose to lower the requirements on the tax and at the same time, you say we will give more money to charity, make more money available to charity; on the other hand to lower the payout requirement, which would give less money to charity?

Mr. GOHEEN. It is only contradictory in the sense that we are talking about two different timeframes. The lowering of the tax means immediate benefit to the public charities, and the lowering of the payout means a greater sustained benefit to them. The latter is so because if you keep the payout requirements up at 6 percent—and as you know, it can rise even higher than that in the way it is currently set—that means that year by year the ability of foundations to support educational and other charitable activities is going to be eroding and declining.

We can't believe—and I am sure my academic and other colleagues here today can't believe—that the needs of the voluntary, not-for-profit sector are going to be any less 10 years hence than they are today.

Senator HARTKE. That is all I have.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Mr. Goheen, it seemed to me in 1969 that some of the foundations were abusing the tax privilege or tax-exempt status that they had and felt for one that it was necessary that something be done about that. I gather you feel that law went too far. You don't feel that it should be totally repealed, I assume—what was done in 1969?

Mr. GOHEEN. I came into the foundation field after 1969, in 1972. Looking around and looking back, I am quite convinced that many of the 1969 tax provisions for foundations were necessary and that they have done good. I agree with what Governor Terry Sanford has said ~~about this~~ in his written testimony. We do think that there are, however, a number of places where the provisions are excessively tight or even a bit punitive, as you suggested earlier.

The two most critical of these provisions with respect to the ability of foundations to help support the voluntary private sector are the matter of the tax and the matter of the payout level. It is those two that we urge need remedy now.

Senator BYRD. What should the payout be?

Mr. GOHEEN. A 5-percent rate of payout gives a foundation, which has good financial management, a fair chance over a period of years to keep its purchasing power up, to keep up with inflation. In my written testimony we have cited and provided economic studies to document that fact. It won't happen year by year. Some years they will be behind and other years ahead, depending on the state of the economy and the flow of inflation; but over the years it should average out. So, we think that the 5-percent requirement is a reasonable one. It is not an easy requirement, and many foundations will have a hard time meeting it until they develop well balanced portfolios and skilled management.

Senator BYRD. You feel it is not unreasonable to ask 5 percent?

Mr. GOHEEN. No, sir; I do not.

Senator BYRD. Thank you.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Goheen and attachment follow. Oral testimony continues on p. 2194.]

STATEMENT OF ROBERT F. GOHEEN, CHAIRMAN, COUNCIL ON FOUNDATIONS, INC.

SUMMARY

1. Foundations are useful elements of our society as independent points of initiative and funding that contribute to the flexibility and strength of America's many voluntary (not-for-profit) service agencies and institutions.

2. Under the Tax Reform Act of 1969, foundations have to function within a carefully worked-out set of regulations designed to assure their entire dedication to charitable purposes. (These rules prevent the use of foundation assets for personal benefit, preclude prolonged retention of interests in closely-held businesses, regulate investments, prohibit partisan political activity and lobbying for legislation, compel substantial annual expenditures for charitable activities, and require full annual reports to IRS, State authorities and the public.)

3. The post-1969 record of foundation compliance with these regulatory provisions is excellent—a fact recently confirmed by the Commissioner of Internal Revenue and the Assistant Commissioner for Employee Plans and Exempt Organizations. Therefore it is more than ever now right and proper to recognize and treat the private foundations as well behaved and useful philanthropic enterprises.

4. Several provisions of the 1969 Tax Reform Act have proved overly restrictive and damaging to philanthropy. Here, the Council wishes to emphasize and seek relief for foundations on just two provisions—namely, the level of the required annual payout and the 4% excise tax on net investment income. We are gratified that members of this Committee have introduced bills, which we can strongly support, to make the appropriate changes. In particular we urge:

(a) Approval of S.2348, introduced by Senator Hartke (with Senators Bentsen, Curtis, Fannin, Hansen, Mondale and Roth as co-sponsors) that would lower the excise tax on net investment income of private foundations to 2%. The revenue raised by the current 4% rate is far in excess of what is required for IRS auditing of foundations, and that difference represents a serious loss to the colleges, hospitals, and other charitable organizations to whom these sums would otherwise have to be distributed.

(b) Approval of S.2475, introduced by Senator Curtis (with Senators Mansfield, Scott, Bartlett, Fannin, Fong, Hansen, Hruska, Taft, Thurmond, and possibly others as co-sponsors) to set the required annual payout as a percentage of assets at a flat 5%. The 5% rate would be more in line with the long-term record of returns on funds broadly invested in American capital markets, and it was the figure proposed by this Committee in 1969.

5. We understand that the Committee may be considering proposals affecting charitable giving in the areas of the minimum income tax and of estate taxes. We submit,

(a) that no changes should be made in either of these areas that would adersely affect charitable giving, and

(b) that with respect both to the minimum tax and to estate taxes, the self-dealing and other restrictions imposed on private foundations by the 1969 Tax Reform Act remove any possible grounds for treating giving to private foundations differently than giving to other charitable organizations.

STATEMENT

1. Introduction

Mr. Chairman, members of the Committee, my name is Robert F. Goheen and I represent the Council on Foundations, Inc., an association of more than 780 grant-making organizations. Among them are some 635 independent and company foundations, classified for the most part as private foundations, and also some 125 community foundations, organizations that almost without exception qualify or expect to qualify for public charity status.

I appreciate the opportunity to appear before this Committee on tax revision matters affecting charitable organizations and charitable giving. In view of the very considerable testimony on foundations under the Tax Reform Act of 1969, assembled by your Subcommittee on Foundations under Senator Hartke's chairmanship, my testimony will be concise.

I intend to make three general points about foundations which, I believe, establish their importance and the propriety of treating them as fully useful philanthropic citizens. Then I shall recommend two specific changes in the 1969 legislation which would enable foundations to carry out their charitable mandate more fully and more consistently than is now possible, with resultant gains—long term as well as short term—for the country's educational, scientific, cultural, social welfare, and other not-for-profit service institutions and agencies. Finally, I wish to speak briefly to proposals in the areas of the minimum tax and of estate and gift taxes which would be injurious to foundations as well as to other charitable organizations.

2. Foundations are useful elements in our society as independent points of initiative and funding that contribute flexibility and strength in the operation of America's many voluntary (not-for-profit) service institutions

Thanks in some measure to continuing Congressional attention given to foundations and philanthropy, but also to the ongoing work of The Foundation Center, the American Association of Fund Raising Counsel, and the recent special efforts of The Commission on Private Philanthropy and Public Needs, the size and shape of the foundation community are now reasonably well documented. The basic data: there are an estimated 26,000 grant-making foundations with current total resources in the range of $27 to $30 billion, contributing about $21,110,000,000 annually to the public charitable purposes enumerated in Code section 501 (c)(3). By fields of interest, education and health are considerably the largest beneficiaries of foundation grants, the two fields together having drawn between 55% and 60% of foundation giving in recent years.

The significance of foundaiton resources, however, lies much less in their magnitude than in the capacities foundations can develop—usually in concert with recipient agencies—to direct limited assets toward beneficial results and to accomplish things that otherwise might not be accomplished, or accomplished as well, or as soon. For more extended discussion of what it is that foundations do, how they do it, and what they accomplish, I would refer the Committee to the study by myself and the staff of the Council on Foundations for The Commission on Private Philanthropy and Public Needs (The Filer Commission).[1] Chapter IV of that study is devoted to foundation endeavors and accomplishments and contains citations to other sources. I will only briefly summarize those observations here.

Past achievements where foundation support played a significant role include such examples as—

—developing municipally supported public libraries throughout the country.

—bringing to maturity and quality a system of medical education for the United States and Canada.

—creating the "Green Revolution" through development of high-yielding disease-resistant grains.

—freeing the country of hookworm.

—reducing greatly such world scourges as malaria, yellow fever, typhus, influenza, rabies, yaws, bilharziasis, syphilis, tuberculosis, and amoebic dysentery.

—building the research base leading to our current knowledge of DNA, termed by some "the single most significant advance in biology of the twentieth century."

[1] "Revised Report and Recommendations to the Commission on Private Philanthropy and Public Needs on Private Philanthropic Foundations" prepared by the Council on Foundations, Inc., 20 August, 1975.

—supporting the American Law Institute, and funding its project such as the writing of the Uniform Commercial Code, which for more than two decades has governed most commercial transactions in this Nation.

I do not mean to infer that all grants have such great impact on our national life. Most grants do useful things at the local or regional level, and vary in size from many millions of dollars to only a few thousand dollars. I shall take only a moment to cite a few recent examples—

—The Robert Wood Johnson Foundation spearheaded $75 million in grants to community hospitals throughout the country to develop group medical practices, making available around-the-clock medical care.

—In Indianapolis, Indiana, The Lilly Endowment alongside many large grants gave $13,000 to a group to provide home meals for retired or disabled persons not adequately served by public welfare programs.

—The Carnegie Corporation made a grant of $369,000 to an organization concerned with the administration of small colleges, to assist over a thousand small colleges throughout the country in administrative planning and management.

—The Kresge Foundation granted $185,000 to Louisiana State University to purchase a laboratory computer system and The Scheidler Educational Foundation gave $18,000 to LSU to study factors contributing to Sickle Cell Anemia.

—The Northwest Area Foundation in Minnesota granted $187,000 to Sheldon Jackson College in Sitka, Alaska to develop an applied fishery science program for native Alaskans.

—The Campbell Foundation in Georgia granted $150,000 to the Northeast Georgia Council of the Boy Scouts of America toward construction and furnishing of a dining hall facility at Rainy Mountain Scout Reservation.

—The Kellogg Foundation made a grant of over $900,000 to the University of Washington Medical Center to support that Center's program of residencies in family medicine.

The key role of foundations in public television is documented in hearings on this topic held by the Subcommittee on Foundations of the Committee on Finance in September of 1974.[8] In sum, that case history supports the view that the aid given by foundations, because of its timeliness and experimental character, was critical in the development of the medium both locally and nationally.

By far the largest number of foundations concentrate their attention in local communities. In the Council's study for The Filer Commission and in other studies done for The Commission, there are examples and case histories describing foundation work and how different elements in the community interrelate in working towards achieving local goals in communities like Atlanta, Boston, Cleveland, Des Moines, Hartford, San Francisco and Spokane.

An example we gave of foundation activity in relation to government was foundation contributions to the start-up costs for the Institute of Medicine, a new unit of the National Academy of Sciences, serving as a source of information to help the government allocate public funds available for the delivery of health care. There are numerous other illustrations.

Foundation funds, then, help make possible many useful public services that would in most cases otherwise have to be provided by tax monies, if at all. They offer "the other door on which to knock," without which many voluntary (not-for-profit) activities would not be initiated and others could not be continued. They facilitate the testing of alternative solutions. They interrelate with, assist, and supplement the broad range of agencies, institutions and systems, private and public alike, through which our society addresses its needs.

In sum, the affirmative contributions foundations have made—and will continue to make—are part of the public record and have been evidenced through research and investigations by Congressional Committees, The Filer Commission, and others.[8] As this Committee knows, foundations have never been and never

[8] "Role of Private Foundations in Public Broadcasting". Hearings before the Subcommittee on Foundations of the Committee on Finance, United States Senate, Ninety-Third Congress, Second Session, September 9–10, 1974.

[8a] "Private Foundations." Hearings before the Subcommittee on Foundations of the Committee on Finance, United States Senate, Ninety-Third Congress, First Session on the Role of Private Foundations in Today's Society and a Review of the Impact of Charitable Provisions of the Tax Reform Act of 1969 on the Support and Operation of Private Foundations, October 1–2, 1973.

[8b] "Private Foundations". Hearings before the Subcommittee on Foundations of the Committee on Finance, United States Senate, Ninety-Third Congress. Second Session, May 13, 14 and June 3, 1974.

[8c] "General Tax Reform". Public Hearings before the Committee on Ways and Means,

will be immune from criticism; but overall their record is, I submit, a good one. The general public appears to share this opinion. A survey by the Gallup organization conducted last month showed 65% expressing attitudes favorable to private foundations and only 9% negative. Under appropriate legislative safeguards, such as now exist, there is, then, both justification and need to encourage and support the contributions foundations can make.

3. Current law requires private foundations to operate in the public interest

Private foundations have been the subject of careful legislative scrutiny going back at least to the early 1960's. They were thoroughly reviewed in the 1965 Treasury Report and in the course of the hearings that led to the enactment of the foundation provisions of the Tax Reform Act of 1969. As a result of these efforts, private foundations are now subject to a great number of restrictions and rules, carefully designed by Congress to do away with the problems that were the subject of Congressional attention. Apart from the 4% excise tax based on investment income that private foundations must pay, these rules—

—prevent the use of foundation assets for personal benefit by regulating dealings between a foundation and those who manage, control or make large gifts to it.
—compel substantial annual distributions in support of charitable activities.
—place limitations on and preclude prolonged retention of substantial business interests.
—regulate foundation investments.
—bar lobbying and partisan political activity.
—require foundations carefully to monitor and account for grants to individuals and to donees that are not public charities.
—require full annual reports by foundations to the IRS, to state authorities and to the public on foundation assets, earnings, grants, administrative costs and other matters.

No other form of charity is so thoroughly regulated to insure the commitment of resources to *bona fide* charitable purposes. These rules and regulations assure that wealth placed in a foundation is wealth dedicated to charity and wealth that cannot be used for personal rather than public purposes.

4. Internal Revenue Service officials have recently confirmed that foundation compliance with these rules is excellent

Immediately following enactment of the Tax Reform Act of 1969, private foundations became the subject of an extensive IRS audit program unprecedented in its scope. Under this program, every organization classified as a private foundation was audited at least once over a five-year period; many were audited more frequently.

In a recent speech to the National Council on Philanthropy, Commissioner of Internal Revenue Donald Alexander said that the Service had found foundation compliance with the regulatory features of the 1969 legislation to be nearly complete. The Service accepted about 75% of the foundation returns it audited without change. The great bulk of the changes made involved only the allocation of costs in determining the 4% tax. Non-compliance with the regulatory measures appears to have been marginal at most. This conclusion is reinforced by the fact that of the more than $290,000,000 private foundations paid in taxes through June 1975, slightly better than 99.5% is attributable to the 4% tax; less than one-half of one percent is attributable to the penalty taxes.

Assistant Commissioner Alvin D. Lurie has also stated that private foundation compliance has been excellent. At a meeting of the Southeastern Council of Foundations in November 1975, Mr. Lurie commented that the five-year audit commitment was designed to place a microscope on the private foundation community. The assessment of the results by IRS was that compliance by private foundations was "superb."

The available evidence demonstrates, then, that the rules and restrictions imposed by the 1969 Tax Reform Act are working and working very well. In these circumstances, there is every reason to treat private foundations as useful and respectable philanthropic citizens. What is required is encouragement for a full,

House of Representatives, Ninety-Third Congress, First Session on the Subject of General Tax Reform, Part 4 of 18, March 14–16, 1973.

[36] "Tax Exempt Foundations and Charitable Trusts". Hearings before the Subcommittee on Domestic Finance of the Committee on Banking and Currency, House of Representatives, Ninety-Third Congress, First Session on Tax Exempt Foundations and Charitable Trusts: Their Compliance with the Provisions of the Tax Reform Act of 1969, April 5–6, 1973.

rational, and sustainable commitment of their resources to the advancement of education, science, culture, and other apsects of the public welfare.

To these ends—to strengthen the capacity of foundations to serve their mandated public purposes both today and tomorrow—certain adjustments in the current law are needed. In particular, as indicated earlier, the Subcommittee on Foundations under Senator Hartke's leadership has assembled voluminous testimony concerning the deleterious effects of the current 4% excise tax and of the level and volatility of the current payout requirement as a percentage of assets.[4] Therefore, I shall not belabor these points today, but shall simply offer two recommendations an abbreviated argument for each.

5. We urge that you accept and endorse Senator Hartke's bill S. 2348, co-sponsored by Senators Bentsen, Curtis, Fannin, Hansen, Mondale and Roth. This bill calls for reduction of the 4% excise tax to 2%

This step is in the direction of the position taken by this Committee in 1969. It is backed by a significant Statement issued by your Subcommittee on Foundations October 4, 1974 which outlines the legislative history of the current tax and advocates this change. The Treasury has also repeatedly endorsed it.

The revenue raised by the current 4% tax is far in excess of what is required for effective auditing and supervision of foundations. In FY 1975, for example, the tax collected more than $56 million above what IRS expended to audit foundations. Year by year, this excess is a direct loss to the colleges, hospitals, welfare organizations, and other service agencies to whom foundations would otherwise have to direct these sums. Minuscule in relation to the federal budget, these dollars could make substantial differences to the agencies and institutions to which they otherwise would have to be paid.

(We would also much prefer that the tax be redesignated an auditing fee and tied to the real costs of the IRS supervision of foundations, for to tax tax-exempt institutions seems to us peculiar in principle and a precedent dangerous to other organizations enjoying tax-exemption on the ground that they serve the public interest. We could also argue that realized long term capital gains ought not to be included in the "net investment income" subject to the tax, especially when those gains are taken in order to meet other requirements of the Law.)

The Hartke bill is simple and direct; appears to have strong Congressional support; will, if passed, bring significant benefits to charitable organizations and do so promptly. We endorse it strongly.

6. We equally urge acceptance and endorsement of S. 2475, developed by Senator Curtis, which sets the required annual distribution for private foundations as a percentage of assets (MIR) at a flat 5%, as against the current complicated and volatile formula based on a 6% requirement. At last report, cosponsors included Senators Mansfield, Scott, Bartlett, Fannin, Fong, Hansen, Hruska, Taft, Thurmond, and possibly others

A 5% MIR was the position of this Committee in 1969 and the rate recommended by Treasury at that time. The restoration of that rate, as proposed in the Curtis bill, has recently again been endorsed by Treasury in a letter to Senator Curtis from Assistant Secretary Charles M. Walker, dated December 19, 1975.

The change is sought in order to prevent a progressive, forced reduction in the capacity of foundations to support charitable endeavors. An MIR requirement of 5% of assets is in line with the historic experience of funds broadly invested in American capital markets. A number of studies by distinguished economists in the past few years, covering most of the past century, indicate that well diversified funds, even under the most expert management, have yielded between 4½% and 5% in real total returns, not the 6% and upwards which experience drawn only from the late 1950's and the 1960's seemed to make predictable when the 1969 Tax Reform Act was passed.[5] Those years were, in fact, an extraordinary and relatively brief period in American financial history.

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[4] "Impact of Current Economic Crisis on Foundations and Recipients of Foundation Money". Hearings before the Subcommittee on Foundations of the Committee on Finance, United States Senate, Ninety-Third Congress, Second Session, November 25–26, 1974.

[5] A basic reference is the study of Lawrence Fisher and James H. Lorie, "Rates of Return on Investments in Common Stocks: The Year-By-Year Record, 1926–65." *The Journal of Business of the University of Chicago* (Chicago, Volume 41, Number 3, July 1968). It showed total returns from an unweighted "index" of all New York Stock Exchange stocks from 1926 through 1968 of 1.3% without reinvesting dividends. The rate of inflation was about 2.3% annually for that period. Roughly extrapolating the same data base to the present would bring total returns to less than 5%. A capitalization weighted index (the Standard & Poor's 500 Stock Index) shows real total returns of 4.4% from 1926–1978.

Pulling together the evidence and supporting these contentions is an attachment to this testimony—a study by Professor Peter Williamson of the Tuck School of Business of Dartmouth College, entitled "Reasonable Investment Expectations and the Payout of Private Foundations." I ask that it be accepted as part of the record, and I commend it to your attention. It will, I trust, convince you that if foundations are not to be compelled into recurrent invasions of principal greater than they can reasonably be expected to offset through long-term capital appreciation, an annual payout requirement of over 5% should be avoided.

The second problem in the current MIR perhaps also requires brief comment. It lies in its intent to adjust the requirement to annual changes in money rates and investment yields. Unfortunately, the measurements required by the statute are subject to great fluctuations from year to year. Such volatility in the annual requirement makes it very difficult for foundations to plan ahead in a systematic fashion, or even to know the extent of the forward grant commitments that they can safety make. The setting of a flat 5% annual requirement in the Curtis bill offers an important incentive to sound, forward-looking planning on the part of individual foundations as well as giving them a fair chance to manage and expend their assets in ways that do not necessarily mean a diminishing capacity to do good.

In addition, let me make clear that the Council on Foundations' advocacy of a *substantial* annual payout requirement predates the 1969 Tax Reform Act. A 5% of assets requirement—or all of income, whichever is higher—constitutes, we believe, a very substantial requirement. Under it, no foundation will be able to aggrandize its assets. Current needs of charity will have to be served well. But, if their fiscal management has been good, there is a fair chance that the purchasing power of foundation assets will still be there ten and twenty years hence to serve what we can be sure will be at least equally great and equally pressing educational and other charitable needs.

7. *Protection of charitable giving under any minimum income tax is important to the well-being of many of the county's not-for-profit service institutions*

We understand that the Committee is considering minimum tax proposals intended to assure that no one shall be able completely to avoid payment of income tax through a combination of tax preference. We endorse that objective, but urge that it will be pursued in ways that will not discourage the large gifts on which so many educational and other charitable organizations depend.

8. *The current unlimited estate tax deduction for charitable contributions should be preserved. Suggestions to place special limitations on the deductibility of such gifts to private foundations as against other 501(c)(3) organizations should be resisted as neither justified nor in the public interest*

Studies for The Filer Commission indicate that the current charitable contribution deductions are "efficient" in the sense that they increase funds committed to charitable purposes more than they reduce taxes. Correspondingly, reducing or eliminating the deductions can be expected to reduce charitable giving more than tax revenues will increase.[6] Moreover, by encouraging testators to make charitable bequests, the deduction helps to disperse wealth more widely than would be the case were that incentive not operative.[7]

As for foundations more particularly, the legislation within which they must now work ensures that money bequeathed to foundations is money committed to public, charitable purpose, and hence there is no reason to treat foundations differently from other 501(c)(3) organizations. Moreover, estate tax deductions are the principal if not the only remaining tax incentives for the creation of new foundations and the augmentation of existing ones.

Nicholas Moldowsky's data for 1871–1958 (presented in *Financial Analysts Journal*, 1959), extended into 1974 by applying to them relevant portions of a study by Peter Bernstein of the span from 1901–1973, indicates real total returns from a broader list of stocks over a longer period between 4¼% and 5%. All these figures, clustering in that range, are consistent with Philip Cagan's recent work on real total returns in *Common Stock Values and Inflation—The Historical Record of Many Countries* (National Bureau of Economic Research, Inc., New York, March 1974 Supplement).

[6] Boskin, Michael J., *Estate Taxation and Charitable Bequests*, a paper prepared for the Commission on Private Philanthropy and Public Needs; Feldstein, Martin S., *Charitable Bequests, Estate Taxation and International Wealth Transfers*, a paper prepared for the Commission on Private Philanthropy and Public Needs.

[7] Bittker, Boris I., *Charitable Bequests and the Federal Estate Tax: Proposed Restrictions on Deductibility*, The Seventh Mortimer H. Hess Memorial Lecture, Association of the Bar of the City of New York, December 1975; submitted by Professor Bittker for the record for these hearings.

The birth-rate/death-rate effects of the Tax Reform Act of 1969 on foundations is another subject on which there has already been extensive Congressional testimony,[8] and I shall not repeat it here. Suffice it to say, the net effect has been to deter very substantially the flow of new money to foundations and make the field more than ever dependent on bequests as a source of new funds. Evidence of the importance of bequests to foundations emerges sharply in a study we have recently done using data assembled by The Foundation Center from foundation returns filed with IRS for 1973. Of the 36 largest gifts received by private non-operating foundations (other than corporate foundations) the gifts received were all or substantially all testamentary in 30 cases, and better than 90% of the dollar volume, or more than $210 million of some $230 million, of the gifts to this group were testamentary in character. In other words, private foundations are today largely dependent on testamentary gifts for such new money as still flows to them.

Were such flows to be entirely discouraged, the result of course would be further to restrict and diminish the alternative funding sources that foundations constitute for institutions and agencies seeking funding for new programs and approaches. Agencies in the non-profit service sector seeking to exercise creative choices would be impaired.

Thank you for the opportunity to present these views.

Attachment: J. Peter Williamson, "Investment Expectations and The Foundation Payout Rate."

[From Foundation News, January/February 1976]

WHAT'S REASONABLE? INVESTMENT EXPECTATIONS AND THE FOUNDATION PAYOUT RATE

(By J. Peter Williamson)

One of the consequences of the Tax Reform Act of 1969 is section 4942 of the Internal Revenue Code, which requires that private foundations distribute to charity the greater of their current investment income of their "minimum investment return." Subject to some special cases, the minimum investment return was fixed at 6 percent of year-end market value, with a provision for an annual adjustment of this rate. It was apparently anticipated that this payout requirement would leave private foundations able to maintain the "real" value of their assets and their spending, provided they made an effort to invest their assets productively. That is, it was apparently assumed that these foundations could expect a total return of 6 percent plus the effective inflation rate.

However, some recent analysis indicates that a foundation with a reasonably aggressive and productive investment strategy can probably afford to pay out not more than between 4.5 percent and 5.0 percent of market value, if it is to anticipate that the market value of its funds and market value of its spending will keep pace with inflation in the nation generally. In order to keep pace with the particular rate of inflation that applies to the activities of private foundations (the rate of inflation, for example, in higher education), these foundations should probably be paying out from 3 to 4 percent per year of market value.

The assets of private foundations are invested for the most part in common stocks, fixed-income securities (hereafter referred to as bonds) and money market instruments including treasury bills, high-grade commercial paper and the like. A number of other possibly more remunerative investment media are available to private foundations, of which perhaps the most obvious are mortgages and real estate equities, but these are also difficult to manage and may be riskier. These other investments present significant problems in terms of developing a capable management staff and achieving necessary diversification. Whatever their availability may be, there seems to be little evidence that they offer the prospect of improved rates of return without increased risk. That is, to the extent that these other investment vehicles could be expected to be more

[8] See, particularly, the testimony of David F. Freeman and Marion Fremont-Smith, hearings before the Subcommittee on Foundations of the Committee on Finance, November 25 and 26, 1974, pages 197 through 218; testimony of John G. Simon, hearings before the Subcommittee on Foundations of the Committee on Finance, October 1 and 2, 1973, pages 165 through 179.

profitable than common stocks, they can also be expected to offer more risk than common stocks.

This is not to say that an all-common stock portfolio will commend itself to most trustees either. Although there will be some exceptions, one concludes that the trustees of most private foundations would feel that to invest all of the assets of their foundation in common stocks would be to take excessive investment risk. This is a reasonable conclusion, and one that would be supported by the trustees of most educational institutions and indeed by most professional investment managers. The appropriate risk level for most private foundations, then, is probably that risk level corresponding to a portfolio that is partly invested in something less risky, and therefore probably less profitable, than common stocks.

The point of all of this is simply that whatever the overall investment strategy of a private foundation is or should be, and whatever kinds of investments are made, the overall risk of the portfolio should probably correspond to the risk of a portfolio that is diversified between common stocks and bonds, and therefore the overall rate of return expectations for the foundation should be consistent with expectations for a portfolio divided between common stocks and bonds—a "balanced" portfolio. Statistics on about 150 college and university endowment funds suggest that a portfolio invested 60 percent in common stocks, 30 percent in bonds and 10 percent in short-term investments is about average. The risk characteristics of such a portfolio probably are appropriate to most colleges and universities and probably appropriate to most private foundations. The question, then, is what one can reasonably expect such a portfolio to produce in the way of total return, and how much of this total return is available for spending if the fund itself and the annual spending are to keep pace with inflation.

The first careful study of long-run rates of return on common stocks was that of Fisher and Lorie, whose analysis of rates of return on New York Stock Exchange stocks for the period 1926–65 was published in the *Journal of Business* of the University of Chicago in 1968.[1] The single feature of this research that has most impressed investors in common stocks is the 9.3 percent rate of total return that an investor would have obtained over the full 1926–65 period, counting appreciation and assuming reinvestment of dividends, had he divided his money over all stocks listed on the New York Stock Exchange. This number has been taken by many investors as a fair estimate of what one might expect in the way of compound average annual return in the stock market. (Of course, private foundations do not reinvest dividends—they are not permitted to under the Tax Reform Act—and the Fisher and Lorie study computed only a 7.3 percent average total return without reinvestment of dividends.)

During the 1926–65 period, the average annual rate of inflation as represented by the Consumer Price Index of the Bureau fo Labor Statistics was about 1.5 percent per year. So the average "real" compound rate of return for the Fisher and Lorie study might be taken to be about 7.8 (9.3—1.5) percent per year. And without reinvestment of dividends, the "real" rate was somewhat lower.

In 1974, an analysis of rates of return on common stocks, long-term, high-grade bonds and treasury bills, for the period 1926–73, was reported by Ibbotson and Sinquefield.[2] This analysis was based upon published and computed indexes, rather than the performances of individual stocks, and was not nearly as exhaustive as the Fisher and Lorie study. But for purposes of practical forecasting, it is probably more useful. Table I summarizes many of the conclusions of the study. The table shows for three classes of investments, for the period 1926–73, the geometric or compound average return, the standard deviation that is a measure of the year-to-year variability in the rate of return, and finally the geometric average annual "real" return which reflects the 2 percent per year average inflation over this period, as represented by the Consumer Price Index. All of the rates of return embrace both appreciation and dividends or interest. The Ibbotson and Sinquefield numbers have been updated here and the 1926–74 averages are shown in parentheses.

[1] Lawrence Fisher and James H. Lorie, "Rates of Return on Investments in Common Stock: The Year-by-Year Record, 1962–65," *Journal of Business* of the University of Chicago, Vol. 41, No. 6, July 1968, pp. 291–316.

[2] Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills, and Inflation: The Past and the Future," Paper presented at the Seminar on the Analysis of Security Prices, Center for Research in Security Prices, Graduate School of Business, University of Chicago, May and November, 1974.

TABLE I.—1926 to 1973

[In percent]

	Geometric average annual rate of return	Standard deviation in rate of return	Geometric average "real" annual rate of return
Standard & Poor's composite ("500") common stock index	9.3 (8.4)	21.9	7.3 (6.2)
Long term high grade bonds	3.6 (3.5)	5.0	1.6 (1.3)
Treasury bills	2.2 (2.3)	1.8	.2 (.1)
Rate of inflation	2.0 (2.2)		

Note: Figures in parentheses are updated to cover 1926–74.

The geometric or compound average rate of return is the best measure of the profitability of an investment. But the geometric average "real" rate of return is an even more useful number. So far as common stocks are concerned, the 7.3 percent average "real" return deducted by Ibbotson and Sinquefield is not far from the 7.8 percent "real" return that comes from the Fisher and Lorie analysis. One can always argue about what periods of time are truly representative and should be used as a basis for making long-run predictions. The period 1926–65 includes enormous variety in economic conditions and stock market performance. There are those who would argue that the depression of the 1930s was an event that cannot be anticipated for the future, so that the experience of this period should not be built into any long-run forecast. But there are others who will argue that the great bull market of the 1950s and early 1960s was an event that no one can reasonably expect to be repeated. So, one concludes that the 1926–65 period is not a bad period to use for prediction purposes. When Ibbotson and Sinquefield updated this period to 1973, it is significant that even though 1973 was a poor year for common stocks, they ended up with an average "real" return over the full period that was not very different from the average "real" return found by Fisher and Lorie.

The Ibbotson and Sinquefield work indicates a geometric average "real" rate of return for long-term, high-grade bonds of 1.6 percent a year. From this, and from a number of other studies of long-term interest rates, one estimates a long-run geometric average "real" total return of 1.3 percent on long-term bonds. We can have even more confidence in the case of bonds than in the case of stocks that long-run rates of return are correlated with inflation, and that those who purchase bonds will demand what they consider to be a reasonable "real" interest rate plus what they predict to be a long-run inflation rate.

The geometric average "real" rate of return on treasury bills computed by Ibbotson and Sinquefield was almost zero. It is reasonable to predict a "real" interest rate on treasury bills over the long run as approximately zero. It turns out that treasury bills are about the best inflation hedge one can find, in the sense that treasury bill yields correlate very closely with rates of inflation, and are high when inflation is high and low when inflation is low. Unfortunately, they simply are not profitable in "real" terms. This should come as no surprise, since one would expect that the better one is protected against inflation by an investment, the less one is going to make in "real" terms.

Table II shows long-run average "real" rates of return from stocks, bonds and treasury bills.

Table II.—1926–1974 Average "Real" Total Return Rates

	Percent
Stocks	5.5–6.2
Bonds	1.3
Treasury Bills	0

This table may be useful in evaluating a spending level. But, before drawing any conclusions from it, it should be pointed out that in deducing "real" rates of return, I have been making use of the Consumer Price Index, which is a measure of inflation for the nation as a whole. There are some who would argue that other price indexes are more appropriate for our purposes, and the GNP price deflator is certainly a candidate. But what, perhaps, is more important is the strong likelihood that inflation for charitable foundations is 2 or 3 percentage points higher than inflation for the economy as a whole. Very briefly, the rate of productivity increase in the economy as a whole seems to have been around 2.5 percent during the first half to three-quarters of this century. But increases in productivity in education, the performing arts and, one supposes, most of the activities carried on by charitable foundations or supported by charitable foundations has been about zero.[8] This would suggest that the costs borne, either directly or through grants, by charitable foundations have been increasing by some 2 to 3 percentage points above the general rate of inflation.

Tables I and II and the discussion so far have been based entirely upon market indexes, which we might take to correspond roughly to the results of completley unmanaged portfolios (with no management fees or transactions costs). It may well be that charitable foundations expect their investment managers to add through their skill to the returns one might expect on unmanaged portfolios. The management itself, of course, introduces transactions costs. So, for prediction purposes, the question comes down to whether it is reasonable to expect investment managers to more than pay their way. That is, is it reasonable to expect the results of their skill to more than cover their fees and transactions costs? Based upon observations of the investment performance of college and university endowment funds, foundations funds, pension funds and mutual funds, I am skeptical that a foundation can anticipate any significant improvement in rate of return from its investment management other than the covering of costs. (Investment management has much to offer, of course, besides the hope of higher rates of return.)

The performance record of college and university endowment funds can give us some indication of what has been accomplished with actual, as opposed to theoretical, portfolios. The available data for these endowments do not go back as far in time as the studies so far referred to here, but it is possible to examine performances over as many as 15 years ending June 30, 1974. (This is the latest fiscal year end for which data are available.) Over the 15-year period, the average annual rate of total return for 51 endowment funds was 4.78 percent. After adjustment by the Consumer Price Index for inflation, the average annual "real" return was 1.12 percent. These rates are about one-and-one-quarter percent below the average total return rate on the Standard and Poor's 500 Index for the same period. (The equity component of these funds in 1974 ranged from 39 percent to 100 percent, and averaged about 60 percent.) The 51 funds had an aggregate value in 1974 of 3.2 billion dollars, perhaps one-fifth of the value of all colleges and university endowments.

Over 10 years ending June 30, 1974, the average annual total return for 80 college and university endowment funds was 2.88 percent, and the average "real" return was minus 1.85 percent. These rates are about 1 percent below the average total return on the Standard and Poor's 500 Index, and the equity component for these funds ranged from 29 percent to 100 percent in 1974, again averaging about 60 percent. The aggregate size of the 80 funds in 1974 was 4.2 billion dollars, representing probably about a quarter of all college and university endowments.

While these performance records alone are not a sufficient basis for predicting the future rates of return on charitable endowment funds, they do make clear that the funds cannot keep up with a stock market average. And, in fact, over the 15-year period, not one fund was able to achieve an average "real" total return as high as 5 percent a year.

These several analyses lead to the conclusion that foundations can afford to spend 4.5 percent a year of market value and expect to keep pace with national inflation. At a 5.0 percent spending rate it may be difficult, but not impossible, to do so. At a 5.5 percent spending rate, the likelihood of falling behind inflation is substantial. In terms of keeping up with the rate of inflation that is probably inherent in charitable foundation activities, at a 3 percent spending rate a foundation has a good chance of maintaining its purchasing power, and at a 4 percent spending rate it has a fair chance.

These conclusions have been based upon the assumption that a foundation portfolio is invested 60 percent in common stocks, 30 percent in bonds and 10

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[8] This aspect of inflation has been dealt with by William J. Baumol and William G. Bowen in *Performing Arts—The Economic Dilemma* (New York: The Twentieth Century Fund, 1966) and in the Ford Foundation report: *The Finances of the Performing Arts* (1974), as well as in a variety of books on higher education. The higher education picture is well summarized in G. Richard Wynn, "Inflation in the Higher Education Industry," National Association of College anod University Business Officers *Professional File*, Vol. 6, No. 1 (January 1975).

percent in short-term investments. Some trustees feel that 50 percent in stocks and 50 percent in bonds would be more appropriate. In this case, the 4.5 percent to 5.5 percent range becomes 4 percent to 5.5 percent, and the 3 percent to 4 percent range becomes 2.5 to 4 percent.

As an aside, I believe these spending ranges are appropriate as well for college and university endowments, so long as the institutions plan to keep pace with inflation. But higher spending rates are justified, and are in fact used, by colleges and universities that can count on significant growth in their endowments through gift additions, and are not required to rely on investment performance alone, as are most private foundations.

As a check on the conclusions reached using average performances of indexes, I calculated what would have happened to a portfolio over the time period 1926–74 at different levels of spending. It was assumed that the fund was invested 60 percent in common stocks, 30 percent in bonds and 10 percent in treasury bills, and that adjustments were made each year to maintain the allocation. The Ibbotson and Sinquefield year-by-year figures were used to simulate the investment performance of this fund, and the Consumer Price Index to deflate (or in some years to inflate) the fund value and the spending to reflect constant purchasing power dollars.

At a spending rate of 4.5 percent of year-end market value, a portfolio worth $1,000 at the beginning of 1926 would have been worth about $970 (in 1926 purchasing power) at the end of 1974. But in almost all of the other years between 1926 and 1974 the fund would have been worth at least $1,000 in terms of 1926 purchasing power. At a spending rate of 5.5 percent a year, on the other hand. that $1,000 would have shrunk to a purchasing power of about $580 at the end of 1974, and the purchasing power would have been below $1,000 in five out of the six years following 1968.

Allowing another 2 percentage points of inflation, to account for the extra inflation in the activities of foundations, would have led to a shrinkage from $1,000 to about $800 in the purchasing power of the fund from 1926 to 1974, at a 3 percent spending rate. But for almost all of the other years between 1926 and 1974, purchasing power would have been $1,000 or more. At a spending rate of 4 percent, however, the $1,000 would have been reduced to a purchasing power of about $480 by the end of 1974, and in all six years following 1968, purchasing power would have been well below $1,000.

I experimented with the possibility that the spending rate in a particular year might be set at the treasury bill rate of the preceding year. This is at least a plausible idea, since we know that treasury bill rates tend to move with inflation. The results, however, indicate that this would be a quite impractical rule. Applying this rule over the years 1926 through 1974 to a $1,000 fund invested 60 percent in stocks, 30 percent in bonds and 10 percent in treasury bills would have produced a wildly erratic spending pattern, ranging from a low of $1.80 in "real" terms in 1937 to a high of $335.60 in 1970. The purchasing power of the fund would have been well protected. It would have tripled by the end of 1974. But the pattern of spending would have been quite irrational.

These spending tests seem to confirm quite well the prior conclusion that a 4.5 percent spending rate will leave a foundation in a good position to keep up with inflation in the economy generally, while a spending rate of 5.5 percent will make keeping up very difficult indeed. If the test is keeping up with inflation inherent in the activities of private foundations, then the corresponding range is 3 percent to 4 percent.

The CHAIRMAN. Next we will call Mr. Charles A. Bundy, trustee, Southeastern Council on Foundations.

STATEMENT OF CHARLES A. BUNDY, TRUSTEE, SOUTHEASTERN COUNCIL ON FOUNDATIONS

Mr. BUNDY. Mr. Chairman, I appreciate this opportunity to appear before you today to present some views on certain aspects of the Tax Reform Act of 1969 as it relates to private foundations. I am speaking as the administrative operating head of a small-to-medium-sized foundation with assets at just over $20 million, making grants to charitable institutions in three counties in South Carolina.

However, I also speak for one of the 149 foundations from 10 States in the Southeast that make up the membership of the Southeastern Council of Foundations. As a member of the board of trustees of that council, I can tell you that the areas which I will cover involve matters which have been concerns of the members as they have discussed them in private conversations and on program panels in recent years.

First, a comment on my general impression of the 1969 Tax Act, and it touches on some of the comments that have been made here already. When the act was being considered by the Congress, I was not in foundation management and I was one of those who also felt that there had been some abuses and that corrective action was needed in this field.

I later joined the foundation which was then making distributions in excess of the requirements of the act. It was doing the kind of things I felt should be done and this was an association with which I felt very comfortable. I simply mention this to emphasize that I have seen at least two sides of the question presented by the Congress at that time. I believe the passage of the legislation has been good for foundations in several respects.

We foundation managers are now clearly advised of our obligations and I feel this has led to really better management of assets and maximum results from the grants we make. The Congress has demanded that we tell more about what we are doing and as a result both the Congress and the people today have a better understanding of the role of foundations in a free society.

The Internal Revenue Service is policing foundations carefully and I believe that the people of the country now feel—or at least those I talk with feel this is a valuable oversight in their behalf.

Like most major legislation, there are aspects that need refinement. We have found the Members of the Congress have been willing to listen to us as we have discussed needed changes. I refer particularly to the members of Senator Hartke's Subcommittee on Foundations as well as the members of the Ways and Means Committee of the House of Representatives.

A great deal of data has been presented to both groups in the last 2 years.

There are two needed changes I would like to support today, S. 2475, sponsored by Senator Curtis and other Senators, and S. 2348, sponsored by Senator Hartke and others.

S. 2475 would set the minimum investment return at a flat rate of 5 percent. Our particular foundation has not failed to meet the minimum rate set under the present law. We are conservative in our investment approach, concentrating on U.S. Government securities and high-grade corporate bonds, but we are striving also for the highest rate of return we can get.

The more we can earn on investments, while protecting those assets so that we have something to earn it with in the future, the more we can give away to charitable and other eligible causes. We take this conservative low-risk approach because many agencies that we support depend on us from year to year and we feel we have to see to it that there is an asset base from which we can earn funds in the years ahead.

There is some danger, however, that a downward drift in interest rates could cause us to have to invade our asset base to meet the minimum investment return requirement. This might provide a temporary advantage to grant recipients, but it would likely reduce our earning power for the future and this, in turn, would be reflected in the reduced grants at some future time.

As you well know, there have been great improvements in the markets in recent years and this has caused us hesitation as managers, particularly as we consider grants payable over a 3- to 5-year period. We don't know what the Treasury rate will be at that time so we are sometimes reluctant to fund a scholarship program or an educational experiment that will span several years.

A rate of 5 percent would bring some year-to-year stability and would be most helpful as we try to plan for the future. It would be more in line with long-term yield experience in the markets, but it would still keep some pressure on foundation managers. We certainly could not relax with a 5-percent minimum investment return requirement.

Since this doesn't directly affect the Federal Government's budget position, and for reasons I have stated above, we hope the Finance Committee will support this legislation.

S. 2348 would reduce the private foundation excise tax on net investment from 4 percent to 2 percent. Even though I understand we are probably the only tax-exempt organizations that pay for their own Internal Revenue Service audits, it is not unreasonable, in my view, for the Treasury Department to collect the audit fee for the policing of private foundations.

I don't know that anyone knew in 1969 just what the cost for IRS audits would be. It is my understanding now that the experience has shown the actual cost to be less than 2 percent. Since we have to distribute all of our net income by the end of the year following that in which it is earned, this is 2 percent that will be paid into the Federal Treasury instead of charitable causes, which is, in my case, the three-county area in which we serve. The same would be true of the other foundations in the Southeast as well.

In 1975 we would have distributed an additional $25,048; in 1974, an additional $21,963; in 1973, an additional $21,647; in 1972, an additional $18,920; and in 1971, an additional $16,731. So you can see that in the last 5 years we could have distributed $104,309 more in our particular area.

Now this doesn't sound like a lot of money as we talk about billions, Mr. Chairman, but in the three counties of South Carolina that we serve this is a significant amount of money.

This, I don't feel, is a major general budget adjustment and it would in my view provide a fairer audit charge for services provided. It would leave modest funds at the local level where they become significant and immediately go to work to meet a human or community need.

I, therefore, urge you to support this amendment.

Mr. Chairman, I have attached a copy of our foundation's most recent printed annual report.[1] Another one will be out next month for

[1] The annual report was made a part of the official files of the committee.

1975. This exhibit demonstrates the kind of programs that we support in one foundation in the Southeast. The adjustment of the minimum investment return to 5 percent will protect the asset base needed to continue this kind of funding. The reduction of the 4-percent excise tax to 2 percent will increase the funds available for distribution to these and similar causes.

I would be glad to answer any questions you might have.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I notice you quoted a figure as to how much you would have been able to give if it had not been for the tax being in excess of the amount necessary for the policing.

Based upon your previous pattern of giving, what beneficiaries would have been the recipients of this additional money that went for taxes?

Mr. BUNDY. We give in five areas—recreation, education, health care, community service and religion. The largest of that goes for recreational purposes to provide golf courses and swimming pools and tennis courts and beach properties, and this sort of thing. The next is in education where we provide funds for public schools as well as the colleges, mostly in the public schools areas.

Senator CURTIS. What do you do for some of the public schools?

Mr. BUNDY. We have a reimbursement program for teachers who are seeking masters' degrees. We spent last year $70,000 reimbursing teachers for work done toward higher education. We have matched local tax funds for the building of vocational schools. We have made several contributions to a regional branch of the University of South Carolina, the most recent being $300,000, which was one-half the cost of the new library building.

Senator CURTIS. Maybe all of those expenditures that you made on behalf of tax-supported education relieved the taxpayers of that amount?

Mr. BUNDY. Yes, sir. We think that is a proper role for the private foundation to take on if perhaps these are things that might have to be delayed a few more years.

Senator CURTIS. What sort of expenditures did you make for health care?

Mr. BUNDY. We have a medical scholarship program where we provide $5,000 a year for 12 students in medical school now, and this is an outright grant. It is designed to bring doctors back to our underserved areas, however, and we require a contract that they will practice in our area for 1 year for each year paid. We have also made direct grants to the major hospital in the area and we have commitments to a second hospital.

We have given gifts to both in the past. We continue to support those institutions.

We have assisted with the nurses education programs in the setting up and funding of those. Our principal purpose is to try to get delivery of health care back to the individual.

Senator CURTIS. Under the heading of religion what sort of gifts have you made?

Mr. BUNDY. These are gifts to individual churches or church groups that are eligible to receive gifts. However, we don't help the larger churches that we feel are well established. Our donations are principally for rural churches or churches just starting and we make gifts for such things as repairing a roof or replacing a Sunday school building or trying to pave a parking lot and buying a church organ and that kind of thing. They are relatively small gifts.

Senator CURTIS. When was your foundation started?

Mr. BUNDY. It was organized in 1942, so we have been in business a number of years.

Senator CURTIS. How many donors do you suppose you have?

Mr. BUNDY. To the capital of the foundation?

Senator CURTIS. Yes.

Mr. BUNDY. Ours was largely the result of one man, Elliott White Springs, the founder, who was a textile executive in South Carolina. Most of our funds—the foundation began to grow after his death as a part of his estate.

Senator CURTIS. Did he give cash or stock in his company?

Mr. BUNDY. He established trusts. Through the years he has given stock in his company and given cash also, but the way these large funds have come to us most recently since his death have been actual cash payments from the trusts, charitable trusts which he established, and we have, in turn, invested that cash principally in Government securities.

Senator CURTIS. Was the purpose of those trusts shares in his business?

Mr. BUNDY. Yes, although we have some of our investments in that business today, it is less than $120,000 out of $20 million in assets.

Senator CURTIS. On the start it is a gift oftentimes of shares in the business?

Mr. BUNDY. Right. We didn't have that problem of having to divest ourselves of shares.

Senator CURTIS. That is what has caused the act to discourage the formation of new foundations. That is all.

The CHAIRMAN. I hope that you understand that there is a basis for a distinction between taxing for audit purposes with regard to a private foundation and with regard to a public foundation.

We have a foundation for the Louisiana State University. We don't even impose an audit tax on them. But it is different where one sets up a private foundation and no one else puts money into it. You have to proceed under the assumption that a lot of people think something has the highest priority they can put on their giving if they all put some money into a foundation. But if only one man is willing to put money into a foundation, it might not be the highest priority expenditure one could make of that money.

I have had occasion to serve on at least one or two foundation boards. People have asked me to serve on them just because I had very severe doubt that the taxpayer was as much interested in the stated purpose of the foundation as he was in avoiding the tax. I have had people tell me that if we could cut the inheritance tax down to a 50-percent rate, they would be happy to pay the tax and leave the money to their children rather than to pay the money into a foundation.

I just hope that you understand when we put these provisions against self-dealing in this audit procedure, and also this payout requirement, that we would like to insist that if one is going to claim the advantage of a tax deduction, he ought to really give something to charity, or to education, and that it not just be a matter of stating a noble purpose about which he does nothing.

We have plenty of hypocrites of that type all the time, certainly a surplus of them in political life. I hope you understand that there was a little bit of logic involved in saying these private foundations at least pay an audit tax.

Mr. BUNDY. I concur with that, Senator, and as I stated earlier, I think many of the provisions of the Tax Act of 1969 were very good and needed, and I think the minimum payout requirement is a good thing. I have no real quarrel with the audit tax, really.

The CHAIRMAN. Thank you very much, sir.

Next we will call Mr. M. Carl Holman, president of the National Urban Coalition.

STATEMENT OF M. CARL HOLMAN, PRESIDENT, THE NATIONAL URBAN COALITION

Mr. HOLMAN. Thank you, Mr. Chairman, for this opportunity to appear before you and your colleagues.

The National Urban Coalition, of which I am president, is an organization made up of representatives of business, minorities, labor, local government, and they share a concern with improving the quality of life in the cities. I am speaking today as president of a 501(c)(3) organization which receives the bulk of its support from corporations and foundations.

I also serve, but am not appearing for, a moderate-sized foundation, so I know what the impact of some payout has been.

I would like to begin by saying I think that foundations play an imperfect but very vital role in a diverse and pluralistic country like this and that especially if you were to look around the country today at what has happened to 690,000 private nonprofit organizations in America, you would see that without private philanthropy these institutions could not survive.

One out of every 10 service workers, one out of every 6 professionals is employed by a nonprofit organization. Even though they have been hard hit by the worst recession since the 1930's, these nonprofit organizations are being called on to fill the critical gaps created by governmental cutbacks at every level.

I don't need to repeat for you what has been said about the impact on the foundations of the current economic recession. I would point out that foundations do certain things that Government cannot do and that corporations could not do. I would indicate, for example, that in our own work we have found that one small foundation took a small barrio health center which OEO deserted and it was about to close its doors in 1972, but it was rescued by some small foundation grant and kept alive until more substantial foundation funding came through in 1975. It was through foundation grants that we were able to follow the inequities in public school financing and to suggest alternatives which would allow States to increase the amounts of money they made available for low-income, rural and urban children.

The first urban homesteading meetings which we held were trying to see how we could hold onto some of the depleted and abandoned housing stock in our cities. They came about whem we brought together people from 10 cities and the lawyers and the private citizens and the real estate people to see how this could be done.

Foundations made this possible. I would not suggest that all foundations are perfect, far from it. There are foundations prior to 1969 that were doing the kinds of things that some of them are now doing after the passage of that law. I would point out, however, that a very disturbing thing is beginning to happen in that giving by individuals is down at least 15 and has been going down in the last few years, that the income of the nonprofit sector as a percentage of the gross national product has slipped alarmingly, and is growing only half as fast as the real national product.

The two most important adverse effects, I think, of the Tax Act have been the focus in 4-percent excise tax and the 6-percent payout. I won't say more about that than some of the others have already said.

I would indicate our support of Senator Hartke's bill, which would reduce the 4-percent tax to a more reasonable 2 percent. I would also support Senator Curtis' proposal to modify the present law and change the specified percentage from the present 6 percent to a flat payout rate of 5 percent.

Now I would like to touch on something which I don't think anyone else has touched on this morning, and it may not be within the purview of this committee. I would like to endorse Senator Muskie's proposal to liberalize the present tax restriction on public charities' legislative efforts. Since 1934 the Federal Government has not allowed nonprofit organization, which have spent a substantial part of their activities attempting to influence legislation, to receive tax deductible gifts, nor are we urging that there be a heavy encroachment of such organizations into what would be massive lobbying.

I would, however, like to suggest that it would be important for the legislatures and the courts to more clearly define what is now a very worrisome area and which causes a great number of foundations to say: "We won't give anything at all."

For example, we were able to take people from this school system and take them to New Detroit, our coalition there, and to see how businessmen working with educators had cut the management costs of government of the schools, had increased their ability to get their dollars worth. There was some concern expressed by one foundation that if we do this since there were some legislators who had also worked on the project that we might be invading this dangerous territory.

It is also my personal belief that we have now come to a point in which the criticism of Government and the distrust of Government may perhaps be going slightly too far and we need to start readjusting the balance.

I am disturbed by the falling rate of voter participation, not only in primary elections, but in other elections. I am disturbed by the statements made in opinion polls that people do not trust the Government, do not believe the Government will work for them, do not believe the Government ever listens to them.

I would, therefore, like to very much suggest that if business corporations have been able to deduct costs of lobbying, trade associations likewise, that at least a larger latitude—and more clearly spelled out latitude—be given to nonprofit organizations.

The courts seem to be moving somewhat in this direction, and I would urge that the Congress enact legislation which clearly defines the constraints within which nonprofit organizations may have a freer voice and present more diverse points of view in the generation of public policy.

Thank you.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. We appreciate your testimony very much. I won't take the time to talk about the measures that other witnesses have spoken on and I have expressed myself.

In reference to the other proposal about which you spoke, as I understand that legislation, what is would do would substitute a rather hazy definition for a more exact one that would be easier to follow; isn't that about right?

Mr. HOLMAN. My understanding, and I always assumed that piece of legislation, especially coming after 1969, is going to undergo some rather vigorous scrutiny. What we find ourselves facing, through foundation grants, looked over a 2-year period is what happened to general revenue sharing actually in the cities? There was great concern on the part of some of the foundations that perhaps they ought not join us in this monitoring effort for fear that it constituted infringement on what our lawyers tell us is a 5 percent—the 5-percent constitutes an insubstantial amount of involvement with legislation.

What I would like to see is the passage of some legislation which would lay out in pretty clear terms what the boundaries are so that people would know, for example, that when can you testify on a bill at your own instance or must you wait until someone may or may not call upon you to do it?

When great public issues are forming, do you have a right as a nonprofit organization to engage in that debate and what are the limits to which you may do this? What I would like to see happen, and I suppose that is what some people meant by the overkill—and there were some very gross and unnecessary errors, I think, made which hurt a great number of causes—which delayed the Latinos and other voting groups getting their voting rights, because other things had been done improperly prior to 1969.

What I would be asking for—and others join in this—with me—would be a clearer definition and somewhat more latitude so that both foundations and nonprofits would feel freer.

Senator CURTIS. I certainly agree with your objective. I believe what you have described has been embodied in a bill over in the House introduced by Congressman Conable. The same bill has been introduced in the Senate and has quite a number of cosponsors, including myself.

Mr. HOLMAN. I welcome that.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Holman follows:]

STATEMENT BY M. CARL HOLMAN, PRESIDENT, NATIONAL URBAN COALITION

Senator Long and members of the Senate Finance Committee, I am M. Carl Holman, president of the National Urban Coalition, an organization of Representatives of business, minority, labor and local government, concerned with improving the quality of life in our urban areas. The coalition has local affiliates in over thirty cities across the country. Together we seek to call attention to and try to solve the more pressing social, economic and fiscal problems of cities, and to lessen racial and ethnic polarization.

I am speaking today as the president of a 501-C-3 organization which receives the bulk of its support from corporations and foundations. I believe that foundations are an imperfect but vital and necessary part of our society. First of all, they stimulate and permit the private sector to play an active role in meeting the social and economic needs of the nation and of particular localities or regions. Foundations are in the American tradition of diversity and plurality, providing initiatives and alternatives not avalable in countries where almost everything is done by the government. And in this period of sharp retrenchment of Federal spending, foundations often provide the sole or major source of income for the more than 690,000 private non-profit organizations in America. Moverover, our current unemployment statistics would be significantly higher without the participation of private philanthropy.

For one out of every 10 service workers and one out of every six professionals is employed by a non-profit organization. More importantly, though hard-hit by the worst recession since the thirties, these non-profit organizations are being called upon to help fill the impossible gap created by governmental cutbacks at every level.

Even though their own funding bases have been seriously eroded, foundations can often respond more quickly to emerging problems and issues than can either government or corporations. This is largely because foundations are not bound by various political priorities and realities, by over-riding obligations to stockholders, or by the natural bureaucratic delay of governments. For example, the Barrio Comprehensive Child Health Care Center of San Antonio, Texas, which was begun in 1971 with a one year OEO grant, was about to close its doors in late 1972 when it was rescued by a series of small foundation grants which succeeded in keeping it alive until more substantial foundation funding came through in 1975. In another instance, it was foundation support which made it possible for the coalition and others to do the early analysis of the inequities in public school financing and to lay out alternatives which might assure increased state educational resources for low income urban and rural children.

Lacking some of the constraints faced by government and business, foundations can be—and some of them are—flexible, innovative and experimental; dealing with issues that are not as readily explored by other agencies. It was foundation funding which allowed the coalition, and three other organizations, to carry out a two year monitoring program of general revenue sharing. The results of this study have provided the Congress with the factual background against which possible changes in the general revenue sharing program can be reviewed.

Critics to the contrary notwithstanding, it was certain foundations that helped spare this Nation even more destructive race and class relations than we have experienced; provided higher education and special training and leadership opportunities for certain segments of the population that would otherwise have been denied—with great loss to the country; which supported American art and culture at a time when our government was almost totally uninvolved, and when the governments of other nations were providing such support as a matter for course.

However, as the Filer Commission report of December 1975 so graphically illustrates, the non-profit sector is "indeed under stress". Emerging from the sharpest recessionary period since the 1930's, and facing a current administration program of domestic budget cuts, the diverse, unorganized, ailing and underestimated "third" sector of the American economy, the non-profit organizations face an uncertain future. Giving by individuals is down at least fifteen percent in the last fifteen years: and income of the non-profit sector as a percentage of the Gross National Product has slipped alarmingly, notes the Filer report. Since 1960, it has grown only half as fast as real national product. Furthermore, certain legislative requirements incorporated into the 1969 Tax Reform Act have had a direct and adverse impact on foundation giving. Perhaps the two most important of these have been the four percent excise tax and the six percent payout requirement.

Historically, private foundations in the United States have been viewed as charitable organizations and thus were free of Federal taxation. In 1964, however, the Treasury Department conducted a comprehensive review of private foundations and the laws which pertained to them. Stemming from this study was the recommendation in 1965 that the Federal tax laws governing foundations be revised, and a compromise audit fee was imposed to pay for a more vigorous Federal supervision and auditing of philanthropic organizations. In practice, the tax imposed at a rate of four percent of net investment income has produced more than twice the amount expended by the Internal Revenue Service. In fact, one of the Filer Commission studies shows that from 1970 to 1978, the tax raised $157 million while the audit program cost only $55 million. The surplus $102 million raised by this tax is money denied, not to the private foundation, but to the charitable recipient of the foundation's money. We believe that the excise tax on foundations should be consistent with the actual costs of auditing, and thus support Senator Hartke's proposal (S. 2348) which would reduce this four percent tax to a more reasonable two percent.

In 1969, when the Tax Reform Act was under consideration, some foundations were accumulating huge amounts of money, and paying out next to nothing to further their charitable purposes. Thus it was understandable that legislative initiative was undertaken to correct this situation. However, recent research at Dartmouth's Amos Tuck School of Business and by the Filer Commission indicates that the six percent payout rate may have destructive consequences: It is likely to destroy the ability of private foundations to support charitable programs at current levels. We believe that the payout rate should represent a realistic balance between the long range objectives of the individual foundations and an assessmnet of current needs in those areas which must rely on foundation support. A payout rate which seriously diminishes foundation resources has a deleterious effect on long range programs. Thus we support Senator Curtis' proposal to modify the present law and change the "specified percentage" from the present six percent to a flat payout rate of five percent.

Lastly, we wish to endorse Senator Muskie's proposal to liberalize the present tax restriction on public charities' legislative efforts. Since 1934, the Federal Government has not allowed non-profit organizations which have spent a "substantial part" of their activities "attempting to influence legislation" to receive tax deductible gifts. For forty years, neither the courts nor he IRS has given a definite meaning to either "substantial" or "attempting to influence legislation". This uncertainty has led many tax exempt groups to simply avoid any activities that might be regarded as endangering their tax exempt status. It has encouraged many donors to hesitate in making grants to groups that have a strong advocacy component. And it is my personal belief that some of the much-discussed "apathy", "hostility" toward government and the noninvolvement of our citizenry as reflected in falling voting rates is in part a by-product of the feeling that government may not really want citizens more actively involved and, however unintentionally, may be raising barriers to more active citizenship.

Since 1962, business corporations have been able to deduct costs of lobbying in relation to legislation affecting their direct interest. Deduction of dues to trade associations that lobby has also been permitted. Yet non-profit organizations, required by law to operate in the public interest and not for personal profit, are not allowed similar freedoms.

The courts are gradually moving in this direction. The 1973 court decision in the *Christian Echoes* case specifically rejected the five percent standard arguing that it obscures the "complexity of balancing the organization's activities in relation to its objectives and circumstances". It is time that the Congress enact legislation which clearly defines the constraints within which non-profit organizations have a freer voice and present more diverse points of view in the generation of public policy, while operating in the public interest.

The CHAIRMAN. Next we will call Mr. James W. Riddell of Dawson, Riddell, Taylor, Davis & Holroyd, and H. Lawrence Fox of Pepper, Hamilton & Scheetz, on behalf of the Ad Hoc Committee on Family Foundations.

STATEMENTS OF JAMES W. RIDDELL OF DAWSON, RIDDELL, TAYLOR, DAVIS & HOLROYD, AND H. LAWRENCE FOX OF PEPPER, HAMILTON & SCHEETZ, ON BEHALF OF THE AD HOC COMMITTEE ON FAMILY FOUNDATIONS

Mr. Fox. My name is H. Lawrence Fox. With me today is James W. Riddell. Together we are testifying on behalf of the Ad Hoc Committee on Family Foundations.

On April 10, 1974, this group, the Hormel Foundation, W. K. Kellogg Foundation, Kresge Foundation, Lilly Endowment, Inc., Maclellan Foundation, Pew Memorial Trust and the Joseph B. Whitehead Foundation, testified before the House Committee on Ways and Means regarding the unfortunate construction of section 4942 of the Internal Revenue Code relating to the annual minimum charitable distributions required by private foundations.

We also testified before the Finance Subcommittee on Foundations on November 25, 1974. Accordingly, in testifying today we will only summarize portions of the foregoing presentations. With your permission a more detailed statement with attachments is submitted for the record.

SUPPORT FOR TAX REFORM ACT OF 1969

At the outset we would like to make it clear that we support congressional action to eliminate certain abuses previously associated with certain foundations, endorse the efforts of Congress to assure that foundations operate properly in the public interest, and commend congressional corrective action which provides safeguards against the recurrence of abuses and which also reassures the public that continued tax exemption for foundations serves the national interest. However, we are concerned that correction of such abuses through undue and unnecessary restrictions are a disservice to the public interest if legitimate foundation operations are thereby curtailed.

CORRECTIVE AMENDMENTS REQUIRED

Previously we testified that two of the rules adopted in the 1969 Tax Reform Act unduly restrict legitimate foundation activities and, accordingly, have consistently urged that each of them be reexamined and changed.

The first rule is the imposition of the 4-percent excise tax on net investment income of private foundations. We concur with both the analyses and conclusions of the Finance Subcommittee on Foundations and the report of the Commission on Philanthropy and Public Needs that the burden of the 4-percent excise tax should be reduced to 2 percent. Accordingly, no further comments will be made in this testimony other than to emphasize the fact that the passage of S. 2348 would automatically increase private foundations' grants to charitable recipients.

The second is the requirement in section 4942 that the annual charitable distributions of private foundations be at least equal to a variable percentage of the current value of investment assets, this being known as the minimum distribution rule.

Since our appearances before the appropriate committees the minimum distribution rule has been studied by the Treasury, the staff of the Joint Committee on Internal Revenue Taxation, the Commission on Private Philanthropy and Public Needs, and the Senate Finance Subcommittee on Foundations. Basically, they have concluded that section 4942(e)(3) is biased against equity-type investments, severely limits investment decisions of portfolio managers, forces premature divestiture, and restricts the formation of new private foundations.

Moreover, the first three concluded that the variable 6-percent rate shall be amended to a fixed 5-percent rate. Based upon the foregoing, and to redress the defects of the statute, Senator Carl Curtis introduced S. 2475, which to date has been cosponsored on a bipartisan basis by over 20 Members. The number of cosponsors is growing as a result of a "dear colleague" letter, dated April 5, 1976, signed by Senators Curtis, Hart of Michigan, Mansfield, and Scott of Pennsylvania.

S. 2475

This bill amends the code to provide that private foundations must distribute annually the greater of their income or 5 percent of the value of their assets. Under current law the applicable precentage is 6 percent; the minimum payout for any taxable year of a private foundation is determined and published by the Treasury on the basis of the relationship of recent money rates and investment yields to money rates and investment yields for the calendar year 1969. Otherwise, if the Treasury does not promulgate a rate by May 1 of each year, the minimum payout is the applicable percentage or 6 percent.

It is virtually impossible for the Treasury to establish a fair rate under the language of section 4942(e)(3) and the rate could greatly exceed 6 percent. These conclusions are supported by the Treasury in a letter to Senator Hartke, dated April 16, 1975.

ENDORSEMENT OF S. 2475

We join the other witnesses testifying today in unqualifiedly endorsing S. 2475 and urge that it be passed this year in order to modify the automatic annual corpus reduction that results from the application of section 4942. As enacted, the statute forces a slow death upon private foundations, the very opposite result from the one intended. Every responsible entity and staff recognize the statute's inequity. Failure to correct the law this year further compounds the original error. In this connection, Senator Percy, one of the chief sponsors for the statute as enacted, is a cosponsor of S. 2475.

Reiterating, we continue to support the concept and purpose of section 4942, namely, charity receive a minimum annual distribution from private foundations. However, section 4942 goes beyond this worthy purpose. In fact, it is detrimental to the existence and further creation of private foundations and, therefore, must be corrected immediately. Also it is inconsistent with the divestiture transition rules for section 4943.

This is true because section 4942 forces the disposition of corpus prior to the distributive requirements of section 4943. The Senate, in the last Congress, determined that this should not occur for the Herndon Foundation. Similar treatment should be provided for all other private foundations this year by enacting section 2475.

This bill does not obviate some of the problems raised in our previous testimony concerning a minimum distribution rule relating to annual asset valuations. However, it completely eliminates all of the problems relating to a variable percentage and reduces the unfairness of a 6 percent or higher rule.

In brief, S. 2475 relieves the Treasury of the impossible burden of establishing a fair variable rate—as mandated by the 1969 law—establishes a more reasonable rate for determining an annual minimum distribution, and is more consistent with the divestiture rules contained in section 4943 than current law. At the same time, charitable recipients will receive adequate support in the future. Finally, enactment has absolutely no Federal revenue impact.

Summarizing, the Treasury, the staff of the Joint Committee on Internal Revenue Taxation, and the Commission on Private Philanthropy have independently concluded that the applicable percentage should be fixed at 5 percent with no discretion on the part of the Treasury to vary it. S. 2475 is consistent with that conclusion and should be enacted promptly to prevent further harm resulting from existing section 4942 which will be detrimental to our Nation.

Senator CURTIS. Mr. Riddell, do you have a statement?

Mr. RIDDELL. No; I join completely with this statement.

Senator CURTIS. Mr. Fox, I did not bring with me from my office the most recent list of cosponsors. Can you read those into the record, because in the other bill I did mention them.

Mr. FOX. This is the list that was formerly called in. We have other Senators we will not name because their calls did not get in officially.

Senator CURTIS. And this is to which bill?

Mr. FOX. This is to S. 2475: Senators Baker, Bartlett, Curtis, Durkin, Fong, Gravel, Hansen, Hart of Michigan, Hruska, Mansfield, McGee, Percy, Scott of Pennsylvania, Stevens, Taft, and Thurmond.

Senator CURTIS. We appreciate your support of the legislation you have mentioned. I think it is important that we clear up some of the erroneous impression that does surround the problems of foundations. In my observation foundations are not created for the purpose of avoiding taxes, but because of a desire to do good. Do you concur with that?

Mr. FOX. We are very proud to concur with that, Senator. Not only do we know from our own individual foundations—Mr. Riddell in particular represents the Kellogg Foundation and I in particular the Pew Memorial Trust—but we know for a fact that all of the group's benefactors were not motivated by tax deductions. Our statistics show that the donors would lose a great deal of money if that were their purpose. But more important, rather than just being proud of ourselves and the other members of our group, before testifying before the House committee, we asked Dr. Norman Ture to make a report and study on private foundations. In particular, this report considered the costs to the government of the contributions.

He determined that each year private foundations give more than the original tax deductions were worth to the donors when the foundations were created. So each and every year your contributions are greater today than the tax benefits that were enjoyed at the time.

Mr. RIDDELL. That is of the total tax benefit to all of the donors to all of the foundations.

Senator, you may be interested in the tax benefit that W. K. Kellogg got. The total of all of the income and estate tax deductions, as is stated in the appended statement, to W. K. Kellogg, was less than $500,000.

Senator CURTIS. The tax benefits by creating the foundation?

Mr. RIDDELL. Yes. To be precise, it was on the order of $340,000. Since the foundation was organized, it has contributed to charities $265.5 million.

Now that seems to be a pretty fair return to the public on a $340,000 investment.

Senator CURTIS. I daresay that all of those gifts contributed to the well-being of our society and in the public good. But it is also true that many of those gifts went for purposes that might have otherwise had to have been paid by government at some level.

Mr. RIDDELL. That would be particularly true in the case of the foundations we represent, as a matter of fact of all private foundations. The gifts of the W. K. Kellogg Foundation have been concentrated in the area of public health and education. We are quite proud of that fact.

We hope to be able to continue to make those gifts free of the requirements of the 4-percent excise tax and of the 6-percent payout. You see, Senator, in 1969 we were all operating somewhat in the dark. There were some abuses in the foundations. Some, without doubt, were organized by their donors for purposes of tax evasion and avoidance. Some foundations were maintained inefficiently with no attention being paid to the amount that was being paid or accrued for the benefit of charity.

We now have the accumulated experience of almost 7 years with which to review the 1969 decisions which were enacted. Now, as Mr. Fox has pointed out to you, several groups have examined those decisions, independent of each other, and reached the conclusion that at least two of those decisions ought to be reexamined.

If this committee determines that it wants to take 4 percent of the total income of foundations and put it into the general funds of the Treasury that is a decision it is free to take; but in 1969 it made the decision that the 4 percent was a set-aside to pay only for the auditing of foundations.

The 6 years of experience have demonstrated, as your own staff and the Treasury has pointed out to you, that the 4 percent is far in excess of the amount required to audit foundations. Therefore, it occurs to us as only reasonable to reconsider the decision by providing for a 2-percent tax, that is to keep the amount that is necessary to perform the audit function. The rest should be returned to charity because by hypothesis we are required to return to charity 100 percent of our earnings.

The second decision was made principally on the basis of the Peterson Report which, in turn, looked to the experience of mutual funds. There were certain assumptions made about the performance of mutual funds. Foundations were asked to perform at least as well as mutual funds did.

Thank God, Senator, both before and since that decision was made the portfolios of the foundations represented here, and indeed of foundations as a whole, have outperformed mutual funds. If we were today held to the standards of mutual funds, the charities who depend on us would be in a sorry fix.

As I said, in the light of experience the 6 years with which your staffs have had an opportunity to look at it, we are simply asking that the law be changed in the light of experience and fact.

Senator CURTIS. One foundation with which I am very familiar has been most generous to many institutions clear across the land. It was created because the donor was of the opinion that his sons should not inherit any more money, and he chose to give it for the public good as contrasted to continuing a concentration of wealth in his own family.

I am sure that type of motivation plus the desire to be helpful to good causes are the two most often used, the two motivations that most often appear in the formation of foundations.

Mr. FOX. That is the case of all our foundations. The donors were more interested in the future of the country as a whole than they were their own particular families. I am sorry that Senator Long is not here now. He had asked several of the witnesses, why not give the funds to a university or a hospital immediately? The answer is first our benefactors wanted grants to be made to educational institutions, hospitals and other similar entities well into future. That is grants should be made presently and in the future. Second, simply, most of these people felt the Nation needed a private foundation so there would be an entity to supply funds to innovative concepts and the programs that might not ordinarily be gotten off the ground unless a foundation were there to step in and start such a program. Then others can make additional contributions.

Mr. RIDDELL. Both Mr. Fox and myself are privileged to represent individuals who have been successful and who have been successful in building major American corporations. Some of those types of gentlemen are still alive.

I draw your attention to this fact, Senator Curtis. In 1968 there were 31,000 viable private foundations in the United States. Today there are 26,000 private foundations. The formation of foundations is practically zero. The number of estate plans that I have examined, as a lawyer, were formulated without regard to the tax benefits resulting from charitable giving. Today, many estates have been changed in my own law office since the enactment of the 1969 act. This is not because of the failure of tax incentives. Rather, donors believe that their attempt to give to the people of the United States the thing that they had built is no longer possible. This attitude is attributable to the ultimate effect of the divestiture rules and of the pay out requirement being 6 percent or more.

In brief potential foundation founders feel that they should have the control over their own intent as donors and that the thing that they are giving will lose its identify once it is given.

Senator CURTIS. We must move on to the next witness, but I recall very vividly the contest we had over divestiture. It was advanced under the notion that it was needed to eliminate conflict of interest between donor and his foundation. It had very little to do with that and it punished thousands of corporations where there wasn't any conflict of interest at all, foundations where there wasn't any conflict of interest at all.

Mr. RIDDELL. The majority of our donors took care of that problem themselves, de novo from the beginning. W. K. Kellogg provided and assured that no member of his family was going to have any control over the future of his intent.

Senator CURTIS. I know of one foundation that was the sole owner of the business, but they were caught under the divestiture rules and there was no possibility of any conflict of interest because nobody else had an interest. There was no donor interest in the business. He had given it all.

[The prepared statement and addenda of the Ad Hoc Committee on Family Foundations follow. Oral testimony continues on p. 2227.]

STATEMENT BY THE AD HOC COMMITTEE ON FAMILY FOUNDATIONS: THE HORMEL FOUNDATION, THE KELLOGG FOUNDATION, THE KRESGE FOUNDATION, THE LILLY ENDOWMENT, INC., THE MACLELLAN FOUNDATION, THE PEW MEMORIAL TRUST, THE JOSEPH B. WHITEHEAD FOUNDATION

I. INTRODUCTION

On April 10, 1974, this Group, the Hormel Foundation, W. K. Kellogg Foundation, Kresge Foundation, Lilly Endowment, Inc., Maclellan Foundation, Pew Memorial Trust and the Joseph B. Whitehead Foundation, testified before the House Committee on Ways and Means regarding the unfortunate construction of Section 4942 of the Internal Revenue Code relating to the annual minimum charitable distributions required by private foundations. We also testified before the Finance Subcommittee on Foundations on November 25, 1974. A copy of that testimony and written statement are attached hereto as Exhibit B. Accordingly, in testifying today, we will only summarize portions of the foregoing presentations.

Support for Tax Reform Act of 1969

Prior to, during, and subsequent to the deliberations of the Tax Reform Act of 1969, we have and continue to:

1. Support Congressional action to eliminate certain abuses (previously) associated with certain foundations;

2. Endorse the efforts of Congress to assure that foundations operate properly in the public interest; and

3. Recommend Congressional corrective action which provides safeguards against the recurrence of abuses and which also reassures the public that continued tax exemption for foundations serves the national interest.

In reaffirming those positions today, we would advise the Committee that we are concerned that correction of such abuses through undue and unnecessary restrictions are a disservice to the public interest if legitimate foundation operations are thereby curtailed.

Corrective amendments required

Previously, we testified that two of the rules adopted in the 1969 Act unduly restrict legitimate foundation activities, and accordingly, have consistently urged that each of them be re-examined and changed. The first rule is the imposition of the 4 percent excise tax on net investment income of private foundations,[1] and the second is the requirement found in Section 4942 that the annual charitable distributions of private foundations must be at least equal to a variable percentage (presently 6 percent) of the current value of their investment assets (hereinafter referred to as the "minimum distribution rule").

Since our appearances before the appropriate Committees, the latter issue relating to the minimum distribution rule has been studied by the Treasury, the staff of the Joint Committee on Internal Revenue Taxation, the Senate Finance Subcommittee on Foundations, and the Commission on Private Philanthropy and Public Needs. All have concluded that Section 4942(e)(3) is biased against

[1] We concur with both the analyses and conclusions of the October 4, 1974, Statement of the Finance Subcommittee on Foundations and the Report of the Commission on Philanthropy and Public Needs that the burden of the 4 percent excise tax should be reduced to 2 percent. Accordingly, no further comments will be made in this statement other than to emphasize the fact that such a reduction would automatically increase private foundations' grants to charitable recipients.

equity-type investments, severely limits investment decisions of portfolio managers, forces premature divestiture and restricts the formation of new private foundations. All have recommended that the variable 6 percent rate be fixed at a 5 percent rate. Based upon the foregoing, and to redress the defect of the statute, Senator Carl T. Curtis (R–Neb.) introduced S. 2475 which, to date, has been co-sponsored on a bipartisan basis.

S. 2475

S. 2475 amends the Code to provide that private foundations must distribute annually the greater of their income or 5 percent of the value of their assets. Under current law, the applicable percentage is 6 percent; the minimum payout for any taxable year of a private foundation is determined and published by the Treasury on the basis of the relationship of recent money rates and investment yields to money rates and investment yields for the calendar year 1969. Otherwise, if the Treasury does not promulgate a rate by May 1 of each year, the minimum payout is the applicable percentage or 6 percent. It is virtually impossible for the Treasury to establish a fair rate under the language of Section 4942(e)(3) of the Code. This conclusion is supported by the Treasury in a letter to Senator Hartke, from then Assistant Secretary of the Treasury Hickman, dated April 16, 1975. (See Exhibit C.)

Endorsement of S. 2475

We unqualifiedly endorse S. 2475 and urge that it be passed this year in order to modify the automatic annual corpus reduction that results from the application of Section 4942. As enacted in 1969, the statute forces a slow death upon private foundations, the very opposite result from the one intended. Every responsible entity and staff recognize the statute's inequity; failure to correct the law this year further compounds the original error.

Reiterating, we continue to support the concept and purpose of Section 4942, *i.e.*, charity receive a minimum annual distribution from private foundations. However, Section 4942 boes beyond this worthy purpose. In fact, it is detrimental to the existence and further creation of private foundations and, therefore, must be corrected immediately. Moreover, it is inconsistent with the divestiture transition rules for Section 4943. The Senate, in the last Congress, determined that this should not occur for the Herndon Foundation. Similar treatment should be provided for all other private foundations this year by enacting S. 2475.

This Bill does not obviate some of the problems raised in our previous testimony concerning a minimum distribution rule relating to annual asset valuations. However, it completely eliminates all of the problems relating to a variable percentage and reduces the unfairness of a 6 percent rule.

In brief, S. 2475 relieves the Treasury of the impossible burden of establishing a fair variable rate (as mandated by the 1969 law), establishes a more reasonable rate for determining an annual minimum distribution, and is more consistent with the divestiture rules contained in Section 4943 than current law. Finally, charitable recipients will receive appropriate levels of support presently and will be more likely to receive such support in the future if S. 2475 is enacted.

Summarizing, the Treasury, the Staff of the Joint Committee on Internal Revenue Taxation, and the Commission on Private Philanthropy, have independently concluded that the applicable percentage should be fixed at 5 percent with no discretion on the part of the Treasury to vary it. S. 2475 is consistent with that conclusion and should be enacted promptly to prevent further harm resulting from existing Section 4942.[3]

EXHIBIT A[1]

A–1 Oral Statement Presented Before the House Committee on Ways and Means, April 10, 1973.

A–2 Written Statement Presented to the House Committee on Ways and Means, April 10, 1973.

A–3 "Impact of the Minimum Distribution Rule on Foundations," by Norman B. Ture, April 5, 1973.

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[3] For a complete analysis of the unintended inequities of Section 4942 and why it must be amended see Exhibit B, Testimony before the Senate Subcommittee on Private Foundations.

[1] These exhibits, previously printed, were made a part of the official files of the committee.

APPENDIX A[2]

Tables published in the 1965 Treasury report which indicate that approximately 90 percent of foundations have ordinary income of less than 6 percent of their fair market value.

APPENDIX B

Brief summary of the increased costs associated with higher education, medical education, and hospital services.

Higher education

Higher education is a labor-intensive service sector of the economy in which it is difficult to achieve the gains in productivity that are experienced in goods-producing industries.

For purposes of historical comparisons of educational costs, the most useful data are those compiled by June O'Neill in a study conducted for the Carnegie Commission. Educational costs per credit hour consistently rose more rapidly than the consumer price index from 1953–54 to 1966–67. Over the period as a whole, educational costs rose at an annual average rate of 3.5%, as compared with a rate of 1.6% for the consumer price index—a difference of 1.9%. However, costs in private institutions of higher education rose more sharply than those in public institutions. The rate of increase for private institutions was 4.8%, or 3.2% more than the consumer price index, and for public institutions, 2.9%, or 1.3% more than the consumer price index.[3]

The most noticeable feature of the budgets of all institutions of higher education is how fast they have gone up in the years since World War II. Total educational and general expenditures on current account by all institutions of higher education went up from less than $1 billion in 1945–46 to more than $7 billion in 1963–64. Total educational and general expenditures less expeditures on organized research have gone up, on the average, more than 7% a year at all private universities and more than 12% a year in three institutions (Chicago, Princeton, and Vanderbilt). The direct instructional cost per student over the period 1955–66 works out to an average annual rate of increase of 7.3% for Chicago, Princeton and Vanderbilt and to 8.3% for all private universities.[4]

Medical education

In the area of medical care, hospital costs and doctors' cost per patient show increases substantially above the general price cost index as illustrated in Bradford, Malt and Oates, "The Rising Cost of Local Public Services," *National Tax Journal*. In the period 1958–71, the average operating budget for medical schools increased from $2,056,000 to $8,475,000, an increase of 412%. The mean salary for basic science faculty and for all ranks of clinical science faculty increased 59% and 66% respectively in the following statistics:

AVERAGE OPERATING BUDGET FOR MEDICAL SCHOOLS (DOES NOT INCLUDE SPONSORED PROJECTS)

Year	Number of schools	Average budget
1958–59	85	$2,056,000
1959–60	86	2,235,000
1960–61	87	2,461,000
1961–62	87	2,755,000
1962–63	87	2,944,000
1963–64	87	3,289,000
1964–65	87	3,674,000
1965–66	87	4,230,000
1966–67	87	4,933,000
1967–68	89	5,518,000
1968–69	91	6,324,000
1969–70	93	7,206,000
1970–71	92	8,475,000

Note: The number of schools reporting equaled total number of schools existing in all years except 1970–71 when 92 of 95 schools reported.

[2] This appendix, previously printed, was made a part of the official files of the committee.
[3] Source: "The More Effective Use of Resources—An Imperative for Higher Education," A Report and Recommendations by the Carnegie Commission on Higher Education, June 1972, pp. 33–38.
[4] Source: "Economic Pressures on the Major Private Universities," William G. Bowen, Reprinted from "The Economics and Financing of Higher Education in the United States," a Compendium of Papers Submitted to the Joint Economic Committee, Congress of the United States, Government Printing Office, 1969, pp. 399–439.

Mean salaries for all basic science faculty (strict full-time)

Year	Mean salary
1963–64	$13,806
1964–65	N.A.
1965–66	15,018
1966–67	15,996
1967–68	17,336
1968–69	18,236
1969–70	19,353
1970–71	19,765
1971–72	21,051
1972–73 (59 percent over 1963–64)	21,972

Mean salaries for all ranks of clinical science faculty (strict full-time)

Year:	
1963–64	$19,044
1964–65	N.A.
1965–66	20,096
1966–67	21,515
1967–68	23,688
1968–69	24,738
1969–70	26,407
1970–71	28,223
1971–72	30,008
1972–73 (66 percent over 1963–64)	31,640

Source: Dr. John A. D. Cooper, Association of American Medical Colleges, One Dupont Circle, Washington, D.C.

Hospital services

A major program concern and site of W. K. Kellogg Foundation expenditures has been the hospital field. The Foundation has assisted a wide variety of programs in community hospitals such as in recent support for coronary care units and the improvement of burn patient care facilities and services.

The increase of such support by the Foundation has substantially parallel the general rise of hospital costs in the United States. Such costs have risen at an appreciably greater rate than the general cost of living. The following is a depiction of the dramatic rise in hospital expenditures between the period 1950 to 1970:

TABLE 7.—TOTAL EXPENSES AND EXPENSE PER PATIENT DAY, COMMUNITY HOSPITALS, 1950–70

Year	Total expenses (in millions) Amount	Percent increase	Expenses per patient day Amount	Percent increase
1950	$2,120		$15.62	
1951	2,314	9.1	16.77	7.3
1952	2,577	11.3	18.35	9.4
1953	2,867	11.2	19.95	8.7
1954	3,121	8.8	21.76	9.1
1955	3,434	10.0	23.12	6.3
1956	3,733	8.7	24.15	4.5
1957	4,160	11.4	26.42	9.4
1958	4,655	11.8	28.27	7.0
1959	5,091	9.3	30.19	6.8
1960	5,617	10.3	32.23	6.8
1961	6,250	11.3	34.93	8.5
1962	6,841	9.5	36.83	5.3
1963	7,532	10.1	38.91	5.6
1964	8,349	10.8	40.58	6.9
1965	9,147	9.6	44.48	7.0
1966	10,276	12.3	48.15	8.3
1967	12,081	17.6	54.08	12.3
1968	14,162	17.2	61.38	13.5
1969	16,613	17.3	70.03	14.1
1970	19,560	17.7	81.01	15.7
Average annual increase		11.8		8.6

Of the nearly $14 billion rise between 1960 and 1970, the following factors have contributed:

1960–70: $14,000,000,000 INCREASE IN TOTAL U.S. HOSPITAL EXPENDITURES

	Billions	Percent
Population changes	1.2	8.6
Increased patient usage	1.9	13.6
Inflation	2.8	20.0
Increased payroll	4.4	31.4
Increased supplies and materials	3.7	26.4
Total	14.0	100.0

The American Hospital Association has informed us that the estimated 1973 per diem cost for hospital care is $102.37. This is in contrast to a similar cost of $15.62 in 1950 and $32.23 in 1960.

One example of rather marked escalation in the cost of program activities supported by the Kellogg Foundation in the health field relates to our recent grant to make possible a national study of education for health administration and as contrasted to an identical Commission in 1952–54. The earlier commission covered a life span of two year with a professional staff complement of two members plus one secretary. The total cost of this national study and which was completely defrayed by the Foundation was $71,199.

The Commission on Education for Health Administration was established in 1972 and its activity is scheduled to be completed by mid-1974. It has a similar purpose as the earlier group. The professional and secretarial complement is precisely the same, although there are some variables, such as complexity and the growth of this field. It is striking that the Foundation's commitment to the present Commission now totals $463,573.78.[5]

Hospital care has taken the largest share of increased spending on health. Since 1960, the cost of a day in a hospital has gone up 204%—to $92 in 1972, on average. The charge may run up to 50% higher in large cities. Physicians' fees, now costing Americans 16.2 billions a year, are up 74% over the same span.[6]

Hospital costs in Michigan have been rising faster than the cost of living since 1960, and particularly since the 1966 introduction of Medicaid and Medicare. From 1966 to 1971, Michigan hospital costs increased by 105.4% with 19.6% attributed to the increase in inflation.[7]

Exhibit B–1

ORAL TESTIMONY OF AD HOC COMMITTEE ON FOUNDATIONS

The Impact of the Current Economic Crisis of the Minimum Distribution Rule (Section 4942 of the Internal Revenue Code of 1954) on Foundations

Mr. Chairman and Members of the Subcommittee, I am H. Lawrence Fox, Washington, D.C., and I am acting as moderator with the following foundations who are represented by:

The Hormel Foundation. Raymond Ondov, Esq.

The Kellogg Foundation, Michigan. Dr. Russell G. Mawby, president; James W. Riddell, Esq.

The Kresge Foundation, Michigan. William Baldwin, Esq.

The Maclellan Foundation, Tennessee. Thomas C. Thompson, Jr., Esq.

The Pew Memorial Trust, Pennsylvania. Robert Smith; H. Lawrence Fox, Esq.

The Woodruff Foundation, Georgia. Boisfeuillet Jones, president.

For purposes of brevity, only four of our Group will testify, however, all are available for answering questions.

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[5] Source: Andrew Pattullo, Vice President-Programs, W. K. Kellogg Foundation.

[6] Source: "Soaring Cost of Health Care", U.S. News and World Report, Inc., January 22, 1973, p. 28.

[7] Source: "Enquirer and News", Battle Creek, Michigan, Thursday, March 15, 1973.

Since our primary concern is with the economic impact of the minimum distribution rule as enacted by the Tax Reform Act of 1969, our testimony will be restricted to Section 4942 of the Code. However, we would like to state that we concur with the analysis and conclusion of the statement of the Finance Subcommittee on Foundations dated October 4, 1974, that the excise tax in Section 4940 should be reduced from 4 to 2 percent.

Mr. Robert Smith will testify on why Section 4942 is operating to the detriment of private foundations. Dr. Mawby will illustrate the erratic application of Section 4942, Mr. William Baldwin will testify on the process for determining the applicable percentage in Section 4942(e)(3), and I will conclude our testimony.

The testimony being given is supported by a study entitled "The Impact of the Minimum Distribution Rule on Foundations" by Dr. Norman B. Ture which was a part of this Group's testimony and statement before the House Committee on Ways and Means on April 10, 1974. That testimony and study, as well as detailed submission for this Subcommittee, is submitted for incorporation into the record.

MR. ROBERT SMITH

Section 4942 requires private foundations to make annual distributions at a prescribed level based upon endowment value. From our experience, this approach is not only unrealistic but is forcing most private foundations to invade their corpus. The resulting decrease in endowment value, coupled with decreasing market values and double digit inflation is detrimental to the future existence of private foundations. In addition to forcing an encroachment on capital, Section 4942 does not give recognition to the fact that many private foundations that are currently able to support major charitable programs are only able to do so because their assets have been historically invested to provide a reasonable appreciation in value as well as a fair current return. Thus, the Group is concerned with the method of determining such a distribution as set forth in Section 4942 since it effectively prevents equity type investments, but is not philosophically opposed to the concept of a minimum annual charitable distribution.

Your Subcommittee's statement that "In our pluralistic society, we should never depend on government alone to support research and innovation. Foundations offer an alternative to that dependence and—as such—they should be welcomed and encouraged." is totally inconsistent with the operation of Section 4942, *i.e.*, a slow but certain death sentence.

A 6 percent or higher rate is not realistic. Standard & Poors indicates that dividend paying stocks will pay less than an average of 4 percent in dividends. Using this as a measuring stick, most foundations will be forced to reduce principal assets. Obviously, a high distribution rate serves charity today but also obviously reduces charitable distributions for the next year and subsequent years by virtue of corpus shrinkage. In our statement to the House Committee on Ways and Means, we set forth several examples which showed that if a 6 percent annual payout requirement had been in effect since their creation, charitable distributions would have been greater than those actually made, but because mandatory invasions of capital would have been required to meet the 6 percent standard during some of these years, the present value of the Foundations' assets would have been reduced with the result that current distributions would have been severely reduced. In other words, the present cost to charitable recipients would have been staggering. Even without considering the current inflation problem to be discussed, if history repeats itself, the future of private foundations and their charitable recipients is bleak. This is totally contrary to the legislative history of Section 4942. For example, in defending his amendment on the Senate floor, Senator Percy states: "The percentage should not be so high as to amount to a delayed death sentence."

From the legislative history, it is clear that Section 4942 is premised upon a foundation's total rate of return being the sum of its dividends, interest and capital gain realized and unrealized, divided by the market value of the assets. The statutory formula is as follows:

Current net income + capital growth — inflation = proper distribution

A simple example, applying this formula, illustrates why today the mandate may be a death sentence. Even assuming an unrealistically high current net income of 6 percent and a capital growth of 2 percent, and an inflation rate of only 8 percent, the application of this rationale shows that a zero distribution rate is appropriate (6%+2—8=0 distribution). Obviously, the Group is not desirous of an amendment requiring no distribution, but we wish to make it clear how unbalanced the statute is.

The failure of the statutory framework to include actual corpus growth and actual inflation, currently causes an automatic distribution in excess of current income which results in a corpus reduction. In addition, these results occur because the minimum investment return rule is expressed as a fixed percentage of the fair market value of the assets held by a private foundation.

Often this fair market value is established by a public market, as in the case of common stocks of companies listed on a national stock exchange. In these instances, the traditional indicia of value is the public's expectance of future earnings. Therefore, increased current earnings by the companies involved produce a proportionately greater increase in traded value, necessitating a greater invasion of principal to comply with the payout requirement.

If the rule continues, private foundations will be foreclosed from investments in marketable securities which would be illogical and detrimental to the long range responsibility of these foundations.

No matter how the problem is stated, under the 1969 Tax Reform Act, foundations must tap their capital resources for the difference between the required distribution rate of 6 percent and their actual cash income. This is unfortunate for foundations and bad for charity.

The next member of our Group testifying is Dr. Russell Mawby, President of the Kellogg Foundation, Battle Creek, Michigan.

DR. RUSSELL MAWBY

Because of the holding of Kellogg Company Common stock by the W. K. Kellogg Foundation Trust, the Trust's market value since inception had appreciated over tenfold and in a manner quite unlike what the appreciation would have been if the assets were in a 50% diversified portfolio, a 33⅓% diversified portfolio, or in an all-bond account. The Trust's 1968 distributions to charity were from 275 to 818% more than would have been possible with income from a 50% diversified fund, from 337 to 481% more than they would have been from a 33⅓% diversified fund and 955% more than would have been possible from a fund comprised exclusively of bonds.

From original gifts from our founder of $45 million, which in 1973 had a fair market value of $590 million, distributions to charity had then totaled $272 million. 1973 income from our continued holdings of Kellogg Stock was 66.5% greater than in 1967 compared with an increase at only 12.8% from our own diversified portfolio. This favorable comparison continued in 1974.

Such a record could not have been achieved under the 6% minimum distribution rule of Section 4942 of the Tax Reform Act of 1969 since that rule would have mandated arbitrary and continuous invasions of corpus, an unsound practice in prudent fiscal management. Had the 6% distribution rule been in affect the following would have occurred:

1. From 1934 through 1974 the trust made an actual distribution of $243 million. Had the minimum distribution rule been applicable, distributions of $271 million (or an increase of $28 million) would have been made;

2. To meet that payout requirement, the trust would have had to sell the equivalent of 18 million shares with a market value of $201 million; therefore, the trust's holdings would have been reduced to a market value of $206 million; and thus

3. The short-term higher return to charity of $28 million would have cost $201 million in corpus value, thereby reducing the current size of the trust by 50 percent. Further, for 1974–75 the distribution from the reduced assets would have been only $10.9 million rather than the $21.7 million which will in fact be distributed. If the full effect of the law had been in operation over the past five years, this year's income would be reduced by $1.9 million.

Thus, in addition to reducing the principal fund, the Tax Reform Act distribution provisions, had they been in effect, would have cut in half the income dollars available for distribution.

If the Tax Reform Act distribution provisions had been in effect, the benefits of half the above projects (based on dollar cost) would never have been realized and would have been lost forever because it is unlikely there would have been any other way for them to have been financed.

In the current market debacle, in spite of havoc being played on portfolios of mutual funds, pension funds, and endowments of educational institutions, the return to charity from our investment in Kellogg continues to increase as evidenced by the fact that our gross income from Kellogg Stock in the fiscal year just completed was 103.6% greater than just 10 years ago—having risen steadily each year; and the market value of our holding of Kellogg Stock at 10/31/74 was 41.5% greater than at 12/31/69, and down only modetly (6.5%) from 12/31/73. By comparison, the decline in the Standard and Poor 500 Stock Index since 12/31/73 has been 24% and the Dow Jones Industrial Average is down 21%. Mutual fund performance has been worse. The efforts of some foundations to meet the high payout requirements of the law has no doubt resulted in an increase in portfolio risk taking to increase income. In the current economic decline those kinds of investments have suffered the most from the decline in stock market values and reduced or omitted dividends.

During the period 1965 through 1973, Kellogg Foundation grants increased an average of 7.25% per year. Also through 1973 there was an annual erosion due to inflation which averaged 3.94%. Thus, it can be seen that through prudent fiscal management and the return of 100% of its income to charity, the Kellogg Foundation, through its grant-making process, has been able to more than counter the forces of inflation in its philanthropic endeavors. Specifically, its annual grants out-paced inflation through 1973 by an average of 3.31% per year. However, because of federal wage and price controls which limited dividends, Kellogg Foundation grants in 1974 were only 3.84% greater than 1973; thus keeping up with our first double-digit inflation in history during 1974 would have required massive invasions of corpus.

In 1975 we expect continued improved earnings from our Kellogg holdings to the extent that our 1975 return to charity will be over $23 million (after excise taxes) or 5.5% greater than in 1974. Throughout this period, and in spite of spiraling administrative costs caused most foundations by the Tax Reform Act of 1969 and by our inflationary spiral, Kellogg Foundation administrative costs have been held to an average of under 5% thus further maximizing our return to charity.

Except for some increase in cost of projects, and decreased earnings in 1974, the current economic crisis has had no appreciable impact on recipients of Kellogg Foundation grants beause the Foundation has been able to continually increase its grants which would not have been possible if the distribution and investment provisions of the Tax Reform Act had been in full operation in recent years.

For our current economic crisis, accurate statistics are not yet available reflecting cost increases in the educational and health sector. However, when the 1975 increase of 5.5% in Kellogg Foundation grants is contrasted to the double-digit inflation figure of 10 to 12.5% for the economy in general it is recognized that we will not now be able to provide charitable funding either to counter or exceed the general level of inflation let alone the cost increases being experienced in the nonprofit sector—with charity being the unfortunate loser.

But even so, the picture would have been far worse if the Tax Reform Act distribution and investment provisions had been in full operation in recent years resulting in a deep cut in principal and income available for distribution to charity.

The time will come when drastic erosions of our corpus will be necessary. Recent history, by those foundations who have consistently invaded corpus for payout purposes, has proved that such continuous invasions, in either bull or bear markets, will drastically erode the capabilities of foundations to fund charitable causes.

The next member of our Group testifying is William Baldwin, President of the Kresge Foundation.

MR. WILLIAM BALDWIN

Under Section 4942(e)(3) the Secretary of the Treasury is authorized to establish the applicable percentage in determining the minimum investment return. The Treasury last exercised this power on April 24, 1974, in T.I.R. No. 1288. While no public information has been made available as to what information the Treasury utilized in determining the appropriate rate, it is our understanding that it was based upoon U.S. Treasury intermediate obligations. The statute mandates that the Secretary consider "money rates and investment yields". Based upon the legislative history, it must be assumed that investment yields is the equivalent of dividend yields. In this connection, the Report's conclusion that "The adoption of a reasonable standard in the case of Section 4942 would seem both appropriate and wise" is wholeheartedly endorsed. Moreover, in light of the fact that time may not permit legislative relief this year, it would be appropriate for the Committee on Senate Finance to direct the

Secretary to include investment yields as well as interest rates in its calculations for Section 4942(e)(3).

The Report also ". . . recommended that Section 4942 be amended to give the public opportunity to comment on proposed changes in the applicable percentage." We obviously endorse this recommendation but also would like to point out to the Committee that the Secretary, without legislation, could propose the standards to be applied by Regulation and give the public an opportunity to comment by promulgating such rules in a Notice of Proposed Rule Making.

Legislation now

Because of the effective date provision in the Tax Reform Act of 1969, Congress must amend Section 4942 this year; if not, private foundations may be faced with a minimum investment percentage of 8 percent or more by 1975, particularly, if the action called for by Mr. Baldwin is not taken. In addition to your Subcommittee's statement indicating the need for a reexamination of the operation of Section 4942, the House Committee on Ways and Means, with Treasury concurrence, has proposed specific amendments:

H.R. 11197.—This bill was unanimously reported out by the Ways and Means Committee in the 92nd Congress. It would have reduced that income equivalent for foundations from six to five percent and provided certain transition rules to allow foundations the opportunity to adjust to Section 4942 (a minimum distribution of three and one-half percent for 1972 and 1973, four percent for 1974 and 1975, four and one-half percent for 1976 and 1977 and a five percent ceiling thereafter). Its substantive provisions were the result of coordination with the Treasury.

Enactment of this Bill would have reduced the impact of corpus invasion by lowering the applicable percentage, but would not have corrected all of the other problems with Section 4942 set forth herein. A similar Bill, S. 3927, has been introduced by Senator Carl Curtis (R. Neb.) in this Congress.

Tax Reform Bill of 1974.—On September 23, 1974, the Committee on Ways and Means tentatively decided that for a 5-year period beginning December 31, 1973, the private foundation charitable expenditure rules in Section 4942 would be modified so that a foundation would not be required to reduce the value of its endowment below the value on December 31, 1970; however, this rule would not reduce the charitable expenditure requirement below the greater of (1) 4 percent of the value of the endowment or (2) the foundation's income for the year. Such an amendment (hereinafter referred to as the "freeze base amendment"), has merit in that it recognizes that there are inequities with the application of Section 4942, but provides no substantive relief to this Group by virtue of the valuation date or freeze base being December 31, 1970.

It is believed that the following example illustrates the application of the freeze base amendment to Section 4942:

Assume that Private Foundation A (hereinafter A) and Private Foundation B (hereinafter B) each have an endowment value of $100 million on December 31, 1970; on December 31, 1975, A's value is $100 million and B's value is $150 million. Further assume that A's income for 1975 is $4.5 million and B's income is $6.75 million.

Applying the amendment, both A and B have a so-called "freeze base" of $100 million. Since the application of Section 4942(e)(3) would cause A to fall below its freeze base, it would be required to pay out the greater of its income ($4.5 million) or 4 percent of the freeze base ($4 million). Thus, the amendment would protect A's endowment, not including any shrinkage due to inflation. In B's case, the application of Section 4942(e)(3) would not cause it to fall below its freeze base and accordingly it would have to pay out the full $10.5 million which would result in an endowment loss of $3.75 million plus inflation.

In brief the freeze base amendment is welcomed because it indicates that the Treasury and the Committee on Ways and Means recognizes that Section 4942 must be amended. However, if this type of amendment is enacted, it must be modified. The previous example amply illustrates this point, *i.e.*, Private Foundation A, whose endowment remained stable was properly benefited, whereas Private Foundation B, whose endowment value had risen was not. In fact, B would be forced to divest assets (notwithstanding Section 4943) even thought it may be assumed that its endowment and charitable distributions steadily increased over the years.

A refinement of the freeze base concept would be to have a moving annualized base, i.e., instead of a constant endowment value as of December 31, 1970, the base for each year should be the endowment value as of December 31 of the previous year. This concept may be illustrated with the prior example except that A's December 31, 1974 endowment value is $100 million and B's December 31, 1974 value is $148 million. For A, the result would be the same as in the previous example. However, for B the minimum distribution would be its income of $6.75 million (which is greater than 4 percent of $148 million).

Another alternative to the freeze base as proposed by the Committee on Ways and Means would be to use the December 31, 1970 base adjusted upwards by inflation or the May 26, 1969 valuation adjusted by inflation.

With any of the foregoing refinement, the concept applies fairly to all private foundations.

Ture Report

After three years there has been time to examine how Section 4942 will operate to undermine overall foundation grants, and an opportunity to further examine the assumptions of the Peterson Report. For this purpose, the foundations subscribing to this statement have had an independent study prepared by Dr. Norman B. Ture. The findings and conclusion of that report, as briefly summarized in its own language, are as follows:

> First, any minimum distribution rule which ignores the foundation's rate of return will have a highly differential, discriminatory and possibly capricious impact on foundations and on their long-term capacity to support charities.
>
> Second, the contention that the investment performance of foundations is relatively poor is based on inadequate information and inappropriate statistical measures; the records of foudations for which data was available in the preparation of this report certainly do not support this contention.
>
> Third, no sound evidence was advanced to support the view that the allegedly poor investment performance of foundations is related to the concentration of their investment assets.
>
> Fourth, it is neither realistic nor reasonable to assume that a minimum distribution rule will result in significant increases in the rate of return on foundation investment.
>
> Finally, the (this) report concludes that the tax savings allegedly realized by those establishing foundations are, in all likelihood, very small. Foundation distributions to charity have represented a sizable amount of benefits relative to the foregone revenues.

Conclusion

From all of the foregoing, three things are apparent: One, the underlying premise of the 6 percent minimum distribution rule is predicated upon false assumptions; two, the statutory formula forces endowment shrinkage which operates to the detriment of charity; and three, this rule must be changed if private foundations are to continue.

The requirement of distributions to charity at a fixed or variable rate of 6 percent of the current market value of the foundation's assets, confronts foundation managers with difficult decisions that do not necessarily relate to the well being of charity. For example, many foundations hold all or substantial portions of the original gifts from their founders. This is often consistent with the founder's expressed desires as set forth in the declaration of trust, and, more importantly, the long-term performance of the donated holdings have justified continued retention rather than venturing into unknow territory through diversification.

If Section 4942 is not amended, it is clear that the principles set forth in the Peterson Report and incorporated in Section 4942 will impair the effectivess of all foundations and eliminate many of them to the detriment of charity. This position is not only supported by the Group's accomplishments and experience, but by the Ture study which indicates that private foundations can give better return per dollar to charity than the Federal Government. No one has suggested increasing the Government's role in advancing philanthropy, which is precisely what must happen if Section 4942 is not revised.

Our conclusion that Section 4942 must be revised is not inconsistent with our opening statement that private foundations have a moral and should have a legal obligation to make minimum annual charitable distributions; that is their function. The Group merely wishes to insure that they will exist in the future so that they will have such a function.

EXHIBIT B-2

THE IMPACT OF THE CURRENT ECONOMIC CRISIS OF THE MINIMUM DISTRIBUTION RULE (SECTION 4942 OF THE INTERNAL REVENUE CODE OF 1954) ON FOUNDATIONS

Written Statement Presented to the Finance Subcommittee on Monday, November 25, 1974, by The Hormel Foundation, The Kellogg Foundation, The Kresge Foundation, The Maclellan Foundation, The Pew Memorial Trust, and The Woodruff Foundation.

I. INTRODUCTION

On April 10, 1974, this Group, the Hormel Foundation, W. K. Kellogg Foundation, Kresge Foundation, Lilly Endowment, Inc.,[1] Maclellan Foundation, Pew Memorial Trust and the Woodruff Foundation, testified before the House Committee on Ways and Means. Copies of our testimony, written statement and a study by Dr. Norman B. Ture have already been submitted to this Subcommittee. For purposes of convenience, they are attached hereto and made a part of this presentation. Accordingly, we will only summarize portions of the foregoing presentation. At that time we indicated that as a Group we support the action taken by the Congress in the Tax Reform Act of 1969 to eliminate certain abuses previously associated with certain foundations. And, we strongly endorse the efforts of Congress to assure that Foundations operate properly in the public interest. We continue to recognize that the abuses of some Foundations necessitated corrective action, both to provide safeguards against the recurrence of those abuses and also to reassure the public that continued tax exemption for foundations would serve the national interest. On the other hand, we are concerned that correction of such abuses through undue and unnecessary restrictions might well be a disservice to that public interest if legitimate foundation operations are curtailed thereby.

We are concerned with the fact that two of the rules adopted in 1969 unduly restrict legitimate foundation activities and, accordingly, urge that each of them be reexamined and changed. The first rule is the imposition of the 4 percent excise tax on net investment income of private foundations, and the second is the requirement that the annual distributions of private foundations must be at least equal to a certain percentage of the current value of their investment assets (hereinafter referred to as the "minimum distribution rule"). These two rules are directly related to three issues raised by Chairman Hartke: 1) the impact which the current economic crisis is having on the Group; 2) the impact it has had on charitable recipients; and 3) the impact it is likely to have on charitable recipients.

A. Section 4940, 4 percent excise tax

We concur with the analysis and conclusion of the Statement of the Finance Subcommittee on Foundations, together with additional views, (hereinafter "The Report") by Chairman Vance Hartke (D. Ind.), October 4, 1974, that ". . . the load of the excise tax should be reduced from 4 to 2 percent." Accordingly, no further comments will be made in this statement other than to emphasize the fact that such a reduction would automatically increase private foundations' grants to charitable recipients.

B. Section 4942, the minimum distribution requirement

The primary goal of this statement is to make it clear that the statutory requirement that private foundations pay out a fixed percentage of their investment assets each year in pursuit of their charitable activities is detrimental to the future existence of private foundations; without a doubt this was not the intended purpose of Section 4942. The rationale behind this novel concept was apparently one, to insure that current distributions were sufficient to justify any tax benefit donors might receive from their contributions, and two, to prevent foundations from growing indirectly by investing in the stock of companies which retained most of their earnings and thereby delaying indefinitely charitable expenditures commensurate with the value of their assets. To satisfy both of these requirements, Section 4942 requires private foundations to make annual distributions at a prescribed level. From our experience, this approach is not only unrealistic but is forcing most private foundations to invade their corpus. The resulting decrease in endownment value, coupled with decreasing market values

[1] The Lilly Endowment, Inc. concurs in this statement, but will testify individually and file a separate statement.

and double digit inflation will eventually eliminate private foundations. Obviously, the Group recognizes that the Committee cannot directly control inflation or stock values, but it can amend Section 4942.

In addition to forcing an encroachment on capital, Section 4942 does not give recognition to the fact that many private foundations that are currently able to support major charitable programs are only able to do so because their assets have been historically invested to provide a reasonable appreciation in value as well as a fair current return. Thus, the Group is concerned with the method of determining such a distribution as set forth in Section 4942 since it effectively prevents equity type investments, and even if that method of determination were acceptable, the 6 percent rate set forth in Section 4942(e)(3) must be reduced. Assuming the latter is not accomplished, the method for determining the applicable percentage by the Treasury has to be amplified. In brief, this Group knows that Section 4942 as enacted in 1969 is detrimental to charity and the well being of this nation but is not philosophically opposed to the concept of a minimum annual charitable distribution.

C. Foundations are important to America

We heartily endorse The Report's conclusion that "In our pluralistic society, we should never depend on government alone to support research and innovation. Foundations offer an alternative to that dependence and—as such—they should be welcomed and encouraged." (The accuracy of the statement is underscored by the national economic picture where the Federal Government is in the posture of having to reduce its expenditures in this area. Thus the need for and burden of private foundations in the nation continues to grow.) This conclusion is totally inconsistent with the operation of Section 4942, *i.e.*, a slow but certain death sentence.

Section 4942 is a part of Chapter 42 of the Tax Reform Act of 1969 which appears to have promulgated a new and unhealthy concept in regard to private foundations. Instead of regarding those who had transferred their funds to a charitable trust as persons to be held in public esteem, the attitude seemed to be that these persons were probably up to nefarious tax schemes warranting elaborate safeguards. The implication somehow was that the Treasury was being cheated, notwithstanding the beneficial role private foundations play in society.

II. THE SUBSTANTIVE PROVISIONS OF SECTION 4942

A. In general

A 6 percent or higher rate is not realistic. Standard & Poors indicates that dividend paying stocks will pay less than an average of 4 percent in dividends. Using this as a measuring stock, most foundations will be forced to reduce principal assets. Obviously, a high distribution rate serves charity today but also obviously reduces charitable distribution for the next year and subsequent years by virtue of corpus shrinkage. In our statement to the House Committee on Ways and Means, we set forth several examples which showed that if a 6 percent annual payout requirement had been in effect since their creation, charitable distributions would have been greater than those actually made, but because mandatory invasions of capital would have been required to meet the 6 percent standard during some of these years, the present value of the Foundations' assets would have been reduced with the result that current distributions would have been severely reduced.[1] In other words, the present cost to charitable recipients would have been staggering. Even without considering the current inflations problem to be discussed, if history repeats itself, the future of private foundations and their charitable recipients is bleak.

B. Legislative History

1. *In General*

The legislative history of Section 4942 is amply set forth in The Report and our testimony before the Committee on Ways and Means. Both make it absolutely clear that the intent behind the development of a minimum distribution rule was not to require foundations to have such a high charitable distribution rate that it would be necessary for them to diminish their endowment as Section 4942 clearly requires. For example, in defending his amendment on the Senate floor,[2] Senator Percy states: "The payment requirement should be high enough to re-

[1] See Exhibit A for revised figures of the W. K. Kellogg Foundation which is illustrative of the Group.

[2] Congressional Record of December 6, 1969, at Pages S15959 through S15964.

quire private foundations to invest their funds productively. *The percentage should not be so high as to amount to a delayed death sentence.*"[emphasis added].

2. *Statute Ignores Inflationary Impact*

From the legislative history, it is clear that Section 4942 is premised upon a foundation's total rate of return being the sum of its dividends, interest and capital gain realized and unrealized, divided by the market value of the assets. The statutory formula is as follows: Current net income plus capital growth minus inflation equals proper distribution.

Assuming dividend or interest income of 4 percent, capital growth at 6 percent and inflation at 2 percent or less, the statute mandates that a private foundation's minimum distribution should be 6 percent or more without an erosion of corpus. A simple example, applying this formula, illustrates why today the mandate may be a death sentence for private foundations. Even assuming an unrealistically high current net income of 6 percent and a capital growth of 2 percent, and an inflation rate of only 8 percent, and application of this rationale shows that a zero distribution rate is appropriate (6 percent plus 2 minus 8 equal 0 distribution). Obviously, the Group is not desirous of an amendment requiring no distribution to charity, but we wish to make it clear how unbalanced the statute is.

From the foregoing, it is readily apparent that when the formula is applied in conjunction with the 6 percent or higher percentage called for in Section 4942 (e)(3), along with little or no capital appreciation and 4 percent current income, there will be a corpus reduction in direct relationship to the applicable percentage. (Note that this example illustrates that the statutory formula unrealistically reduces corpus growth and inflation to constants.)

The failure of the statutory framework to include actual corpus growth and actual inflation, currently causes an automatic distribution in excess of current income which results in a corpus reduction. In addition, these results occur because the minimum investment return rule is expressed as a fixed percentage of the fair market value of the assets held by a private foundation.

3. *The Stature, Contrary to Legislative Intent, May Force Private Foundations to Eliminate Equity Investment*

Besides the formula not taking into account inflation and capital growth, it is illogical because there is no general rule to correlate stock prices and earnings. Often this fair market value is established by a public market, as in the case of common stocks of companies listed on a national stock exchange. In these instances, the traditional indicia of value is the public's expectancy of future earnings. Therefore, increased current earnings by the companies involved produce a proportionately greater increase in traded value, necessitating a greater invasion of principal to comply with the payout requirement. In addition to stocks being valued upon the basis of earnings, dividend policies require companies, if they are to grow and remain financially sound, to limit their dividend distributions to a maximum of 50–60 percent of earnings. Many companies, such as the extractive industries, are forced to retain larger portions of earnings to underwrite exploration and development programs. Likewise, other groups, faced with constant heavy drains for research and development costs, must limit their dividend payments to small percentages of annual earnings in order to provide funds for expanding operations. Thus, many sound companies simply cannot pay out enough dividends to support a 6 percent or higher payment.

This point may be again illustrated by the following example: Assume a stock earns $5 per share. It would sell at about $75 with a multiple of 15. If it derwrite exploration and development programs. Likewise, other groups, faced paid 60 percent of its earnings as dividends, the dividend would be $3 or 4 percent (a little higher than normal) which would still not provide enough income to allow a minimum distribution of 6 percent or more without a corpus reduction. Hopefully, this example should help to make it clear that it is irrational to have a general rule requiring payments based on current values that in no way reflect current earnings.

The irony of this situation is readily apparent. Private foundations are now forced to sell sound income-producing common stocks held over a long period of time only because the investing public places a high value on those same shares for future appreciation potential. If the rule continues, private foundations will be foreclosed from investments in marketable securities which would be illogical and detrimental to the long range responsibility of these foundations. (For example, The Report notes that private foundations will have equity investments.)

No matter how the problem is stated, under the 1969 Tax Reform Act, foundations must tap their capital resources for the difference between the required distribution rate of 6 percent and their actual cash income. This is unfortunate for foundations and bad for charity.

C. Legislative consideration to correct section 4942

In addition to The Report recognizing the need for a reexamination of the operation of Section 4942, the House Committee on Ways and Means, with Treasury concurrence, has proposed specific amendments:

1. *H.R. 11197*

This bill was unanimously reported out by the Ways and Means Committee in the 92nd Congress. However, no tax bills were enacted by that Congress. It would have reduced the income equivalent for foundations from six to five percent and provided certain transition rules to allow foundations the opportunity to adjust to Section 4942 (a minimum distribution of three and one-half percent for 1972 and 1973, four percent for 1974 and 1975, four and one-half percent for 1976 and 1977 and a five percent ceiling thereafter). Its substantive provisions were the result of coordination with the Treasury.

Enactment of this Bill would have reduced the impact of corpus invasion by lowering the applicable percentage, but would not have corrected all of the other problems with Section 4942 as set forth herein. A similar Bill, S. 3827, has been introduced by Senator Carl Curtis (R. Neb.) in this Congress.

2. *Tax Reform Bill of 1974*

On September 23, 1974, the Committee on Ways and Means tentatively decided that for a 5-year period beginning December 31, 1973, private foundation charitable expenditure rules in Section 4942 would be modified so that a foundation would not be required to reduce the value of its endowment below the value on December 31, 1970; however, this rule would not reduce the charitable expenditure requirement below the greater of (1) 4 percent of the value of the endowment or (2) the foundation's income for the year. Such an amendment (hereinafter referred to as the "freeze base amendment"), has merit in that it recognizes that there are inequities with the application of Section 4942, but provides no substantive relief to this Group by virtue of the valuation date or freeze base being December 31, 1970:

MARKET VALUES

Foundation	May 26, 1969	Dec. 31, 1970	Dec. 31, 1971	Dec. 31, 1972	Dec. 31, 1973	Oct. 31, 1974
Hormel	$9,977,672.08	$9,912,111.08	$11,156,415.54	$10,136,157.03	$8,885,073.76	$8,162,010.59
Kellogg	354,000,000.00	434,117,760.00	488,382,480.00	567,400,442.00	560,735,440.00	524,558,960.00
Kresge	437,380,000.00	453,596,000.00	717,340,000.00	872,033,000.00	644,395,000.00	511,602,000.00
Maclellan	45,800,187.00	43,997,030.00	59,684,496.00	87,994,061.00	81,6838,012.00	52,291,000.00
Pew Memorial Trust	425,832,471.00	335,845,239.00	405,985,261.00	400,242,834.00	579,818,369.00	519,298,523.00
Woodruff						

It is believed that the following example illustrates the application of the freeze base amendment to Section 4942:

Assume that Private Foundation A (hereinafter A) and Private Foundation B (hereinafter B) each have an endowment value of $100 million on December 31, 1970; on December 31, 1975, A's value is $100 million and B's value is $150 million. Further assume that A's income for 1975 is $4.5 million and B's income is $6.75 million. Without regard to the freeze base amendment and assuming the applicable percentage in Section 4942(e) (3) is 7 percent, A's minimum income distribution would be $7 million resulting in a corpus reduction of $2.5 million ($7 million required distribution minus $4.5 million income) and B's would be $10.5 million resulting in a corpus reduction of $3.75 million ($10.5 million required distribution minus $6.75 million income).

Applying the amendment, both A and B have a so-called "freeze base" of $100 million. Since the application of Section 4942(e)(3) would cause A to fall below its freeze base, it would be required to pay out the greater of its income ($4.5 million) or 4 percent of the freeze base ($4 million). Thus, the amendment would protect A's endowment, not including any shrinkage due to inflation. In B's case, the application of Section 4942(e)(3) would not cause it to fall below its freeze base and accordingly it would have to pay out the full $10.5 million which would result in an endowment loss of $3.75 million plus inflation.

In brief the freeze base amendment is welcomed because it indicates that the Treasury and the Committee on Ways and Means recognizes that Section 4942 must be amended. However, if this type of amendment is enacted, it must be modified, otherwise the same problems that exist with the statute as enacted in 1969 will continue to exist.

3. *Action Which Should and Must Be Taken*

(*a*) *Legislative.*—Because of the effective date provision in the Tax Reform Act of 1969, Congress must amend Section 4942 this year; if not, private foundations may be faced with a minimum investment percentage of 8 percent or more by 1975. This would be at a time when the corpus of most private foundations is actually shrinking, reflecting both the stock market drop and the double digit inflation. This would further reduce private foundations' ability to keep pace with inflation and to provide charitable contributions for future generations equal to those now being distributed. In order to prevent this irreparable harm to the nation's charitable institutions' grant making policy, the Committee on Senate Finance should favorably consider taking immediate action on amending Section 4942 (this year).

Since both the staffs of the Treasury and the Joint Committee have worked on the development of the freeze base concept subsequent to H.R. 11197, it is logical to assume that this concept is appropriate for immediate consideration by the Committee on Finance in its efforts to correct the inequities of Section 4942. However, it is obvious that the freeze base concept tentatively adopted by the Committee on Ways and Means must be further developed to insure that this concept does not penalize those foundations whose investment policies have created a more valuable endowment over the years. The previous example amply illustrates this point, *i.e.*, Private Foundation A, whose endowment remained stable was properly benefited, whereas Private Foundation B, whose endowment value had risen was not. In fact, B would be forced to divest assets (notwithstanding Section 4943) even though it may be assumed that its endowment and charitable distributions steadily increased over the years.

A refinement of the freeze base concept would be to have a moving annualized base, *i.e.*, instead of a constant endowment value as of December 31, 1970, the base for each year should be the endowment value as of December 31 of the previous year. This concept may be illustrated with the prior example except that A's December 31, 1974 endowment value is $100 million and B's December 31, 1974 value is $148 million. For A, the result would be the same as in the previous example. However, for B the minimum distribution would be its income of $6.75 million (which is greater than 4 percent of $148 million). This results from the fact that the application of Section 4942(e)(3) would cause an endowment reduction below the December 31, 1974 valuation (or annualized base) of $148 million (7% of $150 million equal $10.50 million minus $6.75 million income equal $3.75 million from endowment; $150 million endowment minus $3.75 million equal $146.5 million).

Another alternative to the freeze base as proposed by the Committee on Ways and Means would be to use the December 31, 1970 base adjusted upwards by inflation or the May 26, 1969 valuation adjusted upwards by inflation.

With any of the foregoing refinements, the concept applies fairly to all private foundations. Obviously, such an amendment would be a step toward the elimination of the slow unintended death of private foundations due to the statutory deficiencies previously set forth.

(*b*) *Administrative.*—Under Section 4942(e)(3) the Secretary of the Treasury is authorized to establish the applicable percentage in determining the minimum investment return. The Treasury last exercised this power on April 24, 1974, in T.I.R. No. 1288. While no public information has been made available as to what information the Treasury utilized in determining the appropriate rate, it is our understanding that it was based upon U.S. Treasury intermediate obligations. The statute mandates that the Secretary consider "money rates and investment yields". Based upon the legislative history, it must be assumed that investment yields is the equivalent of dividend yields. In this connection, The Report's conclusion that "The adoption of a reasonable standard in the case of Section 4942 would seem both appropriate and wise" is wholeheartedly endorsed. Moreover, in light of the fact that time may not permit legislative relief this year, it would be appropriate for the Committee on Senate Finance to direct the Secretary to include investment yields as well interest rates in its calculations for Section 4942(e)(3).

The Report also ". . . recommended that Section 4942 be amended to give the public opportunity to comment on proposed changes in the applicable percentage." We obviously endorse this recommendation but also would like to point out to the Committee that the Secretary, without legislation, could propose the standards to be applied by Regulation and give the public an opportunity to comment by promulgating such rules in a Notice of Proposed Rule Making.

D. Other Problems Related to Section 4942

1. *Donative Intent*

In addition to the sound economics associated with owning securities, the trustees may be required to take actions contrary to the desires of the donors as expressed in original trust documents if they divested stock from corpus. Most of the large foundations today were born decades ago out of successful one-family directed corporations. In a national atmosphere that was receptive and generally grateful and in accordance with the law of the land then in effect, family leaders dedicated major portions of their personal fortunes to charity through the establishment of foundations and trusts in various forms. Their wisdom produced certain requirements and restrictions governing the conduct of their trustees. Provisions covered investment policies, income distribution guidelines and rules for grant making among other stated wishes and directions of the donors. As long as those provisions were legal when drawn, done in good faith, in the interest of charity, and provide for prompt payout of cash income, we believe they should prevail and not be subject to change after the program is underway. Surely such a policy will discourage future donors and strikes at the credibility of all tax incentives. The validity of this position was accepted in Section 4943 by virtue of transition rules concerning divestiture. Thus it is discouraging to be exempted from the divestitute requirements of Section 4943 only to be forced into divestiture by Section 4942.

Incidentally, the Group takes pride in pointing out to the Subcommittee that their performance has outdistanced those private foundations who diversified their portfolios rather than remaining in stock ownership in a few companies.

2. *Management Difficulties Caused by 1969 Rules*

There are problems that may not be obvious that a distribution rule based on current value introduces. First, the monthly valuation requirement consumes time and attention that is non-productive of charitable benefit. Foundation managers find themselves viewing invesments like a speculator concerned with short-term market trends rather than with basic soundness of an investment. The short-term trend is not important to the long-term investor and his attention to underlying value is the area of legitimate interest. Instead, we see the current formula attaches such importance to current values that it cannot help but be diversionary.

Second—and probably more important—is the problem associated with handling grants. Foundations typically have some sort of application submission and screening process before final action and these preliminaries are time consuming for both the charity and foundation. It is difficult for the foundation and the charities it supports not to have a fairly concrete and fairly long-term concept of the required distributor. It is unfair to a potential grantee to encourage an application when his likelihood of success is remote and it is unfair to the grants' committee not to have an adequate selection of applications. Thus, fluctuating levels of required distributions are inefficient for both the applicants and the trust.

An example will illustrate the problem. Let us assume that a foundation had dividend income of $1,000,000 and investment management expenses of $30,000 so it has $970,000 to use for charity out of income. If the corpus is $25,000,000 the minimum distribution at 6 percent would be $1,500,000 so corpus must be invaded in the amount of $530,000.

E. Diversification: Not the Answer, Case in Point

From the foregoing discussion, it should be clear that the inequities of Section 4942 are not eliminated by virtue of a private foundation diversifying its portfolio. This statement was amply supported in our Testimony before the Committee on Ways and Means where the experience of the Kellogg Foundation was specifically set forth. In that case, the diversified portfolio out-produced mutual funds and yet it was outperformed by the Kellogg stock. Despite an outstanding growth rate coupled with enormous charitable distributions, the Kellogg Foundation still cannot satisfy Section 4942. This example continues to be illustrative of the Group.[1]

F. Ture Economic Study

After three years there has been time to examine how Section 4942 will operate to undermine overall foundation grants, and there has been the opportunity to further examine the assumptions of the Peterson Report. For this purpose, the foundations subscribing to this statement have had an independent study prepared by Dr. Norman B. Ture. The findings and conclusion of that report, as briefly summarized in its own language, are as below:

> First, any minimum distribution rule which ignores the foundation's rate of return will have a highly differential, discriminatory and possibly capricious impact on foundations and on their long-term capacity to support charities.
>
> Second, the contention that the investment performance of foundations is relatively poor is based on inadequate information and inappropriate statistical measures; the records of foundations for which data was available in the preparation of this report certainly do not support this contention.
>
> Third, no sound evidence was advanced to support the view that the allegedly poor investment performance of foundations is related to the concentration of their investment assets.
>
> Fourth, it is neither realistic nor reasonable to assume that a minimum distribution rule will result in significant increases in the rate of return on foundation investment.
>
> Finally, the (this) report concludes that the tax savings allegedly realized by those establishing foundations are, in all likelihood, very small. Foundation distributions to charity have represented a sizable amount of benefits relative to the foregone revenues."

In addition to the foregoing conclusions from the Ture Report, one other point must be made. Inflation increases the dependence of charitable institutions on private foundations and other private sources for a dependable and continuing flow of funds. The costs of programs normally supported by foundations, institutions, educational, health, and social service organizations have increased faster than the general rate of inflation. During the period 1958–1971 the average operating budgets for U.S. medical schools increased from $2,056,000 to $8,475,000 an increase of 412%. Since 1960 the average cost of a day in a U.S. hospital has gone up 204%—to $92 in 1972. Physicians' fees, which cost Americans $16.2 billion in 1972 were up 74% over 1960. Since the introduction of Medicaid and Medicare costs, for example, in Michigan, hospitals rose 105.4% between 1966 and 1971 with 19.6% of that rise being attributed to inflation. In institutions of higher education costs increased from 1953–54 to 1966–67 to an annual average of 3.5%, as compared with a rat of 1.6% for the consumers price index during the same period—a difference of 1.9%. These increasing costs are seen as limiting the work of many charitable organizations and come at a time when government programs can't meet demand and when budgetary considerations require cutbacks in federal spending. Thus, it is in the public interest that charitable organizations have future access to a number of sources of both private money and public spending to finance their activities. If Section 4942 is allowed to destroy private foundations, the Federal Government will be forced to replace the job now being done by the private sector.

Conclusion

From the foregoing, three things are apparent: One, the underlying premise of the 6 percent minimum distribution rule is predicated upon false assumptions; two, the statutory formula forces endowment shrinkage which operates to the detriment of charity; and three, this rule must be changed if private foundations are to continue to be permitted to serve their function in the support of charitable undertakings.

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[1] See Exhibit A.

The requirement of distributions to charity at a fixed or variable rate of 6 percent of the current market value of the foundation's assets, confronts foundation managers with difficult decisions that do not necessarily relate to the well being of charity. For example, many foundations hold all or substantial portions of the original gifts from their founders. This condition is often consistent with the founder's expressed desires as set forth in the declaration of trust, and, more importantly, the long-term performance of the donated holdings have justified continued retention rather than venturing into unknown territory through diversification of investments.

If Section 4942 is not amended, it is clear that the principles set forth in the Peterson Report and incorporated in Section 4942 will impair the effectiveness of all foundations and eliminate many of them to the detriment of charity. This position is not only supported by the Group's accomplishments and experience, but by the Ture study which indicates that private foundations can give better return per dollar to charity than the Federal Government. No one has suggested increasing the Government's role in advancing philanthropy, which is precisely what must happen if Section 4942 is not revised.

Our conclusion that Section 4942 must be revised is not inconsistent with our opening statement that private foundations have a moral and should have a legal obligation to make minimum annual charitable distributions; that is their function. The Group merely wishes to insure that they will exist in the future so that they will have such a function.

Exhibit C

Letter to Senator Vance Hartke from Assistant Secretary of the Treasury (Tax Policy) Frederick W. Hickman

DEPARTMENT OF THE TREASURY,
Washington, D.C., April 16, 1975.

Hon. VANCE HARTKE,
U.S. Senate,
Washington, D.C.

DEAR VANCE: Your letter of February 27 to Secretary Simon requested that the Treasury Department exercise its statutory authority to refrain from declaring a new private foundation minimum payout rate for 1975. As you know, this question has been under discussion for some weeks between members of my staff, your staff, and the staff of the Joint Committee on Internal Revenue Taxation.

The private foundation minimum payout provisions provide that the minimum payout for any taxable year beginning after 1970 shall be determined and published by the Treasury Department on the basis of the relationship of money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year to money rates and investment yields for the calendar year 1969. While the Committee reports on this legislation indicate that the statute authorizes the Treasury Department to redetermine the private foundation minimum payout requirement "from time to time," we have generally regarded this provision as mandating an annual review of the minimum payout requirement. Nevertheless, the regulations implementing this provision provide that if a new minimum payout requirement is not published for a taxable year by May 1 of that year, the requirement published for the preceding taxable year shall remain in effect. Due to the expiration of the transition period, the minimum payout requirement for both new and old private foundations will be 6 percent for 1975 if a new percentage is not determined and published by May 1.

As I indicated to you last November 22, the Treasury Department has considered over the years a number of different methods for making the annual review of the private foundation minimum payout requirement, including methods involving the use of various composite indices. For the last 2 years, we have used a single index, the change in yield on 5-year Treasury securities. This index has seemed to us to be the best measure of substantial and enduring movements in investment yields and market interest rates, as distinguished from merely transitory changes in market conditions; and we believe the procedure we have used has been generally in accord with the purpose of Congress in providing for a variable payout requirement.

Nevertheless, as was brought out in testimony before your subcommittee, the use of a single index reflecting only interest rates has been criticized on the ground that it does not fully implement the statutory mandate that we consider both market rates and investment yields. On the other hand, the various procedures that have so far been suggested for reflecting yields on equity securities appear deficient either in looking only to dividend yields (and thus failing to reflect capital appreciation) or in leading to sharp annual fluctuations in the payout requirement (where the computation procedure reflects annual changes in such price indicators as the Standard and Poor's 500 stocks). However, alternative computational procedures are still being examined by our staffs with a view to overcoming these difficulties, if at all possible, or to developing proposals for modification of the existing statutory provisions.

In view of these considerations, we have concluded that for this year's annual review of the private foundation minimum payout requirement it would be appropriate to carry out a broad scale examination of a number of different indices of market rates and investment, rather than limiting our examination to the yield on 5-year Treasury securities. In light of this review, and taking into account that the performance last year of market rates and investment yields was quite unusual and erratic, we have concluded that a determination and declaration of a new payout rate is not required.

The joint examination of this issue that our staffs have carried out in the last few months has been most helpful in delineating some of the problems in the present statutory payout formula and in various alternative procedures that have been suggested for determining annual changes in the payout requirement. I am hopeful that this examination will continue and be brought to a successful conclusion, either through a consensus on procedures to be applied under current law or through whatever legislative action may be necessary. We believe that Congress intended for the annual payout determination to be largely a mathematical calculus, with relatively little scope for administrative discretion. An early resolution of the questions that have been raised regarding the annual payout determination is essential if that intention is to be fully implemented.

Sincerely yours,

FREDERIC W. HICKMAN,
Assistant Secretary.

Senator CURTIS. We must call the next witness, Mr. Donald Tollefson.

STATEMENT OF DONALD A. TOLLEFSON, COALITION FOR THE PUBLIC GOOD, ACCOMPANIED BY WILLIAM PENICK

Mr. TOLLEFSON. My name is Donald A. Tollefson, and I am before you today, as a spokesman for the Coalition for the Public Good, through voluntary initiative and, as further indicated in my written text, as a volunteer active with several charitable organizations here in Washington, D.C. I am in charge of the Washington office of Arthur Andersen, and accompanying me today is one of my tax partners, Mr. William Penick, who has made several appearances before committees of Congress that are considering changes in our tax laws. Both Mr. Penick and I will be pleased to answer any questions your committee may have for us at the conclusion of our testimony.

Senator CURTIS. Tell us a little about the Coalition for the Public Good.

Mr. TOLLEFSON. The Coalition is an informal association of top officials of 21 major charitable organizations including, among others, the American Council on Education, the American Hospital Association, the National Health Council, and United Way of America. The organizations which belong to the coalition represent most of the charitable organizations of our country. I am honored to speak for those entities and appreciate the opportunities that your Senate Finance Committee has afforded me to do so.

Senator CURTIS. Your entire statements will appear in the record. I also want to state that while I wish more Senators could be here, your statement will be very, very helpful to the technical men in the offices of the various members as well as the staff of the committee. So if you will, put your entire statement in, and summarize as you like.

Mr. TOLLEFSON. I would like to go on record strongly supporting the testimony of the previous six witnesses, although that is not in my submitted testimony, concerning private foundations and their importance to our society, because the foundations are a source of a very large amount of the contributions that end up in public charities. On behalf of the Coalition, I would also like to go on record supporting approval of S. 2348, related to the lowering of the excise tax on the net investment income of foundations and also S. 2475 which sets the annual payout at 5 percent. I wanted you to know we supported that strongly.

I will try to summarize quickly. There are four matters that concern us particularly. While we are very concerned with the provision in the House bill that would include as an additional tax preference item the excess of itemized deductions over 70 percent of adjusted gross income, with some reluctance we do not oppose it, particularly when it is compared with some of the alternatives that were considered by the House.

Senator CURTIS. That is not a very strong recommendation.

Mr. TOLLEFSON. Yes, sir, you read it correctly. Although this provision was not directed solely at charitable giving, it could have a significant impact on charitable donations because this is the area in which the taxpayer has the most flexibility. If the taxpayer has deductions for interest and taxes, for medical expenses, casualty losses, and things like that, that are going to place him near the 70-percent level, it is the charitable contribution which may not be made in order to avoid what otherwise would be a tax on a gift.

Senator CURTIS. There will be situations where that may be the only controlled deduction that he can avail himself. I think you have established a good point.

Mr. TOLLEFSON. The second minimum tax proposal we wanted to highlight involves the question of minimum tax without separate deductibility of contributions as was originally proposed by the Treasury. The House bill did not incorporate the original proposal of the Treasury; it also did not incorporate a revised provision of Treasury which would have given separate deductibility to the charitable contributions.

Senator CURTIS. Could you give us an illustration of how that might work to illustrate the problem and the points you are making?

Mr. TOLLEFSON. If separate deductibility of the charitable contribution was not allowed, then the charitable contribution again could be the disbursement that the taxpayer would not make in order to avoid becoming subject to the minimum tax provisions. Bill, do you want to add to that?

Mr. PENICK. This is a controllable element and if the minimum taxable income approach would result in a higher tax than the normal tax, there would be really a disincentive for charitable giving.

Senator CURTIS. Is that the present law or just in the House bill?

Mr. PENICK. This was one of the proposals, originally, I think, proposed by the Treasury. The House bill does not have this in it at the present time.

Senator CURTIS. What is the present law in reference to this?

Mr. PENICK. There is no limitation on it at the present time.

Senator CURTIS. In other words, do I understand that the present law is such that if a taxpayer in a certain circumstance increased his giving that that giving could subject him to the minimum tax or a higher minimum tax than if he had not given?

Mr. PENICK. Under present law there would be no limitation. He would not be hurt by having made the larger contribution.

Senator CURTIS. Under the present law, but he will under the House law?

Mr. PENICK. No, sir. He would be hurt under the point Mr. Tollefson just made of the limitation or treating as a preference item the excess of total itemized deductions over 70 percent of adjusted gross income. That would hurt. But the reason on that—I do not want to pre-empt Mr. Tollefson's remarks here—but the reason I think it is important to consider the impact this might have on the minimum taxable income approach—as you well know your committee is giving serious consideration to this as an alternative to some of the House proposals.

Senator CURTIS. What is your recommendation in reference to what the Treasury has proposed?

Mr. PENICK. I think the Treasury proposal which would treat separately charitable contributions is satisfactory.

Mr. TOLLEFSON. They amended their proposal and that would be perfectly acceptable to the charities.

The next matter involves appreciated property gifts. There is no doubt that inclusion of the appreciation in property contributed to charities as preferential income subject to the minimum tax would adversely affect the support of charitable organizations. Further, frankly, we feel it is a contradiction in terms to regard funds a person does not receive as income subject to tax. Without exception, a donor reduces his wealth when he makes a charitable contribution. Therefore, to tax him for having done so seems to fly in the face of logic to us. The application of a tax on appreciated property gifts will most certainly result in many potential donors holding property that other wise would be passed over to charities for the public good since the donor is under no obligation to either give or sell the property that otherwise would be subject to the tax.

Holding the property permanently would result in neither charity nor Government being the beneficiary of the appreciation until the property passes through the donor's estate.

The next major issue that I would like to cover involves the estate tax charitable deduction. For various reasons there are, both in and out of Congress, a number of advocates of a 50-percent ceiling on the estate tax charitable deduction. I would ask the committee to make no change in the estate tax charitable deduction rules since charitable bequests are a very important part of financing charitable services. Since 1974, about $2 billion in bequests were received by the organizations for which I speak and that was about 10 percent of total charitable giving by individuals in that year. Econometric studies made by the Filer Commission suggest that there would be questionable benefits at best in restricting the bequest deduction to a 50-percent ceiling. While only 2 percent of estates filing estate tax returns give more than 50 percent to charity, the amount given was substantial—$338 million in 1969—and that was one-sixth of the total charitable bequests that year. The Commission believes that limiting the deduction to 50 percent would cause about half of such bequests not to be made.

Senator CURTIS. That is limited to one-half of the adjusted gross of the estates?

Mr. TOLLEFSON. Yes, sir. That is correct, is it not?

Mr. PENICK. There is no limitation now. I think that is correct, sir.

Mr. TOLLEFSON. As we see it, the estate tax has two purposes, and one obviously is to generate revenue for the Government. But the primary purpose was and continues to be the limitation of the transfer of wealth to private individuals in the next generation. When a person bequeathes some or all of his estate to a charitable organization, he effectively removes that amount of his wealth from individual hands and makes it available for the public good. Indeed, a charitable gift can effectively accomplish this objective: a very brief example, if you had a $10 million estate, it would be taxed at $6.1 million, leaving $3,900,000 to the heirs. Obviously, if the entire $10 million were given to charity, it would all be used for the public good, and nothing would be left for the heirs.

The last item that I would like to mention, Senator, involves a provision contained in H.R. 10612 that would give charitable organizations access to the Tax Court or a district court in situations where their tax exempt status is denied or revoked or where the IRS delays unduly in making a decision on tax status. The law as it stands gives the Revenue Service the power of life or death over charitable organizations which depend on contributions for their survival. We trust the committee will seek to incorporate this provision in the bill it sends to the Senate so that charitable organizations will be able to have their status adjudicated promptly by the courts while they still have life in them.

As I indicated at the outset, there are many issues I would like to testify to, and I would urge that the committee read my text.

I would like to leave the committee with one overriding thought. Considering the problems of securing adequate funds for charitable organizations and the growing demands that are being placed on them, we believe it is sound public policy to retain the existing incentives for charitable giving in our tax laws, and we would hope, Mr. Chairman, that you and the esteemed members of this committee are going to concur with us and will not do anything that would weaken or detract from America's exceptional heritage of charitable giving. Thank you, sir.

Senator CURTIS. We thank both of you very much. There are many other points I would like to emphasize. The Senate has been in session for the last 40 minutes, so we must wind this up.

Thank you very much.

[The prepared statement of Mr. Tollefson follows:]

Statement on Behalf of the Coalition for the Public Good by Donald A. Tollefson

SUMMARY

1. Identification of witness and of Coalition for the Public Good.
2. Reasons why every issue should be examined carefully for its possible effect on charity.
3. Reluctant acquiescence to House proposal to include as a new preference item excess of itemized deductions over 70% of adjusted gross income.
4. MTI without deductions for charitable gifts should not be enacted.
5. Appreciation in property gifts to charity should not be subject to the minimum tax.
6. No limitation should be imposed on the estate tax charitable deduction.
7. Charitable organizations should have access to the courts for declaratory judgments regarding their charitable status.

STATEMENT

My name is Donald A. Tollefson and I am before you today as a spokesman for the Coalition for the Public Good . . . through voluntary initiative, and as a volunteer active with several charitable organizations here in Washington, D.C. I am currently a member of the Board and a Trustee of the United Way of the National Capital Area, and am also the Administration and Finance Committee Chairman for that organization; I am a Trustee of Hampton-Sydney College in Virginia; a Director of the Downtown Washington, D.C., Kiwanis Club; and an active fund raiser for the American Heart Association, American Cancer Society, the National Symphony and the National Conference of Christians and Jews, all here in Washington, D.C. My activity with these various organizations leads me to feel very strongly about the requests I would like to make of your Committee.

I earn my livelihood with Arthur Andersen & Co., an international accounting firm, and am Managing Partner of Arthur Andersen's Washington, D.C. office. I am accompanied here today by one of my tax partners, Mr. William Penick, who has made several appearances before Committees of Congress that are considering changes in our tax laws. Both Mr. Penick and I will be pleased to answer any questions your Committee may have for us at the conclusion of my testimony.

The Coalition is an informal association of top officials of twenty-one major national charitable organizations, including, among others, the American Council on Education, the American Hospital Association, the National Health Council and United Way of America. The organizations which belong to the Coalition represent most of the charitable organizations of our country. I am honored to have been asked to speak for all these charitable entities and I appreciate the opportunity which the Senate Finance Committee has afforded me to do so.

Charitable giving has become an accepted part of our society for many reasons. In a number of important ways we have followed the principle that the private sector should have a major role in meeting many of the needs of our society; that the private sector and government should complement each other's efforts and that government should provide a climate in which voluntary organizations can fulfill their responsibilities with maximum impact. Our tax laws have recognized this almost from their inception by permitting some easing of the tax burden for those who make contributions to support charitable activities. This is consistent with the free enterprise system where the individual does have the right to decide how his income and property will be used, excepting of course his obligation to support government activities which are for the benefit of all. The continued support of charitable organizations by private citizens is essential if these organizations are to continue to carry on their important role in our society.

There are many proposals affecting charitable organizations which may engage this Committee's attention and which may be debated on the Senate floor in the next few months—too many to be discussed by me at this time. Therefore, I will limit myself to items which are regarded as most serious by charitable organizations. With respect to the other issues, some of which are contained in H.R. 10612, which we generally favor, I would simply urge that their possible impact on charitable giving and the operation of charitable organizations be fully evaluated before they are adopted. Because of the complexity of the tax law, their impact may not be readily apparent. Consequently, I hope the Committee staff will be instructed to examine each of them carefully so that the members of the Senate may be fully aware of their implications for charity before voting to adopt or reject them.

I would like to express the views of charitable organizations on:

1. Proposals to change the minimum tax in ways that would adversely affect charities;
2. Proposals to disallow or to tax a portion of gifts of appreciated property to charities;
3. Proposals to place a ceiling on estate tax charitable deductions;
4. Proposals affecting charity contained in H.R. 10612.

Minimum tax on preferences

With some degree of reluctnace, we have not opposed the provision in the House bill that would include as an additional tax preference item the excess of itemized deductions over 70% of adjusted gross income. While this provision is not directed solely at charitable giving, it could have an adverse impact on charitable donations since this is the area of personal spending where the individual citizen has the most flexibility.

Itemized deductions consist for the most part of interest on home loans, state and local sales, income and property taxes, interest on other personal borrowing, medical expenses, casualty losses, and charitable contributions. The amount of expenditures a person makes for all of these categories except for charitable contributions is for the most part beyond his control. They can be characterized as nondiscretionary expenditures. On the other hand, charitable contributions are voluntary, and a taxpayer can make or not make a contribution as he sees fit.

If a percentage limitation is placed on the total of itemized deductions, and a substantial part of the deductions making up the total is nondiscretionary, it is obvious that, if anything has to give, it will be the discretionary element which in this case is charitable contributions.

This provisions is, however, less objectionable than most other alternative possibilities. Before recommending its minimum tax amendment, the House Ways and Means Committee considered and rejected other proposals to substitute for the existing Minimum Tax, (1) the Treasury's original Minimum Taxable Income scheme with no deductions for charitable contributions, (2) the Treasury's revised Minimum Taxable Income plan with charitable contributions to be deductible as under present law for the calculation of regular taxes, (3) a modification that would have included the appreciation in property gifts to charity as an element of preference income subject to the minimum tax, and (4) the allocation of deductions between taxable and non-taxable income.

Charitable organizations would have been satisfied if the Committee had seen fit to adopt the Treasury's revised MTI proposal with charitable contributions deductible. They would be badly hurt if any of the other proposals are adopted.

The original MTI proposals would have had a devastating effect on the support of charitable organizations. Because it was to be an alternative tax and because no deductions for charitable contributions were to be allowed in calculating it, a donor could, by virtue of making charitable gifts alone, as well as by any number of economic decisions, bring MTI into play and thus subject himself to a higher tax. Furthermore, carryovers of excess charitable contributions from previous years would not be recognized in any year in which he would have been required to calculate his tax on the basis of MTI. On top of this, no donor could have predicted in advance the tax consequences of making charitable gifts, since there would be no way of knowing before the end of the tax year whether the regular tax or MTI would be applicable in his case.

The unpredictability of the original MTI proposal would have made it impossible for charitable organizations to get timely, leadership, pace-setting gifts, the kind that come from those most likely to be affected by MTI. Thus the proposal would have affected all charitable giving, and not simply the giving of those who would have been required to use MTI.

In due course, Treasury recognized this problem and recommended that charitable deductions be allowed in calculating taxes by the MTI method as they are under the regular method. We applaud that decision.

There are reports that some members of this Committee and other Senators favor the alternative MTI approach. If MTI is considered favorable, it is essential that it provide for charitable deductions as recommended by the Treasury.

Appreciated property gifts

As noted earlier, we agree with the decision by the House not to include the appreciation element in property contributed to charity as preference income subject to the minimum tax. If this change had been adopted by the House, it could have had extremely adverse effect on the support of charitable organizations.

It is a long established principle of our tax policy that the charitable donation of appreciated property should be treated as a deduction to the donor measured by its value. That value is what is realized by the charitable organization, and in the interest of encouraging such gifts for the benefit of charitable organizations, this concept should be continued.

Quite often, critics of the present system maintain that the donor of appreciated property does so solely for tax benefits and not because of charitable motivation. It must be recognized that the donor of appreciated property, or any other property, is under no obligation to give the property. He can hold it indefinitely and neither charity nor the government will be the beneficiary of the appreciation until the property passes through his estate.

Prior to 1965, when individual tax rates were as high as 91 percent, it was possible for a taxpayer to realize more from the contribution of property than from its sale and retention of the after-tax proceeds. When the top individual tax rate was reduced to 70 percent and with changes made in the Tax Reform Act of 1969 with respect to the contribution of ordinary income type property, it became almost impossible for a taxpayer to realize more from a gift of property than from its sale.

The incentive to give appreciated property to charity is enhanced by the existing treatment of charitable gifts under the tax law. Even so, the donor pays a significant price in making his gift. He not only foregoes future income that the property might generate and the gain in its value during the time he has invested in it, but he also foregoes all interest and control when he makes his charitable gift. Though he reduces his tax liability in the process, he does pay a price. Consequently, such giving cannot be regarded as a "tax loophole" in the perjorative sense in which that term has come to be used.

Therefore, if this Committee decides to modify the existing minimum tax, we trust it will not do so in a manner that will discourage gifts of appreciated property on which many charitable organizations depend heavily.

The estate tax.—I ask the Committee to make no change in the estate tax charitable deduction. Charitable bequests are an important source of financing for educational, health, cultural and welfare services. In 1974 about $2 billion in bequests were received by the organizations for which I speak, about 10 percent of total charitable giving by individuals in that year.

As the Filer Commission recently pointed out, a wealthy person is given few choices in disposing of his or her property. The incentive to leave funds to charity is strong: in estates which exceed $5 million, $125 goes to charity for every $100 bequeath to individuals.

For various reasons there are, in and out of Congress, a number of advocates of a 50 percent ceiling on the estate tax charitable deduction. Econometric studies made for the Filer Commission suggest that there would be questionable benefits at best in restricting the bequest deduction to a 50 percent ceiling. While only 2 percent of estates filing estate tax returns give more than 50 percent to charity, the amount given is substantial—$338 million in 1969 dollars, or one-sixth of all charitable bequests. The Commission believes that limiting the deduction to 50 percent would cause about half of such bequests not to be made. Michael J. Boskin, Stanford University economist, estimated in his studies for the Commission, that charitable organizations would lose $189 million in bequests, while estate tax revenues would increase by $43 million, a loss of $4.40 to charity for each dollar gained by the Treasury.

As we see it, the estate tax has two purposes. One is to generate revenue for the government. The other is to limit the transfer of wealth to private individuals in the next generation.

As has been indicated already, placing a 50 percent ceiling on the estate tax charitable deduction would produce a relatively small amount of additional Federal revenue, something on the order of one-hundredth of one percent. But it would cost charitable organizations $189 million of funds badly needed to help maintain necessary levels of community service.

Almost everybody agrees that our system of voluntary organizations is one of the nation's great assets, to be nurtured and expanded wherever possible.

Placing a 50 percent ceiling on the estate tax charitable deduction would be a major, and in our view a highly undesirable, departure from long-held public policy.

When a person bequeaths some or all of his estate to a charitable organization, he effectively removes that amount of his wealth from individual hands and makes it available for the public good. Indeed a charitable gift can accomplish this objective more fully than the estate tax itself. For example, a taxable estate of $10 million would be taxed for about $6,100,000 leaving $3,900,000 to the heirs. A bequest to charitable organizations of that $10 million would leave nothing to individual heirs. All of it would be in the public domain just as if it had all gone to the Federal government.

Declaratory judgments.—H.R. 10612 contains a provision that would give charitable organizations access to the Tax Court or a District Court in situations where their tax exempt status is denied or revoked, or where the Internal Revenue Service delays unduly in making a decision on tax status. The law, as it stands, gives the Revenue Service the power of life or death over charitable organizations which depend on deductible contributions for their survival. We trust this Committee will see fit to incorporate this provision in the bill it recommends to the Senate so that charitable organizations will be able to have their status adjudicated promptly by the Courts while they still have life in them.

Mr. Chairman, as I indicated at the outset, there are many other issues that I could comment on. I refrain from doing so out of consideration for the Committee members and others who wish to be heard. I am grateful for your having given the Coalition the opportunity to appear before you and would like to leave you and your Committee with one overriding thought—considering the problems of securing adequate funds for charitable organizations and the growing demands on them, we believe it is sound public policy to retain the existing incentive for charitable giving in our tax laws, and we hope, Mr. Chairman, that you and the esteemed members of your Committee will concur with us that nothing should be done that would weaken or detract from America's exceptional heritage of charitable giving.

Mr. Penick and I would welcome any questions you might wish to raise with us.

Senator CURTIS. We will call Phillip T. Temple.

STATEMENT OF PHILLIP T. TEMPLE, PREEAU & TEITELL, ACCOMPANIED BY EMERSON WARD, M.D., CHAIRMAN OF THE BOARD OF DEVELOPMENT, MAYO CLINIC, ON BEHALF OF THE AMERICAN ASSOCIATION OF PRESIDENTS OF INDEPENDENT COLLEGES AND UNIVERSITIES

Senator CURTIS. Would you tell us about the American Association of Presidents of Independent Colleges and Universities.

Mr. TEMPLE. The American Association of Presidents of Independent Colleges and Universities is an organization of 114 presidents of independent colleges and universities, two-thirds of which receive either no governmental financial assistance or assistance that amounts to less than 2 percent of their annual budgets.

Senator CURTIS. Do you have some members in Nebraska?

Mr. TEMPLE. It does indeed. A list of the colleges is enclosed with our written statement which we ask be put on the record. It is apparent that these independent colleges depend on voluntary contributions from alumni, corporations, and organizations.

Senator CURTIS. Where do you live?

Mr. TEMPLE. Westchester County, just north of New York City.

Senator CURTIS. And you are an attorney?

Mr. TEMPLE. I am, indeed.

Dr. WARD. I am Emerson Ward, a physician and member of the Board of Development of the Mayo Clinic which is in Rochester, Minn., where I live.

Senator CURTIS. Your statements in full will be filed in the record. Even though at this time you are preaching to the Chair, and the entire congregation is not here, I wish you would go ahead and summarize your principal points.

Mr. TEMPLE. In order to give Dr. Ward an opportunity to give his testimony, I will just take a few moments.

The organizations on whose behalf we appear are listed in full in the printed statement. I do want to mention a few for the record. In addition to the American Association of Presidents of American Colleges and Universities and the Mayo Foundation, there is the National Association for Hospital Development, 48 separate New York colleges and universities, and religious organizations. The points that we make, as I stated, are set forth in full in our written statement, but I just want to highlight two parts of that statement.

First, we ask that the tax laws continue to encourage support of charitable organizations by concerned citizens.

Second, much has been said here this morning about the effect of the Tax Reform Act of 1969 on private foundations. It is apparent that the act had an effect upon publicly supported charities and the donors to those charities. Since this time the committee and the Congress as a whole will be considering tax revision we submit this is an appropriate time to look at certain overcorrections which went too far and removed important and proper tax incentives to charitable giving.

These areas of our concern are detailed on pages 32 through 42 of our written statement. We further endorse a proposal which we understand Chairman Long has made which would allow a 1-year carryback for contributions which would then permit a person to make a gift up to 3.5 months after the end of the taxable year and yet have it treated for tax deduction purposes as though it were made during the taxable year. We thank you for this opportunity to present these views. If, after reading the written statement, you or the staff would like any further information, we would be pleased to furnish it to you.

Dr. WARD. I appreciate, too, the opportunity to state to the committee the importance of private giving to the mission of the Mayo Clinic and the Mayo Foundation.

For nearly a century Mayo has provided medical care to all who sought it. In furtherance of this primary purpose, strong programs in medical education and research have been built. We provide training for health professionals at many levels. We have 700 physicians receiving advanced training in the Mayo Graduate School of Medicine. There is a new undergraduate school, a growing program of education in the allied health sciences and a long-standing continuing education program for practicing physicians, dentists, and allied health professionals.

More than 200 members of our staff are actively engaged in research aimed at finding new knowledge of value in prevention of disease and care of the sick, research is ongoing in all major areas of disease in man, and expansion of our efforts in cancer research and the field of immunology, pharmacology, and microbiology has been achieved in recent years. The past 2 years we have built two major laboratories largely through private donations and without public moneys of any sort.

The cost of our educational and research programs will exceed $42 million this year. We rely heavily upon private grants and gifts to meet these expenses. The continued success of our education and research programs will depend critically upon the degree which they are sustained by private gifts of all kinds.

We urge this committee recommend no changes in existing or pending legislation that would remove or reduce the tax incentives for private charitable giving to institutions such as ours. The importance to Mayo of gifts of appreciated securities and real property by individuals, foundation grants, of corporate gifts and especially bequests cannot be overstressed.

Private charitable support has been the basis of Mayo Foundation's achievements to date and will be the basis of our strength in the future.

We therefore ask that your committee recommend legislation that will not only maintain existing incentives for such giving but will remove any provisions in existing laws that tend to unreasonably discourage or penalize the making of gifts to charitable organizations and causes.

At Mayo, as in other medical centers, the reduction of such funds would be directly reflected in the decline in medical education and research and in the application of new knowledge to the care of the sick.

Thank you.

Senator CURTIS. Thank you very much.

This committee or the staff may have occasion to avail ourselves of the offer to provide more information. I concur with your recommendations.

A note has been passed to me that they want me on the floor, and we thank you very much.

[The prepared statement submitted by the preceding witness follows. Oral testimony continues on p. 2288.]

STATEMENT REGARDING PROPOSALS AFFECTING TAX TREATMENT OF CHARITABLE CONTRIBUTIONS TO TAX-EXEMPT INSTITUTIONS

Presented to: Committee on Finance, United States Senate. Hon. Russell B. Long, Chairman.

Submitted by: American Association of Presidents of Independent Colleges and Universities. President of 102 colleges and universities belong to the Association. (List annexed as Exhibit "A").

National Association for Hospital Development. Members are executives of over 600 hospitals located nationwide and charged with obtaining funds from the private sector to meet hospital needs. (List annexed as Exhibit "B").

National Association of Independent Schools. An association of 850 independent elementary and secondary not-for-profit schools. (List annexed as Exhibit "C").

Forty-eight New York colleges and universities. (List annexed as Exhibit "D").

The Christian and Missionary Alliance, a church denomination serving as a missionary-sending organization with over 900 missionaries. The United States constituency is represented by over 1,200 local church groups. The Christian and Missionary Alliance operates three colleges, four retirement centers and four convolescent and nursing homes. (List annexed as Exhibit "E").

The Church of the Nazarene, a Church denomination serving both the United States and Missionary fields with about 600 missionaries and 7,473 ministers in the United States. The United States constituency is represented by 7,427 congregations with a membership of 430,128 and Sunday School enrollment totalling 1,175,212 and 68 Districts. The Church of the Nazarene operates 8 liberal arts colleges, one Bible college, and one Seminary. (List annexed as Exhibit "F").

The Conservative Baptist Foreign Mission Society with a constituency of 2,000 churches and a membership of over 500,000. The Society operates 2 seminaries and 3 colleges.

General Council of the Assemblies of God, a church denomination serving both the United States and foreign fields with nearly 19,000 ministers. The United States constituency is represented by 9,000 churches with a membership of almost 5 million. The General Council operates 27 colleges.

Executive Council of The Church of God, a church denomination having 2,250 local congregations in the United States, 9 general agencies, including 3 schools.

National Board of Young Men's Christian Associations. The Board is the Legal corporate entity of the National YMCA movement. Locally incorporated YMCA's throughout the United States total about 1,900.

The Association of Baptist Foundation Executives, an organization consisting of 25 state and regional Baptist Foundations which are charged with stewardship responsibility for the various Baptist Conventions whose religious and Charitable work they support.

Beloit College, Beloit, Wis.
Bradley University, Peoria, Ill.
Carleton College, Northfield, Minn.
Carnegie-Mellon University, Pittsburgh, Pa.
Choate Rosemary Hall, Wallingford, Conn.
Clark University, Worcester, Mass.
College of the Holy Cross, Worcester, Mass.
Doane College, Crete, Nebr.
Drexel University, Philadelphia, Pa.
General Conference of Seventh-day Adventists, Washington, D.C.
Hendrix College, Conway, Ark.
Holy Cross Hospital, Fort Lauderdale, Fla.
Knox College, Galesburg, Ill.
Lafayette College, Easton, Pa.
LeTourneau College Fund, Longview, Tex.
Middlebury College, Middlebury, Vt.
Millikin University, Decatur, Ill.
Mount Olive College, Mount Olive, N.C.
Mount Holyoke College, South Hadley, Mass.
Mayo Foundation, Rochester, Minn. A charitable corporation dedicated to medical practice, medical education and medical research.
Northfield Mount Hermon School, East Northfield, Mass.
University of Notre Dame, Notre Dame, Ind.
Smith College, Northampton, Mass.
The Society for the Propagation of the Faith, New York City.
Westmont College, Santa Barbara, Calif.
Worcester Polytechnic Institute, Worcester, Mass.
World Literature Crusade, Chatsworth, Calif.
Oral testimony by: Conrad Teitell, member, Prerau & Teitell, New York City.

SUMMARY OF TESTIMONY

I. Comments on three sections of the House-passed tax revision bill (H.R. 10612) concerning charitable contributions

A. Section 301 of H.R. 10612 dealing with changes in the minimum tax for individuals as those changes affect charitable contributions. Charitable contributions should not be subject to any form of minimum tax. However, if Congress believes otherwise, we ask that Section 301 of H.R. 10612 be adopted by the Senate as being far preferable to proposals which would: (1) add the appreciation element in charitable gifts of appreciated property as a new tax preference subject to the minimum tax; (2) subject charitable contributions to a limit on tax preference rule; (3) subject charitable gifts to a minimum taxable income (MTI) rule; or (4) subject charitable gifts to an allocation of deductions rule.

B. Section 701 of H.R. 10612 dealing with accumulation trusts as its provisions apply to transfers of appreciated property to short-term charitable income (lead) trusts (defined in Section 170(f)(2)(B) of the Internal Revenue Code of 1954). These trusts should be exempt—as are charitable remainder trusts and pooled income fund trusts—from the provisions of Section 701 of H.R. 10612. Otherwise, creation of these trusts, which are highly beneficial to charitable organizations, will be greatly discouraged.

C. Section 502 of H.R. 10612 dealing with alimony payments as it applies to charitable contributions by reducing the adjusted gross income base upon which the ceiling on deductibility of charitable gifts is measured. The only change we ask regarding this section is that for the sole purpose of computing the income tax charitable deduction, alimony be added back to adjusted gross income.

II. Other tax revision proposals

The Committee's February 5, 1976 press release stated that it will also hold hearings on "other tax revision proposals which have not been included in H.R. 10612". If the Committee considers the present tax law provisions dealing with charitable organizations and contributions to those organizations we make the following comments:

A. The tax laws should continue to encourage support of charitable organizations by concerned citizens. Public charities perform a vital role in our society and the public would be adversely affected by enactment of proposals removing or reducing tax incentives to contributors. The history of our tax laws shows ever increasing tax incentives to supporters of charitable organizations which benefit the public. Now is not the time to reverse that trend.

B. The following tax incentives to charitable giving removed by the Tax Reform Act of 1969 through "overcorrections" should be restored:

1. Gifts of inventory, crops, donor-created art works, short-term appreciated securities and short-term appreciated real estate. An income tax charitable deduction should be allowed for the property's fair market value minus one-half of the amount which would be taxed as ordinary income on a sale.

2. Appreciated long-term tangible personal property, such as works of art (other than donor-created). An income tax charitable deduction should be allowed for the fair market value, whether the gift is "related" or "unrelated" to the donee's exempt function.

3. Gifts of personal residences and farms with retained life interests. The income tax charitable contribution deduction should not be discounted by straight line depreciation.

4. Pooled income fund trusts. "Broadly publicly supported" organizations described in Internal Revenue Code Section 509(a)(2) and "support organizations" described in Internal Revenue Code Section 509(a)(3) should be allowed to maintain pooled income fund trusts and be remaindermen of those trusts.

5. Charitable remainder trusts. Charitable deductions should be allowed for transfers to charitable remainder unitrusts and charitable remainder annuity trusts even though the trustee has the power to invade principal for the beneficiary if: (1) there is an ascertainable standard of invasion; and (2) based on that ascertainable standard the possibility of invasion is so remote as to be negligible.

6. Charitable gift annuities. Charitable gift annuities should be allowed for more than two lives without the charity being taxed under Internal Revenue Code Section 514 so long as the requirements (other than the maximum two-life requirement) of Internal Revenue Code Section 514(c)(5) are met.

7. Gift of free use of property. A donor to a charity who makes a lifetime gift of the right to use property rent-free or lends money interest-free should not be subject to gift and estate taxes on the rental value of the property or the value of the free use of the money.

8. Gifts of mortgaged property to publicly supported charities. (a) An outright charitable gift of mortgaged property should not be a bargain sale; (b) The prohibition on transferring a mortgaged asset—when the mortgage was placed on the property within the last 10 years—should not apply to charitable remainder unitrusts, charitable remainder annuity trusts, pooled income fund trusts and short term charitable income (lead) trusts; (c) There should be no imposition of capital gains tax when a donor transfers mortgaged property to fund a charitable remainder unitrust, a charitable remainder annuity trust, pooled income fund trust or short term charitable income (lead) trust. This rule should also apply to a gift of a mortgaged personal residence or farm with a retained life estate; (d) Charitable remainder unitrusts and charitable remainder annuity trusts should not be deemed to have unrelated business taxable income merely because the trusts hold mortgaged property or borrow to meet trust obligations; and (e) A charitable organization accepting mortgaged property in exchange for its promise to pay an annuity should not be subject to tax on unrelated business taxable income.

C. To further encourage charitable gifts so vital to the continued existence of most publicly supported charities, the following changes in the tax law are requested:

1. Adjusted gross income ceiling. Increase the adjusted gross income (contribution base) ceiling to 50% of adjusted gross income for all gifts to public charities.

2. The carryover. The five year carryover for "excess" gifts should be extended to 10 years.

3. Charitable remainder variable annuity trust. Authorize a new type of charitable remainder trust—a charitable remainder variable annuity trust.

D. The following proposals would adversely affect publicly supported charitable organizations and the publics they serve and should not be enacted:

1. Gifts of long-term appreciated securities, real estate and tangible personal property for a "related" use to schools, hospitals, health organizations, churches and other publicly supported charities. We oppose proposals which would:

(*a*) Limit the charitable deduction to the property's cost-basis.

(*b*) Limit the charitable deduction to the property's fair market value minus one-half of the appreciation.

(*c*) Allow charitable deductions for the property's fair market value, but tax the appreciation just as if the donor sold the property and contributed the proceeds.

(*d*) Require a longer holding period (e.g., one year) for a donor to be allowed a charitable deduction for the fair market value.

(*e*) Subject the property's appreciation to the 10 percent or other minimum tax.

(*f*) Tax the appreciation element of gifts of appreciated property given to charitable organizations at death.

2. Place a ceiling on the estate or gift tax charitable deduction.

3. Place a percent of adjusted gross income floor on the income tax charitable deduction.

4. Substitute a credit for the income tax charitable deduction.

III. Conclusion

Among all of the deductions the charitable deduction is unique. It is society that benefits the most by allowing charitable deductions, not individual donors. Tax incentives to charitable giving should be increased, not decreased.

TESTIMONY

Mr. Chairman and members of the committee, I am Conrad Teitell, a member of the New York City law firm of Prerau & Teitell, and appear before you in the capacity of special counsel to a number of charitable organizations which have the same general interests and have consolidated their testimony so as to conserve the Committee's time. The organizations on whose behalf I appear are:

The American Association of Presidents of Independent Colleges and Universities; the National Association for Hospital Development; the National Association of Independent Schools; 48 New York colleges and universities; The Christian and Missionary Alliance; The Church of the Nazarene, The Conservative Baptist Foreign Mission Society; Executive Council of The Church of God; National Board of Young Men's Christian Associations; The Association of Baptist Foundation Executives; Beloit College; Bradley University; Carleton College; Carnegie-Mellon University; Choate Rosemary Hall; Clark University; College of the Holy Cross; Doane College; Drexel University; the General Conference of Seventh-day Adventists; the General Council of the Assemblies of God; Hendrix College; Holy Cross Hospital; Knox College; Lafayette College; LeTourneau College Fund; Middlebury College; Millikin University; Mount Olive College; Mount Holyoke College; the Mayo Foundation; Northfield Mount Hermon School; the University of Notre Dame; Smith College; The Society for the Propagation of the Faith; Westmont College; Worcester Polytechnic Institue; and World Literature Crusade.

We thank you for this opportunity to present our views and support your efforts to make our tax laws more equitable.

I. Comments on three sections of the House-passed tax revision bill (H.R. 10612) concerning charitable contributions

A. Section 301 of H.R. 10612 dealing with changes in the minimum tax for individuals as those changes affect charitable contributions. Charitable contributions should not be subject to any form of minimum tax. However, if Congress believes otherwise, we ask that Section 301 of H.R. 10612 be adopted by the Senate as being far preferable to the following proposals which would substantially reduce charitable contributions.

1. The Minimum Tax. Proposals have been made which would subject to the minimum tax the appreciation element in charitable gifts of long-term appreciated securities, real estate and tangible personal property for a "related" use to schools, hospitals, churches, health organizations and other publicly supported charities. These proposals are made even harsher when coupled with other proposals which would lower the present $30,000 plus regular taxes paid floor and increase the present 10% minimum tax rate.

Gifts of appreciated property are a major source of support for most publicly supported charitable organizations. The tax treatment of appreciated property gifts was thoroughly considered by Congress in connection with the Tax Reform Act of 1969 and reflects an evident purpose to retain tax incentives for these gifts. We strongly urge that current law remain unchanged; otherwise a major source of charitable support would be drastically decreased. Thus, charitable gifts of appreciated property should not be subject to the current or any revised minimum tax provision.

2. Limit on tax preferences ("LTP"). Under one proposal, a 50% ceiling would be imposed on an individual's total income which can enjoy tax preferred status.

Tax preferences could include:

(*a*) Appreciation on property contributed to charity.

(*b*) One-half of net long-term capital gains.

(*c*) Tax-exempt interest on state and local bonds.

(*d*) The excess of accelerated depreciation over straight line depreciation.

(*e*) Certain farm losses.

We oppose the inclusion of appreciation on contributed property in LTP because it would substantially decrease charitable gifts.

3. The minimum taxable income (MTI) proposal.

The MTI proposal would for the following reasons substantially decrease support from major contributors on whom we rely for a large part of our private support:

(*a*) The MTI proposal would abolish the fifty percent of adjusted gross income ceiling on the income tax charitable deduction and, in effect, substitute a fifty percent of adjusted gross income ceiling for the total of all deductions (charitable, medical expenses, interest, taxes, etc.). Thus, if an individual makes charitable gifts equal to fifty percent of his adjusted gross income and has other itemized deductions of thirty-five percent, in effect, the ceiling on his charitable contribution deduction would be fifteen percent of his adjusted gross income.

(*b*) The MTI proposal would abolish the five year carryover for gifts by donors who are subject to MTI.

(*c*) The MTI proposal could have a retroactive effect and disallow deductions for charitable gifts made before enactment of MTI and being carried over into MTI years.

(*d*) The MTI proposal would affect even those who have no so-called tax preferences. For example, consider the case of a donor who has ordinary income of $100,000 and no tax preferences. Assume his adjusted gross income is also $100,000 and he has $3,000 in personal exemptions. His cash gifts for the year to colleges, churches, hospitals and other publicly supported charities total $50,000. His itemized deductions for interest, taxes, etc., total $30,000.

Under current law, his taxable income would be $17,000 ($100,000 adjusted gross income, minus $50,000 charitable contribution deduction, minus $30,000 deduction for interest, taxes, etc., minus $3,000 personal exemptions).

Under MTI, his adjusted gross income and expanded adjusted gross income (EAGI) would be $100,000 (because he has no tax preferences). From that subtract $3,000 for personal exemptions, subtract $10,000 and divide by two. His minimum taxable income would be $43,500 and he would be required to pay tax on $43,500 (instead of tax on $17,000 as under current law). In effect, $26,500 in charitable contribution deductions would be disallowed. The proposal would, in the example, impose a 23.5 percent ceiling on cash contributions. If the donor's non-charitable deductions were greater than $30,000, the charitable deduction would be reduced even more.

(*e*) Colleges, universities, churches, hospitals and other publicly supported charities depend heavily on leadership gifts. The MTI proposal would adversely affect contributions from those whose gifts inspire others to contribute. Thus, there would also be decreased gifts from those not subject to MTI.

(*f*) Individuals subject to MTI, or potentially subject to MTI, would likely not make their gifts during the year, but would wait until the end of the year to plan their gifts. Thus, gifts would be delayed or not made at all.

We do not believe that the charitable contribution deduction should be lumped with other deductions in any MTI proposal. Other deductions differ from the charitable contribution which is voluntary. It benefits not the taxpayer, but the general public. Congress, as recently as 1969, increased the ceiling from thirty to fifty percent of adjusted gross income for many charitable gifts to publicly supported charities. Congress determined that tax encouragement should be increased to those who support schools, colleges, universities, churches, hospitals and other public charities.

We are pleased to note that the Treasury—in its latest version of MTI (proposed to the House Ways and Means Committee in July, 1975)—urged exempting charitable gifts from MTI.

We request that charitable contributions not be subjected to MTI—thus retaining the current fifty percent of adjusted gross income ceiling, with a carryover for any gifts which exceed the ceiling.

4. Allocation of deductions (including charitable contribution deductions) between taxable and non-taxable income. A donor's non-business itemized deductions would be allocated between his taxable and non-taxable income, with only the part allocable to taxable income allowed as deductions. The deductions affected could include charitable contributions, interest, taxes, casualty losses, medical expenses, etc. Tax preferences which could cause expenses to be allocated: (a) appreciation on property contributed to charity; (b) tax-exempt interest from state and local bonds; (c) one-half of net long-term capital gains.

Example 1. Donor has $90,000 in taxable salary and $10,000 of non-taxable municipal bond income. His total income is $100,000. Since 10% of his income is not taxed, he must reduce his itemized deductions (charitable contributions, interest, taxes, medical expenses, etc.) by 10%. Thus, if his itemized deductions total $20,000, he can only deduct $18,000.

Example 2. Facts are the same as in Example 1, except instead of having $10,000 in municipal bond income, donor makes a charitable gift of property which has $10,000 of appreciation. The appreciation on the property gift would be treated under one proposal as non-taxable income (just as if donor had $10,000 in municipal bond income). Because of his generosity, donor must reduce not only his charitable deductions by 10%, but also his deductions for taxes, interest, medical expenses, etc.

Two edged sword. The allocation of deductions proposal as it applies to charitable gifts has two aspects:

Aspect 1. By including the charitable contribution deduction in the itemized deductions to be allocated between taxable and non-taxable income, it reduces the charitable deduction.

Aspect 2. By considering the amount of appreciation on property contributed to charity as non-taxable (tax preferred) income, it reduces donor's charitable deduction as well as his other itemized deductions. We oppose this proposal because it would substantially decrease charitable gifts.

B. Section 701 of H.R. 10612 dealing with accumulation trusts as its provisions apply to transfers of appreciated property to short-term charitable income (lead) trusts (defined in section 170(f)(2)(B) of the Internal Revenue Code of 1954). Section 701 of H.R. 10612 would tax at ordinary income tax rates the gain on the sale of appreciated property within three years of the transfer to the short term charitable income trust. The House bill excepts charitable remainder trusts and pooled income funds from this rule. It is believed that its failure to except short term charitable income trusts from this rule is an oversight.

Short-term charitable income trusts are highly beneficial to charitable organizations and will be greatly discouraged unless they are excepted from the harsh provisions of section 701 of H.R. 10612.

C. Section 502 of H.R. 10612, changing the way alimony is deducted, could adversely affect charitable gifts. The House of Representative had only good intentions when it decided to allow alimony to be deducted from gross income instead of from adjusted gross income. By making this technical change, taxpayers who take the standard deduction may nevertheless deduct their alimony payments. However, by providing that alimony is a deduction from gross income (instead of a deduction from adjusted gross income) a high income taxpayer who has large alimony payments will have a reduced allowable charitable deduction. The ceiling on the charitable deduction, depending on the type of gift, is 20 percent, 30 percent or 50 percent of adjusted gross income. By providing that alimony is deductible from gross income, a taxpayer's adjusted gross income and his allowable charitable deduction will be reduced.

Example: Taxpayer has gross income of $100,000 and pays $40,000 in alimony. Assuming no other deductions, his gross income and adjusted gross income would be $100,000. If he makes a cash charitable gift the ceiling on his deduction, under current law, would be $50,000 (50 percent of $100,000 adjusted gross income). If alimony is deductible from gross income, as provided by the House bill, the taxpayer's adjusted gross income would be $60,000 and the ceiling on his charitable deduction would be $30,000 (50 percent×$60,000 adjusted gross income).

We do not ask the Senate to change the intended thrust of the House bill. We do, however, ask it to correct an apparent oversight and make an adjustment which would provide that alimony is added back to adjusted gross income solely for determining the ceiling on the charitable deduction.

II. Other tax revision proposals

The Committee's February 5, 1976 press release stated that it will also hold hearings on "other tax revision proposals which have not been included in H.R 10612". If the Committee considers the present tax law provisions dealing with charitable organizations and contributions to those organizations we make the following comments:

A The Tax Laws Should Continue To Encourage Support Of Charitable Organizations By Concerned Citizens.

First and foremost, the charitable contribution deduction is not a loophole. It differs from other deductions and tax preferences in that it is not economically mandated. Other deductions redound to the individual taxpayer's benefit. A donor is economically ahead by not making a charitable gift because the tax savings are smaller than what he parts with. Charitable contributions are voluntary and redound to the benefit of our nation.

A reduction of current tax incentives to charitable contributors would reduce charitable gifts and result in decreased services to the general public. Reduced tax incentive would, in effect, be indirect taxes on publicly supported charitable organizations.

Schools, hospitals, churches, health, social welfare and other publicly supported charitable organizations perform a vital role in our nation. If the services rendered to the general public by charitable institutions were to be diminished because of reduced private support, the public would suffer immeasurably. The importance of the services to the nation rendered by the institutions represented at these hearings need not be reviewed. They are well known and we stand on our record of serving our communities, states and the nation. We do emphasize that if our services to the general public are to continue and expand to meet new needs, tax incentives to those who support worthy charitable organizations should be increased, not decreased.

Historical, philosophical and practical reasons why current tax benefits for donors should be continued. In no country is private philanthropy as important a part of the national character as in the United States. The inception early this century of our federal tax laws encouraged rather than curbed the generosity of Americans. Since 1917 the government has stimulated private voluntary support by granting tax deductions to those who give to schools, churches, hospitals, health, social welfare and other publicly supported charitable organizations.

Congress has continually increased the tax incentives for charitable giving, starting out with a 15% ceiling on charitable gifts and increasing it over the years to the present 50 percent of adjusted gross income (contribution base) ceiling—with a 5 year carryover for any "excess".

The government has practical reasons for encouraging voluntary financial support. We need the services provided by schools, churches, hospitals, health organizations and other charities. If support for their work does not come from private sources, from where will it come?

Charitable contributions by concerned citizens have enabled educational institutions to maintain freedom of academic inquiry. They have insured separation of church and state. Voluntary charitable contributions have offered the means of maintaining the historical balance between government services and voluntary initiatives, the antithesis of a totalitarian society. The charitable contribution deduction enables our citizens to participate in making decisions, rather than concentrating further power in the hands of the government.

The increased tax incentives for charitable gifts over the years has resulted in expansion and development of charitable organizations which now more than ever depend upon private philanthropic support.

A vast corps of volunteers give not only their money but also their time to charitable organizations. If our private institutions become government institutions, much of this volunteer time is likely to be lost.

The Congress has stated on many occasions that the government is compensated for any loss of revenue by its relief from financial burdens which otherwise would have to be made by appropriations from public funds and by the benefits resulting from promotion of the general welfare.

As the Treasury itself has said: "Private philanthropy plays a special and vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes and act quickly and flexibly.

"* * * In doing so they enrich the pluralism of our social order * * *" (Treasury Report on Private Foundations, Committee on Ways and Means, U.S. House of Representatives, Washington: U.S. Government Printing Office, February 2, 1965, p. 5.).

B. Tax Incentives To Charitable Giving Removed By The Tax Reform Act of 1969 Through "Overcorrections" Should Be Restored.

The Tax Reform Act of 1969 through "overcorrections" removed a number of important tax incentives to charitable giving. As a result, many types of property are no longer contributed or are contributed in reduced amounts. Some of the "overcorrections" have resulted in what we believe to be unintended harsh tax consequences. Thus, some of our suggested changes are technical rather than substantive.

The following is a description of prior law, current law, and suggested changes;

1. Gifts of Inventory, Crops, Donor-Created Art Works, Short-Term Securities And Short-Term Real Estate.

Prior law: Donor was allowed an income tax charitable deduction for the property's full present fair market value.

Current law: The charitable deduction is for the fair market value reduced by the amount which would be taxed as ordinary income on a sale. This results in a deduction for the cost-basis only.

Suggested change: A charitable deduction should be allowed for the property's fair market value minus one-half of the amount which would be taxed as ordinary income on a sale.

2. Appreciated Works of Art (Other Than Donor-Created).

Prior law: Donor was allowed an income tax charitable deduction for the full fair market value.

Current law: Donor is allowed a charitable deduction for the full fair market value only if the gift is related to the donee's exempt function. If the gift is unrelated to the donee's exempt function, the charitable deduction is the fair market value minus one-half the appreciation.

Suggested change: A charitable deduction should be allowed for the full fair market value whether the gift is related or unrelated to the donee's exempt function. The present law creates difficult fact questions. Current law also creates a favored class of charitable organizations.

3. Gift Of Personal Residence Of Farm With Retained Life Interest.

Prior law: An income tax deduction was allowed for the fair market value of a personal residence or farm, discounted by the life tenant's interest (using tables with a 3½ percent interest assumption).

Current law: A deduction is allowed for the fair market value of the property reduced by the value of the life tenant's interest—using tables with a 6 percent interest assumption and taking straight line depreciation into account.

Suggested change: The 6 percent interest assumption is currently realistic. However, the requirement that the gift be discounted by straight line depreciation should be repealed. Under the laws of virtually all states, it is the life tenant's duty to maintain the property. Thus, the property does not depreciate. In fact, most property has been appreciating. Requiring the income tax charitable deduction to be reduced by straight line depreciation substantially reduces the charitable deduction and removes an important tax incentive.

The Treasury recognizes this but says it is bound by the Internal Revenue Code:

"We, too, have observed that in many cases the life tenant's duty to maintain the donated property prevents any actual depreciation in the value of that property (if not actually contributing to its appreciaton over time). However, the rule that depreciation must be taken into consideration in valuing such remainder interest for purposes of the federal income tax deduction is a statutory requirement. Accordingly, except to the extent that maintenance should be taken into account in determining the useful life of the property, the effect of depreciation must be taken into account in valuing the charitable interest." [Letter written by Treasury in response to requests that regulations provide that depreciation not be taken into account in computing deduction.]

4. Pooled Income Fund Trusts.

Prior law: The law did not limit the types of charitable institutions which could maintain pooled income funds.

Current law: Only organizations described in IRC Sec. 170(b) (1) (A), clauses (i) through (vi), can have pooled income funds. These organizations are churches, schools, hospitals, foundations for state and municipal colleges and universities, governmental units and publicly supported charities.

Suggested change: Two additional types of organizations should also be authorized to maintain pooled income funds:

(1) Broadly publicly supported organizations (meeting the one-third support and one-third gross investment tests). This type of organization is one described in IRC Sec. 509(a) (2).

(2) "Support" organizations: This is an organization organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more IRC Sec. 170(b) (1) (A) clause (i) through (vi) organizations. This type of organization is one described in IRC Sec. 509(a) (3).

5. Charitable Remainder Trusts.

Prior law: Income, gift and estate tax charitable deductions were allowed for a gift of property transferred to a trust, with the donor reserving life income. On his death, the then principal was delivered to a charitable organization. A charitable deduction was allowed even though the trustee had the power to invade and use principal for the life beneficiary, if two tests were met:

(1) The standard of invasion was ascertainable (e.g., for the beneficiary's support, maintenance, and medical expenses), and

(2) Based on the ascertainable standard the possibility of invasion was so remote as to be negligible.

Current law: To get a charitable deduction for a charitable remainder trust, the trust must be a charitable remainder unitrust, charitable remainder annuity trust or pooled income fund trust. The charitable remainder unitrust and annuity trust cannot make payments of principal to the beneficiary other than those required to make the annual payments. Under no circumstances can pooled income funds pay principal to life beneficiaries.

Suggested change: The charitable remainder unitrust, charitable remainder annuity trust and pooled income fund trust requirements should be retained. However, a charitable deduction should be allowed for a unitrust or an annuity trust even though the trustee has the power to pay principal to the beneficiary if the two tests of prior law are met.

Many more donors would create unitrusts annuity trusts if they were not concerned about the very, very remote possibility that the beneficiary may need some principal. The charitable remainder would be protected if the two tests are met. If the tests are not met, there would be no charitable deduction.

If a donor authorizes invasion of principal he does so at his peril and has the burden of establishing that the two tests are met if his deduction is questioned. Perhaps the price for putting such a provision in a trust could be a slight reduction in the charitable deduction at the outset. This would compensate Treasury for any additional auditing costs.

6. Charitable Gift Annuities.

Prior law: There was no restriction on the number of annuitants under one agreement.

Current law: Under IRC Sec. 514(c) (5), a charitable organization will be taxed on most of the income earned by donor's gift if the annuity is for more than two lives.

Suggested change: There is no reason for the two-life restriction: The annuity should be able to be for more than two lives so long as the other tests of IRC Sec. 514(c) (5) are met.

7. Gift Of Free Rental Value Of Property Or Interest Free Use Of Money.

Prior law: A donor was allowed income, gift and estate tax charitable deductions for the fair rental value of property he allowed a charity to use rent-free.

Current law: No income tax deduction is allowed for the rental value of property to a charity is allowed to use rent-free. A generous donor who is willing to allow a charity to use his property rent-free (even though he gets no income tax charitable deduction) will under the language of the gift and estate tax laws subject the rental value to those taxes. The value of a loan of money interest free would also be subjected to the gift and estate tax laws.

Suggested change: The gift and estate tax laws should be amended to provide that when a donor makes a lifetime charitable gift of the right to use property rent-free or lends money interest-free, his gift not be subject to gift and estate taxes.

8. Gifts of Mortgaged Property To Publicly Supported Charities: Problems Under The Tax Reform Act Of 1969.

Outright gifts. A donor who makes an outright charitable gift of mortgaged property is considered to have made a bargain sale to the charitable donee (Reg. Sec. 1.1011-2(a)(3). The donor is deemed to have sold the gift property to the charitable organization for the amount of the mortgage—and this is so even though the donee organization does not agree to assume or pay the indebtedness.

Deferred gifts—charitable remainder unitrusts, charitable remainder annuity trusts, pooled income fund trusts, charitable gift annuities, gifts of personal residences and farms subject to retained life estates. Mortgaged property presents so many problems that this important type of asset can in effect no longer satisfactorily be used to make a deferred gift. Here are the problems.

Self-dealing. The private foundation self-dealing prohibitions (Section 4941) are applicable to charitable remainder unitrusts, charitable remainder annuity trusts, pooled income fund trusts and short term charitable income (lead) trusts. Thus, a donor cannot transfer a mortgaged asset to fund one of these trusts if the mortgage was placed on the property within the last 10 years.

Capital gains. The mere transfer of mortgaged property (assuming it does not violate the self-dealing prohibitions of Section 4941) would be considered a bargain sale generating capital gain to the donor. Reg. Sec. 1.1011-2(a)(3) applies this rule to charitable remainder unitrusts, charitable remainder annuity trusts, gifts of personal residences and farms with retained life estates and charitable income (lead) trusts. Reg. Sec. 1.642(c)-5(a)(3) governing pooled income fund trusts provides that the transfer of a mortgaged asset to such a trust generates a capital gain to the donor under the bargain sale rules.

Unrelated business income. Charitable remainder unitrusts and charitable remainder annuity trusts are not exempt from income taxes if they have any unrelated business taxable income (Section 644(c)). These trusts will have unrelated business taxable income if they hold debt-financed property.

To avoid forced sales it is sometimes necessary for the trustee of a charitable remainder trust to borrow to make the required annual payment. It is Treasury's position that such an indebtedness results in the trust having debt-financed income, taxable as unrelated business taxable income.

Gift annuities when funded with mortgaged property. The amount of the mortgage would be added to the investment in the contract and increase the capital gain to be reported by the donor. Reg. Sec. 1.1011-2(a)(3) and (4).

A charitable organization accepting mortgaged property in exchange for its promise to pay an annuity would itself be subject to tax on unrelated business taxable income.

Suggested changes: (1) An outright charitable gift of mortgaged property should not be a bargain sale; (2) The prohibition on transferring a mortgaged asset—when the mortgage was placed on the property within the last 10 years—should not apply to charitable remainder unitrusts, charitable remainder annuity trusts, pooled income fund trusts and short term charitable income (lead) trusts; (3) There should be no imposition of capital gains tax when a donor transfers mortgaged property to fund a charitable remainder unitrust, a charitable remainder annuity trust, a pooled income fund trust or short term charitable income (lead) trust. This rule should also apply to a gift of a mortgaged personal residence or farm with a retained life estate; (4) Charitable remainder unitrusts and charitable remainder annuity trusts should not be deemed to have any unrelated business taxable income merely because the trust holds mortgaged property or borrows to meet trust obligations; and (5) A charitable organization accepting mortgaged property in exchange for its promise to pay an annuity should not be subject to tax on unrelated business taxable income.

C. To Further Encourage Charitable Gifts So Vital To The Continued Existence Of Most Publicly Supported Charities, The Following Changes In The Tax Law Are requested:

1. Increase Percent Of Adjusted Gross Income (Contribution Base) Ceiling On Income Tax Charitable Deduction.

Prior to the Tax Reform Act of 1969 the ceiling on deductibility for the income tax charitable deduction for gifts to publicly supported charities was 30 percent of adjusted gross income (contribution base) with a five year carryover for any "excess".

Current law: The ceiling is 50 percent of the contribution base with a five year carryover for gifts of cash and so-called ordinary income property. For gifts of long-term appreciated securities, long-term appreciated real property and long-term works of art for a related use (so-called long-term capital gain property) the ceiling is 30 percent of the contribution base, with a five year carryover. Under an election, a donor can increase the ceiling to 50 percent of the contribution base by reducing the amount he is deemed to have contributed by one-half of the appreciation. Once making this election, he must similarly reduce his deduction for other appreciated property gifts made during the year or being carried over from earlier years.

Suggested change: The ceiling should be 50 percent of the contribution base for all gifts to public charities for two reasons:

(1) This additional incentive would increase charitable giving and benefit the nation, and

(2) The extremely complicated provisions of current law may deter charitable gifts because the tax consequences are not always certain. We, however, would oppose a change which would make the contribution base ceiling 35 percent for all types of gifts because this would be a step backward and would decrease current tax incentives for charitable gifts.

2. The five year carryover. We ask that the five year carryover for "excess" gifts be extended to 10 years. This would encourage larger charitable gifts now.

3. A new type of charitable remainder trust—a charitable remainder variable annuity trust—should be authorized.

Background. Deferred or so-called life income gifts are an important source of support for many charitable organizations. It enables them to obtain sizable gifts which would not otherwise be made. A donor who wishes to make a charitable gift, but needs income, transfers assets to a trust, retaining life income of some type for himself and/or others. Because these gifts are irrevocable, charitable organizations can better plan for and secure their future.

The Tax Reform Act of 1969 completely overhauled the rules for remainder gifts—allowing three types of charitable remainder trust gifts: the charitable remainder unitrust, the charitable remainder annuity trust and the pooled income fund trust.

A charitable remainder annuity trust provides a donor with a hedge against deflation because he receives a fixed dollar amount (selected at the outset) each year regardless of the trust's fair market value (so long as the trust has assets to make the required payments). But a beneficiary of this type of trust has no hedge against inflation.

A charitable remainder unitrust ostensibly provides a donor with a hedge against inflation. But with the decline of the stock market in recent years, many beneficiaries of unitrusts have not had the hoped for hedge against inflation. In fact, their payments have decreased while the cost of living has increased. The same problem may exist with pooled income fund trusts.

Because of these problems, many donors who would like to make gifts have not done so—all to the damage of charities and the publics they serve.

The charitable remainder variable annuity trust would provide a hedge against inflation and deflation and would make possible remainder gifts that often would not otherwise be made.

Explanation. A donor would irrevocably transfer assets to a trust retaining for one or more lives (or for a term of years not exceeding 20) a "variable annuity amount" (defined below) each year. On the termination of the life interest, the then remainder would be transferred to one or more named qualified charitable organizations.

Determining the "variable annuity amount". Each year the beneficiary (recipient) would receive a fixed percent (not less than 5 percent) multiplied by the net fair market value of the thrust assets (as revalued each year) or a fixed dollar amount (not less than 5 percent of the initial net fair market value of the assets transferred to the trust), whichever is higher.

Example: Donor irrevocably transfers $100,000 to a charitable remainder variable annuity trust. The trust instrument provides that he is to receive each year 5 percent of the net fair market value of the trust (as revalued each year) or $5,000, whichever is higher. In year one, the net fair market value of the trust is $100,000 so the $5,000 fixed amount and the 5 percent multiplied by the net fair market value are the same. Donor receives $5,000. In year two, the trust assets on the valuation date have a net fair market value of $110,000. Since 5 percent of $110,000 is $5,500, the beneficiary would receive $5,500 for the year because that amount is greater than $5,000. In year three, the trust assets decrease in value to $90,000. Five percent of $90,000 is $4,500. The beneficiary would receive $5,000 in year three because that amount is greater than $4,500. In year four the trust assets are worth $120,000. Five percent x $120,000 equals $6,000, so the beneficiary would receive $6,000 for the year because that amount is greater than $5,000. And so on, each year.

Computing the charitable deduction. It is proposed that the income, gift and estate tax charitable deductions be an amount which equals 90 percent of the lesser of the charitable remainder unitrust and charitable remainder annuity trust deductions. Thus, a donor who creates a 5 percent charitable remainder variable annuity trust would: (1) compute the deduction for a 5 percent charitable remainder unitrust using his age and the age of any other beneficiary; (2) compute the deduction for a charitable remainder annuity trust paying 5 percent of initial net fair market value using his age and the age of any other beneficiary; and (3) compute his deduction by taking 90 percent of the lower of the deductions in (1) and (2). Any other reasonable method proposed by the Treasury in regulations for computing the deduction would be satisfactory.

Proposed statutory language for the charitable remainder variable annuity trust appears as Exhibit "G". The trust would have governing instrument requirements—to be specified in Treasury regulations—comparable to unitrusts and annuity trusts. See Treas. Reg. sections 1.664–1 through 1.664–4 for the unitrust and annuity trust regulations. As with the charitable remainder annuity trust, there could be no additional contributions after the initial contribution. But, a donor could create as many new charitable remainder variable annuity trusts as he chose.

D. The Following Proposals Would Adversely Affect Publicly Supported Charitable Organizations And The Public They Serve And Should Not Be Enacted.

A number of proposals which have been made in recent years would reduce essential tax incentives to charitable giving. The Committee has not announced which, if any, of the proposals it is considering. So that our views will be available if the Committee considers the proposals, we comment on them.

1. Gifts of long-term (held more than 6 months) appreciated securities, real estate and tangible personal property for a "related" use to schools, hospitals, churches, health organizations and other publicly supported charities. Proposals have been made which would:

(*a*) Limit the income tax charitable deduction to the cost-basis only.

(*b*) Limit the income tax charitable deduction to the fair market value minus one-half of the appreciation.

(*c*) Allow an income tax charitable deduction for the fair market value, but tax the appreciation just as if the donor sold the property and contributed the proceeds. This proposal could be even harsher if enacted together with other proposals which would tax capital gains at ordinary income tax rates or at increased capital gains rates.

(*d*) A longer holding period (e.g., one year) for favorable capital gain treatment could adversely affect gifts of appreciated property. Under present law, a gift of short-term appreciated securities, real estate, and tangible personal property (for a related use) generates a deduction for the cost-basis only. These assets when held more than 6 months are deductible at the full fair market value. If the holding period is increased to one year, donors would receive reduced benefits for assets contributed which have a holding period of less than one year but more than six months.

(*e*) Subject the property's appreciation to the 10 percent or other minimum tax.

(*f*) Tax the appreciation element on gifts of appreciated property passing to charitable organizations at death.

Gifts of appreciated property are a major source of support for most publicly supported charitable organizations. The tax treatment of appreciated property gifts was thoroughly considered by Congress in connection with the Tax Reform Act of 1969 and reflects an evident purpose to retain tax incentives for these gifts. We strongly urge that current law remain unchanged; otherwise a major source of charitable support would be drastically decreased.

2. Ceiling on deduction for bequests. Current law allows an unlimited estate tax charitable deduction. One proposal would put a ceiling of 50% on the estate tax charitable deduction.

This proposal would drastically decrease bequests now going to charitable organizations. Such a limitation would be an indirect tax on charitable organizations of the federal estate tax imposed on the gift because the charity would not receive the entire bequest, but the bequest reduced by estate taxes. For practical purposes, this is the same as the charity receiving the entire bequest and then having the federal government levy a tax on the property owned by the charity.

Virtually every charitable organization can point to a number of significant bequests of an entire estate or a substantial part of an estate.

Bequests to the Mayo Foundation (which operates the Mayo Clinic, Mayo Graduate School of Medicine and Mayo Medical School), and Doane College, Crete, Nebraska, serve as examples. The Mayo Foundation in a recent two year period received:

1. An entire estate (less some very minor specific bequests) which totalled $1,025,365. This estate was left to the Mayo Foundation for research in cancer and heart disease. The Mayo Foundation has major emphasis in both areas and is receiving National Institute of Health grants to support work in these areas.

The Mayo Foundation received another entire estate (less $8,000 in specific bequests) which totalled $453,247. This was left as an unrestricted gift and was greatly needed to buttress endowment.

The Mayo Foundation has been named as one of three charities to share equally in an estate totalling approximately $4,000,000. This bequest is also unrestricted.

Although these are huge sums of money, these gifts should be viewed in the context of the Mayo Foundation's research and education expenses which exceed $20,000,000 annually. Adverse tax laws would decrease the funds essential for the Mayo Foundation's work. Where would the Mayo Foundation look to replace its lost support?

Doane College is a small liberal arts college in Crete, Nebraska. It recently received an entire estate (except household goods and personal effects) of $346,421.84 for the Doane College Library Trust Fund. The building fund for a new library received $80,000, approximately $25,000 was added to the library budget for new books and periodicals and the balance has been invested in the Library Trust Fund, the income from which goes towards improving the library's book holdings.

This is a tremendous boost to its academic program of Doane College. Where will Doans College look to replace this type of gift if the tax laws are changed so as to reduce the amount of the gift actually received by the College?

No economic enhancement inures to a decedent or his family as a result of a charitable transfer at death. Testamentary charitable transfers diminish the estate otherwise available for the family or other private persons.

Testamentary charitable transfers effect redistribution of wealth. Every deductible dollar paid to charity is devoted to public purposes and in many instances substitutes for federal revenues otherwise needed. In other cases, these transfers fund activities for the public benefit which the government would not, or could not, undertake. In all events, the wealth transferred to charity has been redistributed. It is permanently diverted from the decedent and his family to public use. Any change in the estate tax laws which reduces the funds available for charity will result in diminishing the private sector's ability to sustain eleemosynary institutions. Their existing economic problems will be exacerbated.

A percentage limitation on testamentary charitable transfers would reduce the amount available to charity by more than the taxes levied on the transfer. There would be an indirect effect of such a tax—a reduction in bequests.

We support the American Law Institute's position in the paper submitted to the House Ways and Means Committee in 1973 by Professor A. James Casner for the Law School of Harvard University.

"The 100 percent charitable deduction in the field of transfer taxation should be retained, either under a dual tax system or a unified tax". See Committee print, Prepared Statements Submitted by Witnesses Invited to Appear before The Committee on Ways and Means to Participate in Panel Discussions on Tax Reform, Panel No. 10, Estate and Gift Tax Revision, February 27, 1973, page 265.

If a limit is placed on the federal estate tax charitable deduction, charitable bequests will be substantially decreased because the bequests will be diminished by estate taxes. If a limit is placed on the gift tax charitable deduction—either under the current gift tax law or under a unified transfer tax—a donor could actually have to pay a gift tax on a lifetime charitable gift. This could result in a marked decrease in lifetime charitable gifts. It would be inconsistent to allow an income tax charitable contribution deduction as a tax incentive, and then impose a gift tax (or unified transfer tax) on the charitable gift.

3. Placing a 3 percent floor on income tax charitable contribution deduction. Under this proposal, only gifts above 3 percent of a donor's adjusted gross income would be deductible. Any carryover would be reduced by 3 percent of adjusted gross income in each carryover year.

According to 1970 IRS statistics, of the 35.5 million taxpayers who itemized deductions, 29 million deducted 3% or under for charitable contributions. These deductions total 10.56 billion dollars or 82 percent of all individual contributed dollars. Thus, 29 million out of 35.5 million taxpayers would have no income tax incentive for their contributions if the 3 percent floor provision is enacted. Accordingly, we oppose such a provision.

4. Substitution of a credit for the income tax charitable contribution deduction. One proposal would allow a credit of 24 percent of the value of the gift for all taxpayers, regardless of their tax brackets. We oppose this proposal because it would discourage substantial charitable gifts from those in higher brackets, while not materially increasing gifts from those in lower brackets.

Some view the charitable contribution deduction as reducing the cost of a donor's gift. However, many view the charitable contribution deduction as a means of enabling a generous donor to give more. This is very often the case.

III. Conclusion

Among all of the deductions the charitable deduction is unique. It is society that benefits the most by allowing charitable deductions, not individual donors. Donors would benefit more economically by not making charitable gifts.

Current news abounds with articles concerning the inadequacy of the financial resources of all types of charitable organizations. Never in our history have charitable organizations found themselves in comparable circumstances—in which they are unable to carry on assigned roles without using and depleting endowment and obtaining additional current contributions.

It is no answer to suggest that direct government funding will substitute for funds lost through reduction of tax incentives or taxes on property passing to charity. Funds siphoned off in general revenues reach the public through the charitable stream in the most remote sense, if at all. Reducing current tax incentives would reverse the objective of less, rather than more, government intervention.

When former Secretary of the Treasury, George Shultz, testified in 1973 before the House Ways and Means Committee on the Administration's tax reform proposals, he urged the Congress to "do nothing which will jeopardize the vitality of our voluntary charities, which depend heavily on gifts and bequests". He then went on to say: "These organizations are an important influence for diversity and a bulwark against over reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair."

Mr. Chairman and members of the Committee, thank you again for this opportunity to present our views. We ask that any new tax law continue the long-established and essential tax incentives to charitable giving which undergird our nation's educational, religious, hospital, health, social welfare and other charitable organizations.

We are aware of the time pressures and heavy work load of the Committee and have made our remarks as brief as possible. If the Committee wishes amplification on any point, we would appreciate the opportunity to submit a supplemental statement. We are available, if the Committee wishes, to meet with members of the Committee's staff.

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2266

EXHIBIT "C"

NATIONAL ASSOCIATION OF INDEPENDENT SCHOOLS

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Anniston Academy

Birmingham
Birmingham University School

Helena
Indian Springs School

Huntsville
Randolph School

Mobile
The Julius T. Wright School
St. Paul's Episcopal Day School
University Military School

Montgomery
Montgomery Academy

Tuscaloosa
Tuscaloosa Academy

ARIZONA

Mayer
Orme School

Phoenix
Phoenix Country Day School

Rimrock
Southwestern Academy
Arizona Campus

Scottsdale
Judson School

Sedona
Verde Valley School

Tucson
Fenster School
Green Fields School
Treehaven School

CALIFORNIA

Avalon
Catalina Island School

Carlsbad
Army and Navy Academy

Carpinteria
Cate School

Claremont
Foothill Country Day School
Webb School of California

Corona del Mar
Harbor Day School

Corte Madera
Marin Country Day School

Danville
The Athenian School

Del Mar
San Diego Military Academy

Hillsborough
Crystal Springs School

Idyllwild
Desert Sun School

La Canada
Flintridge Preparatory School

La Jolla
The Bishop's Schools
La Jolla Country Day School

Long Beach
Progress School

Los Angeles
John Thomas Dye School
Marlborough School
The Mirman School
Westlake School

Los Olivos
Dunn School
Midland School

Menlo Park
Menlo School

Monterey
Santa Catalina School
The York School

North Hollywood
Harvard School
Oakwood School

Oakland
College Preparatory School
The Head-Royce Schools
Anna Head School
The Royce School

Ojai
Ojai Valley School
Thacher School

Pacific Palisades
St. Matthew's Parish School

Palm Springs
Palm Valley School

Palo Alto
Castilleja School

Palos Verdes Peninsula
Chadwick School

Pasadena
The Chandler Schools
Mayfield High School
Polytechnic School
Westridge School

Pebble Beach
Robert Louis Stevenson School

Ross
The Katharine Branson and Mount Tamalpais Schools

Sacramento
Sacramento Country Day School

San Anselmo
San Domenico School for Girls

San Diego
Francis W. Parker School

San Francisco
Cathedral School for Boys
The Hamlin School
Katherine Delmar Burke School
Lick-Wilmerding High School
Schools of the Sacred Heart
Broadway Elementary School
Broadway High School
Stuart Hall School for Boys
Town School for Boys

San Marino
Southwestern Academy

Santa Barbara
Laguna Blanca School

Santa Monica
St. Augustine-by-the-Sea Episcopal School

COLORADO

Canon City
The Abbey School

Carbondale
Colorado Rocky Mountain School

Colorado Springs
Colorado Springs School
Fountain Valley School

Denver
Graland Country Day School
Randell-Moore School of Denver

Englewood
Colorado Academy
Kent-Denver Country Day School

Steamboat Springs
Whiteman School

CONNECTICUT

Avon
Avon Old Farms School

Cheshire
Cheshire Academy

Cornwall
Marvelwood School

Danbury
Wooster School

East Haddam
Becket Academy

Fairfield
Fairfield Country Day School
Unquowa School

Farmington
Miss Porter's School

Greens Farms
Greens Farms Academy

Greenwich
Brunswick School
Convent of the Sacred Heart
Daycroft School
Greenwich Academy
Greenwich Country Day School
Whitby School

Hamden
Hamden Hall Country Day School

Hartford
Institute of Living School
Kingswood-Oxford School
Oxford Campus
Watkinson School

Kensington
Mooreland Hill School

Kent
Kent School

Lakeville
Hotchkiss School
Indian Mountain School

Litchfield
Forman School

Madison
The Country School

Middlebury
Westover School

Middlefield
Independent Day School

Milford
Milford Academy

New Canaan
New Canaan Country School

New Haven
Foote School
Hopkins Grammar Day Prospect Hill School

New London
The Williams School

New Milford
Canterbury School

Pomfret
Pomfret School
Rectory School

Rowayton
The Thomas School

Salisbury
Salisbury School

Simsbury
Ethel Walker School
Westminster School

South Kent
South Kent School

Stamford
King School
Long Ridge School
Low-Heywood School

Stonington
Pine Point School

Suffield
Suffield Academy

Wallingford
Choate/Rosemary Hall

Washington
The Gunnery
Rumsey Hall School
Wykeham Rise School

Waterbury
Saint Margaret's-McTernan School

Watertown
Taft School

Westbrook
Oxford Academy

West Hartford
Kingswood-Oxford School Kingswood Campus
Renbrook School

Windsor
Loomis-Chaffee School

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Hockessin
Sanford School

Middletown
Broadmeadow School
St. Andrew's School

Wilmington
Tatnall School
Tower Hill School
Wilmington Friends School

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The Academy of the Washington Ballet
Beauvoir
Georgetown Day School
Georgetown Visitation Preparatory School
Maret School
National Cathedral School
St. Albans School
Sheridan School
Sidwell Friends School

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Boca Raton
Saint Andrew's School of Boca Raton

Clearwater
Saint Paul's School

Delray Beach
Gulf Stream School

Fort Lauderdale
The Mills School
Pine Crest School

Indian Rocks Beach
Cottingham School

Jacksonville
Bartram School
Bolles School
Jacksonville Episcopal High School
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Riverside Presbyterian Day School
Southside Country Day School

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Ransom-Everglades School

Orange Park
St. Johns Country Day School

Palm Beach
Palm Beach Academy
Palm Beach Day School

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Alfred B. Maclay, Jr., Day School

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Independent Day School

Vero Beach
St. Edward's School

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Athens
Athens Academy

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The Arlington Schools
Holy Innocents' High School*
Lovett School
Marist School
Pace Academy
Trinity School
The Westminster Schools

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Augusta Preparatory School

College Park
Woodward Academy

Columbus
Brookstone School

Keysville
Boggs Academy

Mount Berry
Berry Academy

Rome
Darlington School

Savannah
Savannah Country Day School

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Agana
St. John's Episcopal Preparatory School

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Hanahauoli School
Hawaii School for Girls
Iolani School
The Kamehameha Schools
Punahou School

Kamuela, Hilo
Hawaii Preparatory Academy

Makawao, Maui
Seabury Hall

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Anshe Emet Day School
Francis W. Parker School
Harris School
The Latin School of Chicago

Downers Grove
Avery Coonley School

Elgin
Elgin Academy

Evanston
Roycemore School

Lake Forest
Lake Forest-Ferry Hall Academy
Lake Forest Country Day School
Woodlands Academy of the Sacred Heart

Rockford
Keith Country Day School

Wilmette
Loyola Academy

Winnetka
North Shore Country Day School

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The Culver Educational Foundation

Evansville
Evansville Day School

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Howe Military School

Indianapolis
Park-Tudor School

La Porte
La Lumiere School

South Bend
The Stanley Clark School

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Wichita Collegiate School

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Capital Day School
Goshen
St. Francis School
Lexington
Lexington School
Sayre School
Louisville
Kentucky Country Day School
Louisville Collegiate School
Versailles
Margaret Hall School

LOUISIANA

Baton Rouge
Episcopal High School*
Metairie
Metairie Park Country Day School
St. Martin's Protestant Episcopal School
New Orleans
Isidore Newman School
Louise S. McGehee School
Trinity Episcopal School
Shreveport
Southfield School

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Hyde School
Bethel
Gould Academy
Fryeburg
Fryeburg Academy
Hebron
Hebron Academy
Hinckley
Hinckley School
Kents Hill
Kents Hill School
Portland
Waynflete School
South Berwick
Berwick Academy
Vassalboro
Oak Grove-Coburn School
Yarmouth
North Yarmouth Academy

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The Key School
Arnold
Wroxeter-on-Severn School
Baltimore
Boys' Latin School
Bryn Mawr School
Calvert School
Friends School
Gilman School
Roland Park Country School
Samuel Ready School
Bethesda
Country Day School of the Sacred Heart
Holton-Arms School
Landon School
Brooklandville
Park School of Baltimore
Saint Paul's School
Saint Paul's School for Girls
Centreville
The Gunston School
Chestertown
Kent School
Colora
West Nottingham Academy
Easton
The Country School, Inc.
Garrison
Garrison Forest School
Gibson Island
Gibson Island Country School
Glencoe
Oldsfields School
Glenelg
Glenelg Country School
McDonogh
McDonogh School
North East
The Tome School
Olney
St. John's Parish School

Owings Mills
Valley School

Potomac
School of the Holy Child

Rockville
Georgetown Preparatory School
Green Acres School

St. James
Saint James School

Severna Park
Severn School

Silver Spring
Town and Country Day School

Stevenson
St. Timothy's School

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Andover
Phillips Academy
Pike School

Arlington Heights
Saint Anne's School

Ashburnham
Cushing Academy

Belmont
The Arlington School
Belmont Day School
Belmont Hill School

Beverly
Shore Country Day School

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Commonwealth School
Newman Preparatory School
Thompson Academy
Winsor School

Boylston
Shepherd Knapp School

Braintree
Thayer Academy

Brookline
Dexter School
Park School

Byfield
Governor Dummer Academy

Cambridge
Buckingham Browne & Nichols School
Cambridge Friends School
Manter Hall School
Shady Hill School

Chestnut Hill
Beaver Country Day School
Brimmer & May School
Chestnut Hill School

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Brooks School of Concord
Concord Academy
Fenn School
Middlesex School
Nashoba Country Day School

Dedham
Dedham Country Day School
Noble & Greenough School

Deerfield
Bement School
Deerfield Academy
Eaglebrook School

Dorchester
Boston College High School

Dover
Charles River School

Easthampton
Williston-Northampton School

East Northfield
Northfield Mount Hermon School

Fitchburg
Applewild School

Great Barrington
Simon's Rock

Greenfield
Stoneleigh-Burnham School

Groton
Groton School
The Lawrence Academy at Groton

Hingham
Derby Academy

Lenox
Berkshire Country Day School
Cranwell School
Foxhollow School

Lexington
Lexington Christian Academy

Lincoln
The Carroll School

Manchester
Brookwood School

Marblehead
Tower School

Marion
Tabor Academy

Marlborough
Hillside School
Milton
Milton Academy
Natick
Walnut Hill School
Newton
Country Day School of the Sacred Heart
St. Sebastian's Country Day School
Northampton
Smith College Campus School
North Andover
Brooks School
North Dartmouth
Friends Academy
Pittsfield
Miss Hall's School
Sheffield
Berkshire School
Southborough
Fay School
Saint Mark's School
South Hamilton
Pingree School
South Yarmouth
Trinity School of Cape Cod
Springfield
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Watertown
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Wellesley
Dana Hall School
Tenacre Country Day School
Weston
Cambridge School of Weston
The Meadowbrook School of Weston
Rivers Country Day School
West Newton
Fessenden School
West Roxbury
Roxbury Latin School
West Stockbridge
Stockbridge School
Wilbraham
Wilbraham & Monson Academy
Williamstown
Pine Cobble School
Winchendon
Winchendon School
Worcester
Bancroft School
Worcester Academy

MICHIGAN

Birmingham
Detroit Country Day School
Bloomfield Hills
Academy of the Sacred Heart
Bloomfield Country Day School
The Cranbrook Schools
Brookside School
Cranbrook School
Kingswood School
Roeper City & Country School
Detroit
Friends School in Detroit
Glen Arbor
The Leelanau School
Grosse Pointe Woods
University-Liggett School
Interlochen
Interlochen Arts Academy
Oxford
Kingsbury School

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Duluth Cathedral High School*
Fairbault
The Bishop Whipple Schools
Saint James School
St. Mary's Hall
Shattuck School
Hopkins
Blake Schools
Lower School-Blake
Middle School
Minneapolis
Breck School
Blake Schools
Upper School
St. Paul
Saint Paul Academy & Summit School
St. Thomas Academy

Wayzata
Blake Schools
Lower School-Highcroft

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Vicksburg
All Saints' Episcopal School

MISSOURI

Kansas City
Barstow School
Pembroke-Country Day School
Sunset Hill School

Mexico
Missouri Military Academy

St. Louis
Community School
John Burroughs School
Mary Institute
The Principia School
Rohan Woods School
Rossman School
Saint Louis Country Day School
Thomas Jefferson School
Villa Duchesne
Whitfield School

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Omaha
Brownell-Talbot School

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Proctor Academy

Canaan
Cardigan Mountain School

Concord
St. Paul's School

Dublin
Dublin School

Exeter
Phillips Exeter Academy

Littleton
The White Mountain School-St. Mary's

Manchester
Derryfield School

Meriden
Kimball Union Academy

New Hampton
New Hampton School

Plymouth
Holderness School

Tilton
Tilton School

Wilton
High Mowing School

Wolfeboro
Brewster Academy

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Atlantic City
Atlantic City Friends School

Bernardsville
Gill/St. Bernard's School

Blairstown
Blair Academy

Bridgeton
St. John's Day School

Burlington
St. Mary's Hall/Doane Academy

Chester
Garland School

Elizabeth
Pingry School
Vail-Deane School

Englewood
The Dwight & Englewood Schools
Elisabeth Morrow School

Far Hill
Far Hills Country Day School

Hightstown
Peddie School

Lawrenceville
Lawrenceville School

Livingston
Newark Academy

Mendham
St. John Baptist School

Montclair
Montclair-Kimberley Academy

Moorestown
Moorestown Friends School

Morristown
Delbarton School
Morristown-Beard School
Peck School

Mountain Lakes
The Wilson School

North Plainfield
Mount Saint Mary Academy

Pennington
Pennington School

Pine Beach
Admiral Farragut Academy

Plainfield
Hartridge School
Wardlaw Country Day School

Pottersville
The Purnell School

Princeton
Chapin School
Columbus Boychoir School
The Hun School of Princeton
Princeton Day School
Stuart Country Day School of the Sacred Heart

Rumson
Rumson Country Day School

Saddle River
Saddle River Country Day School

Short Hills
Far Brook School
Pingry School
Lower School

Somerset
Rutgers Preparatory School

Summit
Kent Place School
Oak Knoll School of the Holy Child

Tenafly
The Center for Open Education

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Albuquerque Academy
Sandia School

Santa Fe
Santa Fe Preparatory School

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Albany Academy
Albany Academy for Girls
Saint Agnes School

Amenia
Barlow School

Bedford
Rippowam-Cisqua School
Upper School

Brewster
Green Chimneys School

Brooklyn
Adelphi Academy
Berkeley Institute
Brooklyn Friends School
Packer Collegiate Institute
Polytechnic Preparatory Country Day School
St. Ann's Episcopal School

Buffalo
Buffalo Seminary
Elmwood-Franklin School
Nichols School & Nottingham Academy

Congers
Rockland Country Day School

Cornwall-on-Hudson
New York Military Academy
Storm King School

DeWitt
Manlius Pebble Hill School

Dobbs Ferry
The Masters School

East Islip
Hewlett School

Forest Hills
Kew-Forest School

Garden City
Cathedral School of St. Mary
St. Paul's School
Waldorf School of Adelphi University

Garrison-on-Hudson
Malcolm Gordon School

Glen Head
Green Vale School

Hewlett
Lawrence Country Day School

Hoosick
Hoosac School

Jackson Heights
Garden School

Katonah
Harvey School

Lake Placid
North Country School
Northwood School

Locust Valley
Friends Academy
Portledge School

Loudonville
Saint Gregory's School

Lynbrook
Academy of Lynbrook

Millbrook
The Dutchess School
Millbrook School

Mt. Kisco
Rippowam-Cisqua School
Lower School

New Lebanon
Darrow School

New Rochelle
Thornton-Donovan School

New York City
Allen-Stevenson School
The Baldwin School of New York City
Barnard School for Girls
Birch Wathen School
Brearley School
Browning School
Buckley School
Calhoun School
Cathedral School
Chapin School
The Choir School of St. Thomas Church
Collegiate School
Columbia Grammar and Preparatory School
Convent of the Sacred Heart
Dalton School
The Day School
Ethical Culture Schools
Fordham Preparatory School
Friends Seminary
Grace Church School
Hewitt School
The Horace Mann-Barnard School
Lenox School
Little Red Schoolhouse, Inc.
Little Red Schoolhouse
Elisabeth Irwin High School
McBurney School
Marymount School
Nightingale-Bamford School
Professional Children's School
Rhodes School
The Riverdale Country School
Rudolf Steiner School
St. Bernard's School
Saint David's School
St. Hilda's & St. Hugh's School
St. Luke's School
Spence School
Town School
United Nations International School
Walden School

Old Westbury
School of the Holy Child

Oyster Bay
East Woods School

Pawling
Trinity-Pawling School

Peekskill
St. Mary's & St. John's School

Poughkeepsie
Oakwood School
Poughkeepsie Day School

Rochester
The Allendale and The Columbia Schools
Harley School

Roslyn
Buckley Country Day School

Rye
Rye Country Day School

St. James
Harbor Country Day School
Knox School

Scarborough-on-Hudson
Scarborough Day School

Snyder
Park School of Buffalo

South Wales
Gow School

Staatsburg
Anderson School

Staten Island
Staten Island Academy

Stony Brook
Stony Brook School

Tarrytown
Hackley School

Troy
Emma Willard School

Tuxedo Park
Tuxedo Park School

Wallkill
Mohonk Cragsmoor School

White Plains
Windward School

Woodmere
Woodmere Academy

Yonkers
Halstead School

NORTH CAROLINA

Arden
Christ School

Asheville
Asheville Country Day School
Asheville School
St. Genevieve/Gibbons Hall School

Charlotte
Charlotte Country Day School

Durham
Durham Academy

Goldsboro
Wayne Country Day School

Oak Ridge
Oak Ridge Academy

Raleigh
Ravenscroft School

Wilmington
Cape Fear Academy

Winston-Salem
Salem Academy
Summit School

OHIO

Bath
Old Trail School

Canton
Canton Country Day School

Cincinnati
Cincinnati Country Day School
The Seven Hills Schools
Doherty School
Lotspeich School
Seven Hills School

Cleveland
Hathaway Brown School
Laurel School
University School

Cleveland Heights
Beaumont School for Girls

Columbus
Columbus School for Girls

Dayton
Miami Valley School

Gahanna
Columbus Academy

Gates Mills
Gilmour Academy
Hawken School
Upper Campus

Hudson
Western Reserve Academy

Lyndhurst
Hawken School
Lower Campus

North Ridgeville
Lake Ridge Academy

Toledo
Maumee Valley Country Day School

OKLAHOMA

Oklahoma City
Casady School
New World School
Westminster Day School

Tulsa
Holland Hall School

OREGON

Portland
Catlin Gabel School
Oregon Episcopal Schools
St. Helen's Hall/Bishop Dagwell Hall

PENNSYLVANIA

Allentown
The Swain Country Day School

Bethlehem
Moravian Academy

Bryn Athyn
Academy of the New Church

Bryn Mawr
Baldwin School
Shipley School

Fort Washington
Germantown Academy

Harrisburg
Harrisburg Academy

Haverford
Friends School
Haverford School
Jenkintown
Abington Friends School
Kennett Square
Upland Country Day School
Kingston
Wyoming Seminary & Day School
Lahaska
Buckingham Friends School
Lancaster
Lancaster Country Day School
Ligonier
Valley School of Ligonier
Lititz
Linden Hall School for Girls
Malvern
Phelps School
Meadowbrook
Meadowbrook School
Mercersburg
Mercersburg Academy
Merion
Episcopal Academy
Merion Mercy Academy
New Bloomfield
Carson Long Institute
New Hope
Solebury School
Newton Square
Charles E. Ellis School
Newtown, Bucks Co.
George School
Newtown Friends School
Paoli
Church Farm School
The Vanguard Schools
Pennsburg
Perkiomen School
Philadelphia
Academy of the Assumption-Ravenhill
Chestnut Hill Academy
Friends' Central School
Friends Select School
Germantown Friends School
Germantown-Stevens Academy*
Girard College
Lankenau School
Penn Center Academy
St. Joseph's Preparatory School
Springside School
William Penn Charter School
Pittsburgh
Ellis School
Fox Chapel Country Day School
St. Edmund's Academy
Shady Side Academy
Winchester-Thurston School
Pottstown
Hill School
Wyndcroft School
Rose
Ellis School
Fox Chapel Country Day School
St. Edmund's Academy
Shady Side Academy
Winchester-Thurston School
Pottstown
Hill School
Wyndcroft School
Rosemont
Agnes Irwin School
Booth School
Saltsburg
Kiskiminetas Springs School
Scranton
Scranton Preparatory School
Sewickley
Sewickley Academy
Wayne
Valley Forge Military Academy
Westtown
Westtown School
Wynnewood
Montgomery Country Day School
York
York Country Day School

PUERTO RICO

Fajardo
Fajardo Academy
Hato Rey
Caribbean Consolidated Schools
Santurce
Escuelas Las Nereidas
St. John's School

RHODE ISLAND

Barrington
St. Andrew's School
East Greenwich
Rocky Hill School

East Providence
Gordon School
Providence Country Day School

Newport
St. George's School

Portsmouth
Portsmouth Abbey School

Providence
Lincoln School
Mary C. Wheeler School
Moses Brown School

SOUTH CAROLINA

Aiken
Aiken Preparatory School

Charleston
Porter-Gaud School

Greenville
Christ Church Episcopal School

Spartanburg
Spartanburg Day School

TENNESSEE

Bell Buckle
Webb School

Chattanooga
Baylor School
Bright School
Girls' Preparatory School
McCallie School

Knoxville
Webb School of Knoxville

Memphis
The Hutchison School
Lausanne School
Memphis University School
Presbyterian Day School
Saint Agnes Academy
St. Mary's Episcopal School

Nashville
David Lipscomb Elementary & High Schools
Ensworth School
Harpeth Hall School
Montgomery Bell Academy

St. Andrews
St. Andrew's School

Sewanee
The Sewanee Academy

TEXAS

Austin
St. Stephen's Episcopal School

Bryan
The Allen School

Dallas
Greenhill School
Hockaday School
St. Mark's School of Texas

Denton
Selwyn School

Fort Worth
Fort Worth Country Day School
Trinity Valley School

Galveston
Trinity Episcopal School

Harlingen
Marine Military Academy

Houston
Kinkaid School
St. John's School

Midland
Trinity School of Midland

San Antonio
Saint Mary's Hall
Texas Military Institute

San Marcos
San Marcos Baptist Academy

Texarkana
St. James Day School

UTAH

Mount Pleasant
Wasatch Academy

Salt Lake City
Rowland Hall-St. Mark's School

VERMONT

Craftsbury Common
Sterling

Putney
Putney School

St. Johnsbury
St. Johnsbury Academy

Saxtons River
Vermont Academy

South Woodstock
Woodstock Country School

VIRGINIA

Alexandria
Ascension Academy
Episcopal High School
St. Agnes School
Saint Stephen's School

Boyce
Powhatan School

Charlottesville
St. Anne's-Belfield School

Chatham
Chatham Hall
Hargrave Military

Christchurch
Christchurch School

Dyke
Blue Ridge School

Fork Union
Fork Union Military Academy

Fort Defiance
Augusta Military Academy

Front Royal
Randolph-Macon Academy

Greenway
Madeira School

Leesburg
Loudoun Country Day School

Lynchburg
Seven Hills School
Virginia Episcopal School

McLean
Potomac School

Middleburg
Foxcroft School
Hill School

Newport News
Hampton Roads Academy

Norfolk
Norfolk Academy
Norfolk Collegiate School

Orange
Grymes Memorial School

Petersburg
Bollingbrook School

Richmond
The Collegiate Schools
St. Catherine's School
St. Christopher's School

Roanoke
North Cross School

Staunton
Stuart Hall

Tappahannock
St. Margaret's School

Warrenton
Highland School

Waynesboro
Fairfax Hall

Woodberry Forest
Woodberry Forest School

VIRGIN ISLANDS

St. Croix
Good Hope School
St. Croix Country Day School
St. Dunstan's Episcopal School

St. Thomas
All Saints Cathedral School
Antilles School

WASHINGTON

Seattle
The Bush School
Lakeside School

Spokane
St. George's School

Tacoma
Annie Wright School
Charles Wright Academy

WEST VIRGINIA

Wheeling
Linsly Military Institute
Wheeling Country Day School

WISCONSIN

Beaver Dam
Wayland Academy

Delafield
St. John's Military Academy

EXHIBIT "D"

STATE OF NEW YORK INSTITUTIONS

ALFRED UNIVERSITY
Alfred, N.Y. 14802

CANISIUS COLLEGE
Buffalo, N.Y. 14208

CLARKSON COLLEGE OF TECHNOLOGY
Potsdam, N.Y. 13676

COLGATE ROCHESTER DIVINITY
SCHOOL/Bexley Hall/Crozer
Rochester, N.Y. 14620

COLGATE UNIVERSITY
Hamilton, N.Y. 13346

COLLEGE OF NEW ROCHELLE
New Rochelle, N.Y. 10801

CORNELL UNIVERSITY
Ithaca, N.Y. 14850

DOWLING COLLEGE
Oakdale, L.I., N.Y. 11769

D'YOUVILLE COLLEGE
~~Buffalo, N.Y.~~ 14201

EISENHOWER COLLEGE
Seneca Falls, N.Y. 13148

ELMIRA COLLEGE
Elmira, N.Y. 14901

COLLEGE OF WHITE PLAINS
White Plains, N.Y. 10603

HAMILTON COLLEGE
Clinton, N.Y. 13323

HARTWICK COLLEGE
Oneonta, N.Y. 13820

HOBART & WILLIAM SMITH COLLEGES
Geneva, N.Y. 14456

IONA COLLEGE
New Rochelle, N.Y. 10801

ITHACA COLLEGE
Ithaca, N.Y. 14850

KEUKA COLLEGE
Keuka Park, N.Y. 14478

KIRKLAND COLLEGE
Clinton, N.Y. 13323

LEMOYNE COLLEGE
Syracuse, N.Y. 13214

MANHATTAN COLLEGE
Bronx, N.Y. 10471

MANHATTANVILLE COLLEGE
Purchase, N.Y. 10577

MARIST COLLEGE
Poughkeepsie, N.Y. 12601

MILLS COLLEGE OF EDUCATION
66 Fifth Avenue
New York, N.Y. 10011

MOUNT ST. MARY COLLEGE
Newburgh, N.Y. 12550

NAZARETH COLLEGE OF ROCHESTER
Rochester, N.Y. 14610

NIAGARA UNIVERSITY
Niagara University, N.Y. 14109

PACE COLLEGE
New York, N.Y. 10038

PAUL SMITH'S COLLEGE
Paul Smith, N.Y. 12970

PRATT INSTITUTE
Brooklyn, N.Y. 11205

RENSSELAER POLYTECHNIC INSTITUTE
Troy, N.Y. 12181

ROCHESTER INSTITUTE OF TECHNOLOGY
Rochester, N.Y. 14623

ROSARY HILL COLLEGE
Buffalo, N.Y. 14226

RUSSELL SAGE COLLEGE
Troy, N.Y. 12180

ST. BERNARD'S SEMINARY
Rochester, N.Y. 14612

ST. BONAVENTURE UNIVERSITY
St. Bonaventure, N.Y. 14778

ST. JOHN FISHER COLLEGE
Rochester, N.Y. 14618

ST. LAWRENCE UNIVERSITY
Canton, N.Y. 13617

SARAH LAWRENCE COLLEGE
Bronxville, N.Y. 10708

SIENA COLLEGE
Loudonville, N.Y. 12211

SKIDMORE COLLEGE
Saratoga Springs, N.Y. 12866

SYRACUSE UNIVERSITY
Syracuse, N.Y. 13210

UNION COLLEGE & UNIVERSITY
Schenectady, N.Y. 12308

UNIVERSITY OF ROCHESTER
Rochester, N.Y. 14627

UTICA COLLEGE OF SYRACUSE UNIV.
Utica, N.Y. 13502

VASSAR COLLEGE
Poughkeepsie, N.Y. 12601

WAGNER COLLEGE
Staten Island, N.Y. 10301

WELLS COLLEGE
Aurora, N.Y. 13026

EXHIBIT "E"

THE CHRISTIAN AND MISSIONARY ALLIANCE

Graduate School: Alliance School of Theology and Missions
Nyack, New York

Colleges:

Nyack College, Nyack New York
St. Paul Bible College, Bible College, Minnesota
Simpson College, San Francisco, California
Toccoa Falls Bible College, Toccoa Falls, Georgia (affiliated)

Retirement Centers:

Suppes Memorial Home, Glendale, California
Shell Point Village, Fort Myers, Florida
The Alliance Home, Carlisle, Pennsylvania
The Alliance Home of DeLand, DeLand, Florida

Convalescent and Nursing Homes:

Alliance Convalescent Hospital, Glendale, California
Alliance Nursing Center, DeLand, Florida
The Alliance Village, McAllen, Texas
Nursing Pavilion, Shell Point Village, Fort Myers, Florida

Missionary Homes:

Headquarters Missionary Home, New York, New York
Nyack Missionary Cottages, Nyack, New York
Seymour Home, Vermilion, Ohio
Glendale Alliance Center, Glendale, California

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EXHIBIT "F"

CHURCH OF THE NAZARENE -- RELATED COLLEGES

COLLEGES:

1. Bethany Nazarene College
   Bethany, Oklahoma

2. Eastern Nazarene College
   Wollaston, Massachusetts

3. Mid-America Nazarene College
   Olathe, Kansas

4. Mount Vernon Nazarene College
   Mount Vernon, Ohio

5. Northwest Nazarene College
   Nampa, Idaho

6. Olivet Nazarene College
   Kankakee, Illinois

7. Pasadena College
   Pasadena, California

8. Trevecca Nazarene College
   Nashville, Tennessee

Bible College

Nazarene Bible College
Colorado Springs, Colorado

Seminary

Nazarene Theological Seminary
Kansas City, Missouri

EXHIBIT "G"

PROPOSED STATUTORY LANGUAGE FOR THE CHARITABLE REMAINDER VARIABLE ANNUITY TRUST

Internal Revenue Code Sections 664 [income tax], 2055(e) [estate tax] and 2522(c) [gift tax] should be amended to read as shown below. The material deleted is shown in brackets and the proposed amendments are set in bold face type.

SEC. 664. CHARITABLE REMAINDER TRUSTS. [INCOME TAX].

(a) General Rule.—Notwithstanding any other provision of this subchapter, the provisions of this section shall, in accordance with regulations prescribed by the Secretary or his delegate, apply in the case of a charitable remainder annuity trust [and], a charitable remainder unitrust **and a charitable remainder variable annuity trust.**

(b) Character of Distributions.—Amounts distributed by a charitable remainder annuity trust [or by], a charitable remainder unitrust **or a charitable remainder variable annuity trust** shall be considered as having the following characteristics in the hands of a beneficiary to whom is paid the annuity described in subsection (d)(1)(A) [or], the payment described in subsection (d)(2)(A) **or the payment described in subsection (d)(4)(A).**

(1) First, as amounts of income (other than gains, and amounts treated as gains, from the sale or other disposition of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;

(2) Second, as a capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain of the trust for prior years;

(3) Third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and

(4) Fourth, as a distribution of trust corpus.

For purposes of this section, the trust shall determine the amount of its undistributed capital gain on a cumulative net basis.

(c) Exemption from Income Taxes.—A charitable remainder annuity trust, [and] a charitable remainder unitrust **and a charitable remainder variable annuity trust** shall, for any taxable year, not be subject to any tax imposed by this subtitle, unless such trust, for such year, has unrelated business taxable income (within the meaning of section 512, determined as if part III of subchapter F applied to such trust).

(d) Definitions.—

(1) Charitable remainder annuity trust.—For purposes of this section, a charitable remainder annuity trust is a trust—

(A) from which a sum certain (which is not less than 5 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

(2) Charitable remainder unitrust.—For purposes of this section, a charitable remainder unitrust is a trust—

(A) from which a fixed percentage (which is not less than 5 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

(3) Exception.—Notwithstanding the provisions of paragraphs (2)(A) and (B), the trust instrument may provide that the trustee shall pay the income beneficiary for any year—

(A) the amount of the trust income, if such amount is less than the amount required to be distributed under paragraph (2)(A), and

(B) any amount of the trust income which is in excess of the amount required to be distributed under paragraph (2)(A), to the extent that (by reason of subparagraph (A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(4) Charitable remainder variable annuity trust.—For purposes of this section, a charitable remainder variable annuity trust is a trust—

(A) from which the greater of a sum certain (which is not less than 5 percent of the initial net fair market value of all property placed in trust) and a fixed percentage (which is not less than 5 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or

for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use

(e) Valuation for Purposes of Charitable Contribution.—For purposes of determining the amount of any charitable contribution, the remainder interest of a charitable remainder annuity trust, [or] a charitable remainder unitrust **or a charitable remainder variable annuity trust** shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year.

SEC. 2055(e) [ESTATE TAX]

(e) Disallowance of Deductions in Certain Cases.—

(1) No deduction shall be allowed under this section for a transfer to or for the use of an organization or trust described in section 508(d) or 4948(c)(4) subject to the conditions specified in such sections.

(2) Where an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the decedent's entire interest in property) passes or has passed from the decedent to a person, or for a use, described in subsection (a), and an interest (other than an interest which is extinguished upon the decedent's death) in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person, or for a use, not described in subsection (a), no deduction shall be allowed under this section for the interest which passes or has passed to the person, or for the use, described in subsection (a) unless—

(A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust, [or] a charitable remainder unitrust **or a charitable remainder variable annuity trust** (described in section 664) or a pooled income fund (described in section 642(c)(5)), or

(B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

SEC. 2522(c) [GIFT TAX]

(c) Disallowance of Deductions in Certain Cases.—

(1) No deduction shall be allowed under this section for a gift to or for the use of an organization or trust described in section 508(d) or 4948(c)(4) subject to the conditions specified in such sections.

(2) Where a donor transfers an interest in property (other than a remainder interest in a personal residence or farm or an undivided portion of the donor's entire interest in property) to a person, or for a use, described in subsection (a) or (b) and an interest in the same property is retained by the donor, or is transferred or has been transferred (for less than an adequate and full consideration in money or money's worth) from the donor to a person, or for a use, not described in subsection (a) or (b), no deduction shall be allowed under this section for the interest which is, or has been transferred to the person, or for the use, described in subsection (a) or (b), unless—

(A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust, [or] a charitable remainder unitrust **or a charitable remainder variable annuity trust** (described in section 664) or a pooled income fund (described in section 642(c)(5)), or

(B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

Senator CURTIS. The committee stands adjourned until 10 tomorrow morning.

[Whereupon, at 12:50 p.m., the committee recessed to reconvene at 10 a.m., April 9, 1976.]

TAX REFORM ACT OF 1975

FRIDAY, APRIL 9, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 10 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Carl T. Curtis presiding.

Present: Senators Curtis, Fannin, Hansen, and Packwood.

Senator CURTIS. The committee will come to order.

We are very happy that our first witness this morning is the Honorable Barry M. Goldwater, U.S. Senator from Arizona.

Mr. Goldwater, you may proceed.

STATEMENT OF HON. BARRY M. GOLDWATER, A U.S. SENATOR FROM ARIZONA, ACCOMPANIED BY TERRY EMERSON, COUNSEL

Senator GOLDWATER. Thank you, Mr. Chairman.

I am here today to ask that you remove from the tax reform bill any provision restricting attendance by U.S. citizens at conventions and seminars abroad. There is such a provision in section 602 of the House-passed bill, and I ask that you reject it and all similar restrictions.

It is said that this section is aimed at alleged abuses of present law. I will say what it really is. It is a cheap, nitpicking effort to gain a few dollars for the Treasury by people who do not understand the needs of American industry. It also is a flagrant discrimination against foreign countries.

It will make it harder for us to get along in Latin America and other areas that are important to us, and it will incite retaliation against foreign attendance at meetings in the United States and perhaps against U.S. trade.

Mr. Chairman, our tax laws should allow the deduction of travel expenses to attend professional seminars or conventions. They are a legitimate cost of doing business, whether they are held at home or abroad. They help to create a market for U.S. products, and they promote the free interchange of important professional information.

I would oppose cutting down on the free exchange of ideas and knowledge however the provision was worded. But what makes the restriction especially objectionable is the way it openly discriminates against other countries. At a time when our negotiators are talking at Geneva about cutting away foreign trade barriers that impede U.S. commerce, here we are at home setting up barriers of our making that will seriously injure tourism, a major industry of several of our trading partners.

This section says nothing about the possible abuses of convention going in the United States. It does not discourage a businessman in Tucson from traveling 2,124 miles to attend a meeting in New York City, but it does make it more difficult for him to go half that far to Mexico City. It does not prevent a businessman living in Boston from deducting the cost of flying to a convention in Hawaii, which is some 5,250 miles away, but it does limit his freedom to deduct the expenses of travel to Montreal, which is only 250 miles away.

Foreign countries will look at this and they will say: "Wait a minute. If you are so concerned with correcting abuses, why don't you clamp down on the far greater expenditures within your own country that are tax deductible?"

They can point to the 14,743 conventions and seminars that were held in the United States last year and ask why the proposed restriction is not applicable to any of these events. I don't know how our country can defend such a restriction against the charge that it is a nontariff barrier of the very kind our new trade law is designed to prevent.

What is truly ridiculous about this idea is that it will pick up so very little tax revenues. The House Ways and Means Committee estimates the provision will result in added taxes of less than $5 million annually. Yet for this small increase in taxes, we might injure the economies of foreign countries to the tune of hundreds of millions of dollars. And by giving cause for retaliation, we might injure our domestic travel industry, which now benefits by over $300 million a year spent by foreign visitors attending conferences in the United States.

Mr. Chairman, to give you a specific example of how this restriction would harm the economy of other nations, I will use the case of our neighbor on the south, from whom much of the culture and way of life that we live in the Southwest has come—Mexico. Mexico ranks as one of America's major trading partners. In the last 10 years the United States has exported to Mexico over $23 billion worth of goods and materials. From 1966 to 1975, we had a favorable trade balance with her of $7.2 billion. That is how much our exports to Mexico exceeded imports.

Mr. Chairman, in 1975 alone, the United States had a surplus of $2 billion in its trade with Mexico. The same year a record of 2.1 million Mexicans visited the United States as tourists. This year we will receive an estimated 2.5 million visitors from Mexico. Mexican tourists spent $1.3 billion in the United States last year, and this year it will be higher.

On the other hand, American tourists spent $2.3 billion last year in Mexico, which helped to offset some of their huge deficit in trade with us. If we increase this deficit by discouraging Americans from visiting Mexico, she will have to cut back her growth rate and reduce her imports.

Any reduction in imports would be especially detrimental for the United States since we are the source of approximately 70 percent of Mexican purchases abroad. By hampering tourism; we will reduce Mexico's ability to purchase from us, and we may prompt a countermeasure against Mexican tourism to the United States, which is actually growing faster than our tourism to Mexico.

Mr. Chairman, a very important part of Mexico's revenue from tourism originates with conventions held there and attended by U.S. citizens. Some convention or meeting is in progress on almost a steady basis in one or more of Mexico's principal hotels. The same thing might be said of Ireland, Italy, France, Britain, Switzerland, or many other friendly countries of the world. If we restrict American participation at meetings in these countries, we may create disruptions in their economies and retaliatory steps that go far out of proportion with what little tax income will result to the Treasury.

And make no mistake about it, the provision will discourage foreign travel. The provisions are so tedious and restrictive that many businessmen will simply decide not to go abroad rather than cope with the recordkeeping required by the proposal.

Mr. Chairman, a taxpayer going abroad would have to take a stopwatch with him under this provision. Where there is a combination meal-lecture, only the minutes when the speaker is talking can be counted in calculating a tax deduction. This and other harassing conditions of the provisions would make a businessman feel, "Why bother?"

Mr. Chairman, in closing, I urge that you drop this provision entirely from the tax bill that you report. The harm that it would cause is not worth the little tax revenue it might bring in.

There is a slight addition, Mr. Chairman. I realize that the Internal Revenue system is getting pretty hard up. They are about to run out of sources of money in this country. When government at all levels is appropriating 50 percent of the gross national product in this country, Internal Revenue has just about hit the bottom, but I see no reason why we should allow them, or whoever prepared the language of this bill, to make it impossible for American business people to travel in other countries for convention purposes.

Now, if they bring back the idea that there are plenty of places to hold conventions in the United States, Senator Fannin and I come from probably the second most popular convention State in the country, and you can't book conventions in Arizona for years ahead. We are so full.

Mr. Chairman, I think this is a very obnoxious bill. There is one more statement I would like to mention to give you an idea of the impact that this would create.

When the United Nations took the vote about last Thanksgiving relative to Zionism, the Jewish organizations that had conventions scheduled in Mexico tended to cancel them. This totaled 70,000 bed-nights—70,000 bed-nights just from Jewish organizations.

Now, if you say to the American convention-going public, "You can't deduct expenses for attending seminars in Mexico," their tourist business is going to dry up. Maybe other people in the United States who don't live as close to Mexico as Senator Fannin and I do, don't recognize the coming importance of that country and other countries. Thirty-five years ago, they imported 95 percent of everything they used from the United States. Now they have increased domestic production and import about 12 to 15 percent. In other words, we are slowly but surely losing the trade from countries south of us, and by the year 2000 there will be a half a billion people living south of our borders. I think we had better be encouraging trade with Mexico instead of taking utterly stupid steps like this to close down an important segment of their business.

Senator CURTIS. Senator Goldwater, you have given us a very good statement. I agree with you totally. I doubt if this provision would save a nickel for the Treasury of the United States. These conventions are an essential business operation. They will be held some place. Mileage is not a factor.

In addition to all the splendid reasons you gave, I can think of something else. We pay money out of the Treasury to send people, students and others, all around the world on good-will missions, to get acquainted with the other people.

There is no reason in the world that we should stop citizens from spending their own money to go abroad, and the travel, that part of the travel that is within the United States, is important to our economy.

I doubt very much if the Treasury or the IRS originated this idea. I have a guess that this is a misdirected notion of Members of Congress who are big spenders who have been telling their constituents, "Well, if we could just reform the taxes, we could impose a tax on somebody else, and there wouldn't be any deficit, and we could reduce our taxes to nothing, or nearly so, and the Treasury would just overflow."

Well, that isn't the case. If we took the most—if we took all of these proposals, the good ones and the bad ones, and at their face estimate of how much it would save, because in many cases I don't think it is true at all, we might come up with a saving of maybe $2 billion. I have talked with the Secretary of the Treasury about that, and he said, "Yes; about $2 billion if we took their figures for it."

We have a deficit of $76 billion. The only way we can reach that deficit is to look at the size of the Government, get out of some things we are in, and cut down on the welfare state.

It is so easy for someone who wants to avoid that to pound the table and say, "We want tax reform. It will fill the Treasury to overflowing." But if we took all these ideas, and some of them are very damaging, our major budget problems would still be with us.

Senator Fannin?

Senator FANNIN. I want to commend my colleague on his statement. It was brought out that we do have under present law the authority, or IRS has the authority, to correct any abuses that exist. I quote from what is stated, "that under the present code, travel expenses must be directly attributable to the trade and business." There has to be a relationship between one's business and one's attendance at such conventions. So the problem is not the number of conventions, but whether or not there is a relationship to the business or trade of the individual.

I commend the Senator. I know of his extensive promotion of good will with our neighbor to the south. I am pleased to join in his statement, and I will do everything I can to assist him.

Senator GOLDWATER. I thank both you gentlemen. I reiterate what you said. There is plenty in the present law to stop all the abuses going on. I don't say we don't abuse this law. It is abused, but you can't write a law that is going to make religious and decent, honest men out of every American. We have been trying it for 200 years, and we have not succeeded. Just to show you the effectiveness of the law, I took my wife to the Paris Air Show 3 or 4 years ago, and I deducted her. They disallowed it. I honestly don't think that taking her to the Paris Air Show helped my ability to interpret the flight characteristics of Russian aircraft, but she was a lot of fun to have along, and she was a great addition to the economy of France. I can say that.

Senator FANNIN. It placed you in a better mood to do your work.

Senator CURTIS. I think it is the typewriters that cause trouble for a lot of us. If you do these things in longhand, they can't read it, most of the time.

Senator GOLDWATER. It is the Mimeograph machine.

Senator CURTIS. Thank you very much.

We have a vote on, and after recognizing our colleague, the distinguished Senator from Iowa, Mr. Clark, we will recess and vote.

Senator Clark, we welcome you here.

STATEMENT OF HON. DICK CLARK, A U.S. SENATOR FROM THE STATE OF IOWA

Senator CLARK. Thank you, Mr. Chairman. In view of the problems of time and the vote, I think I would simply ask that the complete statement that I have prepared be put in the record, and simply say that I am prepared with regard to the question of the estate taxes, which I know you have been hearing testimony on, I would simply testify that I would hope the committee would increase the exemption from $60,000 to $200,000, and I know that a number of members of this committee have sponsored such legislation, and I know that since 1916, when we first had an exemption of about $50,000, and then I think rates of about 1 to 10 percent, when we increased that in 1942 to $60,000, and then had rates of 3 to 7 percent.

I am simply testifying here, then, this morning, Mr. Chairman, on behalf of those Members in the Senate and the family farmers generally and the small business people, in support of that larger exemption.

Senator CURTIS. Your entire statement will be printed in the record. We appreciate your comment, and we thank you very much for being here.

[The statement referred to follows:]

STATEMENT OF HON. DICK CLARK, U.S. SENATOR FROM IOWA

Mr. Chairman, members of the committee, we have permitted a serious inequity to develop in the way in which we now levy estate taxes. Simply put, the Federal estate tax structures has not kept pace with the times. In 1916, when these taxes became a permanent part of the Federal revenue system, an exemption of $50,000 was authorized and the tax rates ranged from 1 to 10 percent. Today, 60 years later, the rates range from 3 to 77 percent, but the exemption is still only $60,000.

The situation is having an especially serious impact on our farm economy. Estate tax laws are more important to farmers than to other economic sectors because farming in this country is still predominantly a single family operation.

And, estate taxes fall especially heavily on farms because such a large proportion of farm assets are in the very nonliquid forms of real estate and un-real estate such as livestock, machinery, and stored crops. In 1970, for example, real estate assets comprised 68 percent of farm estates; but only 22 percent of nonfarm estates.

It is difficult indeed for a small farmer to sell part of his land, or some of his livestock or machinery as they often must to pay estate taxes. The reason is that part of a farm unit is not always salable in such a form—and because the remaining operation may not be sufficiently efficient to be continued as an individual farming operation. Heavy estate taxes, all too often, mean one more farm sold, broken up and added to a very large operation nearby, leaving a vacant farmsteady and one fewer family farm.

How heavy is the estate tax burden for farmers at this time? In 1942, the $60,000 exemption covered a major part of the value of a 120 acre Iowa farm (with land at $500 an acre—a high price for that year). But today that land might be worth easily $1,500 an acre or more and the current $60,000 exemption covers something less than 40 acres of that farm.

Over the 34 years since 1942, the average size of Iowa farms has more than doubled, and the pressures to increase farm size continue. These forces, together with the steady inflation in the value of farmland combine to make the current $60,000 virtually ineffective in protecting the small and medium sized farm or business from the Federal estate tax. In 1974, approximately 15 percent of all farm sales were for estate settlement purposes.

The arithmetic is clear. The average value of farm assets per farm jumped from $51,440 in 1960 to $169,744 in 1974 and it is still rising rapidly.

The 1975 dollar is worth 65 percent less than the 1942 dollar. Using a simple price deflator to adjust for inflation, the $60,000 personal estate tax exemption authorized in 1942 is worth less than $18,000 today. To establish the exemption at a level equal in real terms to the 1942 exemption would require a current exemption of over $200,000.

Mr. Chairman, I would favor an increase in the current $60,000 Federal estate tax exemption to $200,000. Such a change would be of very significant benefit to farmers and many other small businessmen. From the point of view of the U.S. Treasury, this is a minor tax and the impact of U.S. revenue foregone by increasing the exemption to $200,000 is relatively small.

The impact of the current estate tax structure is certainly not small. Every week I receive a number of letters from Iowans who have farmed the same land for generations, and who want their farm to continue in their family, but who can see no way their heirs can put together enough cash to pay the more than 20 percent of their current assets the federal estate tax claims from a medium-sized farm. They feel, and I agree, that this tax as now levied is a real and serious threat to the continuation of the family farm.

In addition to the increase in the exemption from federal estate taxes to benefit small farms and small businesses, I propose a change in federal estate tax law to help farmers reduce the ravages of constantly increasing land prices. I recommend that for estate tax purposes, farmland be valued on the basis of its agricultural use rather than its current sale price, as is currently done. I recommend that qualifying real property devoted to farming, woodland, or scenic open space be assessed, for estate tax purposes, at its value for those uses if that value is less than its fair market value. Such a provision should buffer farm land values by preventing land sales for commercial, industrial, or residential uses from sharply increasing the assessment of farm land while it is being used for farming.

Senator CURTIS. The committee will stand in recess for a few moments.

[Whereupon, a brief recess was taken.]

Senator FANNIN [presiding]. The hearing will come to order.

The next witness will be Sherwin P. Simmons, chairman, Section on Taxation, American Bar Association, accompanied by Lipman Redman and John S. Nolan.

It is a pleasure to have you gentlemen here with us this morning.

Mr. Simmons, you may proceed as you see fit. Your complete statement will be made a part of the record.

STATEMENT OF SHERWIN P. SIMMONS, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY LIPMAN REDMAN, VICE CHAIRMAN—GOVERNMENT RELATIONS, AND JOHN S. NOLAN, CHAIRMAN OF THE COMMITTEE ON IMPLEMENTING RECOMMENDATIONS

Mr. SIMMONS. Thank you, Mr. Chairman.

On behalf of the 20,000 members of the Section of Taxation of the American Bar Association, I want to thank you for this opportunity to appear here today and present the section's views on this most important legislation. With me are Lipman Redman, vice chairman, government relations, and John S. Nolan, formerly Deputy Assistant Secretary of the Treasury for Tax Policy, and presently chairman of the section's Committee on Implementing Recommendations.

We are filing simultaneously with this statement a detailed technical analysis of the bill consisting of 212 pages; we have previously filed with this committee more than 430 pages of technical comments prepared by individual members of the section.[1] I mention these figures to underline the importance with which we view the bill and to indicate our concern with its provisions.

The section of taxation believes that, although H.R. 10612 makes several desirable changes in the Internal Revenue Code, particularly the changes proposed by the administrative provisions and the individual retirement account amendments, the bill fails to accomplish its stated objectives of tax reform and tax simplification. Indeed, much of the bill not only adds substantial complexity to the law but it does so without accomplishing any real reform. As is detailed in our report, prime examples of new complexities are the provisions establishing the new and very confusing concept known as "limitation on artificial losses" (LAL). These provisions are designed to limit the use of tax shelters and attempt to do so through the creation of new categories and subclasses of property and by the establishment of intricate accounting rules which produce different results between the various categories of property covered. In our view, the reform goals of these provisions can be more effectively accomplished by less complex alternative methods, such as adjustments to the minimum tax.

In addition, several areas of the bill, such as sections 205 and 209 dealing with prepaid interest and allocation of basis to certain assets, respectively, we believe, are best left to an expanded audit program under existing law. Additional examples are sections 207 extending LAL to films and livestock and certain crops and 208 imposing limitations on intangible drilling and development costs. We do not think that the Internal Revenue Code should be further complicated by matters which are really audit problems. In our view, an increased budget for the Internal Revenue Service would permit it to expand its audit program and thereby achieve the goals sought by many of the very complicated provisions of the bill.

We stress these features because of our concern over the failure of the bill to contribute substantially to simplification. To our great disappointment, the bill adds considerable complexity to the law. The

[1] The statement and comments referred to were made a part of the official files of the committee.

section of taxation has become increasingly concerned about the ever-growing complexities of our Federal tax laws. We recognize that the problem of simplification is not susceptible of easy solution. Even where simplification is the agreed goal, the questions are difficult. We also appreciate that simplification must compete with other goals, such as equity, revenue, and economic betterment. We also understand that a highly complicated statutory provision may be required to produce administrative simplification because it resolves an area which has been the subject of confusion and controversy between taxpayers and tax administrators. And we are aware that H.R. 10612 includes many provisions, particularly title XIX, the so-called "Deadwood Bill," which move toward simplification.

Nevertheless, we believe that this bill demonstrates all to clearly the fundamental fact that, in the give and take of the tax legislative process, simplification is the one issue that seems to have no counsel and no lobby. The various forces that shape tax legislation seem to be prepared to sacrifice simplification in compromising other competing interests. It is this process which has produced the enormous complexity of our present Internal Revenue Code. We are concerned that our tax system will not long survive the continuing additions of complexities to the law. One has only to look at the staggering size of the Employee Retirement Income Security Act of 1974 to know that even required reforms have their limits.

Our tax system became the world's best because the process of voluntary self-assessment has worked. If that system is to remain viable, we must do something now to reverse the process of adding complexities. We believe that the effect of the increasing complexities is to widen the gap between the taxes theoretically payable under the tax laws and those in fact collected. In the real world, neither taxpayers, their advisers, nor revenue agents can begin to master all of the relevant intricacies of the present Internal Revenue Code. For this reason (and the quite limited number of tax audits), even the most theoretically complete code provisions tend to have a random application in practice, and therefore often give rise to more serious inequities in fact than those sought to be cured by the intricate refinements of the code provisions.

The section of taxation of the American Bar Association, therefore, urges that, as noted in our detailed analyses, a number of the provisions of H.R. 10612 be carefully reconsidered not only as a separate evaluation of each problem with which they deal, but also as to their impact on the overall tax structure. In addition, the section makes the following recommendations to the Congress and urges their prompt acceptance and implementation:

First, that Congress simplify the internal revenue laws to the maximum extent consistent with basic equity, efficiency and the need for revenue so that such laws can be easily understood and complied with by taxpayers and fairly and consistently administered and enforced by the Treasury Department.

Second, that the Congress cause its tax-writing committees promptly to undertake and publicly commit themselves to a scheduled, long-range, systematic program to achieve such simplification.

Third, that these committees obtain comprehensive proposals for simplification from the Treasury Department and utilize the resources of the Treasury Department, and its experience in the administration of the tax laws, to the maximum extent possible.

Fourth, that in order to accomplish these goals, the Congress designate a group, such as a separately funded section of the staff of the Joint Committee on Internal Revenue Taxation, a separate commission, or other appropriate body to assist and advise the Congress with regard to simplification.

We offer these recommendations not as a panacea nor with the assertion that we are necessarily right in all respects. Rather we urge our position with the conviction that a beginning toward simplification is required now in connection with H.R. 10612 and as an independent matter. We hope that the Committee on Ways and Means of the House of Representatives, the Joint Committee on Internal Revenue Taxation, the Treasury Department, and other interested parties, to all of whom we are communicating our recommendations, will join the Senate Committee on Finance in making that beginning.

The practice of more than 50 years of adding complexity on complexity to the code through periodic revisions and amendments has resulted in a tax system so complex as to defy comprehensions, so complex that uniform enforcement is virtually impossible, so complex that an undue expenditure of time and money is required to comply with the law: and, finally, and most important, a system so complex that the confidence of the public has been eroded and our voluntary compliance system imperiled. Simplification cannot wait until tomorrow—substantial positive steps must be taken today.

Senator FANNIN. Thank you very much, Mr. Simmons. Your timing was certainly almost perfect.

The recommendations are greatly appreciated. I am wondering about the timing, in going through your recommendations. Do you feel that would delay the legislation?

Mr. SIMMONS. Mr. Nolan is our expert on simplification.

Mr. NOLAN. I don't think so, Senator Fannin. I think what we are urging is really a two-step process, an analysis of the provisions of this bill in light of the simplification objective, which means just a separate consideration each time one of these provisions is considered on its merits, that is, is there a simpler way to accomplish substantially the same result, and is the result accomplished by any proposed provision sufficiently important to justify its inclusion in the law, and then, apart from that, we are recommending a comprehensive long-range program of simplification to be undertaken by this committee and the Ways and Means Committee, and I mean we are looking to a 10-year program or something of that nature with a major research effort to support the committee's work in doing so.

Senator FANNIN. As I understand it, you are recommending that as we go through the markup on this legislation we take some of these measures into consideration?

Mr. NOLAN. Yes, and in our technical comments on the bill we have made our own evaluation of whether the particular provision contributes to simplification, or contributes to complexity, and we would hope the committee would consider our own section evaluations of the provisions in that light.

Senator FANNIN. To make it short range immediately, and there are long-range recommendations as far as the changes are concerned.

I note the complexity of it, as you have brought out, is evident, and change does not come over a short period of time. I realize what we are up against.

One matter, Mr. Simmons, on LAL. I know that this has created quite a problem. So many people and Members of Congress do not realize the total benefits that will accrue, or the penalties that will come about if we just take a broad sweep of the LAL. It is disconcerting to me, because I am vitally interested in the development of our energy resources, and if we adopted this provision that came over from the House, I think it would be devastating to the development of our energy resources. Have you approached this from the standpoint of any specific developments that would be affected?

Mr. SIMMONS. No, sir, because of the restrictions on the section itself, we have not approached it from a policy standpoint. We did review the legislation in light of how we thought it ought to be restructured, if it should be the decision of the Congress to proceed.

We did say in our detailed report that a limitation on particular deductions would accomplish the goal in a much simpler way than we believe LAL does.

Senator FANNIN. In your statement on page 2 you do make these recommendations, and refer to prompt implementation. I assume you are doing that because of what is in the House bill, or the concern that you have. Of course, you have brought out the great need for tax simplification in many respects, and if we adopt the proposals that have been made or the proposals in the House bill, it will be far more complicated, instead of simplified.

Mr. SIMMONS. Very much so.

Senator FANNIN. I would just ask another question about the minimum tax. We realize that people want to be fairly treated, and certainly there was a great cry that many people have not paid their fair share of taxes. As a result, Congress enacted the minimum tax which currently is in operation.

Do you feel that the minimum tax has been beneficial or detrimental as far as an incentive is concerned?

Mr. SIMMONS. Well, I can only offer you my personal view. I don't think it has been beneficial at all.

Senator FANNIN. It has created many problems that were not anticipated.

Mr. SIMMONS. Yes, sir.

Senator FANNIN. I have been vitally concerned, because I know that where we have provided incentives to encourage certain energy programs, for example, they have been curtailed considerably by the minimum tax.

In some cases they were offset by a minimum tax.

Mr. SIMMONS. Sir, if I could add a footnote, in our comments in the detailed report relating to this provision we recommended that if there is going to be a minimum tax, then all tax preferences be included. Otherwise, to the extent that they are not, there will be distortions in investment decisions which will result from differing tax rules, and we elaborate on that point.

We don't think that investment decisions should turn on, necessarily, tax rules.

Senator FANNIN. Mr. Simmons, on page 7 of your statement you propose a uniform Internal Revenue Code with respect to family businesses and so forth. Then you say that you would eliminate certain formalistic requirements for issuance of stock in small business corporations entitled to special tax treatment.

You speak of the trap they may set. Can you elaborate on that?

Mr. SIMMONS. Yes. The case of W. & W. Fertilizer Co. in the Court of Claims is a good example. As you are aware, the revocable trust is an attractive estate planning arrangement for many people. It doesn't produce any tax savings, but it is a vehicle whereby the estate owner can arrange his affairs to pass his property to his family in an orderly and smooth way after his death. He still pays all current income taxes and he pays all estate taxes. However, in the W. & W. case, for example, the estate owner transferred his stock in a subchapter S corporation to a revocable trust. As a result, the Court of Claims, according to the law, said that, although the man is going to be taxed on all income and the corpus will be taxed in his estate, the mere fact that the trust holds title to the property is sufficient to deny him the benefit of the subchapter S benefit.

That is just a simple illustration of how just mere formality has produced a result which probably, if the Congress had had an opportunity to consider it, it would not have reached that conclusion.

Senator FANNIN. Thank you.

Other members may have questions, which they will submit to you in writing. We appreciate very much your being here this morning. You have been very helpful, and thank you for your testimony.

Mr. SIMMONS. Thank you.

[The prepared statement of Mr. Simmons follows:]

STATEMENT OF SHERWIN P. SIMMONS, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

SUMMARY

The Section of Taxation of the American Bar Association believes that, although H.R. 10612 makes several desirable changes in the Internal Revenue Code, the bill fails to accomplish its stated objectives of tax reform and tax simplification. Indeed, much of the bill not only adds substantial complexity to the law, but it does so without accomplishing any real reform. Prime examples of new complexities are the provisions establishing the limitation on artificial losses (LAL). In our view, the reform goals of these provisions can be more effectively accomplished by less complex methods, such as adjustments to the minimum tax. In addition, the problems with which several provisions of the bill deal, particularly those included in Title II, are really audit problems which can best be handled by an increased audit program under existing law rather than by the addition of very complicated provisions to the Code.

We stress these features because of our concern over the failure of the bill to contribute substantially to simplification. To our great disappointment, the bill adds considerable complexity to the law.

The practice of more than 50 years of adding complexity on complexity to the Code though periodic revisions and amendments has resulted in a tax system so complex as to defy comprehension, so complex that uniform enforcement is virtually impossible, so complex that an undue expenditure of time and money is required to comply with the laws; and, finally, and most important, a system so complex that the confidence of the public has been eroded and our voluntary compliance system imperiled. Simplification cannot wait until tomorrow—substantial positive steps must be taken today.

Therefore, the Section of Taxation of the American Bar Association urges that a number of the provisions of H.R. 10612 be carefully reconsidered not only as a separate evaluation of each problem with which they deal, but also as to their impact on the overall tax structure. In addition, the Section makes the following recommendations to the Congress and urges their prompt acceptance and implementation:

First, that Congress simplify the internal revenue laws to the maximum extent consistent with basic equity, efficiency and the need for revenue so that such laws can be easily understood and complied with by taxpayers and fairly and consistently administered and enforced by the Treasury Department.

Second, that the Congress cause its tax writing committees promptly to undertake and publicly commit themselves to a scheduled, long-range, systematic program to achieve such simplification.

Third, that these committees obtain comprehensive proposals for simplification from the Treasury Department and utilize the resources of the Treasury Department, and its experience in the administration of the tax laws, to the maximum extent possible.

Fourth, that in order to accomplish these goals, the Congress designate a group, such as a separately funded section of the staff of the Joint Committee on Internal Revenue Taxation, a separate commission, or other appropriate body to assist and advise the Congress with regard to simplification.

STATEMENT

Mr. Chairman and members of this distinguished committee, on behalf of the 20,000 members of the Section of Taxation of the American Bar Association, I want to thank you for this opportunity to appear here today and present the Section's views on this most important legislation. With me are Lipman Redman, Vice-Chairman, Government Relations, and John S. Nolan, formerly Deputy Assistant Secretary of the Treasury for Tax Policy and presently Chairman of the Section's Committee on Implementing Recommendations.

We are filing simultaneously with this statement a detailed technical analysis of the bill consisting of 212 pages. We have previously filed with this Committee more than 430 pages of technical comments prepared by individual members of the Section. I mention these figures to underline the importance with which we view the bill and to indicate our concern with its provisions.

LEGISLATIVE RECOMMENDATIONS OF THE AMERICAN BAR ASSOCIATION

However, before commenting on H.R. 10612, I should like to draw your attention to the Appendix attached to this statement. This Appendix includes a list of 39 of the most important legislative recommendations of the American Bar Association for the technical improvement of the Internal Revenue Code.

These recommendations were developed as a part of the activity of the Section of Taxation of the American Bar Association. Of our 20,000 members, a substantial number work through nearly 45 committees, organized on a subject matter basis. Thus, we have committees dealing with tax aspects of Agriculture, Domestic Relations, Employee Benefits, Partnerships, Real Estate, Subchapter S Corporations, and many other such areas. Our committees from time to time develop legislative recommendations for improvements in the Internal Revenue Code in their particular areas.

These recommendations are carefully studied and voted upon by the particular committee, are submitted to the Council of the Section for analysis and vote, and are submitted to the entire membership for approval at the Annual Meeting of the Section. If approved, they go to the House of Delegates of the American Bar Association, and if approved there, they become official legislative recommendations of the Association. They are unique in that they include a complete legislative draft prepared with painstaking care by a group which includes the foremost tax lawyers in the country. Each recommendation also has a carefully-written summary explanation and full explanation.

At the present time, there are roughly 160 such recommendations outstanding. Because of their importance, we have selected the 39 recommendations included in the Appendix for consideration by this Committee. Many represent matters on which the American Institute of Certified Public Accountants has similar or near-identical recommendations. Complete copies of the draft legislation, summary explanations, and full explanations have already been submitted to your staff.

These recommendations include, for example, a recommendation that farmers be allowed to determine whether they qualify as farmers for special estimated tax payment rules based on their income in the preceding year. The present rule often results in late filing penalties being imposed on farmers because the test is based on the income of the current year as to which there may be uncertainty until it is too late.

We propose important administrative changes—an exemption of earnings up to $100 per week from levy by the Internal Revenue Service where the taxpayer owes a tax debt; judicial review of jeopardy assessments; and provision for court-supervised release of funds from jeopardy assessment so that taxpayer can hire counsel, protect his property, or pay other taxes.

We propose a uniform Internal Revenue Code rule for attribution of ownership of business interests among family members, corporations and their principal shareholders, partnerships and partners, and estates and trusts and their beneficiaries. This would replace a dozen or more existing separate sets of such rules in the Code and would greatly simplify existing provisions.

We would eliminate certain unnecessary formalistic requirements for issuance of stock in small business corporations entitled to special tax treatment. These are a trap for the unwary and sometimes result in forfeiture of benefits intended by Congress for small business.

We propose that basis be redetermined, for purposes of determining gain (but no loss) realized on the disposition of property (other than inventory, receivables from inventory or services, and installment obligations) held for more than 24 months, to reflect price level changes during the holding period. This would mitigate against the impact of progressive and continuing inflation in creating gains which are illusory in economic terms (representing shrinkage of the real value of the dollar rather than any accretion in real wealth) but which are taxed at increased capital gain rates and are subjected to the minimum tax on preferences.

We would allow a charitable deduction to an estate for the distributable net income distributed or permanently set aside for distribution to a charitable remainder annuity trust or a charitable remainder unitrust. This would avoid the uncertainty created by the Tax Reform Act of 1969 as to the deductibility of amounts of distributable net income permanently set aside by the estate for distribution to such a trust.

The foregoing are typical of our recommendations. Their enactment and the enactment of similar recommendations of the American Institute of Certified Public Accountants would be an important step toward simplification and equity in our tax system.

H.R. 10612

The Section of Taxation believes that, although H.R. 10612 makes several desirable changes in the Internal Revenue Code, particularly the changes proposed by the administrative provisions and the individal retirement account amendments, the bill fails to accomplish its stated objectives of tax reform and tax simplification. Indeed, much of the bill not only adds substantial complexity to the law, but it does so without accomplishing any real reform. As is detailed in our report, prime examples of new complexities are the provisions establishing the new and very confusing concept known as "limitation on artificial losses" (LAL). These provisions are designed to limit the use of tax shelters and attempt to do so through the creation of new categories and subclasses of property and by the establishment of intricate accounting rules which produce different results between the various categories of property covered. In our view, the reform goals of these provisions can be more effectively accomplished by less complex alternative methods, such as adjustments to the minimum tax.

In addition, several areas of the bill, such as sections 205 and 209 dealing with prepaid interest and allocation of basis to certain assets, respectively, we believe, are best left to an expanded audit program under existing law. Additional examples are sections 207 extending LAL to films and livestock and certain crops and 208 imposing limitations on intangible drilling and development costs. We do not think that the Internal Revenue Code should be further complicated by matters which are really audit problems. In our view, an increased budget for the Internal Revenue Service would permit it to expand its audit program and thereby achieve the goals sought by many of the very complicated provisions of the bill.

We stress these features because of our concern over the failure of the bill to contribute substantially to simplification. To our great disappointment, the bill adds considerable complexity to the law. The Section of Taxation has become increasingly concerned about the ever-growing complexities of our federal tax laws. We recognize that the problem of simplification is not susceptible of easy solution. Even where simplification is the agreed goal, the questions are difficult. We also appreciate that simplification must compete with other goals, such as equity, revenue, and economic betterment. We also understand that a highly complicated statutory provision may be required to produce administrative simplification because it resolves an area which has been the subject of confusion and controversy between taxpayers and tax administrators. And we are aware that H.R. 10612 includes many provisions, particulary Title XIX, the so-called "Deadwood Bill", which move toward simplification.

Nevertheless, we believe that this bill demonstrates all too clearly the fundamental fact that, in the give-and-take of the tax legislative process, simplification is the one issue that seems to have no counsel and no lobby. The various forces that shape tax legislation seem to be prepared to sacrifice simplification in compromising other competing interests. It is this process which has produced the enormous complexity of our present Internal Revenue Code. We are concerned that our tax system will not long survive the continuing additions of complexities to the law. One has only to look at the staggering size of the Employee Retirement Income Security Act of 1974 to know that even required reforms have their limits.

Our tax system became the world's best because the process of voluntary self-assessment has worked. If that system is to remain viable, we must do something now to reverse the process of adding complexities. We believe that the effect of the increasing complexities is to widen the gap between the taxes theoretically payable under the tax laws and those in fact collected. In the real world, neither taxpayers, their advisers, nor revenue agents can begin to master all of the relevant intricacies of the present Internal Revenue Code. For this reason (and the quite limited number of tax audits), even the most theoretically complete Code provisions tend to have a random application in practice, and therefore often give rise to more serious inequities in fact than those sought to be cured by the intricate refinements of the Code provisions.

The Section of Taxation of the American Bar Association, therefore, urges that, as noted in our detailed analyses, a number of the provisions of H.R. 10612 be carefully reconsidered not only as a separate evaluation of each problem with which they deal, but also as to their impact on the overall tax structure. In addition, the Section makes the following recommendations to the Congress and urges their prompt acceptance and implementation:

First, that Congress simplify the internal revenue laws to the maximum extent consistent with basic equity, efficiency and the need for revenue so that such laws can be easily understood and complied with by taxpayers and fairly and consistently administered and enforced by the Treasury Department.

Second, that the Congress cause its tax writing committees promptly to undertake and publicly commit themselves to a scheduled, long-range, systematic program to achieve such simplification.

Third, that these committees obtain comprehensive proposals for simplification from the Treasury Department and utilize the resources of the Treasury Department, and its experience in the administration of the tax laws, to the maximum extent possible.

Fourth, that in order to accomplish these goals, the Congress designate a group, such as a separately funded section of the staff of the Joint Committee on Internal Revenue Taxation, a separate commission, or other appropriate body to assist and advise the Congress with regard to simplification.

We offer these recommendations not as a panacea nor with the assertion that we are necessarily right in all respects. Rather we urge our position with the conviction that a beginning toward simplification is required now in connection with H.R. 10612 and as an independent matter. We hope that the Committee on Ways and Means of the House of Representatives, the Joint Committee on Internal Revenue Taxation, the Treasury Department and other interested parties, to all of whom we are communicating our recommendations, will join the Senate Committee on Finance in making that beginning.

The practice of more than 50 years of adding complexity on complexity to the Code through periodic revisions and amendments has resulted in a tax system so complex as to defy comprehension, so complex that uniform enforcement is virtually impossible, so complex that an undue expenditure of time and money is required to comply with the law; and, finally, and most important, a system so complex that the confidence of the public has been eroded and our voluntary compliance system imperiled. Simplification cannot wait until tomorrow—substantial positive steps must be taken today.

Appendix to Statement of Sherwin P. Simmons

LIST OF RECOMMENDATIONS OF SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

References are to Section of Taxation Committee originating recommendation; recommendation number (a number indicating 11450 is a reference to H.R. 11450, 89th Cong. 1st Sess., introduced by Mr. Mills (by request), October 6, 1965)); the Internal Revenue Code section which would be amended by the recommendation; the page number in "Summaries of Tax Legislative Recommendations of the American Bar Association, Summer, 1975", a publication of the Section of Taxation; and the page number in the Annual Reports of the American Bar Association, which report the adoption of the recommednations by the House of Delegates.

	Recommendation				
ABA Tax Committee	Record No.	Page 1975 summary	Code section amended	Reference tax lawyer	Reference ABA reports
Administrative practice:					
District court may release funds from jeopardy assessment lien for expense of counsel, protect property, other taxes	11450-87	88	6861	11-160	83-223
Judicial review of jeopardy assessments under declaratory judgment procedure	11450-88	89	6864	11-157	83-221
Exemption of earnings up to $100 per week from levy	1972-1	81	6334	25-875	73-1/106
No requirement for waiting 6 mo. after filing claim for refund to bring suit if issues arose as a result of a 90-day letter	1964-6	86	6532	17-250	90-283
Affiliated and related corporations: 80 percent of stock test requires that stock in each of the 2 or more corporations be owned by each of same 5 or fewer persons	1974-1	69	1563	27-813	1975-1/109
Agriculture: Farmers' right to postpone declaration of estimated tax until Jan. 15 of succeeding year should be allowed if at least ⅔ of gross income for preceding year is from farming	11450-78	79	6073	13-99	86-332
Collections and limitations: Time for refund claim for overpayment attributable to certain carrybacks should include extensions of time for filing return for year of loss	1971-3	86	6511	24-898	97-465
Corporate stockholder relationships:					
Sec. 269(c) presumption of income tax evasion or avoidance for disproportionate purchase price of stock or assets should be repealed as illogical and useless	11450-15	12	269	15-49	88-352
All gain recognized by distributing corporation on distribution of property to corporate shareholder should be added to basis in determining amount taxable to, and basis of, recipient corporation	1969-4	13	301	22-973	95-423
Uniform constructive ownership rule for substantially all Code provisions	1968-1	16	318	21-921	94-307
Installment obligation in 337 sale may be reported on installment basis on distribution in complete liquidation	1967-2	17	331, 337	20-50	93-309
Shareholders in sec. 333 liquidation should receive stock and securities without recognition of gain, subject to carryover basis, if corporation has held them at least 5 yr	11450-20	18	333	16-83	89-287
Subsidiary should qualify for nonrecognition treatment under sec. 337 if parent is completely liquidated within 12-mo period under sec. 337	11450-23	20	337	11-55	83-206
337 application in involuntary conversions—adoption of plan within 60 days; distribution within 60 days of receipt	11450-21	19	337	11-54	83-206
Depreciation and amortization: To provide for amortization of intangibles	1975-1		[1] 189	28-1027 [1] 29-191	1976-1

See footnote at end of table.

ABA Tax Committee	Recommendation: Record No.	Page 1975 summary	Code section amended	Reference tax lawyer	Reference ABA reports
Domestic relations:					
Nonrecognition of gain or loss on transfer of property to spouse in consideration of marriage or pursuant to divorce or property settlement, with carryover basis	1966-7	2	[1] 124	19-63	92-277
Payments incident to divorce or separation payable over a period more than 10 yr not deductible by payor or income to payee if specifically for property rights	1966-6	1	71	19-62	92-276
Excise and employment taxes: Avoid duplication of FICA and FUTA tax on 2 or more employers of the same employee by agreement between employers	[2] 1971-87			24-927	97
General income tax problems:					
Replace away-from-home test with duty-area test for travel expense deduction	1969-16	3	162	22-1031	95-461
85 percent intercorporate dividends deduction should not be subject to taxable income limitation which causes inconsistent and inequitable results	11450-11	9	246	9-20	81-159
60-mo amortization of reorganization and stock issue expenses like organization expense	11450-12	10	248	11-133 12-73 [2] 13-21	83-218 84-150
Income of estates and trusts:					
Allocation of depreciation and depletion between estates and beneficiaries should conform to trust rules—allocation per will or, if none, per allocation of estate income	1968-12	5	167	19-88	92-279
To provide a deduction for the distributable net income of an estate distributed to or permanently set aside for distribution to a charitable remainder trust or unitrust.	1975-3		642	28-1037	1976-1
Partnerships:					
60-mo amortization of partnership organizational expense.	11450-40	45	703	10-44	82-154
Exclusion of certain organizations from subch. K should be automatic unless organization elects to be taxed as a partnership	11450-51	57	761	9-57	81-180
Real estate tax problems:					
Percentage of gross income which cooperative housing corporation must derive from tenant-shareholders reduced from 80 percent to 50 percent, but for each percentage point below 80 percent, tenant-shareholders' deduction for interest and taxes reduced 1/30.	1972-3	9	217	25-903	73-1/106
Inadvertent disqualification of REIT—deficiency dividend procedure, limited taxation of income subsequently held disqualified, and adjustments to E. & P. arising from a disqualification. See H.R. 17488	1965-15	58	[1] 859	18-99 23-1009	91-318 96-449
REITS should be allowed to be orgnaized as corporations. H.R. 17488	11450-52	57	856	16-35	89-282
Sales, exchanges and basis:					
Elimination of requirement for a plan for issuance of stock (in small business corporations) subject to ordinary loss treatment	1974-15	65	1244	27-922	1975-1/109
Amounts received on extinguishment of contractual rights should be treated as received in exchange, as under 1241 in the case of leases and certain distributor's agreements, but certain transactions should be excluded from 1241	1967-5	64	1241	20-97	93-311
Sales, exchanges and basis:					
Limited recognition of gain on reacquisiton of real property by a seller should be extended to personal property, and gain should be capital gain if original gain was capital gain	1972-4	62	1038	25-907	73-1/106
Losses on sales or exchanges between related persons should offset gains on sales and exchanges with such person during the same year	1970-8	11	267	23-1015	96-453
Taxpayers not permitted to recognize loss on sale to related person should get loss when related person sells to unrelated person or property becomes worthless	1962-17	11	267	15-200	88-373
Basis of surviving spouse's share in joint property acquired with community property should be determined in the same manner as the basis of a surviving spouse's share in community property	11450-55	60	1014	9-25	81-160
Members of Armed Forces to have 5 yr (rather than 4 yr) after sale of principal residence to replace	1974-16	62	1034	27-926	1975-1/109
To redetermine basis to reflect price level changes during holding period of at least 2 yr	1975-4		[1] 1023	28-1045	1976-1

See footnote at end of table.

ABA Tax Committee	Recommendation				
	Record No.	Page 1975 summary	Code section amended	Reference tax lawyer	Reference ABA reports
Subch. S corporations:					
Termination of subch. S status if any 5 percent-or-more shareholder has a taxable year different from corporation except in certain justifiable cases	11450-63	67	1372	16-278	89-340
Subch. S election to remain effective, despite new shareholder, unless new shareholder files a refusal to consent	11450-64	68	1372	16-277	89-339
To provide that the maximum number of shareholders that a corporation making an election under subch. S may be increased from 10 to 30	1975-5	....	1371	28-1055	1976-1

[1] New.
[2] Amended.
[3] Now improved as H.R. 6176.

Senator FANNIN. The next witness will be Timothy W. Stanley, president, International Economic Policy Association.

On behalf of the committee we welcome you here this morning. We are very pleased to have you with us.

STATEMENT OF TIMOTHY W. STANLEY, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Mr. STANLEY. Thank you, Mr. Chairman.

Senator FANNIN. Your complete statement will be made part of the record, and you may proceed as you think best.

Mr. STANLEY. Thank you.

I appreciate the opportunity to testify on this subject. IEPA is a nonprofit research organization supported by a select but representative group of U.S. companies with extensive international business experience and interests. For nearly 20 years IEPA has been researching issues in the areas of international trade, investment, finance, balance of payments, natural resources, and taxation.

I hope that the committee will find the detailed analysis of the tax aspects in my written statement helpful in its deliberations. In the time available for this summary I can only highlight a few of the policy questions which lie behind the controversy on this subject.

Your committee has heard or will hear variations on four major themes argued by the proponents of major tax changes affecting foreign-source income. They are:

First, it is alleged that the U.S. tax provisions, especially the credit and the so-called deferral, provide incentives to U.S. firms to invest outside of the United States instead of at home. The investments also allegedly stimulate "export platforms," to produce low-cost goods abroad for export to the United States.

Second, the tax credit for foreign taxes paid and the so-called deferral provisions of U.S. tax laws are said to allow U.S. multinational corporations to escape fair levels of taxation on their income earned abroad.

Third, American MNC's are asserted to be directly or indirectly responsible for the "export" of many jobs, which is thought to have played a significant role in our current unemployment problems.

And fourth, the relative returns to labor and the size of the U.S. GNP are alleged to be lower than they would be if these present tax provisions had been or were completely eliminated.

Thus stated, these points seem rather impressive, especially when presented against the backdrop of serious unemployment problems in many areas of our Nation. Actually, however, these four allegations are based more on myths than facts. But the myths have been repeated so often before congressional committees, in public speeches, and in the media that they are too often accepted as valid, even though the statistics and economic research available today cannot sustain them.

Let me quickly summarize the material in my written statement bearing on these four myths:

First, and most important, U.S. firms have invested abroad in order to serve foreign markets which they could not serve with U.S. exports, either because of cost, transportation, and marketing considerations, or because foreign governments, concerned for their own employment and balance of payments, employed a variety of tariff and nontariff barriers to prevent imports from dominating their markets. To the extent that there was any artificial incentive involved in the growth of U.S. investment abroad, it was not tax policy, but rather the effective overvaluation of the dollar under the old fixed exchange rate system, which has now been corrected.

Foreign investment in so-called export platforms, that is, companies established aboard principally to produce for sales back to the United States, is the rare exception rather than the rule. Aside from trade under the United States-Canadian auto pact, which is, of course, a special case, over 96 percent of what American manufacturing MNC's produce abroad is sold abroad. And these sales incorporate intermediate products and components exported from the United States, and are frequently produced on U.S.-made capital equipment. That is why—again excluding auto trade with Canada—United States manufacturing MNC's export almost twice as much to their affiliates as they import from them.

Second, regarding escape from taxation as a reason for investing, U.S. manufacturing multinationals actually pay higher effective tax rates on their profits than the average for all U.S. corporations. Section III of my written statement provides some data on this, including a survey made by IEPA last year.

Former Treasury Secretary Shultz told the House Ways and Means Committee in 1974 that:

> The basic foreign tax credit must be understood not as a tax loophole or positive incentive to foreign investment, but rather as a part of a system designed to allocate primary taxing jurisdiction to the government within whose borders the income is earned.

Taxes on overseas production are paid to the governments that provide the services where the production takes place and they are, of course, paid currently there. To substitute a deduction for a credit for foreign taxes paid, as sometimes proposed, would lead to double taxation, which no country has accepted as desirable or beneficial; and it would certainly impair the spirit and, in many cases, the letter of the many U.S. double taxation treaties.

The so-called deferral issue is a misnomer. It is hard to see how an American shareholder can fairly be taxed on the earnings of a foreign corporation, over which corporations the U.S. tax authorities have no tax jurisdiction, in which he has an interest before the overseas affiliate has, in fact, distributed its earnings.

Certain foreign "tax haven" abuses which had developed were corrected many years ago. So new proposals for premature taxation, which I find a better word than the word "deferral," would, in my judgment, be counterproductive. U.S. revenue gains might prove illusory since foreign jurisdictions would be tempted to change their dividend withholding or other tax policies or place limitations on remittances to protect their own minority shareholders and balance of payments. The U.S. firms would either have to dip into funds now available at home to pay these premature tax liabilities or else curtail the reinvestment of income needed to maintain their position in highly competitive markets abroad.

Third, regarding the "export of jobs," the overwhelming evidence indicates that a net gain rather than a net loss to U.S. employment results from MNC operations abroad. Further, not only more but better jobs appear to be created than are displaced.

A study by the U.S. Tariff Commission for this committee 3 years ago estimated a net gain of a half million jobs on what it termed the "most reasonable" of three sets of alternative assumptions.

The jobs affected by foreign trade and investments are relatively small in comparison to those affected by the macroeconomic and sociological pressures on our labor force in recent years. The recession, reinforced by the actions of the OPEC cartel, is of course the biggest cause of our current unemployment.

The Vietnam war demobilization, the increasing participation in the labor force of women and youth, and the maturing of the postwar baby boom have all contributed to our present situation. Facing these urgent needs, we must focus on ways to increase employment, as labor force participation rates can be expected to remain high. It may be worth noting, Mr. Chairman, that the proportion of the civilian labor force to the adult population was stable at about 57 percent through the midsixties, but it has been rising since, currently to over 60 percent.

Where are these jobs to come from? Some areas, including government and public services, will grow, and so will some private sector activities. But various trends have already reduced current forecasts of future GNP substantially below the forecasts of 10 years ago. Therefore, one of the key growth areas to provide future jobs is the international markets—especially if the petrodollar wealth now being exacted from oil consumers is effectively recycled to the developing countries having the potential demand and absorptive capacity and supplemented by aid programs. This means that the United States must meet growing local and international competition in foreign markets. Their critics to the contrary notwithstanding, it is the U.S. multinational firms which are the cutting edge of that competitiveness.

Mr. Chairman, all this is very much at issue in the debates over taxation of foreign-source income because it is the more dynamic and innovative companies playing a significant role in international trade, production, and resource development which have provided increased jobs and incomes at home through their sales to foreign affiliates and access to overseas markets. Their growth in domestic employment and production has been higher than firms in industries with lower intensities of foreign investment. Yet it is the MNC's who are the subject of tax proposals—unique among industrial countries—which would be punitive and counterproductive in their economic effects both at home and abroad.

Finally, it has been argued recently that the relative returns to U.S. labor, the size of national income and Treasury revenues would be higher if foreign tax credits became deductions and the so-called deferral was eliminated. This thesis must be subjected to critical analysis, which I do in my full statement.

Senator FANNIN. Mr. Stanley, your time has expired, but if you would cover your conclusions on the last page, we could take that much time. Your entire statement has been made a part of the record.

Mr. STANLEY. Yes.

In conclusion, Mr. Chairman, I would like to comment on the adequacy of the basic data on which all the foreign investments arguments pro and con must rest. Some have said that in today's environment the statistics of yesterday are no longer appropriate. And it may be that some factors have changed, including the adoption of flexible exchange rates, the challenge of OPEC, and the other developments summarized in my written statement.

What information we do have points to substantial, continuing, and positive net benefits to the United States from MNC investment abroad. Senator Inouye has proposed and his subcommitte is currently considering a bill authorizing an updated comprehensive and impartial "benchmark" study of U.S. foreign investment, to be conducted by the Commerce Department. I would like to support this proposal and urge this committee to defer major tax changes which could make U.S. firms less competitive abroad, at least until Congress and the public have had the benefit of updated basic data on the relevant issues.

Thank you.

Senator FANNIN. Thank you very much for a very fine statement, Mr. Stanley, and for all the supporting data. This is greatly needed.

As you realize, there are many that maintain that this does not produce jobs in this country, that it results in exporting jobs. In my experience it is otherwise, and I am in agreement with what you have stated. But we do have the unions contending that this has not been of benefit, and it has not been in operation a long time.

What is your opinion as far as the DISC program is concerned? Do you have an idea as to what you think is done as far as employment in the United States is concerned?

Mr. STANLEY. Mr. Chairman, as you say, I don't think it has been in effect long enough, and the data on which all these discussions rest goes back to the mid-1960's. I am sure your committee will receive testimony from groups on behalf of DISC.

It is my feeling that by encouraging exports, it is inevitable that this will increase our employment, and it is hard to see any way in which it could hurt our employment.

I am mindful, however, of arguments that DISC represents a windfall in some areas, for rewarding people for what they would do anyway, and I know there are proposals to limit the DISC benefits to additionality of exports. If the Congress feels it is essential to change these benefits, this would seem a suitable way to proceed.

Senator FANNIN. That is good. We want to hold the beneficial provisions in DISC, and personally I know of companies that perhaps would not be in a position to continue their operations in this country if we did away with DISC, or if they continued, they would cut back in some cases. I did want to get your thoughts in that regard.

Now, you talk about the foreign investments and the so-called export companies established abroad are the exceptions rather than the rule. Unfortunately they receive a lot of publicity. They are electronic firms, and overall we see the equipment coming in, and it is not of a large dollar value.

Aside from under the United States-Canadian auto market, I assume that you have information, further information, in your detailed data that you have given us?

Mr. STANLEY. Yes, sir, there is a table drawing on the various Commerce Department data on page 9 in my full statement.

Senator FANNIN. Thank you.

Mr. STANLEY. That compares various sales of overseas affiliates of U.S. firms. This isn't generally realized that we are talking about 3.5 percent actually, if you exclude autos from Canada (and 6.7 percent if you don't), and over 96 percent is either sold in the country of production or in a third country.

Senator FANNIN. I do not think we would have great action if the Members of Congress understood that over 96 percent is sold abroad. But this is something that I think is very important, and if you have clarification of it, it should be very helpful.

[The material referred to was subsequently supplied:]

INTERNATIONAL ECONOMIC POLICY ASSOCIATION,
Washington, D.C., April 16, 1976.

Hon. PAUL J. FANNIN,
Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR FANNIN: I wanted to write to express my appreciation for the courteous reception which you and your colleagues accorded me during IEPA's recent testimony to the Senate Finance Committee. We are most appreciative of the opportunity to present our views in the important area of taxation of foreign-source income.

During the questions, you commented that many Members of Congress were probably unaware of the statistics in my statement regarding the very small percentage of the sales of U.S. manufacturing affiliates abroad which come back to the United States.

The statement that over 96 percent of the sales of U.S. manufacturing affiliates (other than those under the U.S.-Canadian auto pact) are sold abroad is based on the accompanying Table 3. It spells out more fully the data which was summarized in Table 2 on page 9 of the statement submitted to your Committee. The enclosure also provides a fuller description of the data and its sources on this subject.

Again, with appreciation,
Sincerely,

TIMOTHY W. STANLEY, *President.*

Enclosure.

Data on Sales of Majority Owned Foreign Affiliates (MOFA's) of U.S. Multinational Corporations

The Department of Commerce's Bureau of Economic Analysis has prepared estimates of total sales by majority owned foreign affiliates based on survey responses by a sample group of American companies. These surveys, which also ask for data on the sources and uses of funds, are conducted annually. The current data are "benchmarked," i.e. statistically compared to the latest benchmark (or mandatory and universal) survey of direct investment abroad, to derive an estimate of the current sales by all foreign affiliates. The most recent benchmark survey of direct investment abroad was conducted in 1966, although legislation to authorize a new—and needed—benchmark survey is currently pending before the Senate Commerce Committee (S. 2839).

The latest estimates by the Commerce Department of foreign affiliate sales for 1973 (*Survey of Current Business*, August 1975, p. 22 ff.) confirm the findings of all previous surveys that over 90 percent of what majority owned foreign affiliates produce abroad is sold abroad. For 1973, the data show the following:

1. For *all* foreign affiliates (in all industry sectors) in which U.S. citizens owned over 50 percent of equity, total estimated sales were $291.5 billion, *93.1 percent* of which ($271.5 billion) were made to customers abroad. Two-thirds of these foreign sales were local sales to local customers.

2. Taking manufacturing alone (because of the greater freedom of choice investors may have in locating their plants in comparison with natural resources industries), the Commerce Department data show that *93.3 percent* of the $140.9 billion sales by foreign affiliates were made to customers abroad, over three-quarters of which were local sales to local customers.

3. The sales data for manufacturing industry foreign affiliates, however, are significantly distorted by the effects of the U.S.-Canadian auto pact. This pact created a single North American market for motor vehicles and parts with duty-free trade. It makes sense, therefore, to treat sales of "transport equipment" by foreign affiliates based in Canada (most of which is covered by the agreement) as equivalent to domestic U.S. sales, for the distribution of such sales between local and U.S. markets is certainly not subject to the same considerations as are the sales of other MNC's. Therefore, subtracting the total sales of U.S. transport equipment industry subsidiaries in Canada ($10.3 billion) from the total sales of foreign manufacturing affiliates, and the exports of the same transport equipment subsidiaries to the United States ($4.5 billion) from the total exports ot the United States from foreign manufacuring affiliates, one finds hat *96.2 percent* of the $130.6 billion total sales by U.S. foreign manufacturing affiliates (ex-transport equipment subsidiaries in Canada) were to customers abroad. In this case, over 79 percent of these foreign sales were local sales to local customers.

4. The Commerce Department data also show the geographical distribution of the sales by the U.S. majority owned foreign affiliates. Over 70 percent of total sales abroad are made by affiliates in developed countries. Contrary to the belief that U.S. affiliated "low-wage export platforms" abroad are increasingly supplying the United States market, over 60 percent of the total foreign affiliates exports to the United States come from developed countries. And these totals, of course, include petroleum and other raw materials. For manufacturing sales, leaving out auto trade with Canada for the reasons explained above, only 15.6 percent of the small amount of U.S. manufacturing foreign affiliate sales to the United States come from developing countries, and over 84 percent of these exports were produced in developed countries characterized, for the most part, by high wages and high corporate tax rates.

TABLE 1.—SALES OF FOREIGN AFFILIATES[1] OF U.S. FIRMS, 1973

	Amount (billions)	Percent
Foreign sales	$271.5	93.1
Local sales	204.0	70.0
Sales to other foreigners	67.5	23.1
Sales to United States	20.0	6.9
Total	291.5	100.0

[1] Over 50 percent of equity owned by U.S. citizens.

TABLE 2.—SALES OF FOREIGN AFFILIATES OF U.S. FIRMS IN MANUFACTURING, 1973

	Amount (billions)	Percent
Foreign sales	$131.4	93.3
Local sales	109.1	77.4
Sales to other foreigners	22.3	15.8
Sales to United States	9.5	6.7
Total	140.9	100.0

TABLE 3.—SALES OF FOREIGN AFFILIATES OF U.S. FIRMS IN MANUFACTURING, 1973 (OMITTING SALES OF TRANSPORT EQUIPMENT SECTOR IN CANADA)

	Amount (billions)	Percent
Foreign sales	$125.7	96.2
Local sales	103.7	79.4
Sales to other foreigners	22.0	16.8
Sales to United States	5.0	3.8
Total	130.6	100.0

TABLE 4.—ORIGIN OF SALES OF FOREIGN MANUFACTURING AFFILIATES TO THE UNITED STATES (OMITTING SALES OF TRANSPORT EQUIPMENT SECTOR IN CANADA)

	Amount (billions)	Percent
Developed country sales	$4.19	84.4
Canada	2.12	42.7
Europe	1.99	40.1
Other	.08	1.6
Less developed country sales	.77	15.6
Latin America	.36	7.3
Asia	.39	7.9
Other	.02	.4
Total	4.96	100.0

Source: Bureau of Economic Analysis, Department of Commerce, Survey "of Current Business", August 1975.

Note: Details may not add to totals because of rounding.

Senator FANNIN. On the basic foreign credit, the statement by Secretary Shultz, I think, clarified some misunderstandings, and I think it is good of you to draw that to our attention.

You speak of certain tax abuses that have been corrected, and you say they have been counterproductive. You are not necessarily recommending, but you are stating that if there were further changes that should be made to clarify what is being done, that you would favor, if it is necessary, taking certain steps in order to save the overall benefits that will accrue?

Mr. STANLEY. Yes, sir.

Senator FANNIN. Thank you very much. We appreciate your testimony.

Senator Hansen?

Senator HANSEN. I have no questions, Mr. Chairman.

Senator FANNIN. You have been very helpful. We appreciate the tremendous amount of work that has been done to compile the information that you have given us.

Mr. STANLEY. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Stanley follows. Oral testimony continues on p. 2332.]

STATEMENT OF TIMOTHY W. STANLEY, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Taxation of foreign-source income

I. INTRODUCTION

This important subject goes well beyond the technical details of taxation and into fundamental questions about U.S. policies regarding the interaction of its own economy with the world economy. I am glad to have the opportunity to give you our views. IEPA is a nonprofit research organization supported by a select and representative group of U.S. firms with extensive international business experience and interests. For nearly two decades, IEPA has been researching issues in the areas of international trade, investment, finance, taxation, balance of payments and natural resources.

Proponents of major tax changes affecting foreign-source income have developed four major themes:

First, the U.S. tax system—especially the credit and the so-called deferral—is alleged to provide incentives to U.S. firms to serve foreign markets through investments outside the United States rather than with U.S. exports, as well as to invest in "export platforms," which produce low-cost goods abroad for U.S. consumption.

Second, the provision of a tax credit for foreign taxes paid and the so-called deferral provisions of U.S. tax laws are said to allow U.S. multinational corporations to escape taxation on their income earned abroad.

Third, American MNC's are accused of being directly or indirectly responsible for the "export" of many jobs, which is thought to have played a significant role in our current unemployment problems.

And fourth, the returns to labor and the size of the U.S. GNP are alleged to be substantially lower than they would be if these present tax provisions were completely eliminated.

Thus stated, these points are superficially persuasive, especially when presented to Congress in an election year against the backdrop of real unemployment problems in many areas. Actually, however, these four points are based more on myths than on facts. But the myths have been repeated so often before congressional committees, in public speeches, and in the media that they are too often accepted as valid—even though the statistics and economic research available today cannot sustain them.

Let us examine them one at a time and on the basis of the available evidence—including the many changes that have occurred in the international economy since these arguments first began to appear over a decade ago.

II. INTERNATIONAL ECONOMIC DEVELOPMENTS

Floating exchange rates

Since the monetary crises of 1971–73, flexible exchange rates have replaced the old Bretton Woods/IMF system of theoretically fixed exchange rates—which were in practice adjustable via periodic crises. The formal dollar devaluations of 1971 and 1973 proved insufficient to stabilize foreign exchange market expectations. By March 1973, most of the major trading countries' currencies were floating; and by July of that year the dollar had slipped to a record low value from which it has since substantially recovered. The float helped, however, to accommodate the world's financial strains that summer, as well as the drastic ones accompanying the oil crises in the winter of 1973–74. Floating has prevented the multiplication and hardening of capital controls and indeed made possible dismantling of some existing controls—notably the U.S. mandatory foreign direct investment controls—to the advantage of more efficient global resource allocation. On the other hand, trade concessions, investment decisions and monetary reform are all affected by the inherent uncertainties of "floating."

Shifts in world trade and U.S. trade and investment

Contrary to some early expectations, the effects of floating did not initially retard the growth in world trade. The nominal value of world trade surged 39 percent from 1972 to 1973 and 50 percent from 1973 to 1974; but in real or volume terms, world trade grew only 13 percent and 4.5 percent respectively. The global recession's effects were more severely felt in 1975, when the value of world trade grew only 4 percent, and in volume terms it declined by 6 percent.

U.S. merchandise exports have benefited considerably from the changed circumstances, although the effects of the first dollar devaluation were delayed. To be sure, devaluation hurts some aspects of the U.S. balance of trade and payments, including imports of essential raw materials and government expenditures abroad. But it has helped U.S. exports perform better than world trade in general in recent years, growing 23.2 percent in volume terms in 1973, 9.0 percent in 1974, and declining by only 2.6 percent in the general recession in 1975. While spectacular agricultural export growth was responsible for much of the initial export surge, the volume of U.S. manufactured exports has also expanded considerably, growing by 8.8 percent in 1973 and 17.1 percent in 1974.

This export performance under floating rates has surpassed the growth in U.S. imports, in contrast with the pre-1971 years when the reverse was true. In volume terms, U.S. imports rose by 4.8 percent in 1973, declined by 3.3 percent in 1974, and declined by a further 11.3 percent in 1975. The effects of these trends in real exports and imports were to help U.S. employment as they represent substitution of domestic goods for imports and increased production for foreign markets.

The most recent survey of multinational corporations—the 1970 "Special Survey" of 298 large U.S. parents and their majority-owned foreign affiliates (MOFA's) showed that 50.6 percent of U.S. exports were sold by these 298 MNC's, and that 23.5 percent of U.S. exports were sales of these MNC's to their MOFA's. Given the proportion of U.S. trade conducted by MNC's, it seems clear that exports of these firms must have grown significantly in recent years in order to allow such large aggregate volume growth. However, except for relatively small samples, such as the IEPA Tax Committee survey reported in Annex A of this statement, more recent data are not yet available.

The changed monetary system after 1971 has also affected U.S. direct investment flows. From 1971 levels, U.S. direct investment capital outflows dropped 25 percent in 1972, but rose almost to their prior (1971) peak in 1973. In 1974, because of financial repositioning after the elimination of OFDI controls, and petroleum industry problems, they were at a level of $7.5 billion, but in 1975, these outflows declined to $5.8 billion. Direct investment income, fees, and royalties, it should be mentioned, have consistently exceeded capital outflows in every year of this 1968–75 period, amounting to a net surplus of income over capital and earning flows since 1948, where the cumulative surplus is $73 billion.

The arguments about the international economy's effect on U.S. jobs must reflect the dollar's movement from overvaluation to market determined rates. But the tax reform arguments, implicitly based on the United States having an overvalued currency, have not, as yet, reflected these developments.

TABLE 1.—DIRECT INVESTMENT CAPITAL OUTFLOW, INCOME AND NET BALANCE, 1948-75

[In millions of dollars]

Year	Capital outflow	Less foreign borrowing [1]	Net capital outflow	Interest, dividends, and br. earnings	Fees and royalties	Total income	Net balance of payments effect
1948	721	....	721	1,604	213	1,277	556
1949	660	....	660	1,112	220	1,332	672
1950	621	....	621	1,294	246	1,540	919
1951	508	....	508	1,492	272	1,764	1,256
1952	852	....	852	1,419	292	1,711	859
1953	735	....	735	1,442	305	1,747	1,012
1954	667	....	667	1,725	328	2,053	1,386
1955	823	....	823	1,912	373	2,285	1,462
1956	1,951	....	1,951	2,171	438	2,609	658
1957	2,442	....	2,442	2,249	446	2,695	253
1958	1,181	....	1,181	2,121	442	2,563	1,382
1959	1,372	....	1,372	2,228	543	2,771	1,399
1960	1,674	....	1,674	2,355	590	2,945	1,271
1961	1,598	....	1,598	2,768	662	3,430	1,832
1962	1,654	....	1,654	3,044	800	3,844	2,190
1963	1,976	....	1,976	3,129	890	4,019	2,043
1964	2,328	....	2,328	3,674	1,013	4,687	2,359
1965	3,486	52	3,416	3,963	1,199	5,162	1,746
1966	3,625	445	3,180	3,467	1,162	4,629	1,449
1967	3,072	278	2,794	3,847	1,354	5,201	2,407
1968	2,880	785	2,095	4,151	1,430	5,581	3,486
1969	3,190	631	2,559	4,819	1,533	6,352	3,793
1970	4,281	378	3,903	4,992	1,758	6,750	2,847
1971	4,738	350	4,388	5,983	1,927	7,910	3,522
1972	3,530	259	3,271	6,416	2,115	8,531	5,260
1973	4,968	372	4,596	8,841	2,513	11,354	6,758
1974	7,455	(2)	7,455	17,679	3,024	20,703	13,248
1975	5,760	(2)	5,760	9,140	3,323	12,463	6,703
Total	68,730	3,550	65,180	108,497	29,411	137,908	72,728

[1] Funds obtained abroad from new stock issues by U.S. corporations and used to finance direct investments. Such funds were minimal pror to 1965 and the introduction of foreign direct investment controls; they are not listed by source since 1973.

[2] Not available.

Source: U.S. Department of Commerce: "Survey of Current Business."

OPEC and the North-South crisis

Another major set of changes has come about in the global economic system. OPEC command over world oil prices has made it necessary for the oil-importing countries to earn added foreign exchange in order to pay for more expensive oil imports. In other commodities, the price surges of 1973–74 were generally caused by a simultaneous world boom and by speculative purchases in an inflationary environment. These price surges have generally been followed by tremendous price drops during the world recession. The commodity producers, however, have tasted the possibility of "resource power" and their ambitions to emulate the success of the OPEC cartel carry the prospect of even wider trade difficulties for the industrial powers. Following Secretary Kissinger's address to the Seventh UN Special Assembly, a "North-South dialogue" has gotten underway with, as yet, an uncertain outcome. The United States has certainly been affected, although not as severely as many other industrial and less-developed countries. Nonetheless, U.S. financial problems in the petrodollar era will be eased by encouraging rather than penalizing U.S. international earnings. The transfer of economic power—at a rate of nearly 3 percent of the oil consumers' annual gross economic product—to a group of new actors on the world scene of uncertain stability and motivations, has far-reaching implications—political, strategic and economic. (Saudi Arabia, with a population less than that of New York City, has now replaced the United States as the second largest (behind West Germany) holder of international reserves.) The significance of these developments is too often overlooked in congressional discussions of foreign economic issues.

The evolving international system

The prospects in this new world are uncertain. Increased monetary flexibility, now legitimized at the Jamaican meeting of the IMF Group of Twenty, has allowed exchange-rate movements to help adjust trade and investment imbalances. But despite such flexibility, oil-related balance of payments difficulties, and the rigors of a world recession with inflation only slowly receding are bound to tempt nations toward "beggar thy neighbor" economic policies and competitive currency "adjustments," such as those we now see in Europe. Despite the foreign policy setback of recent years, the new economic power of Europe and Japan, and the so-called New International Economic Order, the United States is still the dominant Western political power, with the largest, strongest, and most self-reliant economy. In the evolving uncertainties of the international system, it is probably inevitable that the United States will set the trend and pace: either in the direction of mutually beneficial cooperation, openness, trade, aid, and global development through investment; or, alternatively, toward isolationism, increasing autarky, and self-interested manipulation of trade and investment. It is one aspect of this choice—that particularly related to investments—which the U.S. Congress will ultimately decide. A wrong decision on taxation of foreign-source income could well lead to others as the first steps to international "investment wars," caused by highly competitive taxation policies.

III. THE KEY ISSUES: THE FACTS BEARING ON THE MYTHS

The tax "incentive" to produce abroad

Contrary to the views of some critics of direct foreign investment and some academic theoreticians, numerous case studies of actual investment decisions and the available macroeconomic evidence all suggest that the key motivation for foreign investment is its relative effectiveness for serving markets, rather than any tax considerations.

Critics frequently ask why such markets cannot be served by U.S. exports. Many foreign markets can be and are served by exports and the U.S. export performance in the past two years, aided in part by the dollar exchange rate changes, was exceptionally good when viewed in the context of a global recession. For some products, however, the cost, transportation and marketing factors simply do not make it possible to compete effectively for overseas sales from the U.S. production base. Even where this may be theoretically possible, many businesses have found that successful selling in a given market requires an operating and often a manufacturing presence there in order to tailor production to consumer preferences and to take advantage of economic developments on a flexible basis.

Apart from economic and commercial considerations, the main reason for overseas production is that foreign governments, concerned for their own employment and balance of payments, simply will not allow foreign firms to dominate their markets with imports; they employ a variety of tariff and nontariff barriers to prevent it. As much as anything, it was the establishment of the European Community's common tariff barrier which provided a major impetus to U.S. investment to serve the European market.

The evidence now being developed in the GATT trade negotiations suggests that both tariff and nontariff barriers to trade are still more numerous and more serious than commonly thought. Nontariff measures range from formal or informal "buy national" government policies to currency and balance of payments restrictions, entry and valuation policies as well as consumer, environmental and other standards.

In this context, tax considerations are certainly not irrelevant, but numerous case studies show them to be of minor weight in an overall decision to invest and produce abroad.[1]

I have appended to my statement (Annex D) a list of the statutory tax rates in foreign countries which account for four-fifths of the overseas earnings of U.S. companies. With a very few exceptions, these are at the same rates or higher than those of the United States. If taxes were a key factor in overseas investment decisions, one would hardly expect to find over 82 percent of the total U.S. direct foreign investment in manufacturing in developed countries with rates

[1] Some of the earlier research on this point includes: the Harvard Business School's study of "U.S. Multinational Enterprise and the U.S. Economy," by Robert B. Stobaugh, published by the U.S. Commerce Department, Washington, D.C., 1972; "Business International Investment and Trade Study," Business International, New York, 1972; "The Impact of U.S. Foreign Direct Investment on U.S. Employment and Trade," National Foreign Trade Council, New York, 1971; and "Multinational Enterprise Survey," the U.S. Chamber of Commerce, Washington, D.C., 1972.

comparable to the United States, almost all of which is in Western Europe or Canada while less than 18 percent of the manufacturing investment is in the developing world, and much of that is in the larger and more advanced countries.

In areas such as Western Europe, Canada, and Japan, wage rates, as well as effective taxation levels, are currently not dissimilar from those prevailing in the United States when considered in light of productivity differences. Thus, if either lower taxes or lower wages were the primary motivation for investment, one would expect the pattern to be reversed, with much more going to the low-wage and low-tax areas instead of to the industrialized areas. The actual pattern therefore confirms the thesis that effective access to foreign markets is the dominant factor.

It must be conceded, however, that the artificially high value of the dollar under the Bretton Woods system did have a tendency to stimulate American investment abroad, by making U.S. exports more expensive in overseas markets and providing greater financial leverage in purchasing overseas production facilities inexpensively. This is, of course, related to the basic "marketing" rationale discussed above. To the extent this monetary stimulant was a factor, it has been removed, inasmuch as the U.S. dollar is no longer artificially pegged and has floated down substantially on a trade-weighted basis from the 1971 rate established at the Smithsonian conference, as discussed in Section II.

Part of the arguments of the advocates of major tax changes rests on the notion that U.S. foreign investments have become "export platforms" producing low-cost goods abroad for U.S. consumption. Table 2 presents the latest available data from 1973 on the relationship of sales of U.S. majority-owned foreign affiliates to U.S. imports. Only 6.7 percent of foreign manufacturing production is sold in the United States—and almost half of this is goods traded under the U.S.-Canadian auto agreement, in which Congress has, in effect, approved the trans-border internationalization of that industry. If adjustment is made for this special case, then over 96 percent of what American manufacturing MNCs produce abroad is sold abroad, either in the country of production or in third countries.

TABLE 2.—RELATIONSHIP OF THE SALES OF U.S. MAJORITY OWNED FOREIGN AFFILIATES (MOFA'S) TO U.S IMPORTS, 1973

	Amount (billions)	Percent
Total imports 1973	$73.2	100.0
Imports from U.S. MOFA's (including $6,800,000,000 petroleum MOFA's)	20.0	27.3
Imports from non-U.S. owned firms	53.2	72.7
Total manufacturing imports 1973	45.0	100.0
Imports from U.S. MOFA's (including Canada)	9.5	21.1
Imports from U.S. MOFA's Under U.S.-Canadian auto pact	(4.5)	(10.0)
Imports from all other U.S. manufacturing MOFA's	(5.0)	(11.1)
Imports from non-U.S. owned firms	35.5	78.9
Total overseas sales of U.S. MOFA's, 1973	291.5	100.0
Local sales	204.0	70.0
Exports to United States	20.0	6.9
Exports to other foreign countries	67.5	23.1
Total Overseas Sales in U.S. MOFA's in Manufacturing Industry, 1973	140.9	100.0
Local sales	109.1	77.4
Exports to United States	9.5	6.7
Exports under United States-Canadian auto pact	(4.5)	(3.2)
Exports of all other MOFA's	(5.0)	(3.5)
Exports to all other foreign countries	22.3	15.9

Source: "Survey of Current Business," August 1975, p. 22ff; and "International Economic Indicators," August 1975, pp. 52 and 56, Department of Commerce, Washington, D.C.

There are, of course, some exceptional cases, but these have tended to be in sectors such as electronics, where U.S. firms simply could not compete with foreign-based competitors in the U.S. market. In congressional and public discussions of this question, there has been a rather deliberate but misleading confusion of the "investment" issue of who "owns" a given plant producing a given import with the "trade policy" issues of the effects which a given import may have on the U.S. market and on American producers, and the retaliatory and other consequences of seeking to restrict the import in question.

The central issue of trade policy is how to balance the conflicting needs of maintaining a relatively open international trading system including the prohibition of unfair trade practices, with the legitimate concerns of governments for the welfare of their own industries, workers, and consumers. This is highly complex, but even in those cases where American firms are producing a substantial portion of the U.S. imports in a particular sector, the fact that they are American affiliates is not really relevant to the decision of what U.S. trade policy should be, and tax policy considerations are not the proper tool for the problem. In any case, the allegation that U.S. multinationals are "flooding" the American marketplace with foreign-made products is simply not true, as shown by the data in Table 2 above.

The question of tax avoidance

The allegation that the U.S. tax laws, particularly the provision of a tax credit for foreign taxes paid and the so-called deferral provisions, allow U.S. multinational corporations to "escape" current taxation on their income earned abroad is not well founded.

Data provided to the House Ways and Means Committee by the Treasury Department's Office of Tax Analysis show the total taxes paid by U.S. manufacturing corporations in 1974 were 46.5 percent of pre-tax foreign-source income. In contrast, the effective tax rate on the profits of all nonfinancial corporations in the United States in 1974 was 41.4 percent.[8] Last year, IEPA conducted a special survey among the companies represented on its Tax Committee in a way which preserved the confidentiality and anonymity of individual responses. As the results of this survey are relevant to the subjects of this Committee's hearings, I have appended a summary of our results and analysis. (Annex A). Although the sample was small, we believe it was representative, with a relationship of approximately 20 to 1 between the "universe" of U.S. industrial activity and the companies surveyed. It is significant, therefore, that the sample's effective worldwide tax rate for 1973 was 41.7 percent, or slightly higher than the rate for all U.S. nonfinancial corporations in that year.

It is, of course, true that the preponderance of taxes paid on foreign-source income accrues to foreign governments—because it is those governments who provide the services where the production takes place. And, of course, this taxation is not ordinarily "deferred," for subsidiaries are taxed currently in foreign jurisdictions. Former Secretary of the Treasury Shultz stated the facts of the matter very clearly when he told the Ways and Means Committee in 1974 that:

"The basic foreign tax credit must be understood not as a tax loophole or positive incentive to foreign investment, but rather as a part of a system designed to allocate primary taxing jurisdiction to the government within whose borders the income is earned. The system does not reduce the total tax bill of U.S. companies below the amount they would have paid to the United States if the income had been earned here."

To prohibit or substantially limit this credit for foreign taxes paid would amount to double taxation, a principle which neither the United States nor any other country has accepted as beneficial to industrial growth and development. It would deny tax neutrality and it would certainly violate the spirit of U.S. double taxation treaties. Attached to this statement as Annex C is a short description of U.S. tax treaty policy. There are nearly two dozen U.S. double taxation treaties on income taxes currently in force and an almost equal number under negotiation, revision, or awaiting ratification. Avoidance of double taxation, which is one of the major purposes of these treaties, is a matter not only of equity but a business necessity, since otherwise the competition of tax authorities and the resulting tax burden could force foreign investors out of business.

With respect to the so-called "deferral" question, this is a misnomer. It is hard to see how an American company can fairly be taxed on the earnings of a foreign corporation in which it has an interest—perhaps even a minor one, if the affiliate is controlled by a majority of American nationality—before the overseas

[8] "Taxation of Foreign Source Income: Statistical Data," prepared for the House Ways and Means Committee by the Staff of the Joint Committee on Internal Revenue Taxation, September 30, 1975; "Survey of Current Business," February 1976.

affiliate has actually distributed any earnings to the taxpayers who are subject to U.S. taxation jurisdiction. Proposals to eliminate deferral could therefore amount to premature taxation, equivalent to taxing the shareholder of, say, General Motors or AT&T on his pro-rata share of the company's net earnings before a dividend had been declared and paid.

There was substantial criticism, therefore, of the exceptions to the principle of taxing income only when received by the taxpayer which were enacted in 1962 as Subpart F. On the other hand, certain foreign "tax haven" abuses had developed, and the action can, therefore, be defended as necessary to close "loopholes." But the abuses have now been dealt with, and new proposals for "premature taxation" would, in our judgment, be counterproductive especially since they would affect legitimate manufacturing income. U.S. revenue gains would probably prove illusory, since foreign jurisdictions would be tempted either to change their dividend withholding and other tax policies, or to place legal limits on remittances, in order to protect their own minority shareholders. The U.S. firms would either have to dip into funds now available at home for productive investment in order to pay these premature tax liabilities growing out of the income of foreign affiliates, or else they would have to somehow repatriate the necessary funds, thus curtailing the capital needed for reinvestment, harming their position in highly competitive markets abroad.

The export of jobs and unemployment

There have been a number of convincing economic studies showing that U.S. direct investments overseas are not directly or indirectly responsible for any net export or loss of U.S. jobs. In fact, of the more than a half dozen studies that have been conducted in the last few years on the employment effect of foreign investment, only two have indicated a net negative effect. The majority have indicated that there are substantially positive effects, in the range of 500,000 to 600,000 net jobs, created by foreign investment. The 1973 U.S. Tariff Commission study done for this committee estimated a net gain of 500,000 jobs to U.S. employment as a result of MNC operations, on the assumption that U.S. exports could not have captured all of the markets that U.S. foreign affiliates abroad now serve. The Commission indicated that this was the most reasonable of the three sets of estimates presented in their report. This assumption is consistent with several studies estimating that only a small percentage of U.S. MNC production abroad for foreign markets could have been carried out in the United States.[8]

Actual reductions in domestic production or employment in the industries where foreign investment has been intensive are quite rare. More often, production by U.S. foreign affiliates has increased to serve the expanding markets abroad at the same time as U.S. production expanded to supply the growing U.S. market—and also to export capital goods, components, and finished goods to affiliates and others.

The extremes in the debate about displacement or creation of jobs over the past several years indicated either a plus or minus of 500,000 jobs. We believe that the weight of evidence points toward a substantially positive effect. In any case, it should be kept in the perspective of the U.S. economy as a whole; especially when it is ostensibly the subject of a national debate about the basic character of American foreign economic policy and the role of U.S. investments abroad. Although even a 500,000 figure represents only about one-half of 1 percent of the current U.S. labor force, the jobs allegedly created or displaced are vitally important to individuals, industries and communities affected. The burden of adjustment falling on selected areas should be shared as widely as possible via effective adjustment assistance and other programs to ease any individual and community problems without jeopardizing the national interest in maintaining a relatively open economy.

The alleged displacement of jobs by MNCs is so frequently cited that we often overlook the substantial creation of domestic jobs afforded by MNC activities. As noted, the evidence points to not only more but better jobs being created

[8] Professor Robert G. Hawkins estimates that probably only 10 to 15 percent of production abroad could have been carried out in the United States. "Job Displacement and the Multinational Firm: A Methodological Review" (Center for Multinational Studies Occasional Paper No. 3, page 19); and see "The Effect of U.S. Foreign Direct Investment in Manufacturing on the U.S. Balance of Payments, U.S. Employment and Changes in Skill Composition of Employment," by Professor Robert D. Stobaugh, Piero Telesio, Harvard Business School, and Professor Jose de la Torre, Institute for International Business, Georgia State University (Center for Multinational Studies Occasional Paper No. 4).

than may be displaced, so that the net figures are positive. It is useful to recall some of the changing sociological as well as economic factors that have affected the U.S. employment situation over the last few years. The recession, reflecting in part the actions of the OPEC cartel, is of course the biggest cause of our current unemployment. The Vietnam war demobilization, the maturing of the post-war baby boom, and the substantial growth in the entry of both females and youths into the labor force have all contributed to our present situation.

Facing these urgent needs, we must focus on ways to *increase* employment, as labor force participation rates can be expected to remain high. (The proportion of the civilian labor force to the adult population was stable at about 57 percent through the mid-sixties; but it has been rising since, currently to over 60 percent.)

Where are these jobs to come from? Some areas, including government and public services, will grow, and so will some private sector activities. But various trends have already reduced current forecasts of future GNP substantially below the forecasts of 10 years ago. Therefore, one of the key growth areas to provide future jobs in the international markets—especially if the petrodollar wealth now being extracted from oil consumers is effectively recycled to the developing countries having the potential demand and absorptive capacity and supplemented by aid programs. This means that the United States must meet growing local and international competition in foreign markets. Their critics to the contrary notwithstanding, it is the U.S. multinational firms which are the cutting edge of that competitiveness.

This is very much at issue in the debates over taxation of foreign-source income because it is the more dynamic and innovative companies playing a significant role in international trade, production, and resource development which have provided increased jobs and incomes at home through their sales to foreign affiliates and access to overseas markets. Their growth in domestic employment and production has been higher than firms in industries with lower intensities of foreign investment. Yet it is the MNCs who are the subject of tax proposals—unique among industrial countries—which would be punitive and counterproductive in their economic effects both at home and abroad.

Effects on national and labor income

More recent arguments, going beyond the export of jobs question, focus on the estimated macroeconomic costs of capital outflows.[4] It has been postulated that if past foreign investment opportunities had not been taken, for example because of burdensome taxation, that domestic investment as a whole would have increased. The observation that individual firms would not necessarily have invested at home, due to the absence of markets there for their products which were instead produced abroad, is met by an assertion that the rechanneling process of the capital markets would nevertheless have increased U.S. domestic investment on an aggregate basis. As capital markets respond to interest rates and profit margins, it appears to me that capital controls would be necessary to bring about this result.

Let us assume that the most drastic recommendations for tax changes endorsed by a few academicians and a number of spokesmen for organized labor were adopted. That would mean the current taxation of all foreign subsidiary earnings, the elimination of the tax credit for foreign taxes paid and the substitution of a deduction. These changes would sharply increase the level of taxation on the U.S.-owned affiliates abroad, leading, in some cases, to a total tax rate as high as 75 percent. Faced with such taxes and resulting reduction of after-tax profit, many U.S. parents would seek to sell off their overseas affiliates. Thus compelled, there would, of course, be a "buyers' market" which would tend to prevent the owners from getting a full return on their assets. Some of the capital might of course be reinvested in the Eurobond or Eurodollar markets abroad; some companies might choose to take minority direct investment positions there, and some of the capital would probably be repatriated. But such forced repatriation of capital previously invested abroad by increasing the supply of funds in domestic capital markets, could be expected to depress the rates of return of those markets; this, in turn, might lead to a compensating outflow of portfolio capital to take advantage of higher returns abroad. Consequently, capital controls would be necessary to prevent any "gains" in capital returned from U.S. foreign

[4] See Peggy B. Musgrave. "Direct Investment Abroad and the Multinationals: Effects on the United States Economy" (U.S. Senate Committee on Foreign Relations, Subcommittee on Multinational Corporations, August 1975.)

direct investment from being "lost" through additional portfolio investments abroad—which, of course, would have none of the "pull effect" on U.S. exports which has been characteristic of direct investments.

The forced sale of some U.S. direct investment assets abroad would also cut into the size of the return flow of earnings from these investments. In recent years, these have been rising dramatically. The accumulated *net* return from foreign direct investment in 1970 through 1970 was over $38 billion and exceeded the total *gross* capital outflow for the two decades from 1948 through 1968! This source of foreign exchange has helped the United States to come through a period of sharp increases in the costs of basic commodities and imported oil with relatively little erosion of the dollar.

What would be the likely effect on foreigners of these proposed tax changes? Certainly some reciprocal limitations on foreign investment should be expected. That, of course, would have the effect of reducing the net gains for the U.S. supply of capital. In this connection, it is worth noting that the latest Treasury Department's benchmark survey on foreign investment in the United States indicates that total foreign portfolio investment in the United States has more than doubled in the last couple of years and is now thought to be between $80 and $85 billion.[5] (This, of course, is in addition to the foreign direct investment in the United States which in 1974 was about $22 billion, compared to $110 billion in U.S. direct investments abroad.)

The market, as well as any hypothetical action by one or more governments, will influence this large and volatile pool of capital. If returns to capital are falling in the United States due to forced repatriation, foreign investors in the United States would be likely to move their capital in the opposite direction in search of better yields, possibly in anticipation of capital controls, and also to take advantage of the "bargain" assets being sold off by U.S. firms because of prohibitive taxation levels.

On the basis of theoretical models and some critical assumptions, i.e., that all capital available could be fully and productively invested in the United States, even with the loss of substantial foreign markets, a case can be made that U.S. abstention from past foreign direct investment may have resulted in a very modest (one-tenth of 1 percent) increase in U.S. national income, and a small (2–3 percent) increase in U.S. labor's share of after-tax income. I am afraid, however, that those key assumptions and the smooth working production function models do not accurately depict the real world. Moreover, in such a simulation of how the U.S. economy might have developed if a key factor—foreign investment—had not occurred, no convincing case is made as to how it would be affected in the future if we attempt to reverse past trends and force the repatriation of foreign direct investments.

Most probably, such an attempt would cause opposing actions by foreign governments and investors, an offsetting loss of productive investment capital in the United States, and serious impacts on interest rates, profitability, portfolio investment flows and the U.S. balance of payments. In such an environment less efficient use of capital resources would also serve to reduce U.S. production and growth.

Thus, even if one were to accept the argument that a goal of U.S. tax policy should be to increase the relative share of labor in the national income, it would seem far better to approach this as a matter of changes in individual domestic taxation rates than by seeking to disrupt the entire international tax system and, thereby, the world economy.

Unlike some other countries, the United States has historically taxed its citizens and corporations on income received regardless of source. It has, however, allowed credit for foreign taxes paid to assure that income earned abroad would not be subjected to double taxation. The intention of this policy was neither to create incentives nor to penalize companies and individuals for investing abroad.

When evaluating changes in the tax treatment of foreign-source income it is essential to consider the corresponding policies of other industrialized countries because the long-term future of the U.S. economy will depend on its competitive position in the international marketplace. Unilateral changes in U.S. tax treatment of foreign-source income would have the effect of increasing U.S.-owned companies' costs vis-a-vis their German, British, and Japanese competitors. The subsequent U.S. loss of its share of international business would benefit the economies of those countries rather than the United States. The data in Annex B show

[5] "Commerce Today," Nov. 10, 1975, p. 7.

how major foreign countries' tax policies treat their subsidiaries operating abroad. No other country taxes the profits of its nationals' foreign subsidiaries before the money is remitted home. Foreign income is either not taxable at all, or where it is, an appropriate credit is allowed for foreign taxes paid.

The effects of changing the U.S. tax treatment for foreign taxes paid from a credit to a deduction would depend on the tax rates of the foreign jurisdiction involved. A table prepared by Arthur Andersen and Co. is reprinted in Annex D to this statement in order to show both the present statutory tax rates in the major foreign countries (accounting for 82 percent of the 1973 overseas earnings of U.S. manufacturing companies) and what the total tax rates *would* be if foreign taxes were taken as a U.S. deduction rather than a credit. The effect of the combined U.S. and foreign taxes for the 26 countries shown ranges from a low of 59 percent to a high of 82 percent, with most in the range of 70 to 80 percent, a full 50 percent *increase* in effective tax rates!

An increase of this magnitude, of course, would not be applicable to German, Japanese, or other competitors. As a result U.S. firms would be severely handicapped in competing for capital in the same worldwide market in comparison with other investors who face much lower effective tax rates. Thus such benefits to the U.S. economy as U.S. exports to affiliates and the repatriated earnings would tend to be reduced or lost entirely. Similar adverse effects, varying in degree would follow from other types or noncompetitive curtailment of presently allowable foreign tax credits.

As noted previously, "deferral" (which has been a successful slogan for the tax reformers) is a misnomer. Taxes are not "deferred." All subsidiaries are taxed currently by the foreign countries having taxing jurisdiction over their operations. The issue really is whether American companies should be taxed by the United States on their share of the earnings of foreign corporations, before those earnings are distributed by the affiliate and received by the U.S. taxpayer. U.S. tax revenue gains from changing to "current"—or, more accurately, "premature" taxation, are likely to be illusory in the long run, since foreign jurisdictions could change their dividend withholding and other tax policies to capture the entire increased tax liability applicable to subsidiary earnings. Alternately, the tax laws of the host countries or the rights of other shareholders may prevent excessive remittances.

There would also be significant competitive consequences from such a change in U.S. tax laws, especially in developing countries, which have relatively lower corporate tax rates in order to encourage vitally needed reinvestment of domestic earnings for development. The role of foreign investment in the development of less developed countries has long been regarded as both important and legitimate.[6] If, contrary to the announced U.S. objectives in the North-South economic dialogue we have promoted, we now wish to change our public policy stance with respect to investment in developing countries, then the issues ought to be debated substantively and not subsumed into complex questions of tax policy and administration. The United States also has a vital interest in the identification, development, and marketing of overseas natural resources, which could be affected by major U.S. tax changes so that the U.S. economy might suffer as a result.

It would be ironic indeed if, by changing the tax treatment of U.S. firms now operating in less developed countries, they were forced to abdicate industrial development there to Japanese, German, and other international firms—who would then be able to utilize the less developed countries, preferences, established under the GSP provisions of the Trade Act, for sales to the U.S. market.

It may be relevant to review briefly the history of the U.S. Office of Foreign Direct Investment and the controls it administered. These required the repatriation of funds; but often led to problems with the boards of directors of foreign subsidiaries which, as frequently required by local law, included local nationals. Where a company had followed normal dividend practices, it often could not comply with the added OFDI repatriation requirement without borrowing in excess of its normal financing ability. And, if course, the parent company has no legal right to the subsidiary's income until allocated by the board, in accordance with local law. Thus in cases where the local board either could not or

[6] A recent study on this subject is contained in "Foreign Direct Investment and Economic Growth in Latin America" by Kraska and Taira in the "Journal of Economics," Volume I, 1975.

would not take action which might affect the solvency of the subsidiary or the rights of minority shareholders, the U.S. parent was forced to borrow in the Eurodollar market in order to repatriate funds. In most cases this left the foreign subsidiary untouched; but it imposed on the U.S. parent a high foreign interest cost. Current taxation of controlled foreign corporations might be analogous to the experience with OFDI in forcing the transfer of funds to the United States, presenting the U.S. parent with similar difficult choices. It could borrow additional funds in the local market (sometimes difficult because of a high debt-equity ratio), pay the tax itself out of foreign earnings (where profit margins permitted), or pay it out of U.S.-generated earnings, with an adverse effect on company cash flow, employment, and capital formation needs.

Still another option, of course, would be to sell the subsidiary in order to avoid any U.S. tax liability, but this would have an adverse effect on overall U.S. competitiveness in the industry or market area concerned, and would also involve a long-run loss of earnings not only to the parent company but to the U.S. balance of payments.

I have submitted this comprehensive statement to your committee, Mr. Chairman, because, although the technical issues of international "tax reform" are highly complex, they are really only part of a much larger set of issues. At the heart of these is whether U.S. direct foreign investment (often but not always by multinational companies) is in the net interest of the United States. On the basis of the assumptions which have governed U.S. foreign economic policy since World War II, I believe that the evidence is overwhelmingly that it is; U.S. multinational investments have helped not only U.S. trade and the balance of payments but also promoted domestic growth, productivity, and employment. They have facilitated the efficient allocation of resources and made a positive contribution to international economic development.

Contrary to the four myths noted at the outset of my statement: MNC's have not led to a flooding of U.S. markets with low cost goods from U.S. "export platforms" abroad; they have not had any significant advantages in terms of reduced worldwide tax burdens; the domestic job creating function has been greater than any job displacement efforts; and the allegedly higher returns to U.S. labor and national income in a world without foreign investment could only be realized by a stringent program of capital controls which would change the entire international economic system.

The advocates of greatly increased taxation of foreign investment, therefore, are really not talking about tax "reform" but about a fundamental shift in U.S. foreign economic policies. For, in addition to capital controls, there would soon be a need for import controls as well. Otherwise foreign competitors would undoubtedly take advantage of the productive assets available via forced U.S. disinvestment to seek expanded exports into the U.S. market. We would then be well on the way toward a "closed" economic system for the United States.

In theory, such a closed model could be constructed in which we would substantially phase out foreign trade and investment. Thus freed from international competitive considerations, we could try to develop an autarkic base of natural resources, bartering for what we simply had to have from abroad. The political and strategic consequences of any such economic choice would obviously be grave; but even in economic terms, our inflation rates would rise rapidly, our national income would decline, and by denying others access to our markets (leading them to retaliate with trade protectionism) our domestic employment problems would undoubtedly multiply.

By rejecting the extreme of a "closed" economy, I am not necessarily endorsing the opposite extreme of a totally open economy, one with no restrictions on imports or foreign investments no matter by whom or for what purpose. IEPA has long argued that one of America's leading bargaining chips in the world economy is the size and wealth of its own market and that we should liberalize access to it only in exchange for fairer treatment for American products, investments, and labor in foreign markets, including access to natural resources. I believe, therefore, that the United States should seek a reasonable balance between the extremes, but one stressing the openness that has brought about an unprecedented rate of growth in the past two decades for most of the world's economies, including our own.

It is therefore a rather fundamental choice that America faces: no one can give assurances that a choice of the relatively "open" model will be free from cyclical problems, import-caused dislocations, or troublesome capital flows. But the risks seem less than the almost certain adverse political and economic consequences of taking the road toward a "closed" economy.

Earlier in this statement I expressed my belief that providing for growth in meaningful jobs to meet the expanding expectations of our population is one of our major challenges, and that such growth is, in the main, a function of markets—which seem likely to have a larger expansion potential internationally than on a purely domestic basis. If that is the case, the United States must be prepared to continue to compete effectively in the world economy; and imposing punitive taxation measures under the guise of reforms on the most competitive elements of our private sectors, those who are competing in and for that larger market, is hardly a sound approach.

I therefore do not think, Mr. Chairman, that this committee should make fundamental changes in the taxation of foreign-source income which would have harmful effects on the U.S. competitive position. This certainly applies to the credit for foreign taxes paid and to imposing premature U.S. taxation on the income of foreign subsidiaries, for the reasons I have indicated. The effects of such measures on a small sample of companies surveyed by IEPA's Committee on Taxation last year are given in greater detail in Annex A.

The same principle also applies to DISC, which has proved to be helpful to U.S. exports and which thereby supports increased U.S. employment. On the other hand, I am not unmindful of the case that has been made that DISC benefits should be limited to additionality of exports; so that if a change is necessary, this might be an acceptable approach.

Questions have been raised about the adequacy of the basic data on which all arguments about foreign investments, pro and con, must rest. It has been said that in today's environment, the statistics of yesterday are not adequate. Some factors have indeed changed, such as adoption of flexible exchange rates, as well as other developments noted at the beginning of this statement. In my opinion, the net effect of these developments has been to make tax changes even less desirable. But to the extent that the debate revolves around the adequacy of data, a good case can be made for an updated, comprehensive, and impartial study based upon authority given to the Commerce Department to conduct a new benchmark survey of direct investment. In this regard, I would like to go on record as supporting the approach now being considered by Senator Inouye's subcommittee so that Congress and the public will have the benefit of updated basic data on the relevant issues—before fundamental changes are made in the taxation or other key aspects of U.S. foreign economic policy in a rapidly changing world.

Annex A[1]

RESULTS AND ANALYSIS OF IEPA SURVEY

The International Economic Policy Association limits its membership to a select group of U.S.-based companies with international interests. It is, we believe, broadly representative of the international sector of U.S. industry as a whole, with the exception that it does not have any major oil companies among its members.

In order to bring specific facts to bear on the general questions being raised in connection with the taxation of foreign-source income, a survey was conducted among the companies represented in IEPA in a way which preserved the confidentiality and anonymity of individual company responses.

A. Study relationship to total economic activity

The relationship of the microstudy sample to the "universe" of U.S. industrial activity is approximately 20 to 1: From a base of 20 companies surveyed, the 15 actual respondents had total consolidated sales of $39.6 billion and consolidated net income of $2.1 billion, representing 5.9 percent and 5.2 percent respectively of the 1973 Fortune 500 largest industrial companies list. (Of the 20 companies polled, all but one are represented in the 1973 "500" list, with 10 of those being within the first 100 companies.) The Fortune 050 sales, in turn, represent roughly 80 percent of all manufacturing sales, relating the IEPA sample to potentially one-twentieth of this universe.

Of the total consolidated sales reported, $2.6 billion (or 6.6 percent) were export sales of U.S. manufactured goods and services, and $773.9 million of that amount (29.5 percent) were export sales by the companies to their manufacturing subsidiaries and affiliates abroad. This figure also correlates with the findings

[1] Annexes A, B, and C are taken from IEPA Statement to the House Ways and Means Committee, July 21, 1975, on "Changes in Taxation of Foreign Source Income."

of the 1970 special Commerce Department survey which showed that 23.4 percent of all export sales of U.S. manufactured goods and services was to U.S. MNC subsidiaries or affiliates abroad.[3] Since our surveyed companies were broadly representative of U.S. industry (excluding oil) this latest figure suggests that the findings of previous in-depth studies of MNC export-to-affiliate relationships are as valid today as in 1970, and that the MNC's export performance is improving.

B. MNC exports; not "runaway" plants

The total foreign subsidiary and affiliate sales of responding companies was $11 billion. Of this only $405 million, or 3.5 percent, was back to the United States. It should be noted that this includes some raw materials as well as some transportation equipment from Canada which is, in part, subject to the special U.S.-Canadian Automobile Agreement. For comparison purposes, the U.S. Department of Commerce "Survey of Current Business" reports that in 1972, of total sales by majority-owned foreign affiliates (MOFA's) of U.S. companies equaling $159.8 billion (again mostly excluding petroleum), 6.8 percent was exported back to the United States. If transport equipment exports from Canada (covered by the special U.S.-Canadian Agreement) are also excluded, the percentage of exports to the United States from MOFA's equals 3.8 percent. Thus, since IEPA's sample contained no companies that manufacture automobiles (but included companies involved in the trade of automotive parts and accessories), one would expect our percentage (3.5 percent) to be much lower than the overall 6.8 percent and close to the 3.8 percent excluding all transportation equipment. The sample therefore appears to be representative in this respect. This also supports the evidence on larger samples that between 93 and 97 percent of the sales of U.S. affiliates abroad are in host or third countries, so that U.S. direct investments abroad are not a significant "export platform" for sales back into the U.S. market, as sometimes alleged in the "runaway plant" arguments.

C. MNC taxes; paying their fair share

The total pre-tax consolidated income of the respondents to our survey was $3.6 billion, out of which total foreign and domestic income taxes paid totaled $1.5 billion; for an effective overall rate of taxation of 41.7 percent. This, too, counters some popular allegations about the "tax evasion" of multinational companies, since the effective rate of taxation for all U.S. nonfinancial corporations in 1973 was 41.4 percent, according to the Department of Commerce March 1975 "Survey of Current Business." Of course, these companies paid many other taxes as well, including franchise, excise, TVA and social security taxes not counted as "income" taxes, thus raising the total tax burden even higher.

D. MNC employment

With regard to employment, the total employment of the companies participating in the survey relating to U.S. operations was 772,889 of which 46,847 were directly related to exports and 18,558 indirectly related (mainly managerial and corporate R&D) for a total of 65,405. With the respondents' total export sales of U.S. manufactured goods and services at $2.6 billion, one job is supported or created for approximately each $40,000 worth of exports. This, of course, does not include those secondarily related jobs in outside support industries which are generated by sales of manufactured goods and services abroad. When these are included, the figures are in the same range as those derived from Bureau of Labor Statistics estimates of export-related employment; namely, that each million dollars of exports supports about 49 jobs.

Based upon the fact that 29.5 percent of sample export sales of manufactured goods and services were to subsidiaries and affiliates abroad, it can be assumed that the same percentage of export-related employment, or 19,294 jobs, are directly and indirectly related to U.S. manufacturing subsidiaries and affiliates abroad (excluding secondary level employment). In addition, it should be pointed out that of the total 65,405 jobs relating to exports, 46,847 are in direct labor, engineering, and finance (excluding general managerial and allocated R&D), representing over 71 percent of the total.

In looking more closely at the total 65,405 jobs related to exports, we have seen that 19,294 were directly and indirectly related to the existence of U.S. manufacturing subsidiaries and affiliates abroad. For the sake of analysis, if

[3] "Survey of Current Business," U.S. Department of Commerce, December 1972, p. 25.

we expand the results of our survey to the larger "universe" (multiplying the 19,294 by a factor of 20) 385,880 jobs appear to be related to the existence of U.S. manufacturing subsidiaries and affiliates abroad, as explained below.

Applying the 29.5 percent of the IEPA survey's export sales which were to U.S. subsidiaries and affiliates abroad in 1973 (the tax year the survey respondents used) to *total* exports of $70 billion in 1973, approximately $20.7 billion went to U.S. affiliates and subsidiaries abroad. Without U.S. operations abroad some exports would still be made, of course. But without the "pull effect" of the subsidiary and its position in the foreign market, it would be impossible to substitute anything like the same volume of direct exports to unaffiliated foreigners. There might well be additional losses in present exports by U.S. parents directly to such foreigners because of the reduced visibility of the company's products in the general market.

E. Cost of confiscatory taxation

If the provisions of existing tax law regarding the so-called deferral of taxation on unrepatriated foreign earnings and the foreign tax credit were both revised, so that the company was taxed currently on its proportionate share of all income of each controlled foreign corporation in which it actually or constructively owned stock, and if only a deduction were allowed as under Section 162 or 164 for foreign taxes paid, the IEPA sample companies aggregate yearly increased tax cost would be $336.4 million. It was not possible to allocate this according to the credit and the current taxation components because of the varying assumptions involved; but the combined effects of the two are larger, of course, than the sum of both taken individually. This combination would represent a 22 percent increase in the sample's total global income taxes of $1.52 billion.

Expanding this number into "universe" proportions is particularly difficult; for the complexities of U.S. and foreign tax laws and their differences in applicability to both the small IEPA sample of 15 companies and the full range of direct investors, prevents application of any simple multiplier. However, a rough order of magnitude derived by applying the factor of 20 (which represented the sample's consolidated sales and income relationship to all U.S. manufacturing) suggests that all direct investors might face a tax increase of some $6.7 billion from these two tax changes. Although this number is higher than some previous estimates, direct investment earnings have grown from $8.1 billion in 1970 to $17.5 billion in 1973. A simple calculation from published Commerce Department data suggests that up to a $7.5 billion increase in potential U.S. tax liabilities could arise from such changes, although in the event, the actual revenue gains would probably prove illusory.[3]

It may be noted that the recent National Association of Manufacturers "Tax Impact Project Report"[4] estimates hat the first year's total increase in Federal tax receipts flowing from the two proposed tax changes would be $4.09 billion. However, the NAM study was considering the full and final economic consequences from the overall "ripple" effects of the reduced cash flow stemming from confiscatory taxation. These effects—including a slowing of investment and GNP growth—would reduce Federal tax revenues from other sources, even though direct MNC taxes might be raised.

Earlier estimates of tax change consequences tend to confirm the harmful effects of this confiscatory mode of taxation if imposed upon U.S. direct investors. One 1972 estimate for the Joint Economic Committee noted that: "The effects on U.S. revenue of the deferral and credit provisions interact and are not easily summarized. If both provisions were to be eliminated, that is, foreign taxes were made deductible only and U.S. taxes were applied when foreign income was earned, the U.S. revenue gain is estimated at $3.3 billion."[5] Assuming that these calculations were made for 1970, in which the yearly total direct investment earnings were $8.1 billion, the proportional tax increase from these provisions could

[3] Such a calculation can be made with the August 1974 Part II "Survey of Current Business" data (p. 40, Table 13), assuming that an average foreign rate of 40 percent applies, that the same level of dividends and foreign withholding taxes would occur, and that excess credits and losses would not materially affect total U.S. taxation.

[4] National Association of Manufacturers "Report on Tax Impact Project," June 16, 1975. see p. 5, Table 8.

[5] Peggy Musgrave, Joint Economic Committee "Hearings on Tax Subsidies and Tax Reform," July 21, 1972.

be projected to $7.1 billion in 1973, when repatriated and reinvested earnings total $17.5 billion.

F. Fallacy of U.S. revenue gains

The assumption that such amounts would actually accrue to the U.S. Treasury, however, is erroneous for several reasons. In the first place, it would be reduced by foreign withholding taxes applied to U.S. corporate dividends (an average of 12 percent based on IEPA's survey) ; secondly, foreign countries would be apt to respond to U.S. tax changes by changes in their own tax policies. Most companies involved in the IEPA survey indicated that this would most likely take the form of substantially increased rates (or timing incidence) of dividend witholding taxes, or efforts to block the remittance of funds over a certain percentage. The minority shareholder in a corporate affiliate abroad (backed up by host country laws in some countries) might not allow what they regarded as an excessive remittance rate of profits, even if this was required by U.S. efforts to impose double taxation or to tax the affiliate's income extraterritorially, by imposing the tax on the parent before it had actually received its share. Most fundamentally of all, the long-term effects on the affiliate's international competitiveness and profitability would tend to reduce, if not eliminate, the tax base so that, in effect, the net income would not be there for the U.S. Treasury to tax. For various legal as well as foreign country tax reasons, the increased burden of taxation would probably have to be assumed by the U.S. parent. This would substantially lower the availability of capital for domestic investment purposes thus impacting on jobs. In addition, the parent's ability to borrow, which is directly related to *net* profits, would also be severely curtailed.

The increased cost attendant to the various changes in taxation of foreign-source income would necessarily impact upon the availability of capital for the companies involved. Under the most severe and punitive tax options—that is, doing away with both tax credits and so-called deferral—only about 25 percent of the funds earned abroad could be used in furthering productive investments (assuming a maximum 75 percent effective tax rate under the most severe conditions). Over the last three years for which Commerce Department figures are available—1971 through 1973—the average repatriation has been approximately 47 percent. Thus there would be a substantial reduction in capital available for domestic U.S. parents to use for expanding employment opportunities. This reduction might come to 10 percentage points or more. In a time when total capital formation in the United States is almost half the rate of that in Germany and about 40 percent of the rate in Japan, and considering high U.S. unemployment, this does not seem to be the time to be cutting back on available funds for business investment.

As explained elsewhere in this statement, the simplistic notion that the forced unprofitability (by a 75 percent tax rate, for example, of foreign affiliates would simply lead to the transfer of those operations back into the United States, ignores the fundamental reason why the affiliates were established abroad in the first place—namely, to sell to markets which could not be served from the United States whether for reasons of transportation cost, tariff or nontariff barriers, or local marketing considerations. The fact that no more than 3.5 percent of the foreign subsidiaries and affiliates' sales were exported to the United States in this survey shows that U.S. corporations did not develop and are not using their foreign operations as export platforms for the U.S. market.

We believe, therefore, that this survey supports the conclusions of surveys of larger samples on the significant job and balance of trade and payments losses which could accompany tax or other actions lessening the competitiveness of U.S. firms abroad. The companies surveyed were shown to be paying an effective overall tax rate equivalent to the 41-plus percent which is now the effective domestic corporate tax rate in this country, so they are paying their fair share of taxes in all of the many jurisdictions where they operate. They also repatriated (and were taxed by the United States on) $316.7 million, which would project to $6.3 billion for all U.S. manufacturing companies—a substantial plus for the U.S. balance of payments. This also appears to have a rough correlation to the $7.6 billion in earnings, dividends, interest, and royalties and fees repatriated by non-oil U.S. MNC's in 1973. Finally, U.S. corporations significantly add to U.S. exports through their foreign affiliates and subsidiaries abroad, with 29.5 percent going to their MOFA's. Much, if not all, of these exports and the hundreds of thousands of U.S. jobs they support might be lost if these affiliates were, in effect, taxed out of business.

FOREIGN COUNTRY TAX TREATMENT OF THEIR SUBSIDIARIES OPERATING ABROAD

Country and	Principal types of taxes	Corporate tax rate	Territorial application	Foreign dividends, current or deferred
France (1975):				
TVA	20 percent generally 7 percent, 17.6 percent or 33 percent apply to specific sales or services.	Only corporate income generated in France taxable; worldwide income of domiciled individuals taxed.	Not necessary to show foreign tax paid to assure exemption from French tax. (Residents receive credit for 50 percent of corporate profits tax tax paid on dividends.)	Foreign dividends, interest and royalties earned abroad are taxable when distributed.
Income, etc	Up to 62.5 percent.			
Germany (1975):				
TVA	11 percent (5.5 percent for necessary goods).	Domiciled corporations resident taxed on worldwide income.	Foreign tax credit allowed up to amount of German tax.	Foreign earnings are taxed currently in certain cases. Foreign Taxation Act effective Jan. 1, 1972, adopts provisions similar to United States Subpart F.
Income:				
undistributed earnings	51 percent.			
Distributed earnings	15 percent.			
Branches of foreign corporations.	49 percent.			
Japan (1975):				
Income	22 to 52.6 percent.	Domestic corporations and individuals taxed on worldwide income, but corporations may exclude 70 percent of royalties, 30 percent copyright and 20 percent consulting fees.	Foreign tax credit allowed.	January 1973, Japan granted exemption from all taxes on purchases of foreign stocks and bonds.
Inhabitants tax	17.3 percent of corporate tax.			
Enterprise tax	6 to 14 percent.			
United Kingdom (1974):				
Income	52 percent	Corporations and individuals, taxable on foreign source income.	Foreign tax credit allowed.	Dividends taxable when distributed.
TVA	8 percent			
Netherlands (1975):				
Income	45 to 48 percent	Corporations and individuals taxed on worldwide earnings.	Foreign taxed income exempt from Neth. tax or deduction allowed.	Foreign dividends taxed only when received net of foreign taxes. Dividends from foreign subsidiary over 5 percent Dutch-owned are exempt.
TVA	16 percent (or 4 percent on necessities).	Income from shares in Dutch or foreign-associated holding companies excluded.		
Belgium:				
1975: Income (December 31, 1975 and after).	33 to 42 percent	Domiciled corporations and individuals subject to taxes on wo ld-wide income.	Foreign income earned and taxed abroad subject to 1/4 normal rate.	Foreign dividends taxed when remitted to parent.
Branch of foreign corporation.	54 percent.			
1974: TVA	6 to 25 percent.			

FOREIGN COUNTRY TAX TREATMENT OF THEIR SUBSIDIARIES OPERATING ABROAD—Continued

Country and	Principal types of taxes	Corporate tax rate	Territorial application	Foreign dividends, current or deferred
Canada (1975):				
Income:				
Federal	40 to 48 percent	Resident corporations and individuals taxed on worldwide income, but dividend income paid to Canadian corporations by Canadian-controlled corporations not subject to tax. (Canadian corporations pay no taxes on dividends from domestic Canadian corporations.)	Credit of lesser of foreign tax paid or ratio of foreign income to total earnings.	Recent Canadian legislation provides for limited current taxing of dividends received effective, for the 1976 tax year.
Provincial (after credit).	0 to 3 percent.			
Norway (1973):				
Income:				
Federal	26.5 percent	Corporations and individuals subject to tax on net worldwide income.	In 1971 Norway began taxing dividends received by a Norwegian corporation from another corporation 50 percent of net income derived from foreign branch or fixed assets abroad are taxable. Only 50 percent of dividends from foreign subsidiary are taxable if 95 percent Norwegian-owned.	Income taxable as shown in company books; dividends taxable when received.
Municipal	24.1 percent.			
TVA	20 percent (13 percent on capital goods).			
Spain (1975): Income	32.80 percent	Resident corporations and individuals taxable on all income regardless of source.	Foreign tax credit allowed up to amount of Spanish tax. Spanish companies allowed a tax credit of 33 percent on dividends received from domestic or foreign subsidiaries.	Taxed when received.
Switzerland (1975):				
Income:				
Federal	3.3 to 8.8 percent	Territorial concept; corporations and individuals subject to tax on all income and capital except from foreign real estate or permanent establishment abroad. Domestic dividends subject to 30 percent withholding tax which may be refunded to Swiss holder when he pays income tax.	Foreign income not taxable, although taken into account in determining effective rate of income tax.	Foreign income not taxable.
Cantonal	13 to 32 percent.			
Capital:				
Federal	0.0825 percent.			
Cantonal	0.336 to 0.906 percent.			
TVA	4.4 to 6.6 percent			

FOREIGN COUNTRY TAX TREATMENT OF THEIR SUBSIDIARIES OPERATING ABROAD—Continued

Country and	Principal types of taxes	Corporate tax rate	Territorial application	Foreign dividends, current or deferred
Sweden (1975):				
Income:				
National	54.4 percent	Corporations and individuals subject to taxes on income from all sources.	Foreign tax credit allowed for national tax, but deductible for municipal tax.	Not taxed until dividends paid.
Municipal (deductible for national purposes).	18 to 27 percent			
TVA	17.65 percent.			
Argentina:				
Corporate	33 percent	Corporations taxed only on Argentine-source income.	None	Foreign dividends not subject to tax.
TVA	3 to 20 percent (10 percent for most products).			
Mexico (1975):				
Income	42 percent (amounts over $120,000.	Worldwide income	Foreign tax credit allowed but at reduced rate on 1st $120,000 of foreign income.	Taxed but allowed to be excluded since foreign tax credit would eliminate tax.
TVA	3 percent.			
TVA (on luxury goods)	10 percent.			
Brazil (1974):				
Income	30 percent	Corporations and individuals taxed on worldwide income.	Foreign tax credit allowed.	Corporations not subject to tax on dividends received.
Branch earnings	30 percent (+ 25 percent on net).			
TVA	Average 14.5 percent.			
Excise tax on industrial products.	Varies.			

Source: "Tax and Trade Guides," published by Arthur Andersen & Co., and other sources.

ANNEX C

U.S. TAX TREATY POLICY

The first Tax Convention for the United States was not finally executed until 1932, becoming effective in 1935. The accomplishments in negotiating treaties since that date have marked an important step forward in regularizing our economic relations with other nations. There is an inevitable clash between (1) the assertion of unlimited jurisdiction to tax worldwide income, based on domicile, citizenship or state of incorporation and (2) the assertion of unlimited territorial jurisdiction based on the claims of the country in which business is conducted. This clash, unless resolved by agreement, can produce crippling and confiscatory double taxation. Further aggravating the situation could be the multiplicity of different taxes (i.e., excise taxes) levied by other countries which do not generate qualified tax credits against income tax; these often constitute a higher percentage of the total tax burden in foreign countries than in the United States. The present provisions of U.S. tax law allowing so-called deferral and tax credits and tax treaties are a sensible accommodation of the two kinds of jurisdictional problems involved.

A useful philosophical basis for double taxation tax treaties is given by Professor Dan Throop Smith, the former deputy to the Secretary of Treasury for Tax Policy, in his 1962 book entitled "Federal Tax Reform."

"The provisions of tax treaties are an important part of our total law on the taxation of foreign income. The treaties establish common rules on the allocation of income. Through treaties the concept of a permanent establishment has been developed with provisions that each country will tax a foreign company only if it maintains a permanent establishment in the country. This permits casual and exploratory commercial contacts in another country without being subject to its tax jurisdiction. Under treaties each country usually agrees to allow the income taxes paid in the other country as a credit against its own taxes, a right which we give by statute as well.

"Treaties also contain reciprocal provisions by which the countries concerned agree to waive their rights to tax income which they would tax under their statutes. Interest, royalties, and the income of trade apprentices, students, professors, and professional people who are in a country for limited periods may all be made exempt by treaty from taxation in the country of its source, that is, where it is earned. If the countries have about the same tax rates, this does not necessarily give any net tax reduction to the recipient of the income. The country in which the income is received or of which the recipient is a citizen will usually tax it anyway. Since it is not taxed in the source country, there will be no offsetting foreign tax to apply the domestic tax in the country of destination. Taxation is shifted from the source country to the country of destination. Where income flows are substantially the same in both directions, total revenues in each country are substantially unchanged. The principal effect is to relieve taxpayers of the annoyance of having to pay taxes in two countries. Initial transactions and movement of people are encouraged by removing tax annyoances even though tax burdens are not reduced."

There are currently 21 U.S. double-taxation treaties on income taxes in force and operative (the 22nd is a treaty with South Vietnam dated 1967 which is inoperative because of the changed political situation there). The basic 21 treaties have been extended to also cover tax relations with newly independent countries once in the possession of the original treaty countries. Most notably the U.S.–U.K. and U.S.-Belgium treaties were extended to cover Barbados, Gambia, Jamaica, Malawi, Nigeria, Zaire, Burundi, and others. In addition, there are 23 treaties under negotiation, revision, or before the Senate for ratification.

Under each of the treaties, the contracting state exempts enterprises of the other state from taxes on "industrial and commercial profits" (business income) unless the enterprise is permanently established within the contracting state. The United States has, therefore, in effect agreed only to impose its income taxes on affected foreign businesses when they have permanent establishments in the United States and vice versa. For example, a U.S. firm's subsidiary domiciled in Belgium is considered a Belgian corporation, even though it is beneficially owned by the U.S. company.

A different situation exists in the instance of the U.S. income tax treaty with New Zealand which provides that: "The industrial or commercial profits of a New Zealand enterprise shall not be subject to a U.S. tax unless the enterprise is engaged in trade or business in the United States through a permanent establishment situated therein . . ." In this case, the convention literally prohibits the imposition of a U.S. tax on the industrial and commercial profits of a New Zealand enterprise which is itself not engaged in a trade or business in the United States. In this convention, unlike most others, there is no express provision reserving to the United States the power to impose its taxes on its citizens, residents, or corporations as if there were no convention. The use of the terminology "industrial or commercial profits" so long as the enterprise is not engaged in trade or business within the United States, seems to rule out the current taxation (i.e., elimination of the so-called deferral) for U.S. firms' subsidiaries in New Zealand so long as such profits are unrepatriated to the U.S. shareholders and remain as profits of the enterprise.

The most recent double taxation treaty between Belgium and the United States entered into force in 1972 and is a classic example of the current treatment of business profits under tax treaties. Article 7 of that treaty states:

ARTICLE 7—BUSINESS PROFITS

(1) Industrial or commercial profits of a resident of one of the Contracting States shall be exempt from tax by the other Contracting State unless such resident is engaged in industrial or commercial activity in that other Contracting State through a permanent establishment situated therein. If such resident is so engaged, tax may be imposed by that other Contracting State on the industrial or commercial profits of such resident but only on so much of such profits as are attributable to the permanent establishment.

(2) Where a resident of one of the Contracting States is engaged in industrial or commercial activity in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to the permanent establishment the industrial or commercial profits which would be attributable to such permanent establishment if such permanent establishment were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently.

(3) In the determination of the industrial or commercial profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with such profits, including executive and general administrative expenses, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.

(4) No profits shall be attributed to a permanent establishment of a resident of one of the Contracting States in the other Contracting State merely by reason of the purchase of goods or merchandise by the permanent establishment, or by the resident of which it is a permanent establishment, for the account of that resident.

(5) For the purposes of this Convention the term "industrial or commercial profits":

(a) Does include rents or royalties derived from motion picture films or films or tapes used for radio or television broadcasting or from copyrights thereof and rents derived from the leasing of tangible personal property;

(b) Does not include items of income specifically dealt with in other articles of this Convention, except as provided in such articles.

Subject to the provisions of this Convention, items of income excluded from industrial or commercial profits under subparagraph (b) may be taxed separately or together with industrial or commercial profits in accordance with the laws of Contracting State whose tax is being determined.

The foregoing clearly demonstrates that the basic principles of a taxation treaty between two nations are to eliminate unnecessary double taxation of individuals and corporations operating in the respective contracting states.

It appears that imposing U.S. tax on the unrepatriated profits of foreign subsidiaries or affiliates of U.S. firms (i.e., eliminating deferral now provided by the Internal Revenue Code) would go against the spirit if not the letter of the tax treaties now in force between the United States and other countries. Slipping back into a time when there were no tax treaties between developed nations would tend to aggravate business relationships between countries and could lead ultimately to investment and taxation "wars."

If foreign subsidiaries were taxed by the United States currently on their local profits, other treaty signatories could claim that the United States was unfairly seeking unilaterally to shift the tax burden so as to affect the viability of subsidiaries (and their employees) in the other country's jurisdiction. This could create serious frictions between the United States and its major trading partners. If the shoe were on the other foot, the employees, creditors and minority shareholders of a foreign-owned subsidiary in the United States would not welcome having competitive handicaps and a cash flow burden imposed on their U.S.-earned income to meet a foreign government's claims to earnings not yet paid out in dividends.

The hundreds of billions of dollars invested around the world over the past fifteen years have been placed on the basis of an assumed stability in the basic international system of legal and tax treatment. Major changes in the tax treatment of foreign source income by the United States government could jeopardize that stability, which continues to be in the national interest.

ANNEX D[1]

STATUTORY TAX RATES IN FOREIGN COUNTRIES (ACCOUNTING FOR 82 PERCENT OF 1973 OVERSEAS EARNINGS OF U.S. COMPANIES)

[In percent]

	Country	Statutory profits tax rate	Dividend withholding tax rate	Combined foreign statutory rate	Total statutory tax rates (foreign and United States) with foreign taxes— Credited against U.S. tax: U.S. Taxes	Credited against U.S. tax: Total taxes	Taken as a U.S. deduction: U.S. taxes	Taken as a U.S. deduction: Total taxes
1	Canada:							
1a	Manufacturing	40.00	15	49.00		49.00	24.48	73.48
1b	Other	48.00	15	55.80		55.80	21.22	77.02
2	United Kingdom	52.00	15	59.20		59.20	19.58	78.78
3	Belgium	42.00	15	50.70		50.70	23.66	74.36
4	Luxembourg	45.00	15	53.25		53.25	22.44	75.69
5	France	62.50	5	64.38		64.38	17.10	81.48
6	Germany	50.47	15	57.90		57.90	20.21	78.11
7	Italy	35.00	5	38.25	9.75	48.00	29.64	67.89
8	The Netherlands	48.00	5	50.60		50.60	23.71	74.31
9	Norway	49.50	10	54.55		54.55	21.82	76.37
10	Spain	32.80	15	42.88	5.12	48.00	27.42	70.30
11	Sweden	54.40	5	56.68		56.68	20.79	77.47
12	Switzerland	17.00-32.00	5	21.15-35.40	26.85-12.60	48.00	37.85-31.01	59.00-66.41
13	Japan	52.60	10	57.34		57.34	20.48	77.82
14	Australia	45.00	15	53.25		53.25	22.44	75.69
15	New Zealand	45.00	15	53.25		63.25	22.44	75.69
16	South Africa	41.00	15	49.85		49.85	24.07	73.92
17	Mexico	42.00	20	53.60		53.60	22.27	75.87
18	Argentina	45.00	35	64.25		64.25	17.16	81.41
19	Brazil	30.00	25	47.50	.50	48.00	25.20	72.7
20	Chile	19.55	40	51.73		51.73	23.17	74.90
21	Colombia	52.64	12	58.32		58.32	20.01	78.33
22	Venezuela	50.00	15	57.50		57.50	20.40	77.90
23	Libya	60.00	13	65.20		65.20	16.70	81.90
24	India	55.00	25	66.25		66.25	16.20	82.45
25	Philippines	35.00	35	57.75		57.75	20.28	78.03
26	Middle East[2]	49.94		49.94		49.94	24.03	73.97

[1] From statement of Arthur Andersen & Co., before the House Ways and Means Committee, July 15, 1975, on Taxation of International Business by the United States, pp. 28-29.

[2] The rate shown is an average of the rates for the following Middle Eastern countries: Iran, Iraq, Israel, Kuwait, Lebanon, Saudi Arabia, and Syria. The dividend withholding rates varied with the country and in most cases were very low or zero.

Note: The rates listed for those countries with graduated income tax rates are those for the highest level of income.

Source: Tax rates; latest available published statutory rates.

Senator FANNIN. The next witness will be H. Lawrence Fox of Pepper, Hamilton & Scheetz.

Good morning, gentlemen, Mr. Fox, would you identify the gentleman with you for the record?

STATEMENT OF H. LAWRENCE FOX OF PEPPER, HAMILTON & SCHEETZ, WASHINGTON, D.C., ACCOMPANIED BY ERNEST G. WILSON

Mr. FOX. With me today is Ernest G. Wilson of the same law firm.

Senator FANNIN. Your entire statement will be made a part of the record, Mr. Fox, and you may proceed as you desire.

Mr. FOX. As lawyers we have experienced firsthand the ever-changing views of the Treasury as to the scope of the tax exemption available for industrial development bonds, and have concluded that Congress must provide a workable definition of the phrase "air or water pollution facilities" as used in section 103(c)(4)(F) of the code. This is the only meaningful pollution control incentive in the tax laws.

In general industrial development bonds are not tax exempt. An exception involves the acquisition of certain types of facilities by private industry which are for the inherent good of the community: for example, sewage or solid waste disposal facilities and air and water pollution control facilities.

Congress was concerned with the existence of specific problems and sought to maintain an incentive for their elimination which would help offset their costs. The precise means for utilizing the incentive was intentionally left flexible.

In 1968, when Congress enacted section 103(c), it viewed pollution control as a national priority. Issuing tax-exempt pollution control bonds was considered a public purpose similar to financing educational facilities. Nothing has occurred in the last 8 years to undermine that priority. In fact, subsequent legislation such as the Clean Air Act of 1970 and the Water Pollution Control Act Amendments of 1972 are consistent with this view.

In the years immediately after enactment the Treasury understood the congressional mandate and issued regulations to qualify facilities that would not have been acquired "but for" the purpose of pollution control. They were consistent with the congressional intent that the incentive should be as broad as necessary to effectuate the Nation's environmental goals.

With the passage of time the service began finding reasons to conclude that a particular facility or system was not a pollution control device despite the regulations and compelling evidence to the contrary. The service did not consider the fact that the increased volume was evidence that the incentive operates in conjunction with expanding environmental laws.

In order to effectuate this cut-down policy, the service devised unpublished ruling standards or tests which have become known as the "realized pollution, gross savings, and lifing tests. The first is a rule whereby the service holds that facilities which prevent pollution are not for pollution control.

The second provides that pollution control facilities which generate gross economic benefits may not be entirely financed even where expenses exceed benefits.

The third rule is that whenever an existing device is replaced, it is presumed that the new facility adds life to the entire plant and, therefore, may not be entirely financed. After months of application to private rulings, these rules were promulgated in proposed regulations last August.

Many of the written comments note how improper the proposed regulations are and how they could be corrected, including the FEA, EPA, and Commerce Department. Moreover, virtually all the testimony criticized the Government for its abuse of rulemaking authority.

In brief, the proposed regulations defy fairness by incorporating the unpublished ruling standards. Moreover, they amend the code, which overrules Congress and the Nation's environmental policy. The following examples should help the committee understand these conclusions.

First, they adopt the realized pollution test which qualifies only "end of pipe" facilities.

This "black box" standard is legally arbitrary, but, even worse, it is completely divergent from environmental legislation as administered by the Environmental Protection Agency. Taxpayers are frequently ordered to install pollution control facilities only to find that another branch of the Federal Government, the Treasury, has determined that they are not pollution control facilities. Thus, EPA comments in its criticism that "concern over the fact that the provisions such as section 103 diminish tax revenues to some extent should not give rise to a rule which would skew investment in the direction of possibly less efficient and economical means of controlling emissions."

Unless the proposed regulations are amended, an example of this will occur when the FEA orders certain utility companies to convert to coal. If they use fuel pretreatment facilities to meet EPA sulfur emission standards, the service will rule that their pollution control system does not qualify since it merely prevents pollution.

If a less efficient system of scrubbers is used, the service will rule that it qualifies since it captures a pollutant, subject, of course, to a reduction for the gross economic benefit associated with captured sulphur.

Another example is the disqualification of pollution control facilities which the service might allege to also be "safety equipment." If the service unilaterally determines a device is for safety, no matter how great its pollution control function, it is not for purposes of section 103 a pollution control facility.

Another provision disqualifies facilities traditionally used to control nuisance. Is there any pollutant that is not a nuisance?

The final illustration is the rule disallowing pollution control facilities which may be classified as protecting persons or property from hazardous materials. Again, is there any pollutant that is not a hazardous material?

Even if a pollution control device meets the realized pollution test and thus can survive the Treasury's esoteric definition, it may nevertheless be disqualified by the application of a vague, incomprehensible allocation formula. This provides for a reduction of the qualifying costs of a pollution control facility in any case that measurable gross economic benefits result, even where they are offset by operating costs.

Many witnesses have commented on the volume of pollution control bond financing. None have noted that the volume merely reflects the very substantial costs involved in achieving Congress environmental objectives. However, if the volume should be reduced, it makes more sense to do so by a prospective statute which imposes dollar or percentage limitations on the amount of qualifying cost of pollution control facilities than it does to allow an administrative arbitrary definition that neglects the state of the art, the Nation's environmental policy, and the original intent of Congress.

We have included in our written statement a proposed bill in draft form, which provides definitive standards for the qualification of pollution control facilities and would define them in a manner consistent with modern environmental protection techniques.

This concept would reduce the alleged tax revenues losses associated with pollution control bonds, but not eliminate the only important tax incentive for the installation of pollution control facilities in the code.

Alternatively, in lieu of reducing tax-exempt obligations by further restricting the benefits of 103(c)(4)(F), the committee might wish to accomplish the same goal by providing industry with additional incentives, such as, a greater investment tax credit than it currently allowed and/or an accelerated writeoff of pollution control facilities faster than is allowed. Another approach would be to qualify these facilities as being eligible for the taxable bond option if the Finance Committee favorably considers H.R. 12774. However, the foregoing alternatives would not alleviate the specific need for Congress to define what constitutes an air or water pollution control facility.

In addition to considering technical amendments to section 103(c), it would be appropriate for the committee to add substantive amendments which would (1) allow tax-exempt financing of fuel-saving devices and fuel conversion facilities; and (2) increase the exempt small issue from $1 to $5 million and $5 to $10 million. These amendments are contained in a bill introduced last year by Senator Carl Curtis.

Finally, the committee should reaffirm its decision made in 1968 that tax-exempt financing is available for recycling and solid waste disposal facilities. Under existing regulations and interpretations of the code by the IRS, recycling of fissionable materials is not considered to qualify. This is certainly contrary to Project Energy Independence. In addition to this contradiction, the Service's position that only "valueless" items may be considered solid waste should be exposed as being contrary to the intent of Congress. Not even junk cars and old newspapers are worthless.

In conclusion, the amount of pollution control bonds is high because the cost of pollution control is high. The cost of pollution control is high because the job is great and the facilities are unproductive. Financing the unproductive expenditures causes upward pressure on interest rates or inflation and a drying up of funds which could otherwise be used for productive facilities. The tax-exempt bond incentive broadens the market for funds to finance pollution control facilities and it reduces their costs.

By amending section 103(c)(4) the committee certainly can help reduce the existing capital formation problem. Moreover, tax reform is not merely reducing antiquated or excessive business incentives, but insuring the fair interpretation of the laws by the Government.

Thank you.

Senator FANNIN. Thank you very much. You have touched on one of the more controversial subjects present today. Because of the Clean Air Act and Clean Water Act, and our inability to get the amendments that you have referred to, many problems have developed so that it is difficult for many important industries to move forward with necessary development. Protecting our environment is vital but it should be accomplished without completely halting necessary development.

When you discuss municipalities and so forth, it becomes more critical, and I would like to refer to some part of your testimony.

In your statement you talk about scrubbers that are used, and they qualify for some of the economic benefits. Isn't one of the great problems we have that we don't have the proven technology today, for instance, with scrubbers, to achieve the goals that were set out when the EPA rules and regulations were promulgated? Isn't that one of the great problems?

Mr. Fox. That is one of the great problems we have, and we use that as an illustrative example. We used that example because we thought the members and the staff would recognize it immediately.

The state of the art for scrubbers to control sulfur is just not good, but given the choice of being able to finance your facilities at a lesser interest rate, that is the route industry will take. For example the Service is now driving the industry to inefficient systems. It is also consistent with the statutes, and EPA administration of those laws. The Service has forgotten that the state of the art has advanced.

What EPA does today, versus several years ago, is that it actually comes in a plant and tells the company it must change its internal process so that there never is creation of the pollutant. This is instead of ordering the plant to merely meet an ambient air standard, or water standard, by putting on what we describe as a "block box," something at the end of the pipe to catch the junk going into the water or the air.

The IRS says that the prevention of pollution is not pollution control.

Senator Fannin. I know that we had testimony before one of our committees by a man from Consolidated Edison in New York. He said that in 1973 they spent over $100 million for equipment, without any change in the ambient air quality. I don't know whether you are familiar with that particular program or not, but they had it in New York and it certainly was closely examined, and there was some great concern to the Members of Congress with respect to the results.

I don't know if that is typical of the power industry at all. Do you have any information in that regard?

Mr. Fox. Can I respond to you on that later?

Senator Fannin. It is an evaluation problem that we have, and I think that we have the responsibility in the Congress to look at these rules, and to make changes and amendments as we see the need, and that has not been the case sometimes.

Mr. Fox. The statute is already on the books. The legislative history seems to support it, and it seems clear that it supports our contention. It is the administration of that statute that is a problem, and therefore we come to your committee and ask that you specifically spell out the law itself rather than having it said in committee reports.

The regulations go on and on. They also adopt a test which says that if equipment is traditional and customarily used by the taxpayer or an industry in its business, then it may not qualify as being for pollution control.

So this would allow the Service, in the future, to eliminate all pollution control devices by merely determining that a taxpayer would customarily or traditionally have used this device. If they can find one taxpayer in the industry that has such a facility, then it is customary. We think under the regulatory language they might go into foreign countries and determine what is now customary for U.S. companies.

The standards, as we have said, are ridiculous. Only Congress is going to turn this around.

Senator Fannin. I agree, and we have to move rapidly in turning it around.

You have in your statement a recommendation for greater investment tax credit, and accelerated writeoffs, and you refer to section 169 of the Code. Isn't it true that we need flexibility, so that the industry will have the opportunity to decide whether or not they want to write off these costs in the year it is installed, or whether they want to write it off over a period of years?

Mr. Fox. We would think that should be the case, and it should be an option. They could go, for example, tax-exempt financing or have a writeoff or have a larger investment tax credit. Even with that, you still have to redefine air and water pollution control or the Service ~~would~~ come back again and say that you couldn't have the writeoff you were entitled to.

Senator FANNIN. We have had complaints about this.

Thank you, Mr. Fox, for your testimony. Thank you also for your responses. We would like to have you to contribute to the information we need. Thank you both.

Mr. Fox. Thank you.

[The prepared statement of Mr. Fox follows:]

STATEMENT OF H. LAWRENCE FOX, ESQ. AND ERNEST G. WILSON, ESQ., PEPPER, HAMILTON & SCHEETZ

I. INTRODUCTION

The purpose of this statement is to discuss:

1. the Treasury and Internal Revenue Service interpretations of the existing provision of the Internal Revenue Code of Section 103(c)(4)(E) relating to tax-exempt "solid waste disposal bonds" and Section 103(c)(4)(F) relating to tax-exempt "pollution control bonds";

2. the need for Congress to provide a workable definition of pollution control facilities and solid waste disposal facilities;

3. a draft proposal of legislation that will adequately define the scope of eligible tax-exempt bond financing of pollution control facilities and solid waste disposal facilities; and

4. the treatment of the tax-exempt industrial development bond under the Ullman-Conable taxable bond option, H.R. 12774 (approved by the House Ways and Means Committee on March 30, 1976).

II. INTERNAL REVENUE SERVICE AND TREASURY INTERPRETATIONS OF SECTION 103 (C) (4) (E) AND (F)—SOLID WASTE AND POLLUTION CONTROL FACILITIES

The Committee should be aware that the Internal Revenue Service ("I.R.S.") and the Treasury Department have adopted arbitrary and unduly restrictive interpretations of Section 103(c)(4)(E) and (F) of the Code. These questionable standards are embodied in unpublished ruling standards and proposed Treasury Regulations issued on August 19, 1975. In order to reverse these interpretations, the Committee must reaffirm the meaning of pollution control facilities that was clearly intended by Congress in 1968 because one, an administrative agency does not have the authority to amend a statute and two, the effects of the Treasury's action is disastrous because Section 103(c)(4)(F) contains the only meaningful incentive in the Code that relates specifically to pollution control facilities.[1]

Prior to an in depth discussion of the Service's current unpublished ruling standards and the Treasury's proposed Regulations, a review of the legislative history of Section 103(c) is in order.

A. Historical Background of the Statute, In General

Until 1968, the I.R.S. considered all industrial development bonds to bear tax-exempt interest under Section 103(a) of the Internal Revenue Code of 1954.

[1] Section 169 which provides an elective, "rapid" (five year) amortization provision for pollution control facilities as therein defined is rarely elected by taxpayers. This is because the taxpayer electing rapid amortization must forego the investment tax credit.

This administrative position was overruled by the Revenue and Expenditures Control Act of 1968 (P.L. 90–364, 82 Stat. 268) which enacted Section 103(c) and which provides that, in general, industrial development bonds are not tax-exempt. By definition certain State and local obligations are not industrial development bonds.

Moreover, the Act contains exceptions to the new general rule so that certain types of facilities might be financed with tax-exempt bonds just as they were prior to the enactment of Section 103(c). These exceptions are contained in Section 103(c)(4), (5) and (6).[2] Some of these exceptions to the general rule are based on the premise that there are certain legitimate functions of government for which most local governmental units do not possess the expertise required to be directly involved. Therefore, they participate only by setting the policy guidelines and raising funds which are turned over to those in the private sector who possess special skills or knowledge. Examples would be residential real property for family units, sports facilities, convention or trade show facilities, airports, docks, wharves, mass commuting facilities, parking facilities or directly related storage or training facilities.

In addition to those exceptions for special expertise, Congress recognized that certain facilities acquired by private industry are for the inherent good of the community at large whether or not they yield a return on investment to the user. Thus, tax-exempt industrial development bonds may continue to be issued to finance sewage or solid waste disposal facilities; facilities for the local furnishing of electric energy or gas; air or water pollution control facilities;[3] or facilities for the furnishing of water, if available on reasonable demand to the members of the general public. In this latter category, Congress was concerned with the existence of specific problems and sought to maintain the incentive for their elimination by a broad definition, i.e., the precise means for utilizing that incentive was intentionally left flexible.

In addition to the exempt activities, Congress provided that small issues of $1 million or less in which the proceeds are to be used for land or depreciable property should continue to bear tax-exempt interest. Congress recognized the beneficial effects of tax-exempt industrial development bonds for small projects. This exemption was further broadened by Section 401 of the Renegotiations Amendments Act of 1968 (P.L. 90–634, 82 Stat. 1349) where the $1 million incentive was raised to $5 million or less but only if the governmental issuer makes an election. If such election, is made, there are certain built in limitations to prevent taxpayers from going over the $5 million limitation. This limitation includes certain capital expenditures paid or incurred during a six-year period beginning three years before the date of the current issue and ending three years after that date.[4]

B. The Legislative History of Section 103(c)(4)(F) and the I.R.S. and Treasury Interpretations of That Section

1. Unpublished Ruling Standards.

Much has been written about the unpublished ruling standards devised by the Internal Revenue Service relative to Section 103(c)(4)(F) of the Code. See,

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[2] Section 103(c)(4) provides for tax-exempt financing for: residential real property for family units; sports facilities; convention or trade show facilities; airports, docks, wharves, mass commuting facilities, parking facilities or directly related storage or training facilities, sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy or gas; air or water pollution control facilities; and facilities for the furnishing of water, if available on reasonable demand to members of the general public. These special projects are known as "exempt activities". Section 103(c)(5) provides for tax-exempt financing for industrial parks. Section 103(c)(6) provides for tax-exempt financing for land or depreciable property provided the bond issue is $1 million or less and in certain instances $5 million or less; these are known as "exempt small issues."

[3] This conclusion is reinforced by the fact that the Ways and Means Committee, one year after enacting Section 103(c), in discussing the cost of tax-exempt obligations for civic functions included pollution control bonds. See H. Rept. No. 91–413, 91st Cong., 1st Sess., at 172.

[4] The capital expenditures to be taken into account are those which are: (1) made in connection with facilities the principal user of which will be the same (or a related person) as the principal user of the proceeds of the current issue, (2) made as to facilities which (on the issue date of the current issue) are located in the same incorporated municipality or in the same country; and, (3) not financed out of prior exempt small issues.

Alternatives to Tax-Exempt State and Local Bonds, Hearings Before the Committee on Ways and Means, 94th Cong., 2d Sess. (Jan. 21-23, 1976), at 214-32. Briefly summarized, the Internal Revenue Service devised unpublished ruling standards which became known as the "realized pollution test" (facilities which "prevent" pollution are not pollution control devices), "gross savings test" (pollution control facilities which generate gross economic benefits may not be entirely financed even though expenses may exceed benefits on a net basis) and "lifting test" (whenever an existing device is replaced, the Service asserts that the new facility adds life to the entire plant and therefore may not be entirely financed). This trend culminated in the issuance of new proposed Regulations under Section 103(c)(4)(F) on August 19, 1975.

2. Proposed Regulations § 1.103-8(g), Issued August 20, 1985.

The most obvious point about the proposed Regulations is that they are a virtual reversal of the statute as interpreted in the original Regulations published in 1972. Thus, they have justifiably been the subject of extensive criticism by taxpayers, state governments, and Federal agencies, including the Environmental Protection Agency, the Federal Energy Administration, and the Department of Commerce. Some examples of the rules disqualifying pollution control facilities under the proposed Regulations should demonstrate why there has been such wide-spread dissatisfaction with them.

First, the proposed Regulations disqualify facilities that prevent or avoid the creation of pollutants and permit the financing only of facilities that operate to trap or destroy a pollutant on a direct course to the environment. In other words, the proposed Regulations provide that "end of pipe" facilities may be pollution control facilities, but internal process changes or devices which are used to prevent the emission of pollutants at a subsequent point in the manufacturing process are not. This is so even if the process change is made to comply with or under a mandate of environmental authorities. This standard, the "realized pollution test", is incorrect as a matter of law and is arbitrary since it automatically penalizes the most efficient methods of pollution control.

Worse than the obvious abuse of power is the fact that this rule is contrary to the environmental policy of the nation (as enunciated in recent environmental legislation and enforced by the Environmental Protection Agency). Environmental legislation is structured to require the very internal process changes to achieve pollution control that the Treasury has determined are not for pollution control. Thus, taxpayers frequently find themselves in the peculiar position of being ordered by environmental authorities to install a facility or facilities for environmental purposes only to have another branch of the Federal government, namely, the Treasury, determine that the same devices are not pollution control facilities. This aspect of the proposed Regulations (proposed § 1.103-8(g)(vi) has led the Environmental Protection Agency to comment in its criticism of the proposed Regulations that it is ". . . a rule which would skew investment in the direction of possibly less efficient and economical means of controlling emissions".

Another example of the proposed Regulations' arbitrariness is the disqualification of facilities interpreted by the Service as being "safety equipment". This provision permits the automatic disqualification of virtually every type of device installed at a nuclear power plant relating to radiation prevention and control. The proposed Regulations can, and probably will be interpreted to deny tax-exempt financing of facilities that are required by environmental authorities if such facilities also are required by other authorities concerned with the safety and health of the public. It is submitted that all pollution control facilities are related to the safety of the public. Thus, the proposed Regulations could justify the Service denying the incentive to every pollutant control device made.

Another provision demonstrating the Treasury's unilateral determination to reduce or eliminate the statutory incentive by reducing or eliminating the volume of tax-exempt bond financing provides that devices traditionally used to control nuisance are not pollution control facilities. The introduction of this vague concept into the proposed Regulations belies logic and is completely unjustified. It gives the I.R.S. the opportunity to argue in any given case over the undefinable point at which pollution abatement ends and nuisance abatement commences. Under this rule the Service may ignore the fact that many public and private law suits to abate pollution or to punish polluters have proceeded on the theory that all pollution is nuisance. Moreover, this rule could allow the Service to disqualify any pollution control device.

The final illustration of the realized pollution test contained in the proposed Regulations is the rule disallowing pollution control facilities which may be classified as protecting persons or property from hazarous materials. Under this rule, too, the Service could ultimately disqualify all pollution control facilities since all of them by definition are directed to the protection of persons or property from hazardous materials.

These were just a few examples of the operation of the proposed Regulations. In total, they ignore the nation's environmental policy, overrule the Internal Revenue Code, and defy fairness. By applying standards differently to taxpayers, the proposed Regulations guarantee an unfavorable result to all taxpayers. The latter point is illustrated where the proposed Regulations provide that if a manufacturing facility serves a pollution control function, no amount may qualify. However, if the acquisition of a pollution control facility allows a taxpayer not to purchase a "manufacturing device" that otherwise would have been acquired, the taxpayer's allowable financing is reduced by the value of the equipment it did not purchase.

Even if a device meets the realized pollution test and thus can survive the Treasury's esoteric definition of what constitutes a pollution control facility, the facility may nevertheless be disqualified for statutory aid. This is accomplished under the proposed Regulations by reason of the application of a vague, indeed, an incomprehensible, allocation formula in proposed Section 1.103-8(g)(8) which provides for a reduction of the qualifying costs of a pollution control facility in any case that measurable gross economic benefits may be more than offset by the costs of operating the facility, the reduction occurs. The apparent theory is that the taxpayer's qualifying cost of its pollution control facility should be reduced on a pro rata basis to the extent that revenue or savings of any kind contribute to the reimbursement of the capital and operating costs of the facility. Thus, the proposed Regulations are premised upon the view that "true" pollution control facilities cannot recycle waste or otherwise result in any economic efficiencies.

The Service and the Treasury's sole intent may have been to prevent financing any manufacturing device under Section 103(c)(4)(F). In fact, the proposed Regulations were promulgated with explanatory language indicating that taxpayers are entitled to a 12.5% return on investment before losing a part of the incentive. However, when the allocation formula is actually applied, it is biased to eliminate or reduce allowable financing regardless of whether or not the pollution control facility results in a negative return on investment. Therefore, it is difficult to conceive of how the formula can be classified as a reasonable interpretation of the law.

III. SOLID WASTE DISPOSAL FACILITIES, SECTION 103(c)(4)(E) AND ITS INTERPRETATION BY THE I.R.S.

Section 103(c)(4)(E) of the Internal Revenue Code provides for tax-exempt industrial development bonds if substantially all of the proceeds are used for solid waste disposal facilities. Such facilities are defined in Treasury Regulations Section 1.103-8(f) to mean property used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste.[5] A solid waste disposal facility may operate at a profit provided, one, it operates to "dispose of" solid waste within the meaning of Section 203(4) of the Solid Waste Disposal Act,[6] and two, the property is useless, unused, unwanted, or discarded solid material which has no market or other value at the place where it is located. If any person is willing to purchase such material at any price, it is not waste.

The Internal Revenue Service has had considerable difficulty in applying the statute, particularly in cases where the disposal of waste results in a profit to the party disposing of it. If, after all, the party "disposing" of the waste earns a profit, the Service frequently reasons that the waste is not "waste" at all. An example that has occurred with regularity involves incinerators that burn waste material where the heat given off is used to power generators or produce

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[5] In this connection it must be reported to the Committee that the Internal Revenue Service has held that garbage trucks are not solid waste disposal facilities.

[6] Solid waste includes ". . . garbage, refuse, and other discarded solid materials, including solid-waste materials resulting from industrial, commercial and agricultural operations, and from community activities . . .")

electricity. The service reasons that such material is "fuel", not waste. This reasoning was first used to disqualify waste incinerators installed to burn municipal waste in and near Boston, Massachusetts. It has more recently been used to disqualify power boilers that burn useless bark at paper mills.

While the Treasury has issued Temporary Regulations Section 17.1 which were intended and understood to hold that waste incinerators were not disqualified merely because they added some type of "value" to the waste as a fuel, the I.R.S. has persisted.

We recommend that the Congress clarify the meaning of Section 103(c)(4)(E) to include facilities that are used to incinerate materials that is or would in the absence of the incinerator be discarded. We note that the Bill proposed in Exhibit A to this Written Statement would permit the tax-exempt financing of waste incinerators as well as coal, bark and lignite burning equipment, where they are installed to replace oil or gas burning facilities.

IV. PROPOSED LEGISLATION TO AMEND SECTION 103(C) INCLUDING CLARIFICATION OF SECTION 103(C)(4)(F)

On July 8, 1975, Secretary Simon testified before the House Ways and Means Committee and suggested that Congress enact legislation narrowing the definition of pollution control facilities because it was administratively difficult to determine the amount that a particular taxpayer was spending on pollution control. The issuance of the proposed Regulations makes it apparent that the Treasury has taken it upon itself to usurp the Congress' function of legislating tax laws; the thrust of the Secretary's comments were incorporated into the proposed Regulations.

If it is appropriate to reduce the volume of pollution control bond financing, it is submitted that it is up to the Congress to enact legislation. The policy of having an administrative agency attempt to reduce the volume of this type of financing by arbitrarily defining the term pollution control facility to exclude valid, bona fide and recognized methods of achieving pollution control objectives, is poor policy.

We do not agree with the Treasury that the volume of pollution control bond financing should be reduced. Previous Treasury estimates of revenue losses and market reactions are highly suspect. For example, the Treasury argues that pollution control bonds have a substantial effect upon the interest rates on other municipal obligations. This ignores the difference in the market between short-term and long-term obligations, the actual tax brackets of purchasers and the fact that polluters are going to be in the money market anyway.

Financing of pollution control facilities will occur whether or not Congress reduces or eliminates tax-exempt bonds. Thus, the question is not the effect of pollution control expenditures on interest rates but whether or not Congress, not the I.R.S., wishes to continue having an incentive under Section 103(c)(4)(F). In this light, the Committee should not rescind or reduce the only meaningful, available tax incentive for pollution control facilities. Clearly no further statutory restrictions should be adopted without an indepth study of alternative incentives and their cost-effectiveness for pollution control expenditures.

If Congress decided to reduce the volume, it makes more sense to impose statutory dollar or percentage limitations on the amount of qualifying cost of pollution control facilities than it does to arrive at some arbitrary definition that neglects both the state of the art and the nation's environmental policy. Attached hereto as Exhibit A is a draft, with explanation, that would provide definitive standards for the qualification of pollution control facilities under Section 103(c)(4)(F). The proposal defines such facilities in a manner consistent with modern environmental protection techniques. If an appropriate environmental authority certifies that the facilities are installed for pollution control purposes, the device is a pollution control facility.

The draft limits tax-exempt bonds to amounts that vary depending on whether or not the facility is installed primarily for pollution control and whether it is installed at an existing plant or at a new one. At new plants, the amount of pollution control bonds is limited to a percentage of the estimated cost of the entire new plant. At existing plants, the financeable cost is limited to a percentage of the cost of the pollution control facility itself.

Another approach would be for the Committee to consider making available an incentive that taxpayers may elect in lieu of tax-exempt bonds. For example, if the taxpayer chooses to forego tax-exempt financing, it could be eligible for an investment tax credit substantially in excess of what currently is permitted by law or a more rapid write-off of the cost of the facilities.

The draft, in addition to clarifying the definition of pollution control facilities under Section 103(c)(4)(F), has certain other amendments that he Committee should consider at this time. These proposals include tax-exempt financing for fuel saving devices (proposed Section 103(c)(4)(I)) and for the costs of converting gas and oil burning equipment to facilities that burn other more plentiful forms of fuel such as garbage, waste, coal, bark, peat and lignite (proposed Section 103(c)(4)(H)). These proposals would provide an incentive for industry to conserve fuel and to convert its energy consumption to the use of waste materials and natural resources which are more available than certain petroleum products.

The new incentives are contained in S. 1949 introduced on July 26, 1975 by Senator Carl T. Curtis (R. Neb.).

With the onslaught of the energy crisis, the attention of the public and the Congress has turned to the need for a nationwide conservation program. Such a program should have as its goal the most efficient use of scarce natural resources and the elimination of waste with the minimum economic displacement. As the Committee is well aware, recycling, reuse, or conservation of waste products in any form to supply the country with useable products or energy is one method of reducing the use of scarce natural resources. Recycling also eliminates unsightly and indeed sometimes dangerous quantities of unwanted items. Conservation measures include the installation of new facilities or conversion of existing facilities that use more abundant fuels (such as coal, garbage, or sludge) and installation of devices to reduce fuel consumption at industrial plants. Conservation, of course, cannot be limited to those items, techniques or methods that have traditionally been used or that have been thoroughly researched and previously made available for commercial application. Thus, thorough recycling and reuse of the sources (such as can be accomplished with atomic energy) must today be pursued in order to assure efficient utilization of this valuable energy form.

Tax incentives are particularly important to the public where industry does not derive an economic benefit which is the case in most fuel conversion situations and most recycling situations. Thus, draft Section 103(c)(4)(H) (conversion or replacement of gas burning or oil burning equipment) is consistent with the original intent of the enactment of Section 103(c) since the conversion or replacement of oil or gas burning facilities will inherently provide a benefit to the public. If industry will convert some of its energy needs to waste products or to some of the other natural resources in this country, oil or gas otherwise required for industry can provide heat for homes and gasoline for automobiles. In addition, our environment will benefit from the elimination or recycling of wastes.

Draft Section 103(c)(4)(I) provides for the tax-exempt financing of fuel saving devices. It is believed that most industrial complexes currently waste approximately 8 to 10 percent of the fuel being consumed. The acquisition of devices which would reduce or eliminate this waste should be encouraged.

The proposed amendment to Section 103(c)(6)(A) raises the limit on general exempt small issues from $1 million to $5 million and proposed Section 103(c)(6)(D) raises the alternative exempt small issue from $5 million to $10 million. Since the enactment of the exempt small issue exception two problems have arisen: one, inflation, and two, there is an undue administrative burden of the capital expenditures associated with the $5 million exempt small issue. Accordingly, these proposed amendments are needed to keep pace with the rate of inflation in the last six years and the anticipated rate of inflation in the near future. Moreover, they should eliminate some of the administrative burdens associated with the present statute. This amendment is consistent with the Revenue Act of 1971 which amended Section 103(c)(6), in part, by reason of inflation and administrative burden. It is noted that the Ways and Means Committee approved a similar amendment in November 1974 in connection with its consideration of the then pending "Tax Reform Bill of 1974". At that time, however, the Committee approved an increase of the $1 million exemption to $10 million (as opposed to an increase to $5 million suggested here).

Draft Section 103(c)(4)(G) provides that facilities for the furnishing of water, if available on reasonable demand to members of the general public, may be financed with tax-exempt industrial development bonds. The limitation that such facilities must be made available on reasonable demand to members of the general public is unnecessary. The mere acquisition of facilities for the furnishing of water should qualify because water facilities which are acquired by a private business user or industrial entity will alleviate such users' demand from the source of supply being used by the public.

The proposed amendment is consistent with the original intent of the statute that the acquisition of certain facilities through tax-exempt industrial development bonds should be allowed whenever those facilities by their very nature are of sufficient benefit to the general public. It is also consistent with the Revenue Act of 1971 which added Section 103(c)(4)(G) of the Code.

VI. ULLMAN-CONABLE BILL, H.R. 12774

To begin, we applaud the fact that the Ullman-Conable proposal, one, permits municipalities the option of issuing taxable bonds where the bonds would otherwise bear tax-exempt interest, and two, does not intend to provide for Federal supervision over the State and local governments or their obligations. As approved by the House Ways and Means Committee, however, the proposal does not permit the exercise of the option with respect to tax-exempt industrial development bonds. The Bill should not distinguish between tax-exempt industrial development bonds and general municipal bonds. Otherwise there could be definitional problems which could undermine the automatic subsidy under the taxable bond option, one of the key features of the Ullman-Conable proposal.

VII. CONCLUSION

It should be apparent that a more specific definition of the phrase "air or pollution control facility" must be enacted in order to insure industry that the incentive contained in Section 103(c)(4)(F) is still available. This assurance is made necessary by virtue of the fact that the Internal Revenue Code contains no other provisions which effectively off-set part of the cost of acquiring pollution control facilities.

The reason why the Committee should act to define air or water pollution control facility is that the Internal Revenue Service and the Treasury have interpreted the existing law in an unduly restrictive manner. It appears that these agencies have made a policy decision to reduce or eliminate pollution control tax-exempt obligations through the application of unpublished ruling standards and the promulgation of proposed regulations. While the subjective intent of the IRS and the Treasury may be understandable, the objective result is deplorable because, (1) their standards are unreasonable and arbitrary, (2) no governmental agency has the authority to legislate, and (3) the result of their misguided rules is contrary to the nation's environmental goals.

If the Committee determines that there should be a reduction in the amount of tax-exempt industrial development bonds, this should be accomplished prospectively by statute and not retroactively by administrative fiat. Moreover, in lieu of reducing tax-exempt obligations by further restricting the benefits of 103(c)(4)(F), the Committee might wish to accomplish the same goal by providing industry with alternative incentives, such as, a greater investment tax credit than is currently allowed and/or an accelerated write-off of pollution control facilities faster than is allowed under Section 169 of the Code.

In addition to considering technical amendments to Section 103(c), it would be appropriate for the Committee to add substantive amendments which would, one, allow tax-exempt financing of fuel saving devices and fuel conversion facilities, and two, increase the exempt small issue from $1 to $5 million and $5 to $10 million.

Finally, the Committee should reaffirm its decision made in 1968 that tax-exempt financing is available for recycling and solid waste disposal facilities. Under existing regulations and interpretations of the Code by the Internal Revenue Service, recycling of fissionable materials is not considered to qualify; this is certainly contrary to Project Energy Independence. In addition to this contradiction, the Service position that only "completely valueless" items may be considered solid waste should be exposed as being contrary to the intent of Congress.

EXHIBIT A

A BILL To amend Section 103 of the Internal Revenue Code of 1954

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

(a) Section 103(c)(4) of the Internal Revenue Code of 1954 (relating to certain exempt activities) is amended—

(1) by striking "(F) air or water pollution control facilities, or" and inserting in lieu thereof "(F) except as provided in paragraph (8). facilities certified by a Federal or State environmental agency exercising jurisdiction over the facilities as being installed for the purpose, in whole or in part, of abating, controlling or preventing water or atmospheric pollution or contamination at the place where the facilities are installed,

(2) by striking out in subparagraph (G) "if available on reasonable demand to members of the general public." and inserting in lieu thereof "whether or not to the general public,";

(3) by striking out the period at the end of subparagraph (G) and inserting in lieu thereof, "or"; and

(4) by adding at the end thereof the following: "(H) facilities which cause, allow or result in the conversion from or replacement of gas burning equipment to or with oil burning equipment or facilities which cause, allow, or result in the conversion from or replacement of oil burning equipment to or with equipment which burns other energy burning materials such as garbage, coal, bark, peat, or lignite, or "(I) fuel saving devices for industrial facilities.".

(b) Section 103(c)(6) of such Code (relating to exemption from industrial development bond treatment for certain small issues) is amended—

(1) by striking out in subparagraph (A) "$1,000,000." and by inserting in lieu thereof "$5,000,000.";

(2) by striking out "$5,000,000." in the heading of subparagraph (D) and by inserting in lieu thereof "$10,000,000.";

(3) by striking out "$5,000,000 for $1,000,000" in subparagraph (D)(1) and by inserting in lieu thereof "$10,000,000 for $5,000,000;" and

(4) by striking out in the heading of subparagraph (E) ". . . facilities described in this subparagraph are facilities—" and by inserting in lieu thereof ". . . facilities described in this subparagraph, other than those described in section 103(c)(4)(F), (H), and (I), are facilities—".

(c) Section 103(c) is amended by adding at the end thereof the following new paragraph:

"(8) Limitation on Expenditures Under Paragraph (4)(F)—

(A) *In General.*—For purposes of paragraph (4)(F), the face amount of obligations issued for such facilities to be installed at any manufacturing or processing plant or other location that is or could be a source of pollution shall not exceed the amounts described in subparagraphs (B) and (C) respectively of this paragraph after application of subparagraphs (F) and (G) of this paragraph.

(B) *Intallations at New Plants etc.*—In the case of facilities described in paragraph (4)(F) to be installed at new plants (as defined in subparagraph (D) of this paragraph), the aggregate authorized face amount of obligations to be issued therefor shall not exceed the sum of 25 percent of the first $100,000,000 of capital expenditures paid or incurred in connection with such plants, 20 percent of the second $100,000,000 of such capital expenditures, 15 percent of the third $100,000,000 of such capital expenditures and 10 percent of such capital expenditures in excess of $300,000,000 plus the costs and expenses incurred in issuing such obligations.

(C) *Installations at Existing Plants.*—In the case of facilities described in paragraph (4)(F) to be installed at existing plants (as defined in subparagraph (D) of this paragraph) to replace existing facilities similar in use, the aggregate authorized face amount of obligations to be issued therefor shall not exceed 75 percent of the cost of such facilities, plus the costs and expenses incurred in issuing such obligations. In the case of facilities described in paragraph (4)(F) (other than those described in the preceding sentence) to be installed at existing plants, the aggregate authorized face amount of obligations to be issued therefor shall not exceed 90 percent of the cost of such facilities, plus the costs and expenses incurred in issuing such obligations.

(D) *New Plant.*—For purposes of this paragraph the term "New Plant" means any plant or identifiable part thereof, or other location that is or could be a source of pollution, placed in service within the three-year period immediately preceding the date of issue of the obligations described in paragraph (8)(B). A major expansion of the capacity of any plant or identifiable part thereof or a major conversion in the use to which any plant (or identifiable part thereof) is devoted, shall be treated as a separate plant. For purposes of this paragraph a major expansion of capacity shall mean an increase in capacity of 25 percent or more, and a major conversion in use shall mean a change affecting 25 percent or more of the output of the plant. Any plant or identifiable part thereof not described in the preceding three sentences shall be deemed an existing plant.

(E) *Capital Expenditures Taken Into Account.*—The capital expenditures taken into account with respect to any new plant or other source of pollution for purposes of this paragraph are the expenditures which are properly chargeable to capital account and which are either made before the date of the issuance of the issue or can reasonably be expected (at the time of the issuance of the issue) to be made during the three-year period beginning on the date of such issuance.

(F) *Conclusive Presumption if Primary Purpose Is Pollution Control.*—The entire cost of facilities described in paragraph (4)(F) shall be conclusively presumed to qualify (subject to the percentage limitations specified in subparagraphs (B) and (C) of this paragraph) if such facilities are acquired primarily for air or water pollution control. Otherwise, the costs for facilities described in paragraph (4)(F) shall qualify in accordance with subparagraph (G).

(G) *Net Economic Benefits.*—For purposes of this paragraph, the qualifying cost of facilities that are not primarily installed for air or water pollution control shall not include any portion of the cost allocable to and expended for the purpose of increasing the useful life or production capacity of any manufacturing or processing facilities by more than 50 percent or for any portion of such cost allocable to or expended for the purpose of deriving net economic benefits after application of all costs of acquisition and operation arising by reason of such facilities. The term "net economic benefits" shall not include savings arising solely by reason of entrapment, recapture, removal, recovery, or treatment of items that would, in the absence of the facilities, result in pollution or environmental contamination, but shall include net profits that arise by reason of the sale of such items.

(d) Effective Date.—

(1) The amendments made by subsection (a)(1) and (2) of this Act shall apply with respect to obligations issued after the date of enactment of this Act;

(2) The amendments made by subsection (a)(3) and (4) of this Act shall apply with respect to obligations issued after the date of enactment of this Act, but only with respect to obligations issued before January 1, 1980;

(3) The amendments made by subsection (b) of this Act shall apply with respect to obligations issued after the date of enactment of this Act; and

(4) The amendments made by subsection (c) shall apply only with respect to obligations issued after the date of enactment of this Act, except that such amendments shall not apply to reduce the aggregate authorized face amount of any issue of obligations with respect to any obligation—

(1) the issuance of which was authorized or approved before the date of enactment of this Act, by the governing body of the governmental unit issuing the obligation or by the voters of such governmental unit, or

(2) for any plant or other property with respect to which action similar to the action provided in paragraph (1) was taken before the date of enactment of this Act.

Paragraph (2) shall apply to any issuance of obligations only if, in connection with the similar action referred to in such paragraph, there was a specification of the maximum dollar amount of obligations which could be issued or there was a specification of the estimated expenditures to be incurred for the plant or other property; and paragraph (2) shall apply to the issuance of obligations only to the extent that such maximum dollar amount or the amount of such estimated expenditures (as the case may be) is not exceeded. Paragraphs (1) and (2) shall not limit the applicability of subsection (c) if the result of applying such subsection is that a greater aggregate authorized face amount of bonds may be issued than under prior law.

EXPLANATION OF PROPOSED BILL TO AMEND SECTION 103 (C) OF THE INTERNAL REVENUE CODE

The attached proposed bill would amend Section 103(c) as follows:

1. Increase of the Exempt Small Is... $1 million to $5 million and, in certain cases, from $5 million to $10 million.

2. Permit tax-exempt financing of facili... ich furnish water whether or not available to the general public.

3. Permit tax-exempt financing for fuel s... devices for industrial facilities and devices acquired to convert equipment using scarce energy sources (such as crude oil) to use of more plentiful source material (such as garbage or coal).

4. Provide definitive standards for qualification of pollution control facilities under Section 103(c)(4)(F), that is, a qualified facility is specifically defined to mean any that is "installed for the purpose, in whole or in part, of abating, controlling or preventing water or atmospheric pollution or contamination."

a. If facilities are installed "primarily" for pollution control, the entire cost is financible with tax-exempt obligations, subject to the 75 percent and 90 percent limitations and new plant limitation set forth in paragraph 5 below.

b. If facilities are "not primarily installed" for pollution control the amount of bonds that can be issued would be reduced by the following amounts: (1) The amount of funds expended for the purpose of deriving any *net* economic benefits (i.e., after deduction of all costs associated with acquisition and operation of the facility or the increase of such costs in the case of a replacement facility, and (2) The amount of funds expended for the purpose of increasing the useful life or production capacity or processing facilities by more than 50 percent.
For this purpose, net economic benefits does not include net profits realized from the recovery of pollutants unless the pollutant is sold as a byproduct. In this regard, the reduction to be applied is based on Section 169 of the Code.

5. Limit the amount of tax-exempt bonds that could be issued to provide pollution control facilities to a percentage of the qualifying cost of such facilities. The limitation would vary depending on whether the facilities are installed at new or existing plants or other sources of pollution. The limitation would be applied as follows:

(*a*) At existing plants or pollution sources, qualifying facilities installed to replace facilities similar in use could be financed with tax-exempt obligations in a face amount not in excess of 75 percent of the qualifying cost (plus issuance expenses).

(*b*) At existing plants or pollution sources, facilities that *do not* replace existing facilities similar in use may be financed with tax-exempt obligations in a face amount not in excess of 90 percent of the qualifying cost (plus expenses of issuance).

(*c*) At new plants or potential pollution sources, qualifying facilities may be financed with tax-exempt obligations in face amount not in excess of the amount shown in the following schedule (plus costs of issuance):

25 percent of the first $100 million of capital expenditures for the entire plant or site.

10 percent of the second $100 million of capital expenditures for the entire plant site.

15 percent of the third $100 million of capital expenditures for the entire plant, or site.

10 percent thereafter.

Senator FANNIN. The next witness is Mr. Robert W. Blanchette, chairman of the trustees, Penn Central Transportation Co., accompanied by Newman T. Halvorson, Jr., counsel.

Your statement will be made part of the record and you may proceed as you feel necessary.

STATEMENT OF ROBERT W. BLANCHETTE, CHAIRMAN OF THE TRUSTEES, PENN CENTRAL TRANSPORTATION CO., ACCOMPANIED BY NEWMAN T. HALVORSON, JR., COUNSEL

Mr. BLANCHETTE. Thank you, Mr. Chairman. Since my statement will be included in the record, I will summarize it in the interest of time.

What we seek is legislation with respect to the rehabilitation of troubled railroad corporations. In 1962 Congress recognized the fact that rehabilitation of troubled railroads was a longer process than the rehabilitation of nonregulated industrial concerns. The Congress extended to 7 years the period during which a railroad company could avail itself of its tax loss carryforwards.

Basically, therefore, what we seek is a restoration of the 7-year carryover period in accordance with the original intent of Congress.

We understand that in the short time period which the Congress had to consider the tax legislation accompanying the Regional Rail Reorganization Act it was difficult to give full attention all aspects of that legislation. One such aspect is that because these Northeast bankrupt railroads will no longer qualify as regulated companies, the tax loss carryforwards would be shortened from 7 years to 5 years despite the fact that they have been forced to continue to incur losses throughout the bankruptcy proceedings.

When that tax legislation was assembled, both Senator Long and Senator Curtis noted on the floor of the Senate that there would be other aspects of the legislation that could not be adequately considered in the short period of time available, and stated that those matters could be subsequently addressed.

We seek, therefore, legislation consistent with the original intent of the Congress, legislation which would give these bankrupt estates flexibility in arranging and rehabilitating their affairs and which would treat them as railroad corporations for purposes of tax loss carryforwards, because in essence these railroads have been forced to continue operations and to delay their rehabilitation process until a solution to the northeast rail situation could be found.

That solution was found and was implemented on April 1 of this year. We must now begin the job of rehabilitating these corporations, of trying to get something down to the creditors, especially the unsecured small creditors who don't have liens and mortgages to protect their claims.

We believe this flexibility would be of tremendous assistance to the courts in restructuring the affairs of these companies.

Thank you, sir.

Senator FANNIN. Thank you very much, Mr. Blanchette.

Your testimony this morning is on that one subject then?

Mr. BLANCHETTE. Yes, sir.

Senator FANNIN. That the Code should be amended to say that the bankrupt carryforward would be remaining at 7 years, and not cut back to 5 years.

In your testimony you say that the bankrupt northeast railroads present a unique situation created by the Government. You propose an amendment be made, and you believe such a change is required in the interest of fairness and sound tax policy.

You have three matters that you wanted to cover in the text of your remarks. Did you cover those completely in your testimony?

Mr. BLANCHETTE. No; I just summarized them.

Senator FANNIN. Just elaborate a little on those three.

Mr. BLANCHETTE. Yes, sir. I appreciate the opportunity to do that.

Our first point is that unlike the normal bankrupt, when the Penn Central, for example, went into reorganization in 1970, it was unable to begin a reorganization that most companies can attend to when they go into bankruptcy, and the reason for it was that we were required, in the public interest, to continue railroad operations. We could not trim our losses, and we had to, in the public interest—continue passenger service and continue light-density freight lines, and we had to continue our work rules and our labor contracts.

We were not, in short, permitted to use self-help, and although that was in the public interest and was understandable, it meant that we were forced to incur losses.

The second point is that until a solution was found to the northeast rail problem, we could not arrange or restructure even our nonrail assets to absorb our losses, because they were frozen until a solution was found in the form of ConRail. So we did not, there again, have any self-help possibilities for over 5 years.

The third point is that, as a result of the ConRail takeover, we may no longer qualify as a regulated transportation corporation, because we may no longer satisfy the provisions of the Code requiring that 80 percent of our gross revenues be derived from transportation services. Therefore, we think our request for legislation is equitable in the light of this situation.

In essence, Mr. Chairman, the Penn Central situation was that it could not reorganize until a solution was found with respect to the public interest issues. Now that those issues are behind us, we should be given reasonable flexibility to begin our reorganization in a normal fashion.

Senator FANNIN. Thank you very much, Mr. Blanchette. It was a pleasure to have you two gentlemen appear here this morning, and if there are any questions by any members of the committee, they will be addressed to you in writing.

Mr. BLANCHETTE. Thank you.

[The prepared statement of Mr. Blanchette follows:]

STATEMENT OF TRUSTEES OF PCTC, DEBTOR ON TAX REVISION PROPOSALS

SUMMARY

1. An important purpose of both the bankruptcy laws and the net operating loss provisions of the tax laws is to provide a means for the rehabilitation of distressed businesses.

2. Despite filing in bankruptcy in June of 1970, Penn Central was not permitted to make the adjustments in its railroad operations necessary to reduce or eliminate its losses. Rather, Penn Central was required in the public interest to continue in the railroad business for several years, with continuing forced losses, until it has amassed losses that cannot possibly be absorbed even within the 7-year carryover period normally available to railroads.

3. As a result of the ConRail takeover on April 1, 1976, the carryover period for these prior railroad losses will be *reduced* from 7 years to 5 years. This result, in the context of continued forced railroad operations, was not foreseen in 1962 when the 7-year carryover period was enacted, and it cannot be justified in terms of Congress' purpose at that time.

4. The Trustees of the Penn Central, in fulfilling their responsibilities under the bankruptcy laws, should have a reasonable amount of flexibility in implementing the long-delayed reorganization plan.

5. In these circumstances, the Code should be amended so that the carryover period for the bankrupt railroads will be maintained at 7 years and not be cut back to 5 years as a result of the ConRail transaction.

STATEMENT

Mr. Chairman and Members of the Committee:

My name is Robert W. Blanchette. I am Chairman of the Board of Trustees of Penn Central Transportation Company, Debtor, appointed by the United States District Court for the Eastern District of Pennsylvania. I am accompanied by Newman T. Halvorson, Jr., of the law firm of Covington & Burling, Washington, D.C., Special Counsel for the Trustees.

We appreciate this opportunity to present our views on a tax revision proposal that is important to us and to thousands of claimants against the Penn Central Estate. The proposal is that appropriate changes in the Code be made so that the recent ConRail takeover will not have the effect, as it would have under present law, of reducing from 7 years to 5 years the period within which the bankrupt estates may use the net operating losses incurred in railroad opeations prior to the takeover.

BACKGROUND

At the outset of my remarks this morning, I should like to explain the philosophy underlying our position before this Committee. Basically, our position is rooted in the fundamental public policy, expressed in the bankruptcy and tax laws, that give distressed companies some flexibility in rehabilitating their affairs. In large enterprises, such as the Penn Central, this is of particular importance to the small investor and creditors; the large financial institutions are usually able to minimize the impact of bankruptcy by obtaining collateral in the form of mortgages, pledges and the like. The tax laws serve this same public policy when tax loss carryforwards are available to give a debtor some "breathing room" in restructuring and reorganizing its assets.

The bankuptcies of the Northeast railroads present a unique situation, created by the Government, to which our suggestions are addressed. Our proposal that an amendment be made in the loss carryover provisions, and our belief that such a change is required in the interests of fairness and sound tax policy, are based essentially on three facts, each of which reflects this unique situation in the form of government action affecting the Penn Central and the other debtors.

1. Despite bankruptcy, these debtors were not permitted to reorganize themselves by cutting the losses which were incurred in railroad operations and which led to their bankruptcies in the 1960's and 70's. Rather, PCTC and the other bankrupt railroads were required in the public interest to continue their loss-producing railroad operations without substantial change pending the resolution of the Northeast rail crisis. Congress as well as the executive and judicial branches of government imposed this requirement. This is seen, for example, in the Regional Rail Reorganization Act of 1973, effective January 2, 1974, and in the earlier Joint Resolution 59, enacted on February 8, 1973, both of which required the continuation of railroad operations. As a result, PCTC has been unable to make any use of the 7-year carryover period provided for railroads, and instead has been required to pile up additional losses.

2. Pending the legislative solution to the rail crisis, and the determination by ConRail of the assets it was going to take on April 1, PCTC has been unable to absorb any of such losses by rearranging or disposing of either rail or nonrail assets for the benefit of creditors.

3. The solution to the rail crisis adopted by Congress will have the effect of reducing the 7-year carryover period, already inadequate in the circumstances, to 5 years, because PCTC may not qualify as a "regulated transportation corporation" following the ConRail takeover. This is provided by Section 172(j)(3) of the Internal Revenue Code.

In these circumstances, our position basically seeks equitable relief so that the railroad debtors can be rehabilitated in a manner similar to that available under the tax laws in less unique circumstances. We recognize that the public interest required continuation of rail operations in the Northeast regardless of profitability. We also recognize that the public interest requires the protracted valuation proceedings contemplated in the Regional Rail Reorganization Act. We believe that the public interest is also served by an application of the tax laws which recognizes these facts and does not penalize the debtors because of their public utility status.

Congress frequently has recognized that tax changes may be appropriate for particular companies or industries severely affected by government regulation. This was recognized in our own industry, for example, in 1962 when the carryover period for railroads was extended to 7 years. In the present circumstances, the PCTC Trustees suggest that the carryover period should, at the very minimum, be maintained at 7 years. This will provide the railroads a fair opportunity to recoup at least part of the enormous operating losses that they have been forced to incur in the public interest for an extended period following bankruptcy. This proposal would not provide any windfall in the form of a refund of taxes paid in prior years. There would be no effect on federal revenues before 1982 or 1983.

I should emphasize that the major beneficiaries of changes such as those I have outlined would be low-ranking unsecured creditors of the Estate, such as suppliers and injured persons, who without legislation may receive little if any payment on their claims.

EFFECT OF H.R. 12490

As members of this Committee will recall, the Senate on March 25, 1976, passed H.R. 12490, relating to the income tax treatment of exchanges under the final system plan for ConRail, without consideration of certain amendments suggested by parties involved in the transfer of properties to ConRail. This bill was signed by the President on March 31, 1976, as Public Law 94–253. We did not oppose enactment of H.R. 12490 in its final form because, as a result of its consideration in the House Ways and Means Committee, important technical changes were made in its provisions relating to net operating loss carryovers and because we understood it was the sense of the Congress and of the bill's proponents that it not be delayed by consideration of further amendments. It was suggested by certain members of Congress, however, that further changes would be considered by this Committee in connection with the pending tax revision proposals.

In response to the unique situation faced by the Northeast railroads, as described above, H.R. 12490 made one important change in the loss carryover provisions. Under the newly enacted Section 374(e) of the Code, the bankrupt railroads will be permitted to use their prior railroad losses, to the extent they have not otherwise been used, to offset any income which is later received from the Government or from court awards under the Regional Rail Reoragnization Act of 1973. Because of the severe time limitation imposed upon the Congress, however, H.R. 12490 failed to correct an anomalous and unjustifiable result under present law. As I have stated, the carryover period for railroads under present law generally is 7 years but, as a direct result of the ConRail transaction, it will be cut back to 5 years for the Penn Central. This result is contrary to Congress's original purpose in providing a 7-year carryover period.

Congress's purpose in 1962, in extending the carryover period for railroads to 7 years, was to recognize through a specific Code provision that railroads, because of their low rate of return, often need a longer-than-normal carryover period. At the same time, Congress specified that the 7-year period would apply only if the taxpayer qualified as a railroad not only in the loss year but also in the carryover year. Otherwise the carryovers would expire after 5 years. This "lapse-back" provision probably was based on the view that corporations going into nonrailroad businesses with higher rates of return would not need the longer carryover period.

H.R. 12490 made no change in the "lapse-back" provision of present law. Thus, as a result of the ConRail takeover on April 1, these debtor railroads will have only 5 years following each loss year to use their prior railroad losses.

The situation of the bankrupt Northeast railroads was not foreseen in 1962. These railroads did not quit the railroad business voluntarily with the encouraging prospect of absorbing their railroad losses within the shorter 5-year period. Rather, despite bankruptcy, they were forced in the public interest *to continue* in the railroad business for several years, piling one loss on top of another, until they have amassed losses that cannot possibly be absorbed even within the 7-year period, let alone within the shorter 5-year period.

The case would be different if, within a reasonable time after bankruptcy in mid-1970, PCTC had been allowed to adjust its railroad operations so as to reduce or eliminate the losses, or had been allowed to go out of the railroad business entirely. This sort of adjustment is what the Bankruptcy Act is intended to permit. Had this been permitted in our case, the enormous post-bankruptcy losses of recent years would never have been incurred, and some portion of the earlier losses might have been utilized within the 7- year or 5-year period, whichever was applicable in light of the adjustments made. The history of our case, unfortunately, is otherwise.

Indeed, the result under present law may fairly be described as punitive. The Government, having kept the Penn Central in the railroad business for far more than two years longer than it wanted to stay in that business (at least under existing conditions), ought not in fairness cut back by two years the available period for using those involuntary losses.

Without regard to whether the Penn Central is awarded any additional compensation by the courts, reasonable tax policy in these circumstances requires that the previously available carryover period not be reduced as a result of the ConRail transaction. The purpose of the 1962 amendment, including the lapse-back provision, was to give railroads a reasonable period to absorb their losses. That same logic clearly requires that the Code be amended to provide that the carryover period be maintained at 7 years. We have prepared a draft of such an amendment, and I request that it be included in the record as part of my testimony and be given serious consideration by this Committee.

Thank you.

AMENDMENT TO MAINTAIN 7-YEAR CARRYOVER PERIOD FOR THE BANKRUPT NORTHEAST RAILROADS

Section 172 of the Internal Revenue Code of 1954 (relating to the net operating loss deduction) is amended by inserting after subsection (b)(1)(G) the following new subparagraph:

"(H) In the case of a taxpayer which is a regulated transportation corporation (as defined in subsection (j)(1)) and which conveys (or which is a member of an affiliated group of corporations which conveys) rail properties pursuant to section 303 of the Regional Rail Reorganization Act of 1973, a net operating loss of such corporation which was a net operating loss carryover to, or arose in, the first taxable year of such corporation ending after March 31, 1976, shall be a net operating loss carryover to each of the seven taxable years following the taxable year of such loss. This subparagraph shall apply without regard to whether the taxpayer qualifies as a regulated transportation corporation for any period following such conveyance."

Senator FANNIN. The next witness is Alfred W. Hesse, Jr., chief executive officer and acting president, Reading Co., accompanied by Ernest S. Christian of Patton, Boggs & Blow; and Thomas Lefevre of Morgan, Lewis & Bockius.

There are two of you gentlemen? Identify yourselves for the reporter.

STATEMENT OF ALFRED W. HESSE, JR., CHIEF EXECUTIVE OFFICER AND ACTING PRESIDENT, READING CO., ACCOMPANIED BY ERNEST S. CHRISTIAN OF PATTON, BOGGS & BLOW

Mr. HESSE. My name is Alfred Hesse, Jr., and with me is Mr. Christian.

Senator FANNIN. We welcome you gentlemen this morning. The statement you have furnished the committee, the complete statement, will be made part of the record and you may digest it as you desire.

Mr. HESSE. I will comment briefly, sir.

The Reading Co. became bankrupt in November of 1971 and it operated about 1,200 miles in eastern Pennsylvania, New Jersey, and

Delaware—it is the third largest of the bankrupt railroads. Its revenue, while it was operating a railroad, ranged between $140 million and $150 million. It operated a passenger service with 394 trains daily, and handled close to 50,000 passengers a day primarily in the Delaware Valley Metropolitan Area.

On April 1, we did transfer nearly all of our properties to ConRail. Now, this was done pursuant to the final system plan that was approved, and Reading had no say as to which properties were to go or not to go to ConRail. The conveyance was actually made pursuant to an order of the court.

The payment for these properties was administratively determined by the United States Railway Association, which chose what it called the net liquidated value for the properties, and payment as described by the act is made in stock of ConRail to which are attached certificates of value, and if, in 1987, the stock has no value, then the certificates of value will be substituted, and the court will finally determine the value for the property.

When we made the transfer, our tax base was about $208 million, for which we received face value in stock and certificates of value of about $22 million, and certain other benefits have been assumed by ConRail, so that perhaps the total consideration will range between $29 million and $55 million, and that leaves us between $175 and $180 million worth of differential between the tax base and the amount that so far we have actually received.

Now, there will in the future, we hope, be further payments made to the Reading for the properties transferred. That will occur, however, only after litigation in which we will endeavor to prove that as a constitutional minimum, the value of the properties transferred will be in excess of that which we have received right now.

On the present scene, we have about a $55 million tax loss carry forward which will be, or will have to be used within 5 years, and we heartily endorse the recommendation made by Mr. Blanchette just previously that this should be extended to 7 years for the reasons that he stated.

On April 1, when the properties were transferred, our assets, excluding any we might anticipate for legislation, were about $80 million short of our liability. Now, this is the problem that the trustees now face. Here are people who have furnished their money, through bonds, or have loaned funds in order to continue the operations of the Reading, and stockholders who have put their money into this operation, who are not being paid, and yet the railroad was considered so important to the United States that it has provided a special means, and large sums of money in order that this railroad should continue in operation.

The trustees feel strongly that it is their obligation in every way possible to seek to pay these people who initially built the railroad, for the moneys that they have advanced, and, of course, it makes economic sense, and the Congress has recognized for many years that it is desirable that corporations which fall on hard financial times should be reorganized so that they can be good economic citizens again.

Now, how do the trustees propose to do this? One of the things that they propose is to acquire by a small cash payment and installment notes entities which do have net income, and they proposed in that way, in using this, and under such tax losses as may be properly carried forward, that they may protect the income and thus be able to build the estate to a point where it will be able to meet the big obligations that it has to its creditors.

Now, in order to do this, you might say perhaps this is special tax legislation, but this is a special situation. The Public Law 253 recognizes that it is a special situation and says:

ConRail, you will take the base that the Reading had for its assets. This will be an advantage to ConRail, because it will obtain a large depreciation base, and may be insulated from capital gains. That is fine, we agree 100 percent that ConRail, which has been established to restructure the railroads in the Northeast should be protected and make it what the United States deserves—a fine transportation instrument. It should be given this kind of advantage.

All we say is:

Please treat us, also, as being in a unique situation.

The Government has said that we have to transfer the properties, that we cannot liquidate in the normal manner. Here are the people who have contributed to the construction of the rail network in the Northeast who deserve to be paid, and we ask that we be given a chance.

We think that given the type of tax relief we can do so, and I am going to ask Mr. Christian to explain it, because I am not learned in the area of the Internal Revenue Code.

Mr. CHRISTIAN. Public Law 94–353 established that ConRail would be permitted to carry over for use in the future the high basis in the assets that the transfer or railroads had. Of course, we are in agreement with that.

The public law, however, did two other things. It, first of all, precluded the Reading and the other railroads from recognizing the ordinary loss that they in fact realized upon transfer of the assets.

Second, it converted that loss to a capital loss, which in the future can only be realized by disposition of the stock of ConRail which was distributed in exchange for the transferred assets.

Our proposal is that while it is perfectly appropriate to permit the high tax basis to be transferred to ConRail to assist it in the future, it is inappropriate to preclude those transferor railroads who wish to recognize their ordinary loss upon transfer from doing some. There are two ways within the framework of Public Law 94–253, and within the framework of the Internal Revenue Code in which that could be accomplished.

One way would be to permit those railroads to elect to recognize the ordinary loss for tax purposes that they realized upon transfer of the assets to ConRail.

That loss would then be immediately usable, or utilizable, and would be subject either to the 5-year or, as we strongly support, the 7-year expiration period.

That would permit ConRail to have the high basis. It would permit those roads which may be different situation from the Reading to not elect this treatment and to reserve the capital loss in the form of the stock of ConRail.

Another way of doing it would be to provide that the potential loss that exists in the ConRail stock would retain the same character if and when realized in the future, as the loss would have had had it been recognized upon the sale or transfer of the asset. That is, it would be primarily—certainly in our case—be an ordinary loss, or a section 1231 loss within the framework of the code.

That concludes our formal statement, Mr. Chairman. We would be pleased to answer any questions that the committee might have.

Senator FANNIN. Thank you, Mr. Hesse and Mr. Christian. The statement made by Mr. Blanchette covering that one specific area was helpful, and I understand you are in agreement with that.

Mr. HESSE. Very much so.

Senator FANNIN. On page 9, both of you have said in your testimony, since Mr. Christian mentioned it in his oral statement, that there were suggestions made that ConRail be permitted to maintain the high basis in the assets as now provided and would also permit those railroads who do not elect to preserve the potential capital loss in the ConRail stock for the indefinite future.

How many railroads do you think would elect to use this? You said some would and some would not.

Mr. HESSE. I know only of one trustee who told me a couple of weeks ago, and that would be the Central Railway of New Jersey. There may be others. On the other hand, I would assume that an entity so large as the Penn Central, and with such tremendous ordinary tax loss carry forward, would probably elect to take the present law—Public Law 94–253, recognizing that no tax loss would occur until they disposed of their stock later on.

Senator FANNIN. Mr. Christian, did you want to elaborate?

Mr. CHRISTIAN. No, sir, I think that is true.

Senator FANNIN. You say this is consistent with the congressionally established policy that this will not be determined until 1987.

Now, that 1987 determination, does that greatly affect what your earlier reference is to the losses that would be—would that have any bearing?

Mr. HESSE. In 1987, that is when either the stock or the certificates of value are valued, and until that time, we do not know what base the stock will actually have. Of course, we will be able to turn in the certificates for value.

Senator FANNIN. This is my point.

Mr. CHRISTIAN. I think, Mr. Chairman, that the basis of the stock, the technical term of the tax basis of the stock, is determinable right now. That basis is the basis that the assets had. What Mr. Hesse was referring to is that until 1987, it will not be determined precisely what value the stock will have, not what its basis will be. Its basis is determinable.

Senator FANNIN. Thank you.

Thank you, gentlemen. If there are other members of the committee who have questions, they will be submitted to you in writing.

Mr. HESSE. We would thank you for this opportunity, Senator. Thank you.

[The prepared statement of Mr. Hesse follows:]

STATEMENT OF A. WILLIAM HESSE, JR. ON BEHALF OF THE TRUSTEES OF THE READING COMPANY

Mr. Chairman and members of the Committee. I am A. William Hesse, Jr., Chief Executive Officer to the Trustees of the Reading Company. I am accompanied by our special tax counsel, Mr. Ernest S. Christian, of the firm of Patton, Boggs & Blow.

The Reading Company operated the Reading Railroad. Its headquarters were in Philadelphia and the principal lines ran between a point near Harrisburg, Pennsylvania, east to New York Harbor, and north between Philadelphia and Williamsport, Pennsylvania, with a branch line to Wilmington, Delaware.

The Reading Company went into reorganization under section 77 of the Bankruptcy Act in 1971 and is operated by Trustees. On April 1, 1976, the railroad properties were transferred to ConRail.

We thank you for the opportunity to express our views on the tax treatment prescribed in P.L. 94–253 for the transfer of the Reading's bankrupt railroad properties into ConRail.

P.L. 94–253, as signed into law on March 31, 1976, provides that the tax basis of the railroad properties transferred shall be the same in ConRail's hands as it had been in the hands of the transferor railroad corporations. The Reading had a tax basis in those assets far in excess of the amount received from ConRail. The carryover to ConRail of this high tax basis will permit ConRail to take much greater depreciation deductions, will shield it from possible capital gains on distributions of assets, and in the future could contribute to its success. Assisting ConRail to become financially self-sufficient was the purpose of the special tax legislation. However, not only was the tax basis carried over to ConRail, but P.L. 94–253 further provided that the Reading and the other transferors would not be permitted to recognize, as a tax loss, the loss they realized upon the transfer.

We objected to being denied our loss when P.L. 94–253 was under consideration. We reiterate that objection today. The only rationale for denying Reading's loss was that under general rules of taxation basis carriers over to the transferee only if the transferor does not recognize gain or loss.

But we firmly believe that consistency with that general rule cannot logically be invoked to deny the Reading its tax loss. In providing a special carryover of basis for ConRail, P.L. 94–253 has already departed from the general rules.

P.L. 94–253 was not considered by this Committee in public hearings. That is the opportunity we have for the first time today. Thus, while P.L. 94–253 settled the matter of ConRail's tax basis in the railroad properties, that legislation should not be considered dispositive of whether the tax losses should be recognized to the Reading and the other transferor railroad corporations.

We, therefore, urge a further amendment to the Internal Revenue Code to permit the Reading, and others who wish, to recognize the tax loss realized upon the transfer of railroad properties to ConRail.

The final system plan and the effect on the transferor railroads

The Final System Plan was devised by the United States Railway Association and approved by the Congress to restructure the bankrupt Northeast and Midwest railroads into a "financially self-sustaining rail system."

On April 1, 1976, the Reading and others complied with the Final System Plan by transferring railroad properties to ConRail. In exchange, they received ConRail stock and certain guarantee instruments from U.S.R.A. which are referred to as Certificates of Value. These certificates merely represent a guarantee that eleven years hence, in 1987, the ConRail stock will have a value equal to the minimum award to the railroads in payment for their assets. Today, the value of the ConRail stock is only a small fraction of that amount.

In the case of the Reading, we are to receive for our own account ConRail stock with an assumed value in 1987 of not less than $22 million. ConRail has also undertaken equipment obligations of $7 million and certain other presently uncalculated obligations.

Since the tax basis of the assets transferred by the Reading to ConRail in exchange for ConRail stock was approximately $208 million, we have sustained a loss on the transfer of between $175 and $180 million.

Under the Code prior to P.L. 94–253, nearly all that loss is an ordinary loss, not a capital loss. However, P.L. 94–253 not only precluded us from recognizing that loss for tax purposes, it also converted that ordinary loss into a capital loss that can only be realized in the future by sale of ConRail stock. Also, capital losses are by definition less valuable than ordinary losses.

P.L. 94–253 also provided that since Reading would not be permitted to recognize its ordinary tax loss, Reading would have a basis in the ConRail stock equal to its former basis in the assets. If the Reading sold its ConRail stock, theoretically it would have a capital loss equal to its ordinary loss on the assets, but a capital loss is of little practical benefit to the Reading.

—In the circumstances of the Reading—which must be recognized as different from some other larger bankrupt railroads—the practical effect is to extinguish the Reading's $175 to $180 million tax loss and permanently deny the Reading, its creditors, and its stockholders any benefit from the loss.

Need to recognize different effects on transferors

We do not object to assisting ConRail by permitting it to obtain the high tax basis in the transferred assets. We—like the other bankrupt railroads that have received ConRail stock—have an interest in its success.

We also realize that some transferor railroad corporations may not wish to recognize the ordinary loss on the transfer of assets and would be more benefitted by P.L. 94-253 which builds into the ConRail stock a potential future capital loss of the same magnitude.

The deficiency of P.L. 94-253 is apparent. Its effect will vary dramatically according to the amount of net operating losses and the capability of a transferor railroad corporation to offset resulting capital losses against capital gains.

Transferor railroads with very large eixsting net operating loss carryovers which will expire within five years unless used to offset ordinary income, may not wish to add to those large net operating loss carryovers by now recognizing the additional ordinary loss on the transfer of assets. Those additional losses might expire unused. Such a railroad—which may be the predominant position—might prefer to preserve the loss for the indefinite future by transferring the basis to the ConRail stock. Certainly, a future capital loss is better than an unusable ordinary loss that will expire. Some of the transferor railroads which have retained substantial non-rail properties may, in fact, be in a position to utilize a capital loss in the future.

Further, since under another special rule in P.L. 94-253, existing net operating losses can be used in the indefinite future to offset any income from additional awards from the Special Court established to adjudicate value and claims, transferor railroads with very large existing net operating loss carryovers have no need of additional ordinary losses to offset those awards.

The Reading, however, has an existing net operating loss carryover of only $55 million. The ability to use that loss, plus the additional $175 to $180 million ordinary loss from the transfer of assets to ConRail represents a realistic way in which the Reading could continue as an operating company and have a reasonable chance of paying claims of creditors.

The amounts which the Reading Trustees and their counsel believe there is a realistic prospect of recovering in further litigation are approximately $140 million. To the extent that those recoveries are ordinary income, the Reading will need loss carryovers to offset them. Hence, all of the existing carryovers, or more, may be needed for this purpose alone.

To the extent not needed to offset future litigation recoveries, the Reading has been exploring the possibility of using both its existing net operating loss carryovers and the tax loss from transfer of the railroad properties. The basic plan calls for the Reading to acquire profitable, stable, relatively debt-free companies. The purchase price should require a small initial cash payment by the Reading Company coupled with an installment note.

Once a program of acquisitions has commenced, the profits and cash flow from early acquisitions can be used to finance additional ones. Depending on the time available to use the losses, it is possible that a large portion of the losses could be used to help mitigate the deficiencies which would otherwise eventually be suffered by the Reading's creditors.

The plan involves the Reading itself making acquisitions, with its shareholders, bondholders and creditors benefitting as the profits and acquisitions enhance the Reading's value. The Trustees do not intend to try to market the Reading's losses.

The need for such a program and the justice in making it possible is apparent from the Reading's current situation. At the transfer date of April 1, 1976 the Reading's liabilities exceeded the market value of remaining assets by at least $80 million. If the Trustees are successful in utilizing the $175 to $180 million of tax loss carryforwards arising from the transfer of assets to ConRail, all creditors might be paid including accrued interest.

This is just and carriers out the whole social purpose of the Congress to encourage the reorganization of financially troubled entities.

The Reading's suggested approach

Such result can best be achieved either by allowing the transferor railroad to *elect* to have gain or losses recognized upon transfer of its assets, or by providing that the securities received by the transferor railroad take on the same character for tax gain or loss purposes as the transferred assets which were primarily section 1231 assets.

The first approach would permit ConRail to maintain the high basis in the assets as now provided and would also permit those railroads who do not elect to preserve the potential capital loss in the ConRail stock for the indefinite future. At the same time, Reading could elect to recognize an ordinary loss immediately upon transfer of the assets and be able to carry out the plan for utilizing the loss and satisfying the claims of creditors.

The second approach also permits ConRail to maintain the high basis in the assets, is most consistent with the Congressionally-established policy that the total value received by the transferors of the railroad properties will not be determined until 1987, and permits the essential flexibility for differently situated transferor railroad corporations.

Both equity and the spirit of the Railroad Revitalization and Regulatory Reform Act of 1976 demand an amendment to the Internal Revenue Code in one of the two ways we have suggested.

I thank the Committee for its attention.

Once a program of acquisitions has commenced, the profits and cash flow from early acquisitions can be used to finance additional ones. Depending on the time available to use the losses, it is possible that a large portion of the losses could be used to help mitigate the deficiencies which would otherwise eventually be suffered by the Reading's creditors.

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This is just and carries out the whole social purpose of the Congress to encourage the reorganization of financially troubled entities.

Senator Fannin. The next witness this morning is Dr. William Perrault, president, National Association of State Lotteries, accompanied by Edward Powers, executive director, New Hampshire Sweepstakes Commission, and John Winchester, executive director, Connecticut State Lottery, and vice president, National Association of State Lotteries. There are four gentlemen here this morning.

Would you identify the other gentlemen with you?

PANEL OF DR. WILLIAM PERRAULT, PRESIDENT, NATIONAL ASSOCIATION OF STATE LOTTERIES; EDWARD POWERS, EXECUTIVE DIRECTOR, NEW HAMPSHIRE SWEEPSTAKES COMMISSION; JOHN WINCHESTER, EXECUTIVE DIRECTOR, CONNECTICUT STATE LOTTERY, AND VICE PRESIDENT, NATIONAL ASSOCIATION OF STATE LOTTERIES; AND RALPH F. BATCH, DIRECTOR, ILLINOIS STATE LOTTERY

Dr. Perrault. To my extreme left is Mr. Ralph Batch, who is director of the Illinois State Lottery; John Winchester, the executive director of the Connecticut State Lottery; and Edward Powers, the director of the New Hampshire State Lottery.

Senator FANNIN. Your complete statement will be made part of the record.

Dr. PERRAULT. Thank you. Mr. Chairman, members of the committee, members of the committee staff, ladies and gentlemen.

I wish to thank you, on behalf of the thirteen States represented here today by the National Association of State Lotteries, for this opportunity to present our views regarding section 1207 of the proposed Tax Reform Act of 1975, H.R. 10612.

We strongly oppose passage of the bill.

Section 1207 would amend section 3402 of the Internal Revenue Code to provide that:

(1) Proceeds of more than $1,000 from a wagering transaction, if the proceeds are at least 300 times the amount wagered, and

(2) All prizes of more than $1,000 awarded by a State lottery, shall be subject to a withholding tax of 20 percent of the total prize paid.

This bill grossly discriminates against State lotteries. It singles out the payment of a prize for withholding—but no such requirement exists or is proposed for payments of dividends, interest, stockmarket transactions, or any other similar financial transactions.

Yet there is no evidence that lottery winners are less likely to pay taxes than any other group. The Internal Revenue Service itself admits that they have at least 85 percent compliance and have Information Returns, form No. 1099, with the names, addresses, and social security numbers of all who might fail to pay. The lotteries themselves maintain records of everyone who wins more than a few dollars. These records are available to the Service at any time.

The bill even discriminates among types of gambling transactions. All State lottery prizes of $1,000 or more are to be subject to withholding. Yet winnings in all other forms of gambling are subject to withholding only if they are over $1,000 and if they are at least 300 times the amount bet. Thus, under the bill if I bet $1,000 at a race track or casino—and win $250,000—there will be no withholding. The bill favors private gambling for private profit and discriminates against State lotteries whose profits benefit the public, an anomalous result.

The 13 State lotteries have been established to raise badly needed revenue for public purposes, and to attempt to impact illegal gambling. In 1976 these lotteries will gross approximately $2 billion and net $800 million for public purposes such as education, medical care, aid to senior citizens, and reduction of local property taxes.

Passage of this unnecessary bill will hurt us in many ways, and provide little or no aid to the Federal Government.

It will significantly increase the cost of operating lotteries. We will have to hire additional staff and devote expensive computer resources to administer withholding. Every dollar spent on overhead is one less dollar for education, medical care, and other public causes supported by lotteries.

The bill will make it even harder for us to compete with organized crime. People who win lottery prizes know they must pay taxes—and do pay them—but at least they have the pleasure and satisfaction of receiving a check for the full amount of their prize. If this bill passes, however, even that pleasure will be taken away—and more people will be encouraged to gamble illegally—paying no taxes at all. Thus the bill will hurt the lotteries. And it will hurt the Federal Government, because if illegal, tax-free gambling is encouraged, less and not more, taxes will be collected.

Our surveys prove that the public is opposed to this bill. They want and demand to receive the full amount of their prize and then pay taxes. They strongly resent any attempt to hand them $8,000 when they have won $10,000. They want to at least see and hold the whole prize before paying their taxes.

The fact is that in every other major nation conducting lotteries, whether Canada, Britain, or others, lottery prizes are completely tax free, because the ticket buyer contributes so heavily to the public purse by buying tickets and to discourage illegal gambling. If we are truly serious about destroying organized crime, which the FBI states relies heavily on gambling for its power, we will place fewer burdens on legal gambling, not greater ones.

Until recently lotteries have not operated games which compete directly with organized crime. Now, however, New Jersey, Rhode Island, and Massachusetts offer a daily numbers game in direct competition with the illegal game. Other States will soon follow. These legal alternatives will offer prizes equal to or better than those offered by illegal operators. These games offer competitive odds, player selection of number played and type and amount of bet, daily action and daily payoff, easy access to a large number of convenient betting locations, and potentially even the ability to place a bet by telephone. They offer everything the illegal game features—plus total integrity and legality.

For the first time, the objective of severely impacting illegal gambling is within our grasp. This can be done by coupling an attractive, competitive, legal product with strong enforcement of the laws against illegal gambling. The proposed withholding tax will hurt us; it is an extremely strong ally of illegal gambling and severely discriminates against legal wagering operations and those individuals gambling under legal auspices.

The Commission on the Review of the National Policy on Gambling, established by Congress to study all forms of wagering, will report its findings to Congress this fall. The distinguished members of the Commission and its able staff have studied all aspects of gambling in depth for a number of years and will recommend to Congress a comprehensive policy, including recommendations with respect to Federal taxation of lottery winnings.

The State lotteries believe that Congress should wait until the Commission reports before imposing new tax laws which will make it more difficult for the States to raise revenue and combat crime by means of legalized gambling.

The proposed withholding tax is a bad bill. It is not needed by the Federal Government to collect taxes. It discriminates against legal gambling and particularly discriminates against State lotteries. It makes illegal gambling more attractive and encourages organized crime—and in the long run, by hurting State lotteries will reduce the revenue collected by the Federal Government. It inhibits the rights of the States to use lotteries to raise needed revenue and relieve the burdens of the property tax. It is ill conceived and does not have the benefit of the report of the National Gambling Commission. On behalf of the 13 States who are members of the National Association of State Lotteries, I respectfully recommend that it be deleted from the Tax Reform Act of 1975.

Thank you.

Senator FANNIN. Thank you, Dr. Perrault. I am wondering how many of the 13 States that do have lotteries have State laws that require the deduction of the amount of payments?

Dr. PERRAULT. No States currently have that legislation.

Senator FANNIN. Do you know whether or not any of the States that have parimutuels do so? Perhaps I should get that answer from somebody else. I just wondered if you had knowledge of whether or not in the instance of horseracing and dogracing, whether or not they have the requirement of tax withholding.

Dr. PERRAULT. None of either the lotteries or the parimutuels withhold.

Senator FANNIN. It is your testimony that you feel this will be detrimental from the whole concept of these services, and it would also result in the gambling that—illegal gambling—going forward to a greater extent?

Dr. PERRAULT. That is correct.

Senator FANNIN. And you also state that passage of this unnecessary bill will be damaging in many ways, and will provide little or no aid to the Federal Government. You are talking about revenue to the Federal Government, and you bring out in your testimony the change of the attitude of the public, and you anticipate that would result in fewer bets being placed?

Dr. PERRAULT. Yes; which would result in less taxes for the Federal Government.

Senator FANNIN. Do you have any basis for that assumption rather than just the reluctance of people who participate where the Federal Government is going to make a collection?

Dr. PERRAULT. The Federal Government currently is getting those payments, but this legislation would require that that be taken off ahead of time.

Senator FANNIN. I understand. We assume that people do pay their taxes, and of course, we do have the finest tax program in the world.

Dr. PERRAULT. I think an example of that might be provided by Mr. Powers, who has had reaction of the public in New Hampshire.

Mr. POWERS. Yes, Mr. Chairman. We have mentioned this legislation at our drawings, and we have 400 to 500 people at every drawing on each Friday morning. Almost unanimously, the persons in attendance have been very much opposed to this legislation, and very much concerned that they might have their winnings withheld at the time the check is offered and they want to sign a petition, and letters have been coming into your committee indicating their opposition.

Also, in many of the State lotteries, for example, they award automobiles or vacation trips as bonus prizes, and this would be a great concern to the winners. If they want a car, they have to immediately have a tax withheld.

So that we feel the lottery players in the States almost unanimously oppose this type of leigslation, and the disadvantages far outweigh any benefits to the Federal Government.

Senator FANNIN. I did not realize that we had 13 States that had lotteries. Have most of them been scheduled in the last 10 years?

Dr. PERRAULT. Since about 1971, and this represents in excess of 80 million people in the United States. That is continuing to expand as far as the future is concerned.

Senator FANNIN. Continuing to expand? Did any States come into it last year.

Dr. PERRAULT. No; none last year.

Mr. POWERS. Mr. Chairman, it actually has been underway since 1964, and New York started in 1967.

Dr. PERRAULT. Delaware did get in this last year.

Senator FANNIN. If other members have questions, they will submit them to you. We appreciate your testimony and response this morning. Sometimes, this becomes controversial, and there may be questions from the other members.

Thank you, gentlemen, very much.

[The prepared statement of Dr. Perrault follows:]

STATEMENT OF DR. WILLIAM E. PERRAULT, PRESIDENT OF THE NATIONAL ASSOCIATION OF STATE LOTTERIES, AND EXECUTIVE DIRECTOR OF THE MASSACHUSETTS STATE LOTTERY COMMISSION

Mr. Chairman, members of the committee, members of the committee staff, ladies and gentlemen. I wish to thank you, on behalf of the 13 States represented here today by the National Association of State Lotteries, for this opportunity to present our views regarding section 1207 of the proposed Tax Reform Act of 1975, H.R. 10612.

We strongly oppose passage of the bill.

Section 1207 would amend section 3402 of the Internal Revenue Code to provide that: (1) Proceeds of more than $1,000 from a wagering transaction, if the proceeds are at least 300 times the amount wagered, and (2) All prizes of more than $1,000 awarded by a State lottery, shall be subject to a withholding tax of 20% of the total prize paid.

This bill grossly discriminates against State Lotteries. It singles out the payment of a prize for withholding—but no such requirement exists or is proposed for payments of dividends, interest, stockmarket transactions, or any other similar financial transactions.

Yet there is no evidence that lottery winners are less likely to pay taxes than any other group. The Internal Revenue Service itself admits that they have at least 85% compliance and have Information Returns, Form #1099, with the names, addresses and social security numbers of all who might fail to pay. The lotteries themselves maintain records of everyone who wins more than a few dollars. These records are available to the Service at any time.

The bill even discriminates among types of gambling transactions. All state lottery prizes of $1,000.00 or nore are to be subject to withholding. Yet winnings in all other forms of gambling are subject to withholding only if they are over $1,000 and if they are at least 300 times the amount bet. Thus, under the bill if I bet $1,000 at a race track or casino—and win $250,000—there will be no withholding. The bill favors private gambling for private profit and discriminates against state lotteries whose profits benefit the public an anomolous result.

The thirteen states I represent here today are unable to comprehend the logic or the policy underlying this bill.

The thirteen state lotteries have been established to raise badly needed revenue for public purposes, and to attempt to impact illegal gambling. In 1976 these lotteries will gross approximately $2 billion and net $800 million for public purposes such as education, medical care, aid to senior citizens and reduction of local property taxes.

Passage of this unnecessary bill will hurt us in many ways, and provide little or no aid to the Federal Government.

It will significantly increase the cost of operating lotteries. We will have to hire additional staff and devote expensive computer resources to administer withholding. Every dollar spent on overhead is one less dollar for education, medical care and other public causes supported by lotteries.

The bill will make it even harder for us to compete with organized crime. People who win lottery prizes know they must pay taxes—and do pay them—but at least they have the pleasure and satisfaction of receiving a check for the full amount of their prize. If this bill passes, however, even that pleasure will be taken away—and more people will be encouraged to gamble illegally—paying no taxes at all. Thus the bill will hurt the lotteries. And it will hurt the Federal Government, because if illegal, tax-free gambling is encouraged, less, and not more, taxes will be collected.

Our surveys prove that the public is opposed to this bill. They want and demand to receive the full amount of their prize and then pay taxes. They strongly resent any attempt to hand them $8,000 when they have won $10,000. They want to at least see and hold the whole prize before paying their taxes.

The fact is that in every other major nation conducting lotteries, whether Canada, Britain, or others, lottery prizes are completely tax free, because the ticket buyer contributes so heavily to the public purse by buying tickets and to discourage illegal gambling. If we are truly serious about destroying organized crime, which the FBI states relies heavily on gambling for its power, we will place fewer burdens on legal gambling, not greater ones.

Until recently lotteries have not operated games which compete directly with organized crime. Now, however, New Jersey, Rhode Island, and Massachusetts offer a daily numbers game in direct competition with the illegal game. Other states will soon follow. These legal alternatives will offer prizes equal to or better than those offered by illegal operators. These games offer competitive odds, player selection of number played and type and amount of bet, daily action and daily pay-off, easy access to a large number of convenient betting locations, and potentially even the ability to place a bet by telephone. They offer everything the illegal game features—plus total integrity and legality.

For the first time the objective of severely impacting illegal gambling is within our grasp. This can be done by coupling an attractive, competitive, legal product with strong enforcement of the laws against illegal gambling. The proposed withholding tax will hurt us. It is an extremely strong ally of illegal gambling and severely discriminates against legal wagering operations and those individuals gambling under legal auspices.

The Commission on the Review of the National Policy on Gambling, established by Congress to study all forms of wagering, will report its findings to Congress this fall. The distinguished members of the Commission and its able staff have studied all aspects of gambling in depth for a number of years and will recommend to Congress a comprehensive policy, including recommendations with respect to Federal Taxation of Lottery winnings.

The state lotteries believe that Congress should wait until the Commission reports before imposing new tax laws which will make it more difficult for the states to raise revenue and combat crime by means of legalized gambling.

The proposed withholding tax is a bad bill. It is not needed by the Federal Government to collect taxes. It discriminates against legal gambling and particularly discriminates against state lotteries. It makes illegal gambling more attractive and encourages organized crime—and in the long run, by hurting state lotteries will reduce the revenue collected by the Federal Government. It inhibits the rights of the states to use lotteries to raise needed revenue and relieve the burdens of the property tax. It is ill-conceived and does not have the benefit of the report of the National Gambling Commission. On behalf of the thirteen states who are members of the National Association of State Lotteries, I respectfully recommend that it be deleted from the Tax Reform Act of 1975. Thank you.

RHODE ISLAND LOTTERY,
Providence, R.I., April 5, 1976.

Senator RUSSELL LONG,
Chairman of the Senate Finance Committee, Senate Finance Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: The Rhode Island Lottery was promulgated and is regulated by the Legislative of the State of Rhode Island for the direct benefit and enjoyment of the citizens of Rhode Island.

We are operating a very successful off-line numbers game that is in direct competition with the illegal game that is so prevalent in all of our fifty states. The illegal game in Rhode Island has been so substantially affected that they have had to change their game to meet our competition. For the first time, numbers games money is being channelled for legal purposes for the benefit of the people of Rhode Island rather than for illegal purposes for the benefit of crime.

It is therefore essential that the efforts of the Rhode Island Lottery not be impaired by Congressional enactment of a withholding of 20 percent of state lottery prizes that exceeds $1,000, as contemplated by H.R. 10612 since this will obviously place us at a disadvantage to the illegal game.

We receive constant inquiries from our customers as to why state operated lotteries are not totally tax free as is the Canadian lottery and our answer is the logical premise that this is income upon which our federal government depends for revenue, part of which is returned to the various states. We, however, have no logical answer as to the imposition of a withholding tax on lottery winnings that is unique as to any other type of income that is ultimately taxed by the federal government. The Lottery would be in a position, with a withholding tax as contemplated, of being treated as though the federal govenment did not have full faith in either our operation or the conduct of our winners and this classification would be demeaning and would detract from the very high position that we now hold in the minds of our constituents in Rhode Island.

We now report to the Internal Revenue every winner in excess of $600. and it is our understanding that the payment of taxes by these winners has a high degree of compliance. There is, therefore, no logical reason for the imposition of a withholding tax.

I strongly urge the Senate Finance Committee, under your capable leadership, to remove the withholding provision from the Tax Reform Act of 1975 since the imposition of same would be detrimental to our operation, hurt the people of Rhode Island, and would inure only to the benefit of illegal gambling.

Thank you for your kind understanding.

Sincerely,

Major PETER J. O'CONNELL,
Executive Director,
Rhode Island Lottery Commission.

SWEEPSTAKES COMMISSION,
Concord, N.H., March 29, 1976.

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

DEAR CHAIRMAN LONG: Reference is made to my letter of December 10, 1975 which expressed our strong opposition to a provision in the Tax Reform Act of 1975 (H.R. 10612) which would require a 20 percent withholding tax on lottery winnings of $1,000 or more. My letter set forth the reasons for our opposition to this discriminatory legislation. It definitely interferes with the efforts of sovereign states to raise revenue.

It is my understanding that a hearing will be held by your committee on April 9, 1976. While I do not feel it is necessary to restate the many reasons for our opposition, I did want you and your committee to know that we join with the other eleven operating state lotteries, representing close to 80 million people, in requesting that you delete this provision from the Tax Reform Act.

Very truly yours,

EDWARD J. POWERS,
Executive Director.

STATEMENT OF JOHN F. WINCHESTER, EXECUTIVE DIRECTOR, LOTTERY DIVISION, COMMISSION ON SPECIAL REVENUE, STATE OF CONNECTICUT

POSITION OF THE CONNECTICUT STATE LOTTERY WITH REGARD TO THE PROPOSED 20 PERCENT WITHHOLDING ON LOTTERY WINNINGS

We are very much concerned and opposed to any form of federal income tax withholding on state lottery winnings. It is my understanding that the Tax Reform Act of 1975, presently being reviewed by the Senate Finance Committee, contains a provision for state lotteries to withhold 20 percent of any lottery winnings in excess of $1,000. This would be patently discriminatory against state-operated lotteries—such withholding does not exist on many other financial transactions, such as interest earned or dividends declared.

We are currently providing the Internal Revenue Service with lists of winners of larger prizes. By the admission of the I.R.S. itself, over 80 percent of the lottery winners voluntarily report their winnings in their individual tax returns.

Most importantly, the withholding requirement would certainly make the lotteries less attractive to the lottery players in general, and to prize winners in particular. We advertise that a winner will be presented with a check in the amount of $5,000, $10,000, etc. This, of course, is part of the thrill of winning. It would certainly be detrimental to sales if we had to advertise the withholding feature of our larger prizes.

This proposal would make it difficult to give away automobile and vacation prizes, which happen to be two of the most popular awards. The individual winning would have to pay 20 percent of the price of the prize before receiving it, and this obviously would become a burden to many winners who do not have this kind of money available for such occasions. Imagine—an individual who won an automobile appearing in Lottery Headquarters and being confronted with the fact that 20 percent of the value of that car must be paid prior to receipt of the automobile. The individual might have to go to the nearest bank to secure a loan in order to claim a prize. This obviously would become an unmanageable and unwieldy situation which would cause lottery players to desert their favorite pastime in droves.

The administrative costs of the Connecticut State Lottery would have to be dramatically increased in order to perform this withholding function, requiring separate financial records and a definite increase in clerical costs—thus reducing the revenue provided to the General Fund of the State of Connecticut.

I, therefore, recommend that this unfair and arbitrary section of the Tax Reform Act of 1975 be removed on the grounds that it would have deleterious effects on legal, state-sponsored lotteries.

STATE OF MICHIGAN,
BUREAU OF STATE LOTTERY,
Lansing, Mich., April 5, 1976.

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

DEAR SENATOR LONG: It is our understanding that your committee will soon begin deliberations on the Tax Reform Bill (H.R. 10612). We wish to express our objections to section 1207 of that bill.

As you know, state-run lotteries have had to deal with a number of antiquated laws written before the advent of the types of operations that exist now in thirteen states, including Michigan. Laws written to control illegal gambling have been applied to state-run lotteries without concern for their unique nature and purpose.

In a little more than a decade, lotteries have grown in popularity and public acceptance.

We view section 1207 of the Tax Reform Bill as unfair treatment. Many states, like Michigan, have exempted lottery winnings from state and local taxation. Obviously, this is an effort to make lotteries more of an attraction to the public.

Lottery participation is voluntary, and revenue raised by this means goes a long way toward meeting the new revenue needs of the states involved.

In Michigan, we are projecting net revenues of nearly $100 million this fiscal year (1975–76) from lottery ticket sales. While that revenue will not solve the state's budgetary problems, it is fair to say that the situation would be far worse without the lottery's contribution.

It is difficult to evaluate what effect the proposed withholding plan would have on ticket sales, but it is clearly a negative factor. At a time when we are maximizing efforts to increase revenues, any negative element must be considered a threat.

We have been advised that the rate of compliance among winners voluntarily reporting their winnings on a timely basis is high. Weighing the potential administrative burden against what would be achieved in terms of total "non-voluntary" compliance, we see little need for section 1207.

We currently report to IRS the names, addresses and social security numbers of all major prize winners, and there are thousands of those winners each year.

The paperwork involved in withholding 20 percent of the prize would be immense, not to mention impractical in the case of merchandise prizes. We conduct frequent promotions involving new cars as prizes.

We must feel that section 1207 is discriminatory, in that it singles out lottery prize winners for withholding when many forms of "windfall" income are not subject to withholding.

In summary, it is our opinion that section 1207 would unnecessarily burden lottery states and conceivably affect state revenue.

If we can provide your office with further information on this matter, we will be pleased to do so.

Sincerely,

GUS HARRISON, *Commissioner.*

STATE OF MAINE,
STATE LOTTERY COMMISSION,
Augusta, Maine, March 31, 1976.

Senator RUSSELL LONG,
Chairman, Senate Finance Committee, Dirksen Office Building,
Washington, D.C.

DEAR SENATOR LONG: It has been the sentiment and conviction of the Maine State Lottery that the effect of the proposed 20 percent withholding amendment to all legalized gaming businesses, including lotteries, would have very adverse effects.

The mandate of this Commission is that it generate to its fullest potential as great an amount of profit for the State's Treasury as is possible within the purview of the meaning of the term "lottery".

Our senior senator, Edmund S. Muskie, and our junior senator, William D. Hathaway, as well as our congressman from the second district, William H. Cohen, all have supported our view that the proposed 20 percent withholding amendment would have the effect of slowing down lottery ticket sales.

We would be honored and pleased to have these recommended sentiments, which we hereby forward to you, lend their weight as an addition to the similar sentiments which we know have been expressed to you on behalf of all other states which maintain lotteries.

I close with my sincerest appreciation for your efforts and those of the Senate Finance Committee. If you can support our view and intercede on our behalf, we shall be deeply grateful to you.

Very truly yours,

PETER J. GORMAN, *Chairman.*

Senator FANNIN. The committee is adjourned. The next hearing will be held on Tuesday, starting at 10 a.m.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene on Tuesday, April 13, 1976, at 10 a.m.]

TAX REFORM ACT OF 1975

TUESDAY, APRIL 13, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 10:07 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Byrd, Jr., of Virginia, Mondale, Bentsen, Fannin, Hansen, Dole, and Packwood.

The CHAIRMAN. Mr. Secretary, if you want to make a statement, we will be happy to hear it. Otherwise, we will ask you questions. It is up to you.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY, ACCOMPANIED BY CHARLES M. WALKER, ASSISTANT SECRETARY FOR TAX POLICY; WILLIAM M. GOLDSTEIN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY; HARVEY GALPER, ASSOCIATE DIRECTOR, OFFICE OF TAX ANALYSIS; AND VICTOR ZONANA, DEPUTY TAX LEGISLATIVE COUNSEL

Secretary SIMON. Mr. Chairman, I have a six-page statement which highlights my testimony before you at the start of these hearings, which spelled out in detail all of our proposals. They, of course, still stand.

This statement here which I won't bother reading deals with some of the highlights and some of the more important aspects in the area of capital formation, the investment tax credit, reduction of the corporate rate, the sliding scale for capital gains, and the integration of corporate and personal taxes. Then I also go into DISC. I am pleased to announce and I understand that before you is our report that we just finished over the weekend on DISC for 1974, which shows the economic benefits of this program.

Then I talk about one thing that I consider terribly important, the removing of the withholding tax on foreign investments in the United States. I frankly don't know why it was ever in there.

I conclude by saying that I have mentioned a process of continuing tax reform which will eventually and importantly lead us to a tax system which looks as though someone had constructed it on purpose, versus the tax system that we have today.

Whether I live to see that or not, it is doubtful, but we can always pursue that, at any rate.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Our colleague, Senator Tower, asked that I insert a statement of his into the record of the hearings. Senator Tower has utilized this procedure so that more public witnesses could be heard by the committee.

We all welcome Senator Tower's careful analysis, and I commend his statement to my colleagues.

[The prepared statement of Senator Tower follows:]

STATEMENT OF SENATOR JOHN TOWER

Mr. Chairman, I appreciate the opportunity to present this testimony for the Committee's consideration so that the citizens of Texas may be heard on what many consider to be the most important tax issue before the Congress in 1976.

Many excellent bills have been introduced in this Congress to correct the inequities in estate tax law brought about by inflationary pressures since 1942, when Congress last acted in regard to the estate tax exemption level. I agree with my colleagues who have introduced estate tax measures that it is past time for Congress to raise the exemption on estates to an equitable level.

Additionally, President Ford has given priority to revising the estate tax laws in order to protect the integrity of family farms and businesses which presently suffer under the antiquated formula.

Mr. Chairman, as you know, I have joined Senator Curtis in sponsorship of S. 1173, which will go a long way toward solving the problem. I will not go into its features which have already been discussed at length here, but I would like to add some comments by way of suggestion as to how we might improve the legislation.

There are, I think, a number of ways the Committee could act to reduce the burden on heirs of estates. I fully endorse the raising of the exemption to $200,000, and the marital exemption to $100,000.

In addition, there is need—as President Ford has pointed out—to allow a deferred payment of estate taxes due in order not to overburden heirs at the time the business or farm changes hands. I would urge the Committee to allow deferral of tax payment on farm estates for five years as long as the estate remained in agricultural production, and then provide for a ten to twenty year payout period on the taxes due.

In this regard, I would endorse a deduction from farm-related income for estate taxes paid on agricultural estates. This a tax expenditure which affirms farming's critical nature. It would have the advantage of encouraging the maintenance of farm estates in agricultural production, and I think this is healthy for the nation.

I believe it is essential to allow appraisal of farm estates on the basis of their agricultural use, and not on the value of land for shopping centers and housing subdivisions. Such appraisal, based on farm usage, is an additional affirmative step which is needed if we are to maintain land in agricultural production.

Mr. Chairman, a committee bill which encompasses these suggestions would most certainly reduce revenues to the Treasury which are presently gained through the existing system.

However, much of these revenues are ill-gained, in my opinion, because they derive from an exemption that is out of date by 35 years. Losses incurred by other changes I have suggested, I think, will be offset by the benefits to be gained through continued agricultural productivity.

I must stress, Mr. Chairman, that we cannot ignore the intangible benefits to be gained which cannot be tallied in dollars and cents.

By raising the exemption on estates, or by allowing deduction against farm income for taxes paid on a farm estate, we benefit the nation, by encouraging continued agricultural production—a benefit, I might add, which accrues to a world which depends on our agricultural system.

At the same time, we assist those who would stay on the farm by helping to maintain or create jobs which would otherwise be lost in the farming sector. We reinforce the strength of our rural areas by removing one of the costs which drive farm families to the cities.

Further, the action taken by your committee will serve to reaffirm our commitment to the values associated with farming and rural life. I believe very strongly, Mr. Chairman, that this legislation, by helping farm families stay on the farm, will preserve and nourish the social, religious, and family values which make America strong.

The future strength and security of this country depends to a great extent on how well we are prepared to respond to future challenges. I know that farm families are strong families, with strong family bonds between husband and wife, between parents and children. I know that farm families, perhaps even to a greater degree than in urban areas, are more stable because of their ties to the land. On America's farms you find a real commitment to the work ethic which built this country—the "can-do" attitude which marks the American character as unique.

Mr. Chairman, this country is going to lose these values as we lose our farmers. I believe this committee can help prevent that loss by enacting estate tax reform as suggested by the President and so many members of this Congress.

May I say again, it is a please to be able to contribute to this discussion and establish for the record the changes that I believe are in the best interest of this country. I believe I can say with assurance that the people of Texas believe as I do in this regard, and urge the Committee to act promptly on the proposals before it.

Thank you, Mr. Chairman.

Senator FANNIN. Mr. Secretary, it is a pleasure to have you with us again. It is always a pleasure to visit you.

I would like to ask some questions on DISC, since this is something of great interest to me, and it has been quite controversial, I know, but I think that is because it has not been understood.

Mr. Secretary, what has been the effect of the domestic international sales program?

Secretary SIMON. Our analysis, Senator Fannin, is that the DISC program helped in 1974 to the tune of $4.6 billion, and in 1976, our estimates are that it is going to promote exports of $9 billion.

Now, estimates vary and economists disagree on the number of jobs that are created from exports.

The general agreement is that in 1975 about 35,000 jobs were created for each $1 billion of exports, depending on the industry.

So, obviously, this is a very positive effect.

You know, it seems to me that there is one argument that has not been talked about sufficiently in favor of DISC, and I would just like to bring it up, since you have mentioned it.

DISC is a deferral. It is not an exclusion from taxes. It cost us about $1.3 billion in calendar year 1975, but that money will come back to use upon termination of a company's DISC status.

That is in the law. The shareholders of a DISC must pay tax on their accumulated deferred income upon termination of DISC status.

So, what are we losing when we talk about revenue? We are losing the interest, if you will, on this tax deferral for the period that it has been lent.

What are we getting in return for this? Well, facts are obvious. We get the employment benefits and the obvious balance of payments pluses. It is a point that we are not losing this money.

It is a temporary deferral.

Senator FANNIN. You feel that DISC should not be abolished?

Secretary SIMON. It has had a positive effect, and we are getting the necessary bang for the buck. I call it an efficient utilization.

Senator FANNIN. What has been the export performance of the United States with DISC relative to the rest of the world?

Secretary SIMON. Well, we go back to 1971 and we take a look at our share of the exports of industrialized countries. It had been declining for many years, but in 1971 we had 18.9 percent of the market. Today, since DISC, it is slightly above 20 percent.

Obviously, it is not all DISC that accounted for that. The floating exchange rates and the competitive position of the dollar were factors, but so was DISC as we proved in our economic analysis.

Senator FANNIN. Did DISC affect export prices and, if so, to what extent?

Secretary SIMON. There is no evidence that price decisions have been made on account of DISC, no empirical evidence of that at all.

Senator FANNIN. In the world of floating exchange rates, is it true that DISC is ineffective because any increase in exports is offset by an equivalent increase in imports?

Secretary SIMON. The overall balance has to be equilibrium. This means a credit in the surplus account is offset by a deficit in the current account, and vice versa.

Floating exchange rates have helped the United States to restore its competitive position in the world, but DISC has obviously added a kicker to our ability to export in the amount that we have shown.

You know, we have had exports grow from \$43 billion in 1971 to \$106 billion in 1975. We estimate that DISC caused \$4.6 billion of this growth in 1974. Our estimate is \$9 billion for 1975, and it might be larger by the time we finally do the reestimate in 1976.

That is beneficial when you calculate 35,000 jobs per \$1 billion of exports for calendar year 1976—you know, you are talking over a quarter million jobs.

Senator FANNIN. The revenue estimates when DISC was enacted were too low according to many people.

How can you explain that?

Secretary SIMON. Well, of course, any estimates are just that. They are estimates. They are guesses. They are judgments on human response to a program and how, indeed, individuals and businesses are going to act.

Our revenue estimates are always going to be imprecise, and DISC has proven to be much more expensive than anticipated.

There is no doubt about that. What I try to look at when I look at the precise cost of the program is what the benefits have been. You could run a cost-benefit analysis, especially taking into consideration that DISC represents a deferral and not an exclusion, and, therefore, that over a long period of time we essentially will be losing only interest on deferred tax payments. This interest lost is a cheap way to produce jobs in the United States.

Senator FANNIN. Mr. Secretary, what is the effect of the DISC on capital investment?

Secretary SIMON. Obviously, it is helpful, because the DISC program assists companies in financing where they ordinarily would not be able to finance; they would have to borrow. It has also obviously encouraged export industries.

People move in a DISC program and take advantage of export opportunities that exist in the world, where they were not doing this in 1971. Those figures are pretty dramatic.

I will submit for the record how many DISC corporations have been formed and what the experience has been.

[The information referred to follows:]

As of the end of February 1976, 8,382 corporations had elected DISC status. In 1973, 58 percent of U.S. exports were channeled through DISC. Treasury estimates indicate that, by 1977, 75 percent of all U.S. exports will be DISC related exports. Estimates suggest that DISC increased the level of U.S. exports by about $4.6 billion in the period July 1973 through June 1974.

Senator FANNIN. Thank you, Mr. Secretary. My time is up.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Mr. Secretary, I am keenly interested, as I am certain all Americans will be, in your testimony, and I am pleased also, to have this new report here on DISC, the annual report for 1974.

It bears out what you have said, that we have exports in 1974 of about $4.6 billion higher from this country than they would have been absent DISC, and the point is also made that it probably accounts for 230,000 additional jobs.

Secretary SIMON. My opinion is, Senator Hansen, that that is low.

Senator HANSEN. Your point is that that is low. What do you think it should be?

Secretary SIMON. We have used a figure of about 50,000 jobs per $1 billion of export sales in the 1974. DISC report, depending on the industry for this time period, and I think that an awful lot does happen out there in the private sector that we don't have the ability to analyze.

Senator HANSEN. I expect so.

Following along with the questions that Senator Fannin asked you, the House-passed bill eliminates agricultural products from DISC. It is my understanding that the removal of agricultural products was based on the belief that agricultural export incentives are not needed because of the high level of foreign demand for agricultural products.

This committee has heard testimony from various agricultural groups, including the Iowa beef producers and the Minnesota seed producers, who indicate that the foreign demand for their products is not significant, and the elimination of DISC benefits will make them unable to compete internationally.

This, of course, would have an adverse effect on this country's trade balance and employment.

My question is, what is your assessment of the House-passed bill in this regard?

Secretary SIMON. We don't, Senator Hansen, favor that at all. We don't think that our most important export commodity, agricultural products, should be indeed discriminated against. I would say that the House-passed provision is an emotional reaction to the shortages that occurred due to the poor weather in 1972 and 1974.

We will, God willing, once again be living in a day of surplus. Our agricultural efficiency is renowned in the world. Our ability to produce and export agricultural products is important.

Therefore, agricultural products should not be discriminated against if indeed we are going to have a DISC program.

Senator HANSEN. For a long time you have lectured this country—I choose that term and maybe it is not one you would choose, but I choose it because it seems to me you have understood perfectly well what our problems are, and I think you have been especially aware of the increasing dependencies that this country has displayed toward foreign oil which has been brought in here.

That has many ramifications, not the least of which, of course, is a very severe balance of payments problem.

Do you think that until we can get that situation turned around and reversed that it is especially important not to forgo any option this country has in order to counterbalance that outflow of money that is occurring because of our need for energy that comes in increasing amounts from foreign countries?

Secretary SIMON. Of course, counterbalancing the outflow of money is important, but our overall philosophy has been, and should always be, that we favor a free and open world trading order and increasing wherever possible our ability to export and compete in this world in every instance.

Of course, the contradiction in our energy policy here in the United States never ceases to amaze me. Some day I undoubtedly will be asked what my area of greatest failure has been and I will say that that was my inability to articulate and explain to the American people and the Congress what the energy problem is all about.

When the demagogs can beat me on this issue, that saddens me a great deal. To me, it is so fundamental that goods and services are going to be produced in this country only when they can be sold at a sufficient profit and goods that can't be sold at a profit aren't to be produced.

That is the essence of the free enterprise system. The political system is subverting it, taking advantage of the economic illiteracy that exists today.

When we get pleasure from punishing the so-called oil companies. for something we perceive they have done, something is wrong—I don't understand that masochistic tendency. As long as it exists, we are going to prefer to pay the OPEC nations blackmail for their high-priced and higher priced oil in the future, rather than pay our own producers, but don't get me started on that subject.

Senator HANSEN. My time is up.

Secretary SIMON. I am sorry I used your whole 5 minutes.

The CHAIRMAN. We will give you another chance in a few minutes, Senator.

I see in your statement that you feel that DISC is responsible for about 300,000 jobs, and that this represents, or this could be, as large in 1976, as large as $9 billion of exports.

Now, those who have been advocating and/or making speeches for the Congressional Record, advocating repeal of DISC, are estimating that we would pick up $1.5 billion in revenues for the Treasury if the DISC is repealed.

Now, does that square with your studies in this area?

Secretary SIMON. Well, that is the revenue impact, but on the other side of that, Mr. Chairman, one has to measure what economic benefits one gains from the outright deferral that exists due to the DISC program. You could do all sorts of arithmetic games, but I would prefer to say, as I did to Senator Fannin, that we have an actual revenue deferral program here—not an exclusion, but a deferral.

We are deferring $1.5 billion in calendar year 1976, but look at the jobs we are creating in the United States; look at the exports; look at the strength of the American dollar and our competitive position abroad.

The pro side of the ledger outweighs the con.

The CHAIRMAN. I want to pursue this to see if you are looking at the whole picture.

That $9 billion in extra exports jobs should entail about $500 million in additional revenue from corporate taxes to the Government. So, if there is additional revenue of about $500 million in 1976, and the Treasury revenue estimate was $1.5 billion, I would think that would have to mean that the DISC is costing us about $1 billion in gross figures.

Now, is that correct or not?

Does that take into account the income that the people make on these jobs?

Secretary SIMON. The revenue estimate for DISC does not specifically take into consideration these effects. Our overall receipt figures are, of course, based on our analysis of the state of the economy and the number of jobs created. But the DISC estimates are just that; they are estimates. We know they are imprecise, but the degree of their imprecision is not known.

The CHAIRMAN. Well, assuming that it would make up that much revenue for the Treasury, if your other assumptions are correct, it would still appear to be a somewhat inefficient way to pick up additional jobs.

When we were debating this $17 billion tax cut, the estimate was that it would pick up about 700,000 jobs.

Your people might check this with you and see if that is your estimate, but that is the way I recall it. I think I used that figure. Now, if a $17 billion revenue loss would pick up 700,000 jobs, then for a $1.5 billion revenue loss for 300,000 jobs, that is a very high price to pay per job.

Perhaps someone could compute and give us a figure of how much it costs the Treasury to have this incentive.

How much are we paying for each job in that respect?

Secretary SIMON. Yes, sir, we would be delighted to prepare that.

[The information referred to follows:]

The revenue cost (deferred tax) per job in 1976 is estimated at approximately $5,000. The revenue cost per job in the period covered by the 1974 Annual Report is about $3,000. The increased cost per export job between 1974 and 1976 is due primarily to inflation.

Secretary SIMON. I also have a memorandum which I would like to submit that goes along the lines of your question, that is a memo on the feedback results we have discussed and are touching upon right now. There is a shorter run and a longer run, and there is a matter of judgment on the specific industries that would be affected by an increase in taxes if DISC were removed. What we attempt to do, in a macro way, is take a look at our entire economic policy, all the tax adjustments, all the budget and fiscal assumptions, and the overall effect on the economy. Then one makes judgments that are terribly difficult to make, on what behavior is going to be and the response of the various sectors, which is impossible, really.

[The memorandum referred to above follows:]

FEEDBACK EFFECTS OF TAX CHANGES

I. INTRODUCTION

There has recently been a great deal of attention paid to the subject of "feedback effects," or secondary, tertiary, and "ripple" effects of tax proposals on the national economy.

It is said that traditional estimates of the revenue gains and losses of various proposed tax revisions are poor guides to policy because they fail to account for the changes in income and employment which occur as the private economy adjusts to these tax changes. If a proposal to broaden the tax base, for example, causes consumers to spend less and businesses to curtail capital expansion, these behavioral responses will tend to reduce the tax base. The result, the argument goes, is a smaller increase in revenues than revenue estimators had predicted. In extreme cases, it is argued that tax revenues will actually fall, and, more importantly, there will be a waste of resources through unemployment.

In order to assess this type of criticism, it is useful to distinguish several types of responses to tax changes. First, altered tax rules may cause changes in behavior directly by reducing the incentive to pay dividends, to hire construction labor, to buy particular products, and the like. Second, changes in total revenue may result in a change in total spendable income, thereby altering total demand for goods and services and the national rate of unemployment. Third, changes in the structure of the tax system may alter the future potential productive capacity of the economy by affecting, throughout the economy, the desire to accumulate new capital, to undertake education and advanced training, or to employ labor and capital efficiently.

The first of the feedback effects, the price effects, consist of changes in behavior attributable to the direct impact of the tax. While often there is no sound empirical basis for calculating these effects, traditional revenue estimates do incorporate such responses in those selected cases where there is broad agreement on the direction and size of the change. Examples of such estimates are (1) the change in purchases of gasoline that would accompany a change in the gasoline excise tax rate, (2) induced dividend payout accompanying the corporate integration proposals or (3) projected use of a new statutory plan, such as DISC or the proposed BSOP, which did not exist before the change in the tax law. These estimates could be improved, given more resources and greater knowledge of the relationships, and this is one source of "feedback" controversy.

However, the issue has focused primarily upon the second type of feedback, the short-run consequence of tax changes for unemployment, inflation, and revenues that accompany budgets in preparation. This issue will be discussed at some length here. Our basic conclusion is that this type of feedback should not be attributed to particular changes in the structure of the tax system. Rather, these short-run effects depend upon the overall budget position, which is carefully worked out, including these feedbacks, in present revenue estimating techniques, but there is no failure to account for feedbacks.

In a further section questions of long-run feedback are examined.. Here the proper issues are economic growth, efficiency, and the quality of life. Unemployment cannot be considered in he long-run context (although per capita income can), and while forecasts of revenue may be made it will be argued that they are largely irrelevant.

II. FEEDBACK AND NEXT YEAR'S BUDGET

A sample of the short-run concern over feedback effects may be expressed in the following way:

"Question: What will be the effect on FY 1977 social security tax receipts if the rate increase proposed by the President (from 11.7 to 12.3 percent) is *not adopted* and *if the Government does everything else as planned in the budget?*" (The italic phrase is often left unstated, but something of the sort must be assumed.)

The proper answer to this rests on the meaning of "everything else as planned." Will the Federal Reserve make no adjustment to the change in Government debt outstanding? If revenues are reduced after accounting for feedbacks, how is the greater deficit to be financed? Will an offsetting change be made in some other tax? Will debt be retired or expenditures increased?

Thus, the question of the effect of making changes in apparent isolation is not well specified—some assumption must be made about the decisions made about other policy instruments available to the Government, (including for this purpose the Federal Reserve System).

Short-run Projection of Receipts: The Feedback Effect on GNP

What are the assumptions about other policy instruments underlying Treasury projections? While they are not spelled out, they amount to this: that Government will tend to adjust its plans in light of developments to keep the economy on the path set as the objective in the budget. Thus, Treasury methods of projecting tax receipts do take into account the effect of tax law changes on the course of the economy in the short run.

The question to which such estimates are addressed is of the following kind:

"Question: What will be the effect on FY 1977 receipts from the social security tax if the increase from 11.7 percent to 12.3 percent proposed by the President is not adopted by Congress and if instead *the Government takes other measures to assure the attainment of the path of the economy projected in the budget?*"

"Answer: A decrease of $3.3 billion."

This estimate is included in the *Budget of the United States Government for Fiscal Year 1977*. According to the projections there, the total receipts in FY 1977 under existing and Administration-proposed legislation were anticipated to be $351.3 billion. The budget document provides, as well, the effects on tax receipts of each of a series of legislative changes, such as the proposed social security tax rate increase ($+3.3 billion) or the already-enacted Revenue Adjustment Act of 1975 ($−1.3 billion). These estimated receipt changes do incorporate feedback effects in that they are consistent with the path of the economy expected to result from adopting the budget.

To calculate the effect of the entire "package" of tax and expenditure plans contained in the budget requires a kind of simultaneous determination—we cannot estimate receipts until we know GNP; we cannot know GNP until we know receipts and expenditures (which are also sensitive to GNP). The approximation to this simultaneous determination is carried out by coordinated staff work of the so-called "Troika," consisting of the Office of Management and Budget, the Council of Economic Advisors and the Treasury.

The expected course of the economy under a variety of alternative fiscal and monetary options is calculated in the course of developing overall economic policy recommendations by the Administration and the Congressional budget committees. However, it seems most appropriate that decisions about the *structure* of taxes assume that the overall objectives of fiscal policy are realized. With respect to the *structure* of taxation, i.e. deductions, depreciation rules, credits, and the like, we should aim for a system which we regard as fair and which promotes the efficient use of the nation's resources. The *level* of taxes can in principle always be adjusted in a way which does not alter any given desirable structure.

Feedback and the Composition of Employment and Output in the Short Run

In some cases considerable interest is focused on the allocative effects of tax changes. For example, the application of proposed tax shelter limits to investment in real estate may be expected to alter the amount of such investment, affecting first the construction industry and then the level and price of real estate services. Another example is the investment tax credit. My making this feature of the tax system permanent at the 10 percent level we can anticipate that the level of investment in machinery and equipment will be somewhat larger than would otherwise be the case, and we may be interested in estimating the effect of this on employment in the capital goods construction industry and on the division of output between sectors which are more or less favored by this incentive.

Analysis of this type deals with the *composition* of income and employment. The methods available here are different from those used in projecting aggregate output and the associated employment and tax receipts. Short-run forecasting models, which have been designed to give the best possible estimates of the aggregate effects, are not in general designed to give reliable forecasts of the composition of income and employment. As a result, the short-run projections made by Treasury staff are usually developed by starting with a long-run analysis of the effect of tax changes on the composition of income and employment and then estimating the rate at which the adjustment to the long run takes place.

Again, the overall level of income and employment and near term tax collections do not in general depend upon these sectoral changes as some other estimates of feedback effects imply. These measures of short-term economic health depend upon the overall fiscal and monetary posture. If that posture is unchanged, structural changes will primarily shift resources around so that reduction in demand for output in one sector will be offset, perhaps completely, by increased demand elsewhere.

III. LONG-RUN ANALYSIS

Since the degree of slack cannot be forecast very far into the future, the emphasis of long-run analysis is on questions of the level and composition of productive potential in the economy. Long-run questions are also significant, however, and the tax system profoundly affects the answers.

Asking "long-run" questions also makes certain guides to tax policy more clear. It is *not* the real object of tax policy to minimize or maximize revenue flows. The basic long-run fiscal policy issues concern the fraction of the nation's resources which should be devoted to collective consumption and the fraction of the resources left in the private sector which should be redistributed through welfare and similar transfer programs. The tax system to finance the size of the public sector collectively determined to be appropriate should be designed to harmonize with the distributional objectives while interfering as little as possible with the efficient allocation of resources. The fact that a tax change would raise $X of increased revenue in 1985 is not necessarily a virtue. What is important is whether it improves the functioning and fairness of the economic system.

Capital Formation and the Rate of Growth

A concern of long-run analysis is with the effects of the fiscal system on the rate of capital accumulation and the efficiency with which the available capital stock and labor force are used. Economic analysis provides us with some presumptions about the relative effects of different policies on capital formation and efficiency.

For example, because an income tax introduces a differential between the total yield from an investment and the "after tax" yield on which the investor bases his decision there is a presumption that the capital stock is "too small." In the choice between consumption and investment, the balance is tilted toward consumption. There are investment opportunities with yields sufficiently attractive to induce people to forego some consumption, but these go unexploited because of the tax.

Another and equally serious problem is the effect of the tax system on the allocation among sectors of the investment which is made. For example, it has long been recognized that the existence of a separate corporation income tax results in a differential between the before-tax yield on investment in this and the noncorporate sector. By reallocating the present investment from the lower yield noncorporate to the higher yield corporate form, a gain in output could be obtained at no cost to the economy.

However, at this point we do not have at our disposal quantitative models of the U.S. economy which permit us to trace with confidence the comparative effects of alternative structural tax policies on capital stocks, wages, etc., over the long run. Work on remedying this lack is currently being done in the Treasury and we anticipate that this will itself be a "long-term" effort. Quantitative estimates of long-term effects which could reasonably be described as "forecasts" are not now available.

Long-run Receipts Projections

Presently, the estimate of the effect on tax receipts of such proposals as the integration of the corporation and personal income tax are based on extrapolations of trends in corporate profits, dividend payout ratios, etc. No doubt it would be desirable to have a method which determines these variables according to relationships approximating the economy's true reaction. Lacking this, it is important that we regard revenue projections of more than a year or two as rough approximations. Perhaps more important still, we should pay less attention to revenue *projections* associated with tax changes of this sort, and more attention to the effect of the provisions on the overall level of productivity of the economy.

Long-run Effects on Particular Industries or Sectors

Interestingly, it is often possible to make quantitative estimates of the effects of tax policy on particular sectors, even though the effects on aggregates such as the path of capital accumulation are not possible. The reason is that other important economic conditions can be regarded as unchanged by the tax. For example, the application of LAL to real estate would not change the general rate of return on investment or the level of wages enough to require explicit treatment. (The same would not be true for corporate integration.) For these reasons, it is often possible to calculate the probable effect of tax changes on certain cost or price levels and, by making use of the knowledge of the response of demand to these, to estimate output and employment effects.

IV. SUMMARY

Short-run Macroeconomic Effects of Tax Policy

In brief, the conclusions are that, in the context of decisions about the structure rather than the level of taxes, Treasury estimates of short-run effects of tax law changes should be governed by the following general principles:

First, the level of employment, GNP, prices, etc., is determined by the whole set of fiscal and monetary instruments. It is not generally appropriate to associate short-term employment and output effects with particular tax law changes. Exceptions are narrowly drawn proposals specifically designed to affect the timing of employment-generating demand.

Second, Treasury estimates of the receipts associated with specific tax measures, in the budget and in the course of responding to Congressional legislative proposals, should be projected on the assumption that the Administration's overall objectives for employment and GNP are achieved as laid out in the budget and periodic reviews thereof.

Long-run Effects of Tax Policy

For purposes of assessing the long-run effects of tax policy on the path of productive potential, detailed revenue estimates *per se* are not the main consideration. More important are judgments and calculations regarding the level of capital formation and efficiency of resource use.

The CHAIRMAN. Now, Mr. Secretary, we are also going to have a suggestion that we eliminate the 50-percent limitation on the taxation of earned income, and that we tax earned income at a 70-percent rate.

I was talking to a corporate executive of one of the largest companies in America, who told me his income was something in excess of $400,000, that he paid about half of that in taxes, and he also paid a State income tax, so that when you look at what the State collects and the Federal Government collects, he is paying more than half of what he earns anyway.

This man explained that he does not go in for any of these so-called shelters or tax gimmicks that people in very high brackets do, and doesn't want to.

The point he made was that if we are going to tax him at 70 percent on his earned income, he thought he would have no choice about it but to start looking around for some way that he could defer some income taxes, or one of the many things that could be done to reduce his tax liability.

Now, that tends to agree with what I have read, that people who advise folks to go into tax shelters, tend to put in their publications that unless you are paying taxes at a rate that exceeds 50 percent, that it probably wouldn't be worth your while to fool around with shelters.

The thought that occurs to me is that if we are going to tax successful people at 70 percent on what they make over $100,000, as I recall it on $100,000 you pay about 50 percent, if that is all taxable; a single person would pay $53,000 or $47,000, and he is paying 70 percent for everything above that.

Now, if that is the case, it seems to me that causes that man to shift over from that which he knows best, which would probably result in putting plants and payrolls in various counties in this Nation, and to try to find out a way he can keep some of that money, rather than pay two-thirds of it out in taxes.

That is a rather counterproductive thing to do, it seems to me. I would like to get your judgment on that. Do you think we will pick up much money for the Government if we tax earned income up to 70 percent?

Secretary SIMON. Our revenue estimates on that are approximately half a billion dollars.

The CHAIRMAN. How much?

Secretary SIMON. $500 million. There, again that is a judgmental effect. I agree with you, and I can assure you that from my experience as well in the private sector, that when you begin to approach that level of taxation, it forces you to do many inefficient and uneconomic things in order not to pay taxes—you use the rationale, "Well, my money is going to go in taxes anyway, and I might as well go ahead and do this."

This whole idea seems to be one of penalizing the albeit, politically weak and small percentage of our population that begin to approach this upper income.

What happens to incentive? Is that an immutable law of human nature? I rather believe it; a fellow who works in this great country believes that through ability and hard work he can achieve whatever heights he wishes to achieve for himself without the Government taking away all his wealth.

You know I read in the paper the other day that you now have to work through April to pay Federal, State, and local taxes. Pretty soon, if we keep it up, we will be working our way through June, half and half.

If you think you are going to get efficiency and effectiveness that way, I don't know. I would invite you, as I have on several occasions, Mr. Chairman, to take a look at something which appeared on CBS television, which I viewed with some of my people in the Treasury last night, called The Second Battle of Britain.

Perhaps we in the United States could learn a lesson from that. Sometimes I think we are beyond the ability to profit from other people's mistakes. We ought to begin to pay attention because we are heading down a very dangerous road.

The CHAIRMAN. It seems to me the rule of thumb would be that when you tax a man 70 percent on his income, that you ought to expect that he is going to spend 70 percent of his efforts trying to avoid that tax, and 30 percent trying to earn money. When a person spends that much time working at it, it stands to reason that if there is some way he can avoid taxes, then he will.

I don't know if I cited to you the classic case with which I am familiar. Here is a welder who is not taxed at 70 percent; he worked up to where he hits the 50-percent tax bracket, which is fairly easy for a welder to do nowadays.

At that point, that man arranges to be laid off and tells the union to do it; he is laid off. He doesn't want to be fired. He has something better in mind. He just wants to be laid off.

Then he proceeds to draw his unemployment insurance money for the rest of the year and he fixes up his boat and goes fishing, does some hunting when the weather gets a little colder, sits around in the tavern and talks to his friends and watches the football games on television, and when the weather gets nice after Mardi Gras time in Louisiana the man is ready to go back and work until he gets in the counterproductive tax bracket.

Then he becomes a tax eater. That is that man's way of revolting against the counterproductive tax structure.

I imagine you could multiply it by a lot of other people who find themselves discouraged by the fact of being so heavily taxed that very highly motivated people simply find that they can find some way to beat the Government; they feel the Government is being unfair to them.

Doesn't that tend to work out? I think one of the things you are missing in your assumption is that in the Treasury assumptions they seem to assume that if you tax a man at a very high rate, let's say 70 percent on one type of investment, that he will put it into some other type investment.

Do the assumptions take into account the fact that the man might go for the consumption end of it and enjoy life thinking, "What is the point of working all this hard if I can't keep but 30 cents on the dollar?"

Secretary SIMON. I agree with that. The fact of life is that a 70-percent rate makes for bad business deals, or uneconomic deals, or no deals at all, where the guy does what you said, where he says, "Why work when 70 percent of it I can't keep?"

The CHAIRMAN. People talk about seeing how he makes his money and taxing him at 70 percent. Suppose he takes the money and invests it in land and sits there and watches that land appreciate in value, especially if he buys land fairly near a metropolitan area.

How are you going to tax that income currently, tax it out in a capital gain, unless you are going to tax appreciation? Is it practical to expect the Government to go around and tax the people year by year when, due to the erosion of the value of the currency in terms of current dollars, their property is not worth 10 percent more than it was before?

Secretary SIMON. That is right.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Mr. Secretary, what do you anticipate the economy will do for the balance of the year?

Secretary SIMON. Senator Talmadge, we are in the midst of an extremely vigorous and healthy economic recovery. I think all of the business and economic indicators say that, if anything, looking back, our economic recovery came faster and a little stronger than anyone had forecast. If you are going to make errors, you would rather err on the side of being conservative.

Inflation, while still too high, is still trending downward. I believe capital spending, which always lags in a recovery will increase, and certainly in the first quarter of 1977 it will provide a strong impetus for sustaining the recovery that is underway.

Retail sales continue to be strong. The inventory to sales ratio augurs an inventory buildup underway. If anything, and it is a nice concern, if I look ahead toward the end of this year, I have to be concerned with the speed of the expansion rather than of the potential problems that some economists have suggested. That is why I continue to warn against massive deficits and about their impact on the economy next year.

Senator TALMADGE. Do you think there is a danger of getting back into double-digit inflation?

Secretary SIMON. Not presently. Our actions in the months ahead are going to determine the cost in 1977, Senator Talmadge, although some now seem to be satisfied that inflation is in the area of 6 percent.

My goodness, when one looks at the historical inflation rate in this country of 2 to 3 percent, and when one looks at long-term interest rates—and interest rates are necessary to finance jobs and expansion in this country—a 6-percent rate is intolerable. We have to work it down to what you and I would call acceptable.

Senator TALMADGE. What do you anticipate the level of unemployment will be by the end of the year?

Secretary SIMON. I think we have a very fair chance, Senator, of unemployment being under 7 percent at the end of the year.

Senator TALMADGE. What about interest rates at the end of the year?

Secretary SIMON. Inflationary expectations—I certainly don't look for an increase in interest rates. There is always going to be a premium, an inflation premium, on long-term rates.

Economists come before these committees and talk about the decline of interest rates. Well, academic economists have traditionally ignored the financial implications when they talk about interest rates.

They are talking about short-term interest rates, which are very volatile in nature, and go along with whatever the Federal Reserve policy is going to be, which has been a policy of easier money during this recovery. As Arthur Burns has said, that is how we will gain strength.

Here we are with long-term interest rates on double A bonds at a 8¾ percent rate. That is high for a business to pay. That is the prime rate.

So, we have to attack the cause of the high-interest rates, which is inflation, and we cannot take our eye off that ball, because it is going to take several years to get it back down.

We are not going to pay for the sins of a decade by a few months or a year of penance.

Senator TALMADGE. You and the chairman had a discourse about the value of DISC with respect to the value of exports.

The EEC has a value-added tax. They rebate that on all exports. What is the relative value of DISC to our exporters as compared to the VAT for a European exporter?

Secretary SIMON. I don't have a study. You would have to do that on a commodity-by-commodity basis, by country, because every country does it in a different way.

We have been able to quantify with DISC, and we have had a couple of years with DISC, what the actual employment and economic benefits are here in the United States.

The DISC report was placed on your desk this morning.

Senator TALMADGE. I think one witness testified that the DISC benefits amounted to only 3 or 4 percent of what the VAT benefit was to a European trader.

Is that in the ball park?

Secretary SIMON. That sounds low to me. I would have to know what country and what commodity he is talking about because all the VAT's are different.

Senator TALMADGE. Thank you, Mr. Chairman. I have no further questions.

The CHAIRMAN. Senator Packwood?

Excuse me for not calling on you previously. I should have called you sooner.

Senator PACKWOOD. That is OK.

A year ago you testified on the comparative rates of taxation in all of Europe versus the United States, and I think—and correct me if I am wrong—the statements that all of the countries taxed a higher percentage of the gross national product were made, but only Great Britain taxes a higher percentage of productive capital.

Is that a correct recollection of what you said?

Secretary SIMON. I am not sure that that is exactly the way it was stated when we talked about productive capital.

We know that most of the European community has already integrated corporate and personal taxes, so in that way, their taxes are indeed lower.

[Whereupon, at 10:45 a.m. the committee proceeded to the consideration of other business, and reconvened with the regular business at 10:50 a.m.]

The CHAIRMAN. Now, we will go back to our regular hearing.

Secretary SIMON. Let me, Senator Packwood, if I may, get our tax people to work on that, because I would be interested. There are various measurements of national income, GNP, and productive income, and every country is different—Sweden is an unusual one as well.

[The information referred to follows:]

TABLE 1.—TAX REVENUES AS A PERCENT OF GNP FOR SELECTED COUNTRIES, TOTAL REVENUE AND BY TYPE OF TAX ALL LEVELS OF GOVERNMENT: FEDERAL, STATE, LOCAL—1973

[All figures read as percent; bankings in parenthesis]

Country	Total	Sales and excises [1]	Social security [2]			Corporate income	Noncorporate income [3]	Property [4]	Other [5]	Total, excluding sales and excises [6]
			Total	Employer	Employee and self-employed					
Belgium	36.61 (7)	10.89 (4)	10.98 (5)	7.34 (5)	3.64 (5)	3.00 (5)	10.23 (7)	0 (13)	1.51 (9)	25.72 (6)
Canada	33.86 (8)	10.12 (6)	2.92 (12)	NA	NA	4.06 (3)	11.47 (4)	3.22 (3)	2.07 (4)	23.74 (9)
Denmark	44.14 (1)	14.38 (1)	2.33 (13)	NA	NA	1.40 (13)	22.62 (1)	1.80 (4)	1.61 (7)	29.76 (3)
France	36.54 (6)	12.24 (3)	15.17 (2)	11.60 (1)	3.57 (6)	2.24 (8)	4.03 (12)	.68 (10)	2.58 (3)	24.70 (7)
Germany (Federal Republic of)	37.30 (4)	9.39 (7)	12.88 (3)	7.74 (3)	5.14 (2)	1.90 (11)	10.91 (5)	.83 (8)	1.39 (10)	27.91 (5)
Italy	29.23 (10)	9.65 (8)	12.05 (4)	9.70 (2)	2.35 (10)	2.05 (9)	3.60 (13)	.28 (11)	1.60 (8)	19.58 (12)
Japan	22.64 (13)	3.87 (13)	4.14 (11)	2.15 (11)	1.99 (11)	4.73 (2)	6.07 (11)	1.12 (7)	2.71 (2)	18.77 (13)
Luxembourg	37.00 (5)	7.88 (10)	10.29 (6)	5.66 (6)	4.63 (4)	5.70 (1)	9.88 (8)	1.37 (6)	1.88 (5)	29.12 (4)
Netherlands	43.75 (2)	10.54 (5)	16.00 (1)	7.48 (4)	8.52 (1)	2.99 (6)	12.09 (3)	.74 (9)	1.39 (10)	33.21 (1)
Sweden	43.50 (3)	12.31 (2)	8.68 (7)	5.62 (7)	3.06 (7)	1.86 (12)	17.58 (2)	.24 (12)	2.83 (1)	31.19 (2)
Switzerland	26.38 (12)	5.69 (11)	7.20 (8)	2.52 (10)	4.68 (3)	1.99 (10)	8.87 (10)	1.48 (5)	1.15 (11)	20.69 (11)
United Kingdom	32.78 (9)	8.42 (9)	5.51 (10)	2.89 (9)	2.62 (9)	2.51 (7)	10.83 (6)	3.68 (1)	1.83 (6)	24.36 (8)
United States	27.99 (11)	4.72 (12)	6.14 (9)	3.45 (8)	2.69 (8)	3.19 (4)	9.29 (9)	3.56 (2)	1.09 (12)	23.27 (10)

[1] Includes general sales, value added, and specific excise taxes.

[2] Includes contributions of employers, employees, and self-employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or as a fixed amount per person. Thus, for the United States, this category includes contributions to the railroad retirement fund, unemployment insurance fund, workmen's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security type payments made pursuant to the Federal Insurance Contributions Act (FICA).

[3] Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

[4] Includes taxes on net wealth and immovable property. Thus, for the United States this category would largely be made up of the State and local taxes on real and personal property.

[5] Includes taxes on employers based on payroll or manpower, taxes and stamp duties on gifts, inheritances, and capital or financial transactions, and miscellaneous taxes.

[6] Computed by subtracting sales and excises from total.

Source: "Revenue Statistics of OECD Member Countries, 1965–73," pp. 73–81.

Senator PACKWOOD. I think the nearer you were moving toward is that Europe has moved toward consumption taxes, and they have tried to figure out ways to encourage capital formation, and you suggested that is something we might eventually start thinking about. Should we think of value-added tax in this country?

Secretary SIMON. I don't think you would find many economists to disagree, but you bump into lack of progressivity. From an economic point of view, yes, I would favor that, but I am a practical fellow.

Senator PACKWOOD. I am trying to find out ways of encouraging capital formation to make up revenues that this might cause the losses of in the short term. Would you be willing to trade off DISC for a reduction in the corporate profits tax?

Secretary SIMON. We didn't think that was an efficient tradeoff. I am, as you know, in favor of any measures, assuming they are efficient. So the first thing you say is, is there a better way to skin the cat and get a better bang for the buck. DISC was enacted to concentrate on export sales. A 2 percent corporate rate reduction, which certainly is beneficial to capital formation, on the other hand, would not directly address itself to this important export incentive.

Senator PACKWOOD. The question is, would it direct itself generally to more jobs and more capital formation, or are you better off, assuming you are not going to get both? Would you keep 48 percent in DISC or get rid of DISC and have a 46-percent rate?

Secretary SIMON. Again, I think that is comparing apples and oranges. Whatever the employment rate might be on the 2-percent corporate rate reduction, the 2-percent reduction produces a loss. With DISC, on the other hand, the point I made before, I think, is an important one—the $1.5 billion is not lost. It is a deferral.

We are in effect losing the interest on that amount, and so we are creating cheap jobs.

Senator PACKWOOD. Now, you want to indicate accounting losses. You say that by applying the fundamental concept of the income and the expenses of matching that income should be matched—well, I can't remember your testimony on the 17th. I wasn't here.

Are you saying that you should not have a business loss unless it can be applied against income generated from that particular type of business?

Secretary SIMON. Basically that is what the proposal is, yes, sir.

Senator PACKWOOD. What is the fairness of that? Why should a manufacturer not be able to invest his money into real estate and take the accounting loss as opposed to somebody in real estate?

Secretary SIMON. It is the general fairness of the whole tax system. At present, a person can deduct an artificial accounting loss that he has not yet realized.

Senator PACKWOOD. It is not artificial. I don't know how that word crept in. It is a legitimate loss that we allow the people in that business. If we want to encourage investment in low-cost housing, or apartment houses, why is it that you say a person in the real estate business can take a loss, but a person in the manufacturing business can't.

Secretary SIMON. I think, whether it is real estate or whatever, Senator Packwood, a transaction should be entered into on the economic merits of the deal and not on the favorable tax consequences of the investment.

Senator PACKWOOD. With respect to LAL, you are saying that if you generate your income a certain way, then it is legitimate to take an accounting loss against the income, but if you generate your income in a different way, then you can't?

Secretary SIMON. That is the difference between the passive investor and the fellow who is in the real estate business, and generating his livelihood in real estate. The so-called passive investor, if you will, who just delves into real estate, or whatever other activity that has a tax benefit, is there purely and simply for the tax benefit involved.

Senator PACKWOOD. So you like the idea of locking everything in the business they are in and saying they can take the losses in that business?

Secretary SIMON. No, indeed. I am not in favor of restricting the freedom of the individual whatsoever.

Senator PACKWOOD. But you give a great preference to those in that base.

Secretary SIMON. No. I don't think the tax system should create an incentive to go into particular areas for tax purposes only, or for very little economic reasons, which is what happens.

Senator PACKWOOD. Like municipal bonds?

Secretary SIMON. That is a tax expenditure, yes, indeed.

Senator PACKWOOD. You are for the tax consequences rather than the merits?

Secretary SIMON. That is a quid pro quo for the State and local governments to make their own financing decisions rather than the Federal Government; the Federal Government has afforded tax exemption.

Senator PACKWOOD. If a person invests in bonds, and there is a loss in the bonds——

Secretary SIMON. There usually is.

Senator PACKWOOD. You know that. The person would be allowed to take the loss if he is in the investment business.

Secretary SIMON. I don't think that is a proper comparison. The investors are the millions and millions of people in the United States, whether for their own individual account or through institutions in which they have beneficial interests. I don't think that is a proper comparison myself.

Senator PACKWOOD. Go ahead, Mr. Chairman.

The CHAIRMAN. Senator Byrd?

Senator HARRY F. BYRD of Virginia. Mr. Secretary, in your statement today I don't think you mentioned the problem or question of depreciation. Looking at it both from the point of view of the development of business and from the point of view of the Treasury Department, what do you feel is the appropriate—or what do you feel would be the appropriate depreciation rate? How should the present law be changed in that regard?

Secretary SIMON. We think the depreciation lives are approximately correct, Senator Byrd, in that they represent, to the best of our judgment and experience, the actual useful life of the particular piece of equipment that is being depreciated. There are more efficient ways and fairer ways, indeed, to provide tax benefits and capital formation incentives for corporations than by increasing the ADR.

I also think it would be difficult, as someone suggested, to justify an increase from 20 to 40 percent, again based on what the actual useful life of the equipment is. I think it would lend to jiggering, just as with the investment tax credit, an on-again/off-again movement that I think we shouldn't have in our tax system.

So I think we can defend this present system on the question of an increase in depreciation.

Senator HARRY F. BYRD of Virginia. I take it you would not favor liberalizing it like Canada has done, and as I understand England has done.

Secretary SIMON. No, sir, we would not favor that step from the present rate of depreciation.

Senator HARRY F. BYRD of Virginia. So you think the present law is about right as far as depreciation is concerned? You would leave it alone?

Secretary SIMON. Yes, sir.

Senator HARRY F. BYRD of Virginia. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Mondale?

Senator MONDALE. Mr. Secretary, the House has passed, or is about to pass, a bill that would permit funds that are returned to employees upon the termination of a pension plan to be exempt from taxation if the funds are rolled over into another pension program—in other words, the bill is trying to avoid, I think, the unintended tax on the disposition of funds where a pension plan is terminated?

A lot of that is happening now, as a result of the Pension Reform Act.

Do you favor that House-passed measure?

Secretary SIMON. Yes, sir; we do.

Senator MONDALE. My mail suggests that there is a lot of consternation around the country, and would you agree that the quicker we could pass that, the better?

Secretary SIMON. Yes, sir; I do.

Senator MONDALE. As you know, there has been a lot of activity recently here and around the country which has dealt with the reform of the estate and gift tax laws. In our area, where land values, particularly, have soared—and a lot of it as a result of inflation, the same kind of inflation that strikes small businesses and others—the result has been an increase in that old tax law with the $60,000 exemption, leading to a point where the heirs must sell the farm to pay the taxes.

In an article in the New York Times, one scholar estimates that 100,000 to 200,000 family farms a year will pass out of family ownership because of the bite of that tax. Many propose an increased exemption, a more liberalized option for the installment payment of the tax by the heirs and the possibility of evaluating a farm for farming purposes, as long as it stays a farm, to prevent wholesale sale of the farms close to the urban sprawl.

Do you favor that effort?

Secretary SIMON. You touched on three things. Overall we absolutely favor estate and gift tax reform. As you know, the proposals that President Ford has put forward include a 5-year moratorium on the payment of estate taxes attributable to a small farm or family business and then payments over a 20-year period with interest at the rate of 4 percent, rather than 7 percent, which would be extremely helpful.

The President has also recommended that the exemption be increased from $60,000 to $150,000.

I have a great deal of trouble, however, in assessing land, which really has the same characteristic wherever it is, whether you grow on it or don't, at an artificial value. I think we can give the necessary relief through the other two measures which are pretty similar to what you have suggested, so we won't have any forced sales, which is what we are trying to avoid. The proposed exemption will be helpful because the average value of small farms in this country is about $180,000.

As I mentioned when I was previously before the committee, we have also proposed a free interspousal transfer.

Senator MONDALE. Would you favor the adoption of an estate tax revision roughly along the line we are suggesting as a part of the pending tax reform proposal?

Secretary SIMON. Yes, sir.

Senator MONDALE. What do you estimate the cost of that estate tax revision to be in the next fiscal year?

Secretary SIMON. It is small, because our recommendation has a phasein.

Senator MONDALE. You step up to $150,000 over 4 years.

Secretary SIMON. For fiscal 1977, our proposals will cost slightly less than $100 million.

Senator MONDALE. Do you have the steps there?

Secretary SIMON. It goes from less than $100 million for fiscal 1977, to slightly more than $1.8 billion for fiscal 1978.

Senator MONDALE. We estimate that raising the exemption to $150,000 now would cost about $1.7 billion.

Has the President made an accommodation for that cost in his budget?

Secretary SIMON. Not for fiscal 1977.

Senator MONDALE. He has?

Secretary SIMON. No, sir.

Senator MONDALE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bentsen.

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

Mr. Secretary, I would just like to comment on something a bit afield from the hearing this morning, but very much in your jurisdiction.

That is the question of our pension reform legislation, which I felt was a very major step in protecting the savings and the pension rights to some 30 to 40 million persons.

In talking to people throughout my State, I find innumerable small pension plans were thinking of terminating, because of the reporting requirements, and because of the amount of costs that they are incurring in the way of accounting costs and actuarial costs, and I have urged time and time again for the Treasury Department and the Department of Labor to give this their immediate attention, and I have been told they are, but nevertheless, when I go back out among the folks, they will give me stacks of papers that high [indicating] telling me they have to have that in by May 1, or some other date, and that they have their local attorneys trying to decide what these regulations really mean, and they still are confused and confounded.

Now, the last thing we wanted to bring about was the termination of many good pension plans. What we were trying to set up were minimum standards, not the ideal plan, but something to protect against the aberrations where people took advantage of pension plans.

It doesn't seem to be coming out that way. We are running into the same old thing. We write so many pages of law and it gets multiplied many times over in the way of regulations and it appears extremely burdensome. I would ask that the Secretary express his concern to the people in his Department and bring us some evidence that you are simplifying the procedures.

Secretary SIMON. I just couldn't agree with you more. We seem to go to great lengths in Government to make things just as complicated as possible. We pass laws, and then in response to these laws we have to write regulations in the Labor Department and the Treasury Department, and they are regulations that really take a Philadelphia lawyer to be able to understand. It creates a terrible burden for people.

We are working in this area on a model plan that would assist the small businessman and the people who are indeed being overburdened by these regulations, but I think we need to reexamine this entire area, because it certainly is an awfully lot more complex one than we had thought.

Senator BENTSEN. We had some hearings on this, and we had small businessmen testify, and part of what you have done is in response to that, but maybe we have not gone far enough.

Secretary SIMON. Maybe we need simplification of the law itself.

Senator BENTSEN. We would be glad to have your suggestion on that. Senator Nelson and I are very much involved in pension reform, and if you will give us a recommendation, it would be helpful. A lot of these small plans are going to terminate now, and we are never going to get them back into being. I would appreciate your help.

We had one small businessman testify before us, as I recall the numbers, it was like $750 per person in the plan in reporting costs and actuarial costs and accounting costs, and now what that means with a lot of these small plans with 20 and 30 people, they are going out of business.

Secretary SIMON. Just filling out the pension forms may cost the American businessman some 130 million man-hours and all forms combined may amount to $20 billion a year. Isn't that atrocious?

Senator BENTSEN. Mr. Chairman, we could fill a football stadium several times a year with Government forms people are filling out.

Let me touch on another point there. This may be politically impossible, but I look at the situation of tax shelters and the concern over the abuse of tax shelters, the cumulative abuse by individuals. One thing that we have to keep is confidence in the tax system, and when we find someone who has a cash flow of $1 million a year or so and pays no taxes, and that is reported, we lose confidence in the tax system. So you come up with proposed limitations on artificial accounting losses, and have come up with a proposed alternative tax. Take a person on personal income today. The top tax bracket is 50 percent. I was talking to some people the other day who are knowledgeable, who advised me of one entertainer who made $12 million last year. That entertainer will pay a tax of 50 percent.

Now, if you had a risk capital situation, and a return on it, you would have a tax of 70 percent. So what you are having is a lot of people making stupid tax decisions and going into uneconomic and foolish tax shelters to get down to something like 50 percent, things they would never go into. You would really put a death knell on tax shelters that are not wise economic investments, if we could find a way politically to equate risk capital with what a wrestler or professional entertainer has to pay, who may be making as much as $1 million or $12 million a year. Would you care to comment on that?

Secretary SIMON. It is called equity, you know, Senator Bentsen. Our tax system is based on the principles of equity, simplicity, and efficiency, and nobody could accuse it of any of those three. [Laughter.]

As I said in my conclusion, the only part of my statement that I read this morning, "Let us have a true tax system that is progressive in nature and looks as though someone had constructed it on purpose."

You want equity. Why should we discriminate if a fellow has the ability to entertain the American people and make $12 million a year, fine. But we should begin to think about treating everyone as equally as we can.

You know, what results, and this is my dialog with Senator Packwood—inefficient economic decisions of people just out to beat a tax system; a misallocation of resources. It results in more condominiums, perhaps, than would be built economically, or maybe bad movies, or all sorts of other things that wouldn't occur. You know my feeling on that so far as simplification.

Months back in this hearing Senator Long said:

> You know what the Congress would do with that, simply remove all loopholes, lower the lower end down to 4 percent, because that is where the voters are, go up gradually, and keep the middle or upper income levels where they are, or higher.

That could be statutorily handled, saying that any jiggering you do at the upper end has to be met with a jiggering at the lower end. But you want to get back to the system as it started. It wasn't being used as a social and economic tool as our tax system is today, with its mass of complexities. I think simplification is an idea whose time is coming.

Senator BENTSEN. I am in effect asking if risk capital shouldn't be entitled to the same maximum amount of tax as someone who is making several million dollars a year personally.

Secretary SIMON. I agree with you, and I could make an economic case that risk capital is more economically productive than other types of income.

The CHAIRMAN. If I might interject, there are amendments being proposed to put them on the same basis by raising the maximum tax on earned income up to 70 percent.

Secretary SIMON. That is the wrong way.

The CHAIRMAN. That is the kind of thing you can predict. You might propose eliminating deductions in exchange for taxing at a lower rate. But by the time it finds its way through Congress, you will have no deductions but you will be paying at the same tax rate.

Senator BENTSEN. I understand some of the problems there.

The CHAIRMAN. Pardon my interruption.

Senator BENTSEN. I think it is not politically feasible to bring it all down to 50 percent. How much loss in revenue would you have if there was a maximum 50 percent tax as there is on personal income?

Secretary SIMON. We will supply that for the record. I am sure it would be over a billion dollars.

[The information referred to follows:]

The revenue loss if there were a maximum tax rate of 50 percent applied to unearned income (as well as earned income) would be $1½ billion for the calendar year 1976.

Senator BENTSEN. It would kill a lot of phony tax shelters if you did that.

Secretary SIMON. I would agree with that. That is in line with what Senator Long said a while ago, too.

The CHAIRMAN. Senator Dole?

Senator DOLE. Thank you, Mr. Chairman.

You may have touched on this. Does the administration place a high priority on estate tax reform?

Secretary SIMON. Yes; it does.

Senator DOLE. How do you answer the argument of Senator Kennedy and others who say this would be helpful to the extremely wealthy?

Secretary SIMON. Our separate programs are not designed for the extremely wealthy. On the contrary, the first proposal that I discussed here a couple of seconds ago, providing for deferred estate tax payments at a lower interest rate to avoid forced sales, is a tremendous advantage, but it applies in full only to estate taxes attributable to farms and small businesses valued at $300,000 or less. Our increase in the exemption from $60,000 to $150,000 is a recognition of what has occurred since 1942, in terms of inflation. The interspousal transfer is obviously of great assistance to all married taxpayers, but particularly those at the lower income levels. So I can't understand how somebody can accuse these proposals of being benefits for the rich. On the contrary, they are aimed exactly in the opposite direction.

Senator DOLE. That is my impression and my understanding after talking with a great many farmers whom I don't put in the category of being extremely wealthy. People I represent would qualify, and they don't see it as a benefit for the extremely wealthy.

Yesterday, the Government Operations Subcommittee focused on lost revenues to the Government due to underpayment of income tax attributable to underreporting of income from corporate and interest dividends.

Do you have any idea how much revenue we are talking about and how much may have been lost?

Secretary SIMON. I have read that. I am not familiar, frankly, with any work that we have done to quantify those numbers. We require the recipients of interest and dividends over a certain amount to pay, as we do many people, estimated taxpayments, and if they are seriously out of whack at the end of the year, there is a penalty.

Senator DOLE. Apparently the problem may be when the corporate dividends are actually reported. It is a computer problem, and they are underreported, and there is revenue or tax not paid on some interest by banks and some dividends by corporations.

Secretary SIMON. Well, I am sure that that problem exists. I will ask the Commissioner to what extent it exists and if he has done the computer work that is necessary to come up with a number if that indeed is a real problem. We were putting interest on dividends on computers a couple of years ago, and I assumed it was going to be done relatively mechanically.

Senator DOLE. I think it probably gets into the computer problems more than anything.

Secretary SIMON. I am sure of that.

Senator DOLE. There is talk of reducing or repealing the intangible drilling costs deduction. Again this may be a question that is based on where you are from. Some of us see that as having a rather serious impact on oil exploration. Do you share the view of some of us who are concerned about that?

Secretary SIMON. I have strong views. I come from New Jersey, and we have no oil or gas in New Jersey, but my feelings on this are well known, and they are the feelings of the President. We have done too much to this industry already. We control its prices, and it is the only sector in the economy that is continuing under controls. We should know by now what controls do: just take a look at the natural gas area of the energy business. We have removed its depletion, we jigger around with the foreign tax credit on oil companies, and now we want to start attacking the intangibles.

Some of the well-meaning people who seem to get political mileage out of making all these popular political suggestions, and it is not more than playing on the economic illiteracy of the American people, are compounding our energy problem in the United States rather than trying to assist it.

I answered this question at great length for Senator Hansen before.

Senator DOLE. Many of us haven't seen much done to improve the energy situation. We don't look upon this as any effort to help energy. We have indicated that it might be of great benefit in domestic politics, but as far as helping us find an energy supply, it does very little.

I have some other questions, Mr. Chairman.

The CHAIRMAN. Before we interrogate the Secretary further, I would like to ask the committee's pleasure on another matter.

[Discussion of another matter.]

The CHAIRMAN. Now, let's go back to the other questioning.

Senator Hansen?

Senator HANSEN. We were talking about the investment tax credit earlier, Mr. Secretary.

Let me ask you, there have been proposals made that there should be—I think these proposals largely have come from the corporations, some good sized ones, ones that have been in tough financial situations, so that they have not had taxable income against which could be credited the investment tax.

The proposal has been made that if there has been no tax liability incurred, that the investment tax credit ought to be refunded.

What is your position on that proposal?

Secretary SIMON. I think it was 2 years ago, Senator Hansen, that we proposed a refundable tax credit with a basis adjustment. I believe you are familiar with the basis adjustment. We think it was very equitable, but of course, a lot of people were affected by that because when you made a basis adjustment it helps some and hurts others.

The fact is, if my memory serves me, the 7-percent investment tax credit would have had an approximate revenue loss to the Treasury in 1976 of about $5.5 billion. The current 10 percent investment credit on eligible investment in 1976 will cost $8.3 billion and a basis adjustment would reduce the cost to Treasury by about $2.6 billion by 1980.

So, obviously, somebody was indeed benefiting.

Now, I happen to favor refundability. If the investment tax credit is a subsidy to encourage private business to buy more machinery and equipment, there are reasons why it should be refundable, so that it is of equal utility, if you will, to all businesses. If it is not refundable, it is of very little value to a new business or a growing business, which does not have the profitability at that stage to take advantage of the investment tax credit.

Also, many businesses are cyclically sensitive and cannot use the credit during down-swings. You have the temporary market disruptions; we saw the automobile companies in a temporary market disruption just a year ago.

Small business, necessarily, make irregular investments, and the utility of the investment tax credit to them absent refundability is questionable.

We think the investment tax credit is useful, and I think it has been demonstrated how useful it is because we have put it on and taken it off three times since 1962. We ought to make it of widespread utility by making it refundable.

Having said that, I would not want to go back to the corporations with unused credits and allow them to achieve what I would consider a windfall, because I don't feel we should reward inefficiency or what has happened in the past. We ought to do it prospectively to encourage additional investment for more jobs.

Yes, it would be of great utility in that way.

Senator HANSEN. I know people ofttimes talk about the tax loss through the investment tax credit. Do you have figures to show recently how much stimulus may have been given to job production and such activities as a result of the encouragement that is given business generally to invest in equipment and machines that otherwise may not have been purchased?

I know that is a pretty difficult thing to get a handle on.

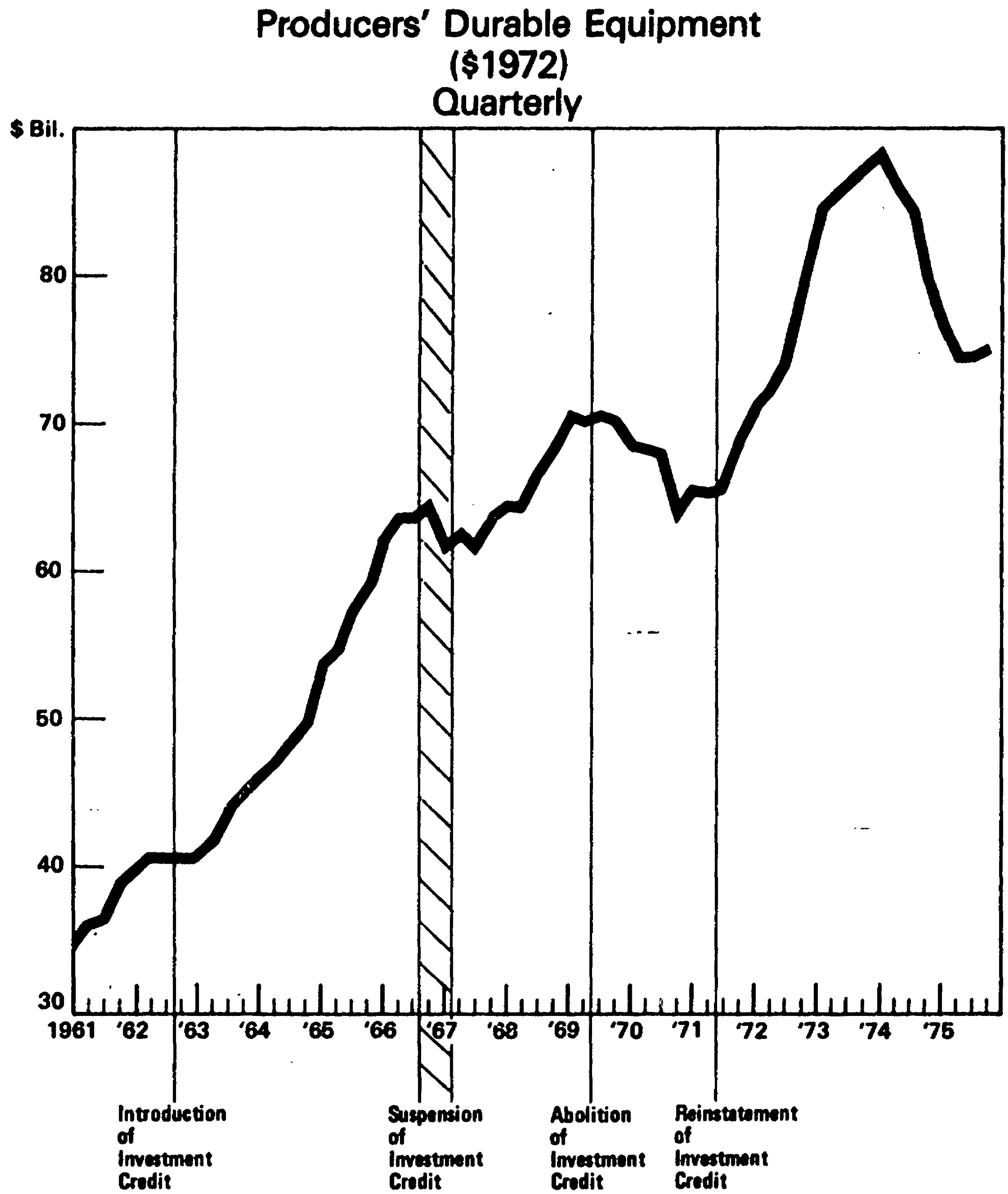
Secretary SIMON. Well, I will supply for the record the experience of the three times in the last 14 years where we have turned the credit on and shut it off, and the pattern of investment both absolutely and relative to GNP.

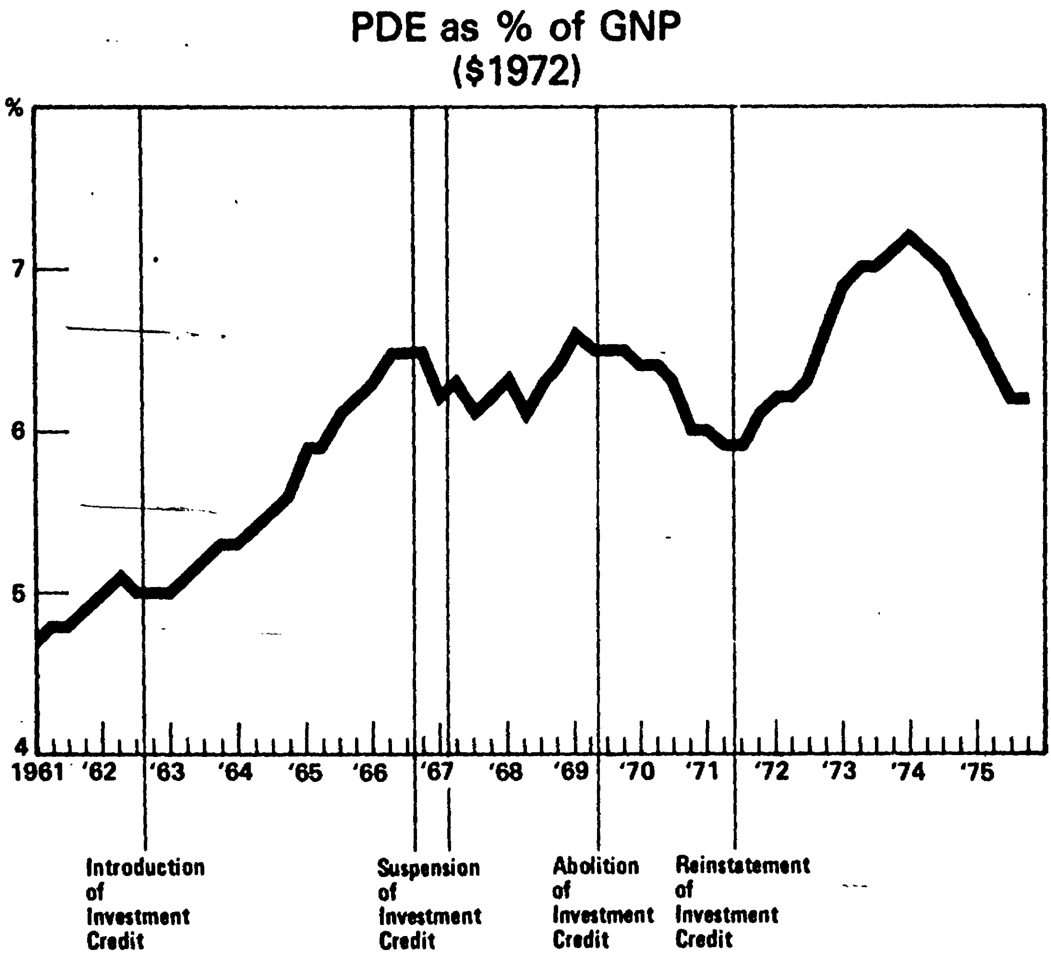
[The information referred to follows:]

The attached graphs show constant-dollar expenditures on producers' durable equipment (PDE) and these expenditures as a percentage of constant-dollar GNP by quarters for the period 1961–1975.

The investment tax credit (ITC) was introduced in the third quarter of 1962 and, as can be seen, PDE expenditures experienced a strong boom from then until 1966. The investment credit was suspended in the fourth quarter of 1966 and then reintroduced (with some liberalization) effective in the second quarter of 1967. PDE expenditures were stagnant for 1967 and then began rising, reaching a new peak in early 1969.

The ITC was removed "permamently" in the second quarter of 1969—half a year before the peak of the longest economic expansion in history. The ITC was reintroduced in the second quarter of 1971, right after the "trough" of the recession. This introduction of the credit was again followed by an investment boom which led to a record level of spending, both in real terms and as a percent of GNP. The economy entered another recession in 1974 and PDE dropped sharply, recovering only in the last half of 1975.





Senator HANSEN. Could you summarize for my benefit now generally what you think has been the positive factor?

Secretary SIMON. It has very definitely been positive, yes. The numbers escape me, frankly, as to what occurred.

Senator HANSEN. Another proposal that has been made insofar as the percentage that has been used—what is your recommendation? You favor a permanent investment tax credit; do you not?

Secretary SIMON. Yes; of 10 percent, and 12 percent under our 6-point utility program for nonoil- and gas-burning utilities.

Senator HANSEN. We have a real problem in this country, and we are conscious of it in the West where we have an abundance of various kinds of energy, and that is the pollution control devices that are being required now for installation on powerplants and that sort of thing.

What is your position as to how these improvements should be funded?

Let me say that among the various proposals that I have heard of is one that would permit a capital——

Secretary SIMON. We favor 5-year amortization on pollution control equipment.

Senator HANSEN. So they can write off at 20 percent per year.

Secretary SIMON. Yes.

Senator HANSEN. I have no further questions, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, I am pleased to hear what you said with regard to the refundable aspects of the investment tax credit.

The idea of a basis adjustment sounds like the old Long amendment. When we started out with the investment tax credit, I said it didn't make any sense to me to let a fellow depreciate 100 percent of his investment when he had been given a credit to begin with at 7 percent. That was my amendment, saying that you could only depreciate 93 points if the Government gave you a 7-percent advantage to start with.

But in due course, after giving the thing a chance to show what it could do for the economy, I was persuaded by those who came in with the Kennedy administration, including President Johnson, to give the thing a chance and see what it would do if you just let them have the 7-percent investment tax credit without reducing the basis. It proved to be something that very much stimulated the economy.

Now, having been compelled to yield on that one, when it was my own amendment, I don't think that I will insist on it as your amendment. It just seems to me that by the time people here persuaded me that my own amendment was in error, I ought to be willing to accept the view that if you want to use it as a stimulus, that it ought to be a stimulus. I don't think I could go with you on a Simon amendment which would be the same as the Long amendment because I have abandoned the Long amendment.

If we are going to do it, I think we should do it on a refundable basis for people who did not make enough profits to lay their credit against those taxes, so that it would be regarded as an incentive and a subsidy for those who are buying the equipment.

Secretary SIMON. Under that compellingly good logic, Mr. Chairman, I will withdraw the Simon amendment.

The CHAIRMAN. Well, if it wasn't like my own amendment, which I had abandoned on an earlier occasion, I would be in there fighting for it.

Now, this does concern me that people whom you want to make investments, as we do with respect to the railroads, right at the very time that you want to make those investments the most is the time of an economic downturn, and we find the credit is not available to them.

Therefore, I think they ought to have it on a refundable basis. I think we ought to consider saying at some future point that the unused credits that the companies have earned could be made good. Maybe we could say that now we have budgetary problems, but perhaps a year or two from now that they could start maybe having some of those credits made good.

If they have a good year and make a lot of money, they could take the credit. Isn't that right?

Secretary SIMON. Yes, sir.

The CHAIRMAN. And if they could look to some point at which they would be able to use the credits that they have earned, or are entitled to, but just don't have enough earnings by the limitations placed on them to take the credit, maybe we could move the refundability far enough forward so that it wouldn't interfere with the current budget and let them take it off the 5-year period in the future.

Does that appeal in any way to you?

Secretary SIMON. What you are describing is a phase in on prior credits, and obviously it would have, I think, a significant revenue impact. It would be a subsidy for specific industries, airlines and railroads, and indeed, I am sure, the Chrysler Corp. would benefit from this in a major way. That is the way it would be perceived.

I must admit that my bias is that I think refundability is fair as far as trying to accomplish everything we want the investment tax credit to accomplish, and to provide true incentive for investment.

We are doing it prospectively, and that is the best way to accomplish it.

The CHAIRMAN. I believe I am thinking on a somewhat different basis than you, Mr. Secretary. I am not talking about a credit that a person earns which has now expired because he was unable to take it.

I am talking about a credit that is currently available to him, so that if he made a good profit in this year, he could take it right now. But in a loss year, with the economy in a downturn, he might not make enough this year.

Secretary SIMON. This might be the last year of the investment tax credit from *x* years ago.

The CHAIRMAN. How far back would that be?

Staff tells me it would be 7 years back.

Secretary SIMON. It is generally 3 years back and 7 years forward.

The CHAIRMAN. Well, a 7-year-old investment tax credit, then, would expire this year.

It seems to me at least we ought to consider keeping that alive for a person so that he would have an opportunity to take it at some future point.

Now, some day we are going to start planning some countercyclical devices in these tax laws, and in effect this tends to be that in that it helps companies to make investments at a time when the economy is on a downward trend, and it occurs to me that it is not a matter of retroactivity when you say this is a credit that is available now, and it will expire at the end of the year, but at some future point it will become a refundable credit.

Secretary SIMON. Actually, the difference between what you and I are saying is that I would like to start refundability prospectively. Seven years from now we would be doing what you are suggesting now on the retroactive basis. Again, what we have to do is look at who the beneficiaries are, what the revenue loss is, and are we getting the best bang for the buck?

The CHAIRMAN. I don't like to vote for something where we leave a taxpayer believing if he does something he will be rewarded, and the taxpayer does that, he does not get the benefit out of it. The fellow who needs it the most gets left out, and the fellow who is getting the best of it——

Secretary SIMON. The fellow knew at the time he made his investment what his tax break was going to be. He made it on the existing tax law at the time. As I say, it is a small point. We both like the refundability idea. Whether or not it would be partially retroactive or all prospectively effective, that is the issue.

The CHAIRMAN. I do not think I am making my point clear. I don't think you are doing anything retroactive if you take a credit that is presently a valid credit, but which a person cannot take because he has not earned enough profits in order to take it against existing taxes, but you simply amend the law so that he can take it against some of the other taxes paid, like the social security taxes, or even on a refundable basis so long as it is a valid credit that has not expired.

I don't look on that as retroactivity, but we will discuss it later on. The other Senators should have their turn.

Senator Packwood?

Senator PACKWOOD. Bill, since you first came here as Under Secretary, I have heard you testify 100 times, and I never failed to understand what you were talking about, but I cannot understand your position on the accounting losses or in some cases actual losses that some people can write off. We are talking about real estate, buildings, and apartment houses. Under present law today, a deduction is the interest that you pay to the bank while you are building the building, and the taxes you pay on the land, even though you are getting no income from it for the moment.

That is a deduction from other income, and it is actually money that you have paid out.

Under your bill, the administration's bill, what you are saying is that if you are in the real estate business you can continue to deduct those losses against further real estate income, but you cannot deduct them from other income.

I don't understand why, because they are not artificial losses.

Secretary SIMON. Let me get my tax expert to try to explain the technicalities.

Mr. WALKER. I think the concept of matching, which is the genesis or the foundation stone of the LAL concept, is to take the items that are saying. I don't understand the merit.

Senator PACKWOOD. I understand the genesis. I understand what you are saying. I don't understand the merit.

Mr. WALKER. The merit is simply to try to handle the abuses that have been perceived and have indeed occurred in the sheltering of nonrelated income—I say "nonrelated" in the sense of not related to the investment.

Senator PACKWOOD. I understand it is not related, but what is immoral about it?

Mr. WALKER. Nothing is immoral about it.

Senator PACKWOOD. What is wrong with it?

Mr. WALKER. It is wrong in the sense that it is sheltering income from the tax burden that has been perceived to be properly due.

Senator PACKWOOD. Why don't you get at it with a minimum income tax?

Mr. WALKER. A minimum income tax or a minimum taxable income is a concept that could lend itself to that.

Senator PACKWOOD. I think the best testimony we had was from the New York Bar Association. They said:

> If you have preferences that you don't want, eliminate them, but don't get the two mixed up, and don't encourage people to do things with a preference that you think is a good idea, and then say that you won't let them deduct it and levy a tax on it anyway.

Mr. WALKER. I think the difference between the testimony you refer to and the administration's proposal is one of technique.

Senator PACKWOOD. No; Mr. Walker, it is not technique.

Mr. WALKER. Let me go on for a moment, if I might. The purpose of the tax shelter has been twofold. There have been situations where there has been an undue deferral of taxation on the one hand, and an elimination or exclusion of income on the other.

I think what the bar association mentioned was a minimum taxable income concept to get at the perceived abuses.

Senator PACKWOOD. No; that was not what they said. Use the minimum taxable income concept if you want to guarantee that everybody who has income pays tax—they don't object to that.

I can agree with that, and you won't any longer have millionaires paying no tax. But that is different from what you are saying.

Mr. WALKER. No; let me go another step or two beyond where I was, Senator.

If the bar association technique is going to close all the shelters, as I think our system has done, it would have to utilize the minimum taxable income concept to attack both the tax exclusion and the tax deferral process. This can be done, except that it arrives at the same degree of complexity and the result sought as the combination of LAL and minimum tax that we have come up with.

We have gotten into this in quite some depth, and it is our view that our proposal is the best solution to the problem.

I think the bar association people simply weren't that specific as to what items of preference they would include in their minimum taxable income approach. If they were to include the same number of preferences and to achieve the same results as those achieved under our approach, I think they would end up with the same degree of complexity and really the same results.

It is really just a question of how we go about it.

Senator PACKWOOD. Would the construction interest and taxes have a tendency to lock into the real estate business those people now in it, and it would be in my mind a discrimination against outsiders getting into it because they don't have the deferral?

Mr. WALKER. I think there is that element in it, Senator Packwood.

Senator PACKWOOD. I am talking about real money made. Let's take the depreciation that we put into law on some projects. If the project is a good idea, why should we say the only people who can take the accelerated depreciation are the people in the business? The point of the acceleration is to get money into what the social policy is.

Mr. WALKER. The answer, Senator Packwood, is that the shelter abuses that have been perceived have utilized this accelerated depreciation concept in a way that is felt not to have been fair and reasonable. Granted, however, there is a desire to increase the investment in real estate, and that is the reason for accelerated depreciation.

Senator PACKWOOD. We have passed a law saying "Please, Mr. Capitalist, put your money in low-cost housing," and the capitalist does it, and you say, "Oh, we didn't mean you. We only meant you people who are in the business."

Mr. WALKER. Just in passing, HUD wants to wait 5 years if the legislation will have an impact upon their programs, so they can find another way to stimulate various investments in low-income housing.

Senator PACKWOOD. I know my time is up.

Secretary SIMON. You talk about the passive investor whose major purpose is to escape taxes. You know, this is controversial. We have testified on this for over 3 years now, and there is no doubt about that. What we are trying to do is devise a system that is equitable, where there aren't these so-called loopholes, and there is no doubt about that. We have a system that is efficient in the allocation of resources, and the question is whether through tax benefits, whether in real estate or what-have-you, we ought to encourage the passive investors who otherwise wouldn't go into the other industry on economic grounds to invest purely for tax reasons.

Senator PACKWOOD. We did this when we passed the law. That is the only reason we set up these preferences to encourage the passive investor to get into them.

Secretary SIMON. Many have argued that it has resulted in bad housing, and more housing than we require.

Senator PACKWOOD. Maybe we ought to get rid of the preference in this case. We want intangible drilling costs written off, or do we want accelerated depreciation costs? If not, we could change it.

Secretary SIMON. Let's see the best way possible to accomplish this. We feel our approach is the best way. Obviously it is arguable.

The CHAIRMAN. Mr. Secretary, I must say that that part of it does not particularly make sense to this Senator. Here is something that is tax law which is very favorable to those who are in on it, so insiders are in and outsiders are out. If you are not in this business, you can't get in. One Senator used to say he was against any combine he wasn't in on. For the people who are not in on the combine, that is too bad.

If you are in it, you can continue to get the benefit of it. At the time you arrive at the pie counter, they told you not that there wasn't any pie left but they are closing the door.

Secretary SIMON. There is no inconsistency from the Treasury's point of view. Our original LAL proposal did not have aggregation in there. That benefits people who are in the business. But we were forced to withdraw from our position—say we outright lost. From a tax purist point of view, we would not have encouraged the tax system to provide this benefit, but I guess other proponents prevailed.

The CHAIRMAN. It seems to me that fairness would indicate that, you ought to make it sufficiently attractive so that a person could keep enough of his income so that he would work all year long in his chosen profession or with the skill that he knows best, and not go into something else because it is so much more attractive after taxes than what he is in. If you try to achieve that sort of tax uniformity and that type of tax justice to begin with, you shouldn't have to worry about the other.

If you are going to fail to do that, and if you tax 70 percent away from him, you ought to assume that logically he is going to spend 70 percent of his time finding ways to avoid taxes and the other 30 percent trying to earn more.

If that is how it is going to be, if someone is going to have some tax advantage that people in other lines of endeavor do not have, it seems to me that that is not fair, and that anybody who wants to ought to be able to go into the business. I know it doesn't make too much sense to make cattle ranchers out of lawyers and doctors, but if you are going to give the cattle rancher an advantage, you ought to give it to everybody.

That is how I was taught that the free flow of capital in this society was something that was very beneficial. If it were profitable on balance, people would go into it; and if it wasn't they wouldn't.

Senator HANSEN. If you would yield a moment——

The CHAIRMAN. I am through.

Senator HANSEN. Speaking of the cattle, a few years ago there was, great, great concern nationwide over this enormous tax loophole and the names of Oppenheimer and Blackwatch were familiar, splashed across the pages of the Wall Street Journal and the New York Times.

What happened? A lot of those guys didn't come out too well. They found out what those of us in the cow business had known for a long time, that the market could go down as well as up.

My guess is that some people in the cow business who were looking for a buyer were tickled to death that there were these loopholes at the time, because if you have something to sell, you obviously would like to have those persons possibly interested in purchasing your outfit be just as numerous as you could possibly get them.

But, you know, I think about another thing. In minimum tax I expect one of the reasons we got into that, and I remember that was about my first experience in this committee—I remember Mrs. Dodge only by reputation, but she was held up as the horrible example of what was wrong with our tax system, and here she was making income in excess of $1 million a year, as I recall it, and I think maybe there were 100 or 200 others according to some of the estimates I heard, people like her who made an income and in those amounts, who paid no income tax.

I agree completely with my friend, Senator Packwood, and with you, Mr. Chairman, that if the concept is wrong, let's change that, but, you know, I have to believe that the reason the Congress passed that law was not that there was any good economic reason for passing it, but simply because it sure made awfully good politics to get up on the stump and say, "You are going to get this person's taxes raised so we can lower yours."

As you have often said, tax reform is raising your taxes and lowering mine, and that is the appeal that this had. What wasn't said was that Mrs. Dodge helped subsidize a lot of school districts and municipalities and sewer districts all over the United States. She made it possible for people living in those communities, and in those taxing districts, to be able to afford improvements at less cost than would otherwise have been the case, or at least that is my feeling, simply because of the decisions she had made a long time ago to invest all of her money in tax-exempt bonds.

Secretary SIMON. I testified to that before this committee at that time, and was questioned verv closelv, if my memory serves me, by Senator Williams, and that is absolutely correct.

If in fact her purchase of municipal securities and holding them was a terrible investment over time, as all bonds have proven to be over time, and in inflationary periods, then indeed the beneficiary was not Mrs. Dodge.

Senator HANSEN. I think politics instead of sound economic reasoning has been gotten involved in our tax reform laws, and I think that is going to be true this year, too, Mr. Chairman. Who wants to say they are going to tax the little guy and permit the accumulation of investment capital that could indeed, and I believe will, be the greatest job promotion deal we can get going.

I take a pretty dim view of these attempts to cure the unemployment problem in this country by saying we are going to pour dough into public service jobs.

I think that to the extent we are able to give capital the encouragement that it has demonstrated a willingness to respond to, can be the way we will cure a lot of things, including inflation and including unemployment, too.

The CHAIRMAN. I want to get this straight for the record, Mr. Secretary.

In your judgment is there any moral justification for allowing someone who is in the business, let's say, of making widgets, to have a greater tax incentive and greater tax advantages than people in other lines of endeavor—but denying that right to the other people who would like to go into the business of making widgets, or investing money in the widget business?

Secretary SIMON. Our original proposal, Mr. Chairman, in attempting to close what are perceived as loopholes that generate uneconomic opportunities, did not, as I said before, including aggregation. The bill before you differs because there are those who have the muscle and got the thing changed in the Congress, not because the Treasury Department wanted it so. That is the democratic system, lobbying.

The CHAIRMAN. I hope the Department can furnish us with Treasury studies that would help in seeing whether we are making progress or not. I am amazed how complicated we made these laws with the 1969 act and even perhaps with the 1964 act.

Back during the past, during passage of those bills, there were studies which indicated that of people making more than $5 million, 23 percent of that group paid no Federal income tax.

You have some old studies back there to that effect; not in the time that you were in the Treasury, Mr. Secretary, but back under previous administrations.

Secretary SIMON. We have that celebrated 108 individuals who made in excess of $200,000 a year.

The CHAIRMAN. I think I put it in the record myself, and you have to have a Treasury study somewhere, and that may be what Hale Boggs was referring to when he said he thought there might be a taxpayer revolt.

I wish you could get that, and you may have a later study. It was impressive to me that back at that time you had people making as much as $5 million—and not just one, but a number of them apparently—who were paying us no Federal income tax.

[The study referred to follows:]

INFORMATION ON HIGH INCOME NONTAXABLE INDIVIDUALS

The last comprehensive Treasury study of individuals with high adjusted gross incomes who paid no tax was conducted on returns filed for 1970. Those findings were presented in testimony before the Joint Economic Committee on July 21, 1972 by then Under Secretary of the Treasury Edwin S. Cohen.

The tables below show, for tax years 1966 through 1974, the number of returns filed, the number of nontaxable returns filed and the percent nontaxable returns represent of all returns filed. The data for 1974 show that 244 returns with adjusted gross incomes of $200,000 or more were nontaxable. This is an increase of 120 percent over 1970 when 111 such returns were filed. However, since taxable returns with adjusted gross incomes of $200,000 or more have more than doubled since 1970, the percent of high adjusted gross income returns which are nontaxable has remained about the same, 0.78 percent in 1974 as compared with 0.73 percent in 1970. Even so, this percent has steadily increased since 1971 when nontaxable returns with adjusted gross income of $200,000 plus dropped to a low of 0.45 percent of all returns at those income levels. The sharp drop in the nontaxable fraction after 1969, when nontaxable returns equaled 1.62 percent of all high adjusted gross income returns filed, is attributed to tax reforms such as repeal of the unlimited charitable contributions deduction and imposition of the 10 percent minimum tax which were enacted in 1969.

We have not collected recent data on nontaxable returns with $5 million or more of adjusted gross income, however, there were 12 nontaxable returns with adjusted gross income of $1 million or more in 1974. They represented 1.09 percent of all returns filed in that income class.

To help place these data on nontaxable returns in perspective, there were 30,888 taxable returns with adjusted gross incomes of $200,000 or more in 1974 who paid $5.1 billion in tax, an average of $165,000; and 1,084 taxable returns with adjusted gross incomes of $1 million or more paid 1974 taxes totaling $1.1 billion, or $969,000 apiece.

Adjusted gross income class (thousands)	Number								
	1966	1967	1968	1969	1970	1971	1972	1973	1974
ALL INDIVIDUAL INCOME TAX RETURNS FILED FOR TAX YEARS 1966 THROUGH 1974 BY ADJUSTED GROSS INCOME CLASS									
0 to $100	70,107,259	71,584,888	73,646,485	75,752,277	74,202,141	74,485,387	77,458,094	80,556,944	83,173,754
$100 to $200	40,940	51,352	63,000	63,605	62,467	72,856	91,707	110,176	135,304
$200 to $500	10,004	12,738	15,467	14,786	12,830	15,089	19,233	21,929	26,842
$500 to $1,000	1,578	2,096	2,634	2,509	1,751	2,192	2,666	2,635	3,194
$1,000 or more	644	835	1,122	1,211	642	833	1,030	903	1,096
Subtotal: 200 or more	12,226	15,669	19,223	18,506	15,223	18,164	22,929	25,467	31,132
Total	70,160,425	71,651,909	73,728,708	75,834,388	74,279,831	74,576,407	77,572,730	80,692,587	83,340,190
NONTAXABLE INDIVIDUAL INCOME TAX RETURNS FILED FOR TAX YEARS 1966 THROUGH 1974									
0 to $100	13,450,982	12,978,572	12,439,462	12,112,249	14,962,060	14,659,735	16,703,288	16,424,803	16,004,457
$100 to $200	213	232	316	445	289	218	317	458	722
$200 to $500	103	104	140	188	90	67	88	142	196
$500 to $1,000	33	40	51	60	18	12	14	15	36
$1,000 or more	18	23	31	52	3	3	6	7	12
Subtotal $200 or more	154	167	222	300	111	82	108	164	244
Total	13,451,349	12,978,971	12,440,000	12,112,994	14,962,460	14,660,035	16,703,713	16,425,425	16,005,423
NONTAXABLE INDIVIDUAL INCOME TAX RETURNS AS PERCENT OF ALL INDIVIDUAL INCOME TAX RETURNS FILED FOR TAX YEARS 1966 THROUGH 1974									
0 to $100	19.19	18.13	16.89	15.99	20.16	19.68	21.56	20.39	19.24
$100 to $200	.52	.45	.50	.70	.46	.30	.35	.42	.53
$200 to $500	1.03	.82	.91	1.27	.70	.44	.46	.65	.73
$500 to $1,000	2.09	1.91	1.94	2.39	1.03	.55	.53	.57	1.13
$1,000 or more	2.80	2.75	2.76	4.29	.47	.34	.58	.78	1.09
Subtotal $200 or more	1.26	1.07	1.15	1.62	.73	.45	.47	.64	.78
Total	19.17	18.11	16.87	15.97	20.14	19.66	21.53	20.36	19.20

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

The CHAIRMAN. I don't believe that you will see that now, the horrible examples that we heard described to us. I do not believe we had one yet cited to us that there was someone making a million dollars who was not paying a Federal income tax to us. If someone makes $500,000 it does not sound good to have that person escape the Federal income tax.

Up to this point we have not been able to take the view that we are now going to tax all income no matter how earned. For example, there is a constitutional argument that the power to tax is the power to destroy, and the Federal Government does not have the right to tax an instrumentality of State government and it is my understanding that that is why we have not been taxing these State and local bond issues.

Secretary SIMON. That is *McCulloch* v. *Maryland*, if I remember my prelaw accurately, and that is correct. Even though it has never been constitutionally tested, I must believe it is a quid pro quo for State and local governments to make their own financing decisions and not have to come to the Federal Government.

I argued that case with Stanley Surrey on many occasions and lost, but we won it in the Congress in 1969.

The CHAIRMAN. If we try to tax the interest on these State and municipal bonds they are going to take it to the courts. I don't know how the Supreme Court will decide it but up to now they have not been in a position to go to court. But if the Congress has the right to exercise the power, it has the power to destroy local government with taxes.

Do you agree with that?

Secretary SIMON. Yes; I certainly do.

The CHAIRMAN. At some point, if you are going to leave any residual effect at all of the idea of home rule and the idea of people themselves controlling the Government, that the people own the Government rather than the Government owning the people, and the States formed the Union rather than the Union forming the States, then it would seem to me that you would not want to tax the interest on these State and municipal bonds.

I assume amendments will be offered to that effect. Unfortunately we have not had a hearing on that. The last time it was up, there were some suggestions that we ought to tax it indirectly. The Governors made their presentations, the mayors made their presentations, the county commissioners were heard from, the bankers were heard from, and the building and loan people and the people who buy the bonds were heard from, and the Congress—particularly the Senate—was persuaded not to have anything to do with it.

Secretary SIMON. You are absolutely correct. Being a "little bit pregnant" in this area is impossible, because the minute the camel's nose is under the tent, and you just decide that you may tax 10 percent of it, you have effectively determined your ability to tax all municipal securities. At that point whatever subsidy exists—and it now exists to the extent of about 30 percent of taxable interest rates—would disappear, and the cost of State and local governments and taxes would rise for all of us.

The CHAIRMAN. I don't see any doubt about it, but if you are going to get into it, it seems to me that if 70 percent is going to be the tax rate that some of us would want to go to, that their attitude would be logically that if that is what you want to do, this is no reason we ought to give the States and local governments a better break than our Federal bonds, and that is the 70 percent tax rate.

We can tax it if we want to do it, but I for one have not quite bought this theory that it is our duty to tax everybody the same amount regardless of how he made his money, or what he did with it.

Now, that is the point that gets us to a difference of opinion on the theory of tax expenditures. I personally regard the investment tax credit as being a tax expenditure and that is a subsidy that we are paying out of the Treasury for a designated purpose.

But when we allow somebody a rapid tax writeoff to simply take more rapid depreciation of the machinery that he buys, when we allow someone to take his depreciation in 1 year rather than on the 5-year basis, or 5 years rather than 10, I have difficulty looking upon that as a tax expenditure; and I likewise have difficulty when the tax rate varies from 70 percent down to 14 percent, that it is a tax expenditure if we fail to tax "x" percent, or the exact same percent from each taxpayer because one man has made his money one way and another man has made his money one other way; or because one man gave to a university and the other man did not.

Secretary SIMON. I agree with you. You know, what you are basically saying, Mr. Chairman, is that if depreciation recognizes an economic reality, then it is not a tax expenditure; and I happen to agree with that, personally.

Then we can argue in the individual instances as to whether or not there is an economic reality, and whether a fast writeoff is a tax break that exceeds the useful life, or what-have-you. But I basically agree with you.

The CHAIRMAN. We had a witness before us a few days ago who denounced the theory that in view of the fact that the government had a prior right to taxation, and taxing away all the earnings of its citizens, that the earnings of the people belong to the people first and to the Federal Government second.

Secretary SIMON. That is a theory that is alien in the United States, Mr. Chairman.

The CHAIRMAN. This witness has been working on a law review article on the subject, and he made the statement that this thing has been in effect a long time and that it has been applicable in this country. It goes back to the medieval times when the governor was the lord of the manor and the earnings of the serf belonged to the lord of the manor and when the lord permitted the serf to go to church an hour, that was a tax expenditure because the serf was not earning money for the lord—that is, for the lord of the manor. [Laughter.]

We have the same theory of tax expenditure in the United States back at the time when slavery was legal in some States of the Union. All of the earnings of the slave belonged to the boss, the slaveholder; and if he permitted the slave to go to church, it was a tax expenditure because the slave at that moment was not earning money for the slaveholder.

I am happy to say that so far as I know, my relatives were not slaveowners.

That concept of tax expenditures, one would think, has had its precedents here in the United States when slavery was legal, because it is clear that the earnings of the slave would have been the earnings of the master.

I don't buy that theory.

Secretary SIMON. I am not going to get into a debate on slavery, but, you know, we talk about what founded this country. We fought a war 200 years ago on this whole business of economic freedoms and taxation without representation. I think it is pretty clearly established—although it is being eroded by government right now—that it is the peoples' money, it is the peoples' freedoms, and it is the people who run this country. Our taxes represent the necessities, if you will, of life. This is not, however, the quid pro quo for the Federal Government to decide what should be done with our money, even though that is a principle worth stating.

The CHAIRMAN. I think it is our right and our duty here to tax every citizen for a fair share of the cost of supporting this Government, but I don't buy the theory—and I never will—that that is the Government's money first, and his money second.

That is just not the case.

Thank you very much, Mr. Secretary.

Secretary SIMON. Thank you, Mr. Chairman.

[The prepared statement of Secretary Simon and report follow:]

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY

Mr. Chairman and members of this distinguished Committee: On March 17, 1976 I presented to this Committee a comprehensive statement on major tax revisions and the extension of expiring tax cut provisions. All of our proposals are fully spelled out in that statement. This morning, I will simply highlight briefly some of the more important aspects of our program, and answer any questions you may have.

FAIRNESS OF TAX SYSTEM

In my March 17 statement, I indicated that a major issue before you concerns the way to enhance the fairness of the tax system. We are fortunate to have a highly successful tax system which over the years has commanded widespread respect and a high degree of voluntary compliance. We can be sure that Americans will continue to support this system so long as they have confidence that all are paying their fair share and as long as they feel they are getting their moneys' worth. Many people today feel that taxes are being imposed upon them without their consent, and that too many of their fellow taxpayers are escaping their responsibility through dozens of loopholes.

We all believe that our tax system should be fair and equitable, that it should be simple, and that it should promote efficient use of our resources. But we cannot move toward these goals if we continue to have a system which permits individuals with high economic incomes to pay little or no tax. Unabated, this practice not only undermines seriously the progressivity of the income tax, but equally important, undermines its perceived fairness.

In my previous testimony, I urged you to adopt our LAL (Limitation on Artificial Losses) proposal. The House has already done so. We believe that LAL effectively limits the principal tax benefit associated with tax shelters—deferral of tax liability—by applying the fundamental concept that the income and the expenses of generating that income should be matched.

I also referred to the problem of high-income taxpayers who do not pay their fair share of the tax because of substantial exclusions from income. We renewed, in modified form, our 1973 MTI (Minimum Taxable Income) proposal to deal with this problem. MTI is an alternative tax which will subject taxpayers to progressive income tax rates.

I am, of course, aware that over the past few weeks you have received testimony on LAL and MTI. I am generally pleased that many of the witnesses have supported the MTI alternative tax concept as opposed to the present minimum tax. There have also been proposals that would apply an alternative tax such as MTI as the sole vehicle to deal with the dual problem of deferrals of tax liability and exclusions from taxable income. The claim is made that this is simpler than the combination of LAL and MTI. I am not convinced that this s the case, but in any event, this is not the real issue. The real question for you to consider is whether these proposals deal as effectively as our recommendations with the two distinct problems of deferrals and exclusions. If these proposals are not at least as effective as ours, are you willing to say to those millions of Americans who correctly perceive tax shelters to be a tax break for sophisticated and rich taxpayers that we have opted for a less effective remedy because it may be simpler?

In this context, we should not lose sight of the fact that an ineffective solution simply means that our income tax is not as fair as it should be and that low- and middle-income taxpayers are bearing a heavier tax burden than would otherwise be possible. We continue to believe that LAL, in combination wtih MTI, will solve effectively the two distinct problems of deferrals and exclusions which have undermined the progressivity of the tax and its perceived fairness.

CAPITAL FORMATION

In the area of capital formation, I would like to emphasize again how important it is that we make some progress in removing the impediments to the process of investment in our economy. The rapid development of the U.S. economy over the years has resulted from the favorable combination of the Nation's natural resources, our productive labor force, and the efficient application of capital which has emphasized reliance on competitive market forces and profit incentives to stimulate growth and efficiency. The allocation of human and material resources has generally been left to the market rather than to unwanted government controls, although such intervention has unfortunately increased. The resulting decisions about prices and output are not the result of central planning; instead, they reflect the long-term balance between what we want and what can be supplied. The market system has served us well and it remains the key aspect of our productive economy. We must assure that the flow of new capital and its effective use are not hampered by the tax system for in the long-run we shall all be the losers if we do not.

Several of the proposals before you are designed to offset the drag on capital formation now built into the tax system. Among the steps which should be taken toward this objective are:

Make permanent the investment tax credit at its present level of 10 percent, to increase the incentive for enterprise to invest;

Reduce the top corporation tax rate from 48 to 46 percent and make permanent the other rate and exemption changes effected in 1975 to encourage investment in this sector, and to offset slightly the tax bias against corporate investment;

Adopt the President's Broadened Stock Ownership Plan to reinforce the objective that all Americans participate in the free enterprise system and thereby strengthen its economic, social and political base of support;

Adopt the sliding scale treatment for capital gains to increase the rate of capital formation and to reduce the "lock-in" effect which prevents investments from flowing to their most productive uses.

Adopt our proposal for the integration of the corporate and personal income taxes to remove fully and permanently the tax bias against corporate investment arising from the double taxation of corporate income.

We should not neglect to make progress on integrating corporate and personal income taxes. This is a very fundamental change which directly confronts the distortive effects of the tax system on the financial structure of our corporate sector, which removes fully the bias against corporate investment and which honestly recognizes that the burden of taxes is ultimately borne by people. Let us also catch up with our competitors in the world marketplace by taking the step that most of them have already taken—integration of corporate and personal income taxes.

These measures are not designed to produce mere shortrun stimulus. They should themselves be regarded as investments—investments in a prosperous future of higher wages, better jobs, and an economy with the muscle we shall need to do the things we want to do as a Nation.

BROADENED STOCK OWNERSHIP PROPOSAL

More specifically, we are very enthusiastic about the prospect of adoption of our Broadened Stock Ownership Proposal which I discussed in detail on March 17. By allowing deferral of taxes on certain funds invested in common stocks, we would be encouraging broadened stock ownership by low- and middle-income working Americans and thereby enabling them to demonstrate their faith in the free enterprise system. It is only as we strengthen the public support for our free enterprise system that we can begin to find the much needed sources of capital for our corporate sector. We believe that our proposal will at once engender a greater sense of participation in the free market system by the large group of low- and middle-income Americans and give them an opportunity to build a reasonable estate for themselves and their heirs.

CAPITAL GAINS AND LOSSES

The sliding scale proposal for the taxation of capital gains and losses which I also discussed on March 17 is designed to promote capital formation and make sure that investments flow to their most productive uses. At the same time, the proposal will reduce the unwarranted taxation of inflationary gains.

Under our proposal, the amount of capital gain which may be deducted in computing adjusted gross income will increase the longer the asset has been held by a taxpayer. If an asset has been held for less than one year, the gain would be fully taxable; if held between one year and five years, 50 percent of the gain would be taxable. If the asset has been held from five up to 25 years, the percentage of the gain which is taxable will decrease by 1 percentage point for each year that the asset has been held. Thus, if an asset has been held for 25 years only 30 percent of the gain would be taxable.

The sliding scale proposal represents a sensible rule of thumb to avoid converting the income tax into a capital levy on shifts in investments and, as I mentioned earlier, it will reduce the unwarranted taxation of inflationary gains. As I explained in my March 17 testimony, we have assumed that our proposal will not have an impact on Fiscal 1977 receipts.

DISC

With respect to DISC, I am pleased to announce that the 1974 Annual Report on DISC has now been completed by Treasury. This morning I have distributed to you copies of the report. In my March 17 statement I discussed the DISC provisions, emphasizing that the Administration supports DISC in its present form and opposes the cutbacks contained in the House Bill.

Total U.S. exports have increased dramatically in recent years, from $43 billion in 1971 to $106 billion in 1975, and the U.S. share of the exports of industrialized countries has grown from 18.2 percent to 20.2 percent in this period. DISC has contributed to this growth in U.S. exports, and has helped expand our position in world markets. Treasury estimates suggest that the total DISC effect in the period covered by the Report was an export stimulus of $4.6 billion. Projections indicate that the effect of DISC on exports in 1976 could be as large as $9 billion. The employment associated with these additional exports in 1976 is estimated at as much as 300,000 jobs. These additional exports and jobs come at a time when we are experiencing unutilized economic capacity.

The repeal or reduction of the DISC program would adversely affect exports and the associated employment. DISC has encouraged firms to invest in the United States rather than abroad and we must continue to meet foreign competition. DISC helps U.S. firms achieve this goal.

The contributions made by DISC provide perusasive arguments not only for the continuation of DISC, but also for making no changes in DISC at this time. Moreover, it must be remembered that DISC has been in place for only a short time. Many companies have made significant investments in reliance upon it. DISC, like the investment credit, should not be turned on and off, depending on the whim of the moment. We must resist the temptation to adopt stop-and-go policies which create a climate of great uncertainty for business planning.

FOREIGN WITHHOLDING

Finally, I would like to urge you again to eliminate the existing withholding tax provision on foreign investments in U.S. securities. Our present withholding system is counterproductive. It hampers our economy, impedes the competitive position of U.S. financial markets in the international capital markets, denies access to foreign capital markets, favors short-term foreign debt investment, and needlessly complicates our tax law, in order to raise an insignificant amount of revenue. It should be repealed promptly.

Elimination of the withholding tax will increase investment by foreigners in the United States. It will also improve the relative attractiveness of long-term securities and reduce the present imbalance favoring short-term securities and bank deposits (which are presently exempt from withholding). Access to foreign funds will permit the United States to continue its role as a capital exporter, including the recycling of funds flowing into and out of the oil producing countries. Further, elimination of the tax will assure our financial markets of maintaining their preeminence in the international capital market. The existence of this withholding tax has impeded their ability to compete. Repeal of the tax is also consistent with principles of tax equity and other rules relative to source of income. Finally, repeal of the withholding tax will eliminate what has become a complex patchwork of legislative and treaty provisions and thereby simplify one area of the tax law. The basic point is that the many benefits of eliminating the tax outweigh the small revenue loss.

CONCLUSION

This morning, I have merely emphasized the highlights of our tax program. As I mentioned in my March 17 testimony you have before you an extremely challenging agenda. Let us take the steps I have urged upon you in the direction of a better income tax code, but let us not stop there.

Let us have these steps represent a part of the process of continuing true tax reform which will take us eventually to a tax system which looks as though someone had constructed it on purpose, a simple progressive tax on a broad base which adequately reflects individual taxpayer's ability to pay. That is the tax break all Americans are waiting for.

[Whereupon, at 12 noon, the committee was adjourned to reconvene at the call of the Chair.]

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