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 6 OF 8 PARTS
(Written Testimony)

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STATEMENT OF SENATOR CHARLES H. PERCY

Mr. Chairman, I am submitting this statement for the Committee's consideration to express my concern about some of the amendments that have been proposed to H.R. 10612 and to raise some points that are of sufficient importance to merit the Committee's attention and action at this time.

In my judgment, many of the proposals that are being made to reform our tax system and to alleviate existing and future employment needs are shortsighted and will prove highly counterproductive in the long run. They will reignite inflationary pressures and rob the private sector of the resources it needs to provide an adequate number of well-paying jobs in the future.

I am convinced that the only means to assure a healthy economy, full employment and an acceptable standard of living for all American workers and their families in future years is to increase our level of capital investment today. To meet these goals by 1980, the Bureau of Economic Analysis of the Department of Commerce estimates that we must increase the proportion of our GNP devoted to fixed business investment to 12.4 percent annually during the intervening five years. Such investment has averaged 10.1 percent during the last five years, an actual reduction from the preceding five years. In dollar figures, Secretary of the Treasury Simon has estimated that meeting these goals will require more than $4 trillion in saving and investment over the next decade.

I am afraid that discussions of this type and figures of this magnitude are what give rise to expressions such as "pointy heads in Washington", but examined in its constituent parts, the need is real and well substantiated.

To achieve full employment during the next ten years, we will need at least 19,000,000 new jobs. However, a large percentage of investment during this period—it was 62 percent during the decade of the 60s—must be devoted solely to replacing and modernizing existing equipment. Also, a significant portion of investment must be devoted to pollution control equipment, safer working conditions and other expenditures necessary to maintain and improve the quality of our lives. We will need significant investment over and above such "non-productive" investment if we are to provide 19,000,000 new jobs, enable the payment of higher wages, and maintain our standard of living. Adequate investment is the key to attaining the level of productivity necessary to meet these goals.

Unfortunately, we are on the opposite course. The rate of growth in U.S. productivity has steadily declined in relation to earlier levels and in relation to other industrial nations of the world.

This poor record is directly attributable to U.S. incentives for business investment compared to those in other industrialized countries.

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Pierre Rinfret of Rinfret-Boston Associates made a country by country comparison of investment incentives when he testified before the Ways and Means Committee in 1973. He traced the rate of capital recovery from an hypothetical $10 million investment in the United Kingdom, West Germany, France, Italy, Canada, Japan and the United States. After five years, under the most favorable tax advantages available, only 57.7% of capital invested in the U.S. was recaptured, whereas from 70.5% to 99.2% was recaptured in the industrialized foreign nations.

It is for this reason that I am deeply concerned by proposals to reduce those investment incentives that our tax law now provides, or to greatly increase federal borrowing for the purpose of funding millions of jobs in the public sector. What we should be doing is increasing the investment capital available to the private sector.

This does not necessitate ignoring the very critical problem of unemployment today or mean that there is no justification for public sector jobs. I have supported funding for a reasonable number of these job opportunities. They are a quick and relatively non-inflationary means of assisting the unemployed and helping state and local governments maintain services during recessionary periods and of providing a stepping stone for the chronically unemployed and improving local services when employment levels are higher.

However, it is impossible for the public sector to provide jobs for all the unemployed without government dangerously dominating the economy. Guaranteed government jobs for all at prevailing wage rates would produce extreme competition, resulting in a new round of inflation or necessitating strict wage controls. In addition, government cannot possibly provide meaningful, productive jobs for millions of people without directly competing with, and eventually entering, the domain of private industry.

Assisting those who are unemployed today and contributing to tomorrow's capital needs are not mutually exclusive goals and it is possible to do both in a sound and productive way. There are two proposals now pending before the Committee which I believe can assist in accomplishing this goal.

The first is S. 2629, which I cosponsored last year when it was introduced by Senator Bentsen of this Committee. S. 2629 provides a 10 percent tax credit for additional workers hired by private business in 1976 and 1977, and requires that the dollar value of the credit for all but the first two workers be plowed back into new investment. Eligible workers are limited to those who have been unemployed for at least six weeks and the credit is limited to $800 per new hiree, thus targeting the bill's impact on the neediest.

This proposal can help overcome the normal post-recession lag in hiring, counter some of the non-productive costs—such as payroll taxes—of hiring new workers, and fund new investment.

The second proposal was made by the President earlier this year and was introduced in the House as H.R. 11854. It allows very rapid amortization on new plant and equipment in areas of over 7 percent unemployment. The new investment generated by this incentive will help reduce unemployment in the construction industry—which is now running at 15.5 percent—while laying the base for new jobs in the future. In addition, this type of investment incentive can serve to keep industry in cities like Chicago, which lost 8.4 percent of its jobs from 1970 to 1974. East St. Louis has been even harder hit by businesses moving to the suburbs and other areas of the country.

We should not be lulled into complacency by the fact that there is excess capacity in industry at this particular point in time. The economy is on a steady upward track. Today's excess can quickly turn into the large production bottlenecks that occurred in 1973 and lead to spiraling price increases.

Our rate of capital formation is demonstratably insufficient and I believe the situation is critical enough to deserve the Committee's attention and action at this time. I urge that these proposals, or ones similar in intent and effect, be included in the tax reform bill reported to the floor this spring. And, I strongly urge the Committee to reject proposals that will actually decrease the existing incentives for investment and job creation in the private sector.

STATEMENT OF SENATOR MARK O. HATFIELD

I appreciate the opportunity to present a statement to the Committee on Finance as a part of the current hearings on income tax revision. I know that the Committee has been hearing from many individuals and organizations in regard to the specific provisions of H.R. 10612 and some of the more general issues which must be dealt with at the same time.

I do not envy the task of the Committee in giving careful consideration to the pending tax bills and the problems not covered by these bills. All of us in the Senate who are not members of the Finance Committee and have had ideas and concerns about taxation would like the Committee to deal with the bills we have drafted and introduced. This creates an almost impossible, but necessary, task of sifting, reconciling and collating. If this is not done, the process of considering amendments in the full Senate will be lengthy and exhausting.

With these considerations in mind, I wish to call the attention of the Committee to two bills I have introduced and ask that they be given favorable consideration. I hope they will be considered at the committee level, where they can be made a part of bills to be reported to the full Senate.

Presumably, both of these bills could be attached as amendments to H.R. 10612, but I am willing for other vehicles to be utilized.

The projected impact of the first bill is relatively minor, but to the senior citizens who would be affected, this legislation is of major importance. This bill, S. 1142, is being drafted as an amendment to be offered at the appropriate time. It would increase the exclusion from gross income of capital gains from the sale of a residence or property by an individual who is 65 years or older. Present law allows an exclusion of $20,000 from capital gains tax for the sale price of the home or property. When this exclusion was enacted as a part of the Revenue Act of 1964, the amount was well in line with the sales price of existing home. In fact, the median sales price of existing homes in 1966 was $18,760. The intent of the law in 1964 clearly was that the typical senior citizen not pay capital gains tax on his or her home or property when selling it. Many elderly persons are forced to give up their homes for health reasons or choose to live in housing which is less demanding during that stage of their lives. We should not allow the inflated prices of homes to create heavy capital gains taxes when these homes are sold.

The need for increasing the exclusion to conform with the intent of the law is easy to document. The median sales price of existing homes during February, 1976, according to the National Association of Realtors, was $36,200. Increasing the exclusion to $35,000 would bring these figures into closer alignment. The amount of $35,000 was selected by the House Ways and Means Committee in legislation reported out of committee in August, 1974. Although the Committee did not include a similar provision in H.R. 10612, the bill is comprehensive in scope and is a suitable vehicle for this provision.

There seems to be a growing interest in Congress to make some changes in estate and gifts taxes. Property values have made the dollar amounts in the laws out of date. For those who retain their homes until their death, the problem is in the area of estate taxes. For those who sell their homes, the problem is with the laws governing capital gains.

I realize that the Finance Committee is under some constraints to be certain that the net effect of tax changes is in the direction of increasing revenue, but I feel a change of this type is well justified in becoming a part of the balance sheet of tax changes. I ask that the Committee give this careful consideration. It would seem to me that this is a change that the House Ways and Means Committee would accept, in the light of their previous action.

Secondly, I want to bring to the attention of the Committee my intention of offering my Simpliform tax bill, S. 802, as an amendment to H.R. 10612, specifically in relation to Title III, on the minimum tax. This amendment is being drafted and will be introduced in the Senate, hopefully before Committee action takes place.

In this week's issue of "Newsweek," Milton Friedman has an essay entitled, "Tax Reform: An Impossible Dream." In the essay he outlines two possible approaches to tax reform: one would place a maximum rate of 25% on personal income taxes and the other would place a flat rate on all income above personal exemptions, less only the strictly occupational expenses. His proposals bear some resemblance to my amendment and ought to be given consideration. What interests me most, however, is his conclusion. He says his ideas and other reform plans will not be seriously considered because "lawyers and tax accountants and government civil servants would lose if it were enacted." Moreover, according to Friedman, legislators would also resist the enactment of major tax reform because they would be surrendering their opportunity to gain political points by granting "relief" periodically in the form of tax cuts. Professor Friedman's pessimism or realism, if you will, ought to motivate the Congress to engage in some serious soul-searching as we give consideration to major tax legislation. If Friedman is right that attorneys, tax accountants and civil servants can effectively prevent the adoption of major tax reform, then something is wrong with our legislative process. Moreover, if the members of Congress themselves have unthinkingly joined this unholy alliance of inertia, then this is a very serious indictment.

The desire to have legislative "goodies" to pass out from time to time is hard to resist. For example, Congress clung to the system of granting statutory increases in Social Security benefits for many years, partly because of the political gain derived from voting for more money for the thirty million Social Security recipients. Eighty million people filed individual income tax returns in 1973, so the temptation is even greater to retain a system which allows Congress to grant periodic tax cuts as a result of the inflation of tax receipts. It is my hope that the days and weeks spent by the Senate this year on tax revisions will include a careful look at major tax reform.

My specific amendment is the adaptation of my bill, S. 802, to the minimum tax. The bill would eliminate most tax deductions, thus greatly broadening the tax base. This would simplify the tax instructions and reporting forms and would permit a lower basic tax rate, beginning at 10% and graduated upward to a maximum of 50%. The tax form would contain only four lines and a person would know at any time during the year what his tax obligation would be. My proposed amendment would provide that the calculation method in my Simpliform bill would be an optional alternative to the minimum tax for those up to $200,000 in income and would be mandatory for incomes above that.

Professor Friedman makes a good case for tax simplification and reform in his article in "Newsweek." He points out that a much lower proportion of taxpayers filed returns with a net taxable income of $100,000 or more in 1972 than in 1929, at which time the top tax rate was 25%. Friedman's point in limiting the tax rate to 25% is that this would remove the need for upper income taxpayers to spend money for tax attorneys and accountants in locating tax shelters and converting ordinary income into capital gains. Thus, a taxpayer who pays at an actual rate below 25% would be willing to pay the 25% in order to save the cost of the tax advice and financial manipulation.

The same reasoning would support the use of my Simpliform plan. Some taxpayers would voluntarily adopt Simpliform in order to reduce their tax compliance cost. According to one estimate, $2 billion is now spent on compliance, which does not benefit the federal coffers and is lost to the taxpayers as well. Those who are high enough on the income scale to be required to use Simpliform can be sure that their rate would not exceed 50% and that they would avoid the confiscatory 70% under present law. I cannot accept Friedman's suggestion of a flat 16% on all income. Fairness requires that we retain the progressive principle in our income tax, particularly since the non-progressive nature of Social Security taxes partially offsets the progressive income tax and pushes the total tax burden of some middle income people far above the tax rate paid by some of the wealthy. I do not think the "tax revolt" is aimed at the progressive concept, but rather at the flagrant violation of this concept in our total tax system.

Since the introduction of S. 802 last year, I have been pleased with the interest of many people across the country. Some have shared Professor Friedman's pessimism about the prospects for tax reform; others have been optimistic and have even supported it in spite of possible higher tax obligations for themselves. Recently, officials in the Administration have been advocating tax simplification and reform very similar to that provided in my tax bill. Secretary Simon has been saying repeatedly that this should be the direction of tax revision. The question now is whether we can get beyond the stage of saying it is a good idea and begin to give tax simplification definite consideration in actual legislative form. If others can propose alternative bills or amendments which would achieve tax simplification and reform more effectively than would Simpliform, I would be happy to support their proposals. But so much of what has been discussed and proposed is reform in name only, and it certainly does not simplify the tax laws. We cannot speak of reform if major tax breaks are left untouched. We cannot ask a taxpayer from one income bracket to give up certain benefits if others are allowed to cling to their own loopholes. There is an inevitable "all or nothing" dimension to tax reform.

Mr. Chairman, I am attaching a brief summary of the Simpliform tax plan to my testimony and will make available to the Committee the text of my amendments, converting this bill and my senior citizens home sales bill to appropriate amendment form. I ask that the Committee give these amendments careful consideration in the context of the markup of tax revision bills in the near future.

BRIEF SUMMARY OF SIMPLIFORM TAX PLAN

Purpose.—To reform the individual income tax and eliminate tax loopholes.

Summary.—Simpliform would replace most income tax deductions and exemptions with a uniform and fair tax rate. Nearly all taxpayers would use a simple, two-step calculation to determine their tax.

The tax rate.—Eliminating the loopholes would allow the rate to be lowered for most people. A couple with income under $5,000 would pay no tax. Above that the standard rate would be 10% with a surtax added for income above $10,000.

The surtax is summarized in this table:

Income over —	But not over —	Basic surtax	Additional surtax (percent)	For income over —
$10,000	$15,000	....	5	$10,000
15,000	20,000	$250	10	15,000
20,000	25,000	750	16	20,000
25,000	50,000	1,500	20	25,000
50,000	100,000	6,500	25	50,000
100,000	500,000	19,000	30	100,000
500,000	1,000,000	160,000	35	500,000
1,000,000	....	340,000	40	1,000,000

Tax credits.—In place of the present system of personal exemptions, Simpliform would allow a $250 credit for adults. The present personal exemptions provide up to four times as much tax saving for the wealthy as for the lower income person. Simpliform's restriction of credits to adults removes the tax disadvantages from the single and childless taxpayers.

Statement of Senator Joseph M. Montoya

Mr. Chairman: I would like to express my gratitude to the Committee for permitting me to testify concerning legislation which I have proposed to amend the Internal Revenue Code.

The need for reform of our tax laws is not a controversial subject—not anymore. Everyone—taxpayers, tax experts, members of Congress, businessmen, lawyers—everyone has at least one pet 'reform' which he would like to see become law. However, the decisions about exactly which reform should be passed, or exactly how that reform should be accomplished are not so easy. That is the very difficult job which this Committee has tackled, and I commend both the Chairman and the members for the thorough and excellent work you are doing.

The bill which has come to the Senate from the House, HR-10612, is the end product of many months of difficult work by our colleagues in the other Chamber. I am appreciative of the time required to adequately review that bill, and to consider additions or changes which Senate members would like to make. I hope that my proposals will be included in your serious consideration, along with the many other excellent proposals which have been made.

Briefly, the tax law changes I am proposing are of two kinds: Changes in the amount of tax to be paid in certain instances, and changes in the administrative practices and procedures of the Internal Revenue Service in collecting taxes.

I will submit for the record a more detailed statement each of the amendments to the Code which I have proposed.

I would like to address the general thrust of my legislative proposals, however.

As you know, the Appropriations Subcommittee on Treasury, Postal Service and General Government, of which I am Chairman, has held hearings for several years to examine taxpayer services provided by IRS, procedures used for tax collection and audit, and to provide a forum or taxpayers who were critical and had found it impossible to make their complaints through other channels. I first announced that I would hold these hearings late in 1972. I was amazed at the immediate and overwhelming response from citizens.

It became clear to the Subcommittee that many citizens were angry and frustrated. They were losing confidence in the tax system itself. Our first hearings uncovered many serious problem areas, and subsequent work by the Subcommittee—including the second set of hearings in 1974—confirmed the need for us to prepare corrective legislation.

We heard testimony from IRS officials, tax assistance professionals, tax assistance volunteers, tax lawyers, CPA's, tax reform organizations, and from taxpayers themselves. In all of this material, the most distressing element was the increasing evidence of bitterness and frustration which is expressed by a large percentage of the public.

On Thursday of this week I will hold the first of four field hearings in New York. We will hold hearings in the next few weeks in Oklahoma City, San Francisco, and Chicago. We will have a full day of public hearings in each city. Once again, we have received many requests from taxpayers who wish to testify on specific grievances, and from tax professionals who wish to testify on recurrent problems. I will make a report to the Congress on our hearings, of course, and I will make the hearing testimony available as quickly as possible to this committee.

American taxpayers have always paid their taxes voluntarily, and we Americans have always had a high degree of faith in the fairness, integrity, and capability of those who administer our tax law. I am afraid, however, that the public's faith is growing weaker every day.

Most serious among the many problems uncovered in our hearings were complaints about the process of audit selection, the lack of protection for privacy of information furnished on tax forms, the difficulty in obtaining information on appeal rights, the inequities and arbitrary procedures used in the collection process, the suggestion of misuse of IRS powers for political or personal attacks, and the feeling of taxpayers that IRS agents were working under a "quota" system in which they were required to return a certain number of dollars to the Treasury.

Several months ago, "The Report to the Administrative Conference of the United States on Administrative Procedures of the Internal Revenue Service" was published. The conclusions of this impartial report largely bear out the reports of our Subcommittee. The legislation I have proposed addresses the problem areas in accordance with the recommendations of this report.

In January and April of last year I introduced five bills to make the following administrative changes in our tax code: S. 136, a bill which requires IRS to inform taxpayers who are being audited specifically how their returns were selected for audit, how the audit system works, and how they may appeal an adverse decision. The procedural changes made by this legislation would bring openness and candor back into the relationship between taxpayer and tax collector, and would restore confidence in the fairness of the system to many disillusioned citizens.

S. 137, a bill which would provide for judicial confirmation of the amount and need for jeopardy assessment. The law now allows IRS to seize any amount of a taxpayer's assets if the IRS officials "believe" that collection of a deficiency is in jeopardy. I have proposed that when jeopardy assessment seems necessary IRS be allowed to proceed, but that within five days IRS must seek confirmation from the district court with an opportunity for the taxpayer to be heard in the proceedings. The right to judicial review seems to me to be the most ordinary and proper protection for the rights of taxpayers.

S. 138, a bill which will adjust the schedule of income which is exempt from levy by the IRS. Currently the code exempts specific dollar value personal effects and necessary tools of a trade. Inflation has made most of these exemptions meaningless, and I believe the exempt income should be based on the number of dependents in a taxpayer's household, and should be tied to the consumer price index. Families should not be left with no income while a tax dispute is decided or a delinquent tax paid.

S. 139, a bill which would establish a five year term for the Commissioner of Internal Revenue, thus removing him from political pressure. Ample evidence of the need for this legislation is to be found in our hearings and in the report of the Select Committee on Presidential Campaign Activities.

S. 1511, a bill which will insure the confidentiality of income tax returns and provide safeguards governing access to information on those returns. The tax records, under my proposal, would be declared to be 'confidential' rather than 'public' records, and stiffer penalties would be mandated for unauthorized disclosure or misuse of tax information. Penalties would apply to those who receive as well as those who release information illegally.

Mr. Chairman, I wish to add that I am a cosponsor of Senator Magnuson's omnibus taxpayer rights bill, which addresses many of the same problems I have already discussed, and which provides, in addition, legal assistance for taxpayers and a taxpayer service and complaint assistance office within IRS.

In addition to the legislation discussed so far, I want to bring to the attention of the committee a serious problem which has come up in testimony before my subcommittee. I believe that the chairman of this committee is already preparing legislation in response to this concern, and I wish to make my support of his efforts clear.

In 1969, the Internal Revenue Code sections 7463 and 7456(c) were amended to provide that the Tax Court would appoint tax commissioners to hear small tax cases. This was an attempt to provide a more equitable and fair hearing for the small taxpayer who is the backbone of our tax system, who files over 80 percent of all individual returns, reports over 65 percent of taxable net income, and pays about 60 percent of all taxes collected. This very important taxpayer, however, usually does not have legal assistance in a dispute over his taxes, and clearly needs better legal service.

The system devised in 1974 is not working well, or as the Congress intended it to work. The commissioners appointed are not empowered to act as judicial officers; they are soon to be asked to take on additional tasks as the Tax Court jurisdiction expands into other areas, and yet they have no tenure, no status, and do not even render a final decision. The Small Taxpayer Court should have equity jurisdiction, it seems to me, in order to provide better assistance to the public.

I hope this committee will prepare and present legislation to establish a Small Taxpayer Court. There are thousands of small claims courts which work well for the average citizen, and I believe the Small Taxpayer Court would accomplish what I believe to have been the intent of the Congress originally.

In addition to the administrative changes I have proposed, I would like to briefly review the legislation I have introduced to make substantive tax law change. This committee has received testimony concerning many major changes in tax structure. I endorse and support those which are going to provide a more equitable tax assessment for the middle income taxpayer who now carries too heavy a load.

The changes I am proposing are embodied in three bills to protect or provide relief to senior citizens, and in one bill I introduced last year to provide more effective encouragement to home ownership and home building. Specifically, I propose:

S. 2870, a bill to equalize tax treatment for retirees under Federal retirement plans with the tax treatment provided for retirees under social security and railroad retirement. Social security and railroad retirement benefits are tax free, as I believe they should be. Federal retirees, however, must use the retirement income credit provision for tax relief.

The RIC was originally intended to conform to tax exemptions provided for social security beneficiaries. However, the dollar amount allowed was last amended in 1962. Inflation has, of course, made that base rate ridiculous. My proposal is that Federal retirees be allowed tax exemption on retirement income up to the amount of the maximum social security benefit for the current year. Changes in social security benefits would thus automatically correct the exemption for Federal retirees to keep their benefits equitable. Retired civil servants, contrary to popular myth, receive comparatively low incomes, and every dollar which must be paid in taxes is a dollar which cannot be spent for essential needs. The importance of this simple change in our tax law can be demonstrated by the volume of mail I have received in support of this bill.

S. 2695, a bill which would provide a taxpayer credit equal to $250 when the taxpayer houses a senior citizen within his home. This legislation is aimed at halting the segregation of the elderly and the warehousing of senior citizens in nursing homes and rooming houses, often substandard. The small tax credit given would encourage and assist middle- and lower-income families to provide elderly relatives a home, and would be much less expensive to the Government than the construction and maintenance of senior citizen housing and nursing homes.

S. 2346, a bill which would protect the elderly citizen from loss of his home or undue economic hardship resulting from increases in property taxes by providing a tax credit for the amount of property tax in excess of that paid before retirement age. The bill would also allow a similar credit for increases in rent caused by higher property taxes.

Finally, I wish to mention S. 2082, a bill to provide a credit in lieu of a deduction for interest paid on a mortgage on the taxpayer's principal residence. Clearly, the construction industry is in serious trouble, with unemployment rates as high as 50 and 60 percent. The average home being constructed today is only available to families in the top income brackets. The deduction now given for interest paid on a mortgage was intended to encourage home ownership, but in effect it is regressive. Inflation has now changed the base figures so that we must find a way to make this particular tax expenditure work to better advantage for the average American family. I believe that goal will be reached by changing the law so that those families with incomes below $20,000 will be assisted. That can be done if we provide a tax credit rather than a tax deduction. Library of Congress estimates that 100,000 new single family homes would be built and sold this year if my proposal were in effect, because families would be able to qualify with the small boost in take-home pay this bill would provide.

I also wish to mention my full support of one other legislative effort: Changes in the estate tax law which would allow family farms to remain within a family after the death of the owner.

Mr. Chairman, I deeply appreciate the time the Committee has given to me to speak on the tax reform matters which concern legislation I have proposed. I am deeply disturbed that taxpayers are losing faith in our tax system, and believe that it is applied unfairly in some cases. Taxes should be clear, equitable, and fair. They should not be applied in such a way as to be injurious to any one group, and they should be collected with courtesy and consideration for the rights of the taxpayers.

I believe that the tax reform legislation this Committee is preparing can and will be the most important and far-reaching legislation which comes out of the Congress this year. There is no reason why American taxpayers should be in revolt—and I believe that sensible corrections in our tax law will insure that confidence and approval are once again the essence of citizen response to the Internal Revenue Service and Government itself.

Detailed Description of Tax Reform Proposals of Senator Joseph M. Montoya

I. Proposals to Correct Administrative Procedures and Practices of the Internal Revenue Service

S. 136, a bill to amend the Internal Revenue Code of 1954 to require the establishment of formal procedures and criteria for the selection of individual income tax returns for audit, to inform individuals of the reasons why their returns were selected for audit, and for other purposes. The Taxpayer Audit Disclosure Act.

The audit power of IRS is awesome. It should, therefore, be carefully circumscribed. Taxpayers have the right to assurance that when their returns are selected for audit the procedures used are nondiscriminatory, and fair. This can best be accomplished by oversight by Congress of the criteria used for selection of returns for audit. This bill would mandate that the Secretary report to the Joint Committee on Internal Revenue Taxation the specific criteria used for selecting returns for audit, and the procedures followed.

The taxpayer who is being audited is further entitled to full information concerning his audit. This legislation would provide that written notice be given to the taxpayer clearly specifying the reasons for and the manner in which his return was selected for audit. Secrecy in the area of tax procedure is unwarranted and inexcusable. No national security danger is present when the American citizen is fully informed concerning a procedure which affects the tax system of the United States. It is to our advantage to operate in the open on tax matters, and faith in the fairness of our tax system will be established in no other way.

The taxpayer who is being audited should be furnished with a description of the audit process, and should be fully informed of his rights under the law. The IRS publication 556 (Audit of Returns, Appeal Rights and Claims for Refunds) or a similar publication should be sent to the taxpayer two weeks before the actual audit so that he is properly informed and prepared. At the present time the taxpayer often has to request this information, and is not even aware of the existence of publication 556. The average taxpayer does not have legal assistance, and should not have to depend upon "volunteer" assistance in order to be informed of his rights under the law. This is a minimum service which IRS should supply.

In addition, the Congress and the public are entitled to full information concerning audit records of IRS. This information was formerly available in a publication called "The Audit Story." This publication, or one which contains the same full information should be made available again.

A full report to the Congress should be made concerning (a) the number of individuals selected for audit, (b) the classification of individuals whose returns were audited by income levels, geographic distribution, and profession, (c) the number of individuals found to have made underpayments or overpayments, and other detailed information concerning audits.

It is essential that full trust in the system of auditing Taxpayer returns be returned to the public. No taxpayer should feel frightened or frustrated by a tax agency of the Government.

S. 137: A bill to renumber section 6864 of Part II of Subchapter A of chapter 70 as section 6865 and to insert after section 6863 a new section to provide for judicial oversight of jeopardy assessment in the following manner and for the following reasons:

Jeopardy assessment is an unusual governmental power, allowing the Secretary of the Treasury, or his delegate, to take immediate action through assessment if it is believed that revenue will be jeopardized by normal procedures. Originally this power was given to the Secretary because Congress wished to provide a tool for IRS which could be used in emergencies when the taxpayer was preparing to flee the country in order to avoid payment of taxes, or when the taxpayer was divesting himself of assets in order to avoid payment. The IRS agent, acting for the Secretary, has authorization to take jeopardy assessment action solely on his 'belief' that it is necessary. There is no limitation through judicial review, and no protection under current law for the civil rights of taxpayers.

Questions concerning the constitutionality of the jeopardy assessment power have been repeatedly raised. The Supreme Court has upheld the law as written where the question of due process is concerned, but the serious questions concerning equal protection guarantees and discretionary power given to the Secretary have not yet been addressed by the Court. The American Law Division of the Library of Congress has researched the question and have issued a report written by Howard Zaritsky, Legislative Attorney for the Law Division.

The Fifth and Sixth Circuit appeals courts have overturned the IRS position in jeopardy assessment cases, while the Second and Seventh have sustained. There are appeals pending in the Third, Fourth, and Ninth circuits. There seems to be sharp controversy over the issue. Chief Judge John R. Brown of the Fifth Circuit has called the jeopardy assessment power "a weapon with atomic potentialities in the arsenal of the tax gatherer."

In the case determined by the Supreme Court, the Court stated:

> Where only property rights are involved, mere postponement of the judicial enquiry is not a denial of due process if the opportunity given for the ultimate determination is adequate . . . 283 U.S. at 596–597.

As the law now stands, the taxpayer is given little protection against an error in judgment by the IRS agent, and the opportunity for ultimate determination is restricted because of the damaging effect of delay.

The bill proposes to leave the jeopardy assessment power as a tool for IRS, but would circumscribe that power by providing certain protections for the taxpayer:

(1) Within 5 days after an assessment is made, IRS would file in a U.S. district court a petition for approval of assessment, giving the reasons for making such an assessment.

(2) Taxpayer would have the right to file a written request for a hearing with the appropriate district court, and hearing will be held within 5 days.

(3) Burden of proof would be on Secretary or his IRS delegate to satisfy the court that collection of revenue would be jeopardized by delay and that the amount assessed is reasonable.

(4) On the day in which petition for assessment is filed, IRS must furnish to taxpayer a written notice of the provisions of this section and a form for requesting a hearing if desired.

Providing these protections to taxpayers against arbitrary or unnecessary use of this powerful tool by IRS will in no way endanger the legitimate use of the jeopardy assessment tool, and would give taxpayers a very necessary legal avenue of protest. It in no way endangers the powers of a public servant to be required to explain his actions or to promptly notify citizens of action taken against them and their rights under the law.

S. 138: A bill to amend the Internal Revenue Code by revising provisions relating to property exempt from seizure for collection of taxes.

Testimony before the Appropriations Subcommittee on Treasury, Postal Service and General Government, by Mr. Alex J. Soled, representing the American Bar Association, included recommendations of the Committee on Collections and Limitations of the Tax Section of the American Bar Association. The report of that committee stated:

> In an era where a succession of laws has been enacted providing for support and subsidy payments by governments to low-income individuals and families who are living at poverty or bare subsistence levels, it is anachronistic for the Treasury to levy on a taxpayer's total earnings where to do so would take all funds even if committed to other creditors, and could leave such taxpayer living at sub-subsistence level.

The bill proposed would create a schedule of income exempt from levy based on the number of dependents in a taxpayer household, and would key the schedule to the Consumer Price Index so that changes resulting from inflation will be reflected in the income exempt from levy. It would also increase the dollar value of fuel, provisions, furniture, and personal effects from $500 to $1,000 in value exempt from levy.

The maximum exemption levels presently in the law were put there when inflation had not yet changed the value of our dollar. At the present time no salary or wage is exempt from levy, although the code does exempt wearing apparel and school books, food, fuel, furniture and personal effects worth up to $500 per family, books and tools of a trade or profession, up to $250 in value, and unemployment, railroad retirement, and workmen's compensation payments.

It should be noted that the IRS itself has taken the position that wages should not be levied in hardship cases. That is commendable. However, once again this is an arbitrary decision concerning a matter which should apply equally to all taxpayers and which should be administered with compassion and decency by the Government in its relations with taxpayers and citizens.

The bill proposed would exempt necessary wearing apparel and school books for the family of the taxpayer, and up to $1,000 of fuel, provisions, furniture and personal effects of the family. In addition, the tools of trade and books of business or profession necessary for the taxpayer would be exempt. Income or wages would be exempt according to the number of taxpayer dependents, and would be determined by the Secretary when the Bureau of Labor Statistics of the Department of Labor indicated that the CPI increases necessitated raising the amount exempt from levy. Dollar amounts exempt from levy would be raised by the percent increase each year.

S. 139: A bill to amend section 7802 of the Internal Revenue Code of 1954 to define the term of the Commissioner of Internal Revenue. *Establishment of a 5 year Term for Commissioner of Internal Revenue.*

This bill would depoliticize the top official of our tax collection system by establishing a five year term for the Commissioner of Internal Revenue Service. The President would appoint the Commissioner every five years, and he would be confirmed by the Congress, removable only for malfeasance in office and allowed to serve only one term.

The job of Commissioner of Internal Revenue should not be subject to pressure from the White House or from any other part of the government. It should be a professional and orderly position, with clear and firm insulation against political pressure of any kind.

Former Commissioner Johnnie Walter and present Commissioner Donald Alexander have both chronicled political stress and have appealed to the Congress to provide the kind of protection from pressure which this bill attempts to offer. We have seen a recent series of attempts to use the IRS for partisan politics. Recent reports by the Select Committee to Study Governmental Operations With Respect to Intelligence Activities (Volume 3, Internal Revenue Service) have underlined our need to examine political pressures on this powerful arm of government. The Watergate investigations contributed considerable evidence of political pressure having been put on IRS officials. In addition, the Committee of the Judiciary of the House of Representatives in Book VIII (Internal Revenue Service) of their report demonstrated clear evidence of the effort to use IRS for partisan political purposes. One former Commissioner, Randolph Thrower, stated that he had to threaten to resign in order to prevent White House interference.

The effect of this bill would be to change the status of the Commissioner, so that he no longer would serve at the pleasure of the White House. This would remove temptation from any Administration employee to misuse tax information or tax collector powers.

The integrity of the tax collector and the tax system and service is of great importance in a nation like ours, which depends on voluntary self assessment of taxes. We have been fortunate that the men who have held the position of chief tax collector have for the most part resisted pressures from outside of the tax system. This bill would insulate the tax system from such pressures.

S. 1511: A bill to amend the Internal Revenue Code of 1954 to insure the confidentiality of individual income tax returns and to provide procedural safeguards governing access to such returns by Government agencies.

This bill is an amended version of legislation which has been introduced by me in the past two years. It would do the following things:

(1) Make tax returns confidential rather than public documents. This will make disclosure of personal information on tax returns much more difficult.

(2) Provide for taxpayer consent if tax return information is to be disclosed to any agency or government or other person. The Secretary or his delegate would notify the taxpayer in writing of the request to inspect his return, and the IRS would not release information until the taxpayer had provided that written consent required. The IRS must specify the name of the person or agency which is requesting permission to inspect the return, and the reason for such request.

Exceptions to the taxpayer consent requirement would be limited to inspection by a State body for the purpose of administering state tax law, inspection of a corporate tax return by a shareholder in that corporation, inspection of a return by the House Ways and Means Committee, Senate Finance Committee, Joint Committee on Internal Revenue, or a select Committee of either House or Senate, and to the inspection of a return by an employee of Department of Treasury or Department of Justice in connection with administration or enforcement of the Internal Revenue Code.

(3) A Federal officer charged with enforcing Federal law could apply to appropriate district court for an order granting access to the return specified in the order. The district courts of the United States would have jurisdiction to hear, determine, and issue orders directing the Secretary to release for inspection and copying the returns requested for purposes of law enforcement. Courts would issue such orders only if there is probable cause to believe such information is necessary for the investigation or prosecution of violation of Federal law, and that no other source is reasonably available to the officer seeking the order.

(4) The President, by use of a written request personally signed by him, could request information to be used by him in consideration of persons for appointment to Federal office. Such information would be limited to: Knowledge of whether the individual has filed a return during past three taxable years, whether the individual has been subject to any penalty or the subject of any deficiency proceeding within preceding eight taxable years, and whether individual has been subject of an investigation for failure to comply with any provision of Internal Revenue Code during last three years.

(5) Statistical information will be provided to Social Security Administration and Railroad Retirement Board concerning information and taxes imposed by Chapters 2, 21, and 22.

(6) The penalties for unauthorized disclosure of tax return information will be changed so that the unauthorized disclosure will be a felony punishable by a fine not to exceed $10,000, imprisonment for not more than 5 years, or both. If the offender is an officer or an employee of the United States, he shall be dismissed from office or discharged from employment.

In addition, any person who knowingly receives unauthorized tax return information shall be guilty of a felony punishable by a fine not to exceed $10,000, imprisonment for not more than 5 years, or both.

(7) The Comptroller General is authorized under this bill to investigate the use of tax returns by any agency of government in order to ascertain if proper and legal procedures are used.

This bill would begin to provide protection against malicious or careless use of personal information required by the government to be put on tax returns. The balance between the right to privacy of the citizen and the responsibilities of government officials who receive and handle private information is a very precarious one. It is extremely important that we provide the greatest possible protection to taxpayer information, and that we do that clearly and legally. The conclusion of many taxpayers that their rights to privacy are now unprotected and that the system is a threat to their personal freedoms is a very dangerous situation. When the people give power to men in government, it is essential that protections against the misuse of that power be put firmly in place. This bill would provide that kind of protection.

II. PROPOSALS TO PROVIDE RELIEF OR TO PROTECT SENIOR CITIZENS

S. 2870: A bill to amend the Internal Revenue Code of 1954 to treat Federal retirement system income the same as social security income to the extent that such retirement income does not exceed the sum of old age benefits which may be received under title II of the Social Security Act.

Runaway inflation has severely affected retirement income for all senior citizens. The Congress has attempted to alleviate some of this burden through repeated increases in social security benefits.

This bill would provide equity for those elderly retirees who have pensions under Federal retirement programs rather than under social security.

Benefits received by retired workers under social security are tax free. The same is true of benefits received under the Retired Railroad Workers Act. In an effort to provide equity of tax treatment to those not covered by social security—mainly the Federal retiree—the retirement income credit provision (section 37) of the Internal Revenue Code was established, with dollar amounts which could be computed as a credit against tax paid. Unfortunately, the fixed dollar amounts have not been recomputed since 1962, with the result that the base against which the retirement income credit is figured is no longer realistic.

This is clearly an inequity, giving workers in different retirement groups different tax treatment. Although percentage increases in civil service and military retirements have taken place, the income tax bite has kept many of these retirement incomes below the actual purchasing power level which workers had planned for and been led to expect in their senior years.

This bill would remove the necessity of continual amendments by the Congress to change the dollar amount provided in the Retirement Income Credit provision. It would tie the amount of income exempt from taxation for Federal retirees to the amount allowed free of taxation for social security beneficiaries and railroad retirees.

The small tax saving which this would provide for many older persons is of vital importance to them.

An example which illustrates the inequity is provided by the following figures:

A husband and wife each receive social security benefits of $300 per month (annual)	$7,200.00
They receive additional income from other sources (annual)	3,500.00
Total income	10,700.00
Total Federal tax	0.00
However, if retirement benefits are from civil service annuities in the same amount (annual)	7,200.00
Additional sources are the same	3,500.00
Total income is the same	10,700.00
But tax would be (approximate)	1,104.50

Even if retirement income credit levels are raised, as has been proposed in the House of Representatives, the inequity would not be alleviated.

The bill I have proposed would avoid the necessity of readjusting ceilings every few years, and would provide the evenhanded and fair tax approach which I believe the Congress intends for all retired workers.

The Library of Congress Economics Division has done a brief analysis of the legislation proposed and their estimate of the total cost would be around $500 million for federal civil service pensions. Their analysis points out that there would be a recoupment of 25 to 50 percent of that sum after feedback effects are taken into consideration.

The average retirement benefit for federal retirees is $5,080. This constitutes 70 percent of total income for annuitants and their families, and 49 percent of income for survivors. With this very low average retirement benefit, it is easy to understand why approximately one-half of retirees would not be affected by this bill because they have incomes too low to have an income tax liability. However, for those who have made savings over the years in order to provide for their senior years, the current system results in unfair and inequitable tax treatment.

This bill has received strong support from many groups of retired persons, including NARFE, National Association of Letter Carriers, and others.

S. 2346: A bill to amend the Internal Revenue Code of 1954 to provide a credit against tax with respect to State and local property taxes, and for other purposes.

This bill would grant much needed tax relief to elderly persons who have been caught in the crunch between fixed incomes and rising property taxes during the recent severe inflationary period.

The bill provides a credit against Federal income taxes of a taxpayer who is 65 years of age in the amount equal to the sum of State and local property taxes paid during the taxable year up to the amount by which property taxes on the principal residence of the taxpayer exceeds the property taxes paid on a principal residence prior to the 65th birthday of the taxpayer.

For those taxpayers who are 65 years of age and who do not pay property taxes but who lease their principal residence, an amount equal to the applicable percentage of such individual's rental payment increase following the 65th birthday of the taxpayer.

The applicable percentage in the case of senior citizens who are renters means the percentage certified to the Secretary or his delegate by the Governor of the State in which the principal residence of the taxpayer is located. The Governor will determine the applicable percentage for his State by computing the average percentage of rental payments paid by individuals for rental within the State which is attributable to the sum of local and State property taxes imposed on the owner of property. The applicable percentage for the State may not be less than 15 percent or more than 30 percent.

This bill would address the problem of the elderly retired family who is increasingly being forced to move out of his own home or his rented home because of inflated property taxes and inflated rent. These senior citizens are often forced to move to substandard housing. The Advisory Commission on Intergovernmental Relations has compiled statistics to show that homeowners over the age of 65 pay an average of 8.1 percent of their income for property taxes—almost twice the 4.1 percent that the nonelderly pay. Of these homeowners over 65, there are 1.3 million with annual incomes of $2,000 or less who pay property taxes of 15.8 percent of their meager income. One in every five homeowners over 65 are in this lowest income group. Two-thirds of all elderly homeowners have incomes under $6,000 and pay an average of 6.2 percent of that income to property taxes.

This is not a minor problem and not a temporary one. Those persons who have planned ahead for retirement are not prepared for increases in living costs which inflation has thrust upon them. When increases in taxes add to that burden, the result is often tragedy.

S. 2695: A bill to amend the Internal Revenue Code of 1954 to provide a tax credit with respect to housing senior citizens in the principal residence of the taxpayer.

This bill would provide a tax credit of $250 to each taxpayer who houses a citizen over 61 years of age within the taxpayer's principal place of residence. The credit will apply in addition to the current dependency deduction to which a taxpayer is entitled if he provides over half of the support for a parent or other elderly relative, in the cases where that is applicable.

The credit may not exceed the liability for tax of the taxpayer, and no credit will be allowed with respect to an individual if the taxpayer is allowed a deduction under section 162 or 212 with respect to expenses he incurs in connection with providing lodging for such an individual.

The thrust of this legislation is to encourage maintenance of older persons within the home, and to halt the segregation of the elderly in warehousing nursing homes or substandard housing. For the middle income family this small tax advantage would in many cases make it possible to maintain an elderly relative within the home in spite of the additional cost for care.

The resources which senior citizens have to offer to the social fabric within the home are very great, and are more and more often being wasted as elderly members of the community are forced to live alone or away from family and the general community.

Our current shortage of adequate nursing homes is a major concern of many Members of Congress. Building and staffing these facilities is a great cost to communities, States, and to the Federal Government. Helping a family to keep a senior member at home rather than in a nursing home will be much cheaper and better way to assist in the care and reasonable provision for the elderly.

The use of a credit rather than a deduction to accomplish the purposes of this bill will be much more equitable, and will make it possible for citizens in the lower middle income bracket to benefit from this legislation.

Congressman James Scheuer of New York has introduced a parallel bill in the House of Representatives and has had very good support from other Members of the House.

The Economics Division of the Library of Congress has made a revenue estimate of S. 2695, which indicates the following:

> Revenue loss would be approximately $365 million, assuming the taxpayer was not allowed to take credit for himself or spouse.
>
> If taxpayers 62 and over were included in the bill, revenue loss would be increased by $1.7 million.

III. AMENDMENT PROPOSED TO PROVIDE A CREDIT IN LIEU OF A DEDUCTION FOR INTEREST PAID ON A MORTGAGE ON A TAXPAYER'S PRINCIPAL RESIDENCE

S. 2082. This bill would provide encouragement for home ownership and would increase the homes built and purchased by middle income families, particularly those in the lower middle income bracket, by using a credit in lieu of a deduction.

This bill, like many other tax reform amendments offered, attempts to correct the regressive nature of the deduction offered on interest payments for a mortgage.

The deduction which Congress has provided for interest payed on a home mortgage was intended to encourage home ownership and increase the number of homes in the United States. Unfortunately, rapid increases in interest rates, the regressive nature of the deduction in our tax system, and inflationary building cost rises have forced us into the situation we face today: Only the families within the very top income brackets can afford to purchase an average home today, and only they can qualify for a mortgage.

The tax deduction method of providing a tax expenditure to encourage home ownership and homebuilding is no longer working to our advantage.

The bill I have prepared would provide a tax credit of 45 percent of the interest paid on a mortgage owed by a taxpayer for his principal residence. The dollar limitation of $2,000 would keep this tax expenditure within bounds and would make it most helpful to those in the middle income family groups which are now being shut out of the market.

It now requires an annual income in excess of $25,000 to purchase the average home being built today. However, the median family income is only a little more than $12,000. Less than 20 percent of all American families can afford to buy a home today, or are able to take advantage of the tax deduction for interest on a mortgage.

Library of Congress estimates for the cost of this bill would be $4.5 billion. However, secondary effects would significantly lower the total cost of this proposal. New construction and the stimulative effect on the economy would return enough money to the Treasury to lower the cost of this tax plan by $2.6 billion the first year, and by $1.5 billion the second year. The real cost, therefore, would be $2 billion or less. The econometric model indicated very little if any inflationary pressure from this change. Estimates of at least 100,000 new single family homes are offered by the model, if this bill were put into law.

Statement of Senator James A. McClure

In October of last year I introduced a bill—S. 2465. That bill was designed to accelerate capital formation and with it, job creation and productivity in the private sector. At that time the official unemployment rate exceeded eight percent and prospects for a rapid recovery were less bright than they are today. Despite this recent improvement there is *more not less* need for tax changes which will increase the pool of savings available for capital formation.

During the next five years the challenge which the private sector must face is a considerable one. Its perimeters may be stated in both human and financial terms. Between now and 1980 we must create at léast 12 million jobs for those who are currently unemployed and for several million new entrants to the labor force.[1] In order to accomplish this monumental task and provide for the future security of these same jobholders, American industry must invest over this current decade close to one trillion five hundred billion dollars ($1,500,000,000,000) as measured in 1972 constant dollars. Stated another way, between 1975 and 1980 fixed capital investment must equal 12 percent of our projected Gross National Product. This required annual rate of investment in fixed capital is substantially higher than the 10.4% rate which characterized the period 1965–1970.

The consequences of our failure to save and invest at this 12 percent rate will be both predictable and painful. The growth in our labor force will not be matched with a growth in job opportunities, new entrants will be discouraged, job habits and skills will not be learned, income maintenance programs, entitlements and other welfare spending will increase; Federal deficits will rise rather than fall, productivity will decline and inflation will become not epidemic but epidemic as deficits are created and monetized.

At the federal level the impact of unemployment is staggering. Each one percent increase in the unemployment rate, above four percent, results in revenue losses and expenditure increases totaling $16 billion. For as long as unemployment rates remain at high levels budgetary balance cannot be achieved and efforts to hold inflation in check become increasingly less successful as the rate of money creation exceeds the annual rate of production of goods and services.

The Federal Government can do little to alter the size of the labor force or its growth. However, efforts can be made to insure that sufficient capital investment is available to create the jobs which a growing labor force demands. That is the purpose of the Jobs Creation Act and the tax changes which the Act requires.

Let me turn briefly to the subject of capital needs. We have all seen the results of several studies of capital needs. Among them one stands out as complete in the sense that it relates capital investment to a series of established national goals such as full employment, rising GNP,

[1] Full employment at 95 percent of labor force.

energy conservation, capital replacement, and a cleaner environment. In that same context, it examines aggregate investment needs and relates them in dollar terms to the realization of each of our many goals in a disaggregated form. The study to which I am referring was requested by the Council of Economic Advisors and was performed by the Bureau of Economic Analysis. The results of that research were made generally available in December of 1975.

The approach followed by the Bureau was as follows:

1. GNP and its major components were projected through 1980.
2. The aggregate GNP projections were disaggregated by industry group.
3. Input-output analysis then related final industry sales to domestic investment requirements by industry.
4. Historic capital input requirements were then adjusted by industry to reflect the demands of environmental regulations which currently exist.
5. Finally, investment needs were related to energy conservation and increasing energy independence.

The figures which resulted represent a clear challenge to this society for they indicate that the price of a brighter future is a less profligate present. We cannot perpetuate an approach to our federal tax law and federal budget which rewards consumption and penalizes savings and investment. Over 200 years ago Adam Smith in reflecting on the causes of the wealth of nations concluded that wealth lies not in our hoards of precious metals but in the productive interaction of land, labor and capital. Our material success is related not to the fact that we work harder or longer today than we did 200 years ago but rather that we work more productively with an ever-expanding capital base.

As a nation we stand at a crossroads. One road, that traveled by Great Britain, has the immediate appeal associated with redistributing existing wealth, but it also holds in store the ultimate pain of sharing not the wealth but the resultant poverty. The other, less frequently traveled road, promises continued progress and gradual enrichment for all members of society. The provisions of the Jobs Creation Act are clear directions to pursue the path which we have so successfully traversed in the past. Their rapid implementation will reduce revenues at the federal level only slightly and for a short period. Various estimates of the revenue and employment effects of S. 2465 are available and I submit one of them for the record. It was undertaken by Dr. Norman Turre and Associates. I invite the Committee to study this submission and contact the organization responsible for it. Finally, I would remind the Committee that while we are told that the power to tax is the power to destroy we must also realize that the power to tax can become the power to create. It is to this creative power that the Jobs Creation Act is addressed.

Economic and Federal Revenue Effects of the Jobs Creation Act of 1975

INTRODUCTION

The Jobs Creation Act of 1975, H.R. 10015, introduced by Representative Jack Kemp (R. N.Y.), contains more than a dozen provisions to reduce the bias against private saving and capital formation in the existing Federal income tax. The bill, if enacted, would drastically reduce that bias. It would dramatically shift the emphasis to tax policy toward meeting the present and prospective requirements of the U.S. economy for a far higher rate of savings and capital formation than has been realized, on the average, over the three decades since the end of World War II.

The effects of the bill's provisions on private saving and capital formation, on employment, and on GNP would, similarly, be dramatic. Full implementation of the proposed provisions would sharply accelerate the increase in capital outlays, employment, and GNP over a three-year transition period during which individual and business savers would adjust their savings and investing plans and behavior to the more nearly neutral tax environment. In the third full year after enactment, GNP originating in the private sector of the economy (measured in 1974 dollars) would be $248.9 billion greater than if present (i.e., 1974) tax provisions are continued. Capital outlays would be $81.1 billion greater than otherwise. Full-time equivalent employment would rise by 10.9 million jobs above levels otherwise attained. Additional significant gains in output, employment, and capital outlays above postwar trend would occur following this transition period, although these clearly would be of smaller magnitude.

Enactment of the Jobs Creation Act would increase rather than reduce tax revenues. Associated with the sharp increases in GNP, employment, and capital outlays in the transition period would be a substantial increase in the bases of the major Federal taxes. The revenue estimates in the summary table take into account these so-called "feedback" effects; the amounts shown for each provision in each year are estimates of the revenue increases generated by the enlargement of the total tax base resulting from the expansion of economic activity, offset in part by the initial reduction in effective tax rates or in particular elements of the tax base.

In the last transition year, there would be a net increase of $25.2 billion in Federal tax revenues. Even in the first year after enactment Federal tax revenues would increase—by an estimated $5.2 billion—over the amounts that would otherwise be realized.

The principal provisions of the bill and the estimated economic effects of each provision are presented in the following table.

EFFECTS OF THE JOBS CREATION ACT OF 1975

[Money amounts in billions of 1974 dollars]

Proposal and years after enactment	Private GNP	Increases in Employment (thousands)	Capital outlays	Federal revenue
1. Savings tax credit of 10 percent, up to $1,000 ($2,000 for joint returns), not exceeding tax due:				
1	31.0	1,780	22.3	1.9
2	40.2	2,100	23.3	4.8
3	50.1	2,430	24.3	7.9
2. Exclusion of domestic corporate dividends from adjusted gross income:				
1	20.9	1,200	15.5	.6
2	28.7	1,510	16.3	3.1
3	35.7	1,740	17.0	5.3
3. Exclusion of $1,000 of capital gain per year:				
1	9.0	520	6.8	1.6
2	12.7	920	7.1	2.8
3	15.6	760	7.4	3.7
4. Reduction of normal corporate tax rate from 22 to 20 percent (with no change in surtax):				
1	11.0	630	7.7	1.1
2	13.7	710	8.1	2.0
3	17.7	860	8.4	3.2
5. Reduction of surtax rate from 26 to 22 percent (no change in normal tax rate or surtax exemption):				
1	20.0	1,150	14.1	2.0
2	25.0	1,300	14.8	3.7
3	32.3	1,570	15.3	5.8
6. Increase in surtax exemption from $2,000 to $100,000 (with present normal and surtax rates):				
1	11.0	630	7.7	1.1
2	13.7	710	8.1	2.0
3	17.7	860	8.4	3.2
7. Increase to investment credit from 7 percent with limitations to 15 percent for all Sec. 1245 property:				
1	23.9	1,370	17.4	4.3
2	31.7	1,660	18.2	6.8
3	39.9	1,940	18.9	9.4
8. Increase in asset depreciation range (ADR) from 20 percent to 40 percent:				
1	12.9	760	7.0	2.3
2	22.2	1,250	7.4	1.8
3	28.2	1,520	7.7	1.6
9. Optional capital recovery allowance:				
1	55.6	3,400	16.7	8.7
2	70.3	4,070	17.4	11.5
3	82.4	4,550	18.0	14.2
10. Combined effect:				
1	151.4	7,180	74.6	5.2
2	200.5	9,020	77.9	14.6
3	248.9	10,910	81.1	25.2

Note: The estimates respect to any combination of these proposals are not necessarily equal to the sum of the individual estimates. An estimate will be forthcoming for provisions of the bill which are not included above if adequate data become available.

Estimates for certain of these proposals may differ from previous estimates for similar or identical proposals because of revisions in government data and underlying assumptions. Assumptions used in this table are consistent among alternatives.

Where exact quantification of variables was impossible, conservative assumptions above the values of those variables were employed. A full documentation of the estimated procedure is available upon request.

Estimates are based on changes with respect to the law in 1974 rather than the temporary provisions enacted in 1975. Effects for year 1 are for 1975 and assume that the proposal would have been operative since Jan. 1, 1975. Effects for years 2 and 3 refer to 1976 and 1977 levels of GNP, employment, and so forth, relative to their assumed trend values had the 1974 law remained unchanged. Note that employment effects are not cumulative; the 40 percent ADR for instance would lead to an increase of 1,520,000 full-time equivalent employees in year 3 over the number of such employees in the absence of this tax change, not 760 plus 1,250 plus 1,520 1,520 equals 3,530,000.

SUMMARY OF PROCEDURE FOR ESTIMATING THE ECONOMIC AND REVENUE EFFECTS

The analysis of the effects of the bill's several provisions on GNP, employment, capital formation, and Federal tax revenues begins with a determination of the impact of the proposed tax changes on the cost of private saving, hence the cost of capital in the private sector. The change in the cost of saving is treated as the percentage decrease in the pretax return per dollar of saving and investment required to make that dollar of saving and investment "worthwhile". For this purpose, an investment equation of the familiar discounted cash flow form is used; and investment is considered to be "worthwhile" if the present value of its expected after-tax cash flow over the life of the investment is at least equal to the present value of the outlays made to acquire the asset(s). Since changes in tax provisions obviously affect the absolute amount and/or the present value of the after-tax cash flow, they change the amount of the pretax return on the investment required for it to be "worthwhile".

The second step in the analysis delineates and measures the private saving and investment response to the change in the cost of capital determined in the first step. The lower the cost of capital, other things being equal, the greater will be the amount of capital people will want to own. An explicit relationship between this change in the amount of desired capital and the change in the cost of capital is specified. This relationship then is used to estimate the increase in the desired stock of capital resulting from the reduction in the cost of capital provided by the tax proposal under examination.

A second relationship is specified to estimate changes in pretax returns resulting from changes in the stock of capital. These two relationships are then combined to estimate the increase in the amount of capital which equates the new required pretax return and the pretax return which that amount of capital will actually provide. Through step two, then, the model estimates the effect of various tax proposals on the cost of capital and consequently on the stock of capital.

The third step in the analysis is to estimate the changes in GNP and in employment resulting from the increase in the stock of capital. Achieving the desired increase in the stock of capital obviously requires capital outlays above the amounts that otherwise would be spent. In the period in which the adjustment to the tax changes occurs (assumed to be three years), these additional capital outlays sharply increase GNP and employment. In addition, as the increases in the stock of capital come on stream, they expand production capacity and output. Associated with the enlarged amount of capital are additional demands for labor services, resulting in an increase in employment, in wages, or in both above the increases that would otherwise occur.

The final step in the analysis is to estimate the effects of the tax changes on Federal tax revenues. Each of the provisions in the bill would reduce one or more income tax rates or initially reduce the amount of income to which the tax rates apply. Estimates of these initial effects on Federal tax revenues clearly are unsatisfactory and unrealistic, since they do not take into account taxpayers' responses to the changes in the tax provisions. In addition to these initial impact revenue effects, therefore, it is necessary to estimate the so-called "feedback" effects. These feedback effects are the increases in Federal tax revenues generated by the expansion of the individual and corporation income tax and the payroll tax bases which result from the increases in GNP, employment, labor compensation, and returns on capital, as estimated in step three. If initial revenue effects exceed feedback effects, there is a net reduction in Federal tax revenues; if feedback effects exceed initial effects, there is an increase in Federal tax revenues. The analysis in step four shows that each of the provisions in the bill for which estimates were made would on balance increase rather than reduce Federal tax revenues.

TECHNICAL REPORT, ECONOMIC AND FEDERAL REVENUE EFFECTS OF THE JOBS CREATION ACT OF 1975

PREFACE

The Jobs Creation Act of 1975, H.R. 10015, contains more than a dozen measures to reduce the bias against saving in the existing Federal income tax and to stimulate output, investment, and employment. Norman B. Ture, Inc. was asked to provide estimates of the effects on private sector GNP, capital outlays, and employment, and on Federal revenues, from nine of the bill's most significant provisions taken separately and as a group.

The estimates were derived from a reduced-form private saving and investment behavior model, described in detail in this report. A model of this character is particularly suited to analysis of the effects of tax changes by virtue of the fact that its specifications focus on the effects of such changes on the cost of saving and of capital, the principal impact of the tax changes proposed in the Job Creations Act of 1975. It minimizes the estimation hazards inherent in more elaborate, multisector, multi-equation econometric models, in which errors of concept, specifications or quantifications in one or more of the very large number of equations ordinarily used may have an untoward effect on the estimated results. Moreover, it avoids the conceptual ambiguities and pitfalls in the specifications of multipliers and accelerators which are important features of many of the multi-equation models. In the reduced-form model presented in this report, saving and investment behavior is specified as depending on the relative cost of consumption vs. claims to future income, given levels of income; changes in income levels are taken into account by estimation of their trend values and the changes therein resulting from changes in total production capacity in response to the proposed tax changes. In most of the multi-equation econometric models treat saving and investing as functions of disposable income, ascribing insufficient weight or influence to changes in the relative cost of saving and investment.

The model presented in this report is a general equilibrium model in that the basic investment equation on which it relies imposes the constraint of equal returns at the margin on private saving in all forms. Thus, a tax provision which alters the return on saving allocated to a particular outlet results in both a shift in the allocation of total saving among alternative outlets and a change in the aggregate amount of saving.

The quantitative estimates in the report should be viewed as measuring direction and order of magnitude of the effects of the specified tax proposals. While these estimates are sensitive to alternative assumptions about the values of the parameters and variables in the model, we are confident that, as presented, they reasonably represent the results which may be expected from implementation of the tax proposals.

PROCEDURE FOR ESTIMATING EFFECTS OF THE JOBS CREATION ACT OF 1975

A. Overview

The Jobs Creation Act of 1975 contains more than a dozen measured to reduce the bias against saving in the existing Federal income tax and to stimulate output, investment, and employment. Norman B. Ture, Inc. was asked to provide estimates of the effects on private sector GNP, capital outlays, and employment, and on Federal revenues, from 9 of the bill's most significant provisions taken separately and as a group.[1]

The details of the estimation procedure are described below for each alternative; a sketch of the process should clarify the discussion. First, capital stocks, national income, gross product, and employment in the private sector are projected through 1977 under present law using their postwar trend rates of growth. Next, the effect of each proposal on the cost of capital and the increase in the desired stock of capital in response to the lowered cost of capital are calculated. This increase in the stock of capital allows estimation of the increase in capital outlays resulting from a proposal. Associated with the increase in the stock of capital is an increase in employment, hence in national income. The additional investment and higher national income together provide an estimate of the increase in private GNP. The added GNP also increases Federal revenues by raising the tax base; this increase is partially offset by an initial impact revenue loss, calculated by applying the reduction in the tax rates or tax base to the present law levels of income. The net effect on Federal revenues equals the difference between these two revenue estimates.

B. Data

It was assumed that full response to each proposal would take 3 years. This reflects the time required by taxpayers to assess the effects of a provision on the cost of capital. to adjust their saving and investment decisions, and to plan for, order, and install new equipment and structures.

Estimates were prepared for each of the first three years after enactment. It was assumed that the provisions were in effect from January 1, 1975. Thus, year 1 refers to 1975, year 2 to 1976, and year 3 to 1977. Present-law assumptions were based on projections of 1973 values at their 1947–73 trend rates of growth, using the 1974 tax law. (Changes resulting from the Tax Reduction Act of 1975 were not considered.) No attempt was made to forecast the rate of inflation; all money amounts are expressed in billions of 1974 dollars.

The estimates with respect to any combination of these proposals are not necessarily equal to the sum of the individual estimates, since some proposals overlap (8 and 9) or interact (4 and 8). Certain combinations (4 and 5, for instance) are additive, however.

Two approaches are available for estimating the stock of capital in the private sector. The more straightforward and reliable method is

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[1] Estimates for the effect of increasing the ceiling for contributions to Individual Retirement Accounts from $1,500 to $2,000 per year and of an alternative amortization period for pollution control facilities will be forthcoming if adequate data becomes available. Economic effects of two other provisions of the bill, relating to extension of time for payment of estate tax and interests in family farming operations, were considered to be of too small magnitude to warrant estimation.

to add up the financial claims held by the household sector, pertaining to assets in the private sector. Since governments do not own a share of privately held assets in the United States, and since the aggregate of corporate asset holdings have a counterpart in one or another set of financial claims in the household sector, this approach should provide a complete and unduplicated accounting. According to the Federal Reserve Board, household sector private financial assets totaled \$2,302.3 billion at the end of 1973.

The alternative is to count up the value of physical stocks of equipment, structures, and inventories. There are severe difficulties involved in achieving a complete count and in valuing on a current basis assets of widely varying ages and degrees of obsolescence and deterioration. Nevertheless, estimates by the Commerce Department's Bureau of Economic Analysis for 1973 amount to \$2,286.1 billion, remarkably close to the Federal Reserve estimate of \$2,302.3 billion.

The latter figure was converted to 1974 dollars multiplying by the ratio of 1974 to 1973 deflators for gross private domestic investment. Values were computed through 1977 by compounding the stock at an annual rate of 3.8%, the postwar trend rate of growth for capital.

Private sector national income and gross product for 1973 were converted to 1974 dollars using the ratio of 1974 to 1973 deflators for gross private product, then extrapolated at their postwar trend rates of growth.

The number of private sector full-time equivalent employees was projected to grow at its 1947–73 trend rate of 1.2% per year. It was assumed that the trend rate of increase in wages would not be affected by any of the proposals and that all resulting increases in labor income above the trend value would be attributable to increases in the number of full-time equivalent employees.

C. Estimation procedure

1. Cost of capital change

The analysis begins with a determination of the decrease in the cost of capital resulting from a tax proposal. This can be represented as the pretax income needed to make a given investment worthwhile under the proposal, less the pretax income needed under present law. An investment may be considered "worthwhile" if the present value from the expected after-tax cash flow over the life of the investment equals or exceeds the initial outlay. It is assumed that the volume of investment when adjustment to the tax change is completed is such that the present value of the net cash flow just equals initial outlay.

For an individual, four types of investment can be distinguished: depreciable and nondepreciable, corporate and noncorporate. An investment equation may be written for each:

1. Investment in depreciable corporate assets

$$I_1 = (1-t_p) \text{ div } (1-t_e)\sum_{1}^{n} y(1+r)^{-i} + t_e\sum_{1}^{m}(1+r)^{-i}D_i + c(1.12)^{-1}ITC$$

$$+ (1-t_g)(1.12)^{-n}CG$$

2. Investment in depreciable noncorporate assets

$$I_2=(1-t_p)\sum_1^n(1+r)^{-i}y+t_p\sum_1^m(1+r)^{-i}D_i+c(1.12)^{-1}ITC+(1-t_g)(1.12)^{-n}CG$$

3. Investment in nondepreciable corporate assets

$$I_3=(1-t_p)\text{ div }(1-t_c)\sum_1^n(1+r)^{-i}y+(1-t_g)(1.12)^{-n}CG$$

4. Investment in nondepreciable noncorporate assets

$$I_4=(1-t_p)\sum_1^n(1+r)^{-i}y+(1-t_g)(1.12)^{-n}CG$$

where

I=amount initially invested
y=pretax earnings required for each of n years to repay investment of I
D_i=depreciation in year i on asset I, given depreciable life m
ITC=investment credit earned in first year
CG=capital gain realized after n years
div=dividends received by individuals as a fraction of corporate cash flow
c=fraction of depreciable assets that are eligible for investment credit
r=rate at which future income is discounted to present value
t_p=marginal tax rate on personal capital income
t_c=marginal tax rate on corporate income
t_g=marginal tax rate on personal capital gains

These four equations may be weighted on the basis of corporate and noncorporate ownership of depreciable and nondepreciable assets to yield a single aggregate equation. Weights used were: I_1=.45, I_2=.25, I_3=.2, I_4=.1.

Typical asset life was assumed to be 12 years, the average for equipment eligible for the investment credit, according to unpublished Treasury Department data. This is only one component of total asset holdings but is intermediate in life between inventories and structures, the other major components. Data for these components are incomplete or unreliable and no estimate of their average life was attempted.

It was assumed that a depreciable asset with a 12-year life which is eligible for the 20% Asset Depreciation Range (ADR) would be depreciated over 9.5 years at double declining balance rates with optimum switchover to straight line depreciation. Installation at mid-year was assumed. Under present law, an effective investment tax credit rate of 5%, rather than the nominal 7%, was assumed, reflecting Treasury estimates of the effects of limitations of net income, useful life, and the reduced credit rate for public utility property.

The amount of capital gains accrued per year were assumed to equal the ratio of undistributed corporate profits to pretax corporate cash flow, an average of .220y for the years 1947–74. Capital gains were assumed realized after the useful life of 12 years, so that realized gains equaled 12x22y=2.64y per dollar of investment.

Dividends reported on individual income tax returns have consistently averaged 17% of corporate after-tax cash flow. This fraction was used for div. Approximately 70% of depreciable assets are eligible for the investment credit, so this percentage was used for c. A discount rate of 12% was chosen for r.

From Internal Revenue Service *Statistics of Income* data, marginal tax rates were calculated: for personal capital income, .33; for corporate income, .463 (a weighted average of the .22 rate on the 6.4% of income that appears on returns reporting less than $25,000 of taxable income, and the .48 rate for all other corporate returns); for personal capital gains, .21 (one-half the marginal rate for a weighted average of individual taxable returns reporting capital gains).

Thus, under present law, the combined investment equation.

$$I = (1-t_p)\sum_{i=1}^{12}(1+r)^{i}y[\mathrm{div}\ (1-t_c)(.45+.2)+(.25+.1)]$$

$$+(.45t_c+.25t_p)\sum_{i=1}^{9.5}(1+r)^{-i}D_i+(1+r)^{-1}(.45+.25)cITC+(1-t_g)(1+r)^{-12}CG$$

$$=.67(6.195)y[.17(.537)(.65)+.35]+[.45(.463)+.25(.33)](.620)I$$

$$+.893(.7)(.7)(.05)I+(.79)(.257)(2.64)y.$$

This equation is solved for y under present law. For each alternative, the equation is reformulated and solved again for a new y. Then the decrease in cost of capital equals the difference between new and present-law y as a percent of present-law y. The reformulations are described below under the discussion for each proposal.

2. Capital stock change

As the quantity of capital increases, the marginal product (i.e., the pretax return) of capital decreases. The percent increase in quantity of capital associated with a given percent reduction in its marginal product is the elasticity of demand for capital, e_d. It is widely assumed to equal −1. The present increase in total saving, or equivalently in desired total capital, dK/K, which occurs in response to a given percent reduction in the cost of capital, dy/y, depends as well on the elasticity of supply of savings, e_s, that is on the percent increase in assets that savers wish to hold for a given percent change in the return that they receive. For this study e_s is very conservatively assumed to equal ½, implying that a 1% increase in the return on savings would elicit an increase in the aggregate amount of saving of only 0.5%. (A less conservative estimate would raise all of the estimated effects.) The exact relationship among these variables is:

$$\frac{dK}{K}=\frac{e_d dy/y}{1-e_d/e_s}=\frac{1}{3}\frac{dy}{y}$$

That is, a given percent reduction in the cost of capital will raise the equilibrium (post-transition) capital stock above its trend value by one-third as great a percentage. For instance, a 6.9% reduction in the cost of capital (as in the case of the saving tax credit) will lead to a 2.3% rise in the stock of assets. It is assumed that it takes 3 years to achieve this increase in stock, so that by the end of 1977 the stock is 2.3% or $66.9 billion larger than the trend value of $2,910 billion which it would attain in the absence of the proposal. It is further assumed that this increase will occur in 3 equal increments. Hence capital outlays would rise above present levels by $22.3 billion per year beginning in 1975, if the provision were in effect from January 1, 1975. Starting in 1976, there would be an additional increase in outlays to cover replacement of the depreciable portion of the augmented net stock. In recent years, replacement investment for depreciable assets has averaged 4.4% of the previous year's total net stock. Thus additional replacement investment in 1976 would total about $.044 \times 22.3 = \$1.0$ billion, in addition to the $22.3 billion increase in the net stock, for a total of $23.3 billion in incremental outlays in 1976.

3. GNP and employment change

Increases in net stock raise the nation's productive capacity and hence its output. Associated with these increases in capacity and output are additional demands for labor services, which result in a rise in the average wage rate, in the number of employees, or in both.

This study makes two assumptions regarding labor: (1) the shares of GNP going respectively to labor and capital will remain constant (an assumption which has been valid over the postwar period), and (2) the increase in the labor share will be attributable to increases in employment rather than to increases in the general wage rate. These conditions may be expressed notationally as follows:

(1) $rK/wL = c$
(2) $d(wL)/wL = dL/L$.
where r = price of capital services
K = stock of capital
w = wage rate
L = number of full time equivalent employees
c = a constant

If Q = private GNP, then Q may be expressed as the sum of labor and capital income:

$$Q = rK + wL = cwL + wL = (1+c)wL.$$

The percent change in private GNP, dQ/Q, is given by

$$dQ/Q = d(1+c)wL/(1+c)wL = dL/L$$

Private GNP will increase by the same percentage over trend as the increase in capital and labor inputs over their respective trends. In addition, during the three-year transition, in which capital outlays increase in order to raise capital stock to its new growth path, GNP is further increased by the amount of the additional capital outlays and by the additional capital consumption allowances. Employment increases proportionately during this transition period.

4. Revenue change

The increase in total Federal revenues was estimated as the sum of additional tax receipts from three sources: income taxes on income from capital (corporate profits, interest, rents, and proprietor's income); income and payroll taxes on labor income (wages and salaries); and indirect business taxes (mainly Federal excise taxes). To determine the appropriate marginal tax rates to be applied to each source, it was necessary to divide national income and Federal revenues into the three categories. National income is readily divisible, but since personal income tax and nontax receipts in the National Income Accounts apply to income earned from capital as well as labor, use of a single average tax rate would understate the rate paid by those receiving income from capital who are in higher tax brackets than the population as a whole. Partial segregation of these capital-income recipients is provided by the 1966 and 1969 editions of *Statistics of Income—Individual Income Tax Returns*, which classifies taxpayers by major source of income. In each of those years, the average tax rate (tax after credits as a percent of adjusted gross income) for those whose major source of income was capital (business or professional net profit, partnership net profit, dividends included in adjusted gross income, or net gain from sale of capital assets) was approximately 1.67 times as high for those whose major source of income was salaries and wages.[1] This ratio was used to find the average tax rates on capital and labor income, t_K and t_L in the equation

$T = t_K K + t_L L$, where

T = the sum of personal tax and nontax plus contributions for social insurance,

K = the sum of proprietors' income, rental income of persons, and net interest included in national income, and

L = compensation of employees.

"Personal capital-income" tax revenues, $t_K K$, were added to Federal corporate profits tax accruals. The sum was divided by the sum of personal capital income (K) and corporate profits to yield an overall capital tax rate. These calculations were made for 1971–74. In that period, the capital tax rate varied from .323 to .331 averaging .33. In that same period, the labor tax rate climbed from .166 to .190 (reflecting the rise in social security rates and the effect of inflation in pushing individuals into higher income tax brackets). By plotting the logarithm of the labor tax rate against labor income, the labor tax rate was found to rise, on average, 5.7 percent for every $100 billion increase in employee compensation. The marginal rate, that is, the rate on the increment of labor income, associated with these changes in average rate was found to be .33. Finally, an indirect business tax rate of 0.19 (the rate in both 1973 and 1974) was applied.

The total Federal tax rate equalled the sum of these three components, or approximately .35, i.e. .33 on both the labor and capital share, and .019 on the total. This rate was multiplied by the increase in GNP found above. From the resulting amount, an initial impact estimate was subtracted to yield a net revenue figure.

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[1] The separation of income sources was nearly but not entirely complete. For those reporting salaries and wages as a major source, other sources supplied approximately 3 percent of adjusted gross income; for those with one category of capital income as a major source, other sources accounted for 17–19 percent of adjusted gross income.

D. Estimation procedure for specific proposals

1. Savings tax credit of 10%, up to $1,000 ($2,000 for joint returns), not exceeding tax due

The credit would apply to net additions to taxpayer holdings of savings account deposits, federal government debt, investment company shares and other corporate securities, and life insurance reserves. Holdings of these assets amounted to $1,694 billion in 1973. To find out how much the credit would reduce the cost of capital and lead to an increase in asset holding, it was necessary to distribute these assets by income bracket using the Internal Revenue Service's *Statistics of Income—1973 Preliminary Individual Income Tax Returns.* This was accomplished by assuming that the distribution of eligible assets is the same as the distribution of interest reported on taxable returns. A preliminary estimate of the amount of additional saving induced by the credit was necessary in order to find the actual decrease in the cost of capital. Initially it was assumed that a 10% credit would lead households to increase their stock of eligible assets by 1%, or $16.9 billion. This was added to the actual increase in assets of $88.7 billion reported in 1973. Then eligible savings for each adjusted gross income (AGI) class were estimated by multiplying reported interest income in each class by the ratio of total eligible saving to total interest income. These totals per AGI class were divided by the number of returns, in each class to derive average saving per return in each class (joint and nonjoint returns were handled separately). Average tax per return was also computed for each AGI class. Then for each class, the average amount of credit per return was calculated and multiplied by the number of taxable returns to yield the overall initial impact revenue loss and increase in eligible savings. The actual decrease in cost of savings implied by this latter total proved to be 6.9%, rather than 10% as first indicated. This 6.9% decrease in cost of capital translates to an increase of 2.3% in all types of assets.

2. Exclusion of domestic corporate dividends from adjusted gross income

This tax change was incorporated in the overall investment equation of part C by dropping the term $(1-t_p)$ from in front of the dividend term in equations 1 and 3. The resulting reduction in cost of capital equaled 4.8%, implying a 1.6% growth in the 1977 capital stock relative to its present-law trend value.

The implied revenue gain was offset by an initial impact loss computed by multiplying the amount of dividend income in each AGI class by the marginal rate associated with that class and summing all classes. This loss was reduced by 10% to remove dividends from foreign corporations, which would remain taxable, and to allow for the likelihood that for taxpayers with large amounts of dividend income, some of that income would fall in lower brackets and be taxed at lower than the marginal rate. Dividends were distributed among AGI classes according to *Statistics of Income—1973 Preliminary Individual Income Tax Returns;* tax rates per AGI class were derived from the 1972 volume.

3. Exclusion of $1,000 of capital gain per year

This proposal was handled by changing the final term of the investment equation from $(1-t_g)(1+r)^{-n}CG$ to $(1-.67t_g)(1+r)^{-n}CG$, reflecting the fact that average capital gain per return is about $3,000, so that approximately two-thirds of all gain would remain taxable. The exclusion would reduce the cost of capital by 2.1%, raising 1977 stock by 0.7%.

The implied revenue gain was reduced by an initial impact loss equal to $1,000 per return times the number of returns reporting capital gains in each AGI class times the marginal tax rate associated with each class.

4. Reduction of normal corporate tax rate from 22% to 20% (with no change in surtax)

This proposal would lower the tax rate for all corporations by 2% from a weighted average of 46.3% to 44.3%. Incorporating this change in the investment equation led to a 1.2% reduction in the overall cost of capital, and a 0.4% increase in the 1977 stock.

In calculating the resulting revenue gain, the marginal tax rate on capital income was lowered to reflect the lower rate on corporations. Further, an initial impact loss of 2% of taxable corporate income offset part of the gain.

5. Reduction of surtax rate from 26% to 22% (no change in normal tax rate or surtax exemption)

This provision would lower from 48 to 44% the marginal tax rate on the 93.6% of taxable income going to corporations with taxable income exceeding $25,000. Thus the weighted average corporate rate would fall from 46.3% to 42.6%, indicating via the investment equation a reduction in the overall cost of capital of 2.2% and an increase in 1977 stock of 0.7%.

Calculation of the net revenue effect involved considerations akin to those mentioned above under proposal 4.

6. Increase in surtax exemption from $25,000 to $100,000 (with present normal and surtax rates)

This change would lower the marginal tax rate from 48% to 22% on the 7.4% of net income between $25,000 and $100,000 reported on corporate returns with taxable income greater than $25,000. This is equivalent to a 1.9% drop in the weighted average corporate rate. When included in the investment equation, this yielded a 1.2% reduction in the cost of capital, the same as for proposal 4.

7. Increase in investment tax credit from 7% with limitations to 15% for all Sec. 1245 property

Currently, taxpayers may claim a 7% credit on Sec. 1245 property (equipment and certain business structures), subject to limitations on net income, useful life, and public utility property. The Treasury estimates that these restrictions lower the effective rate to approximately 5%. The bill would remove these restrictions and raise the rate to 15% for all taxpayers. This would be equivalent to a 5.5% across-the-board reduction in the cost of capital, and would raise 1977 stocks by 1.8%.

The implied revenue gain would be reduced by a 10% increase in the credit applied to eligible investment which would have occurred in the absence of the change in law. The Treasury estimates this loss at about $4 billion per year.

8. Increase in Asset Depreciation Range (ADR) from 20% to 40%

This provision would permit faster write-off of depreciable assets. The tax life for the asset used in the investment equation would be shortened from 9.5 to 7 years, with a concomitant increase in the annual depreciation deductions. The cost of capital would fall by 2.2%, and 1977 stock would rise by 0.7%, compared to present law projections.

Private GNP would be boosted by higher capital consumption allowances as well as by the higher capital outlays and national income effects found with previous alternatives. For example, first-year depreciation deductions for the typical asset used in the investment equation would equal 14.3% of investment cost, rather than 10.5%. For the portion of investment which would have occurred even under present law, there would be an initial impact loss equal to the marginal capital tax rate (.33) times the increase in depreciation deductions.

9. Optional capital recovery allowance

This proposal would speed up write-offs to 5 years for equipment and 10 years for structures. Moreover, a full year's capital recovery allowance could be claimed in the first year, instead of the current half year's allowance. This would lower the cost of capital by 5.2%, and raise the 1977 stock by 1.7%, relative to present law projections. Procedures for estimating effects on GNP and revenue would be the same as those of provision 8.

10. Combined effect

Combining all of these provisions would remove domestic dividends and up to $1,000 of capital gain per year per return from AGI, lower the weighted average corporate tax rate from 46.3% to 39.9%, raise the investment credit from an effective rate of 5% to 15%, and lead to adoption of 5- and 10-year write-offs for depreciable assets. It was assumed that all taxpayers would adopt the optional recovery allowances in lieu of the increased ADR: the latter therefore, is not included in the following equation. The resulting investment equation would be:

$$I=\sum_{i=1}^{12}(1+r)^{-i}y[\text{div }(1-t_c)(.45+.2)+(1-t_p)(.25+.1)]$$

$$+(.24t_c+.25t_p)\sum_{i=1}^{5}(1+r)^{-i}D_i+(1+r)^{-1}(.45+.25)cITC$$

$$+(1-.67t_g)(1+r)^{-12}CG=6.195y[.17(.61)(.65)+.67(.35)]+[.45(.39)$$

$$+.25(.33)](.787)I+.893(.7)(.7)(.15)I+[1-.67(.21)](.257)(2.64)y$$

This results in a 16.2% reduction in the cost of capital, and a 5.4% increase in the 1977 stock.

It should be noted that the combined effects are less than the sum of the nine separate estimates. The principal reason is that certain combinations, such as lower corporate tax rates and more rapid write-off of depreciable assets, are partially offsetting.

TESTIMONY SUBMITTED BY HON. STANLEY N. LUNDINE, A U.S. CONGRESSMAN FROM THE STATE OF NEW YORK

Mr. Chairman and members of the committee: I appreciate having this opportunity to address the subcommittee as it conducts these vital hearings on tax reform. As the newest member of Congress, I'd like to share with you some of the feelings and sentiments I received from the people in New York's 39th Congressional District during the recent special election.

I made a promise to the people in my district: I promised to come before this committee and represent them—the individual taxpayers whose voice is too often not heard when Congress considers tax reform. The corporate industries are heard. The large trade and professional associations are heard. The traditional lobbyist interests are heard. But for too long, the people have not been heard and the people have something to say.

As I traversed the part of New York we call the Southern Tier during my campaign, I quickly discovered that "tax reform" was not simply an "issue" with the people; they have gone beyond that stage. The people are demanding that their elected representatives take strong, specific initiatives to bring about reform and they are keeping a close watch on our Congressional performance. They are very serious about this and I wholeheartedly support their actions and involvement.

They want basic changes in the Internal Revenue Code and they want changes now! They are upset because the federal tax structure has remained substantially unchanged since the enactment of the Tax Reform Act of 1969. Payroll taxes have been increased, income taxes have been reduced, and the investment tax credit has been suspended, reinstated, and then increased. But the basic structure of the income and payroll taxes, which now account for over 90% of federal tax revenue has not been altered.

That the tax structure has been relatively stable does not mean that it enjoys general public approval. Many taxpayers, including both liberals and conservatives, Democrats, Republicans and Independents, regard it as unfair. The 1969 legislation, which was enacted in response to public pressure, was expected to be a first step in reforming the tax system, but no further steps have yet been enacted. Despite the legislative impasse of the past several years, interest in tax reform has not abated, but rather has increased to a new, militant level.

Tax reform is urged not only for economic and equity reasons, but because the tax system has become extremely complicated. Congress has repeatedly added new provisions to the tax laws in its effort to balance the competing demands of various groups. The result is an Internal Revenue Code well-nigh impenetrable to all but a few experts.

In response to this increasing pressure from the taxpayers, the House, late last year, passed its version of the bill now before this committee. Although perhaps not comprehensive by everyone's definition, the House bill does make important progress toward an ultimate comprehensive reform by providing for greater tax equity by simplifying I.R.C. provisions and administration, by eliminating some of the most abused tax shelters and by beefing up the minimum tax. The bill passed by the House does not represent a satisfactory answer to the taxpayers' rightful demands for reform, but it is an important beginning.

While some people view any tax as an unwarranted and onerous burden, I found that most people recognize the need for the government to levy taxes to raise revenues necessary to pay for government functions. Most people also recognize that taxes play an important stabilizing role in the economy and, if properly designed, can help to promote economic growth. However, the individual taxpayer will only support an equitable system where he or she knows that everyone, individuals and corporations alike, is paying his fair share. The people are protesting now not against federal taxes, but against the incredible and obvious inequity in our current tax system.

The people are protesting this unfair system and they are cheating on their own tax returns. I bring that up because it tells us something important. Until recently the taxpayers in this country had an extremely high compliance rate on their returns. Nobody enjoyed paying taxes, but everyone did pay, and paid their full share.

The growth of loopholes and preferential treatment made available to wealthy individuals and corporations and the refusal by Congress to do anything about it left a justifiably bitter taste with the individual middle income taxpayer. Today the I.R.S. estimates that approximately 70% of all tax returns are not in full compliance. These aren't big, fraudulent cheaters, these are people so frustrated and annoyed by an unfair tax system that they rebel in one of the only ways they can. I am not condoning or supporting cheating by any taxpayer, but I believe we should realize what is happening, why it is happening and that we in Congress, by restoring faith and fairness in the tax system can end it.

Many see the major drawback of the present tax system in its violation of two basic principles of tax equity:

First, the principle of progressive taxation—that the share of an individual's income taken by taxes should increase as income rises; commonly referred to as vertical equity.

Second, the principle of horizontal equity which states that taxpayers in similar economic circumstances should pay roughly the same taxes, regardless of income sources.

The current U.S. tax structure, including federal, state and local taxes has substantial redistributive effects in favor of the affluent. In 1973, 24 individuals with adjusted gross incomes of over $1,000,000 did not pay any taxes. The tax shelters and preferences almost exclusively used by the wealthy—depreciation speed up, investment credit, artificial deductions on tax shelters in real estate, farming operations, certain oil and gas wells, and equipment cases—will cost the Treasury and the nation's taxpayers over $8 billion for the year ending June 30, 1976. Perhaps the major innovation in the 1969 Tax

Reform Act was the enactment of a tax on preference items previously excluded under individual and corporate income taxes. Under this minimum wage tax, an individual was to have been taxed at the rate of 10% on the sum of his income from tax preferences less a $30,000 exemption. It appeared that a small, but positive, step toward tax equity had been taken. However, as a result of the loopholes in the minimum tax, 92,000 individuals reporting tax preference income totaling $3.1 billion paid no minimum tax at all. Similarly, 75,000 corporations, with tax preference income of $1.6 billion paid no minimum tax at all.

These figures do not, of course, tell the whole story, they merely represent the tip of the iceberg. But they should be enough to tell us that reform is desperately needed. The average American taxpayer already knows it. That average taxpayer may not be knowledgeable in the use of sophisticated devices such as capital gains, accelerated depreciation and the investment tax credit, but he or she is very much aware that the middle income groups are enduring a bigger share of the tax burden as in years past and they will not tolerate this byzantine construction of an "equitable" tax system any longer.

Economics is not a simple subject, but our tax law is needlessly shrouded in dense complex language that obscures its meaning and hides its effects on public and private decision making. With 1,890 pages of the Internal Revenue Code and with 4,526 pages of accompanying regulations, even sophisticated analysts must struggle to comprehend the implications of tax policy. The code should be drastically shortened and simplified.

The present tax system works against 85 percent of all individuals—those with adjusted gross incomes of under $20,000. They get fewer and smaller tax breaks; they pay more of the taxes which the I.R.S. says they owe; they spend millions of dollars on commercial preparers for tax advice that is often wrong; and they get an inferior brand of justice from I.R.S. when differences do arise.

I believe that many of these problems could be effectively resolved with a basic, radical change in the system. All special preferences and credits in the tax law—loopholes—should be cast aside. In their place, we should impose a single progressive income tax with substantially lower rates, leaving the individual's income tax to rise as his or her income rises. The basic result of such a change would be that people in income brackets above $100,000 per year would pay more taxes than they do now and those with incomes below $20,000 would pay less.

Although there are some middle and lower income taxpayers who are afraid of losing the miserly deductions they now enjoy, I am convinced that if they truly believed that we in Congress were preparing a fair and comprehensive tax reform package of this type and if they were honestly shown how grievously they fared under the present system, they would not only support this type of change they would demand it.

This simplification approach would have the desirable dual effect of eliminating thousands of ambiguous regulations and loopholes from the Internal Revenue Code and of providing a clear and fair understanding of each individuals tax obligation. By this one change we could remove the veil of confusion which currently exists as the norm and basis for every encounter with the code by every individual taxpayer and ensure that the "average" taxpayer could prepare his or her return competently and completely without professional assistance.

Another major equity problem for the low and middle income taxpayer is the payroll tax—especially the social security tax. The payroll tax combines two regressive features. It takes a flat percentage of covered earnings and sets an earning ceiling so that those with incomes above the ceiling are not subject to additional tax payments.

Recent I.R.S. figures show that at least one-half of all American income earners pay a higher social security tax than income tax. Viewed with this insight it is obvious that "tax reform" proposals—such as President Ford's—which contemplate a slight reduction in income taxes and a higher social security tax represent regressive reform which will increase the heavy burden of the low and middle income worker and will, by robbing Peter to pay Paul, have no substantive effect on the total tax dollars collected.

Between 1969 and 1974, receipts from individual income taxes rose by $32 billion or 36 percent. In the same period federal social security insurance taxes and contributions rose by $30 billion or 75 percent. (Corporate income taxes in the same period rose by $2 billion or only 5 percent). The figures are clear and their impact obvious—those who can least afford it are being asked to increase their already burdensome tax payment.

I believe the payroll tax should be revised to apply only to earnings above a fixed minimum per capita, that there should be a standard deduction of $2,000 and that the maximum taxable earnings limit should be raised substantially.

It is also time that the tax laws be viewed as line items in the national budget. Economically, it makes little difference whether the Federal Government provides subsidies through direct grants and Treasury checks or by failing to tax someone who would otherwise be taxed. Procedurally, however the two methods of being on the Federal take are vastly different. Appropriations are reviewed each year by the Congress in an effort to determine whether a given program merits further funding. Tax expenditures (loopholes and preferences), in contrast, are rarely, if ever reviewed. In the appropriations process, Congress must act affirmatively to open the Treasury "tap"; but Federal dollars "spent" under the tax laws continue to be spent until the Congress acts to turn the tap off. As a result, tax expenditures are self-perpetuating, remaining on the books long after their original justification has disappeared.

Congress should be required to review Federal tax expenditures annually and to act affirmatively if it wishes to continue any one of them.

If active approval is not given, the benefits should lapse. In this way, the burden of justifying the spending of public money would be shifted where it belongs.

Past disappointments with tax reform may be due in large part to a failure on the part of elected officials and tax "experts" to convey a message to the general public. The key to action on tax reform is both a broader public agreement on the proper distributional, or equity, goals of society and a deeper public understanding of the contributions that a better tax system can make to the achievement of the best and most efficient use of the society's available resources.

Constructed as it must be from a complex set of trade-offs whose dimensions are uncertain and whose ingredients inspire sharply differing individual evaluations, a good tax system is a delicate, ever changing work of political and economic partisanship. At one and the same time it must be:

Simple enough to be widely understood but complex enough to deal effectively with economic reality;

Equitable in its allocation of burdens between rich and poor but sensitive to the potential disincentive effects of high tax rates;

Frugal in its commitment of resources to administration and compliance but generous in applying them in the pursuit of fairness and justice;

Evenhanded in its treatment of similarly situated taxpayers but alert to the social benefits attainable with well-designed tax incentives.

Obviously, tax reform is a difficult and complex issue. I do not come before you today with all the answers to the questions, but I do have two specific points on which to conclude. The individual taxpayers who represents the backbone of the tax system and in fact our entire governmental process know an equitable tax system when they see one. He or she may not be able to write all the components of such a system, but they know one when it is put pefore them. The current tax system fails miserably to provide these taxpayers with the security of an equitable and acceptable system.

My final point is that neither I nor any individual in the country—be he a Congressman, Senator, economist, or private taxpayer—should feel precluded from discussing tax reform simply because he does not know all the answers. I have outlined today some of my major concerns for comprehensive tax reform. I have offered the types of solutions which I support. But I am not asking this committee to take all of my suggestions and incorporate them, and only them, into the legislation you are now considering. Nor is the individual taxpayer asking that all of his ideas be accepted in a new, comprehensive tax reform package.

What I am asking for and what the individual taxpayer is properly demanding is that this committee, as the appropriate body of the Senate of the United States, not shirk from its responsibility to the people. The people know that it is time now to begin a sincere and committed discussion of comprehensive tax reform. You, like I, have been elected to serve the people and we will only continue to serve and hold their trust as long as they believe that we are acting in their best interest. This committee, along with the House Committee on Ways and Means has the resources—in your own membership, in your staff, and in your ability to call expert witnesses—to ensure a forum for discussing and drafting vitally needed tax reform legislation. I for one believe it is a duty which the people deserve to have fulfilled.

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
Washington, D.C., May 13, 1976.

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

DEAR SENATOR LONG: The National Association of Life Underwriters (NALU) is a federation of over 1,000 State and local associations representing approximately 135,000 life and health insurance agents, general agents and managers, and we would like to take this opportunity to express our opinions concerning certain provisions of H.R. 10612 now pending before the Senate Finance Committee.

Employee retirement savings

NALU strongly supports the provisions of the House bill which correct an inequity in the current laws applicable to private retirement systems. The basic problem was aptly summarized in the Ways and Means Committee report as follows, "If an employee is an active participant in a qualified pension, et cetera, he is not allowed to make deductible contributions to an IRA or to the plan. Even though the benefits provided by such a plan may be less than the employee could provide for himself under an IRA, the employee is not allowed to make up the difference through deductible IRA contributions or by making deductible contributions to the plan."

The current law has resulted in some employees withdrawing from employer sponsored plans in order to take advantage of the new IRA's. Problems have also arisen for employees who are currently covered under qualified plans from which they may not withdraw even though in some instances they would benefit from such withdrawal and subsequent establishment of an IRA.

While NALU urges that the House bill's provisions relating to IRA's and LERA's be retained, we would hope that at least one other change in the current laws governing eligibility to participate in an IRA would be adopted. Under IRS interpretation of present law, some members of the Active Reserve components of the U.S. Armed Forces are disqualified from taking the deduction for individual retirement savings due to their participation in the Armed Forces retirement system. Several bills have been introduced in the House which would assure the active reservist that he would not be disqualified from availing himself of the deduction from an IRA due to his accrual of "points" under the military retirement program.

The addition of this provision by the Finance Committee would appear desirable for two reasons. First, the current law may discourage qualified military personnel from enlisting in the U.S. military Reserve program thereby depriving the Armed Forces of potentially valuable contributors to our system of national defense. Second, the nature of the Armed Forces Reserve program is such that it is often the case that the active reservist will not eventually accrue the necessary amount of retirement points in order to receive any benefits from his years of service as a reservist.

Limitation on deduction for nonbusiness interest

NALU is troubled by the implications for the economy implicit in the proposed $12,000 limitation on the deduction for nonbusiness interest which is incorporated in the House bill. Under this proposal, for the first time, a limit would be placed on the deductibility of interest paid in connection with indebtedness incurred by a taxpayer in purchasing a home or other goods and services of a personal nature.

The Ways and Means Committee in its report on this provision of the bill stated that, "certain economic goals, such as homeownership, should be within the reach of as many people as possible and thus the deduction for personal interest should be continued." However, the committee also noted that, "interest on borrowing should not be deductible where the loan proceeds are spent for items of a luxury nature." NALU contends that the vast majority of taxpayers taking advantage of the current personal interest deduction are not going into debt to finance the purchase of luxury items.

The current inflation which is being experienced throughout the Nation is resulting in continually increasing costs for essentials of a personal nature such as private housing, education, automobiles, home appliances, and insurance. In view of these increasing costs it appears probable that the $12,000 limitation will soon begin to exert a detrimental impact on the economy as consumers reduce their financed personal expenditures for nonluxury items in order to avoid the unfavorable tax treatment which would be triggered by the $12,000 ceiling.

Compounding the problem is the fact that the House proposal will drastically curtail the current limitations on deductibility of an individual's investment indebtedness interest. The interest on funds borrowed to acquire or carry an individual's investment assets will also be limited by the new $12,000 limitation (to the extent not absorbed by the personal interest deduction) plus the amount of the individual's net investment income and long-term capital gains. Consequently, the proposals contained in this section of the House bill will tend to reduce consumer expenditures for essential goods and services as well as dampen the incentives for individuals to take advantage of investment opportunities which are not connected with their trade or business. For the above reasons, NALU opposes the adoption of the unrealistic limitation on the deduction for nonbusiness interest as it appears in the House bill.

Sick pay exclusion

NALU urges the committee members to retain the current provisions in the law which provide favorable tax treatment to sick or disabled employees. Present favorable tax treatment of sick pay wages in many cases may result in additional inducement to employers to establish sick pay plans for their employees as a fringe benefit. In many cases long-term sickness and disability plans are partially or wholly funded by insurance premiums paid by the individuals themselves. In such cases the sick pay exclusion would offer an additional incentive to the individual to insure that he will be able to provide for himself and his family during periods of absence from work due to sickness or accident.

If change in the current law is found to be necessary in the interests of simplification, NALU suggests the following two proposals which would result in simplification but would also continue to encourage the establishment and participation of individuals in sick pay plans.

First, the current law mandates complicated different lengths of waiting periods for individuals based on percent of salary covered by the employer and dependent on whether the individual has been hospitalized during his leave of absence. NALU recommends that simplification would be well served by the adoption of a waiting period of 7 days for employees generally and no waiting period for those employees who are hospitalized during their absence from work due to sickness or accident.

Second, current law provides the amount of sick pay excluded may not exceed $75 a week for the first 30 days and $100 a week after the first 30 days. As another means of achieving simplification, NALU proposes that the maximum sick pay exclusion not exceed $200 a week throughout the entire period during which the exclusion is available. The proposed higher maximum amount would also reflect the effects of inflation which have occurred since the passage of the original sick pay legislation.

Separate deduction for health and accident insurance premiums

Although the House bill contemplates no change in the current treatment of the deductibility of health and accident insurance premiums, it has come to our attention that the Treasury Department is advocating the repeal of the present allowable deduction (one-half of premiums paid up to $150) for health and accident insurance premiums.

With skyrocketing health care costs and the increasing need for broad range health coverage for all individuals rapidly becoming the major domestic issues, it is desirable that individuals continue to be encouraged to obtain adequate health insurance coverage. For this reason, NALU supports the House position of leaving unchanged the present separate deduction of accident and health insurance premiums.

In view of the inflationary trend of the economy since the original passage of the existing limitations, in recognition of the desirability of tax simplification, and in line with supporting the concept of encouraging private individuals to provide insurance for their health care needs, NALU would additionally support the removal of the existing limitations on the separate deductibility of health and accident insurance premiums.

Deductions for expenses attributable to business use of the home

NALU opposes the provisions of the House bill which result in the loss of deductions for an individual who may currently deduct a portion of the expenses incurred in maintaining a personal residence which is also used by the individual in his trade or business. The language of the House bill, with minor exceptions, would prohibit such a deduction unless the portion of the expense so incurred was associated with an area of the home which is used exclusively, on a regular basis, as a place of business where the homeowner/businessman maintains his principal place of business or deals with patients, clients, or customers in the normal course of his trade or business.

While we can sympathize with the administrative difficulty of verification of such a deduction by the IRS, we can find no valid reason why any administrative difficulties should preclude the deduction of what would otherwise be an ordinary and necessary business expense to the taxpayer. For this reason, we urge the committee to consider the deletion of the proposed House language with respect to this issue.

NALU appreciates the difficulty of the task with which the Senate Finance Committee is faced in attempting to review and revise the current House proposals and if we may be of any assistance to you in elaborating on the comments and suggestions which we have presented herein, please do not hesitate to let us know.

Sincerely,

JACK E. BOBO,
Secretary, National Association of Life Underwriters.

STATEMENT BY THOMAS J. REESE, LEGISLATIVE DIRECTOR OF TAXATION WITH REPRESENTATION

Mr. Chairman and members of the committee, my name is Thomas J. Reese, and I am legislative director of Taxation With Representation, a public interest taxpayers' lobby with almost 18,000 members.

With great reluctance, Taxation With Representation supported the tax reform bill as passed by the House of Representatives. The bill needs to be strengthened and any attempts to weaken it should be opposed. In this statement I will comment briefly on the various provisions in the bill. If you would like further information on any of my comments, please let me know.

Tax shelter provisions (title I and II).—Fundamental tax reform is preferable to palliatives such as the limitation on accounting losses (LAL), which simply add a new layer of complexity to the tax code. The basic keys to fundamental reform in the tax shelter area are:

(*a*) Realistic depreciation and depletion, which reflect actual exhaustion of capital assets.

(*b*) Capitalization of all expenditures for assets lasting more than one year.

(*c*) Matching of business related income and expense through accrual basis accounting.

However, it seems clear that the tax writing committees are not ready to adopt reforms as basic as those outlined. Under these circumstances, proposals such as LAL constitute a second best solution, provided that they are not themselves riddled with loopholes. The exemptions in the House bill, such as the one for development wells, should be eliminated. Furthermore, LAL should apply to real estate on a per property basis.

In addition to the LAL proposals, there are several tax reforms that—although less sweeping than those just outlined—would help to make tax shelters less attractive, and would thus ease the problems that LAL is designed to solve. Among them are: (*a*) Capitalization of construction period interest and taxes in the case of real estate, (*b*) use of accrual basis accounting for farms grossing above a set amount, say $100,000 per year, (*c*) repeal of percentage depletion for all minerals, and (*d*) capitalization of intangible drilling costs for successful wells.

Minimum Tax (title III).—Fundamental reform is preferable to the complexity of the minimum tax. As outlined in connection with the discussion of tax shelters above, fundamental reform means a return to realistic depreciation and depletion, capitalization of long-term investments, and proper matching of business income and expense. In addition, in the context of the minimum tax, it also means: (*a*) Taxation of unrealized capital gains that now escape tax at death or gift, and (*b*) termination of tax exempt privileges for industrial development and pollution control bonds and introduction of a direct interest subsidy for municipal bonds large enough to make States and localities better off than they are now.

But if fundamental tax reform is unattainable, the minimum tax constitutes a second best solution provided that it is not—as at present—riddled with loopholes. The House bill has taken a good step in this direction, and the House provisions should be retained. Furthermore, the coverage of the minimum tax should be expanded to include unrealized appreciation of capital gains at death and gift, and the interest on industrial development and pollution control bonds.

Tax simplification (*title V*).—We support revision of the tax tables for individuals (sec. 501) and the deduction for alimony (sec. 502).

The retirement income credit (sec. 503) is acceptable, given that we continue to exclude social security receipts from gross income. However, as was pointed out to the Ways and Means Committee on June 24, 1975, by John S. Nolan, former Deputy Assistant Secretary for Tax Policy, a better solution is to "tax social security benefits like all other forms of income except to the extent of an arbitrary one-third, deemed to represent a return of the taxpayer's own contributions to the social security system." As Mr. Nolan pointed out at that time, the correct way to protect low income elderly persons from income tax is through the low income allowance or the minimum standard deduction. Excluding social security from income complicates the tax system greatly by creating the need for the retirement income credit. It also violates tax equity by benefiting the rich more than the poor.

We support the change of the child care deduction to a credit (sec. 504). A credit is more equitable than a deduction, since deductions are worth more to high income people. On the other hand, neither a deduction nor a credit do any good for a person too poor to pay taxes who are those most in need of child care assistance. To be truly equitable, the credit should be refundable. Furthermore, we question the child care deduction or credit is a proper method of providing child care assistance. Such provisions complicate tax forms and confuse taxpayers. Would it not be better to spend the $655 million directly for child care centers or for lowering taxes for all low income families?

Taxation With Representation opposes increasing the exclusion for sick pay (sec. 505). We believe that the sick pay exclusion should be repealed without any exceptions. If veterans or social security benefits are inadequate, they should be raised. Trying to deal with such problems by use of a blunt instrument such as the sick pay exclusion means that there will be wide disparities in the tax situation of similarly situated individuals, depending on whether they qualify for the exclusion or not.

We oppose further increases in the moving expense deduction (sec. 506), which is principally claimed by well-off executives. In contrast, individuals who are out of a job get no help from this deduction in their efforts to move out of high unemployment areas.

Business related income (*title VI*).—The revision (sec. 601) of the deductions for business use of homes, and rental vacation homes is a great improvement over present law. This section should be supported.

The limitation on deductions for conventions outside of the United States (sec. 602) is so weak as to be almost meaningless. Deductions for conventions outside of the United States should be disallowed unless the foreign location is more appropriate to the purpose of the convention.

We support the taxing of qualified stock options (sec. 603). The grant or exercise of such options produces income, often large amounts of income, and it should be recognized for tax purposes. Existing law sharply discriminates in favor of those who work for stock corporations, and against those who work for governments, universities, and other groups that do not issue stock.

We do not object to section 604, which will provide uniform treatment of bad debt losses, whether the loss arises from a direct loan or from a guarantee. We strongly oppose section 605 which, in the case of State and Federal legislators, would reverse the normal rule relating to the tax deductibility for living expenses. Legislators, like other taxpayers, should not be permitted to deduct such expenses unless they are actually in travel status, away from their business home. There is no justification, for example, for a rule that allows a Congressman to deduct the cost of living in Washington, when ordinary taxpayers are denied a deduction for living expenses at their normal place of business. Furthermore, the statement that the IRS will "apply rules of reasonableness" in determining the amount of allowable deductions is an open invitation to cozy incestuousness, leading to virtual elimination of Congressmen from the tax rolls. Congressmen should pay taxes like everyone else.

Accumulation trusts (title VII).—We support this provision, although it seems to us that the throwback rule should apply even if a beneficiary has not yet become 21.

Investment credit changes (title VIII).—We support the application of the investment credit for up to $100,000 of used property. But we do not support a 4-year extension of the 10-percent investment credit (sec. 801). Why should the credit be extended for 4 years when the personal income tax credit is extended for only 1 year?

We oppose the retroactive features of applying the investment credit to movie and television films (sec. 802). We do agree, however, that it makes more sense to have the credit for films made in the United States rather than for films shown in the United States.

SUMMARY

In summary, if energy conservation and development measures are needed, they should be funded through direct appropriations, not tax gimmicks, so that the costs and results of the programs can be regularly reviewed. As the Manhattan project and the Moon program demonstrate, research projects funded through direct appropriations show results, and outlays are promptly cut when the project has achieved its objectives. In contrast, programs funded through the tax system go on and on, and there is never any review of the results or any end to the costs.

In general, we believe that the Congress should leave incentive and subsidy programs to those committees of the House that are in a position to authorize and appropriate funds for those programs. Expenditures authorized in that way will be automatically reviewed each year to evaluate their effectiveness; there is no corresponding review of tax incentives. That is one reason why tax incentives are inherently wasteful.

Statement of the Federal Tax Division of the American Institute of Certified Public Accountants

H. R. 10612

Sections Commented Upon

TITLE I—LIMITATION ON ARTIFICIAL LOSSES

101—Limitation on artificial losses.

TITLE II—OTHER AMENDMENTS RELATED TO TAX SHELTERS

Section:

201—Recapture of depreciation on real property.
203—Farm excess deductions account.
204—Method of accounting for corporations engaged in farming.
205—Treatment of prepaid interest.
206—Limitation on the deduction for nonbunsiness interest.
207—Limitation of certain losses to amount for which taxpayer is at risk.
209—Player contracts in sports enterprises.
210—Certain partnership provisions.

TITLE III—MINIMUM TAX FOR INDIVIDUALS

Section:

301—Minimum tax.

TITLE IV—EXTENSIONS OF INDIVIDUAL INCOME TAX REDUCTIONS

No comments.

TITLE V—TAX SIMPLIFICATION IN THE INDIVIDUAL INCOME TAX PROVISIONS

Section:

501—Revision of individual tax tables.
502—Alimony deduction.
503—Revision of retirement income credit.
504—Child care deduction.
505—Changes in exclusions for sick pay and certain military, etc., disability pensions.

TITLE VI—BUSINESS RELATED INDIVIDUAL INCOME TAX PROVISIONS

Section:

601—Deductions for expenses attributable to business use of homes, rental of vacation homes, etc.
602—Deductions for attending foreign conventions.
603—Qualified stock options.
604—Treatment of losses for certain nonbusiness guaranties.

TITLE VII—ACCUMULATION TRUSTS

Section:

701—Accumulation trusts.

TITLE VIII—INVESTMENT CREDIT CHANGES

Section:

802—Investment credit for movie and television films.

TITLE IX—CONTINUATION OF CHANGE IN CORPORATE TAX RATES AND INCREASE IN SURTAX EXEMPTION

No comments.

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TITLE X—CHANGES IN THE TREATMENT OF FOREIGN INCOME

Section:
1011—Exclusion for income earned abroad.
1013-1014—Provisions affecting foreign trusts.
1015—Excise tax on transfers of property to foreign persons.
1021—Investment in U.S. property by controlled foreign corporations.
1022—Exclusion for earnings of less developed country corporations.
1023—Exclusion from subpart F of certain insurance company earnings.
1024—Shipping profits of foreign corporations.
1031—Determination of foreign tax credit on overall basis.
1032—Recapture of foreign losses.
1033—Gross-up of dividends from less developed country corporations in determining the foreign tax credit.
1034—Capital gains for foreign tax credit purposes.
1041—Nonresident alien and foreign corporation investment in the United States.
1042—Changes in sec. 367 ruling requirements.
1053—China trade act corporations.

TITLE XI—AMENDMENTS AFFECTING DISC

Section:
1101—Amendments affecting DISC.

TITLE XII—ADMINISTRATIVE PROVISIONS

Section:
1201—Income tax return preparers.
1202—Declaratory judgments for 501(c)(3) organizations.
1203—Assessments in case of mathematical or clerical errors.
1207—Withholding tax on certain gambling winnings.
1212—Public inspection of written determinations by Internal Revenue Service.

TITLE XIII—TECHNICAL INCOME TAX PROVISIONS

Section:
1301—Tax treatment of certain cooperative housing associations.
1305—Clarification of definition of produced film rents.

TITLE XIV—TREATMENT OF CERTAIN CAPITAL LOSSES; HOLDING PERIOD FOR CAPITAL GAINS AND LOSSES

Section:
1401—Increase in the amount of ordinary income against which capital losses may be offset.
1402—Individual carryback of capital losses.
1403—Increase in holding period.

TITLE XV—INDIVIDUAL RETIREMENT ACCOUNT AMENDMENTS

Section:
1502—Limited employee retirement accounts.

TITLE XVI—REAL ESTATE INVESTMENT TRUSTS

Section:
1601—Deficiency dividend procedure for REIT's.
1602—Trust disqualification when income tests not met.
1604—Other changes in limitations and requirements.
1605—Excise tax on certain undistributed REIT income.

TITLE XVII—AMORTIZATION OF CERTAIN RAILROAD GRADING AND TUNNEL BORES; TAX TREATMENT OF CERTAIN RAILROAD TIES

No comments.

TITLE XVIII—TAX CREDIT FOR HOME GARDEN TOOL EXPENSES

Section:
1801—Tax credit for home garden tool expenses.

TITLE XIX—REPEAL AND REVISION OF OBSOLETE, RARELY USED, PROVISIONS

General comment.

TITLE I

Limitation on Artificial Losses

SECTION 101

Present law

At present, taxpayers are able to create "artificial" losses through a combination of various provisions in the law. These artificial losses are used to shelter otherwise taxable income from the income tax. Essentially, these provisions are:

Limited partnership provisions allowing the pass-through of losses without the assumption of liability.

Basis provisions which permit the taxpayer to increase his basis by the amount of liabilities to which the property is subject.

Allowance of the cash-basis method of accounting particularly with regard to farm operations.

Accelerated deduction provisions designed to encourage taxpayers to make certain types of investments deemed socially or economically desirable by Congress. Among these are accelerated depreciation, rapid amortization, deduction for construction period interest and taxes, and deduction for intangible drilling and development costs.

Under present law there are no statutory provisions restricting use of artificial losses generated by tax shelters.

Proposed change

The proposal calls for insertion of five new sections in the Internal Revenue Code restricting the use of such losses. These are as follows:

Sec. 466.—Accelerated deductions attributable to LAL property will be allowed as a deduction only to the extent of related income from the property.

Sec. 467.—LAL property is defined to include real property, leased property, and farm, film, oil and gas, and sports franchise property.

Sec. 468.—Accelerated deductions of each class of LAL property are defined in this section.

Sec. 469.—The deferred deductions would be allowed when a disposition of LAL property is made.

Sec. 470.—Miscellaneous definitions are provided in this section.

AICPA comments

In general, we feel the LAL approach will add much unnecessary complexity to the Internal Revenue Code. We suggest that through use of the concept of minimum taxable income (MTI), tax shelter abuses could still be curbed without much of the complexity which LAL would introduce. Assuming that the committee decides to go ahead with LAL as proposed in H.R. 10612, however, we offer the following specific comments.

Bill section 101(a)

Code section 466(a)(2)(A).—Since the committee reports clearly indicate that estates and trusts are included in the LAL provisions, it would be consistent with other sections in the bill to clearly state this by adding after individual, "including estates and trusts."

Code section 466(a)(2)(B).—This section provides that an electing small business corporation is subject to the LAL provisions. Proposed code section 466(b) provides that each taxpayer shall maintain a deferred deduction account for each class of LAL property. Presumably, the deferred deduction account would be maintained by the Subchapter S corporation (the taxpayer) and not individual shareholders. The deferred deductions would be based solely on the net related income of the subchapter S corporation and an individual shareholder would be unable to use net related income from other similar LAL property to reduce his deferred deductions. Many real estate properties are owned in subchapter S corporations, and it is inequitable to not treat the properties of these corporations similar to that of a partnership, which are allocated to each individual shareholder on an item basis. Such treatment is accorded partnerships by proposed code section 470(d)(4)(A).

Code section 466(c)—For earnings and profits purposes, certain accelerated deductions, i.e., accelerated depreciation, are already eliminated by statute. Other accelerated deductions for construction period interest and taxes are not presently covered in code section 312 and these would appear to be deductible for earnings and profits, even though disallowed as a deferred deduction. This problem will arise in the determination of earnings and profits of a subchapter S corporation regarding the character of distributions to a shareholder.

Code section 466(c)—Deferred deductions are allowed in later years to the extent of the excess of net related income from such properties over accelerated deductions in that year. This may create an inequitable situation in the subsequent year of sale of this LAL property. Net related income under proposed code section 468(g)(2) includes a capital gain, not reduced by the code section 1202 deduction, but this deduction may thereby create a net operating loss in the year of sale. Such net operating loss could be disallowed as a carryback as a result of the capital gain deduction. Also, a net operating loss carryback, as a result of the deferred deductions being allowed in the year of sale, could be limited by capital gains in prior years. There should be some provision whereby net operating losses created by the allowance of deferred deduction accounts are not limited as to carryback and carryover either by the code section 1202 deduction with respect to that particular class of LAL property, or otherwise. Without such a provision, many accelerated deductions will not provide a tax benefit, even where gains are recognized in subsequent years.

Code section 467(b)—this section specifies that a deferred deduction account shall be maintained for each "class" of property. But for some types of LAL property, the class of property is defined in terms of a class for each individual item of property. It is foreseeable that by using sales between related or nonrelated parties, "dispositions" could be timed to advantageously use the resulting acceleration of recognition of the deferred deductions. By defining "class" in such terms, timing manipulations could become attractive tax sheltering uses for deferred deduction accounts.

Code section 468(f)(2)(B)—this section requires the LAL basis of player contracts to include ordinary income recognized by the transferor on the transfer of a sports franchise. Proposed bill section 209 requires notification by the transferor of any gain on the sale or disposition of a franchise, but not the breakdown of gain between ordinary income and capital gain. These are inconsistent, and as a practical matter, when is a final determination made of the ordinary income element on the transfer by the transferor? These transfers have been subject to significant litigation in past years and leaves the transferee with an unlimited statute-of-limitations problem. This might be resolved by requiring the transferor under proposed bill section 209 to report to the transferee the ordinary income and capital gain portion as reported on the transferor's tax return for the year of sale.

Code section 469(a)—it appears that the disposition of LAL property of a subchapter S corporation relates solely to the corporation and not individual shareholders. Therefore, the sale by an individual shareholder of his stock in a subchapter S corporation would not provide any deduction for his deferred deduction account. This treatment is not consistent with that provided partnerships under proposed code section 470(d)(4)(B).

Code section 469(d)(1)(E)—The installment sale provisions of proposed section 469(d)(1)(E) seem to produce a distortion of income over the term of the sale because there is no provision for the amortization of the deferred deduction account. Instead, proposed code section 469(e)(3) would treat the last payment as a "disposition." Thus, it appears that only at the end of the sale transaction would the balance of deferred deductions be recognized. It is not clear if gain realized by the installment sale would be considered "gross income from such class." If so, there may be no distortion. The committee report implies this is the case and that in this way the deferred deductions are to be amortized. However, if such is the congressional intent, then it should be set forth clearly in the proposed section.

Code section 469(e)(2)—This section would apply to a code section 351 transfer from an individual to a corporation, and states that the transferee increases the basis of property received by the amount of the deferred deduction account of the transferor. This is not a deemed disposition under proposed code section 469(c)(1), since the property in the hands of the corporation could still be the same class as in the hands of the transferor. It is not clear in this situation that the transferor's basis in the stock of the corporation would be increased by the amount of the deferred deduction account not allowed as a deduction, since it is not deemed to be a disposition. If so, the transferor would lose the deferred deductions, as well as the basis, since proposed code section 470(d)(1) requires adjustment to basis for deductions not allowed.

Code section 470(d)(4)(B)—There appears to be a technical problem with a distribution to a partner described in code section 751(b), which reduces his interest in partnership property. A distribution of cash from a partnership to a partner which reduces his partnership interest will create a change in the partner's interest in partnership property. Would this change in partnership interest allow a deduction for the change in his deferred deduction account? It appears that there needs to be an expanded definition of a disposition of a partner's interest in proposed code section 470(d)(4)(B).

Bill section 101(c)(3)—See our comments under bill section 204(b)(2).

TITLE II

Other Amendments Related to Tax Shelters

SECTION 201—RECAPTURE OF DEPRECIATION ON REAL PROPERTY

Present law

Under current law the recapture of depreciation on the sale of real property is based on a sliding scale, the amount of recapture decreasing the longer the property is held. The percentage of recapture varies between commercial and residential rental properties and between depreciation taken before 1970 and that taken after 1969.

Proposed change

In the case of real estate, the bill would provide for the complete recapture of all depreciation in excess of straight-line depreciation to the extent of any gain involved at the time of the sale of the property. (This is the rule which currently applies in the case of commercial property.)

AICPA comments

We agree with this proposal on the ground that it will simplify the concept and the computation of recapture.

SECTION 203—FARM EXCESS DEDUCTIONS ACCOUNT

Present law

Under present law taxpayers engaged in farming operations must maintain an excess loss account which is essentially a cumulative summary of the excess of farm losses over income. This excess loss account is used in determining the amount of ordinary income recapture which must be recognized by the taxpayer on subsequent sale of farm recapture property.

Proposed change

The bill would repeal the farm excess deductions account provisions for net farm losses sustained after December 31, 1975.

AICPA comments

We agree with the repeal of this provision, especially in view of the other provisions in the proposed legislation (bill sections 101 and 204).

SECTION 204—METHOD OF ACCOUNTING FOR CORPORATIONS ENGAGED IN FARMING

Present law

Under present law, a taxpayer engaged in farming activities may report the results of such activities for tax purposes on the cash method of accounting, regardless of whether the taxpayer is a individual, a corporation, a trust, or an estate. This privilege was granted over 50 years ago at a time when most such operations were done by small family owned farms, the rationale being the need for a simplified method for these unsophisticated farmers.

Proposed change

A new provision (section 447) would be added to the Internal Revenue Code. This would require all corporations, other than small family owned corporations and subchapter S corporations, and certain partnerships to use the accrual method of accounting for their farm operations.

AICPA comments

Bill section 204(a)—code section 447(a)(2)—It is not clear if a second tier partnership could circumvent the statute, since a corporation may not be a partner in such partnership. It would be clear if this section read . . . "if a corporation is 'directly or indirectly' a partner in such partnership."

Code section 447(b)(2)(8)—This section allows a family corporation to elect exception from proposed code section 447(a). By not electing, such family corporation would obtain the benefits of code section 481, by reason of bill section 204(b)(2).

The committee reports state that both a subchapter S corporation and a family corporation can elect to use the accrual method, but the statute does not contain this provision for a subchapter S corporation. Presumably, a subchapter S corporation could change to the accrual method of accounting under present law with IRS approval, but proposed code section 447 would not automatically allow use of code section 481. Proposed code section 447(b)(2)(B) should be redesignated as section 447(b)(3), and should apply to both subchapter S and family corporations.

Bill section 204(b)(2)(C)—This section provides that the net adjustment under code section 481(a) may be taken into account over a 10-year period This conflicts with the present position of the IRS in revised procedure 75–18 (1975–14 I.R.B. 24). It also conflicts with the full absorption regulations (regs. sec. 1.471–11(e)(3)(i) which provide that the net adjustment may be taken into account ratably over a period designated by the taxpayer not to exceed the lesser of 10 taxable years or the number of years the taxpayer has been on the inventory method from which he is changing. Subparagraph (C) should provide that the code section 481 adjustment will be taken into account over period of years not to exceed 10 years, beginning with the year of change.

SECTION 205—TREATMENT OF PREPAID INTEREST

Present law

Under present law there is considerable uncertainty as to the deductibility of prepaid interest. Court decisions are made on a case-by-case basis as are decisions of the IRS where the prepaid interest does not cover a period of more than 12 months. No section of the statute specifically addresses the issue.

Proposed change

The proposal would require taxpayers to capitalize any prepayment of interest allocable to a period after the tax year in which the payment is made. This deferred interest would then be amortized over the appropriate period.

AICPA comments

For situations not covered by bill section 101 above, for example, the prepayment of interest on a personal residence, we recommend that the Internal Revenue Service's existing position on prepaid interest as stated in revised rule 68–643 (1968–2 C.B. 76) be enacted into law. Additionally, we make the following specific comments.

Bill section 205(a)—code section 461(g)—This section may conflict with proposed code section 447 with respect to the accrual method for farm corporations. Such corporations are allowed a 10-year spread of the net amount of the adjustment from the cash to accrual method by bill section 204(b)(2). Such net adjustment would presumably include interest from cash to accrual method. In such instance would bill section 204(b)(2) or proposed code section 461(g) apply?

Code section 461(g)—This section is not consistent with the present law on changes in methods of accounting. A taxpayer who has consistently deducted interest on a loan under the cash basis, in accordance with the contract or agreement, has established a method of accounting under code section 446. This situation exists in many business enterprises whether conducted in partnership or corporate form. A change in such method for a trade or business should provide for the application of code section 481 and a 10-year spread consistent with that allowed farm corporations in bill section 204(b)(2).

Bill section 205(b)(2)—This exception should be made permanent by striking the words "before January 1, 1976." This change would exempt prepaid interest from disallowance where paid under a binding agreement or contract in existence on September 16, 1975. Such treatment would be consistent with the investment interest limitations of present code section 163(d)(6).

SECTION 206—LIMITATION ON THE DEDUCTION FOR NON-BUSINESS INTEREST

Present law

Under present law there are numerous limitations on the deduction for interest allowed under section 163. These limitations are for investment indebtedness, amounts paid in connection with insurance contracts, interest related to tax-exempt income, carrying charges chargeable to a capital account, and interest on transactions between related taxpayers. None of these limitations, however, place a ceiling on the amount of other interest which may be deducted.

Proposed change

Under the proposal, the deduction for nonbusiness interest will be limited to $12,000 per year.

AICPA comments

We believe that this proposal is contrary to well-established public policy, and that the current restrictions placed on the interest deduction as listed above are sufficient to prevent any abuse. Such a limitation as the one proposed here would not only be harmful to the depressed housing industry, but would also worsen the capital shortage facing our country.

In any event, we suggest that interest paid on Federal and State income tax deficiencies should not be classified as nonbusiness interest, but should be deductible without regard to any limitation imposed by this section.

SECTION 207—LIMITATION OF CERTAIN LOSSES TO AMOUNT FOR WHICH TAXPAYER IS AT RISK

Present law

Under present law, as mentioned previously under bill section 101, a taxpayer's basis in property includes not only his cash investment, but also any liabilities to which the property is subject. If such a liability is of a nonrecourse nature, the taxpayer obtains a high basis without undertaking any personal risk as far as having to repay the loan.

Proposed change

The proposal would limit the use of such leveraging involving nonrecourse liabilities in certain types of farming and movie film tax shelters. The bill would limit the investment with respect to which deductions can be taken to the investments "at risk," but would not affect basis determination for other purposes.

AICPA comments

In general, we agree with the proposed change with respect to the limitation of loss to the amount the taxpayer is at risk. We would define being at risk, however, to include the amount of any debt, whether nonrecourse debt or not, to the extent of the fair market value of the property. Also, we feel that the section should be applied on a cumulative basis.

Additionally, we note that the proposal does not define the term "at risk." In the committee report there is a detailed explanation, but this is not reflected in the proposed code change. Such a definition should be the legislative determination of Congress, rather than left to the regulationmaking discretion of the Commission in construing congressional intent.

SECTION 209—PLAYER CONTRACTS IN SPORTS ENTERPRISES

Present law

There is nothing specific in the current law which would indicate how much of the aggregate purchase price of a sports enterprise must be allocated to player contracts. Because of this, substantially all of the purchase price may be allocated to player contracts which are depreciable and which therefore can be used to generate large depreciation deductions.

Proposed change

In the case of sports enterprises, the bill would specify clearly the portion of an aggregate amount paid to purchase a team of assets which is allocable to player contracts. The bill specifies that the amount allocable to player contracts by a purchaser could not exceed the amount of the sales price allocated to such contracts by the seller. In addition, the bill provides for complete recapture of all previously unrecaptured depreciation on the sale of a player contract or sports franchise.

AICPA comments

We agree with the proposal that the tax basis to a buyer for player contracts should equal the tax basis of the seller increased by the gain recognized by the seller on the transaction, since we believe that conceptually this is implicit in present law and the proposed language would simplify administration in this area.

We do not agree with the recapture proposal unless it is coupled with grant of a right to use accelerated methods of depreciation of the cost of the player contracts, nor do we feel that the proposed language change fully resolves any ambiguity as to the applicability of code section 1245 to player contracts.

SECTION 210—CERTAIN PARTNERSHIP PROVISIONS

Present law

The four areas with respect to partnership taxation which are addressed by this section of the bill are: The additional first year depreciation allowance (bill section 210(a)); the deductibility of partnership organizational costs and syndication fees (bill section 210(b)); the issue of retroactive allocation of partnership profits or losses to a new partner (bill section 210(c)); and partnership special allocations (bill section 210(d)).

With respect to the additional first year depreciation allowance, under present law the dollar limitation imposed for property acquired by a partnership is determined on an individual partner basis. Thus the total additional first year depreciation taken by the members of a partnership may well exceed that allowed a corporation.

On the issue of the deductibility of partnership organizational costs and syndication fees, a recent Tax Court decision (*Jackson E. Cagle, Jr.*, 63 T.C. 86, 1974) and a revenue ruling (Rev. Rul. 75-214, 1975-23 IRB 9) hold that payments made by a partnership to one of its partners are subject to the capital expenditures rules of code section 263. In spite of these pronouncements, it is still contended by many practitioners that guaranteed payments (as distinguished from a share of the profits) made to a partner are automatically deductible without regard to code section 263.

With regard to the issue of retroactive allocations, under present law it is not clear whether or not a retroactive allocation of partnership profit or loss may be made to a new partner buying an interest in a partnership. Because of this, it may be possible for a new partner who buys in at the end of the partnership year to deduct expenses which were incurred prior to his entry into the partnership.

On the last issue, that of partnership special allocations, at present there are restrictions on the specific allocation of an item of partnership income or deduction where the allocation may be solely tax-motivated. There is, however, no restriction on a special allocation of the partnership's entire net income or loss for the year.

Proposed change

Bill section 2210(a) provides that the dollar limitation on the amount of partnership property qualifying for the additional first year depreciation allowance shall be applied at the partnership level.

Bill section 210(b) contains a provision to the effect that any expenditures in connection with the organization of a partnership or the sale of an interest in a partnership would have to be capitalized. In addition, guaranteed payments to a partner would be subject to the capitalization test of code section 263.

Under bill section 210(c), the retroactive allocation rules would be clarified by calling for an allocation of partnership gains and losses according to the partner's varying interest during the year.

Bill section 210(d) would apply the tax avoidance rules currently applicable only to individual items of income or deduction to allocations of the total income or loss of the partnership.

AICPA comments

Our comments, by each of the four subsections of bill section 210, are as follows:

Bill section 210(a)—This section would apply the dollar limitation on additional first-year depreciation at the partnership level.

Basically, the proposed legislation is inconsistent with the aggregate theory generally applied to items of partnership income, deduction, credit, et cetera. It appears to be inequitable to apply the aggregate theory to such items of detriment to the taxpayer as investment interest, tax preference items, and excess farm losses and, on the other hand, apply the entity theory to an item of tax benefit to the taxpayer such as the additional first-year depreciation allowance.

The committee report indicates that the legislation is directed at tax shelter partnerships, giving an example of an equipment leasing limited partnership which obtains $160,000 in additional first-year depreciation on a $1 million executive aircraft, comparing this to a $2,000 allowance had the aircraft been purchased by a corporation. We think that the example is inappropriate. As indicated above, a partnership generally is treated as a conduit to the partners with respect to items of income, deduction, et cetera, rather than as a separate taxable entity.

If Congress's sole concern is to deny the benefits of multiple additional first-year depreciation allowances to investors in equipment leasing partnerships, the problem is adequately covered in another section of the Tax Reform Act, that is, the LAL provisions affecting equipment leasing. The committee report under section 101 of the bill makes it clear that bonus depreciation is considered to be a part of the accelerated deductions subject to LAL.

It should be noted that the Partnership Income Tax Revision Act of 1960 which was passed by the House as H.R. 9662 provided for the aggregate theory approach in this area as follows:

> If any limitation on the amount of the exclusion or deduction of any item of income, gain, loss, or deduction affecting the computation of taxable income, or on the amount of any credit, is expressed in terms of a fixed amount, or a percentage of income, such limitation shall be applied only to the partner and not to the partnership.

The committee report on H.R. 9662 acknowledged that the regulations provide that many limitations are to be applied at the partner level. The bill provided statutory basis for this rule in the regulations. The report stated: "To do otherwise would permit the avoidance of the limitations by setting up multiple partnerships."

Bill section 210(b)(1) and 210(b)(2)—The objective of this provision is to disallow any deduction with respect to syndication fees or organization costs of partnerships. Our position can be summarized as follows: The treatment of costs of organizing partnerships and raising capital of partnerships should generally be conformed with the treatment of similar items with respect to corporations.

Thus, we feel that:

1. A partnership should be permitted to amortize organization expenses over a period of not less than 60 months;
2. The law should make it clear that disallowed amounts do not reduce the tax basis of a partner's interest in the partnership; and
3. Any inference that a partner may not deduct the expenses of selling a partnership interest should be eliminated.

The bill is too restrictive with regard to never allowing a deduction for organization costs and for the costs of promoting the sale of an interest in partnership (hereinafter referred to as syndication costs) to either the partnership or a partner and, as such, places a partnership in a detrimental tax position in relation to either an individual or a corporation.

For example, a corporation is allowed to amortize organization costs under the provisions of code section 248. While the cost of raising capital may not be deducted by a corporation, the stockholder who contributes these funds to the corporation is allowed to include this amount in his tax basis for his stock. In so doing, he claims a deduction for this cost when he sells his stock. A partner, on the other hand, would never be allowed to deduct the cost of raising capital or syndication costs under the provisions of this bill.

The bill would also disallow a deduction to a partner for expenses incurred in selling his interest in a partnership.

This provision is contrary to the general rule which allows deductions from the selling price in computing the gain or loss on the sale of property.

While the committee report on H.R. 10612 explains that the reason for this provision is to disallow a current ordinary deduction for these types of expenses, the bill entirely eliminates the deductibility of these items.

Finally, we would like to point out that the term "syndication fees", which is used in the heading of the proposed new section, is nowhere defined in the section itself.

Bill section 210(b)(3)—The objective of this provision is to make it clear that payments which otherwise would be required to be capitalized by the partnership cannot be deducted as guaranteed payments under code section 707(c). The committee report on H.R. 10612 explains that the purpose of this amendment to code section 707(c) is to make it clear that, in determining whether a guaranteed payment is deductible by the partnership, it must meet the same tests under code section 162(a) as if the payment had been made to a person who is not a member of the partnership, and the normal rules of code section 263 (relating to capital expenditures) must be taken into account.

While we agree with the rationale of this provision, we recommend that the statutory change be made to code section 706(a) rather than section 707(c) to avoid an anomalous result as to the timing of the reporting of income by the recipient partner. Code section 706(a) provides that the partner who receives a guaranteed payment must include it in his income based on the deduction of the partnership for the taxable year of the partnership ending within or with the taxable year of the partner. The partnership may deduct the capitalized payments only through a series of depreciation deductions, or upon sale of the property, or, perhaps, never (for example, if the payments were for syndication fees). Therefore, the language of code section 706(a), literally taken, could result in an indefinite deferral of the income by the partner receiving the payment for services.

Another problem of including this as part of code section 707(c) is the effect it may have on payments made to retiring partners or a deceased partner's successor in interest under code section 736(a) (2). That section provides that payments made in liquidation of the interest of a retiring partner or a deceased partner shall (except as otherwise provided) be considered as a guaranteed payment described in code section 707(c) if the amount thereof is determined without regard to the income of the partnership. If such payment is subject to determination of current deductibility under the provisions of code section 263, the partnership may not be entitled to the relief provision granted to it presently under code section 736(a) (2). Thus, a payment in liquidation of a partner's interest may have to be capitalized under the technical language of the bill. (The committee report to H.R. 10612 notes that it is not intended to affect adversely the deductibility to the partnership of payments described in code section 736(a) (2), but did not stipulate a provision for avoiding this technical interpretation.)

Bill section 210(c)—The purpose of this section is to provide a needed clarification in the law concerning "retroactive allocations." We concur with the proposed change. We believe, however, that the amendment to code section 706(c) (2) (B) made by subsection (1) of bill section 210(c) is unnecessary. The addition of the parenthetical phrase "(by sale, exchange or otherwise)" to code section 706(c) (2) (B) is superfluous. "Sale or exchange" is referred to prior to the word "reduced." It follows that "reduced" refers to a transaction other than a sale or exchange.

Bill section 210(d)—this amendment would, in effect, eliminate the general rule of code section 704(a), providing that a partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement. In order for the partnership agreement to govern, a partner would first have to establish (1) a business purpose for the allocation, and (2) that no significant advoidance or evasion of tax would result from such allocation.

As discussed further below, we believe that the proposed change would cause an unwarranted interference by the Government in normal business relationships without any significant corollary benefit to the Government in its ability to combat tax avoidance.

The reason given in the committee report for the proposed change in the law is that code section 704(b) conditions the validity of allocations of particular items of income, deduction, and so forth, upon a lack of tax avoidance motivation; that no similar test is established with respect to the general allocation of profits or losses under code section 704(a); and that a similar condition should be imposed with respect to the latter.

We believe that there is sufficient authority under present law to disallow artificial or sham allocations, those which have no economic substance, or those made for the principal purpose of tax avoidance. In many cases the problem lies with interpreting what the partnership agreement actually says. Thus, for example, if the partnership agreement states that 100 percent of partnership losses shall be allocated to partner A, but it is apparent from reading the entire partnership agreement, or through external evidence, that partner A is not at risk for 100 percent of such losses, the allocation will not be recognized because the substance of the partnership agreement is that such losses are not in fact allocated to partner A. Another example would be as follows: A and B form a partnership in which A contributes all of the capital; B provides services, but no capital.

The partnership agreement provides that profit and losses will be shared equally. However, the agreement also provides that in no event shall B be obligated to contribute capital to the partnership; further, that upon liquidation, A must look solely to the partnership assets for return of his capital contribution and that B shall not be liable to A for any deficiency. Notwithstanding the profit-and-loss allocation provision standing alone, it appears that A bears 100 percent of the risk of loss, at least until his capital contribution has been exhausted. The agreement is ambiguous, and therefore, a factual determination would have to be made as to what the intention of the parties was. Such an inquiry is not unique to partnerships. The issue of "substance versus form" pervades the tax law—one must examine the substance of an agreement taken as a whole. It is clear that the general rule stated in code section 704(a)—that is, that a partner's distributive share of income, gain, loss, and so forth, is to be determined by the partnership agreement—is subject to the inquiry of what the substance of the agreement is.

In support of the argument that the IRS is unable to combat tax avoidance plans in partnership allocations, the committee report cited the *Kresser* case. In a footnote in the case, the Court gave some support to the petitioner's argument that the issue of tax avoidance could not be applied to code section 704(a), but was limited to allocations of items under code section 704(b). However, the Court said that it did not have to resolve that issue because it found that the allocation in question was not bona fide. The Court cited the *Court Holding Co.* case, quoting the following language therefrom: "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." In other words, the Court found sufficient authority under general principles of tax law to negate a scheme for artificial allocations of income or loss which lacked economic substance. We believe that the great majority of abuses which have been effected through allocations of partnership income or loss could be handled in a similar fashion. The lack of judicial precedent in this area seems to indicate that the problem may lie in inadequate enforcement of the law rather than a defect in the law.

Numerous problems would be caused by the proposed legislation. The law reverses the existing presumption that, in general, partners deal at arm's length and, instead, presumes that partnership allocations are made for tax avoidance purposes. This puts the burden upon each partner in the partnership to establish that (1) there is a business purpose for the allocation, and (2) no significant avoidance or evasion of tax results from the allocation. The partner has the burden of establishing not only that there was no tax avoidance motive, but that there was no tax avoidance per se. A whole new set of vague concepts would be introduced into the partnership tax law, such as "permanent method of allocating taxable income" and "significant avoidance or evasion of tax." This legislation very likely would restrict partnerships from making arm's-length allocations of profits or losses among its partners by imposing ambiguous standards upon such allocations even though no "tax shelter" or intention of tax avoidance is involved. It would give the revenue agent the license to judge what he or she believes to be the proper allocation of profits or losses among the partners.

The proposed statute states, in effect, that partnership profits and losses will be allocated as follows:

1. If the affected partner can prove that the partnership allocation has a business purpose and does not result in significant tax avoidance, the partnership will be permitted to allocate profits and losses as provided in the agreement.

2. Failing such proof, profits and losses will be allocated in accordance with the partnership's "permanent method" of allocating taxable income.

3. If the partnership does not have a "permanent method" of allocating taxable income, income will be allocated in accordance with the partnership's interest in the partnership (determined by taking into account all facts and circumstances).

The committee report further restricts the ability of a partnership to control its own affairs in the way it defines "permanent method." It states that: "A partnership will ordinarily be considered to have a 'permanent method' of allocating taxable income or loss if (1) it has consistently applied such method over a number of years, and (2) it meets both the business purpose and significant tax avoidance tests provided under the amended section 704(b)." Thus, a partnership which has been in existence for only 1 or 2 years could not have a "permanent method." Also, it would be questionable if a partnership had a "permanent method" if the profit-and-loss allocations varied from year to year even though for a legitimate business purpose.

One example would be annual changes in allocations among members of a professional partnership based upon performance and other subjective factors. Another example would be an allocation of losses to a partner to the extent of his capital contributions (he being the partner primarily at risk), with all profits allocated to that partner thereafter until such time as his capital account had been restored, with profits being allocated on some predetermined ratio thereafter. Any method of allocating partnership profits and losses other than the most simple "50-50" split would be suspect under the proposed legislation.

The requirement that the partner receiving the allocation establish that "no significant avoidance or evasion of * * * tax results from such allocation" is a major departure from existing law, which states that a provision in a partnership agreement is to be disregarded where the principal purpose of the provision is the avoidance or evasion of income taxes. The new provision could operate to deny allocations where there is no intent to avoid taxes if the Commissioner makes a subjective determination that avoidance in fact resulted.

The examples under regulation section 1.704(b) point out situations in which there are valid business purposes which result in permissible tax avoidance because the principal purpose of the allocation is not tax avoidance and the allocation has susbtantial economic effect. Example (2) of that regulation allows a partner who is a resident of a foreign country to be allocated a percentage of the profits derived from operations conducted by him within such country even though the percentage is greater than his distributive share of partnership income. Although each example of a special allocation in the regulations might result in substantial tax avoidance, it is permissible so long as the principal purpose for that allocation is not the avoidance or evasion of income taxes.

In discussing the business purpose and lack of significant tax avoidance tests, the committee report states that "This dual test is intended to incorporate all of the factors currently taken into account in testing an allocation under present law (regulation sec. 1.704-1(b)(2))." Contrary to this statement in the committee report, the test does much more than that; it does away with the time-honored concept of "principal purpose of tax avoidance" and introduces a new concept of "significant tax avoidance."

What appears to be a technical defect in the proposed statute is that in order for the partnership agreement to govern, the individual partner receiving the allocation is the one who must come forward with the burden of providing the legitimacy of the allocation. Inasmuch as each partner will receive an allocation, apparently each partner individually would be required to make his case. This would appear to be adminstratively impractical.

The committee report starts out with the premise that any allocation which is disproportionate to the capital contributions of the partners is a "special allocation" and that special allocations are used to avoid taxes. In other words, the committee report seems to take the view that any time allocations of income deviate proportionately from capital contributions they are abnormal and thereby suspect. We believe that this view is erroneous and would put in jeopardy any partnership in which a partner is compensated for services through a share of profits. Any partner thus compensated for services would, under the proposed legislation, have the burden of establishing not only that his motives were pure but, probably, also that his share of profits represented reasonable compensation for services performed and the partners having contributed the capital were reasonably compensated therefor. The burden of proof would be upon the partner to establish the fairness of the allocation. This could have an especially significant impact upon professional partnerships where it is common to have discretionary subjective allocations among partners based upon performance, seniority, and other factors.

If it is felt that the existing law is not adequate to cope with tax avoidance schemes in partnerships, we believe that remedial legislation should be limited to a provision which would have the effect of disregarding any provision in a partnership agreement concerning a partner's distributive share of income, gain, loss, deduction or credit which has as its principal purpose the avoidance of taxes.

It would be far preferable to deal with the problem of partnership allocations through the administrative and judicial systems than to introduce a set of new and ill-defined concepts which could throw the law into a state of confusion. The existing legislation in this area has been in the code since 1954. Nevertheless, there have been only a handful of cases in this over-20-year period attacking tax avoidance partnership allocations. Furthermore, the IRS has been successful where it has sought judicial redress. To insert new and more vague requirements in the code we feel would be a step backward in the tax administration process.

TITLE III

Minimum Tax for Individuals

Section 301—Minimum Tax

Present law

The minimum tax under present law is an addition to the regular income tax. Basically, it is 10 percent of the sum of the items of tax preference, less a $30,000 exemption and less regular taxes paid for the year and certain taxes paid carryovers. The items of tax preference are:

1. Excess investment interest.
2. Excess depreciation on real property.
3. Excess depreciation on personal property subject to a net lease.
4. Rapid amortization of pollution control facilities.
5. Rapid amortization of railroad rolling stock.
6. Excess of fair market value over the option price on exercise of stock options.
7. Certain bad debt deductions for financial institutions.
8. Percentage depletion in excess of basis.
9. Fifty percent of long-term capital gains.
10. Rapid amortization of on-the-job training and child care facilities.

Proposed change

The following changes to the minimum tax would be made by this section of the bill:

Increase the tax rate to 14 percent.

Lower the exemption from $30,000 to $20,000, subject to a phase out if preference income exceeds $20,000 to a point where there should be no exemption at a preference income level of $40,000.

Limit the deduction for regular taxes paid to one-half of regular taxes.

Add as a tax preference item certain intangible drilling costs on oil and gas wells.

Add as a tax preference item all itemized deductions in excess of 70 percent of adjusted gross income.

AICPA comments

The general comments we made under bill section 101 that we prefer use of the minimum taxable income concept to curb the abuse of sheltering certain types of income, would equally apply here.

TITLE V

Tax Simplification in the Individual Income Tax Provisions

SECTION 501—REVISION OF INDIVIDUAL TAX TABLES

Present law

Under present law, taxpayers having adjusted gross income of less than $10,000 ($15,000 for 1975) and not itemizing deductions must use the optional tax tables provided by the IRS. Individuals who itemize deductions or have adjusted gross income in excess of $10,000 ($15,000 for 1975) must use the rate schedules. These tax tables are a source of considerable taxpayer error.

Proposed change

The Bill would base the tax tables on taxable income rather than adjusted gross income and extend their applicability to taxable incomes up to $20,000. Thus, all taxpayers with taxable income of less than $20,000 would compute their taxable income by subtracting the amount of their personal exemptions and deductions from their gross income, and then merely look up their tax in the tables.

AICPA comments

We agree with the proposal to revise and simplify the tax tables.

SECTION 502—ALIMONY DEDUCTION

Present law

Under present law the deduction for alimony paid is allowed only if the taxpayer itemizes his deductions.

Proposed change

The deduction of alimony payments would be moved from an itemized deduction to a deduction from gross income to arrive at adjusted gross income.

AICPA comments

Although we recognize that there may be problems in having too many items as deductions for adjusted gross income, since alimony represents a type of income sharing and is reported as income by the recipient, we endorse this proposal.

SECTION 503—REVISION OF RETIREMENT INCOME CREDIT

Present law

A tax credit for retirement income is available to certain retired taxpayers. A taxpayer's retirement income credit is 15 percent of the smaller of (1) the retirement income he receives during the taxable year, or (2) $1,524 ($2,286 in the case of spouses computing credit on combined income) less the sum of nontaxable pensions and annuities, including social security, and current earned income. If a taxpayer is under 62, the $1,524 figure in (2) above must be reduced by earned income in excess of $900. If a taxpayer is 62 or older but under 72, the appropriate figure in (2) above is reduced by 50 percent of the earned income in excess of $1,200, but not in excess of $1,700, and by 100 percent of the earned income over $1,700. Earned income causes no reduction if the taxpayer is 72 or older.

For a taxpayer under 65, retirement income includes only a pension or annuity from a public retirement system. The retirement income of a taxpayer who is 65 years or older includes taxable pensions, annuities, interest, dividends, and gross rents (to the extent they are not earned income), but not royalties.

Wages, salaries, and other forms of earned income are not retirement income.

Proposed change

The bill restructures the present retirement income credit and converts it to a tax credit for the elderly, available to all taxpayers age 65 or over regardless of whether they have retirement income or earned income. The maximum amount on which the credit is computed is increased to $2,500 for single persons age 65 or over (or for married couples filing joint returns where only one spouse is age 65 or over) and to $3,750 for married couples filing joint returns where both spouses are age 65 or over.

These maximum amounts for computing the credit are reduced, as under present law, by social security benefits and other exempt pension income. The bill, however, eliminates the earnings cutback and provides an income phaseout based on adjusted gross income (rather than just earned income) above $7,500 for single persons and $10,000 for married couples to limit the benefits to low- and middle-income elderly taxpayers. Under this phaseout the maximum amount on which the credit is computed is reduced by $1 for each $2 of adjusted gross income (AGI) above the indicated AGI levels.

The bill eliminates the provisions of present law that limit the credit based on the amount of a taxpayer's retirement income; thus, the credit will also be allowed for earned income.

In addition, the bill eliminates the requirement that to be eligible for the credit, the taxpayer must have met the test of earning $600 a year for 10 years. Further, the variation in treatment of married couples depending on whether they are separately eligible for the credit is eliminated.

AICPA comments

The proposed change simplifies the application of the credit and limits it to lower and middle-income taxpayers. We approve of this approach.

SECTION 504—CHILD CARE DEDUCTION

Present law

Under present law expenses incurred for employment-related household services, child care, disabled dependent or spouse care may be deducted as an itemized deduction. The maximum deduction is $400 a month, but if the taxpayer's adjusted gross income exceed $35,000 (combined with the spouse's, if married), the allowable expenses must be reduced by one-half of the amount over $35,000. To qualify for the deduction, four requirements are imposed:

1. The taxpayer must have been gainfully employed during the period the expenses were incurred;
2. The taxpayer must have maintained a household that included one or more qualifying individuals;
3. The expenditures must have been necessary to enable the taxpayer to be gainfully employed; and
4. The payments for the service must have been to other than relatives (except cousins) or dependent members of the taxpayer's household.

For married individuals, both must have been gainfully employed (unless one was disabled) substantially full-time and a joint return must be filed.

Proposed change

The bill replaced the itemized deduction for household and dependent care expenses with a nonrefundable income tax credit. Taxpayers with qualified expenses may claim a credit against tax for 20 percent of the expenses incurred (up to certain limits) for the care of a child under age 15 or for an incapacitated dependent or spouse, in order to enable the taxpayer to work. The income limit of $35,000 beyond which the deduction is phased out is to be removed.

The bill also extends the credit to married couples, where the husband or wife, or both, work part time, and the deduction also is to be made available to married couples where one is a full-time student and the other spouse works.

AICPA comments

The proposed change broadens the application of the section, and, as subsequently modified, raises the income level at which the deduction starts to phase out. We approve of such changes.

SECTION 505—CHANGES IN EXCLUSIONS FOR SICK PAY AND CERTAIN MILITARY, ET CETERA, DISABILITY PENSIONS

Present law

An employee may exclude from income amounts received under a wage continuation plan for a period during which he is absent from work on account of personal injuries or sickness. After a 30-day period the maximum exclusion is $100 per week. There is no limit on the severity of accident or sickness which will qualify.

Proposed change

The sick pay exclusion would be repealed generally under the bill. The exclusion for disability income would be available to taxpayers under age 65 who are permanently and totally disabled (after that age they will be eligible for the revised elderly credit). The maximum amount of income that may be excluded will remain at $100 a week. The maximum amount excludable is reduced on a dollar-for-dollar basis by the taxpayer's adjusted gross income (including the disability income) in excess of $15,000. For this purpose, permanently and totally disabled means inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.

AICPA comments

This provision applies the sick pay exclusion provisions to disability retirement payments, but limits the utilization of this provision to lower income taxpayers. The recent change in the regulations applying the exclusion to disability payments until mandatory retirement age is reached has clarified the present law. We oppose this change on the ground that there seems no purpose served by the added limitation this section would insert.

TITLE VI

Business Related Individual Income Tax Provisions

SECTION 601—DEDUCTIONS FOR EXPENSES ATTRIBUTABLE TO BUSINESS USE OF HOMES, RENTAL OF VACATION HOMES, ET CETERA

Business Use of Residence

Present law

Current law in this area is found in administrative rulings and court decisions, the two of which are at odds on certain aspects. The Internal Revenue Service's position is to allow the deduction only if maintaining an office in the home is required as a condition of the taxpayer's employment. On the other hand, court decisions have permitted the deduction if the office in home is "appropriate and helpful" to the taxpayer in his position of employment.

Proposed change

In general, the bill provides that a taxpayer will not be permitted to deduct any expenses attributable to the use of his home for business purposes. An exception is made if a portion of the home is used exclusively on a regular basis as:

1. The taxpayer's principal place of business;
2. A place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal cause of his trade or business; or
3. As rental property.

AICPA comments

We feel that the proposal as to business use of a home is an over-reaction, and that present law is sufficient to deal with any abuses which may arise. It is inequitable to punish all taxpayers whose homes are an adjunct to their business for exaggerated deductions claimed by a few. To the extent that the congressional reaction is in response to IRS defeats in the Tax Court, we feel that an examination of those cases does not indicate that the courts have awarded any unjustified deductions to the taxpayers involved. The burden of proof that the deduction claimed is an ordinary and necessary business expense, and that the amounts arrived at are reasonable, still rests on the taxpayer.

Rental of Vacation Homes

Present law

Under present law, section 183 of the Internal Revenue Code provides that if an activity is not engaged in for profit, the amount of the allowable trade or business deduction (such as depreciation, maintenance, and utilities) cannot exceed the amount of the gross income derived from the activity. The determination of whether an activity is engaged in for profit is made by reference to objective standards taking into account all the facts and circumstances of each case. There is a presumption that a taxpayer is engaged in an activity for profit if in 2 of the last 5 taxable years the activity actually produced a profit. This provision was intended to cover the rental of vacation homes used for personal purposes.

Proposed change

If a vacation home is used by a taxpayer for personal purposes for the greater of 14 days or 5 percent of the actual business use, then section 183 limitations will be applicable whether or not the presumption under present law would otherwise apply. This means that the allocable deductions for trade or business or the production of income relating to the vacation home, which would be allowed if the activity were engaged in for profit, are not to exceed the gross income from the business use of the vacation home.

If the vacation home is used for less than 14 days or less than 5 percent of the actual business use, then this limitation will not be applicable and the allocable expenses will be allowed even if such expenses exceed the gross income from the business use.

These special rules will not apply if the vacation home results in a profit for the year or if there is no personal use of the vacation home during the year.

AICPA comments

Although we generally favor the proposal as to vacation homes, on the ground that this is a potential abuse area and that the approach being taken is as good as any alternative that would be reasonably objective in its application, we feel the administrative rules should be adequate for this particular problem.

SECTION 602—DEDUCTIONS FOR ATTENDING FOREIGN CONVENTIONS

Present law

With regard to expenses incurred attending foreign conventions, the general test of deductibility presently used by the IRS is whether the meeting is primarily related to the taxpayer's business or whether it is primarily personal in nature. With regard to the actual travel expenses, code section 274(c) requires an allocation between business and personal if the trip is for a period of more than 1 week or the personal portion is more than 25 percent.

Proposed change

Under the bill no deduction would be allowed for expenses paid in attending more than two foreign conventions in any year. With respect to the two allowed conventions, the bill limits the deduction which may be taken both for travel and subsistence expenses.

AICPA comments

We agree in general with the proposed change, but we would like to point out a few problems we noted in the specific proposal language.

The reference in proposed code section 274(h)(2) to "the lowest coach or economy rate" would seem to produce a result contrary to congressional intent if taken literally. For foreign travel, the rate structure is such that trips of different length produce different coach rates—with the most expensive being a trip for less than 8 days. In addition, the coach rate can be even less when ground packages of certain amount are purchased and/or tickets are purchased far enough in advance. It seems to us that "lowest" should be replaced by such a word as "standard" or be defined for this purpose. If defined, the definition might be "the lowest rate available without advance reservation, without the incurrence of any specific minimum amount of other charges, and without regard to the length of time outside the United States."

We are also concerned with the language "during the calendar month in which such convention begins," because it seems to impose an undue restriction on any expense for a convention where a rate increase takes place during the month the convention is held. Thus, if a convention begins on December 19 but an airline rate increase took place on December 2, the taxpayer would be allowed to deduct only the lowest rate charged during December even though there was no way he could actually travel at that rate. We would suggest deleting the quoted phrase, and substituting "at the time at which such convention begins."

SECTION 603—QUALIFIED STOCK OPTIONS

Present law

Under present law, a qualified stock option is not treated as income when it is granted or when it is exercised. In addition, when the stock acquired under the option is sold or exchanged by the employee, the difference between the option price and the amount received by the employee is generally treated as long-term capital gain or loss.

Proposed change

The bill provides that in the future, qualified stock options will be subject to the rules of section 83 of the Internal Revenue Code (which applies today in the case of most nonqualified options granted after June 1969). Generally, the value of the option would constitute ordinary income to the employee if it had a readily ascertainable fair market value at the time it was granted (and was not nontransferable and subject to a substantial risk of forfeiture). If the option did not have a readily ascertainable value, it would not constitute ordinary income at the time it was granted, but when the option was exercised the spread between the option price and the value of the stock would constitute ordinary income to the employee.

AICPA comments

We feel that the above proposal would constitute a favorable amendment to the tax law. While taxing the compensatory portion of stock options, taxpayers will still be allowed the favored capital gains treatment for taking the market risks subsequent to their being taxed for this compensation element.

SECTION 604—TREATMENT OF LOSSES FOR CERTAIN NONBUSINESS GUARANTIES

Present law

Presently, an individual taxpayer's "nonbusiness" bad debts are treated as short-term capital losses which is not as advantageous as a deduction for an ordinary loss. On the other hand, however, if the individual's loss results from a situation where he only guaranteed the debt of another individual, he can treat the loss as a business bad debt under certain circumstances.

Proposed change

Under the bill when a taxpayer has a loss arising from the guarantee of a loan he will receive the same treatment as where he has a loss from a loan which he makes directly.

AICPA comments

We disagree with this proposal. With the acute capital shortage this country faces now and for the future, expansion rather than contraction of the tax incentives for noncorporate financing or noncorporate business would seem desirable. We agree that it is anomalous to treat a guarantee more favorable than a direct loan, but we believe that the solution is to allow the business bad debt deduction for the loan rather than to deny it to the guarantor.

TITLE VII

Accumulation Trusts

SECTION 701

Present law

At present, an accumulation distribution from a trust is taxed under one of two alternate methods—the exact method or the shortcut method. The shortcut method was designed to simplify the otherwise complex computations under the exact method. However, in discharge of their fiduciary obligation to pay the lowest tax, trustees at present have to first compute the tax under both methods. In addition, the capital gains throwback rule, which was enacted in 1969, has proven to be more complex than was expected.

Proposed change

Under the bill there is only a single method for computing the tax on accumulation distributions, which is a variation of the present shortcut method. In addition, the capital gains throwback rule is repealed and other changes to the taxation of accumulation distributions are made.

AICPA comments

We support the adoption of legislation simplifying the taxation of distributions of accumulated income and gains by trusts. We recognize in bill section 701 an enlightened effort to relieve the undue administrative burdens falling upon both taxpayer and the Internal Revenue Service under the exceedingly complex provisions of the unlimited throwback rule. Such complexity stands in the way of an even-handed, knowledgeable application of the tax law. Furthermore, it is obligatory for records to be retained for extensive periods of time; far longer than is required for enforcement of other areas of taxation. Thus, the throwback provisions will prove to be unworkable in an ever-growing number of situations.

However, we believe that bill section 701, by failing to address certain aspects of the rule, perpetuates a situation which lacks simplicity, certainty, and equity.

It has been our position that the applicability of the throwback rule should be limited to a 10-year period. We believe that the isolation of funds in a trust for 10 years is a sufficient detriment to prevent the abuse sought to be eliminated by the throwback rule in most cases. The placing of a time limitation upon the throwback rule, twice that operable before 1970, would greatly simplify an extraordinarily complicated area of the tax law, and would relieve the onerous duties placed upon taxpayers, fiduciaries, and the Internal Revenue Service. The modified shortcut rule does not cure the inherent problems of an unlimited throwback rule. It continues to have reference to the records of the unlimited past.

We offer the following specific comments with regard to the proposed legislation.

Bill section 701(a)—in general, we support a simplified single method of computing tax on accumulation distributions. The proposal changes the computation in the following significant ways:

1. The choice of determining the tax by use of the "exact" or "shortcut" method, whichever produced the lesser tax, is eliminated.
2. The shortcut method is modified to cover a 5-year period, less those years producing the highest and lowest taxable incomes; and the shortcut method would become the only allowable tax computation.
3. The income deemed distributed is added to the taxable income of the beneficiary, rather than to gross income; but a new limitation is imposed: the taxable income before the distribution shall be deemed not to be less than zero.
4. Refunds are denied for the excess of tax previously paid by the trust on the distributed income over the tax payable by the beneficiary thereon.

We concur in the change to a single method of computing the additional tax, and in the manner in which the shortcut method has been modified to eliminate from the averaging process the highest and lowest income years. We recognize that the elimination of a choice of methods could increase the tax burden on some taxpayers, but we feel this is outweighed by the administrative simplicity, certainty, and consistency which would result.

However, where lower bracket beneficiaries and those with business losses are involved, more overall tax than is reasonable may be paid because of the proposed new floor on taxable income at zero and the denial of refunds to the beneficiaries. The fair objective of the throwback rule is to equate the overall tax paid with the tax which would have been payable if the income had been distributed to the beneficiary upon its receipt by the trust. Obviously, the shortcut method could operate for or against the taxpayer depending upon the fluctuations and trend in his personal income during the years of trust accumulations. We do not believe that the zero floor and no refund rules, which may have been intended as safeguards to the revenue-producing integrity of the shortcut method, but which nullify its impartial operation, are necessary. Nor do we feel that they are desirable in view of the likelihood that, in most cases where they will come into play, excessive taxes will be the end result. We believe that abuses of the trust form are adequately safeguarded against by the multiple trust rule, which prohibits the utilization as a credit of taxes paid by a third trust. Accordingly, we suggest that the zero taxable income floor and no refund rules be deleted from the bill.

In one instance, where substantial foreign taxes are paid on income earned by the trust, the adoption of the new shortcut method can cause an inequity which should be cured. The consequence of the addition of "an amount" to the beneficiary's taxable income is to obscure the character of the income previously taxed in the trust and passed through to the beneficiary. If foreign income does not maintain its character, the foreign tax credit will not be available. Consequently, the beneficiary of a trust having income from foreign sources may pay a double tax upon an accumulation distribution. The appeal of simplicity is great; however, no method should impose confiscatory taxation upon some taxpayers. Accordingly, we suggest that the proposed shortcut method be revised merely to insure that the foreign character of the income earned during the 3 years which enter into the computations may be taken into account by a taxpayer in measuring the tax liability under bill section 701 (a).

The bill provides that the multiple trust rule eliminating tax credits shall not apply if a distribution of accumulated income is less than $1,000. We believe that this is a sensible deminimus rule. It is a concept which should be applied more extensively—to those situations where little, if any, tax abuse is present and, therefore, where application of throwback is an unavailing administrative burden for both taxpayer and Internal Revenue Service. Accordingly, we propose adoption of a deminimus rule under which throwback will not be required if the aggregate undistributed income of all trusts of which the taxpayer is the beneficiary does not exceed $1,000. This will eliminate throwback from the concerns of many small trusts where technical advice is not normally obtained, and where the professional assistance necessary to cope with its operation would be inordinately costly.

Bill section 701(b)—the bill provides that the throwback rule will not apply to accumulations before the birth of the beneficiary or before he reaches 21 years of age. This exception does not apply in the case of distributions under the multiple trust (three or more trusts) rule. It is our opinion that the minority exception is a desirable provision which will simplify the operation of the tax law by greatly reducing the number of instances where throwback applies, and typically where little abuse could be present.

Bill section 701(c)—the caption of bill section 701(c) includes the term "accounting income," but the text refers only to "income". We suggest that the former be used, and that the term should be clarified in substance as follows: "accounting income as determined under the State law applicable to the trust."

Bill section 701(d)—the captial gains throwback provision is incongruously complex in light of its modest goal of retaxing income which, as a matter of tax policy, receives favorable treatment. The repeal of this provision will be substantial progress toward simplification of the tax law. Bill section 701(e), commented upon below, fills the void which might otherwise have been created by repeal of capital gain throwback.

Bill section 701(e)—the intent of this provision, as recited in the report of the Ways and Means Committee, is to prevent abuse of trusts by the transfer of appreciated property thereto to take advantage of a lower rate of tax when the property is sold. It operates by establishing a 2-year holding period (without tacking on the transferor's holding period) in order to realize long-term capital gain. It applies to assets acquired by the trust if the fair market value exceeds the price paid by the trust. The bill creates what may be unintended technical problems.

The section should, but does not, contain a provision making it inoperative where any gain will be taxed directly to the transferor under grantor trust rules. Secondly, the limitation on the gain to which the modification of the holding period rules applies should be measured by the unrealized appreciation transferred from grantor to trust. It is the transfer over of that element of the value of the property which is the abuse cited in the committee report. Instead, the limitation is the entire gift to the trust, regardless of the extent of the transferor's unrealized gain (or absence thereof). So, for example, if, as is usually the case, a trust receives an outright gift of property from a grantor who happens to have a basis equal to its value, then subsequent gains recognized during the 2-year period will be deemed short term. We recommend technical changes in bill section 701(e), which will properly limit its application: it should not apply to grantor trusts; nor to appreciation realized after receipt of the subject property.

In view of the favorable tax treatment accorded capital gains, a serious policy question exists as to whether the transfer of appreciated property to a single trust is an abuse requiring modification of the holding period. The tax saving is limited to a maximum of approximately $15,000, regardless of the amount of the gain and assuming the grantor is in the highest tax bracket. Trusts serve an age-old, legitimate function in social and economic planning. The tax saving compared with the value of the property transferred is relatively minor where a single trust is created. It is the tax benefit derivable from the creation of multiple trusts, where one would suffice to accomplish financial planning, that amounts to abuse. We urge reconsideration of the provision, and a decision to limit the application of the holding period provisions to situations where multiple trusts are created by the transfer of appreciated property.

TITLE VIII

Investment Credit Changes

SECTION 802—INVESTMENT CREDIT FOR MOVIE AND TELEVISION FILMS

Present law

Prior to 1971, it was not clear whether the investment credit was available for movie or television films. One court held that movie films were tangible personal property eligible for the investment credit. In the Revenue Act of 1971, it was made clear that motion pictures and television films were to be treated as tangible personal property which is eligible for the investment credit. However, there remain important unsettled issues, such as how to determine useful life, the basis on which the credit is computed, and how to determine whether use is predominantly within the United States.

Proposed change

The bill would provide different methods to deal with the problems of the proper treatment of the investment credit for motion pictures and television films with respect to the past and with respect to the future.

For the past, one of two alternatives would be available. The first method available for the past is what in most respects has been the IRS litigation position. Taxpayers under this method would be eligible to receive credit for their films if it is demonstrated on a film-by-film basis that the film satisfied both the useful life requirement and the requirement that there must be no predominant foreign use. Under the second alternative, a taxpayer may elect to take an investment credit on the basis of 40 percent of the cost of all of his films without regard to the estimated useful life of the film for purposes of depreciation and also without regard to whether the film is shown predominantly outside of the United States.

For future years, taxpayers could elect to take an investment credit on a two-thirds basis for all films, instead of determining useful life on a film-by-film basis.

The bill also provides that the investment credit should be available in the case of films to the persons who bear the risk of loss if the film is not a successful picture. This rule applies under any of the alternatives set forth above.

AICPA comments

We take no position on the proposed rules for determining the investment credit for movie and television films. It is our feeling that specific operating details attempting to apply the general provisions of the tax law to specific industries are more properly a subject for regulations and revenue procedures, and not for legislation, and it would be our preference that this problem be resolved in that way.

TITLE X

Changes in the Treatment of Foreign Income

SECTION 1011—EXCLUSION FOR INCOME EARNED ABROAD

Present law

Present law permits U.S. citizens living or residing abroad to exclude from income $20,000 ($25,000 in certain cases) of their income earned abroad.

Proposed change

The bill would phase out this provision over a 4-year period. In recognition of certain additional expenses which are incurred by U.S.

citizens living and working abroad, however, the bill provides a deduction for certain tuition expenses of dependents of such taxpayers, subject to a $100 per month per dependent limitation.

AICPA comments

We feel that the earned income exclusion should be retained to eliminate the inequities that would result if U.S. taxpayers residing abroad are required to pay the higher of the U.S. tax rate and the foreign tax rate. It should be noted that substantially all countries no longer tax an individual when he transfers his residence to another country, i.e., their tax system is based on a residence rather than citizenship concept. The present U.S. tax rules do not go that far, but at least give some recognition to the fact that an individual will be residing for a period of time outside the United States and therefore will be living under substantially different economic and social conditions.

SECTIONS 1013 AND 1014—PROVISIONS AFFECTING FOREIGN TRUSTS

Present law

Originally, foreign trusts were created by U.S. persons to avoid taxation of capital gains. Such gains were not taxed when realized because the trust was beyond the taxing jurisdiction of the United States. When the gains eventually were distributed, they passed tax-free to the beneficiary.

In 1962, in recognition of the proliferation of this device, Congress revised the code to make foreign trusts less attractive: capital gains became a part of distributable net income (code sec. 643(a)(6)(C)); and the throwback rule was made unlimited (the 5-year throwback rule remained applicable to domestic trusts). As a result, the capital gains eventually were taxed to the beneficiary.

The relative advantage of foreign trusts emerged once again in 1969. The Tax Reform Act extended the unlimited throwback rule to domestic trusts, and capital gains throwback was initiated. At present, the foreign trust is clearly preferable to the domestic trust in the appropriate circumstances.

If the foreign trust is not engaged in a trade or business within the United States, and if the trustee is not physically present for 183 days or more during the taxable year, there are attractive opportunities for tax deferral. The foreign trust may invest, for example, in U.S. securities. Dividends and interest would be subject to withholding tax at 30 percent or lower treaty rate, if applicable. Capital gains, though the sale or exchange takes place in domestic markets, are immune from U.S. taxation until they are distributed.

Foreign trusts have appeal where the family can: (1) forego the use of the assets for an extended period; (2) invest primarily for appreciation rather than income; (3) bear the expense of travel to the foreign situs (Bermuda, the Bahamas, the Cayman Islands, etc.—locations which recognize trusts, because they derive their legal systems from the English common law) for execution of the trust instrument (a procedure urged by cautious practitioners); and (4) can afford the sophisticated tax adviser who will design the suitable foreign trust vehicle.

Proposed change

Sections 1013 and 1014 of the bill would effectively curb the use of foreign trusts for tax avoidance purposes. The U.S. person who transfers property to a foreign trust which has or acquires a U.S. beneficiary will be treated as the owner of the trust property, and thus will be taxed currently on its income and gains. Annual returns will have to be filed by such persons.

Where settlers are not taxed currently (where the foreign trust is not created by a U.S. person), the tax under the throwback rules on amounts of accumulated income distributed to the U.S. beneficiary will be supplemented by a 6-percent nondeductible surcharge.

AICPA comments

We support the removal of tax incentives for the creation of foreign trusts. We believe that the methods employed in bill sections 1013 and 1014 would attain that goal. We do, however, offer suggestions for modification of the provisions where we view them as being unduly harsh.

The application of grantor trust rules to trusts created by United States persons nullifies the trusts for tax purposes, and ignores the actuality of the surrender of economic benefit by the settlor. We considered and rejected as an alternative the taxation of income, whether or not distributed, to the beneficiaries. We concluded that, as a rule of universal application, that taxing method would fail. Trusts which permit the trustees to sprinkle and accumulate income, and trusts where the identification of specific beneficiaries from among a class awaits future events would be beyond the reach of the rule. Nonetheless, the abuse—deferral of taxation—can be interdicted without inflexible severity. If the terms of the governing instrument preclude deferral, why should the draconian approach of imputing income and gains to the settlor be taken with respect to the trust?

Accordingly, we suggest that the grantor trust provisions of bill section 1013 be used with appropriate restraint, confined to circumstances where the abuses must be curbed. The beneficiaries should be taxed under the present rules, if the instrument requires the trustee to distribute income and gains annually. The grantor trust rules should be invoked where the trustee instrument does not contain that requirement.

The 6 percent surcharge imposed by bill section 1014 is intended to negate the benefits of tax deferral in instances where the income of the trust was not taxed to the settlor under the provisions discussed above. It will apply to the U.S. beneficiary of a foreign trust created by a foreign settlor.

The theoretical benefits of tax deferral, the interest-free loan from the U.S. Treasury, are dubious. In recent years, the borrowing of funds for investment purposes more often than not generated losses. But, money has its price, and a charge for deferral is justifiable. Nonetheless, the form of charge and the rate selected should render justice.

Proponents of surcharge contend that it applies more fairly than a deductible interest charge. We accept that proposition in the context of the throwback rule. However, if interest is to be abandoned as the price for the use of money, then the charge should be reflective of recent investment occurrences. From that perspective the 6 percent rate, when converted into a pretax interest rate in a wide range of brackets, is excessively high. We believe that the surcharge should be reduced to 3, or at most 4, percent.

SECTION 1015—EXCISE TAX ON TRANSFERS OF PROPERTY TO FOREIGN PERSONS

Present law

Under present regulations, a transfer of appreciated stock or securities to a foreign corporation, trust or partnership is subject to a 27½-percent excise tax unless it is established before the transfer that tax avoidance is not one of the principal purposes of the transfer or the transferee is an organization exempt from income tax under code sections 501 to 504. Then, after the tax is paid, if the transfer is shown to the IRS to be free of tax avoidance, the taxpayer gets a refund.

Proposed change

The bill provides for a 35-percent excise tax on the transfer of all appreciated property to a foreign corporation, trust or partnership.

AICPA comments

The extension of this excise tax to all appreciated property transfers will work a hardship on people who are engaged in international trade. The purpose of code sections 1491 and 1492 is to tax a transfer where there is a donative intent on the part of the transferor. With U.S. businessmen and corporations entering into more joint ventures abroad in partnership form, including limited liability companies treated as partnerships, it seems an undue burden for them to have to pay a tax on the transfer if they don't get a ruling, and then to have to claim a refund if the income from the property transferred to the partnership is going to be subject to U.S. tax in any event. We, therefore, suggest a provision to the following effect: That transfers made without donative intent by persons engaged in a trade or business to a foreign partnership will not be subject to code section 1491.

SECTION 1021—INVESTMENT IN U.S. PROPERTY BY CONTROLLED FOREIGN CORPORATIONS

Present law

Under present law an investment in U.S. property by a controlled foreign corporation (CFC) is treated as a taxable distribution to the corporation's U.S. shareholders. The type of property which is classed as a U.S. investment for this purpose is presently very broadly defined.

Proposed change

Bill section 1021 amends code section 956, so as to limit the definition of "U.S. property" for purposes of determining which investments by a CFC will create subpart F income. After the amendment, "U.S. property" would be limited to investments in shares and obligations of a U.S. shareholder of the CFC and in tangible property which is leased to or used by a U.S. shareholder of the CFC.

AICPA comments

This section takes a step in what we believe to be the right direction by limiting the scope of code section 956 to apply only in cases of certain CFC transactions with U.S. entities. However, we feel that this proposal is still too stringent and that bona-fide leasing transactions, such as leasing of equipment to a related U.S. entity, should not subject to CFC's earnings to current U.S. tax. We strongly urge that consideration be given to the repeal of code section 956 in its entirety. It appears that the objectives of this section, in its proposed amended form, can be met through use of the existing statute (for example, section 482) and judicial decisions (such as those finding constructive dividends).

Given the proposed change in its present form, however, we make the following specific comment. The language of bill section 1021(b), which amends the attribution rules of code section 958(b), is somewhat confusing. It is intended to modify the code section 958(b) attribution rules so as to permit the attribution to U.S. persons of stock owned by foreign persons. This is accomplished by making paragraph (4) of section 958(b), which normally prevents such attribution, inapplicable. It is intended, however, that a special rule be provided so as to prevent the attribution of shares of a CFC to a wholly owned U.S. subsidiary thereof except where the U.S. subsidiary has a "significant part of its assets" consisting of U.S. property. This term "significant part" is, of course, susceptible to broad interpretation. We suggest that some percentage measure be substituted in the statute in lieu of this term. In the interest of improving the language of the statute and incorporating the above suggestion, the last full sentence of paragraph B of bill section 1021 could be changed to read as follows:

> Paragraph (4) shall ont apply for purposes of section 956(b)(1), but section 318(a)(3) shall not be applied for purposes of section 956(b)(1) to treat a domestic corporation as a U.S. shareholder of a controlled foreign corporation if all of the stock of the domestic corporation is owned directly by the controlled foreign corporation and less than (a stated percentage) of the adjusted basis of the assets of the domestic corporation consists of U.S. property (within the meaning of section 956(b)(1)).

SECTION 1022—EXCLUSION FOR EARNINGS OF LESS DEVELOPED COUNTRY CORPORATIONS

Present law

Present law contains an exception to the rules providing for dividend treatment on the sale of stock of a subsidiary if that subsidiary can be classified a less developed country corporation.

Proposed change

Bill section 1022 repeals the less developed country exception from the ordinary income treatment provided by code section 1248 for earnings accumulated while a CFC was a less developed country corporation where the stock sold or exchanged was owned for a continuous period of at least 10 years.

The repeal provision permits the continued application of the exception with respect to those earnings of a CFC which were accumulated during any taxable year beginning before January 1, 1976.

However, in addition to continuing the application of the exception to those previously eligible pre-1976 earnings; namely, in those cases where the shares were held for 10 years, the exception is made applicable also in those circumstances where the shares have been owned for less than 10 years. The effect will be to subject to capital gains tax all of those gains attributable to pre-1976 earnings without regard to holding period.

AICPA comments

This appears to be a retroactive amendment of the code in that it would prevent the application of section 1248 ordinary income treatment in circumstances where a taxpayer might have planned for such treatment and intended to accomplish his planned result by disposing of the shares prior to the expiration of the 10-year holding period.

If it is desired to liberalize the application of the previous exception by extending it to taxpayers who have held shares for less than 10 years, we suggest that this result be accomplished by providing taxpayers with an option to have the exception either applied or not applied, at his election, where the holding period is less than 10 years as of January 1, 1976.

SECTION 1023—EXCLUSION FROM SUBPART F OF CERTAIN INSURANCE COMPANY EARNINGS

Present law

Under present law, foreign personal holding company income is subject to current taxation. An exception to the definition of foreign personal holding company income is made, however, for certain income of a foreign insurance company from its investment of unearned premiums or reserves.

Proposed change

This section of the bill amends code section 954(c) to provide a controlled foreign corporation which is a casualty insurance company with an additional exception from the definition of foreign personal holding company income for dividends, interest, gains, et cetera, attributable to investments of assets equal to one-third of the CFC insurance company's premiums earned on insurance contracts.

AICPA comments

This is a very liberal exclusion from subpart F and will probably result in the ordinary CFC insurance company generating no foreign personal holding company income, by definition. We suggest only one technical comment. The parenthetical reference "as defined in section 832(b)(4)" should follow the phrase "premiums earned on insurance contracts" rather than the phrase "taxable year."

SECTION 1024—SHIPPING PROFITS OF FOREIGN CORPORATIONS

Present law

At present one of the categories of income subject to current taxation under subpart F is income derived from the use of an aircraft or vessel in foreign commerce, except to the extent the profits are reinvested in shipping assets.

Proposed change

Bill section 1024 amends the recently enacted base company shipping rules by providing that if "substantially all" the property of a corporation consists of aircraft or vessels used in foreign commerce, the property will be considered to be subject to any unsecured liability of the corporation which is evidenced by a written obligation and payments on such liabilities will be considered reinvestments in shipping assets.

AICPA comments

Our only comment here relates to the use of the vague phrase "substantially all." It would seem better advised to provide a percentage measure in the statute if the framers of the statute have in mind some concept of what would constitute "substantially all."

SECTION 1031—DETERMINATION OF FOREIGN TAX CREDIT ON OVERALL BASIS

Present law

Under present law there are two alternate limitations on the amount of foreign tax credit which can be claimed: the overall limitation and the per-country limitation.

Proposed change

The bill would repeal the per-country limitation, leaving only the overall limitation to apply.

AICPA comments

We agree in general with the repeal of the per-country limitation and the requirement that all taxpayers use the overall limitation in computing their foreign tax credit.

In the committee report, it was recognized that the adoption of the overall limitation method may seriously affect the consolidated tax liability of an affiliated group, and it was anticipated that the Commissioner would permit such companies to discontinue filing consolidated returns. It is suggested, because of the adverse impact the overall limitation will have on many taxpayers, that blanket permission be given to all affiliated groups to discontinue filing consolidated returns upon enactment of the bill.

We would like to point out that proposed code section 904(e)(4)(B) provides that under the transitional rules for carryovers, amounts reduced by the overall limitation are reduced in proportion to the taxes paid or accrued . . . The committee report states that the reduction is on the basis of "the ratio of the credits allowable," and an example given illustrates the reduction on the basis of the credits rather than the taxes. It is suggested that this inconsistency be corrected.

The retention of the per-country limitation in the case of income and losses from Puerto Rico and other possessions is found in bill section 1031(c) under "Effective Dates." It is not clear how this provision will be worked into the code.

SECTION 1032—RECAPTURE OF FOREIGN LOSSES

Present law

Repeal of the per-country limitation, as provided in bill section 1031, will prevent a taxpayer who has foreign losses from reducing his U.S. tax on U.S. income if the taxpayer also has foreign income equal to or greater than the amount of losses. In the situation where overall foreign losses exceed foreign income, however, the excess of these losses can still reduce the tax on U.S. income. In this latter case, if a taxpayer later receives foreign income on which he obtains a foreign tax credit, the taxpayer will have received the benefit of having reduced his U.S. income for the loss year while not paying a U.S. tax for the later profitable year.

Proposed change

This provision of the Bill requires that where a loss from foreign operations reduces U.S. tax on U.S. source income, the tax benefit derived from the deduction of these losses will be recaptured by the United States when the company subsequently derives income from abroad.

AICPA comments

It is our opinion that this provision, when considered in conjunction with the repeal of the per-country limitation on the foreign tax credit, will primarily apply to U.S. taxpayers with limited foreign operations or those who are undergoing the startup costs of engaging in international trade. This provision will thus discourage U.S. taxpayers with a minimum of foreign source income from investing in international operations where substantial startup losses are anticipated.

We question whether requiring both a recharacterization of foreign source income as domestic source income, and a denial as available credit the foreign income taxes imposed on such income, is necessary to achieve the stated goals. When considered in conjunction with the other provisions of the bill, it is arguable that either an income recharacterization or a credit denial (but not both) should suffice. The introduction of both concepts further complicates the Internal Revenue Code.

We believe it would be more appropriate to amend section 367 of the code to require a recapture of losses previously deducted when property is transferred to a foreign corporation in a transaction which is not taxed because of a 367 ruling, rather than have such a provision buried in the foreign tax credit provision, as proposed in the bill.

SECTION 1033—GROSS UP OF DIVIDENDS FROM LESS DEVELOPED COUNTRY CORPORATIONS IN DETERMINING THE FOREIGN TAX CREDIT

Present law

Under present law, the amount of dividend from a less developed country corporation included in income by the recipient domestic corporation is not increase (that is, grossed up) by the amount of taxes which the domestic corporation receiving the dividend is deemed to have paid to the foreign government. Instead the amount of taxes is reduced by the ratio of the foreign taxes paid by the less developed country corporation to its pretax profits. The failure to gross up the dividend by the amount of the foreign taxes that are deemed paid results, in effect, in a double allowance for foreign taxes because of the fact that the amount paid in foreign taxes not only is allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is allowed as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax).

Proposed change

Dividends received by U.S. shareholders from less developed country corporations are to be "grossed up" by the amount of taxes paid in the less developed country both for purposes of computing U.S. income and for purposes of computing the U.S. foreign tax credit applicable to that income.

AICPA comments

The present rule for computing deemed paid foreign taxes in connection with dividends from less developed country corporations, in some circumstances, operates to the disadvantage of an investor when compared with the result that would be achieved under a gross up rule. There are a number of ways that this disadvantage could be eliminated. In the interest of simplicity, we recommend that the matter be resolved by allowing the recipient of a dividend from a less developed country corporation to elect either the general gross up rule or the less developed country corporation rule.

With regard to the special transition rule provided in the bill, we would ordinarily agree that a 2-year grace period would be sufficient. However, such a period may not be long enough for this purpose since many less developed countries will prevent the withdrawal of all accumulated earnings in such a brief period of time. We suggest that either a longer fixed period of time be permitted or, in the alternative, that an indefinite period of time be allowed upon a showing by the affected taxpayer that he could not have withdrawn as a dividend the accumulated earnings of his less developed country corporation during the 2-year grace period.

In addition to amending code section 902, section 343 of the bill makes various other conforming amendments to appropriate sections to the Internal Revenue Code, including a conforming amendment to section 960 which provides rules for the computation of deemed paid credits in connection with imputed dividends taxable under subpart F. We suggest that since section 960 is being conformed to section 902 for this purpose, an additional amendment be made to section 960 at this time to conform it in all respects with section 902 and most particularly by providing therein for the same treatment in connection with imputed dividends as is provided under section 902(b) (2) in connection with actual dividends.

SECTION 1034—CAPITAL GAINS FOR FOREIGN TAX CREDIT PURPOSES

Present law

Presently most countries impose little tax on sales of personal property by foreigners if the sales are not connected with a trade or business. This system permits taxpayers to plan sales of their personal property in such a way that the income from the sale results in little or no additional foreign taxes, yet the amount of foreign taxes they can use as a credit against their U.S. tax liability is increased.

Proposed change

The bill provides specific rules for determining the extent to which income from the sale or exchange of capital assets from sources outside the United States is to be included in the limiting fraction in calculating the foreign tax credit limitation.

AICPA comments

Bill section 1034 proposes to amend code section 904(b) to deal with capital gains in the computation of the foreign tax credit. One problem the provision is designed to overcome results from the fact that capital gains realized by a corporation are subject to a lower rate of tax than ordinary income. (The similar problem with respect to individuals is intentionally ignored.) The provision deals with this problem by decreasing, for code section 904(a) purposes, foreign source capital gains. However, no comparable adjustment is made to U.S. source capital gains. Although present law favors the taxpayer with foreign source capital gain, a taxpayer with U.S. source capital gains is at a disadvantage. The congressional intent can be achieved by either adjusting both the U.S. and foreign source capital gains or by providing a separate code section 904 calculation on capital gains.

SECTION 1041—NONRESIDENT ALIEN AND FOREIGN CORPORATION INVESTMENT IN THE UNITED STATES

Present law

Under present law a 30-percent withholding tax is imposed on dividends and interest received from U.S. investments by foreign persons. A temporary exemption exists for foreign deposits held in U.S. banks.

Proposed change

Interest and dividends paid by a U.S. person are generally to be exempt from U.S. tax if received by a nonresident alien individual or a foreign corporation. This exemption would not be available if the income is effectively connected with a U.S. business or if the payor is owned by foreign persons.

AICPA comments

In general, we believe the objective of the changes made by this section is a desirable one. We do question the failure of the section to include the area of equity capital, however. We believe it would be in the best interests of the United States for the exemption to apply not only to interest income but to dividend income and thus not artificially distort the capital structure of our businesses because of the income tax concerns of the foreign investors.

In addition to our general comments, we offer the following comments regarding specific matters:

Investment by controlled foreign corporations.—We question the logic of encouraging the investment of funds held outside of the United States by controlled foreign corporations (CFC's) through section 1022 of the bill but not allow the interest on such obligations to be exempt from U.S. tax. If it is desirable to encourage such investments by CFC's, it seems logical that the encouragement should not be undercut by treating the interest income on such investment differently than interest income paid to other foreign investors. It should be remembered that the interest income may well be taxable subpart F income under section 951 of the code.

Constructive ownership and attribution rules.—While under U.S. tax principles it is very logical to apply the concepts of tracing ownership and constructive ownership in determining the flexibility of income to investments made in the United States, the same principles are almost impossible to apply to investments made from outside of the United States. Under bill sections 1041(a) and 1041(b), the lifting of the exemption when the investor owns more than 10 percent of the corporation or foreign investors in total own more than 50 percent of the corporation creates provisions which, as a practical matter, are unworkable.

Ownership by foreigners of U.S. securities can easily be disguised so that it is impossible for the U.S. borrower to identify who is the specific owner, much less identify the relationship of that owner to another owner through trusts, partnerships, estates, et cetera. Attribution rules will largely be ineffective since the borrower will not be in a position to obtain the necessary information to identify the relationships of the debt owners involved. Foreign investors will basically not understand such requirements and will consider them to be an intrusion on their privacy when asked to provide information to establish whether such a relationship exists. Under circumstances, since the borrower may not be able to establish the relationship, either he will be at risk in not withholding a tax or it will be necessary for the U.S. Treasury to grant a blanket exemption when information is not available. If the burden is put on the borrower to establish the nonexistence of such a relationship, this will only discourage the lender from providing his funds.

A further point relating to this area involves the question of whether particular foreign entities are comparable to specific legal entities under U.S. tax law. For example, the provisions of bill sections 1041(a) and 1041(b) apply to "stock owned in a corporation." The laws of many countries establish entities which could be construed to be corporations for U.S. tax purposes but which do not have stock as evidence of ownership and which in fact may not be corporations for U.S. tax purposes. Some countries have entities which they call trusts but which are totally different from the concept of trusts under the U.S. legal system, and thus the effect of their existence on ownership relationships will be very difficult to identify.

It is our suggestion that the provisions in this area not attempt to restrict the allowance of the exemption in situations where identity of ownership is beyond the practical control of the U.S. Government and the U.S. business involved.

Provision regarding exchange of information.—Bill section 1041(d) involves questions similar to those discussed above regarding the applicability of the exemption. While it is logical to give the Treasury the authority to deny the exemption in certain circumstances, there are practical questions which arise under such a provision. If the intent is to rely on the exchange of information for identification of the interest recipents, what result will lie if there is no tax treaty which would require such information to be furnished? In such a circumstance, is the borrower not able to take advantage of the exemption to reduce his interest cost? Similarly, we question the effectiveness of such an exchange of information since it is our understanding that, as a general matter, there has been limited exchange of information under existing treaties which have been in existence for many years. Under those circumstances, we question whether the authority to revoke such an exemption would increase the effectiveness of this information exchange in the future. This provision may only discourage foreign investors from making investments.

Technical wording.—It is our suggestion that the wording determining interest qualification under bill sections 1041(a) and 1041(b) be the same as the wording used in code section 861(a)(1) relating to source of income. This would eliminate many questions as to which interest is intended to be covered by this provision and avoid the need to define such things as "United States person," "agency," or "instrumentality," and so forth.

Estate tax.—With regard to the estate tax exemption under bill section 1041(e), the same comments relating to equity capital investments made above are appropriate for estate tax exemption considerations. It has been our experience that foreign investors have been sufficiently concerned over the risk of U.S. estate tax that particular investments have been peculiarly structured in order to avoid the risk of the tax applying. We believe it is as much in the interest of the United States to encourage equity investments by an estate tax exemption as it is in our interest to encourage such investments in the form of debt obligations. We believe the exemption should be broadened to include equity investments.

SECTION 1042—CHANGES IN SECTION 367 RULING REQUIREMENTS

Present law

In order to reduce the possibility of tax avoidance through a transfer of assets to foreign corporations, code section 367 provides for full recognition of any gain within an otherwise tax-free reorganization involving a foreign corporation, unless the Service is first satisfied that the plan is not for the purpose of tax avoidance.

Proposed change

The bill provides for a liberalization of code section 367 and, accordingly, establishes separate rules for three different categories of transactions:

1. With respect to transfers of property out of the United States the requirement of an advance ruling is replaced by a requirement that the taxpayer file a request for clearance with the Internal Revenue Service within 183 days after the beginning of the exchange. In addition, the bill provides that the Secretary may designate by regulations those transactions which do not require the filing of a ruling request. It is contemplated that the transactions so designated will be clear-cut situations where significant tax avoidance possibilities do not exist or where the amount of any code section 367 toll charge can be readily ascertained without a ruling request.

2. With respect to other transfers including transfers into the United States and those which are between foreign corporations, a ruling is not required; however, the Secretary is to provide regulations setting forth the extent to which a foreign corporation will not be treated as a corporation as he deems to be necessary or appropriate to prevent the avoidance of Federal income taxes.

3. Rules are established regarding Tax Court review of Revenue Service negative opinions or no action decisions relating to requested rulings under code section 367.

The bill does not change present law which provides that a code section 355 distribution of stocks or securities is treated as an exchange, whether or not it is an exchange. Also, a transfer of property to a foreign corporation as a contribution of capital by persons having at least 80 percent voting control would continue to be treated as an exchange of property in return for the equivalent value of stock of the corporation.

In addition to amending code 367, certain dispositions of stock of foreign corporations previously exempt from tax under code section 1248 because of other tax-free sections are to become subject to taxation under this section. Thus, such events as dividends paid in the stock of a foreign corporation or stock sold or distributed to noncorporate shareholders in liquidation would trigger the taxation of previously untaxed section 1248 earnings.

AICPA Comments

We feel that while it is necessary to protect against tax avoidance transfers to foreign corporations, the elimination of the requirement to obtain code section 367 rulings in advance is a positive step in the direction of eliminating tax provisions which delay or impede appropriate business transactions. Taxpayers should be in a position to determine the tax effects of a given transaction from the statute and regulations rather than be subject to delay involved in obtaining an Internal Revenue Service determination in advance.

Code section 367 as amended by the bill, however, still leaves a great deal of discretion in the hands of the Commissioner of Internal Revenue. We recommend that in the following cases a 367 ruling not be required:

1. Any transfer between or among foreign corporations where the foreign corporations are—

(*a*) Controlled more than 50 percent both before and after the transfer by the same U.S. person, and

(*b*) Incorporated within the same country.

2. Any reorganization involving two foreign corporations which are not controlled by U.S. shareholders as defined in code section 957.

3. Any change in status of a foreign corporate entity from one form of entity to another.

There may be other examples for which there are equally good reasons why code section 367 should not be applicable, but these three take care of the situations where it is obvious that tax avoidance is not involved.

The bill is retroactive with respect to exchanges in any taxable year beginning after December 31, 1962, which involve solely foreign corporations. However, many of the transactions which might otherwise be granted relief under the retroactive provision will have occurred in statute-barred years. The bill does not provide for waiving the statute of limitations in such instances. It is our opinion that a provision waiving the statute of limitations would be a consistent extension of the overall liberalization in this area.

The provision establishing review authority of the Tax Court does not apply unless the exchange (regarding which a ruling is required) has begun. In such circumstance the taxpayer is forced to enter into a potentially taxable transaction and hope to be victorious in the Tax Court. The taxpayer's risk is great. This relief provision should not be limited to transactions already in process but should relate also to prospective exchanges.

SECTION 1053—CHINA TRADE ACT CORPORATIONS

Present law

At present a corporation qualifying as a China Trade Act Corporation may, upon meeting certain requirements, be allowed a special deduction which can completely eliminate its income subject to tax.

Proposed change

The special China Trade Act Corporation provisions would be repealed by the bill.

AICPA comments

The amendments as written are in line with our understanding of them, as outlined in the Ways and Means Committee's summary, and we find the provisions to be technically correct as drafted, with one exception. Section 1053(d)(2) of the bill should be revised to read: "Section 1504(b) is amended by striking out paragraph (5) *and redesignating paragraphs (6) and (7) as paragraphs (5) and (6).*"

The *underlined* words appear to have been inadvertently omitted.

TITLE XI

AMENDMENTS AFFECTING DISC

SECTION 1101

Present law

At present the profits generated by a DISC are taxed, not to the DISC, but to its shareholders when distributed. Each DISC is deemed, however, to have distributed an amount equal to 50 percent of its profits.

Proposed change

Under the bill, the tax deferral benefits of a DISC are to be computed on an incremental basis. In connection with this, a new category of deemed distributions from a DISC to its shareholders is added. In addition, the bill would amend the definition of qualifying "export property" by restricting the exclusion from qualification of natural-resources property to only those which are eligible for *percentage* depletion. This change modifies the provision contained in the 1975 Tax Reduction Act. The Ways and Means Committee reports indicate that the original provision may have had the unintended result of excluding from qualifying property that property the supply of which is neither inexhaustible nor renewable. The proposed restriction, aimed primarily at oil and gas, is accomplished by a change of the reference to depletion from section 611 of the code (which includes cost depletion) to sections 613 and 613A which cover percentage depletion.

The 1975 Tax Reduction Act also excluded from qualification property the export of which is prohibited or curtailed under the Export Administration Act of 1969 (50 U.S.C. 2403(b)). However, the Tax Reduction Act in its final form omitted a provision which was in the House bill (H.R. 17488) covering the exclusion of agricultural and horticultural commodities and products.

In this bill Congress intends to exclude agriculture and horticultural property if in "short supply." Under its provisions a product is "not in short supply" when marketing quotas are in effect either for the year of sale or have been in effect for 2 of the 5 years preceding the year of sale (proposed code section 993(c)(2)(D)(ii)), or, if the Secretary of the Treasury determines a commodity or product to be in excess of normal supply for that taxable year.

AICPA comments

If the purpose of this provision is (as is believed to be the case) to prevent agricultural, et cetera property in short supply from qualifying, this amendment is not necessary. Present law (code section 993(c)(3)) grants the President authority to exclude from the category of qualifying property export property which he determines is not in sufficient supply to meet domestic requirements. According, since DISC treatment of certain products can be terminated at any time, it appears appropriate to keep the definition of export property flexible to provide for circumstances when property is no longer scarce. Moreover, the provision in this bill (proposed code section 993(c)(2)(D)(ii)) may create a conflict with existing code section 993(c)(3) in a case where, for example, a commodity has had marketing quotas in 2 out of the 5 preceding years, thus qualifying for DISC treatment, but which is in short supply and the President so designates it under code section 993(c)(3).

The bill also terminates DISC benefits for military goods. Some doubt may be raised here about the enforceability of the exception provision for "military" goods to be used solely for "nonmilitary" purposes.

Tax benefits for DISC's are to be reduced for taxable years after 1975 by allowing DISC benefits only to the extent that the DISC's gross export receipts for the taxable year exceed 75 percent of the export receipts of the base period ("adjusted base period gross receipts"). Technically, the reduction of benefits is accomplished by adding a new category of deemed distribution from a DISC to its shareholders. These amounts are deemed distributed to the shareholder of the DISC first, that is, prior to the computation of the deemed distribution of one-half of DISC taxable income provided under present law.

The bill provides that the Secretary should, by regulations, issue rules for annualization in the case of short taxable years. The committee report indicates that short taxable years in the base period should "generally" be annualized. It is believed that annualization of a short taxable year in the base period would penalize a DISC which was in existence for a part year, and would be inconsistent with the treatment of a DISC not in existence for a year (or years) in the base period.

The new rules contain an exception for "small DISC's" (those having taxable income of $100,000 or less for the taxable year). The exception is phased out on a 2-for-1 basis in the case of taxable income over $100,000, so that a DISC having $150,000 taxable income has no deferral, unless it has an increase in export receipts over its adjusted base period gross receipts.

Analyzing these rules, the apparent effect is that small DISC's having less than $100,000 taxable income are not encouraged to increase export sales, but merely to retain taxable income below the $100,000 level, and DISC's with taxable income of between $100,000 and $150,000 have no incentive to increase export sales beyond a certain point. For example, a DISC having $120,000 taxable income is entitled to the same deferral benefit whether it earned the $120,000 after a 100 percent or 200 percent or even a 300-percent increase in export sales, i.e., it is not encouraged to increase export sales beyond the 100-percent increase in this example.

A substantially less complex formula, one which is more in harmony with the new DISC rules, could be provided by defining small DISC's to include those DISC's which during their base period had adjusted taxable income of $100,000 or less. The new rules, in harmony with the other proposed provisions of the bill relating to the determination of base-period years, should not apply to such small DISC until taxable income for a new base period first exceeds $100,000

In addition to simplicity, this method would clearly provide an incentive for small DISC's to increase exports in the future, but particularly during the next 5 years, during which the base period, and their status as a small DISC, remains unchanged.

TITLE XII

Administrative Provisions

SECTION 1201—INCOME TAX RETURN PREPARERS

Present law

Presently there is no regulatory provision relating to tax return preparers in the code.

Proposed change

Numerous specific provisions would be enacted to permit the IRS to more effectively regulate tax return preparers. These are explained below, along with our specific comment on each provision.

AICPA comments

The basic provisions of H.R. 10612 with regard to income tax return preparers, and our comments thereon, are as follows:

1. Each prepared return, statement or other document must contain the identification number of the return preparer and other data sufficient to identify the preparer.

Comment.—We agree that identification of return preparers is vital to the IRS's efficient oversight of this area.

2. Each preparement must furnish to taxpayers a copy of the return or claim for refund prepared by the tax return preparer at the time the return is presented for the taxpayer's signature.

Comment.—We agree with requiring returning preparers to furnish copies of the returns to the taxpayers.

3. Each return preparer or every person employing a tax return preparer must file an annual report listing the name, address, identification number, and place of work of each preparer they employ. This report is to be filed by July 31 for a 12-month period ending June 30.

Comment.—We agree with this proposal as an effective and uncomplicated way to regulate the performance of commercial tax return preparers. Utilizing its computer capability, the IRS could process the information returns to identify all returns prepared by a particular tax return preparer. This would enable the IRS to determine whether the returns were done in a competent manner and whether any "pattern of abuse" exists. In addition, this filing requirement would have the psychological effect of impressing on tax return preparers that a workable enforcement procedure is in effect and that improper practices could easily be detected.

4. Each return preparer or employer of return preparers must retain for three years either a list of taxpayers for whom returns were prepared or copies of their returns and claims for refund.

Comment.—Tax return preparers should be required to make copies of all returns they prepare and retain them for at least 3 years. We suggest, however, that safeguards be imposed to prevent the IRS from conducting "fishing expeditions."

5. Penalties are provided for negligence or fraud on the part of the tax return preparer. A $100 penalty is provided for negligent or intentional disregard of Internal Revenue Service rules or regulations by a tax return preparer. A $500 penalty is provided for a willful attempt to evade, defeat or understate any tax by a tax return preparer.

Comment.—Negligence penalties should be imposed on persons who prepare returns for compensation. The burden of proof, however, should be on the Service as distinguished from the burden on the taxpayer in negligence cases. Unless the burden of proof is on the Service, preparers could be placed in a very tenuous position because of the many uncertainties that exist in our tax system.

6. In order to prohibit a tax return preparer from continuing to prepare returns when it is determined that he has engaged in improper conduct with respect to the preparation of tax returns, an injunctive proceeding could be brought against such a preparer.

Comment.—The Service should have authorization to obtain judicial injunctions to prevent future preparation of tax returns for compensation in cases of consistent or willful preparation of false or deficient returns.

7. The Internal Revenue Service would be authorized to provide the names, addresses, and taxpayer identifying numbers of preparers to State authorities charged with enforcing State provisions regulating tax return preparers.

Comment.—This provision relates to the broader issue of making tax return information available to various State agencies. This subject is also encompassed in the recommendations made by the Administrative Conference of the United States which were released in December 1975. Since the matter is currently under consideration by the Privacy Protection Study Commission, we suggest that it may be appropriate to defer legislation on this point until the Commission concludes its study.

SECTION 1202—DECLARATORY JUDGMENTS FOR 501(C)(3) ORGANIZATIONS

Present law

Because of the present usual long delay in obtaining a court test of any adverse determination by the IRS, an exempt organization may suffer substantially from the lack of contributions during the time its exempt status is pending.

Proposed change

The bill provides a procedure whereby an exempt organization may ask the Tax Court or a district court for a declaratory judgment as to its status and classification under section 501(c)(3) of the Internal Revenue Code. Under this procedure, if the IRS makes an adverse determination with regard to the initial qualification or the continuing qualification of the organization as a "public charity," or as a private foundation, the organization may petition the court for a declaratory judgment.

AICPA comments

This section appears to be appropriate and in line with recent legislation on pension plans and their exempt trusts. However, the provision which delays implementation for 1 year after date of enactment, would not seem necessary. These provisions should be made available at the earliest possible date.

SECTION 1203—ASSESSMENTS IN CASE OF MATHEMATICAL OR CLERICAL ERRORS

Present law

Presently, where the IRS finds a mathematical error appearing on a tax return the normal requirements of a notice of deficiency prior to an assessment are waived. Questions have been raised, however, as to whether the Service has overextended its use of this mathematical error summary assessment power.

Proposed change

The bill sets forth a precise definition of "mathematical error" and in addition provides greater protection for taxpayers who wish to contest IRS summary assessments in mathematical error cases.

AICPA comments

We are in favor of the change because of the fact that it gives taxpayers rights where previously the Service could proceed summarily.

SECTION 1207—WITHHOLDING TAX ON CERTAIN GAMBLING WINNINGS

Present law

Certain wagering income is subject to reporting by the gambling facility on form 1099, and several problems have arisen in this area.

Proposed change

The bill would replace the present information reporting rules covering race track, keno, and bingo winnings by requiring withholding of 20 percent of the winnings at the time of payment. In the case of wagering transactions, this would apply to winners if the payout is more than $1,000 and is based on betting odds of 300 to 1 or higher. This withholding would also apply to winnings of more than $1,000 from wagering pools and lotteries.

AICPA comments

This proposed amendment to code section 3402 would try to make tax collectors out of certain gambling facilities. We have no objection to this, but we do have reservations as to their ability and willingness to perform. This may be a statute which is not or cannot be complied with, or enforced without a tremendous expenditure of effort and dollars.

SECTION 1212—PUBLIC INSPECTION OF WRITTEN DETERMINATIONS BY INTERNAL REVENUE SERVICE

Present law

Private ruling letters are issued by the National Office of the Internal Revenue Service in response to formal written requests submitted by taxpayers, and generally relate to transactions which are still in proposed form and yet to be consummated. The private ruling letter briefly summarizes a specific set of facts describing a proposed transaction, and sets forth ruling paragraphs detailing the tax consequences which flow from the transaction.

Technical advice memorandums are issued by the National Office upon request by district directors in connection with the examination of taxpayers returns or claims for credit or refund. As in the case of private ruling letters, technical advice memorandums interpret and apply the tax laws to specific sets of facts, but always involve completed transactions with respect to which tax returns have already been filed by specific taxpayers.

Both private ruling letters and technical advice memorandums could be considered part of a taxpayer's tax return information which should be exempt from disclosure, but both have been the subject of recent litigation involving requests to compel Internal Revenue Service disclosure of these documents under the Freedom of Information Act.

Proposed change

Under this section of the bill, private rulings and technical advice memorandums would generally be made available for public inspection.

AICPA comments

We believe that legislation is necessary to insure that the mandates of the Freedom of Information Act are invoked without infringing upon the fundamental rights of taxpayers to have remain confidential their tax return information submitted to the Internal Revenue Service.

While we support the general concepts of section 1212, we believe the legislation would be improved if it incorporated the recommendations included in a memorandum of understanding of March 4, 1976, arrived at by representatives of the Internal Revenue Service, the ABA Tax Section, the AICPA, the Public Citizen Litigation Group, and Tax Analysts and Advocates on this proposal for public inspection of rulings and related documents.

TITLE XIII

Technical Income Tax Provisions

SECTION 1301—TAX TREATMENT OF CERTAIN COOPERATIVE HOUSING ASSOCIATIONS

Present law

The litigation on the subject of tax-exempt status for homeowner associations and condominium housing associations has produced a rule which makes it extremely difficult for such organizations to qualify as tax-exempt. This is in spite of the fact that they are not profit-oriented but instead are organized solely for the exclusive benefit of the homeowners.

Proposed change

The bill provides that in the case of cooperative housing corporations, condominium management associations, and residential real estate management associations, only the nonexempt function income is to be taxable. Exempt function income is defined to include membership dues, and fees and assessments from the tenant-shareholders or the owners of the housing units.

AICPA comments

The AICPA is in general agreement with providing a tax exemption for cooperative housing corporations, condominium management associations and residential real estate management associations. We are also in agreement with the proposal for taxing "the unrelated business income" of such organizations.

The definition of income for the purposes of measuring the tax in proposed code section 528(d) and for defining a "cooperative housing association" in subdivision (c) of proposed section 528 should be clarified, however, so as to exclude special capital improvement assessments of the type covered by Revenue Ruling 74–563 (1974–2 C.B. 38). This ruling provides that special capital improvement assessments represent contributions to the capital of the corporation.

SECTION 1305—CLARIFICATION OF DEFINITION OF PRODUCED FILM RENTS

Present law

Under present law the IRS has taken the position that an interest in a film, for purposes of the definition of produced film rents in the personal holding company provisions of the code, must be a depreciable interest. If a production company has only a profit participation after a picture is completed and released, but legally does not have an ownership interest sufficient to claim depreciation, some revenue agents have treated all of the company's income as personal service contract income under section 543(a)(7) of present law.

Proposed change

In order to avoid ambiguities, the bill amends present law regarding personal holding company income to set forth more clearly the nature of the qualifying "interest" in a film. In the case of a producer who actively participates in producing a film, the term "produced film rents" will include an interest in the proceeds or profits from the film, but only to the extent that this interest is attributable to active participation in production activities.

AICPA comments

The change to broaden the definition of produced film rents for personal holding company tax purposes is a change desired by the industry. It is a clarification of existing law which removes an implication that a producer must have a depreciable interest in a film to qualify for section 543(a)(5).

TITLE XIV

Treatment of Certain Capital Losses; Holding Period for Capital Gains and Losses

SECTION 1401—INCREASE IN THE AMOUNT OF ORDINARY INCOME AGAINST WHICH CAPITAL LOSSES MAY BE OFFSET

Present law

Currently an individual may offset a maximum of $1,000 of ordinary income with his capital losses.

Proposed change

The bill would increase the amount of ordinary income against which net capital losses can be offset from $1,000 to $4,000. This increase would be phased in over a 3-year period.

AICPA comments

We favor the increase of the present $1,000 to $4,000 and would favor a further increase to $5,000.

SECTION 1402—INDIVIDUAL CARRYBACK OF CAPITAL LOSSES

Present law

Individuals presently may only carry forward unused capital losses. Corporations, on the other hand, carry back a capital loss 3 years and then forward if not used up.

Proposed change

The bill would give individuals with losses in excess of $30,000 the option of treating their net losses as corporations currently do. Thus, such individuals could elect a three-year carryback of capital losses against capital gains (but without a deduction for losses against ordinary income) and a carryforward of unused capital losses. Individuals who use the carryback option would have to recompute their tax for the prior years to which the losses are carried back.

AICPA comments

We favor allowing a 3-year capital loss carryback to individuals, although we would prefer that the $30,000 of loss required before any excess can be carried back be either reduced or made a condition precedent to a carryback but not a limitation on the amount that can be carried back.

SECTION 1403—INCREASE IN HOLDING PERIOD

Present law

Currently the cutoff which determines whether a gain or loss on the sale of a capital asset is short term or long term is 6 months.

Proposed change

The bill would change the holding period cutoff to 1 year instead of the present 6 months. The change would be phased in over a 3-year period so that the holding period would be 8 months in the first year, 10 months in the second year, and 1 year thereafter.

AICPA comments

We agree with this suggestion, but only if it is tied in with an increase in the present 50 percent long-term capital gain deduction. Such an increase was proposed by the Ways and Means Committee in its draft tax reform package of 1974.

TITLE XV

INDIVIDUAL RETIREMENT ACCOUNT AMENDMENTS

SECTION 1502—LIMITED EMPLOYEE RETIREMENT ACCOUNTS

Present law

At present, if an employee is an active participant in a qualified pension plan, he is not allowed to make deductible contributions to an IRA or to the plan. Even though the benefits provided by such a plan may be less than the employee could provide for himself under an IRA, the employee is not allowed to make up the difference through deductible IRA contributions or by making deductible contributions to the plan.

Proposed change

In order to permit employees in this situation to provide for their own retirement out of before-tax funds, the bill makes two major changes in this area: (1) an active participant in a nongovernmental plan or annuity contract will be permitted to make contributions to an IRA for himself, and (2) an active participant in a nongovernmental qualified plan which was in existence on the day ERISA was enacted is to be permitted to deduct employee contributions to that plan. The IRA limits on deductions continue to apply, but they are to be reduced by the amount of employer contributions allocable to the employee.

AICPA comments

The use of LERA's, IRA's, and other voluntary employee contribution vehicles will add additional burdens of increasing complexity to the administration of participants' accounts. The same desired result, a single $1,500 deductible contribution, could be more simply obtained by permitting employees to elect not to be covered by their employers' plan, provided that code section 410(b), relating to broad coverage requirements, were amended to permit employees covered by IRA's to be classified as those who have engaged in good faith collective bargaining as provided in code section 410(b)(2)(A).

We fail to see why participants in pre-ERISA plans are permitted to contribute to LERA's, but participants in post-ERISA plans must establish IRA's in order to secure a deduction for voluntary contributions. This discriminates against the post-ERISA participant since his plan cannot take advantage of existing portfolio management. It is suggested in the committee report that the need for creation of LERA's is most acute for plans established before enactment of ERISA, since those plans were designed without taking IRA's into account. Nevertheless, this need would still exist for post-ERISA plans having the same low contribution and benefit structure. Thus, it is our opinion that there is no real economic or other substantive reason for such dichotomy of pre- and post-ERISA plans.

TITLE XVI

Real Estate Investment Trusts

SECTION 1601—DEFICIENCY DIVIDEND PROCEDURE FOR REIT'S

Present law

Under present law if, upon audit, a REIT fails to meet the income distribution requirements it will lose its qualification as a REIT.

Proposed change

The bill establishes a deficiency dividend procedure which would allow a REIT that fails to meet the income distribution requirements upon an audit by the IRS to make a late distribution to its shareholders to avoid disqualification. This procedure would only be available if the REIT initially missed the 90-percent distribution requirement for reasonable cause. The REIT would be subject to interest and penalties on the amount of the adjustment.

AICPA comments

We agree in general with this concept, but suggest clarification be made of the "reasonable cause" requirement.

SECTION 1602—TRUST DISQUALIFICATION WHEN INCOME TESTS NOT MET

Present law

Under present law a REIT will lose its qualification as such if it fails to meet all of the income tests.

Proposed change

A REIT that fails to meet the income source test upon audit by the IRS would not be disqualified but would be allowed to pay tax on the amount by which it failed to meet the source tests. This provision would be available only if the REIT initially had reasonable ground to believe and did believe that it met the income source tests.

AICPA comments

We agree in general with this concept.

SECTION 1604—OTHER CHANGES IN LIMITATIONS AND REQUIREMENTS

Present law

Under present law REIT's are restricted in the types of income which they may receive and still remain qualified as a REIT. A leeway is provided that up to 10 percent of REIT income may be of the nonqualified type. Also, under present law, a REIT must be operated either as a trust or association, but not as a corporation.

Proposed change

Certain types of income which customarily are earned in a real estate business which do not presently qualify under the income source test for REIT are to be treated as qualifying income. These include (*a*) certain rents from personal property leased together with real property; (*b*) charges for services customarily furnished in connection with the rental of real property whether or not such charges are separately stated; and (*c*) commitment fees received for entering into agreements to make loans secured by real property. Since in view of these and other changes a significant portion of income is to be removed from the category of nonqualified income, the income source requirements are increased so that nonqualified income could be only 5 percent of gross income (rather than the present 10 percent). Also a corporate tax will be imposed on nonqualified income at the REIT level.

A REIT would be permitted to operate in corporate form. (Under present law a REIT must operate as a trust or association.)

AICPA comments

We agree in general with these concepts.

SECTION 1605—EXCISE TAX ON CERTAIN UNDISTRIBUTED REIT INCOME

Present law

None.

Proposed change

In view of the proposed deficiency dividend procedure, the bill would encourage prompt dividend distributions by modifying the present rule dealing with dividends paid by a REIT after the close of the taxable year to require a 3-percent charge on the amount by which a REIT actually distributes less than 75 percent of its income in the year received. Also, a new REIT would be required to be on a calendar year.

AICPA comments

We agree in general with this concept.

TITLE XVIII

Tax Credit for Home Garden Tool Expenses

SECTION 1801—TAX CREDIT FOR HOME GARDEN TOOL EXPENSES

Present law

None.

Proposed change

Under the proposal, taxpayers would be entitled to take a 7 percent credit for the cost (limited to $100) of tools and equipment primarily for use in a home garden.

AICPA comments

We question the commonsense of this section of the bill in terms of the administrative feasibility and costs of such a provision.

TITLE XIX

Repeal and Revision of Obsolete, Rarely Used, Provisions

GENERAL COMMENT

We are in favor of the congressional objective of repealing obsolete or seldom-used sections of the Internal Revenue Code and of simplifying words throughout the tax law. We, therefore, are in agreement with the proposed changes made by this title.

Independent Business Association of Wisconsin,
Milwaukee, Wis., April 21, 1976.

Senator Russell Long,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

Dear Senator Long: On behalf of the members of the Independent Business Association of Wisconsin, and the 78,000 small- and medium-sized businesses in the State of Wisconsin, we reaffirm our support for H.R. 10612 and urge Senate consideration of this important tax reform legislation.

We firmly believe that meaningful tax reform is vital to the growth and stability of all small, growing independent enterprises in our Nation. Our members have been actively seeking corporate-tax legislation that would allow greater retention of earnings.

The only avenue to growth for a small independent business is through retained earnings. Unlike large publicly owned businesses, these companies are unable to raise capital through public offerings of their stock. Nor are they able to borrow at the interest rate available to the large corporations.

Our organization will be presenting further information demonstrating the need for tax reform for small business during "The Washington Presentation," on May 11, 1976. We would be pleased to have you attend our luncheon presentation.

Sincerely,

Bruno J. Mauer, *President.*

Statement of the American Council for Capital Formation

Mr. Chairman and members of the committee, the American Council for Capital Formation is grateful for the opportunity to present its views to this committee. The goals of the council are supported by some 1,600 individuals and businesses that believe a higher rate of capital formation is essential to the future well-being of this Nation.

Introduction

This testimony consists of three parts: a brief review of the available evidence which indicates that the United States will be facing a severe capital shortage unless we eliminate the bias in our tax laws against capital formation, a summary of recommendations for reducing the bias in our tax laws against capital formation, and finally, a discussion of the negative effects on capital formation of the existing additive minimum tax and of the minimum tax proposal in H.R. 10612.

The Problem of Inadequate Capital Formation

Serious studies of our long-term capital outlook, by the Brookings Institution, Data Resources, Inc., the U.S. Department of Commerce, and others, all agree that the demand for capital in the years ahead will be increasing at a much greater rate than we have experienced in the recent past. By the best estimates available, the United States will need the incredible sum of $4.5 trillion in new capital funds in the next 10 years—three times the $1.5 trillion of the past decade. The Department of Commerce has concluded that private fixed investment must increase from the 10.4 percent of GNP that characterized the 1965–74 period to 12 percent of GNP between now and 1980, if we are to have a capital stock sufficient to promote full employment, control pollution, and maximize development of our domestic energy resources.

It has been recognized by economists, at least since the days of Adam Smith, that in order for a society to grow and prosper it must accumulate capital and channel it into productive investment. In other words, a society must consume somewhat less than it produces and use those savings to create capital goods which in turn increase productivity. The main source of our Nation's prosperity has been our willingness and ability to save and produce productive capital.

Since 1960, however, the United States has had the lowest level of capital investment among the major industrialized countries. Significantly, among these nations, only the United Kingdom has shown a productivity growth rate slower than that of the United States. Japan's rate of investment and productivity growth rate have been triple our own; the rates in Germany, France, and Canada are all substantially higher than ours.

All of these nations give more favorable tax treatment to capital investment than do we. Productive investment is the major factor promoting increases in productivity. If through continued underinvestment, we lose the ability to compete effectively with other industrialized nations, we will suffer a further loss of markets and jobs to competitor countries, and a decline of our world political, economic, and military positions.

The U.S. Treasury estimates that to reach full employment we will need to create almost 20 million new jobs by 1985—7 million more than we created during the past decade. Dr. Henry Wallich, of the Federal Reserve Board, and others have concluded that as a result of inadequate past investment, the United States is already experiencing an overall shortage of capital with respect to jobs. Under this condition, which we have experienced in the recent past, there are not enough jobs to provide full employment even when industry is operating close to capacity. Capital capacity falls short of labor force capacity. Obviously, therefore, labor has fully as much interest as business in remedying this serious condition.

Increasing investment is the fundamental factor in creating jobs. Yet, unfortunately, our capital-to-labor ratio for new workers is declining, while most of the European countries and Japan have been rapidly increasing their capital investment per worker ratio. Prof. Paul W. McCracken, former Chairman of the Council of Economic Advisers, has concluded that the amount of nonresidential capital formation per person added to the labor force in the United States during the 1970's has declined by 22 percent from the levels reported in the 1956 to 1966 decade.

During the period from 1947 to 1967, the shares of U.S. income going to labor in the form of wages and salaries and to capital in the form of before-tax profits, interest, and rents remained basically constant, with approximately 70 percent to labor and 30 percent to capital. Since 1967, however, there has been a significant decline in the capital share, with labor getting a much larger share, and in the pretax rate of return to business capital. The estimated pretax rate of return on invested capital of nonfinancial corporations has declined from about 14 percent in 1967 to about 8 percent in 1974.

The process of business adjusting to lower returns to capital results in a decline in capital formation until the stock of capital shrinks relative to labor. As capital becomes less abundant relative to labor, its rate of return rises. But as a result, we end up with less capital relative to labor, which in tourn diminishes the productivity of labor. Diminished labor productivity, in turn, causes a lower wage rate in real terms, which results in a decline in real economic growth, thus reducing new job formation.

In other words, without increased capital formation, increased productivity will be stifled, real economic growth will diminish, and fewer jobs will be created.

During 1973 and the early part of 1974, the U.S. economy suffered major shortages in many basic industries including chemicals, steel, paper, and fertilizer. These shortages served to exacerbate inflationary pressures and hinder growth in the economy. This lack of sufficient industrial capacity was a result of inadequate prior investment which caused a capital shortage in the affected industries.

The Council of Economic Advisers has noted several inhibiting factors which may cause business to fail to provide adequate new investment to avoid future shortages. For example, actual rates of return on business investments have lagged, in recent years, as a result of such things as increased costs resulting from environmental and safety regulations. These factors force businessmen to increase their "investment risk" premiums, in turn reducing the number of acceptable investments.

Also, the Council refers to the fact that general price inflation has raised corporate taxes by a greater proportion than the before-tax return on fixed capital. This has occurred because inflation-induced inventory profits have boosted the tax base. In addition, inflation has caused the real value of historical cost depreciation allowances to decline.

In addition, the Council points out that the increase in corporate debt-equity ratios has partially resulted from the tax treatment of interest as deductible expense. This has made debt financing particularly attractive during inflationary periods, thus increasing business financing risks in turn increasing the cutoff rate of return on many new projects.

Finally, the Council argues that fiscal policies have been biased against private investment by emphasizing the stimulation of consumption through Federal tax and expenditure policies rather than investment. When these policies have led to inflation, monetary restraint has been imposed which has led to incomplete capital formation through the business cycle.

Quite clearly, therefore, the bias in our tax laws against capital formation must be eliminated to insure sufficient productive capacity to create full employment and reduce inflation-producing shortages.

Recommendations

1. *Elimination of double taxation of corporate dividends.*—Currently, corporate profits are taxed at the corporate level, and then taxed again when they are distributed to shareholders.

We must begin to eliminate the two-tier tax on corporate profits and tax business income only once; major European nations and Japan are moving in this direction. Integration of corporate and personal taxes would do much to eliminate the bias toward debt financing and against equity financing. The corporate tax is ultimately paid by consumers in higher prices and/or by stockholders. In the final analysis, corporations do not pay taxes, they are merely a form of doing business—people pay taxes.

2. *Permanently extend the investment tax credit (ITC) at a 12-percent level, remove restrictions relative to earnings, and make it fully "refundable."*—That is, grant it as a cash rebate to businesses which earn nothing or too little to realize the full benefits of the credit.

There is wide agreement that the credit has been a valuable device for reducing the cost and increasing the supply of capital and, in so doing, providing jobs and material supplies which reduce inflationary pressures. The President's Advisory Council on Labor-Management Relations unanimously endorsed a 12-percent ITC in early 1975.

3. *Provide for fairer and more realistic depreciation allowances.*—Depreciation allowances under the tax code do not reflect the true cost of capital replacement. The United States has the most restrictive depreciation allowance provisions of almost any major industrial country. A more realistic approach would be to permit business to "catch up" by depreciating assets at a rate which reflects the impact of inflation rather than original cost.

4. *More equitable capital gains tax rates.*—Taxes on capital gains in the United States are among the highest in the world. This bias against capital formation could be reduced by taxing a smaller portion of the gain the longer the asset is held, partly to offset the impact of inflation. Such an approach would help free up locked in capital, encourage new investment, and treat long-term investors and small businessmen more equitably. Capital should not be included as a "preference item" under any minimum tax.

5. *Provide tax incentives for stock ownership.*—A plan allowing taxpayers to defer tax payments or providing for tax credits for income invested in common stocks up to some limit would have a number of desirable benefits. Such a plan would encourage additional savings and investment in productive equity markets, thus stimulating business expansion, which in turn will provide new jobs and greater material well-being. The program would have the desirable socially stabilizing benefits of expanding ownership of American enterprise to many more citizens and providing additional motivation and reward for individual nest egg savings.

6. *Provide tax deferment for dividend reinvestment.*—Deferral of personal taxes on corporate dividends immediately reinvested in the same business would probably cost little in terms of revenue in the short run—and practically none in the long run—but at the same time provide a significant incentive to increasing the equity funds that a debt-heavy corporate structure so badly needs. Even though now taxable, the dividend reinvestment plans now offered by a number of companies attract a relatively large amount of funds. Tax deferment should increase that amount significantly.

These recommendations are not intended to be exhaustive nor can they be achieved overnight. They are, however, goals that we should move toward in an effort to shift our tax system from its current bias for consumption toward emphasis on new capital formation to help insure our long-term economic well-being.

The problems of the "minimum tax"

Conceptually, the minimum tax is a paradox. The present minimum tax came into being as part of the Tax Reform Act of 1969. It imposes a special 10-percent tax on so-called preference income, which is defined as the value of certain income tax deductions, including accelerated depreciation, charitable contributions, depletion allowances, certain interest deductions, and capital gains.

These preference income provisions were intentionally placed in the tax code because it was felt to be socially and/or economically desirable to encourage certain types of behavior on the part of individuals and businesses. But the result of the existing minimum tax is to penalize individuals and businesses for successfully operating in a manner which the tax code recognized as being socially and/or economically desirable.

The justification for some type of minimum tax is that everyone ought to pay some Federal taxes regardless of how beneficial his spending and investment practices might be. In reality, the present minimum tax is an additional tax that unduly penalizes the use of incentives (or preferences). Moreover, the proposed minimum tax amendment, as contained in the House-passed H.R. 10612, would make the situation even worse by eliminating the existing deduction for "other taxes paid." Such a tax, in actuality, is simply an added tax on already taxed income.

The imposition of the existing minimum tax on a corporation is especially undesirable. To the extent that such a tax reduces corporate profits, it makes it more difficult for business to provide jobs at reasonable rates of pay. The corporate minimum tax also reduces the rate of return to stockholders, thus discouraging additional equity investment. Furthermore, the additional tax increases the pressure on the corporation to raise prices in order to cover its costs.

Another highly questionable impact of the additive minimum tax results from the inclusion of capital gains as a preference item. As previously noted, U.S. capital gains taxes are already higher than those of virtually all other industrialized nations. The existing capital gains tax tends to lock in investment and discourage capital formation, yet the minimum tax proposed in H.R. 10612 would increase this already excessive tax even further. When one realizes that a substantial part of most capital gains results from inflation, and in no sense represents an increase in real wealth, the capital-destroying aspect of such a tax is readily apparent. Given the crisis in capital formation and the resulting well-established justification for reduced taxes on capital gains—to promote savings and investment over consumption, to encourage necessary risk taking, to reflect higher replacement costs resulting from inflation, and to prevent the lock in of investment capital in nonproductive enterprises—sound and prudent economic policy supports the removal of capital gains from the additive minimum tax.

If a minimum tax is believed to be necessary, a fairer, more effective, and less complicated means of achieving such a goal can be accomplished by using a "minimum taxable income" approach. In essence, the MTI would be an "alternative tax," whereby the beneficiary of certain deductions, preferential rates and/or exemptions would calculate tax liability in two ways, and pay the higher of the two. Again, however, the "untaxed" portion of capital gains should not be included even in the "MTI" approach.

Such an alternative tax method would result in a true minimum tax on economic income and would treat all income alike for purposes of the additional tax assessment. It would not, however, impose unfair additional taxes on income which has already been taxed at high rates, nor would it be heavily biased against capital formation, as is the additive minimum tax proposed in H.R. 10612.

Finally, the alternative MTI approach could be substituted for the need for complex "limitations on artificial losses" provisions. The proposed LAL provisions are believed by many tax professionals to be unworkably complex and in all likelihood will have an adverse impact on many economic activities which by no means can be characterized as "tax shelters." The basic purpose of LAL can be more effectively, more equitably, and more simply handled by enacting MTI.

In conclusion, it is realized that some have argued that MTI would not bring in as much revenue as the existing additive minimum tax provisions. This is debatable. In any event, the issue of an additive versus an alternative tax ought not to be decided on the basis of a relatively small amount of money (in terms of total Federal Government receipts), but rather on the basis of whatever is workable and consistent with national needs for a higher rate of savings and capital investment.

STATEMENT OF THE ELECTRONIC INDUSTRIES ASSOCIATION

The Electronic Industries Association is the national association representing the $35 billion electronics industry. Our members comprise manufacturers of a broad range of products from the smallest component to large systems for defense and space. Our industry represents a leading edge of technology and innovation and, as such, has a vital interest in the continued expansion of the American production capability.

The announcement of these hearings contained a request for statements on three subjects—growing capital needs, creation of new jobs, and noninflationary economic growth. The comments we are submitting are based on the premise that these three items are inextricably joined in terms of a basic need to assure adequate growth capital for the expansion of industry's capacity in the United States.

There is sometimes a temptation when viewing tax reform and its effects on industry to think solely in terms of the impacts on corporate profits, or those benefits to industry which may be derived through the tax system. It must be made clear, however, that a discussion of a tax structure which will provide adequate expansion capital is one of defining a most basic and necessary process through which productive assets can be introduced into the very foundation of our economy. Capital, quite simply, creates the necessary room and opportunity to expand our industrial base. In the $35 billion electronics industry, this base is estimated to almost double in size in the next several years. Without a sound tax policy which encourages proper amounts of capital infusion, the electronics industry, and other industries, will simply not be able to meet the demands of the market in the near future.

Having stated this basic rationale for capital—namely, the base upon which expansion can be predicated—it is important to not lose sight of some very important secondary effects which derive from assuring sufficient capital. These include replacement and modernization of existing capital assets, providing the means to make the United States energy self-sufficient, and permitting development of full-scale measures to alleviate environmental concerns.

One important additional point must be stressed in establishing the overall importance of sufficient capital investment to industry. This is the creation of new jobs. To the degree that Federal tax policy is structured to assure adequate incentives to attract investment of equity capital for the expansion of our economy, one can easily find a direct correlation between that investment of capital and the number of new jobs which can be made available. In electronics, for instance, it is estimated that an initial capital investment of $25,000 is necessary to create each new job. The converse is, of course, true. A restriction of equity capital inevitably forces industry into a posture in which the creation of new jobs is diminished or even reversed. To the extent that tax policy can be structured to result in the creation of new jobs, there would be less inclination toward the more counterproductive measures of seeking public service jobs to eliminate unemployment.

Having stated the need for a policy which encourages the expansion of capital investment, it would be helpful to compare that need against current conditions. This will provide some index of the necessity for the Congress to act in the interests of the overall U.S. economy. The recent erosion of business profits has caused business to raise more and more of its needed expansion money from external sources. Profits, of course, are one of the prime sources of funds for capital expansion. Simultaneously, however, the inflationary forces at work have provided little incentive under the current tax laws for the investment of funds in capital equipment, machinery, or other depreciable assets. It is important here to distinguish between a tax policy which frees up equity capital for investment and the current situation we find ourselves in where the capital necessary for expansion is not coming from profits or from equity capital, but rather from debt-financed sources. Debt capital, while providing at best for limited expansion, does not result in the creation of new jobs. This is so since the capital is available only at much higher costs with no correlation on rates of return.

Given the compelling needs for capital expansion and present economic trends in the country, it seems obvious that the Congress must move swiftly and constructively to provide the proper incentives within the tax structure to attract new equity capital—and also to slow the inflationary forces.

We urge the Congress to act on a package of tax reform which would serve to restore a capital-conscious tax policy. This in turn will assure the creation of new jobs and provide the ways and means to fully address energy, environmental, and safety concerns insofar as the solutions require capital assets.

1. Congress should institute a program for the phaseout of double taxation of corporate earnings. The current policy of taxing both corporate earnings and distributed dividends creates a disincentive to investment by double taxation of the benefits which could be derived from investing capital for industrial expansion.

2. The current temporary increase in the investment tax credit to 10 percent should be made permanent. In fact, many have called for an additional increase to 12 percent based on current economic conditions. The investment tax credit alone is a viable inducement to the attraction of needed investment capital. However, we have been faced in recent years with an unusual degree of uncertainty regarding the status of the investment tax credit. This has worked against investor confidence. Therefore, not only is it important to make the credit permanent, but also for the Congress to do it in such a way that investors may rely with certainty on its permanence.

3. Congress should revise depreciation schedules in such a way so as to recognize "replacement costs" rather than perpetuating the present policy grounded in the use of original costs in asset depreciation rates. The current useful life provision is simply anachronistic given today's inflationary pressures. This has resulted in far too little internal capital formation.

4. There should be a phaseout of capital gains tax on depreciable investments.

As a final thought, we have recently heard much discussion putting forth a shortsighted view that one answer to expansion and current economic conditions is to expand consumption. We submit that one of the negative imbalances at work at this time is a strong shift of capital from expansion to consumption. To the extent that consumption is disproportionately utilizing large amounts of available moneys, we urge rejection of any such notion that increased consumption offers a solution to the problems we have discussed. Rather, Federal tax policy should be properly restructured so as to reverse this trend by enhancing the attractiveness of investment in industrial expansion by available sources of equity capital.

Statement of Patrick Healy, Secretary, National Milk Producers Federation

The National Milk Producers Federation, on behalf of its member dairy cooperative marketing associations across the Nation and their dairy-farmer members, appreciates the opportunity to discuss several tax issues of great significance to dairy farmers.

We will direct our comments today toward two specific issues: The tax status of cooperative marketing associations under the Internal Revenue Code; and the need for revision of our estate tax laws.

WHAT ARE COOPERATIVES?

Agricultural cooperatives are organizations of farmers who have banded together in an effort to improve their economic lot. They are a basic form of self-help in which farmers seek to solve their own problems, improve the quality and services of their produce, and try to obtain improved returns for the labor and investment required to produce the Nation's food and fiber.

They are entirely voluntary. No farmer needs to join a cooperative or to remain a member unless he wishes to do so. In practically every case, membership is open. Any farmer who wishes to avail himself of the services of the cooperative and to participate in it is welcome to do so.

Some dairy cooperative associations are bargaining associations through which farmers can bargain as a group for the sale of milk to processing and distributing plants. Without such associations, farmers have no bargaining power and are in the position of having to take whatever price the dairy companies may choose to pay for their milk. Cooperatives also check weights and butterfat tests of the milk sold by their members, thus eliminating the possibility of false or inaccurate tests and weights.

Other dairy cooperatives are manufacturing units. These are groups of farmers who, instead of selling their milk as a raw agricultural product, have organized cooperatively to manufacture it, on a cost basis, in their own plants, built with their own capital, in order to obtain a better return by selling it in the form of finished dairy products.

Cooperatives also purchase for their members, on a cost basis, supplies and equipment needed in the operation of their farm.

CONGRESSIONAL APPROVAL OF COOPERATIVES

There is a long history of congressional action to encourage farmers to improve their own positions through the organization and operation of cooperatives. The policy and intent of Congress in this respect has been well established by many enactments. These would include the Capper-Volstead Act of 1922, the Agricultural Marketing Act in 1929, numerous provisions relating to cooperatives which were enacted during the 1930's, and other legislation relating to cooperatives including a major rewriting and strengthening of the Farm Credit Act passed by Congress in 1971.

In 1929, Congress said, "It is the policy of Congress to promote the establishment of a farm marketing system of producer-owned and producer-controlled cooperative associations." Congressional support for cooperatives was reaffirmed in the enactment of the Agricultural Fair Practices Act in 1968 in the following statement:

> Because agricultural products are produced by numerous individual farmers, the marketing and bargaining position of individual farmers will be adversely affected unless they are free to join together voluntarily in cooperative organizations as authorized by law. Interference with this right is contrary to the public interest and adversely affects interstate commerce.

That cooperatives have justified the confidence placed in them by Congress is amply attested by the fact that this policy of encouragement has been consistently maintained for more than 50 years.

COOPERATIVES HELP FARMERS

Cooperatives have rendered valuable service to agriculture. Through them, farmers have provided services for themselves where needed services were not otherwise available.

They have kept processing and marketing margins in line by processing and marketing their own produce in their own plants when the margins charged by others were excessive. More importantly, cooperatives assure their members a continuing market for their production. In the case of a commodity such as milk, the importance of this cannot be overstated. In the same manner, when prices charged for feed, fertilizer, farm equipment, and other production needs have been excessive, farmers have set up their own purchasing operations.

Even in areas where there are no cooperative plants, the fact that farmers can set up their own plant if processing margins become excessive serves as a strong influence to keep these margins within reasonable bounds.

Farmers have not organized cooperatives for the fun of it. In most cases, they have been driven to do so either because the services they need are not available or because excessive profits were being taken at their expense or reliable markets are lacking. Unless there is a very real need for farmers to organize, the setting up of a new cooperative is quite likely to fail.

COOPERATIVES ARE IMPORTANT TO CONSUMERS

Although farmers' cooperatives have been reasonably successful in the field of agriculture, they have neither achieved nor sought unreasonably high prices. Controls against undue enhancement of prices are provided in section 2 of the Capper-Volstead Act. In actual practice, it has never been necessary to use this section. In addition, cooperative marketing associations are subject to the same constraints under our antitrust laws as are faced by ordinary business firms.

This country is so large, and its agricultural resources are so great, that cooperatives could not unduly enhance prices even if they desired to do so. However, cooperatives have not sought unduly high prices. They have taken the position that prices should be at levels which reflect a fair return to the farmer, taking into account his labor and the investment and risk involved.

Consumers have no right to enjoy food at prices which do not provide reasonable compensation to farmers, any more than they have a right to enjoy industrial products made with sweatshop labor. Hourly returns for the labor of dairy farm operators, as reported by the Department of Agriculture, have been far below $1 per hour in many of the past years. In 1968, the USDA reported hourly returns for dairy farmers in three test areas to be $1.07, $1.08, and $0.91 (Agriculture Information Bulletin No. 230, September 1968). Increased prices for milk in recent years have not substantially changed this picture.

Cooperatives perform a valuable service to consumers by keeping processing margins under reasonable control. Furthermore, cooperatives are an important and vital factor in the production of the abundant supplies of high quality food which this country enjoys.

TAXATION OF COOPERATIVES

Throughout the years, there has been considerable debate and controversy over the tax status of farmer cooperatives. Some, in an effort to discredit cooperatives or to cast them in an unfavorable light, have charged that cooperatives are businesses operating under a complete tax exemption. This is untrue and arises in part from a misunderstanding of the nature of the cooperative, its functions and its operations.

Businesses operated by individuals, partnerships, cooperatives, and small business corporations are taxed alike in that only one level of tax is imposed on earnings. This tax is paid by the individual, the partners, the members of the cooperative, or the stockholders.

It must be constantly borne in mind that the cooperative is the farmer. In its operations in the market, the cooperative functions in behalf of its farmer members. The policies it pursues are those laid down by the farmers who own and use the cooperative. The cooperative's operations are performed on a cost basis with all net benefits realized from the operation of the cooperative passed back to the individual farmer in proportion to his patronage.

The only tax benefits available to cooperatives which are not equally available to other business entities are the special benefits provided by Congress for agricultural cooperatives. These benefits are limited to a deduction for stock dividends and a deduction for incidental income allocated to patrons. Exemption from a double tax results from the method of operation and not from the law. Any business operated could contract in advance to perform a service for patrons at cost, less necessary expenses, as cooperatives do. If it did so, each of these types of business enterprises would be subject to only one level of tax just as cooperatives are.

Only a farmer cooperative can qualify for the tax exemption. The cooperative must do at least 50 percent of its business with its own farmer members. This applies to both marketing and purchasing cooperatives. Both members and nonmembers must be treated alike.

Any net savings or earnings must be distributed to all patrons on the basis of their patronage, without regard to whether they may or may not be members of the cooperative.

The earnings arising from the operation of a cooperative must be passed back to its patrons, and the patrons are taxed currently and at the full amount. This tax is charged currently without deferment. This is true whether the farmers elect to receive their savings in cash or allow them to be retained as capital funds of the cooperative.

It must be borne in mind that the cooperative is an extension of the farmer's activity. On the farm, he is a producer of food and fiber. When he joins with his fellow producers to organize and operate a cooperative marketing association, he is extending his farm activities into the market, but is doing so under carefully prescribed limits which detail the scope of the activities, the types of products handled, and the degree of non-member activity which the organization might have.

The present tax status of cooperatives has served to bring the earnings of cooperatives under Federal taxation, to the extent that they are a part of the individual farmer's income. It cannot be argued that this income escapes taxation. The system has worked well from the standpoint of equity and must be continued.

An aspect of the cooperative taxation issue that is often overlooked is the impact changes would have on the cooperative's ability to maintain its capital structure. The largest single source of capital represented in the plant and equipment of cooperatives is the retained member earnings. Under policies established by their boards of directors and membership, cooperatives rotate this equity on an established schedule.

This unique situation places the cooperative in a difficult situation. In essence, it means that the portion of its basic capital structure that arises from retained earnings must be constantly renewed. A removal of the present tax treatment of cooperatives would, for many, render this capital generation process impossible. By doing this, the farmer would effectively be denied the capability of using the cooperative as a marketing tool. This would be a severe blow to agriculture and to the consumer, as well, since it would mean the loss of one of the strongest competitive elements in agricultural markets today.

ESTATE TAXES

As others have pointed out, there has been no significant modification of estate tax laws since 1942, so the current review is timely. Agriculture in particular has changed dramatically during the intervening 34 years. Our comments will be addressed entirely to the impact of estate taxes on agriculture and modifications which we endose.

Two primary factors have contributed to the need to review the handling of agricultural estates—inflation and increasing farm sizes.

In 1942 the average farm, including buildings, was valued at $34 an acre. Today it is valued at $340 an acre—10 times its 1942 value.

During that same period the average U.S. farm has more than doubled in size, increasing from 182 to 385 acres.

Combining these figures results in an average farm value more than 20 times what it was in 1942. It has gone from $6,100 to $131,300.

This is only the value of the farm. It does not include such personal property items as machinery, livestock, feed or supplies which are an integral part of the farm operation.

In 1942, even in the most intensive type of agriculture, these personal property items plus the farm value of $6,100 would not reach the $60,000 estate tax exemption level. In other words there was no type of farming in which the average farmer would have paid an estate tax if all of his assets were farm related.

By 1976 this has changed substantially. The University of Minnesota has provided figures from their farm-business summary. This data is for a 240-acre farm with a dairy herd of 35 to 44 cows, a size which appears to be average for Minnesota. In submitting this they have taken 1974 data from their records and updated it to 1976.

On this prototype Minnesota dairy farm values have been determined as follows:

Land	$94,000
Buildings, excluding dwelling	51,000
Personal property	70,000
Total	215,000

To this we have arbitrarily added a $20,000 value for the dwelling, making the farm total $235,000. It is this set of figures which we will use in commenting on various proposals.

One of our biggest concerns has been the negative impact of existing estate tax laws on the continued existence of family farm units.

As shown in detail later in this testimony the tax on an average dairy farm worth $235,000 is presently $40,200, over 25 percent of the value of the estate. This is a financial burden often beyond the ability of the family member operating the farm to pay, much as he may desire to continue to operate the farm. As an alternative he finds himself forced to sell off a portion of the farm, leaving him with a less-efficient smaller unit. Or he finds it necessary to sell the entire farm to a neighboring operation and his farm, as an operating unit, ceases to exist.

Such changes in estate tax law as are developed by your committee should be designed to overcome this forced-sale aspect of present law and encourage, where practical, the continued existence and operation of family farm units.

President Ford, recognizing the agricultural estate problem, has publicly announced two proposals.

The first of these is an installment payment approach, with no interest for the first 5 years and a 4-percent interest rate for another 20 years, applicable in full to farm-type (and other) estates up to $300,000 and with reduced benefits on estates up to $600,000.

While this program could be beneficial we have some doubts on the practical application of it and so expressed ourselves in a letter to Secretary of the Treasury William Simon on January 30. A copy of our letter is attached as a part of this statement. The committee's attention is invited to the specific points we have raised, as they can be helpful in drafting legislation to implement the President's proposal. Secretary Simon responded to our letter on February 25. While he recognized the points we raised he also indicated that the safeguards in present law, which many farmers consider too rigid to make this program practical, would continue to apply.

While we recognize the need for IRS to have a reasonable ability to collect taxes by this means, we believe a "rule of reason" should prevail in order that the program may serve its intended purpose. Unless it has sufficient flexibility to permit changes prompted by advancing technology a deferred payment approach might do more harm than good.

The dairy industry offers a good illustration of this type of change. Twenty-five years ago nearly all of the Nation's milk went to market in milk cans. Today most of it is handled in bulk cooling tanks at the farm and then transferred to tank trucks to be moved to market. Along with the farm tanks have come milking parlors and pipeline milkers. These changes have greatly improved milk quality, so all have benefited.

We ask that any legislation covering installment payment of farm estate taxes be such that this type of change will not be inhibited.

President Ford has also advocated increasing the estate tax exemption from $60,000 to $150,000, phased in over the next 5 years.

While we endorse the concept of increasing the estate tax exemption, we believe he does not go far enough—and is taking too long to do it.

We recommend that any change in this exemption be made effective immediately. When one realizes that no change has been made for 34 years we see no logic in waiting longer to establish the level which, through the legislative process, is now determined to be proper.

While an exemption of $150,000 is a decided improvement over the present $60,000 level, it would still leave a substantial tax to be paid by the average Minnesota dairy farmer mentioned earlier. A large number of bills being considered by your committee would raise the exemption to $200,000. We endorse this figure.

Using our Minnesota dairy farm figures we have computed the Federal estate tax with a $60,000, a $150,000, and a $200,000 exemption. In so doing we have subtracted $10,000 in each case for such deductible items as funeral expenses, estate settlement costs, etc.

	Exemption level		
	$60,000	$150,000	$200,000
Estate value	$235,000	$235,000	$235,000
Less deductibles	−10,000	−10,000	−10,000
Total	225,000	225,000	225,000
Less basic exemption	−60,000	−150,000	−200,000
Taxable estate	165,000	75,000	25,000
Federal estate tax	40,200	13,700	2,300

It is noted that under the President's proposal this average farm would still pay a substantial amount, $13,700, in taxes. For each $3,600 the value increases above these figures at least an additional $1,000 would be due. Tax totals at this level would be difficult for the average farmer to pay.

If a $200,000 exemption is applied the tax is $2,300. Along with this, however, the lower rate brackets which apply would result in $500 additional tax on the next $3,600 and the progressive rate increase above that amount is far less steep than under the President's proposal.

We also urge adoption of a built-in adjuster, based on the Consumer Price Index, to keep the exemption up to date with inflation and changing economic conditions.

Other proposals before the committee would increase the marital deduction. We note that increasing the basic exemption to $150,000 or to $200,000 would permit the farm in the illustration we are using to pass to the wife without payment of estate tax. To assure that this occurs we believe an even greater marital exemption should be permitted.

Particularly we urge this where the wife is an active participant in the operation of the farm. Presently IRS has held that only proven financial contributions by the wife can be subtracted in determining the net estate.

We urge consideration of the active participation by the wife in the operation of the farm as a contribution by her to the overall farm value and therefore to be excluded from taxation. Many dairy farms, because of the amount of labor involved, are in practice husband-wife partnerships. For estate purposes they should be so treated.

The last major proposal before your committee is to have agricultural property, when it has been and continues to be used for farming, appraised on its agricultural rather than some other potential use. This we support.

It is tragic to have family farms, some of which have been in one family for many years, broken up because it has been determined that they could command a higher sales price if converted to a shopping center, a subdivision or some other nonagricultural use. As long as the family desires to continue to operate this as a farm it should be appraised on its farm value and the estate tax determined accordingly.

As we visit with the dairy farmers of our member association we find them deeply concerned about present estate taxes and what these could mean to their farms. We commend the Committee on Finance for these hearings. We urge prompt action on your part in developing an equitable program which will assure the continued existence of the family-farm type agriculture so prevalent in the United States.

NATIONAL MILK PRODUCERS FEDERATION,
Washington, D.C., January 30, 1976.

Hon. WILLIAM E. SIMON,
Secretary of the Treasury,
Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: The National Milk Producers Federation is composed of most of the dairy cooperatives in the United States. We, therefore, have an active interest in legislation which affects the dairy farmer members of these cooperatives, most of whom are family-farm operators.

We have evaluated the President's proposal to extend the time of payment for such estates to 25 years with liberal interest terms. We commend the President for recognizing a serious existing problem.

Estate taxation presents a major problem for farm operators throughout the Nation. At the present time, they are faced with a situation where many family farms are sold, in whole or in part, in order to permit payment of these taxes. This inhibits the orderly transfer of ownership within a family and actually contributes to an increasing concentration of ownership of agricultural land. Some estimates place the amount of agricultural land transferred for the purpose of meeting estate tax liabilities as high as 25 percent.

The proposal advanced by the President can be helpful in meeting this problem. To fully address the question, we do feel that it should encompass a degree of tax relief in addition to the increased ability to defer taxpayments. A number of proposals have been put forward which would increase the estate tax exemption from $60,000 to $200,000 while providing for valuation of agricultural land for agricultural purposes. Inclusion of these features in reform of our estate tax system, in addition to the deferred payment plan, would yield substantial benefits by permitting continued maintenance of family-type units. This is essential to continuing and advancing the productivity of agriculture.

There are some points which need to be kept in mind as legislative language is developed to implement President Ford's proposal, if it is to provide a meaningful step toward improving the ability to maintain family-farm units.

Presently, as you are aware, there is a procedure where, under certain circumstances, estate taxes can be paid over a 10-year period. It is our understanding that this procedure is inhibited by the fact that the estate must post a bond for up to twice the outstanding amount. Additionally, the administrator of the estate is held personally liable for these taxes. We recognize that the Internal Revenue Service must have some reasonable ability to collect, but the present limitations seem far too severe and need to be modified.

This raises an extremely serious question as to who, under your proposal, is considered the actual owner of the property for the 25 years after the creation of the estate. During this period, does it continue to be an estate? Or does title vest with the heir who has assumed operation of the farm? If the latter is the case, what lien rights does IRS have against one man's property to collect the debt of another?

Under present law, it is our understanding that the estate tax obligation must be paid before a property can be sold. Presumably, this is necessary to clear title before transfer.

Assuming that this same interpretation applies to the proposal (that the property continues to be owned by the estate until the tax is paid), what incentive is there for the heir (or heirs) to make improvements on the property? We are sure it is not the intent to freeze such a property to the point that it cannot keep up with the changing technology. If that were to occur, your proposal could do more harm than good.

Other questions also arise. What opportunity would there be to sell all or a part of the property during this 25-year period? What would happen if their heir who is operating the farm were to die during that time?

In summary, any proposal which is developed must not be so rigid in its desire to assure that the tax is paid that it hampers the orderly operation of the property as a family-farm operation.

Sincerely,

PATRICK B. HEALY, *Secretary.*

AMERICAN LAND DEVELOPMENT ASSOCIATION,
Washington, D.C., April 20, 1976.

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

DEAR SENATOR LONG: The American Land Development Association (ALDA), for the many cogent reasons listed herein, very strongly opposes two provisions of H.R. 10612 as it passed the House. The first would impose an arbitrary ceiling on the deductibility of nonbusiness interest. The second would impose severe requirements that a taxpayer would have to meet before a taxpayer would be allowed to deduct the legitimate expenses incurred with respect to a vacation home. Both of these provisions, if enacted into law, would have a very serious adverse impact on the building industry and on employment levels in the construction trades. To the extent there are existing abuses, they can be handled administratively under existing law without the necessity for enactment of such harsh measures.

Limitation on Nonbusiness Interest Expense Deductions

Section 206 of H.R. 10612 would place a ceiling of $12,000 on personal interest expense that may be deducted in any taxable year. The same provision would place severe limitations on the amount of deductible interest on investment indebtedness although it is not the purpose of this letter to address itself to that aspect of section 206. The imposition of a ceiling on personal interest expense expressed in a numerical figure is unjust and discriminatory. In an era when the purchasing power of the dollar continues to shrink, the resort to a dollar figure is arbitrary and capricious. The personal interest expense figure taken as an itemized deduction had admittedly increased year after year. However, much of this is due to inflation and the fact that mortgage interest rates are 2 to 3 points higher than the traditional level of 6 percent. It is well known that a comparable home could be purchased in 1960 for less than half the amount that would have to be expended today. The steadily rising price of homes, townhouses, and condominiums has slowed somewhat due to the current economic conditions. However, there is nothing to indicate that the long-range picture will be any different than it has been over the past decade or so. Under these circumstances, the imposition of a ceiling on personal interest expense would discriminate against newer families that are striving for the American dream—to own their own home.

The provision is clearly contrary to longstanding congressional intent to allow personal interest expense as a legitimate itemized deduction. If section 206 becomes law, it would establish an undesirable precedent for disallowing other justifiable deductions such as those for charitable contributions.

The provision strikes directly at homeowners and would-be homeowners since the major component of personal interest deduction consists of mortgage interest. This is clearly inconsistent with the congressional intention of encouraging family homeownership. The provision would clearly make it more costly to acquire and own a home and in that sense it is inconsistent with the tax credit for the purchase of a new home which Congress enacted last year.

The view is expressed by those who support section 206 that there are not that many homeowners or would-be homeowners who would have mortgage interest expense of $12,000 or more. But as indicated, more and more taxpayers continue to fall into this category as the prices of new homes, townhouses, and condominiums continue to rise. And even if mortgage interest is not that high, there are other personal interest expenses which could easily increase personal interest expenditures to a point that exceeds $12,000. For example, many middle-class families are undertaking substantial loans to finance college education for their children. And it isn't unusual to incur loans to cover unexpected medical and dental expenses. Then there are the usual other types of consumer loans incurred to buy automobiles and household effects.

No matter how the interest expense costs are derived, once they exceed the proposed ceiling, they effectively increase the tax liability of the individual. To the extent this occurs, it reduces the capability of the individual to own or acquire a home.

Taxpayers, if this proposed ceiling is enacted, would thereafter have to live with the uncertainty of knowing that if Congress has arbitrarily set a ceiling of $12,000, it would at some point legislate a lower ceiling or wipe out the deduction for personal interest expenses altogether. The proposed ceiling could be a crushing burden to taxpayers who are presently legally obligated to pay interest on outstanding loans. And the uncertainty could cause taxpayers to be hesitant about making major purchases, including homes, and thus concomitantly obligating themselves to incur loans that would be necessitated by the purchase. This uncertainty is bound to have a seriously dampening effect on the economy.

Furthermore, section 206 is discriminatory in that it would limit the amount of deductible interest to individual taxpayers, but place no similar limitation on corporations or other business enterprises.

The provision would also make for many new administrative complications and carry with it added tax litigation. One of the original reasons Congress was disposed to allow interest as a deduction even where incurred for nonbusiness reasons is that it frequently is difficult to draw the line between loans incurred for business and investment purposes and those incurred for personal reasons. According to the committee report, a loan would be considered to have been made for personal reasons and hence the interest would be subject to the ceiling where the proceeds of the loan are used for "personal purposes to provide the taxpayers with a standard of living which is clearly out of the ordinary." It appears that if the provision is enacted. Congress would place the burden on the IRS of ascertaining on a case-by-case basis what is the established living standard for each American. Thus, IRS would have this problem in addition to the very sticky one of deciding in close cases whether the loan has been incurred for an investment or business purpose as opposed to personal purposes. If enacted, it would take years for the IRS to draft and promulgate regulations that would establish guidelines so that taxpayers would know whether they had to observe the ceiling on deductible interest or could ignore it. Thus, to include section 206 in the Internal Revenue Code would only create chaos and uncertainty for many years for both the IRS and taxpayers.

The use of an arbitrary dollar ceiling will mean that more and more homeowners will find that their Federal tax liability will increase without any increase in real income. This, of course, further compounds and further increases the effective tax increase. As this occurs, it is going to impair the capability of taxpayers to maintain their homes and the capability of newly formulated families in acquiring homes. The provision hurts present family homeowners in that it fails to grandfather in the interest expense on loans on existing homes and other purchases on which indebtedness was incurred. It will also especially hurt future families who can expect to have to incur ever larger mortgages and other consumer loans as inflation and other factors force up the price of homes and other consumer products.

For the reasons above, Congress should not impose any limitation on the nonbusiness interest deduction.

Vacation homes

Section 601, as contained in H.R. 10612, would add section 280 to the Internal Revenue Code. The purpose of this section would be to limit deductions for expenses of an office at home and for those expenses attributable to the rental of vacation homes. This letter is directed at the latter limitation. This provision would limit the deduction a taxpayer-owner could take with respect to his second home if the personal use exceeded 14 days (or any part of a day) or 5 percent of the number of days during the year in which the house is rented at a fair rental. Personal use of the property includes use by the owner and relatives as well as anyone who uses the home under a reciprocal arrangement, or any other individual who uses the vacation home unless he pays a fair rental.

Enactment of this provision would have a detrimental effect on the economy and severely cripple the second home industry by imposing limitations upon otherwise legitimate tax deductions for millions of taxpayers. It should be recognized that the second home industry is a major industry in this country today with more than 3.5 million second homes. It has been estimated that more than 5 percent of all housing in this country consists of second homes, that second home sales exceed $7 billion and that between 8 and 10 percent of all new housing starts are second homes. Furthermore, a 1973 comprehensive survey of plans for future ownership of second homes shows that overall second home ownership is projected to more than double by 1985 and that resort condominium unit ownership is expected to more than quadruple over the same period given 1973 consumer attitudes and economic conditions.

To understand why the second home industry has become a significant economic force in our society requires only a cursory review of well-known trends in the United States. The growth of leisure time and the accompanying desire for healthy, family-oriented outdoor recreation and sports activity have been key factors. Increasing affluence, earlier retirement, the shorter workweek (and its more recent byproduct, the 4-day week, now practiced by some 3,500 companies across the country) improving retirement and other benefit programs have been fundamental to the growth of the second home industry. Increasing longevity, a more mobile population, and the well-known problems of the cities have also encouraged this generation to seek a haven in the more tranquil settings which second homes provide. In addition, the problems of inflation have encouraged the purchase of real estate, with second homes a popular choice.

Losses suffered by individuals

Proponents of this provision express the view that these new definitive rules are necessary to curb the abuses of wealthy taxpayers. On the contrary, this provision would not only not hit the wealthy taxpayer, but would really clobber the middle-class taxpayer. The truly rich who have second or third homes do not need to and in fact do not rent their own homes, and thus properly do not take business deductions on these properties. On the other hand, these business deductions are necessary to the average taxpayer who owns a second home and must rent to maintain it. Studies show the average owners of a second home have an income of $15,000 or less. Consequently, if these figures represent a true picture, this section really would hit hardest at middle America—that group of taxpayers who are the backbone of the American tax system and faithfully, honestly, and voluntarily pay their taxes every year. Some supporters of this section mistakenly believe that all taxpayers have bought vacation homes for the sole purpose of avoiding the payment of any Federal income taxes—that is, they have bought the homes as a tax shelter. This view ignores the fact that many taxpayers may have sacrificed a second car, a new principal home, trips, or a vacation. In many cases, they may have made these sacrifices so that later on they can retire in these homes and live without Government handouts. For many taxpayers this is probably the only type of investment which they can handle now and which may provide them with the means to pay higher educational expenses of their children. Government policy in the past has been to encourage those who are thrifty. This proposal is a reversal of that policy and would discourage and blunt the efforts of such taxpayers who save and try to provide for their own retirement.

Enactment of this provision would appear to have a dramatic adverse impact on the present individual owners including future retirees by way of a decline in the market values of rental homes previously purchased in prior years. Undoubtedly most of these second homes were acquired in the sincere belief that limited personal occupancy would not preclude the deduction of legitimate business expenses under existing or prior law. Reversal now of existing tax policy could very easily require many individuals to alter substantially their retirement plans and would, in the case of many retirees, impose additional financial burdens at a time in their life when it is not possible for them to generate the additional capital and income to cover the added costs of ownership.

If this section is adopted, a taxpayer who acquired a vacation home with the objective of making a profit notwithstanding limited personal use could be denied certain tax deductions simply because he occupied the property for more than 14 days or 5 percent of the total rented time in a particular year. This would be a harsh result and appears to conflict with statements on page 104 of the Senate Finance Committee Report (S. Rep. No. 552 91st Cong. 1st sess. (1969)) explaining Section 183. That explanation indicates that the determination of whether an activity is not engaged in for profit will depend upon whether the taxpayer entered the activity with the objective of making a profit.

Under this section, the taxpayer's objective, and reasonable expectation of profit would be irrelevant merely because of extremely limited personal use, even including occupancy required in connection with necessary property management functions such as maintenance, refurbishing, and repair and inspection of the activities of local rental and management agents engaged by the owner. Relatively frequent trips to perform these property management functions are often a necessity if the taxpayer is seriously in the rental business. In this regard, this section represents a striking departure from the tax treatment accorded other activities entered into for profit. Material discrimination against the acquisition of rental homes as an investment and as a means of engaging in a profitmaking activity is the result.

Individuals nearing retirement especially hurt

One significant group of individuals which would feel this discrimination quite heavily consists of those persons who, in contemplation of retirement, have acquired or have become contractually committed to acquire a rental property in a resort or residential community. A large percentage of the sales of condominiums, townhouses and other dwellings is represented by persons so motivated. While these individuals are employed in a geographical area distant from the rental home, they often place such home on the rental market. They depend upon the rental income to permit them to carry the ownership of their rental homes in anticipation of retirement. The limited amount of permitted personal use of such dwelling under this section would so substantially restrict the tax deductions now available for business expenses that it would preclude many of these individuals from acquiring such properties, make it financially more difficult for others to do so, and could produce for them a substantial economic loss in the form of decreased market values.

The acquisition of a rental home in anticipation of retirement (frequently conceived of as a method of achieving some protection from continuing inflation in the costs of land and home construction and in the many other circumstances with which we are familiar) does not possess those traditional characteristics of certain real estate tax-shelter program which many assert favor the wealthy.

Since inflation increases those expenses (maintenance and operating expenses, as distinguished from interest) which would not be deducted if section 183 is applied, these individuals would be bearing not only the general adverse effects of inflation, but also the specific effect of having the deductibility of such out-of-pocket business expenses limited or eliminated.

Effect on building industry

Enactment of this section would aggravate further the depressed economic conditions in the building industry by causing a severe and immediate adverse impact on the completion and marketing of many thousands of condominiums, townhouses and other dwelling units currently under construction or development in the retirement and resort areas of this country. Furthermore, it would only compound the staggering problems now confronting the real estate industry with respect to interest rate levels, inflationary construction costs, availability of mortgage credit, the high cost of fuel, and increasing community concern with environmental impact considerations.

In addition, new home starts are down nationally, business failures in the construction industry are up and still climbing, some of the largest publicly held companies have reported losses, are discontinuing operations or have liquidity problems, and more significantly, unemployment in the construction industry is staggering. In this connection, recent testimony by Mr. Robert Georgine of the AFL-CIO Building Trade Department before the Joint Economic Committee on March 4, 1976, showed that unemployment in the construction industry is at a staggering 15.4 percent. That rate he said, is double the national average. Thus, in our view, enactment of this provision will only cause further unemployment.

Given these nontax problems to be solved by the real estate industry, it is an especially bad time for it to be disadvantaged, relative to other sectors of the economy, by this change in the tax laws.

Effect on small communities

Many small communities throughout the country whose total existence depends upon tourism and recreation as a main source of income could be adversely affected by this provision. Thus the geographic implications to the second home industry should be examined carefully before any further tax limitations are placed on individual owners of second homes. For example, surveys show that in Maine, Vermont and New Hampshire, more than 15 percent of all housing units presently in those States are second homes. Therefore, the economic implications of events affecting those States could be severe.

Certainly the economic impact of recreation and resort areas especially in rural areas and low income areas should be examined before any action is taken on this section. Studies have shown that tax base and economic growth of recreational and resort developments have had a significant impact and perhaps a major impact on low-income and rural areas. Studies have also shown that tourism and recreation as a main source of income are a positive growth factor for family incomes particularly in the lowest income bracket. In comparisons of income levels for tourism-recreation-dominated areas over the 1949-69 period, the study reveals that these areas showed faster income growth than all other areas except those where Government services and public administration were the dominant source of income.

Existing law and rules are adequate

There is no indication from the Internal Revenue Service that there is rampant abuse in this area. Certainly there is nothing that cannot be adequately handled under existing law and under existing regulations published by the Internal Revenue Service. (See section 183 and regulations thereunder.)

It is true that the regulations presently provide guidelines rather than mechanical tests for determining whether an activity is engaged in for profit. However, in view of the wide variety of activities intended to be brought within the ambit of section 183, the guidelines approach was, and continues to be, eminently sound. Even if the focus is limited to vacation homes, there are numerous combinations of prevalent fact situations. In this connection, one must logically take into account not only the type, value, location and usage of the property itself, but also the widely differing motivations and circumstances of the owners of such properties.

The following are illustrations of the substantial differences which exist in the factual situations involved.

1. Some vacation homes are beach cottages or mountain cabins which, because of their location, are really usable for only 3 or 4 months of the year, while others are condominium apartments or individually owned hotel units located in established year-round resort areas.

2. Some owners acquire their properties primarily as an investment and intend to make only minimal and sporadic personal use of the properties. Other owners (frequently the most affluent) who acquire their properties for personal recreational purposes, do not deduct depreciation and operating expenses and thus are not affected by section 183. Still others purchase rental units in resort/residential communities with the intention of moving there upon retirement. Such people typically spend some time during each year in their future homes to acclimate themselves to the way of life in the area during periods in which rental prospects are poor.

3. Some owners use their units during the prime rental season while others may use their units only during the "off" season when rental prospects are poor or during other periods for which no tenant has been obtained.

4. Furthermore, in many cases, some owner occupancy is required in connection with necessary property management functions.

Accordingly, in view of the above, it appears the regulations under section 183 are as definitive as the diverse situations which are likely to be encountered permit to be adopted at this time. The adoption of more definitive rules at this time would be warranted only if the existing rules have proved inadequate and they haven't. In view of the short period of time that section 183 and the regulations have been in effect (section 183 has been in effect only since 1970 and the regulations were adopted in July, 1972), it is difficult to understand how it could be fairly determined at this early date that these provisions are inadequate to achieve their objectives, absent a showing that the Internal Revenue Service cannot eliminate any abuse in this area by using the existing rules in its audit program. The tax laws are far too complex to permit substantive changes without there first being a reasonable demonstration of need for change, which is not presently established.

In our view, the determination of whether or not the ownership and operation of a vacation home constitutes an activity engaged in for profit should continue to be handled by the Internal Revenue Service on a case-by-case basis under section 183 and under pertinent case law, at least until such time as there is a better understanding of the number and variety of situations which may be involved, the efficacy of section 183, and the economic impact of any change to existing law on the real estate industry and individual owners.

Shortcomings of the section

It would be extremely difficult, and perhaps impossible, to devise a mechanical test which would produce a fair and equitable result in most circumstances.

The proposed definitive rules are far too restrictive, and would operate inequitably in most situations. For example, assuming arguendo that less than 14 days of personal occupancy is a reasonable limitation with respect to a beach cottage in the Northeast, it is not a reasonable limitation with respect to a condominium townhouse in the Southeast, or in year-round resort areas. Would the 5-percent limitation eliminate this inequity? It will not. The proposed definitive rules would apply the percentage test with reference to the actual time during which the property was rented during the taxable year. In view of the fact that in many cases such actual rental time will not be known with any degree of certainty until the year is over, or nearly over, an owner desiring to occupy his property in the spring or early summer might well be required to limit his occupancy to less than 14 days to avoid risking the loss of deductions to which he would otherwise be entitled. Furthermore, to apply such a percentage test would make the deductions dependent upon factors which are often beyond the control of the taxpayer. For example, economic conditions could reduce the rentals for a season or a taxpayer might, whatever the reasons, have more vacancies for one season than in another season.

Congress has consistently permitted a deduction for the legitimate expenses incurred for the production of income and in the operation of a business. This section, in essence, would disallow a large part of the legitimate expenses connected with property held for the production of income. Congress also has long recognized that the same property may be used for personal use part of the time and employed for the production of income the balance of the time. The only requirement is that there be a clear allocation made of the expenses attributable to the period when the property was held for the production of income. Take IRS form 2106. This is the form that outside salesmen use to report their deductible expenses. The form provides for the taxpayer to make an allocation between personal use and business use of his automobile. By limiting the deductions in the case of vacation homes, Congress would clearly be discriminating against investors in second homes as compared to those taxpayers who invest in automobiles, apartment buildings, office buildings, etc. who are permitted to take a depreciation deduction and other legitimate deductions for the entire period such property is held for rent and for the production of income regardless of the period of actual time the property is rented.

Revenue estimates

If one examines the revenue that would be raised by this provision, it is extremely small in terms of the national budget as compared to the adverse economic effects this provision would have on the building industry and construction employment. The revenue estimates are misleading, even as low as they are because they do not take into account the ripple effect to the economy. If this provision is enacted it is not unreasonable to expect that there will be many taxpayers who will be unable to continue ownership of their second home and that thousands of taxpayers will never be able to undertake the acquisition of a second home. Certainly then, under these circumstances, construction of second homes would be severely cut back, unemployment in the building industry would further increase, and many of the resort and recreational communities would suffer an erosion of their principal economic base. Consequently, enactment of the provision could produce revenue shortfall, not the revenue gain as is suggested by the committee report.

A recent study by Dr. Norman B. Ture (this study has been submitted to the Senate Finance Committee by the National Realty Committee) indicates that the interest limitation in section 206 discussed above would alone result in a decline in investment in real estate by $0.4 billion and some 17,000 workers engaged in employment in the real estate field would be affected.

While Dr. Ture's study does not relate to the provision dealing with vacation homes, there is a relationship between the two proposed sections. If proposed section 601 were enacted and a taxpayer's personal use exceeded the limits imposed, presumably the interest expense would be subject to the same limitation ceiling imposed on the deductibility of interest contained in section 206. Obviously this would have an even more dampening effect on the economy and particularly on the home building industry and the construction trades.

Conclusion

It is our strong recommendation that the committee take no action on either of the two provisions, at least not until such time as an impact statement can be prepared which will show the direct effect these two provisions will have on: (1) the construction industry . . . single family, multifamily, and other houses; (2) unemployment in the construction industry; (3) the extent to which it would increase the effective tax to homeowners; (4) the impact on small vacation communities; and (5) the total secondary and tertiary effects of such provisions.

If section 601 relating to vacation homes is not deleted, then we urge that some of the more onerous provisions be modified. For example, a taxpayer should be allowed to occupy his second home for at least 90 days and not be limited to the proposed 14 days. Or if a percentage test is retained, the percentage should be increased and should be based on the entire period the property is normally held out for rental. And, in addition, depreciation should be allowed for the same period and not just for the period that it is actually rented. In other words, depreciation should be allowed over the period that the taxpayer can reasonably anticipate rental income.

In conclusion, it is submitted that the two proposed provisions do nothing to reform the law, they simply add complexity, raise very little revenue, and would have a serious adverse economic impact on the economy as a whole and particularly to the construction industry. Consequently, we feel neither provision should be enacted.

Sincerely yours,

GARY A. TERRY,
Executive Vice President.

Recommendations of the Rochester Tax Council on DISC, Federal and State Taxation of Foreign Income, and Capital Formation

Summary

I. DISC

The current DISC deferral program, which has been responsible for a significant increase in exports by members of the council, should be continued substantially in its current form. At most, such program should be changed to adopt the incremental DISC provisions included in the Tax Reform Act of 1975, which include a base period covering taxable years beginning in 1972, 1973, and 1974 and a 5-year freeze on such base period. Any additional amendments to curtail further the export incentives currently existing in the DISC deferral program will cause substantial harm to the export position of domestic companies. (The House bill contains technical drafting errors in proposed 995(b)(1)(D) and 995(c)(1), which errors should be corrected if the House bill is adopted.)

II. U.S. TAXATION OF INCOME EARNED BY FOREIGN SUBSIDIARIES OF DOMESTIC CORPORATIONS

Inasmuch as the foreign operations of U.S. corporations have a beneficial impact on American jobs, exports, and balance of payments, multinational corporations should be encouraged rather than prohibited or restricted by harsh changes in the U.S. tax law. Of special concern are proposals to limit creditable foreign taxes to an effective rate of 50 percent and to eliminate partially the deferral of tax of foreign subsidiaries of U.S. corporations. The subpart F provisions of the code have gone as far in the direction of eliminating deferral as Congress can go without significantly injuring the competitive position of U.S. investment abroad. Changes in the foreign tax credit area should be limited to the amendments contained in H.R. 10612 to repeal the per-country limitation, to gross-up less-developed country corporations' dividends, to recapture foreign losses, and to limit the foreign tax credit available with respect to foreign capital gain income. If legislation other than the above were recommended, a specific bill should be proposed and public hearings held on such bill so that taxpayers directly affected by such proposed legislation could make substantive comments thereon.

III. STATE TAXATION OF FOREIGN SOURCE INCOME

Uniform Federal legislation is urgently needed to prevent a State from taxing the foreign source income of multinational corporations doing business within the State. The council supports legislation to amend the Internal Revenue Code to preclude States from taxing dividends from foreign sources and from applying the "unitary business" concept to the income of foreign corporations.

IV. CAPITAL FORMATION

Tax legislation which would enable corporations to meet their ever-increasing capital requirements is urgently needed. Such legislation might include a partial elimination of the double taxation of dividends, faster depreciation writeoffs, an increase in the rate of investment credit and making the credit a permanent feature of the tax laws, and a reduction in the corporate income tax rate.

Statement

The Rochester Tax Council is a voluntary group of 12 companies having substantial facilities in the Rochester, N.Y., area and collectively manufacturing a wide variety of high technology products. Membership in the council presently includes the following corporations:

Bausch & Lomb, Inc.
Champion Products, Inc.
Corning Glass Works.
Eastman Kodak Co.
R. T. French Co.
Gannett Co., Inc.
Garlock, Inc.
Gleason Works.
Schlegel Corp.
Security Trust Co.
Sybron Corp.
Xerox Corp.

The members of the council also have major facilities in the various States listed on appendix A.

Current tax proposals of concern to members of the council include the taxation of DISC's, the Federal tax treatment of the income of controlled foreign corporations, State taxation of foreign income, and the taxation of income from capital.

I. DISC

As is the case with other domestic industrial corporations, exports by council members have increased greatly since the DISC legislation was enacted. Between 1971 and 1975 exports by the industrial corporations included in our council increased from $549.7 million to approximately $1.085 billion—an increase of more than 97 percent. We believe that a significant portion of this increase is attributable directly to the tax incentives offered by the DISC program and provides strong support for continuation of such program.

This almost 100 percent increase in exports by council members has resulted in increased employment in the Rochester area and increased tax revenues to the U.S. Treasury. It is estimated that in 1972, approximately 19,420, or 12 percent, of the approximately 161,828 individuals employed by industrial members of the council were engaged in manufacturing or sales jobs which were sustained by the export sales of such corporations. It is estimated that by reason of increased export sales, in 1975 approximately 26,111, or 14.5 percent, of the approximately 180,073 individuals employed by industrial members were engaged in manufacturing or sales jobs sustained by reason of export sales.

Thus, between 1972 and 1975, export-related jobs in the Rochester area increased by more than 34 percent. This dramatic increase in the number of employees engaged in export-related jobs results from the substantially larger percentage increase in export sales as opposed to domestic sales during the period. The total sales by industrial members of the council increased from approximately $5.345 billion in 1972 to $7.5 billion in 1975—an increase of more than 40 percent. Export sales during this period increased by approximately 69 percent (from approximately $640.5 million in 1972 to $1.08 billion in 1975), whereas domestic sales increased by approximately 36 percent (from approximately $4.704 billion in 1972 to approximately $6.417 billion in 1975). Thus, of the increase in employees by industrial members between 1972 to 1975 of approximately 18,245, a substantial number of them were hired to fill jobs created by increased export sales.

In addition, it is estimated that the total U.S. income taxes withheld from wages of employees of the council who were employed in jobs sustained by export sales amounted to approximately $214,743,160 during the years 1972–75 and that the corporate income taxes paid during these years by reason of the income earned by both the industrial corporations and their DISCs on exported products amounted to approximately $366,260,736.

The above export sales, employment, and tax collection statistics with respect to industrial members of the council tend to refute the criticisms most frequently leveled against the DISC program, that is, that it is nothing more than a tax windfall for exporting companies in that it has been responsible for only a marginal increase in exports and U.S. jobs and that it has resulted in substantial losses of revenue to the U.S. Treasury. On the contrary, the above statistics support the conclusions of the House Ways and Means Committee that the DISC legislation has been responsible for a significant increase in exports. Such statistics provide substantial support for continuation of the DISC program.

For the above reasons, when the DISC deferral program was being considered by the House Committee on Ways and Means last fall, the members of the council urged that no changes be made in the current DISC deferral program. They recognized, however, that possibly valid criticisms could be made that the deferral benefits under the current program are based only on a company's overall export performance, rather than on its total performance in terms of American jobs and the U.S. balance of trade or on a company's increase in U.S. exports over the level prevailing during a base period prior to enactment of the DISC legislation. For this reason, the council supported incremental DISC provisions included in the Tax Reform Act of 1975, H.R. 10612, which is currently being considered by this committee. The incremental export approach would provide a strong incentive to increased U.S. exports. At the same time, it would eliminate the criticism that the present DISC provisions provide a tax bonanza to exporting companies without regard to whether their export performance is improving.

During the House deliberations on the Tax Reform Act of 1975, the council advanced the position that the base period for taxable years before 1981 should include taxable years beginning in 1969, 1970, and 1971, rather than taxable years beginning in 1972, 1973, and 1974. The use of 1969–71 as the base period would reflect the fact that these years were the last 3-year period in which export sales were not being encouraged by the present DISC provisions of the code. Under the base period included in the Tax Reform Act of 1975, companies which have expanded exports under the present DISC program will be penalized by having a base period used for measuring export improvement be one which is itself affected by the present DISC incentives.

While the members of the council believe that their position with respect to the appropriate base period is valid, they consider the base period included in the House bill an acceptable compromise to meet possibly valid criticisms of the DISC deferral program. However, the members urge this committee not to make additional amendments which will further curtail the export incentives currently existing in the DISC deferral program. At the very least, the present DISC legislation should be retained substantially intact until the difficulties currently being encountered by the United States in treaty negotiations in Geneva are satisfactorily resolved.

The House bill being considered by this committee provides that the initial base period shall remain in effect for a minimum period of 5 years. The members of the Council consider that the House bill contains the minimum period for which the base period should be effective. Investment in manufacturing facilities and marketing programs to spur exports must be made on a long-term basis, with reasonable assurance of continuity in the tax rules applicable to export sales. As a result, any base period that is selected must be effective for a sufficient number of years to provide a reasonable incentive to domestic companies to increase U.S. exports. The members of the Council consider that maximum export incentives can be assured only by a long-term freeze on the base period for at least 10 years, and accordingly, they initially urge the House to make the initial base period effective for 10 years. However, they consider the 5-year freeze a sufficient period to provide reasonable export incentives, but would emphasize that they consider any freeze on the base period of less than 5 years too short to provide reasonable export incentives.

Finally, the proposed amendments to the current DISC legislation included in the House bill contain a drafting error which should be corrected by the committee if the House bill is adopted. Proposed sections 995(b) (1) (D) and 995(e) (1) should be amended to provide that only the adjusted taxable income of the DISC, as defined in proposed section 995(f) (3) with respect to small DISC's, shall be taken into account in computing the taxable income for the taxable year attributable to base period export gross receipts. Unless this technical amendment is made, the DISC income which is already deemed distributed under section 995(b) (1) (A), (B), and (C) would again be included in the computation required to determine the deemed distribution required by reason of base period export gross receipts. This double inclusion was clearly unintended.

II. U.S. TAXATION OF INCOME EARNED BY FOREIGN SUBSIDIARIES OF DOMESTIC CORPORATIONS

A. Introduction

Substantial evidence is available, and previously has been submitted to the House Committee on Ways and Means, concerning the beneficial impact of the foreign operations of U.S. corporations on American jobs, exports, and balance of payments. The Council shares the views which most industry members have expressed that such operations, on balance, make a substantial contribution to the U.S. economy in all these important areas. The favorable balance-of-trade and balance-of-payments experience of our own small groups of Rochester-based companies fully supports this conclusion. Export sales of several of the industrial corporations included in our Council increased from \$549.7 million in 1971 to \$1.07 billion in 1975, while imports for the same firms went from \$70.9 million to \$187.3 million during the same 4-year period. Clearly, the high technology producing companies in the Rochester area have generated far more in new exports during this 4-year period—an increase in exports between 1971 and 1975 of over \$520.3 million, with imports going up by only \$116.4 million. Thus, our Rochester group has made a major positive contribution to the U.S. balance of trade, with growth in exports exceeding growth in imports by approximately 4½ times between 1971 and 1975.

These comparisons are even more impressive if figures for the period before the substantial increase in oil prices are included. Export sales of several of our members increased from \$340.5 million in 1967 to \$1.07 billion in 1975, while imports for the same period went from \$62.1 million to \$187.3 million, with an increase in exports during this period of approximately \$729.5 million and an increase in imports of approximately \$125.2 million. These figures indicate that growth in exports exceeded growth in imports by almost six times between 1967 and 1975.

Another comparison that indicates the strong export effort of our Rochester-based companies is that from 1971 to 1975, the net trade balance of several members of the group improved from \$478.8 million to \$885 million. The improvement in net trade balance from 1967 to 1975 is equally impressive, from \$278.4 million in 1967 to \$885 million in 1974.

The overall balance-of-payments performance of our Rochester companies also has been strikingly beneficial to the U.S. economy. As indicated on appendix B, during the period 1972–75, the dollar inflow from dividends, interest, royalties, fees, and exports of several members of our group amounted to approximately \$4.44 billion. Outflow, consisting of capital transfers, dividends to foreign shareholders, interest, royalties, fees, and so forth, and imports, amounted to only \$986.6 million. Thus, the net balance of payments inflow of several of our Rochester industrial companies during the 4-year period was approximately \$3.45 billion. For the 9-year period between 1967 and 1975, the net balance of payments inflow of several members of our group was approximately \$5.789 billion.

These favorable balance-of-payments and trade statistics directly support our position that multinational private enterprises such as our Rochester-based industrial companies should be encouraged rather than prohibited or restricted by harsh changes in our tax law. Consequently, as a general matter, the Council opposes any legislation which would result in any material increase in tax (whether United States or foreign) on U.S. direct investment abroad. The Council is particularly concerned about the following two proposals in the foreign tax area which are currently being considered by a special task force of the House Ways and Means Committee and would urge that this committee not take any action on these or similar proposals during its current tax reform deliberations.

B. Proposal To Limit Creditable Foreign Taxes to an Effective 50-Percent Rate

Although it is definitely preferable to various other proposals that have been made with respect to the foreign tax credit, such as its complete repeal, the proposal to limit creditable taxes each year to an effective tax rate of no more than 50 percent in any country is defective for several reasons. Such proposal fails completely to take into account the many differences between U.S. and foreign tax law in respect to timing of income and deductions. A 50-percent effective tax rate limit would substantially write out of the present law the rule permitting 2-year carryback and 5-year carryforward of excess foreign tax credits, which was designed to alleviate this serious problem.

Furthermore, industry generally does not have "hidden royalties" or huge excess foreign tax credits which provided the rationale for the imposition of a 50-percent limit on creditable foreign taxes in the case of foreign oil extraction income in the Tax Reduction Act of 1975, enacted last March.

Changes in the foreign tax credit area should be limited to repeal of the per-country limitation, the gross-up of less developed country corporations dividends, the recapture of foreign losses, and a limitation on the foreign tax credit available with respect to foreign capital gain income. Amendments of the Internal Revenue Code to adopt changes in the foreign tax credit in these areas are contained in H.R. 10612 currently being considered by this committee. Going beyond this point will significantly harm American business abroad, U.S. exports, and the U.S. national interest.

C. Proposal to eliminate partially the "deferral" of tax

The Rochester Tax Council is opposed to any change in the tax rules that would tax all or part of the reinvested income of foreign subsidiaries of U.S. corporations before distribution of such income as dividends. We feel that the subpart F provisions of the code as amended by the Tax Reduction Act of 1975 have gone as far in this direction as the Congress can go without significantly injuring the competitive position of U.S. investment abroad. No major industrial country in the world to our knowledge goes as far as the United States in taxing foreign corporations controlled by their nationals through the subpart F provisions. Under these circumstances, we strongly urge that Congress avoid changes in the tax treatment of foreign source income which will put U.S.-owned foreign corporations at a market disadvantage in competing with foreign-owned companies for a fair share of growing foreign markets.

D. Conclusion

The members of the Council urge this committee not to recommend any amendments to the Code with respect to either the foreign tax credit or the deferral of tax on foreign income other than the amendments passed by the House in the Tax Reform Act of 1975. If, however, the committee recommends additional legislation in either of these areas, it is requested that in view of the importance and complexity of the subject matter, the committee propose a specific bill and hold public hearings on the proposed bill. It is hoped that any future legislation with respect to the taxation of foreign income will not be enacted through procedures similar to those followed by Congress when it passed the Tax Reduction Act of 1975. As a result of the procedures followed in enacting the foreign tax provisions contained in the 1975 act, which resulted from an amendment on the Senate floor which was substantially written in conference, those taxpayers directly affected by the amendment were not given the opportunity to make any substantive contributions to the legislation. The members of the Council urge that similar procedures not be followed in the current tax reform deliberations.

III. STATE TAXATION OF FOREIGN SOURCE INCOME

Another subject of great concern to industrial members of the Council is the ability of a State to tax the foreign source income of multinational corporations doing business in the State.

The Federal tax laws relating to the taxation of foreign source income are designed to avoid double taxation in the international area. The laws of the various States, however, presently do not contain provisions similar to those of the Federal income tax laws which define when income is derived from sources outside the United States and provide the extent to which that income should be taxed, if at all. It is essential that a uniform Federal law parallel to the Federal income tax laws be enacted to restrict state taxation of foreign source income. Only then will it be assured that individual State laws will not thwart international tax policy.

The most common method used by a few States to tax foreign source income of multinational corporations doing business within the State is application of the so-called unitary business concept of taxation. It is well established that in appropriate cases the business of a single corporation may be treated as unitary in nature and that its total income may properly be apportioned under a formula that fairly attributes a proportionate part of the corporation's income to a particular State.

When applied in a multicorporate setting, however, the unitary business doctrine of combined or consolidated reporting requires that a corporation with a business location in the State income in its apportionable tax base not only the entire income of such corporation, but also the income of such of its out-of-State affiliates as are found by the State to participate with the corporation in a single business unit. This broad approach to corporate taxation can, in effect, result in taxation by a State of the income of corporations that have no real contact with the State. Since it is not applied by all States, the unitary business concept can also result in more than 100 percent of a company's income being subjected to State taxation, or can result in a company with a loss paying substantial income taxes to a State. In addition, it can result in a company paying tax on an allocable portion of the entire income of another corporation, even though there is not complete unity of ownership between the two corporations. Finally, as it has been interpreted by a few States, such as California and Oregon, the unitary business concept results in the income of foreign affiliates being included in the apportionable tax base of a corporation with a business location in the State, even though the activities in the State in no way contribute to the earnings of such foreign income.

Another method used by some states to tax foreign source income of multinational corporations is to include dividend income from affiliates within the tax base of a multinational corporation with a business location within the state. It is well recognized that double taxation results from the taxation of profits in a subsidiary corporation and the subsequent taxation of dividends form those profits when they are paid to the parent corporation. In recognition of the clear inequity of taxing both corporate profits and corporate dividends received, the Federal Government and numerous states have granted relief by giving full or partial exclusions or deductions for domestic intercorporate dividends received. In addition, the Federal Government allows a foreign tax credit for dividends received from a 10-percent-or-more-owned foreign affiliate. Many States, however, have not enacted legislation that would prevent double taxation in this area. Some States even tax the "gross-up element" of dividends received by multinational corporations from their foreign subsidiaries without providing an offsetting credit or deduction for the foreign taxes paid.

In its recent treaty negotiations with the United Kingdom the U.S. Treasury Department recognized the inequity of the unitary system of State taxation as it applies to foreign income. The treaty prohibits a State from applying the unitary system to the United Kingdom parent of a United Kingdom subsidiary doing business in the United States. This limited approach to a solution to the problem of state taxation of foreign income should be expanded through uniform Federal legislation.

For the foregoing reasons, the Council urges uniform Federal legislation to deal with the pressing problems resulting from attempts by the states to tax foreign source income. The council supports legislation to amend the Internal Revenue Code to preclude states from taxing dividends from foreign sources and from applying the unitary business concept to income of foreign corporations.

IV. CAPITAL FORMATION

The industrial members of the council are concerned about the shortage of investment capital needed by United States industry to sustain economic growth and employment and the increasing reliance by industry on long-term debt to finance capital requirements. As a result of inflation, rapid technological changes, and governmental regulations, the capital required to sustain economic growth has increased substantially over the last decade. Industry has not been able to meet its cash needs from retained earnings, depreciation allowances and new equity issues, but rather has and continues to meet an increasing amount of its capital needs through debt financing.

The increasing capital requirements of the industrial members of the council illustrate the magnitude of the capital problems of corporations engaged in the manufacture of high technology products. Between 1955 and 1974, the capital expenditures of several of the industrial members of the council increased from approximately $49.7 million to $1.022 billion. During the same period, the research and development expenditures of such members increased from approximately $38.8 million to approximately $414.3 million. Finally, the net working capital of such members increased from approximately $274.9 million in 1955 to more than $1.95 billion in 1974.

The council urges that the committee consider tax reform which would aid American industry in meeting its ever-increasing capital demands without further resorting to debt financing. Such reform might include:

1. Legislation, such as that recommended by the administration, which would partially eliminate the double taxation of dividends, thereby making equity investments more attractive to investors.
2. Legislation which would permit faster depreciation writeoffs.
3. Legislation which would increase the investment tax credit to 12 percent, make the credit a permanent feature of the tax laws, and provide full credit for assets having a useful life of at least 5 years. The provisions of the Tax Reform Act of 1975, which extend the 10-percent investment credit for an additional 4 years, while helpful, should be liberalized to stimulate further capital accumulation.
4. Legislation which would eventually reduce the corporate income tax rate from 48 percent to no more than 40 percent.

Appendix A

States in Which Members of Rochester Tax Council Have Substantial Facilities

California, Colorado, Connecticut, Georgia, Idaho, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan Mississippi, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

APPENDIX B

ROCHESTER TAX COUNCIL—BALANCE OF PAYMENTS DATA

	1972	1973	1974	1975
Inflows:				
Dividends	$139, 237, 510	$146, 107, 313	$156, 263, 442	$156, 116, 135
Interest	9, 309, 722	12, 151, 005	21, 584, 387	23, 835, 820
Royalties, fees, etc	57, 291, 820	77, 735, 292	73, 916, 000	91, 502, 778
Exports	604, 758, 393	791, 123, 895	1, 010, 477, 747	1, 072, 439, 442
Total inflows	810, 597, 445	1, 027, 117, 505	1, 262, 241, 576	1, 343, 894, 175
Outflows:				
Capital transfers	51, 741, 147	65, 128, 314	162, 345, 381	32, 724, 973
Dividends	6, 011, 748	7, 011, 748	9, 214, 253	11, 169, 921
Interest	5, 156, 250	5, 850, 000	9, 275, 000	15, 272, 477
Royalties, fees, etc	1, 230, 000	2, 335, 000	1, 940, 000	2, 033, 657
Imports	93, 194, 666	130, 154, 595	187, 427, 384	187, 369, 182
Total outflows	157, 333, 811	210, 479, 657	370, 202, 018	248, 570, 219

Net balance of payments inflow:	
Total inflow, 1972–75	$4, 443, 850, 701
Total outflow, 1972–75	986, 585, 696
Total net balance of payments inflow, 1972–75	3, 457, 265, 005

Testimony of J. Ashton-Greene of New Orleans, La.

It is a great pleasure to be here and to give to this Senate Committee on Finance a few of my ideas on tax reform and other matters.

I will be brief as your time is limited and you have many other persons and groups to hear.

Why tax reform? Simply answered, the present system is unjust and inequitable.

Why now? Now, because the tax burden is perceived as being overly heavy on the middle class, the backbone of the country. Now, because the tax system is overly complex, and needs simplification.

My remedies: 1. Make mandatory that American citizens have a government issued identity card, complete with fingerprints.

2. Overhaul the Internal Revenue Service, and make it a separate department outside of political influence, and under a nonpolitical director.

3. Scrap the Internal Revenue Code and start all over again. It has, it appears, been only a form of work relief for CPA's and high paid tax lawyers, and legislative lobbyists, and hangerson.

4. In all your deliberations, endeavor to follow the ends of justice, that is, to give to each man his due.

Your attention is also called to my exhibit (*a*) enclosed, a letter to the editor, New Orleans Times-Picayune, July 20, 1975, "Government Snoops," which discusses Internal Revenue agent's harassment of American taxpayers by spying on their drinking and sex habits. This is to be made a part of this testimony, and is to be included in the record.

[From the Times Picayune, New Orleans, La., July 20, 1975]

Views of Readers: Of Cajuns, Refugees, Grain, Park

CAJUN REPLY

PASS CHRISTIAN, MISS.

EDITOR, THE TIMES-PICAYUNE: I refer to your editorial of July 13, "Public TV Under Fire," covering the controversy touched off by the TV presentation of "The Good Times are Killing Me." I must agree with Jimmie Domengeaux on his resentment of the way in which Louisiana Acadians are characterized in this "documentary." I must likewise commend Lieutenant Governor Fitzmorris for his condemnation of the feature's crudeness and vulgarity; also for his effort to have the proposed presentation canceled. And finally, what is so special about PBS that it should be above investigation for the manner in which our tax money is sp[illegible]

Your refere[illegible] to Governor Edwards is entirely beside the point. He may be a "coonass," whatever that is, but he would hardly qualify as an authority on the Acadians, nor has he been delegated to speak for the Acadians of Louisiana.

I was raised in a typical Acadian home of south Louisiana and can see nothing in the controversial TV "documentary" that is remotely representative of Acadian culture or the history of our people in their accomplishments and dedication to ideals over a span of 3 centuries on this continent. At the beginning of the 19th century, when collegiate training was a scarce commodity in this country, Acadians of Louisiana were sending their sons and daughters to Grand Coteau, where Jesuits and sisters of the Sacred Heart maintained colleges. Acadians gave Louisiana two of her early governors as well as important state and national leaders.

Why pick "The Good Times are Killing Me," with its crudeness, vulgarity and shameless measure of clownish fabrication, to portray our people to the rest of the world?

GEORGE ARCENEAUX.

PARK TRAFFIC

NEW ORLEANS.

EDITOR, THE TIMES-PICAYUNE: Dean William Turner's excellent letter regarding land use in Audubon Park brings other points to consider.

With the very attractive Oldtown-Uptown Shopping Center being built in close proximity to the park, further traffic congestion will soon emerge. It is unfortunate that a riverfront expressway was never built to divert traffic away from residential areas. Even a raised overpass above the railroad tracks by Leake Avenue at Broadway would help. I presume traffic lights will be installed before the shopping center is opened not afterward.

Such piecemeal planning for a city the size of New Orleans can only result in vast sums of money wasted as corrections are belatedly made. Citizens become irate, families become divided because of the lack of foresight, and—unfortunately—lack of public interest prevails.

CATHERINE WOLFE.

REFUGEE SCHOOL

EDITOR, THE TIMES-PICAYUNE: I would like to thank you for your editorial of July 9, in which you commended the Jefferson Parish School Board and the Archdiocese of New Orleans for the Vietnamese-American School being conducted here at St. Joseph the Worker in Marrero. I think the people of Metropolitan New Orleans, particularly the Marrero community, also need to be commended for the warm reception they have given the refugees.

Perhaps it is a sign of our growing realization that America is a land of immigrants and in receiving the Vietnamese we are simply receiving the latest arrivals. It is particularly fitting that this should take place as we begin the first month of our Bicentennial year. For the true greatness of our country will be found in our ability to live up to our ideal of being a land where many different races, cultures and religions can come and be truly American without giving up what is most precious to them.

DOUGLAS A. DOUSSAN,
Pastor, St. Joseph the Worker Church.

GOVERNMENT SNOOPS

NEW ORLEANS.

EDITOR, THE TIMES-PICAYUNE: The Internal Revenue Service has now come out with another unsavory report on its spying on the sex and drinking habits of American taxpayers in the Miami area: Operation Sunshine.

Not long ago it was Operation Leprechaun, using informants to probe political corruption in the same area.

Could there be a Bebe Rebozo-Key Biscayne connection?

Since the IRS is involved, and probably has been involved in such un-American activities, and the above is just a minor example that surfaced to take the heat off other operations, then our Congress, the Senate and the House of Representatives ought to get busy and pass some meaningful tax reform legislation to protect the innocent taxpayer against the government that is supposed to serve and not terrorize.

J. ASHTON-GREENE.

NO GRAIN DEAL

HARAHAN.

EDITOR, THE TIMES-PICAYUNE: From all indications, Secretary of Agriculture Earl Butz is about to sucker John Q. Public into another Russian grain deal. Remember the grain deal of 1972? Remember the shape it put this country in? Farmers have not yet fully recovered.

The objection is not selling our excess grain to a foreign country. The objection is allowing Russia to act as a middleman. Russia sold us a bill of goods in 1972 by professing bad crops. Russia bought our wheat for something like $3.64 per bushel and then sold this same wheat to Italy for over $5.54 per bushel. This entailed 800 million bushels of wheat. Multiply this $1.90 profit per bushel by 800 million and get a fair idea how much Russia suckered us...

Rather than face another Russian "flim-flam" let's be sure that our grainaries and silos are full and overflowing before we sell one bushel to Russia or anyone else. Let's also make it understood that Butz is not to overstep his authority. Congress should also be consulted on this deal. It should be made perfectly clear that we are selling Russia this grain for its own consumption and not for resale to any other foreign country. Middlemen we can do without.

JIM MAHONEY.

STATEMENT OF WALTER E. ROGERS, PRESIDENT OF INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

As president of the Interstate Natural Gas Association (INGAA), I have prepared this statement on behalf of the association.

INTRODUCTION

INGAA is a nonprofit industry organization whose membership includes virtually all the major interstate natural gas pipeline companies in the United States. Our member companies today serve all of the lower 48 States, with the exception of Vermont, through an underground pipeline network. They account for 90 percent of the total interstate sales of natural gas and provide the vital transportation link between the gas producer at the wellhead and the distributor who makes final delivery of gas to the consumer.

Natural gas provides 30 percent of our Nation's total energy requirements supplying fuel for househeating purposes for over 33 million customers and over 50 percent of the energy used by American industry.

Gross utility plant of the 81 pipeline companies regulated by the Federal Power Commission (FPC) amounted to $24.7 billion at December 31, 1974, sales revenues for 1974 were $11.6 billion and annual sales of natural gas were 17.9 trillion cubic feet in 1974 [1]

INDUSTRY EFFORTS TO MEET THE SHORTAGE OF NATURAL GAS

We have a serious gas shortage in the United States. The problem of curtailments of natural gas has increased sharply in the last 2 years.

To counter this trend the pipeline industry embarked on numerous massive projects to use naphtha, natural gas liquids and gasification of coal as synthetic gas to augment natural gas supplies. In addition large quantities of natural gas have been discovered in the artic regions in Alaska. The cost of these announced projects alone equal the present investment in facilities by the pipeline industry. As other projects become feasible, the total expenditures undoubtedly will exceed $50 billion. As presently structured and regulated, the natural gas industry simply will not be able to finance them.

THE DIMENSIONS OF THE FINANCING PROBLEM

The report of the FPC's National Gas Survey [2] projected the capital requirements of the gas pipeline industry for the 1970–90 period at $81.5 billion to provide a 2-percent growth and $237.4 billion to provide a 5 percent growth to supply the Nation's gas requirements. To put these projections in prospective, the gas pipeline idustry faces capital requirements between four and nine times as large in the 1970–90 period as its present investment in utility plant of approximately $25 billion.

THE FINANCIAL CONDITION OF THE GAS PIPELINE INDUSTRY

The natural gas pipeline industry, like other industries, is faced with the problems of high capital costs and shortages of available capital and, in addition, is faced with two basic disadavntages in competing with other industries for capital: (1) investor concern with regulatory policies and regulatory lag; and (2) investor concern with the availability of natural and synthetic gas to maintain or increase authorized delivery volumes.

The natural gas transmission industry has had a higher ratio of debt to equity than other regualted and nonregulated industries. The composite debt ratio of major pipelines of approximately 57 percent compare to the general range of 20 percent to 30 percent for manufacturing companies, approximately 45 percent for the Bell System and 50 percent to 55 percent most of the major electric and gas distribution systems.

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[1] Statistics of Interstate Natural Gas Pipeline Companies, 1974, Federal Power Commission.

[2] National Gas Survey, volume III, 1973, page 354.

It appears that convenants in pipeline debt and preferred stock securities restricting total debt, dividends and other expenditures, requirements as to the ratio of earnings to fixed charges or interest coverage tests will inhibit a major infusion of capital in the form of long-term debt or preferred stock thus forcing the industry to seek additional common equity. The natural gas transmission industry is approaching all of these extremely competitive capital markets in the decades ahead with substantially less financial flexibility than other regulated or nonregulated industries.

In addition to the rate return on investment, the investor is increasingly aware of the change in the industry's gas reserve life index which declined from 27 years in 1950 to approximately 11.9 years in 1970 and has a somewhat shorter life today. Without additional cash flow from depreciation and an improvement in rate of return, raising additional capital will be very difficult in the decades ahead.

THE SITUATION CURRENTLY FACING THE GAS PIPELINE INDUSTRY

Inflation has taken its toll of all industry but more so in the case of the capital intensive gas pipeline industry because of the necessity to seek new sources of gas during a period of extreme capital shortage. The natural gas industry is also subject to two other conditions mentioned previously, namely, investor concern over regulatory policies and regulatory lag, and investor concern over future availability of gas supplies.

What can be done to meet the vast need for capital funds to finance future gas supply projects?

The answer is to make investment in energy companies more attractive. First, we are endeavoring to convince the FPC to provide a greater percentage of funds generated internally for reinvestment. This would include FPC approval of higher rates to cover increased book depreciation, the cost of money expended during construction periods and a more realistic return on common equity. Second, we encourage this Committee to provide the tax incentives that are a most important element of any national energy policy designed to increase the supply available to industry and the general public.

RECOMMENDATIONS

INGAA urges this committee to take favorable action on the following matters:

Provide a permanaent investment tax credit of 12 percent on all energy projects.—The investment tax credit has proved to be an effective incentive to invest in facilities to modernize and boost production capacity. One of the deficiencies of the tax policy has been the on and off effect of the investment tax credit. Long-term commitments to capital expansion programs cannot be stimulated unless the investment tax credit is made permanent. Such a permanent credit can also be utilized as a reduction in the demand for outside capital and would be an important step in bringing into existence supplement fuel sources such as liquefied natural gas, synthetic natural gas and coal gasification.

Provide for faster recovery of investment through increased depreciation and amortization allowances.—The replacement of production capacity is a major concern to capital intensive industries and often a conflict between the taxpayer and the uniform application of industry averages which the Internal Revenue Service uses. More flexibility is needed. This might be accomplished by an optional capital recovery system over a 5 to 10 year period or an increase in the asset depreciation range (ADR) from 20 percent to 40 percent. Thus, those taxpayers such as natural gas pipelines would have the additional cash flow available for new source of gas supply.

Provide for the deductibility of startup costs of energy facilities.—There is concern that the present law is not sufficiently clear on this point. In the view of the extremely high costs and long leadtimes of new energy facilities, it is important that the present law be clarified in order that these facilities not be delayed to await clarification in the courts.

Eliminate double taxation of dividends.—The double taxation of corporate earnings on the corporate and shareholder levels has had adverse effect on corporate financing. In addition to other adverse effects, the nondeductibility of dividend payments has encouraged extensive use of debt, creating undesirable debt equity ratios. To make equity securities more attractive and to enable industry to accumulate necessary capital in the future, this deterrent to capital formation should be eliminated.

In testimony before this committee on March 17, 1976, Secretary Simon suggested a phaseout of the double taxation using a corporate level deduction and a stockholder credit. The stockholder credit would increase the attractiveness of equity investments and would facilitate capital formation. The corporate deduction would not provide capital formation for regulated utilities, however, for regulatory commissions it will undoubtedly require that the benefit be flowed through to the customers in the form of reduced rates. Thus, the integration of corporate and individual taxes would best be achieved solely through the stockholder credit.

Continue the full deductibility of intangible drilling and development costs for individuals.—The limitations on these costs as provided in H.R. 10612 would reduce the capital available to the independent producers many of whom depend on individual investors as a source of capital. Drilling oil and gas wells is a high risk venture and requires a high return which historically has included tax incentives. Faced with a regulated price on the product and a reduction in tax incentives, these investors are likely to choose alternative investments. We view this as a step backward in the continuing effort to find new sources of natural gas.

CONCLUSION

Both the Congress and the administration are attempting to establish an energy policy for the Nation, which will make us less dependent upon the political and economic policies of other countries. We believe the actions taken by this committee will have a substantial impact upon the ability of our industry to continue to meet the energy policy of this Nation.

Many of the industry's critics would label our recommendations for incentives as loopholes. We are confident that the committee will see through such mislabeling and recognize that incentives are essential to maintaining our Nation's supply of energy and a healthy economy.

STATEMENT OF THE FINANCIAL EXECUTIVES INSTITUTE

(1) CAPITAL FORMATION

FEI believes that the substantially increased level of capital investment by business that will be required over the next decade should be encouraged by the following capital formation provisions:

1. A flexible capital-recovery allowance system permitting capital investments in machinery and equipment to be recovered over as short a period as 5 years, a substantial reduction in the capital recovery period for industrial buildings, with recovery in both cases starting as progress payments on new construction are incurred.
2. A permanent 12-percent investment credit.
3. Immediate writeoff of pollution control expenditures at the taxpayer's election.
4. Steps toward alleviating double taxation of corporate distributions.

These changes are needed in order to provide adequate employment opportunities for a growing labor force, to reduce inflationary pressures by increasing capacity to meet consumer demands, to replace and modernize obsolete and wornout facilities, to develop new energy sources, and to meet environmental and safety standards.

The hugeness of the capital requirements with which we are faced is apparent from separate studies recently carried out by General Electric Co.[1] and the New York Stock Exchange.[2] In these studies, gross private domestic investment (including residential structures and inventory accumulation as well as business fixed investment) for the period 1974 to 1985 is estimated to be about $4.5 trillion—three times the $1.5 trillion total for the previous 12 years. Even when stated in current dollars to eliminate the effect of inflation, the 1974 to 1985 requirement is still roughly 1.5 times greater than that of the prior period.

The critical problem.—The critical problem to be overcome, if these projected capital requirements are to be met, is that of providing funds in such large amounts. For example, the New York Stock Exchange study previously referred to projected a potential capital shortfall of $650 billion through 1985. Contributing to the problem is the fact that the ability of American industry to generate funds has been seriously inhibited by the deterioration of real corporate profits due to inflation and by an increased reliance on debt financing.

Analyses prepared by the Department of Commerce indicate that although corporate profits were widely reported as "record breaking" in 1974, "real" profits, after adjustments for inventory profits and

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[1] Business Capital Requirements—1974–1985; by Reginald H. Jones; Financial Executive: November 1974.

[2] The Capital Needs and Savings Potential of the U.S. Economy; The New York Stock Exchange: September 1974.

underdepreciation of assets, actually declined to the lowest point in a decade. While reported profits of nonfinancial companies for 1974 totaled $65.5 billion compared to $38.2 billion in 1965, an apparent 71-percent increase, real profits when adjusted for inflationary factors actually declined by 50 percent, and this despite a substantial population increase.

If retained earnings available for reinvestment by business are restated on the same basis to account realistically for inventories and depreciation, a decline is noted from $20 billion in 1965 to $6 billion in 1973—a period in which real gross national product (the total economy) grew 36 percent. For 1974, the preliminary figure for undistributed profits was a negative $10 billion.

The deterioration of real business profits and retained earnings, along with the depressed state of the equity markets, has forced corporations to rely more and more on debt financing. While in 1960 debt financing constituted only 24 percent of the capital raised by nonfinancial corporations, the figure had increased to 37 percent in 1970, 48 percent in 1973, and in 1974 it increased to 54 percent of the total.

Effects of tax policies.—Federal tax policies affect capital investment decisions by determining the aftertax earnings and cash flow available for investment and by establishing incentives or disincentives for future investment. Recognition of the important role played by such policies in helping business to generate internal funds to finance capital investment led to the enactment of accelerated depreciation in 1954 and the investment credit in 1962, the issuance of the depreciation guidelines in 1962, and the asset depreciation range (ADR) system in 1971.

Despite these changes, American businesses still have a competitive disadvantage compared with other leading industrial countries, which have generally adopted more favorable capital recovery allowances than the United States. An American firm using both ADR and the investment tax credit can recover 54.7 percent (or 60.7 percent with the temporary 10-percent credit) of the value of new investments over the first 3 years. By comparison, the allowances in other nations within the first 3 years are as follows:[3] Canada—100 percent; France—67.5 percent; Italy—67.9 percent; Japan—63.9 percent; United Kingdom—100 percent; West Germany—49.6 percent.

In addition, depreciation allowance based on historical costs have been seriously eroded by inflation and are thus inaequate to provide funds for replacements of existing assets. In an article published by Machinery and Allied Products Institute in December 1974, entitled "Inflation and Profits," George Terborgh makes a comparision on current cost double-declining balance depreciation of nonfinancial corporations with depreciation allowed them for income tax purposes for the years 1965 to 1973. Mr. Terborgh's analysis shows an understatement of capital costs for 1973 of $9.3 billion and a cumulative understatement of $43.1 billion over the 9-year period. The comparable figure for 1974, based on 9-month actual, was $11.2 billion.

[3] "The Treatment of Capital Recovery Allowances in the United States and Other Countries," by B. Kenneth Sanden and Charles T. Crawford; International Tax Journal, May 1975.

A prime example of an industry suffering from the erosion of depreciation allowances by inflation is the steel industry. The extent to which inflation has deflated the dollars recovered by the steel industry through statutory capital recovery allowances since 1953 is graphically set forth by the American Iron & Steel Institute in its revised study entitled "Steel Industry Economics and Federal Income Tax Policies" (June 1975). This AISI study projected a trend of steadily increasing deficiencies in statutory allowances.

Another drain on available funds is the demand for capital to protect the environment which has been steadily increasing and can be expected to continue to increase in the future. According to a Bureau of Economic Analysis survey conducted in November and December 1973 and reported in Survey of Current Business, July 1974, nonfarm business spent $4.9 billion for air and water pollution abatement plant and equipment in 1973 and planned to spend $6.5 billion in 1974. These amounts represented 4.9 percent and 5.8 percent, respectively, of total expenditures for new plant and equipment.

Pollution control expenditures are obviously different from those made for productive facilities. Even though resulting in physical property, they are generally not income producing and, in addition, increase annual operating and maintenance costs.

The magnitude of future capital investment needs, the projected shortfalls in available capital funds, the impact of inflation, the rapid pace of technological change, and the growing intensity of competition from foreign industries—much of which is subsidized by their governments—pose a tremendous threat to our continued economic well-being.

Lagging capital formation and economic growth.—On May 7, 1975, Secretary of the Treasury William E. Simon presented testimony before the Senate Finance Committee on the subject of our capital investment needs for the future, in which he drew upon an abundance of documentary evidence showing that the United States has not been keeping pace in its capital investments and that we must devote more of our resources to this purpose if we are to achieve our most basic economic dreams for the future.

Mr. Simon's statement included statistics which demonstrated that during the period 1960 through 1973:

> Total U.S. nonresidential fixed investment as a share of real national output ranked last among a group of 11 major industrial nations. The U.S. investment rate of 13.6 percent lagged 5.8 percentage points below the average of the entire group.
>
> The average annual rate of real economic growth for the 20 nations belonging to the Organization for Economic Cooperation and Development (OECD) ranged from a high of 11.1 percent for Japan, to a median of about 5 percent for Australia, the Netherlands and Norway, to a low of 2.8 percent for the United Kingdom. The United States during this time experienced an average growth rate of 4 percent a year—17th among the 20 nations.
>
> The United States experienced a 3.3-percent average annual growth in productivity based on manufacturing output per man-hour. This rate was the lowest of the 11 major OECD nations, which had an average growth of 6.1 percent.

Mr. Simon's summarization of the record included the following comments:

> As other nations have channeled relatively more of their resources into capital investment and have acquired more modern plants and equipment, they have eroded our competitive edge in world markets.

Our record on capital investments reflects the heavy emphasis we are placing on personal consumption and Government spending as opposed to savings and capital formation.

Our record also reflects a precipitous decline in corporate profits since the mid-1960's.

While the U.S. economy remains sufficiently large and dynamic to overcome our investment record of recent years, our future economic growth will be tied much more directly to the adequacy of our capital investments.

Estimates of future needs vary, but it is relatively clear that in coming years we will have to devote approximately three times as much money to capital investment as we have in the recent past.

It is an economic fact of life that increased productivity is the only way to increase our standard of living. For the sake of future economic growth—jobs, real income, and reasonable price stability—the inescapable conclusion is that Government policies must become more supportive of capital investment and that we must make a fundamental shift in our domestic policies away from continued growth in personal consumption and Government spending and toward greater savings, capital formation and investment.

Mr. Simon's testimony before this committee on March 17 reaffirmed the difficulties which our Nation will face in the absence of adequate capital investment.

Recommendations.—In order to meet the long range challenge thus posed, business must be permitted to develop the capability to more effectively modernize its productive capacity by assurance of the availability of an adequate supply of capital funds. Financial Executives Institute believes that the most effective way to provide such funds is through realistic Federal income tax treatment of capital costs, from the standpoint both of allowance for capital recovery and of other sources of capital investment, such as reinvestment of earnings. We recommend the following:

1. Depreciation reform.—Depreciation charges based on historical costs have been seriously eroded by inflation and are thus inadequate to provide funds for replacements of existing assets.[4] The allowance of price-level depreciation would recognize the loss of purchasing power through inflation. Although it would not fully negate the effects of inflation for all industries, the adoption of a flexible capital cost recovery allowance system in lieu of the present rigid concept of depreciation allowances should be adopted as an alternative to price-level depreciation. This concept should encompass the ultimate goal of permitting taxpayers to amortize (for Federal income tax purposes) capital costs at rates to be determined at their discretion over as short a period as 5 years (1) using accelerated depreciation methods and (2) an investment credit based upon the useful life which would be available if in lieu of the election the taxpayer depreciated the property under other available methods. Industrial buildings should be included because they are an essential part of the industrial activity and are frequently integrated with the equipment they house. It is also recommended that in cases of the construction of long leadtime property capital recovery should be permitted to start as progress expenditures are incurred, rather than waiting until the time the property is placed in service. We endorse any meaningful and substantive Federal income tax policies which move toward those objectives.

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[4] In some other countries, up to 150 percent of the cost of assets may be recovered, as an additional incentive for capital investment.

2. Investment credit.—The investment tax credit has gained acceptance as a vital element of capital formation. Its effectiveness throughout the years has been diluted, however, by its suspension on one occasion and termination on another. In addition, there have been recurring suggestions that a variable rate be applied so as to convert it to a countercyclical fiscal tool. In many cases large scale capital projects must be planned on an international basis and the completion may cover several years. Rational capital investment planning is very difficult if periodic changes in the investment tax credit must be anticipated. In the absence of any congressional action, the rate will revert to 7 percent at the end of this year. If the investment credit is to effectively accomplish the objective of encouraging capital formation, it should be retained as a permanent feature of the tax laws, preferably at a 12-percent rate.

The Congress has already taken a major step in improving the effectiveness of the credit by providing that it is allowed in limited cases as expenditures are made, rather than when the facilities are placed in service at a later date. A logical extension of this action to cover all qualified expenditures as they are made would not result in any overall reduction in the Federal revenues, but it would increase the effectiveness of the credit and remove some of the complexity in the current law.

3. Pollution control expenditures.—Because the demand for capital to protect our environment has proven to be a tremendous drain on resources available for investment in productive facilities, more realistic tax treatment of expenditures for pollution control facilities should be enacted.

Congress has previously recognized that special treatment for pollution control facilities is appropriate, and it provided for the amortization of the cost of these facilities over a 60-month period. That provision expired at the end of 1975. This treatment, however, for all practical purposes, proved to be ineffective for many industries, because the investment tax credit was not available for the cost of facilities for which taxpayers elected the 5-year amortization allowance.

What Congress should now do is to enact legislation which would permit all expenditures for air and water pollution control facilities to be deductible as incurred, since these expenditures are not capital in nature because they neither prolong the life of the related asset nor do they add to productive capacity. Most significantly, they are generally not income producing. Therefore, there is no basis in the traditional concept of matching costs and revenues for requiring the amortization of the related costs over a protracted period. If the current deduction cannot be enacted immediately, then an interim step should be taken to reduce the recovery period, while allowing accelerated methods of depreciation and the full application of the investment credit.

Congress should also define "pollution control facility" more precisely so the incentives will not be denied by unduly restrictive administrative interpretation.

4. Double taxation of corporation earnings.—Contributing significantly to the present capital shortage is the impact of the U.S. tax system on corporate shareholders. This system is inequitable, indeed, it is punitive because it imposes a double tax on distributed corporate earnings—first on the corporation at its full income tax rate and again on its shareholders—as ordinary income at individual income tax rates. This heavy tax burden on equity capital results in a bias in favor of debt financing, which is reaching its economic limit as related to equity. Furthermore, this imbalance has contributed to the current high rate of inflation so that an additional infusion of equity is necessary to assure continued availability of debt financing at reasonable cost and to retard the current inflationary trend. An acceptable means of reducing the tax on corporate profits is necessary if we are to significantly reduce the present bias against capital formation.

The double taxation of corporate profits can be eliminated or mitigated at either the corporate or the shareholder level. Provisions which would fully or partially redress double taxation at the shareholder level would include:

A partial or total tax credit or income exclusion for dividends received by shareholders;

An imputation system wherein the shareholder receives a credit for a pro rata portion of the taxes paid by the corporation in which he holds stock, such as is presently in effect in France and Belgium; or

A procedure whereby a shareholder may defer the payment of tax on any dividend which is reinvested in stock of the paying corporation.

At the corporate level, techniques for mitigation of double taxation include:

A split rate system whereby profits that are distributed are taxed at a lower rate than earnings that are retained in the business, such as has been adopted in Germany; or

A credit against tax liability for all or a portion of dividends paid by a corporation, or a total or partial deduction from taxable income for dividends paid by a corporation.

In considering a statutory change with respect to the taxation of dividends, it is important that two points be kept firmly in mind. First, the most direct and quickest way to get an infusion of funds for equity investment would be to grant relief at the corporate level. Second, the initial adverse effect upon revenues resulting from a reduction of corporate tax collections would be more than offset by higher personal income tax collections due to payment of higher dividends, to the faster reinvestment of corporate funds in job-creating capital facilities, and to higher corporate tax collections as the additional facilities increase corporate income.

(2) (A) CURRENT TAXATION OF UNREMITTED INCOME OF CONTROLLED FOREIGN SUBSIDIARIES

FEI believes that any attempt to change the tax laws so as to tax currently unremitted earnings of foreign subsidiaries of U.S. companies would upset tax neutrality, make competition by U.S. companies in foreign countries unprofitable, would not in the long run improve funds flows and would, in sum, damage the U.S. economy.

Effects of multinationals' operations.—Multinational corporations have been the mainstay of the United States' role as a leader in international economic development. Public and private studies clearly demonstrate that the operations of U.S. multinationals produce net balance-of-trade surpluses of several billion dollars each year; that overseas investments raise U.S. exports, and that repatriated profits earned from overseas investments contribute many billions of dollars to the U.S. balance of payments.

From 1961 through 1972 U.S. direct investors received $61.5 billion in interest, dividends, and branch earnings and $14.6 billion in direct investment fees and royalties for a total of $76.1 billion. These balance-of-payments receipts compared with $33.9 billion of capital outflows for a net balance of payments advantage to the United States of $42.2 billion.

To an important extent, the economic health of the United States depends upon the economic health of its multinational enterprises. Their domestic sales account for one-third of total sales of U.S. manufacturing firms. They perform two-thirds of the privately funded industrial research and development performed in the United States. In addition, foreign investments by U.S. multinationals have increased domestic employment. An emergency committee for American Trade survey revealed that in the 1960's, 74 leading multinational manufacturing companies expanded their U.S. employment by 36.5 percent. The net remitted earnings (total remitted earnings minus total foreign direct investment) of the key American firms with foreign direct investments have, for a recent 5-year period (1967–1971) provided the capital to create or maintain more than 200,000 U.S. jobs.

Present tax provisions regarding foreign source income.—The present U.S. system of taxation of multinational businesses has as its basic objectives:

Equal taxation of U.S. taxpayers having the same amount of income regardless of national origin.

Tax neutrality as to making decisions whether to invest at home or abroad.

Under its present neutral system, the United States taxes its nationals or residents on their worldwide income. Only income actually realized by the taxpayer is subject to taxation.

Foreign taxes cannot be credited against U.S. tax with respect to income earned in the United States.

Defects in reasoning for change.—Considerable confusion exists today over longstanding tax principles that are intended to achieve tax neutrality as contrasted with tax incentives that Congress has seen fit to enact for purposes of stimulating the economy, stimulating export trade, or helping to redress an adverse balance of payments.

The so-called deferral of tax on the earnings of foreign corporations is not a tax incentive nor a loophole. It is not a part of our tax laws but is a basic, well-established principle of corporate law.

Any corporation, including a foreign subsidiary, is a separate and distinct entity from the shareholder and no taxable incident can occur until there is a transaction between the two, such as a dividend. To argue that the earnings of a foreign subsidiary should be currently subject to tax in the hands of a U.S. shareholder is to totally disregard the legal foundation of a corporation. The United States has no jurisdiction over the foreign entity so, in reality, such a proposal, if enacted, would be a penalty on U.S. shareholders in foreign corporations. Then, why not the same penalty with regard to domestic corporations? Would corporate losses also flow through to the shareholder?

The proposal could result in disaster for investments in foreign entities, while the existing law, with the so-called deferral of taxes on the undistributed earnings of foreign subsidiaries, is a clear example of tax neutrality. The present law provides neither an incentive nor a disincentive to U.S. companies to make foreign investments. Moreover, in many cases the earnings are undistributed simply because foreign subsidiaries are restricted from paying substantial dividends by their local laws.

Taxing undistributed profits of foreign subsidiaries would make it difficult for American-owned companies to compete effectively with European, Japanese, or other foreign-owned firms operating in countries with a foreign rate of taxation less than the 48-percent U.S. rate, usually in the developing countries. Foreign operating subsidiaries of U.S. companies compete directly with local foreign industry and would pay the local foreign income taxes. To subject these subsidiaries to an additional U.S. income tax on their undistributed profits would dry up their funds available for reinvestment in replacement plant and equipment. They would be forced to more costly external borrowing to finance either replacement or expansion equipment. This would gradually erode their competitive position in the local market and ultimately force withdrawal from it.

Contrary to current misconceptions, the present tax provisions do not provide a bias toward investment abroad. The effective tax rates in the principal countries in which U.S. foreign investment is concentrated are generally the same or higher than the U.S. tax rate.

Furthermore, even over the short term, there is no certainty that the current taxation of unrepatriated earnings of a foreign subsidiary would necessarily result in a flow of funds to the United States for investment in the United States. If a foreign manufacturing subsidiary has, after paying local foreign taxes at rates less than the U.S. rate, reinvested its aftertax earnings in needed plant and equipment, the foreign subsidiary will not be able to make a dividend distribution to the United States to pay some new U.S. tax on its unremitted earnings. Instead, the U.S. parent company would probably find it necessary to pay the additional U.S. tax from its domestic funds, thereby reducing the funds available for new U.S. investment in plant and equipment.

Over the long run, it is even clearer that the proposal to currently tax undistributed earnings of foreign subsidiaries would have an adverse impact on the U.S. economy. Proposals such as amendment No. 161 offered by Senator Hartke to the Tax Reduction Act of 1975 would violate the existing principle of tax neutrality and would place U.S. business at a substantial competitive disadvantage in world trade. Ultimately, this competitive disadvantage would be reflected in a curtailment of U.S. investment abroad with a resulting impact on export sales from the United States and a larger potential loss of U.S. jobs. It seems inconceivable that the Congress would knowingly enact a measure which would place American business at a substantial competitive disadvantage in world trade, that would violate the principle of tax neutrality which has existed for so many years in our tax laws, and that would mistakenly rationalize this potentially disastrous economic result as the "removal of a tax incentive" or as a "loophole closer."

(2)(B) FOREIGN TAX CREDIT

FEI believes that any dilution or elimination of foreign tax credit would place U.S.-based multinationals at a competitive disadvantage vis-a-vis foreign based, foreign controlled businesses, with a resultant adverse effect on U.S. jobs, U.S. exports, and U.S. balance of payments.

Present U.S. tax provisions.—Under present law, the United States taxes the worldwide income of any domestic corporation. A U.S. taxpayer who pays foreign income taxes on income from foreign sources is allowed a foreign tax credit against his U.S. tax on the foreign source income. A credit (usually called the deemed-paid credit) is also allowed with respect to dividends received from foreign corporations operating in foreign countries and paying foreign income taxes. This credit system is based on the principle that the country in which business activity is conducted has the primary right to tax the income from that activity and the home country has a residual right to tax such income, but only so long as double taxation does not result.

Tax neutrality.—Most other industrial nations, including the United Kingdom, Germany, Canada, and Japan, also use the credit system to avoid double taxation of income, although some countries (e.g., France and the Netherlands) avoid double taxation by exempting all income from foreign operations. The credit system follows the general taxing principle of tax neutrality.

Hardship of change.—The overall tax rate applicable to income received from foreign sources is usually the higher of the foreign income tax rate or the U.S. rate. If the foreign tax credit should be terminated (and foreign taxes allowed only as a deduction against taxable income), the total tax burden on foreign source income received by a U.S. company would be increased by approximately 50 percent of the foreign rate. In many areas, this means the total income tax rate on foreign earnings would approximate 75 percent, since corporate tax rates in developed countries are generally comparable to the U.S. rate.

U.S. companies would be placed at a severe competitive disadvantage if their profits from foreign business activities were taxed at 75 percent while their foreign competitors earnings were taxed at significantly lower rates. Eventually, this competitive disadvantage would undoubtedly lead to the closing of U.S. companies foreign manufacturing facilities and this in turn would cause a substantial reduction in exports which usually accompany such foreign activities. The ultimate result would be the loss of jobs in the United States.

Accordingly, we believe that the foreign tax credit should be maintained in its present form to mitigate the inequities of double taxation and to permit U.S. business to compete on an equal footing in foreign markets—thus supporting and creating U.S. jobs and U.S. exports with a resulting favorable impact on the U.S. balance of payments.

(2)(C) DISC

FEI believes there should be no further erosion of DISC benefits. The basic purposes of DISC when enacted into law in late 1971 were to (*a*) create more U.S. jobs, (*b*) stimulate the U.S. economy, (*c*) increase the efficiency of U.S. production for both domestic and foreign markets, (*d*) provide U.S. tax treatment of export income more comparable to that afforded exporters of other countries (e.g., exemption from VAT), and (*e*) improve the U.S. balance-of-payments position.

Since DISC was enacted into law, U.S. exports have increased dramatically from $43 billion in 1971 to $107 billion in 1975. It is not possible to quantify the specific contribution of DISC to this improvement, because of the various factors affecting international trade. However, there should be no doubt that the DISC provision has contributed to this dramatic growth in U.S. exports with its favorable impact on U.S. jobs which has helped to soften the impact of a depressed domestic economy. The Commerce Department has estimated that $7 to $9 billion of increased export sales in 1974 were attributable to DISC and that these increased sales created 280,000 to 360,000 export-related jobs. DISC has been beneficial as a means of financing export-related receivables during a period when business has been facing a liquidity problem. Without that, such a level of exports could not have been sustained.

The considerations which resulted in passage of the DISC legislation in 1971 are even more valid today as the U.S. strives to revitalize its economy in the face of increased costs of energy-related imports and increased competition in world markets by foreign producers supported by governmental export-related programs of their own countries. Any further erosion of DISC benefits would adversely affect the competitive position of U.S. exporters vis-a-vis foreign competitors who receive benefits of incentive programs of their countries. It would increase their future export sales, with a resultant adverse effect on U.S. jobs. The importance of DISC to U.S. export trade is evidenced by the action being taken by GATT members protesting this U.S. legislation.

(2) (D) EXCLUSION OF INCOME EARNED ABROAD BY INDIVIDUALS

This statement is submitted to set forth the position of FEI with regard to the provisions of H.R. 10612 as they relate to the taxation of income earned abroad. For the reasons described below, FEI does not believe that such provisions of the bill should remain as is. FEI has also set forth its recommendations for alternative tax measures should it nevertheless be determined that the current statutory treatment of income earned abroad requires modification.

Statutory proposal.—In general, section 911 presently provides that a U.S. citizen (and in certain cases a resident alien) who is a bona fide resident of a foreign country or who is present in a foreign country or countries for at least 510 days during an 18-month period may qualify for exemption from U.S. income tax on either $20,000 or $25,000 of earned income per year. Section 1011(a) of H.R. 10612 would phase out the exemption over a 3-year period so that section 911 would be repealed for years after 1978. During the 3-year period that the exemption would remain applicable in modified form, the proposed statute would assure that the foreign income taxes allocable to the excluded income could not be used as either a credit or deduction. Finally, to alleviate some of the hardship resulting to taxpayers working abroad, special statutory provisions would be made to permit deduction of certain expenses for tuition costs for dependents and municipal type facilities and service provided by the employer.

Economics of working abroad.—The repeal of section 911 would have a severe impact on the ability of U.S. enterprises to maintain qualified personnel abroad at a time when it is essential that there continue to be an American presence to supervise and administer our foreign operations. It is generally recognized that the cost of living for a U.S. citizen working abroad and the additional nonbusiness travel expenses incurred for the employee and his family are substantially higher than the costs that the employee would have incurred in comparable employment in the United States. Moreover, the economic value of the income received is often overstated due to the fact that many foreign economies are less stable than ours and the foreign currency which must be used locally may be subject to constant variation through exchange rate fluctuations. Although the House Ways and Means Committee took note of some of these hardships, it stated its belief that similar conditions and variations exist within the United States. In the experience of FEI member companies, however, the American employee working abroad would seldom be able to maintain the same standard of living that he would enjoy in the United States if compensated solely at the salary level for the equivalent job in the United States.

U.S. corporations actively involved in overseas projects must pay a premium above U.S.-base salary in order to secure qualified U.S. personnel in locations where qualified local personnel are unavailable. Thus, most corporations provide an "uplift" of as much as 25 percent of the U.S. net "after-tax" base as well as allowances for living and education expenses which are necessary to equate the living standards of U.S. employee overseas with their counterparts in the United States. All of these payments are includible in gross income for U.S. income tax purposes and, absent the benefits of section 911, would substantially increase the employee's tax burden even though his economic position has not changed. Moreover, due to the progressive nature of our income tax system, this income which lacks real economic value to the employee will be taxed at an increased marginal rate. A similar result will generally occur in connection with the foreign income tax rates applicable to the compensation received by the employee residing in a particular foreign country.

The difficulty in maintaining U.S. staff personnel abroad can only be accentuated by the repeal of section 911. If U.S. industry instead attempts to retain U.S. staff abroad but is compelled to increase its salary incentives to these employees, the additional cost factor will lessen cost competitiveness and place U.S. corporations at a definite disadvantage in competing with foreign business. In turn, there would be a potential loss of performance of related services in the United States as well as a potential adverse impact on export sales of U.S. goods.

It is noteworthy that while much can be offered in support of section 911 little can be offered of substance to support its repeal. Certainly, the impact of its repeal as a revenue-producing measure is not significant.

Potential for abuse unfounded.—The House Ways and Means Committee referred to the potential abuse of section 911 by using foreign tax credits related to excluded earned income to offset U.S. tax liability attributable to nonexcluded income. The Ways and Means Committee in its report concluded that the present exclusion may apply to as much as $40,000 or $50,000 of income. It is respectfully submitted that such is not the case. Section 904 limits the use of foreign tax credits so that only the U.S. income tax attributable to foreign source income will be subject to offset by the foreign tax credit. In order for the U.S. foreign based employee to be able to take full advantage of his foreign tax credits, he must derive an additional $20,000 or $25,000 of foreign source income not subject to foreign tax. Since his earned income is presumably subject to foreign tax, this would require that such amounts be accumulated through activities not related to his employment such as investment income. It is highly unlikely that many employees will have sufficient capital to generate such amounts of foreign source income and, even if so, be able to assure that such income is free from foreign taxation.

If the Congress believes a potential for abuse of the section 911 exclusion exists, the proper remedy would be to deny the foreign tax credit as to the portion of foreign taxes allocable to the excluded income. This, in fact, is what the proposed bill does during the 3-year phaseout period. To elimiate the section 911 exclusion itself is tantamount to killing the patient in order to cure the disease.

The Ways and Means Committee also referred in its report to the fact that many U.S. employees are not subject to foreign taxation either because the country of residence imposes no tax or because methods are employed to avoid foreign taxation (e.g., remittance to a bank account outside the country of residence). Whether in fact this is a wide scale practice is not established. In any event, it appears to be a dubious reason to repeal section 911. If no foreign tax is paid, then the abuse of foreign tax credit provisions is without substance. Moreover, avoiding foreign income taxes does not mean lesser U.S. tax payments; in fact, it could mean the taxpayer would pay a larger U.S. tax.

There would appear to be no sound basis to repeal section 911. It is a reasonable measure providing relief to taxpayers who are placed in a disadvantageous economic position.

Alternative proposal.—In the event that Congress nevertheless determines to repeal section 911, FEI proposes that additional forms of tax relief for U.S. personnel working abroad are necessary. Although the provisions for deduction of tuition expenses and exclusion from income of municipal type facilities provided to the employee are appropriate, they are insufficient to alleviate the problems faced by U.S. taxpayers working abroad. Therefore, it is proposed that a new statute be enacted providing U.S. citizens working overseas for more than a short period with a special deduction in the nature of a cost-of-living allowance.

It is recognized that the drafting of such legislation would be difficult. However, the problems are not insurmountable and the benefits outweigh the potential difficulties in implementation. A special deduction could be allowed as a percentage of earned income, the particular percentage for various geographical areas being in the discretion of the Treasury and being dependent on the numerous economic indicators which are readily available.

Alternatively, a more subjective statute could be enacted permitting a deduction for those expenses which would not have been incurred by the taxpayer's counterpart working in the United States. Items which could be included are costs incurred to comply with foreign income tax laws, moving expenses in excess of the generally applicable limitation on moving expense deduction, overseas living allowances, emergency medical coverage, personal security measures and transportation expenditures which are incurred as a result of an employee being located abroad. Also included should be the two factors covered under the proposed legislation.

(2) (E) REPEAL OF PER-COUNTRY LIMITATION AND RECAPTURE OF FOREIGN LOSSES

FEI opposes section 1031 and 1032 of H.R. 10612 which, in the foreign tax credit area, would repeal the per-country limitation and would provide for the recapture of foreign losses. These two sections of the House bill are inextricably bound together and, if enacted, would further increase the tax burden on U.S. business operating abroad.

Per-Country Limitation.—Under present law, a U.S. taxpayer is allowed a foreign tax credit against the U.S. income tax attributable to foreign source income. To prevent a U.S. taxpayer from using the credit to offset U.S. income tax not attributable to the foreign source income, there are currently two alternative limitations provided (sec. 904)—the overall and the per-country limitations.

The per-country limitation, originally enacted into law in 1932, is the method which is applicable unless an election to use the overall method is made. In concept, the limitation treats a taxpayer's income as being divisible into separate categories based on the country from which the income was derived, with the limitation being computed separately for each of such categories. The election to use an overall limitation, enacted in 1960, was passed by Congress to permit a taxpayer to have the option of treating its foreign profits as a single category of income instead of breaking down such income based on the country of source. If the overall election is made, it can be revoked only with the Commissioner's consent. Thus the option is not changeable from year to year.

Congress provided the two alternatives because of the infinite variety of business circumstances which may arise in the course of international operations. Recently, however, certain economists have decided that one of the other limitation is subject to abuse. Unfortunately, the specialists cannot decide which method should be eliminated. H.R. 10612 has adopted the position that the per-country limitation should be repealed. FEI recommends that there be no change in the present law, thus allowing taxpayers to make the initial choice of the limitation best suited for their circumstances. Over the years, the varying conditions will balance the respective advantages of disadvantages of the particular option chosen.

Recapture of foreign losses. In addition to the repeal of the per-country limitation, H.R. 10612 would also provide that to the extent of the net foreign source loss derived in a given year a portion of the foreign source income derived in subsequent years would be treated as U.S. source income for purposes of computing the tax credit under the overall limitation. The proposal is intended to protect against a taxpayer deriving a double benefit from the foreign loss by having such loss offset U.S. source income when computing the U.S. tax liability.

FEI, however, submits that the potential abuse is of limited applicability to a *de minimis* number of taxpayers. First, most foreign activities of U.S. taxpayers are conducted through subsidiary operations, as reported in 1975 by the "House Ways and Means Committee Prints on Taxation of Foreign Income". No deduction is available to the U.S. taxpayer for losses derived by the foreign subsidiary. Moreover, the loss reduces subsequent profits otherwise available for remittance as dividends to the parent which results in a corresponding reduction in the foreign tax credit available to the U.S. taxpayer. Second, most foreign countries permit the carryforward or carryback of such losses in a manner similar in concept to the net operating loss provisions under U.S. tax law. When subsequent profits are reduced by those loss carryforwards, foreign taxes otherwise payable on such profits are eliminated. For U.S. tax purposes, such foreign profits will be subject to taxation without the benefit of an offsetting foreign tax credit, thereby eliminating any double tax benefit.

The potential abuse, therefore, exists only in the limited situation generally where a U.S. taxpayer: (1) has a net foreign loss; (2) conducts its operations through branches rather than subsidiaries; (3) incurs such loss in a country which imposes an income tax but no provision for the carryforward or carryback of operating losses. Even in that case, however, if the credit were reduced for subsequent years, as this legislation propose, the U.S. taxpayer would pay tax on income which it did not realize on a net basis. There is an apparent conflict in the equities of this situation. The guiding rule of U.S. taxation of foreign source income is that all income must at the minimum bear a tax burden equal to the domestic tax rate of 48 percent, even though the foreign tax burden is lower. Correspondingly, the current rule operates to protect the U.S. taxpayer from bearing a higher burden than 48 percent based on U.S. tax accounting standards unless the foreign tax rate is higher than that figure. Considering the benefits which flow to the American economy, and Treasury, from the foreign investment, it is clear that the public interest would not be served by abrogating the rule.

Consistently, it would seem that the conflict in equities should be resolved by continuing to allow the full tax credit in the given situation. In any event, recapture of losses should not be applicable to those situations where the foreign country permits the carryforward or carryback of such losses or where the loss is incurred by a foreign subsidiary.

Finally, any provision for the recapture of foreign losses should be inapplicable to losses incurred on investments made prior to 1976. Alternatively, the provision should be inapplicable to losses incurred on investments made prior to 1976 to the extent that the losses are incurred in a year prior to 1980. This would afford companies with existing loss investments a reasonable period to attempt to correct the loss situation or to dispose of the loss investment prior to becoming subject to the new loss recapure provisions.

Tax neutrality.—During the hearings before the House Ways and Means Committee, advocates of change placed strong emphasis on "tax neutrality". However, if true neutrality were to be achieved, major U.S. tax benefits would have to be extended to foreign operations, such as the investment tax credit, the dividends-received deduction and a subsidiary loss flowthrough by means of the consolidated return provisions. In cases where the foreign tax rate exceeds 48 percent, tax neutrality requires a cash refund to the taxpayer.

Although no one is seriously proposing the foregoing, it does point out the other side of "tax neutrality" and the fact that foreign operations have certain disadvantages.

Extraordinary losses.—If loss recapture and the use of the overall limitation are to become mandatory, it would be appropriate for the legislation to deal with the distorting effects of extraordinary losses. This is particularly true where a taxpayers' losses are related to investments and operations established prior to changing the rules. While it might be an acceptable concession to simplification to ignore losses of relatively small amounts, when they become larger, either individually or in the aggregate, there should be some provision for isolating them in order to prevent them from destroying a significant portion of the taxpayer's foreign tax credit.

The Tax Reduction Act of 1975 included the loss recapture and mandatory overall limitation provisions with respect to foreign oil-related income or loss. Those provisions carefully excluded from their scope income or loss from business operations in the various U.S. possessions and territories. Such operations are particularly vulnerable to the provisions. To be consistent with the Tax Reduction Act, these operations should likewise be excluded from coverage under the proposals discussed herein. This would also be in accord with the longstanding intent of Congress to promote sound economies in world areas of U.S. responsibility.

(2)(F) LESS DEVELOPED COUNTRY CORPORATIONS

As passed by the House Ways and Means Committee, H.R. 10612 would repeal the present provision of section 1248 under which gain realized upon disposition of shares of a less developed country corporation under certain circumstances is taxed as a capital gain rather than ordinary income. It would amend the provisions of section 902 to require gross up of dividends received from less developed country corporations. FEI opposes these proposed changes.

Enactment of these changes, following the repeal in 1975 of the exclusion from subpart F income of income reinvested in qualified investments in less-developed countries, would represent a complete reversal of the position taken in 1962 to encourage investments in less developed countries and would impose an additional burden on U.S. business in trying to compete with non-U.S. business in these areas of the world. Such action would be counter to the long-established policy of the Government to encourage the private sector to assist less developed countries in their economic development. It would come at a time when these areas are taking positive steps to improve their economic positions but, because of the energy crisis and inflation, under circumstances making it not only more imperative to do so but more difficult than in the past. Included are natural resource countries whose development is important to the United States as a source of raw materials to foster the growth of the U.S. economy as well as other countries that have to rely upon imports to satisfy their own material requirements.

Many of these countries rely upon tax incentives to encourage industry to establish manufacturing facilities in their countries—incentives available to all businesses and not just those under U.S. control. The proposed changes in U.S. law would deny U.S. businesses the benefits from these incentives in the future, including those applicable to investments which were made in accordance with long range plans developed in reliance upon present law. On the other hand, foreign business interests would continue to benefit from these incentives under policies of their government, as for example, agreements negotiated by Japan with Brazil and other countries which provide for substantially more favorable tax treatment of income from Japanese investments in less developed countries than present U.S. law provides for U.S. investment in such countries.

Thus U.S. business investing in less developed countries in the future would be at a severe economic disadvantage vis-a-vis foreign competitors. In general, these countries represent large economic growth potentials for U.S. trade, which U.S. business should be free to develop on an equal basis with its competitors. Inability to do so would result in U.S. business either gradually abandoning these areas to foreign competitors or failing to maintain its competitive position therein. Either would affect the competitive position of U.S. business throughout the world, with adverse consequences on U.S. trade, employment and balance of payments position.

The electronics industry is an example of one which has found it necessary to go abroad to remain competitive in the international marketplace. However, as a result of investing abroad rather than abandoning the industry to competitors, not only have U.S. businesses continued to participate in their industry but they also have been able to preserve U.S. exports of components used in foreign manufacture and other drawthrough exports as a result of the U.S. presence abroad. Otherwise, these exports would not be made. Moreover, these exports have served to maintain U.S. employment related to their design, engineering and distribution.

As documented by studies prepared by the National Association of Manufacturers, the National Foreign Trade Council and others, the ability of industry to compete in the international marketplace on a competitive basis has had a salutary effect on the domestic economy. Changes in tax law such as those proposed, which would impose an additional competitive burden on U.S. business, are not in the best interests of the United States.

(2)(G) FOREIGN CAPITAL GAINS

FEI believes that no legislation is needed to cope with any manipulations of U.S. tax liabilities that may be caused by foreign source capital gains. H.R. 10612 contains legislation designed to impose further limitations on the utilization of foreign taxes as a credit against the U.S. income tax liability of the taxpayer who has paid or is deemed to have paid such taxes on foreign income.

In the case of foreign sales of personal property (other than stock), corporations under the legislation would not be allowed to credit available foreign tax credits against the tax on such income unless such gains were subject to a foreign tax of at least 10 percent. The same is true of stock in a corporation and other personal property except where sold in a country in which 50 percent or more of its gross income is derived.

In addition to the above change, H.R. 10612 would amend the allowable limitations on foreign tax credits in section 904, as as to limit both the numerator and the denominator of the fraction (taxable income from foreign source to taxable income from all sources) by eliminating therefrom 30/48's of net capital gains. This reduction obviously would decrease the effect of capital gains in the fraction and would generally serve to limit the effect of foreign source capital gains in the utilization of foreign tax credits.

The concern of the Ways and Means Committee last year is apparent. It involved a fear that taxpayers can manipulate their tax liability of selling personal property abroad in such a manner as to use available foreign tax credit to satisfy any U.S. taxes otherwise due. To the extent that there is any justification for the fear that manipulation in determining the country of sale has caused U.S. tax loss, section 1.861–7(c) of the Income Tax Regulations is available to the Commissioner of Internal Revenue. That section permits the IRS to determine the substantive location of a sale of personal property in any case in which the sale transaction in question was arranged for the primary purpose of tax avoidance.

But beyond all this there are conceptual difficulties. How, for example, is manipulation possible in the case of gain realized upon liquidation of a foreign subsidiary? There is no justification for not treating any such gain as foreign source gain merely because the country of incorporation did not tax the liquidation gain at a 10-percent or greater rate. Consider also the case where a portion of the gain on disposition of stock of a controlled foreign corporation is taxable as a dividend under section 1248. You would have the anomalous situation of a portion of the gain being recognized as foreign source income and a portion as U.S.-source income.

Coming back to the 50-percent test, take the case of foreign holding company. There might be no single country from which 50 percent or more of the company's gross income would be derived, thus making it impossible for any gain from sale of its share to be treated as foreign source income regardless of the amount of foreign tax paid on the gain. This seems completely unwarranted. As a minimum, should any change in law be made, gain from sale of shares of stock in the country in which the corporation is organized should be treated as foreign source gain whether or not any foreign tax was paid on the gain. A further complication is that in the case of minority investments in foreign corporations, the taxpayer might not be able to obtain information regarding sources of gross income of the corporations whose share were being sold.

To the extent any foreign tax were paid on a gain which for any reason, including those mentioned above, was treated as U.S.-source gain, the taxpayer would be subject to double taxation unless he had excess limitation from other foreign-source income transactions. This result would be contrary to the Government's effort through tax treaties and the like to eliminate double taxation of income.

(2)(H) AMENDMENT TO SECTION 367

FEI urges adoption of section 1042 of H.R. 10612 enacted by the House last year. The effect would be to eliminate the burdens and inequities resulting from the administration of section 367 in its present form while at the same time still providing the Treasury Department with adequate means to police potential tax avoidance schemes through the vehicle of foreign corporations.

Speed in consummating a transaction is, of course, crucial in many instances. Thus, as a result of the advance ruling requirements of section 367, the ensuing delay in many instances has proven costly to taxpayers because of the time the Service requires for its consideration or a ruling request. In addition, there have been cases where U.S. shareholders of a foreign corporation who have not known of a proposed transaction regarding such corporation or who have learned of it too late to obtain an advance ruling, have been penalized even in those cases where it is clear that an advance ruling would have been issued had a timely application been filed.

Certainly the requirements of an advance ruling result in a delay to no one's benefit where, under the guidelines set forth in revenue procedure 68-23, C.B. 1968-1, 821, the transaction will be accorded a favorable section 367 ruling as a matter of course without any toll charge. In addition, the Service normally regards the guidelines as ironclad rules to be applied even where the facts would indicate the absence of a tax avoidance motive so that in those cases where the guidelines provide for a toll charge, a taxpayer is confronted with a choice of either paying it as demanded by the Service regardless of the specific facts presented, or treating the transaction as taxable, or abandoning it altogether. In view of the foregoing, Financial Executives Institute recommends the adoption of section 1042 of H.R. 10612.

(3) MINIMUM TAX ON CORPORATIONS

FEI urges repeal of the minimum tax as it affects corporations. Originally, the minimum tax was to apply solely to individuals with the objective of assuring that persons with significant amounts of income would pay at least some taxes. The professed objective was to foster a wider respect for the tax laws by moving toward greater tax equality; that is, counteracting the tax favoritism enjoyed by a few publicized individuals with substantial income sheltered by the existing tax provisions. In considering amendments to the minimum tax as part of the Tax Reform Act of 1975, the Ways and Means Committee continued to examine the minimum tax as it applies to individuals and determined that the existing minimum tax does not adequately accomplish the original goal. H.R. 10612 would make substantial revisions to the minimum tax to achieve the initial objective, but would make no changes with respect to corporations. The result of the Ways and Means proposed amendments is to reinforce the preliminary approach that the minimum tax should apply only to individuals; however, the Ways and Means bill does not repeal the present provisions of the minimum tax that apply to corporations.

The minimum tax has had an impact on corporations where there exist none of the abuses which Congress sought to eliminate. In any given year, the relationship between tax preference items and the corporate taxpayer's ordinary tax liability could generate a liability for the minimum tax if the level of net income is temporarily low while tax prefrence items remain at or near normal levels.

The present minimum tax imposes an especially serious penalty on corporations engaged in the mining of vital minerals and hydrocarbons since the benefit of percentage depletion as established by Congress may be substantially reduced by application of the minimum tax. Other provisions of law have also been affected by the minimum tax. For example, heavy industries must make major capital expenditures for pollution abatement facilities in response to Federal and State requrements. Those expenditures may have qualified for a 5-year amortization period, but some companies have been unable to utilize the shorter writeoff provision because it would result in a minimum tax liability.

The alleged abuses which the minimum tax was originally intended to remedy do not arise in the corporate tax structure. FEI recommends that the House bill be amended to delete any application of the minimum tax to corporations.

(4) EMPLOYEE MOVING EXPENSES

The Tax Reform Act of 1969, by expanding the deductible categories of relocation expenses, generally recognized the inequity of imposing income tax on reimbursed moving expenses incurred by an employee assigned to a new work location by his employer. The inequity consists of placing the employee in a posture where economically he has no net benefit but nonetheless incurs an additional tax liability. Unfortunately, the partial relief of this inequity was accomplished by an enactment of complex rules and unrealistically low dollar limitations.

In order to promote tax equality among employees, conserve the audit time of the IRS, and eliminate the animosity and ill will of the employee-taxpayer, FEI recommends that all moving expenses incurred by an employee in connection with relocation to a new work location which are reported to the employer and reimbursed by the employer be made nonreportable by the employee in his tax return.

Short of complete removal of the tax inequity imposed on relocated employees, code section 217 should be amended to realistically recognize present-day costs and practicalities involved in relocating to a new work location. At a minimum, code section 217 should be amended to:

1. Increase the existing maximum limits of $1,000 to $2,500 to at least $2,500 to $10,000 and, preferably, higher.
2. Increase the allowance of expenses of occupying temporary living quarters from 30 to 90 days.
3. Increase the 1-day temporary living allowance while packing at the old work location to a minimum of 5 days.
4. Reduce the restrictive 50-mile rule to more than 20 miles, which was the rule prior to the 1969 amendment.

5. Provide for the exclusion from income of the reimbursed cost of moving household goods without a restrictive mileage test.

Statement on Behalf of the National Venture Capital Association

Summary

I. IMPORTANCE OF VENTURE CAPITALISM

Venture capitalism, which deals with businesses in new and emerging fields, is a vital element of the Nation's economic well-being. Venture capitalism promotes competition, creates jobs, develops new products, improves the country's balance of payments, and provides other important advantages to the United States. Generally, this development is accomplished with relatively small amounts of initial venture capital and the genius of a small group of individuals. Almost every major American industry can trace its beginnings to a relatively small venture capital investment and the dedication of a small group of innovative individuals.

II. GENERAL RECOMMENDATIONS

An essential aspect to the survival of venture capitalism, and to the continued development of the Nation's economy, is the ability to readily draw from private capital sources for new and emerging businesses in various stages of development. When this ability, or the ability to attract individual talent, is diminished, the industry is seriously handicapped. Many recent enactments of Congress and others that are now proposed would seriously infringe on the ability to form capital and to attract individual talent. In considering legislation, Congress should at all times keep in mind the full effect that any changes may have on the well-being of venture capitalism in this country.

III. SPECIFIC RECOMMENDATIONS

The association believes that the following changes in the tax laws are vitally needed to revitalize venture capitalism in this country:

A. *Incentive stock options.*—As a complement to the use of ESOP's, incentives for attracting young innovative genius to new fields are needed. One way of accomplishing this is through sensible tax laws permitting an individual to profit from the growth of the company to which he devotes his talents and energies, without applying unreasonable tax burden to that profit. The attached proposal is designed to accomplish this objective.

B. *Rollover of investments.*—The high capital gains taxes on any realized venture capital investment severely depletes the sources of capital available for future capital investments. It would be in the direct economic best interests of all parties concerned if no tax were imposed to the extent amounts realized from one venture capital investment were reinvested in another venture capital enterprise. The deferral of taxes achieved through such a provision would be more than compensated by the increased revenues from the newly formed businesses.

C. *Reduced capital gains taxes.*—A reduced capital gains rate structure is of vital importance to the continued investment health of the country. This could be achieved either through a general reduction in tax rates or through a graduated capital gains rate structure declining with the length of the holding period involved. As in the case of the rollover proposal, the NVCA believes that such a tax reduction, by stimulating investment, would produce more revenue than the revenue forgone by the rate reduction.

D. *Net operating loss carryovers.*—An extended or unlimited net operating loss carry forward position would be a meaningful improvement in our tax laws. The artificial carryover limitation currently in existence has no basis in fact or in logic. Modification of this provision to provide more equitable treatment for new businesses that have initial loss periods would be an important improvement in the equity of our tax structure.

Statement

Mr. Chairman, and members of the Senate Finance Committee, my name is Richard Hanschen. I am a resident of Dallas, Tex., and president of New Business Resources, Inc., and appear here today accompanied by our counsel, Leonard L. Silverstein and Stuart M. Lewis, on behalf of the National Venture Capital Association (NVCA). I serve as Chairman of NVCA's Incentives Committee and am a director of NVCA.

NVCA was formed as a result of our members' awareness of the same set of concerns respecting the Nation's economic and industrial health which are the source of the current very vital hearings. Our goals are the fostering of a broader understanding of the importance of venture capital to the vitality of the U.S. economy and the encouragement of the free flow of capital to young companies. A list of our membership is attached.

NVCA feels that venture capital plays a vital role in promoting healthy competition in our economy, creating jobs and developing innovative ideas, products and industries. We are also very concerned, as we believe this committee to be, that unless our Nation's tax and financial laws and regulations are structured so that they are receptive to, and, when possible, affirmatively stimulate the attraction of capital to small, high-risk enterprises, America's worldwide industrial and economic leadership will be irretrievably lost, and its standard of living—for all the people—will be inevitably lowered.

Venture capitalism also plays a very important role in broadening stock ownership in this country, largely through the use of employee stock ownership plans (ESOP's). In fact, ESOP's and venture capitalism mutually assist one another in a highly advantageous fashion. Once the initial venture has established the beginnings of a successful business, ESOP's are often used to distribute stock to the employees while raising needed additional financing capital for the young business. Thus, while the initial, higher risks involved in starting the business are usually borne by the venture capitalists, the company employees, through an ESOP, may get the benefit of the growth in the more established company by virtue of their stock ownership. What is needed to complement the ESOP is a method of increasing stock ownership to important management employees. Our proposal in this regard, entitled the "Incentive Stock Option Proposal," is described more fully in our testimony and in the attached memorandum.

So that this committee may fully appreciate the tremendous impact which the venture capital industry has had, and will continue to have, upon the daily lives of Americans let me briefly review some recent developments in the electronics field.

In 1969 we started Mostek, a new company based on the introduction of a new chemical processing technology, ion implantation, for the processing of a new type of semiconductor. Since that time, Mostek has paid $11 million in corporate taxes and created 3,000 new jobs. Mostek, through ion implantation, was the first company to put all of the circuits on one chip for the pocket calculator. This single technological advance sharply reduced the labor content of calculators and other electronic equipment and was the steppingstone for the U.S. industry to marshal their forces and reestablish their dominant picture in the worldwide electronics industry. As a result, pocket calculators are now within the price reach of almost every American and a major new industry has developed in the United States. This was accomplished with a relatively small initial investment of venture capital.

Going back in time, most of you are familiar with the contributions of a then new company to electronics, Texas Instruments, in bringing the transistor from a Bell Labs experimental level to a commercial reality. The impact of the transistor during the 1950's for making possible the large central computer industry and the military instrumentation industry is a well-established fact. The further invention by Texas Instruments of the integrated circuit has caused electronics to pervade all of industry, and the resulting new industry of minicomputers made by new companies such as Digital Equipment, Data General, Computer Automation, and possibly as many as 20 other companies, has not only provided jobs and taxes, but has also been the major factor in improving the productivity of industry.

Digital wristwatches provide an example that is currently in the process of developing. They are also a product of MOS technology. Today they are worn by only a few people because of the relatively high prices. Tomorrow, I predict—and I am proud to say that the development will come from the city of Dallas, soon to be the watch capital of the world—absolutely accurate digital wristwatches will be produced in mass quantities at reasonable prices. Again an innovative industry will be developed that provides products that the average American can afford while the American economy at the same time receives the benefits of the creation of a new industry.

In addition to calculators and electronic watches, the MOS-LSI technology has spawned the new intelligent terminal industry. This new industry has new companies such as Datapoint, Linolex, Sycor, Incoterm, Vydec, and Data 100. The impact of intelligent terminals is being felt more in the front office and will be a key factor in increasing productivity by automation of the white collar functions of industry.

The relevance of this committee's interests to the business of the membership of NVCA may be readily demonstrated. Our typical member is a supplier of risk capital. This may constitute a pension trust or a syndicate of investors. It is in each case a pool of capital, estabilshed by an operating business managed by persons trained to evaluate new and untried enterprises which show exceptional promise for development of new capabilities—the advancement of a new generation of technology, for example, or the formation of an entirely new indsutry such as pocket calculators.

To justify the commitment of capital inventures of this nature, the investing organization must be able to assure itself—while at the same time recognizing that some losses are inevitable—that the enterprise in which the investment is to be made will ultimately return the invested amounts and also produce a profit commensurate with the risk. The returned capital, together with the profits, can thereafter be recycled in other enterprises. Only if such a climate is maintained and sustained can the multiplier effect on the nation's economy be felt on those who ultimtaely serve it in terms of jobs, new products and newly needed services.

You'll all agree that there has never been a question in these past two decades about the competitiveness of free enterprise in the electronics industry. The competitiveness is brought about by the introduction of new companies highly motivated to make their own contribution in their industry. My terminology for this is distributed competitive free enterprise.

Although you may classify our activities as small businesses because of their size at the start, I want to stress that the capitalization required is such that we have to be prepared to finance a company that can do $50 to $100 million annually within the first 5 years of existence. In the case of Mostek, approximately $5 million of private capital and $15 million of public money was raised, and to date Mostek has retained earnings of $12 million. With debt leverage and by turning assets into revenues at a 1:2 ratio, it has enough capital to grow from its current $60 million level to $100 million.

To sustain this process of inflow of capital, realization of gain and future reinvestment, our tax and financial laws must be so worked that:

(1) The tax burden to be met when enterprises are sold is not excessive, as it is today;

(2) This tax burden must attach only at such time as the venture capital enterprise generates the funds with which to pay the tax;

(3) Losses, when realized by the business in which funds are invested, are available to offset income from other sources when realized, or as ordinary—not capital—losses so that the venture capitalist may accurately anticipate the net after-tax cost of making the initial venture capital investment; and

(4) The operating enterprise in which the venture capital investment has been made must be able to foresee steady, and hopefully expotential, growth of its own business with opportunity for the managers as well as the owners to realize upon ~~its own~~ capital yield potential. Thus, key and other employees, particularly those

who are highly trained technical personnel with intense, but short-lived, creative and applied scientific capacities, must have the opportunity for reasonable equity participation in the enterprise.

My purpose here is to tell you that a series of random changes have combined to make it almost impossible to duplicate the building of a Mostek in the United States today. Recently, we sold Linolex to 3M solely because the capital formation structure that enabled us to create Mostek has been decimated.

My concern stems from the fact that the venture capital community 5 years age was starting between 10 and 15 new companies a year. To the best of my knowledge, there was only one such high technology company initiated in 1974 in the United States. The number was about the same for 1975 and the trend seems to be continuing into 1976. Thus, it appears that the amount of dollars available for new venture capital projects is precipitously declining. Doubtless, the general state of economic health in the United States contributed to this decline, but there are other causes which NVCA wishes to bring to the committee's attention.

One such cause is the unintended adverse impact of recent general legislation. For example, important and useful as is the Employee Retirement Income Security Act of 1974 (ERISA), it contains what appear to be very serious side effects. A very adverse effect stems from a provision in that statute, section 404(a)(1), which imposes certain fiduciary standards upon persons managing pension funds. While it is desirable to have adequate fiduciary controls, a consequence of these tighter controls has been to virtually eliminate pension funds as a potential resource for risk enterprises. While we are hopeful that the desired clarification of this provision can be quickly obtained through regulations we are concerned that no such prompt action will result. Unless these regulations are issued, or ameliorator legislation is promptly enacted, a major source of risk capital—already in short supply—will be permanently lost to the Nation's economy. All that is necessary is that the clarifying regulations or legislation, as the case may be, establish that a pension fund may make a full range of investments including those of high risk, so long as the portfolio is reasonably and prudently balanced when viewed in its entirety.

Since the committee has already heard considerable testimony specifically criticizing many of the detailed aspects of H.R. 10612, NVCA will not discuss in detail the unfortunate and adverse results we believe would be produced if the "tax reform" measures in that bill were adopted. In general, NVCA feels the adoption of H.R. 10612 would be counterproductive to the restoration of a healthy economy and could have long range effects from which our society may not ever fully recover. Provisions such as LAL could trigger very adverse business reactions and would further aggrevate the problems of capital formation, which is so critical to this Nation.

In particular, however, we wish to state that section 206 of H.R. 10612, which limits deductible interest to $12,000 per year should not be adopted. This provision has received little attention due to the other, more drastic provisions of the bill, such as LAL. The administration has solidly opposed this provision as being detrimental to capital formation. We hardily agree. Adding new, very burdensome limits on the ability to raise capital, either by increasing the cost of capital formation or by reducing the sources from which the capital can be raised, is the exact opposite of the types of proposals Congress should be considering. Further, since there is no escalator on the $12,000 limit, the "real" limit in economic terms (discounting for inflation) will be continually declining. As such, we recommend that the committee take special notice of this "sleeper" and that it be eliminated from any bill enacted.

There are other areas of equal concern to NVCA and, we believe, to this committee, in which new legislation is sorely needed so that the restrictive rules of present law can be modified and a climate for the formation of venture capital enterprises can be continuously created. NVCA has these specific recommendations:

1. *Incentive stock option.*—The association believes that a vital ingredient to encouraging venture capitalism is obtaining the necessary individual genius with which to develop the new products and technology that are the sine qua non of venture capitalism. To do this requires the cooperation and genius of an individual or group of individuals working in a new field.

If one reviews history, he can quickly see that these creative contributions originate with young men between the ages of 25 and 35. In most cases, they have no capital to invest and may still be in debt from their college educations. Young men building companies in their own image and principles rather than in some other industrial leader's image is the cornerstone to building new companies. It is imperative that these young men have ownership positions in the companies in order to commit the decade of time that is necessary to grow an organization from startup to a major contributor of jobs and taxes in our economy. If Tom Watson had not left NCR to create IBM, would we have our computer industry today?

Venture capital organizations are high-risk businesses, and the individuals required to make a venture capital operation succeed are in great demand by major established industries. In order to persuade such individuals to take a chance on a venture capital business, as opposed to the security of an established corporation, some direct incentives for that individual are necessary. To that end we have developed a proposal, which we have entitled the incentive stock option proposal, which would permit reasonable individual equity participation in the business. A copy of this proposal, with a memorandum of detailed explanation, is attached to this testimony. The essence of the proposal is not to create a new loophole but simply to provide fair and equitable treatment for those who wish to have a stake in the corporation for which they work. This incentive will, when coupled with venture capital's use of ESOP's, greatly assist the economy by both stimulating the development of new industries and broadening the stockownership in these new fields.

Under existing law, stock options are essentially treated in one of two ways. Either the option is a qualified option under the Internal Revenue Code and thereby entitled to certain favorable tax treatment, or it is a nonqualified stock option and not entitled to that special tax treatment. Qualified options have become the subject of increasing demand for repeal. Section 603 of H.R. 10612, which we oppose, would essentially repeal qualified stock options. In addition, such options are largely inflexible and have many disadvantages attached to them, as has become especially apparent in recent years. Nonqualified options, on the other hand, are subject to special tax rules which can have discincentive effects. Employees receiving stock subject to nonqualified stock options may in fact be forced to sell their stock in order to pay taxes due on receipt of the stock in question. In many cases the stock may be largely unmarketable, and the employees may be put in a disadvantageous position.

Our proposal is simply to match the taxation with the disposition of the stock in question. That is, if an individual exercises a stock option and receives stock, the individual will only be taxed at such time as he in fact disposes of the stock and otherwise realizes gain. This relies on the old and fundamental tax principle that income taxes should be paid out of the funds which generate the income. In this way the individual has the choice to continue his equity participation in the company until such time as he wishes to sell for economic or other reasons. At that time and only at that time will the individual be taxed on his investment. The taxation so imposed will be at ordinary income rates, subject to certain averaging provisions designed to take into account, to a limited extent, the period over which the individual has held the stock.

Further explanation of this proposal would be inappropriate at this time. The details are described more fully in the memorandum attached. We feel that this would be an important means of providing realistic and fair taxation of individuals who receive an equtiy investment in their company.

2. Rollover provision.—One of the important hindrances in accumulating the capital necessary for venture capitalism is the tax imposed when an investment in a venture capital operation is withdrawn. An important method for increasing the capital available for venture capitalism would be to defer the tax on a realized venture capital investment if the capital in question is reinvested within a stated period into a new venture capital business. The Internal Revenue Code contains precedent for this type of deferral, which is usually referred to as a rollover provision. By postponing the collection of the tax on the amounts reinvested in venture capital businesses, the U.S. economy will undoubtedly be economically ahead in that the new capital invested will over the years probably generate more revenue collections from the business created than the Federal Govenment would have received had it fully taxed the capital in question and thereby decreased the amount of private capital available for venture capital reinvestment. The rollover in question could be implemented either by a provision simply deferring the tax for amounts reinvested or by the adoption of a tax credit measured by the amount of a realized investment which is reinvested.

3. Reduced capital gains taxes.—In addition to the rollover provision just discussed a reduction should be made in the capital gains tax applicable to venture capital investments. Such investments are high risk investments and are usually relatively long-term investments. New businesses just developing are genenally unmarketable for a period of several years until they have produced a developed product which can be sold and which allows the company to go public. The problem previously alluded to, that is, the drain of private capital sources due to the tax on realization of a single venture capital investment, can partially be alleviated by reducing the capital gains tax applicable on the realization of such an investment. A reduction in this tax to reflect the importance of and the need for venture capital would be entirely appropriate and in the best interest of the U.S. economy.

In this connection, I should add that NVCA supports Senator Bentsen's bill, S. 443, for a graduated capital gains rate. Increasing the fluidity of capital by reducing taxes would be beneficial both to the economy as a whole and to the venture capital business.

4. *Subchapter S modifications.*—Under the Internal Revenue Code the shareholders of certain types of corporations can elect to be taxed directly on all corporate income and not pay separate corporate taxes. Such corporations are referred to as subchapter S corporations. NVCA is concerned that the rules regarding which corporations can qualify for this treatment are overly restrictive. Corporations and trusts cannot be shareholders of subchapter S corporations. The number of permissible shareholders cannot exceed 10. The corporation is only allowed to issue one class of stock. These restrictive rules severely limit the use of subchapter S corporations without serving any valid goal. They were initially added to limit the use of subchapter S corporations when they were in the experimental stage. Since subchapter S corporations are now an accepted and widespread form of business operations, these unduly restrictive provisions should be deleted or modified. If, for example, corporations and trusts could be shareholders, then subchapter S corporations would be much more usable as venture capital businesses.

5. *Net operating loss carryovers.*—The final provision which the association would like to bring to the attention of the Senators concerns a question of corporate taxation. Under current law corporate net operating losses can generally be carried forward for only a limited span of years, usually not more than five. The association cannot understand the logic or wisdom of this artificial time limitation. New venture capital businesses typically lose money in their very early stages but grow into profitable businesses as the years progress. The effect of the capital loss carry forward limitations in many cases is simply to deny full equalization of the tax burden on the corporation for losses sustained in their development periods. The association would strongly back any provision to remove the limitation on corporate loss carry forwards or to at least extend the carry forward provisions to a period of at least 10 years. Other provisions in the Internal Revenue Code applicable to carry forwards to have no limitation or have limitations beyond 5 years. We feel that this modification would improve the equitable taxation of venture capital businesses and would thereby stimulate their growth.

Conclusion

NVCA has tried to present a general description of the industry and an explanation of the importance of the health of venture capitalism to the United States generally. NVCA also wishes to make it clear that venture capitalism is at a crossroads today and any threats on its existence could have serious and unfortunate effects for the United States.

SUMMARY

Incentive stock option proposal

Following is a proposal for modification of the statutory rules governing the Federal income tax treatment for certain types of employee stock options. This proposal is designed to achieve greater equity participation by employees in their employing corporation while providing a balanced and fair law that taxes recipient employees in an appropriate manner at an appropriate time.

Under current law employers wishing to provide employees with employer stock have numerous alternative methods available. Two of the most popular methods are qualified stock options and nonstatutory stock options. These two alternatives represent widely diverse approaches to this subject. For qualified stock options, taxation of the employee is generally deferred until a disposition occurs and any gain is usually taxed at capital gains rates. For nonstatutory stock options, taxation is at ordinary income rates and in many cases will occur before the employee is actually able to dispose of the stock. Consequently, in the latter case an individual may be taxed on income before he can effectively generate funds from that income with which to pay the tax.

Due to the liberal treatment afforded to qualified stock options, efforts have recently been made to repeal this provision. Such a measure was approved by the House Ways and Means Committee in the 93d Congress. This repeal would provide too drastic an alternative for the treatment of stock options. The need for a more balanced proposal suggests the adoption of the attached as a more appropriate method of taxing employee stock options, whether or not the qualified stock option provisions are repealed.

The goal of the incentive stock option proposal is to encourage equity participation by employees through the use of stock options. This is achieved by modifying the harsh rules applicable to nonstatutory options to provide that the employee is not taxed until such time as an actual disposition of the stock occurs. However, unlike qualified stock options, which provide for capital gains treatment of any gains, the incentive stock option proposal recognizes that any amounts received on disposition are taxable as compensation—that is, ordinary income—to the employee. Consequently, while the employee does not generally recognize income until an income fund is generated with which to pay the tax, at the same time any amounts received are taxed in the same manner as other compensation.

In short, if fairer and more appropriate tax treatment is provided for employee stock options such options will probably be utilized more fully with a resulting benefit to all involved. Employees will receive a greater stake in the free market system without the cost of such compensation being unduly borne by the Federal treasuries.

MEMORANDUM

Incentive stock option proposal

This memorandum presents a proposal which responds to current national needs for capital formation. The proposal presented involves the use of the Federal income tax laws. This has been formulated in a manner, however, which harmonizes the principle that income is generated when a "gain or profit" is realized with the doctrine that the payment of tax attributable to the realization of the income should be timed—that is, measured—by the receipt of actual economic capacity—the funds—with which to pay the tax. This proposal would enable an employee to receive stock as compensation for his commitment to an enterprise, but to defer the burden of ordinary income tax until such time as the stock—at its then value—is disposed of by the employee. In this manner, the government is assured of receiving the tax due at ordinary income rates, but the employee is spared the burden of payment on illusory gain—if the stock declines—and on value not realized when the stock is sold or disposed of.

I. BACKGROUND

The Internal Revenue Code has for many years employed various structural mechanisms to encourage businesses to allow employees to participate in the ownership of their company.

The principal methods of encouraging such equity participation have traditionally been so-called "qualified" stock options and "nonqualified" stock options. Qualified stock options, defined under section 422 of the Code,[1] have been granted special tax treatment under section 421. The special treatment granted includes both (1) deferral of any tax on the exercise of the option, and (2) taxation of all gain—in an otherwise taxable transaction such as a sale—at long-term capital gains rates. Nonqualified stock options are governed by section 83. A more recent provision, this section generally assumes that the stock—if not subject to restrictions on transfer—is taxable at ordinary income rates, and imposes the tax at the time of exercise of the option. If, however, the stock is subject to certain substantial restrictions described in section 83, the value of the stock remains taxable at ordinary income rates, but the imposition of the tax is deferred until such time as the restrictions expire.

Thus, qualified options receive both deferral of tax and capital gains rates, while nonqualified options possess neither favorable attribute. It is only in the case of a qualified option that the taxable event—realization of income—is tied to the time of taxable capacity, that is, the time at which the employee receives funds from the transaction, and thereby is in a position to pay the appropriate tax.

Section 83, added to the Internal Revenue Code in 1969 as part of the 1969 Tax Reform Act, was designed to correct certain perceived abuses in the tax laws. Congressional concern focused both on the deferral of tax (in certain situations) and on the conversion of ordinary income (from compensation) into capital gains.[2] Section 83, which applies to all transfers and covers all classes of "restricted property" (i.e., not just stock), was enacted in conjunction with the continuation of the qualified stock option provisions and assured full taxation of the ordinary income element in stock transfers, but did not adequately deal with the problem of the timing of the tax. Thus, under section 83, taxable income arises when an option to acquire property,

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[1] All references to sections are references to sections of the Internal Revenue Code.

[2] See Staff of Joint Committee on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969, 109–113.

including stock, is exercised, whether or not the stock is, or can be disposed of—that is, whether or not the option holder has the economic capacity to pay the tax. It is this rather punitive, and certainly burdensome, aspect of section 83 to which the attached proposal is particularly related.

In the 93d Congress, the House Ways and Means Committee, in its deliberations concerning major tax reform legislation, proposed the repeal of the existing provisions under section 422 of the Internal Revenue Code establishing qualified stock options. If this repeal occurs in the 94th Congress,[3] section 83 of the code would become essentially the governing provision for all categories of stock options. This change, if enacted, would seriously hamper equity participation, especially in high-risk businesses. However, even if the qualified stock option provisions are not repealed, an important need exists for a change similar to that suggested here in that neither existing method of treatment for stock options offers the necessary flexibility to carry out important business needs while providing equitable, rational tax treatment.

II. GENERAL REASONS FOR THE PROPOSED AMENDMENTS

One of the long recognized goals of this country has been the encouragement of equity participation in business by employees. This has been reflected in numerous provisions of the tax law as well as in other areas of the law.[4] A repeal of the qualified stock option provisions would remove a major incentive used to encourage such equity participation.

The application of section 83 to all such transactions would, in many cases, actually discourage employee stock ownership since the employee may not be able to afford the tax on the relatively unmarketable stock of a closely held corporation or other corporations with no established market for their stock. In addition, even in the case of a relatively marketable stock, a positive value is achieved by encouraging equity participation by employees.

For these reasons, it is proposed that new section 84 be added in accordance with the attached proposal. This proposal is designed to insure that stock received through employee stock options will be taxed at ordinary income rates but that the tax will not be imposed until the employee generates the cash with which to pay the tax. This modification will serve both the goals of preventing tax avoidance and encouraging equity participation by employees.

III. DETAILED EXPLANATION OF PROPOSED AMENDMENT

The proposed new section 84 provides that a special election may be made with reference to stock received pursuant to an incentive stock option. This election would permit the optionee to defer any

[3] Chairman Ullman endorsed the 1974 committee action on qualified stock options. "Committee Member Selections of Proposals for Consideration in First Phase of Tax Reform" 19 (Aug. 25, 1975). See also sec. 311, H.R. 1040 (94th Cong., 1st sess.). This provision of Cong. Corman's bill would repeal the qualified stock option provisions.

[4] Recently this has been dramatically reflected in legislation encouraging the use of employee stock ownership plans, which encourage employers to adopt such plans and consequently provide equity participation by employees. See, e.g., Tax Reduction Act of 1975 (Public Law 94-12), sec. 301; Trade Act of 1974 (Public Law 93-618), sec. 273.

taxation (1) on the receipt of a stock option, and (2) on the exercise of the option, until the date of disposition of the stock in question. At that time, the full amount of profit then realized becomes taxable as ordinary income (unlike the current treatment of qualified stock options which grants capital gains treatment). The tax would be computed under an income averaging method similar to that applied to lump-sum distributions under the Employee Retirement Income Security Act of 1974 (Public Law 93-406).[5] The individual would at such time have in hand the funds with which to pay the tax imposed. Gain at the disposition would thus be computed as the difference between the amount received (or the fair market value of the stock, if higher) over the amount paid for such stock. Using the higher of the proceeds or the fair market value to measure the amount of compensation will prevent unjustified avoidance of income taxes through transfers by gifts and other noncompensatory and inadequately compensated transfers. On the other hand, a clear hardship which may result under present law is avoided. No longer would an employee be taxed on the illusory "paper" value of stock at the date of exercise, because if such stock declines in value before disposition, income is never realized. In addition, the Internal Revenue Service in most situations will not be faced with the difficult, and administratively burdensome, requirement of valuing stock whose value may be unclear.

The term "incentive stock option" is defined in such a way as to limit the applicable stock to common stock of the employing corporation or its parent. Since the purpose of the proposal is to encourage equity participation by employees, an employee must continue with the company for at least 10 years after receiving the incentive stock option in order to realize the full benefit of this provision. If, for some reason, the employee's services are terminated within that 10-year period, the incremental right to exercise the option must not have accrued at a rate faster than 20 percent per year. Also, the employee must not by virtue of his option acquire more than a 10 percent interest in the company (when his other holdings at the time of receipt of the option are considered). If the option is exercisable after the employee's death, it must be fully exercisable as to all shares covered. The reason for this is that since death triggers the income tax, the recipient of the option must be free to exercise the option and generate whatever income can be realized from the sale of the stock.

The election would be made in accordance with regulations prescribed by the Secretary or his delegate, it being intended that such election would be made at the time the property would otherwise be taxable in accordance with subsection (a) of section 83, but no later than the time for filing the tax return for the year in which the option is actually exercised. In the event of death the election would have to be made within 9 months following the date of death (the time in which the estate tax return must be filed). If an election is made under proposed new section 84, an election under existing section 83(b) would not be permissible. If an election under section 84 were made and a loss were eventually incurred on the property due to forfeiture or worthlessness, such loss would be treated in accordance with exist-

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[5] Since income averaging is provided it is anticipated that sec. 1348, relating to the maximum tax on earned income, would not be applicable.

ing tax principles. Any loss allowed would accordingly be limited to the employee's basis in the property.

The proposal also allows the employer a deduction at the time and in the same amount as the employee has income. This achieves a matching of deductions with income. No gain or loss would be recognized to the corporation, however, pursuant to section 1032.

The proposal makes no reference to whether options themselves are marketable, i.e., readily tradeable. The intention is that the receipt of the incentive stock option, whether or not marketable, would not generate income. This avoids the extremely difficult problem (especially in light of the increased trading in options) of determining when an option is marketable. If an option is in fact traded, however, such an event would generate income under section 61 and this provision would not prevent recognition of such income.

The stock acquired pursuant to this election would be separately identified and would not lose its identity due to stock splits or other changes in the character of the stock. Any stock dividends received on such stock would not be subject to the section 84 election.

The term "disposed of" is defined to include all transmittals of the property including transmission at death. The recipient of any stock (whether the estate, an individual, a trust or any other person) would be treated as having income in respect of a decedent. This means generally that the stock would be taxed at death in accordance with the rules of sections 84 and 691. The person taxed would not receive any increase in basis by virtue of the estate tax basis stepup[6] but would receive an increase in basis due to the realization of gain. The person taxed would also be entitled to the benefit of the deduction under section 691(c) for any estate tax attributable to this income. In this situation the tax would be computed on the basis of the actual fair market value of the stock, giving due consideration to whether the stock is readily marketable or not. In the case of an incentive stock option passing at death, the tax will be applied as if the option were fully exercised immediately following the optionee's death.

These disposition rules are similar to the disposition rules for installment obligations under section 453(d) except for the special rules on disposition at death. A requirement of realization at death was added to insure that the deferral of tax involved did not extend beyond one lifetime. It is hoped that some type of payment extension could be provided in appropriate hardship cases, such as those in which the stock is unmarketable. Comparable hardship extensions are provided under the Internal Revenue Code in certain specific situations.[7]

In accordance with the Internal Revenue Service position on disqualifying dispositions of qualified stock options, it is anticipated that the income attributable to stock acquired under an incentive stock option would be treated as described in Rev. Rul. 71-52.[8] That is, this income would not be considered "wages" for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act or the collection of income tax at source on wages. Consequently, no withholding would be required. The income would, however, be reportable

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[6] Internal Revenue Code, sec. 1014.

[7] See, e.g., Internal Revenue Code, secs. 6161 (providing a general 6 month extension), 6162 (liquidation of personal holding company), 6166 (closely held businesses).

[8] 1971-1 C.B. 278.

by the employer on form W-2 (if the optionee is still an employee) or form 1099 MISC (if the optionee has terminated employment), if the necessary information is available to the employer.

IV. REVENUE EFFECTS

No detailed estimates have been made of the revenue effect that would result from the accompanying proposal. Since new section 84 grants a tax deferral, when compared with section 83, some initial revenue loss might be expected. However, in reality the revenue impact should be positive since the presence of section 84 would provide an incentive to new industry. This should induce more venture capital, create more jobs and generally enhance the economy. In addition, since all gains are taxed evenutally, even without any induced effect, a revenue balance should be realized after a few years.

PROPOSED STATUTORY LANGUAGE—ADD NEW SECTION 84 AS FOLLOWS

SECTION 84: INCENTIVE STOCK OPTION ELECTION.—

(a) GENERAL RULE.—Any person who performs services for a corporation and receives an incentive stock option in return for such services may elect to include in gross income for the taxable year in which the stock received pursuant to the exercise of the option is disposed of the amount determined in accordance with subsection (b). If such an election is made, section 83 shall not apply with respect to either the receipt of the option or the receipt of stock pursuant to the option.

(b) AMOUNT OF TAX.—

(1) The tax for any taxable year is an amount equal to 10 times the tax which would be imposed by subsection (c) of section 1 if the taxpayer were an individual referred to in such subsection and the taxable income were an amount equal to one-tenth of the excess of—

(A) the amount received or the fair market value of the stock at the time of disposition whichever is higher, over

(B) the sum of (i) the amount (if any) paid for such property, and (ii) the minimum distribution allowance.

(2) In the event that employment is terminated within 10 years from the date the incentive stock option was issued, when in lieu of "10" and "one-tenth" in paragraph (1) there shall be substituted the number and fraction corresponding to the number of full years of active employment.

(c) MINIMUM DISTRIBUTION ALLOWANCE.—For purposes of this section, the minimum distribution allowance for the taxable year is an amount equal to—

(1) the lesser of $10,000 or one-half of the total taxable amount on the disposition for the taxable year, reduced (but not below zero) by

(2) twenty percent of the amount (if any) by which such total taxable amount exceeds $20,000.

(d) TERMS DEFINED.—

(1) Incentive stock option.—For purposes of this section, the term "incentive stock option" means an option to purchase common stock of the employing corporation, or its parent, if

(A) the option would not, if fully exercised when received, confer upon the optionee ownership of more than 10 percent of the corporation's outstanding stock,

(B) the option provides that, in the event of termination of employment within 5 years after the date the option is received, the option will be exercisable only with respect to the percent of the total shares covered by the option that correspond to the ratio of the number of full years of active employment over five.

(C) The option provides that, in the event of death, the option will be immediately exercisable with regard to all stock covered thereunder, notwithstanding any restrictions (other than payment of the option price) that may otherwise have been applicable.

(2) Disposition.—For purposes of this section, a disposition will be deemed to have occurred when the stock is sold, exchanged, transmitted by gift, transmitted at death pursuant to subsection (e) or otherwise disposed of.

(e) SPECIAL RULE FOR DISPOSITIONS AT DEATH.—

(1) Stock held at death.—If at death a decedent holds stock on which an election under subsection (a) is made, then a disposition shall be deemed to have occurred immediately following the decedent's death and the income realized shall be treated as income in respect of a decedent to the recipient in accordance with section 691.

(2) Option held at death.—If at death a decedent holds an option to which an election under subsection (a) may be made (or has previously been made), then the recipient of such option shall be deemed to have exercised such option fully and to have disposed of the stock received, immediately following the decedent's death. Any income realized shall be treated as income in respect of a decedent to the recipient in accordance with section 691.

(f) DEDUCTION BY EMPLOYER.—In the case of a transfer of stock pursuant to subsection (a), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such stock was transferred, an amount equal to the amount included in the gross income of the person who performed the services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performs such services.

(g) ELECTION.—An election under subsection (a) shall be made in such manner as the Secretary or his delegate may prescribe and may not be revoked except with the consent of the Secretary or his delegate, provided that in the event of death such election may not be made more than 9 months following the date of death.

STATEMENT BY LOUIS H. T. DEHMLOW, PRESIDENT, GREAT LAKES TERMINAL AND TRANSPORT CORP., PRESIDENT, NATIONAL ASSOCIATION OF PLASTICS DISTRIBUTORS VICE PRESIDENT, NATIONAL ASSOCIATION OF CHEMICAL DISTRIBUTORS; TRUSTEE, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. Chairman, I am grateful for your invitation to submit written testimony to the Senate Finance Committee hearings on tax revision on the subject of capital formation. I would like to focus my remarks on the capital needs of the wholesaler-distributor firms. In particular, I urge the passage of legislation which would increase the corporate surtax exemption to $100,000 and increase the estate tax exemption to $200,000.

DISTRIBUTION FIRMS—THE OWNER'S STAKE

Distribution firms, one of which I am president, are small businesses. Virtually all are family owned companies, which means that they are owned by the same individuals who manage them. These men are personally responsible for the success or the failure of their businesses. For many, the firm represents 51 to 74 percent of the owner's personal net worth. So you find us fighting for our lives, because our businesses are our lives.

Right now most small businesses are starving from the lack of working capital, and their perpetuation beyond the life of their controlling stockholder is threatened.

GROWTH IN SALES DEPENDS ON GROWTH IN CURRENT ASSETS

Unlike manufacturing firms which depend on investment in fixed capital to succeed, the sales of distribution firms rely on their current assets—especially their inventories and accounts receivable. In fact, about 80 percent of a distributor's after-tax profits are reinvested in assets. Distributor's sales depend to a great extent on the size of our inventories and accounts receivable. The three are positively correlated.

INVENTORIES

After buying merchandise from manufacturers, distributors store it in their warehouses until it is sold to customer-users. Although this is only one of the many marketing functions that distributors perform, they still can only sell what they have in their inventories. Therefore, in order for sales to increase, inventories must also rise.

During periods of inflation, the cost of those inventories rises, bringing along with it increased pressure on financing our capital requirements. We must somehow find extra funds to finance additions to our inventories.

ACCOUNTS RECEIVABLE

At least 98 percent of our sales are made on an open account—that is, on noninterest bearing accounts receivable. Distributors, in effect, finance other fledgling small businesses. This means, however, that by extending credit to our customers at no charge, we forego interest income. Moreover, we have to pay interest charges of many of our purchases and loans.

During times of stable prices, we can work out a balance between the two and treat the resulting cost as a normal business expense. During inflationary periods, however, interest costs—both foregone and paid—rise, thereby weakening our financial position and reducing our working capital. So, again, we must somehow find extra funds to finance our accounts receivable.

SOURCE OF FUNDING

Distribution firms are unable to borrow heavily in the capital market. Virtually all of the U.S. wholesaler-distributors are family firms, the shares of which are not traded on an exchange or over the counter. Therefore, with limited access to external funds, we are forced to fall back on depreciation allowances and reinvested earnings to finance our working capital requirements.

DEPRECIATION ALLOWANCES

Although depreciation allowances provide important funding, they are still not sufficient. In 1975, they provided only 54 percent of internally generated funds for the distributors, compared to a 79 percent average for all corporations.[1]

REINVESTED EARNINGS

Therefore, distributors have had to rely on reinvested earnings in order to finance their working capital requirements. For many years, distributors have paid out less than 25 percent of their after-tax net incomes, compared to at least a 60 percent average for all corporations. In order for distribution firms to grow, their reinvested earnings must also grow.

PROPOSAL: INCREASE CORPORATE SURTAX EXEMPTION TO $100,000

So, I urge that the Senate increase the corporate surtax exemption to $100,000 on a permanent basis in order to provide additional needed internal funds.

According to Dr. Norman Ture, consulting economist to the National Association of Wholesaler-Distributors, raising the corporate surtax exemption to $100,000 will foster the growth of small businesses in America, because 60 percent of the tax savings generated by such legislation will be realized by firms with net incomes of less than or equal to $100,000.[2]

ECONOMIC EFFECTS

By 1977, 720,000 new jobs will be created in the private sector and real wages will rise by $10 billion over the projected figure for that year if such legislation is enacted. Gross national product will increase $17 billion by 1977 over the projected figure for that year. And the Federal Government will realize a net gain of $3 billion by 1977.[3]

SMALL BUSINESS PERPETUATION THREATENED

Today the perpetuation of many small businesses is threatened by the economically unrealistic burden of estate taxation. As the situation now exists, the death of the controlling stockholder of a company

[1] McCamant, William C., Ture, Dr. Norman B. "Tax Reform: Capital Formation in the Wholesale-Distribution Industry," before the Select Committee on Small Business and the Subcommittee on Financial Markets, Senate Finance Committee, Sept. 25, 1975, p. 24.
[2] Ibid., p. 7.
[3] Ibid., pp. 7–8.

often leads to the forced sale or liquidation of that firm. Therefore, I urge that the estate tax exemption be increased to $200,000 to relieve this burden and allow businesses to continue uninterupted beyond the death of its principal owners.

The present level of the estate tax exemption of $60,000 was established in 1942. Since then the purchasing power of the dollar has declined because of inflation. But the exemption has not risen to offset this decline. This results in an increase in the effective tax rate of estate taxation and the relatively high burden that the small businesses have to bear.

HISTORICAL COMPARISON OF TAXES AND TAXABLE ESTATES

For example, today an estate worth $10 million [4] would have to pay a tax of $6,042,600, which represents about 61 percent of the total estate. Using the GNP implicit price deflator and indexing the exemption, we find that in 1942, this estate would have been worth $3,125,000 and would have been taxed $1,299,600, or about 42 percent of the total estate. This represents an increase of 45.5 percent.

An estate worth $350,000, however, would be taxed $78,500 in 1974, or 22 percent of the total estate. Again, using the deflator and indexing the exemption, this estate would have been worth $109,375 in 1942 and taxed $4,842, or 6 percent of the total estate. This means it would have experienced an increase in taxes of 255.5 percent.

Inflation over the decades also has meant that more estates are now subject to estate taxation. From 1941 to 1973, there was a more than 600-percent increase in the rate of estates taxed.

So, not only are small businesses being taxed at an unrealistically high effective tax rate, but there are also more small estates subject to estate taxation. Therefore, I urge that the estate tax exemption be increased to $200,000 in order to maintain equal purchasing power with the dollar and to comply with the original intent of the law.

PRESENT TAX LEADS TO FORCED SALE OR LIQUIDATION OF BUSINESSES

Now, it's unlikely thta the Federal Government meant to have estate taxation lead to the forced sale or liquidation of small businesses, but today this is often the case, because in many cases these are the only two alternatives open to the surviving heirs. Many cannot afford to pay the unreasonably heavy burden of the estate tax without relinquishing control of the business.

Tied up in the firm is 51 percent to 74 percent of the decedent's net worth, so the money for taxes couldn't come from his estate. Life insurance proceeds payable to the corporation amounts to less than $100,000 in the majority of cases.[5] And the debt to net worth ratio of most distribution firms is already so high that the addition of the added tax liability would mean that banks and other lending institutions would hesitate to loan that business any more money.[6] So, the

[4] Davis, John C., III "The Effects of Estate Taxation on Small Business Perpetuation", before the Select Committee on Small Business and the Subcommittee on Financial Markets, Senate Finance Committee, Sept. 25, 1975, pp. 8–9.

[5] National Association of Wholesaler-Distributors "Profile of the Perpetuation Crisis", 1975, p. 2.

[6] Robert Morris Associates, Annual Statement Studies, 1975 Edition, p. 113. The debt to net worth ratio for wholesalers of chemical and allied products (of all sizes) averages to 1.9.

result would be that, in many cases, the heirs of the controlling stockholder would be forced to either sell or liquidate the firm in order to pay the estate tax.

SMALL BUSINESS: A POTENT FORCE IN THE U.S. ECONOMY

The cessation of small businesses not only harms the controlling stockholder's family, but it also has adverse repercussions throughout the rest of the economy. We have to look beyond who gets the initial tax savings. We must also consider who benefits in the long run.

According to Senator Gaylord Nelson, chairman of the Senate Small Business Committee, the 12,600,000 small businesses represent 97 percent of all U.S. business enterprises. Together they contribute one-third of U.S. GNP and 43 percent of private business output, and they hire 52 percent of the Nation's workers in the private sector.[7] While paying about one-half of their earnings in taxes, the small businesses also contribute substantially to the revenues of the Federal Government. So what happens to small businesses strongly affects the health of our economy. By raising both the corporate surtax exemption to $100,000 and the estate tax exemption to $200,000, small businesses will prosper and perpetuate to the benefit of the entire economy.

Respectfully submitted.

LOUIS H. T. DEHMLOW.

GREATER PHILADELPHIA CHAMBER OF COMMERCE,
Philadelphia, Pa., April 20, 1976.

Re Comments of Greater Philadelphia Chamber of Commerce on the Tax Reform Bill of 1975 (H.R. 10612)

DEAR MR. CHAIRMAN: The Greater Philadelphia Chamber of Commerce requested the opportunity to testify on H.R. 10612. By telegram we were informed that it would not be possible for us to testify but that the committee would be glad to receive a statement if submitted by April 23 and give it the same consideration that would be given oral testimony. Therefore, through its Federal Tax Committee the chamber is taking this opportunity to communicate to the Committee on Finance the views of its members concerning various provisions of H.R. 10612. We have also included comments on some proposals that are not included in the House bill.

The Greater Philadelphia Chamber of Commerce represents business, industry and the professions in Philadelphia and the four contiguous counties of Pennsylvania. It has a membership of over 2,400 firms.

In preparing this statement we have been particularly attentive to the smaller businesses which might not have another channel through which to reach the committee. One of the clearest impressions that emerges from our efforts in preparing this statement is that many of the House provisions will have a serious impact on businesses that merits consideration before legislation is passed in the name of tax equity. In the interest of brevity, we have not included detailed discussions of proposals that have been covered by other witnesses.

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[7] Nelson, Senator Gaylord, "Small Business Community Gets 'Bum Deal'," the Journal Herald, Nov. 28, 1975.

The subjects are as follows, each of which is on a separate page for convenience:

1. Relationship of tax reform to capital formation and jobs.
2. Moving expenses (section 506 of the bill).
3. Business use of homes (section 601 of the bill).
4. Capital loss carryback by individuals (section 402 of committee bill).
5. Discriminatory treatment of equipment leasing and real estate ventures (sections 101, 205 and 301 of the bill).
6. Limitation on nonbusiness interest (section 206 of the bill).
7. Partnership provisions (section 201 of the bill).
8. Distribution of accumulated income of trusts (section 701 of the bill).
9. Investment tax credit (section 801 of the bill).
10. Domestic international sales corporations (section 1101 of the bill).
11. Proposed changes in the treatment of foreign income (sections 1011–1053 of the bill).
12. Proposed effective dates of limitation on depreciation of movies (section 207 of the bill).
13. Withholding local income tax by Federal agencies (sections 1205–6 of the bill).

Additional Changes

1. Treatment of bad debt deduction in computation of minimum tax on corporations.
2. Proposed changes in treatment of municipal bonds.
3. Implementing the Filer Commission report.
4. Treatment of condominium management or homeowners association as exempt civic association.

1. STATEMENT OF GENERAL PHILOSOPHY CONCERNING RELATIONSHIP OF TAX REFORM TO CAPITAL FORMATION AND JOBS

a. In general

The members of the Greater Philadelphia Chamber of Commerce are sincerely concerned with the vitality of the economy, curbing inflation, providing employment and encouraging capital investment. In that sense it is respectfully submitted that many of the present provisions of H.R. 10612 directly conflict with these objectives and should be deleted or amended. The main concern of the chamber is that the so-called reform provisions will deter business activity and have an adverse effect on the economy.

Essentially speaking, the tax laws should encourage, and not discourage, investments by the individual investor in our free enterprise system. Many of the partnership tax provisions have been placed in the laws for just such a purpose. However, the utilization of those measures has enabled some taxpayers, temporarily at least, to lower, or postpone, the income tax they pay during a given year.

Commentators, who are not professionally qualified in interpreting the Federal income tax laws, have seized upon the temporarily insignificant tax payments of some investors by advocating the "plugging of loopholes" in the Internal Revenue Code.

Apparently, the Ways and Means Committee has reacted to these criticisms to the present partnership tax provisions by proposing amendments that would serve to prevent the individual taxpayer from currently receiving many of the tax incentive benefit provisions. In doing so, the Ways and Means Committee may trigger the upsetting of the delicate balances presently contained in the Internal Revenue Code by making the code such a hodgepodge as to be largely unintelligible to the individual middle class investor.

In short, there presently is a rhyme, or some symmetry to the code that makes business sense. A patchwork job of "plugging loopholes" would, in our view, not only destroy the symmetry but be counterproductive. It has been said by Senator Walter Mondale that "one man's loophole is another man's living."

If the Congress wishes to encourage individual middle class investors to contribute to and participate in the ownership of this country's assets, as it has recently done in connection with employees stock ownership plans and individual retirement accounts, then it must continue to give incentive to taxpayers who have earned their savings through the sweat of their brow. The main area for the middle class investor to put one's savings to work, and also having the Government share somewhat in the resulting temporary illiquidity and economic losses to the investor, is in the partnership area. If the Government is to withdraw its temporary support for sharing in these losses (by postponing immediate taxation) to investors, then it will largely leave the ownership of significant assets to the large corporation or the very wealthy. This is not in line with a philosophy of free enterprise—one that has enabled a person to make a mark in this world through individual ability.

In short, under the partnership provisions, there is an opportunity for a number of people, who do not have great wealth but who have money to invest, to pool together their funds to purchase real estate, invest in oil and gas ventures to enable our citizens to obtain needed fuel supplies, and engage in similar ventures that supply much needed facilities and supplies to business and to our general population. Thus, the partnership situation contributes both to new plant and property, as well as providing a secondary market for existing plant and facilities, without redistributing all wealth to the large corporations and the very wealthy.

The free enterprise philosophy should be encouraged for people who are willing to take a risk. Unfortunately, the willingness to share risks of loss with middle class investors, has been placed in doubt. If the proposed changes are enacted into law, the results will be highly undesirable. Capital will not be invested; investment opportunities for the middle class will evaporate and in the very short run serve to shift our economic base. Thus, merely to pass legislation for the purpose of doing a patchwork job of supposedly "plugging loopholes" in our tax laws, will serve to collect less tax by shifting sources of capital and investment, thereby being counterproductive.

b. Effective dates

The House bill is basically keyed to 1975; it is urged that the Committee on Finance promptly announce that all effective dates will be no earlier than the date the committee acts so that business can continue while the measures are considered.

2. MOVING EXPENSES (SECTION 506 OF THE BILL AND SECTIONS 217 AND 82 OF THE CODE)

The bill proposes to liberalize the treatment of moving expenses by increasing the $1,000 maximum deduction for premove house hunting and temporary living expenses at the new job location from $1,000 to $1,500. It also increases from $2,500 to $3,000 the maximum deduction for qualified expenses for the sale, purchase or lease of a residence and makes other technical changes.

The consensus is that the new limitations are still unrealistically low and should be further increased with a view to permitting an employer to make whole the employee who incurs additional expenses in order to change job locations and in addition to fairly treat the person who is changing employer. The liberalization should increase the mobility of the work force by permitting the unemployed or underemployed to more actively seek the best market for their services.

Section 506(b) of H.R. 10612 raises the limitations on the maximum amount deductible by an individual for specified expenses incurred in moving from one location to another if certain conditions are met. Specifically, it increases the deduction for the aggregate expenses incurred on house hunting trips to the new location and for meals and lodging while living in temporary quarters at the new location from $1,000 to $1,500 and for the total of the above two items and specified costs of purchase and sale of residences from $2,500 to $3,000.

We applaud the recognition of the effect of inflation on these expenses since the enactment of the original limitations in the Tax Reform Act of 1969. However, we offer the suggestion that the limitations are unrealistically low in certain instances producing a tax hardship on the employer and employee as detailed below.

Limitation on House-Hunting Trips and Temporary Living Expenses

The proposed limitation of $1,500 on these moving expenses is inadequate as illustrated by the expenses projected on three typical long distance moves:

	New York to—		
	Chicago	Dallas	Los Angeles
Househunting, 1 trip:			
Air fare (for 2, round trip coach)[1]	$296	$468	$753
Lodging (3 nights)[2]	75	75	75
Meals (4 days)[3]	100	100	100
Subtotal	471	643	928
Temporary living expense:			
Number of nights/days to reach limitation	11/12	9/10	6/7
Lodging (family of 4)[2]	$550	$450	$300
Meals (family of 4)[3]	480	400	280
Subtotal	1,030	850	580
Total	1,501	1,493	1,508

[1] Ignores cost of ground transportation during trip. This could include parking at airport or limousine service, then at new location, the cost of a rented car or public transportation.

[2] Lodging for 2 (househunding) estimated at $25 per night and $50 per night for a family of 4 renting 2 rooms. This would be a low rate at a moderately priced hotel in a major city.

[3] Meals for 2 (househunting) estimated at $25 per day and $40 per day for a family of 4.

Very little room for temporary living expenses is left after one house hunting trip of limited duration. The number of days a family of four could stay in temporary quarters before exceeding the limit ranges from 7 to 12 days. Yet, the same code section provides that up to 30 days of living expenses could be deducted. Assuming no house hunting expenses, the maximum for this example is 18 days.

An employee who must make a second house hunting trip or needs more than 4 days to make purchase arrangements would have even less room for deducting temporary living expenses.

Limitation to Include Purchase or Sale of Residence

As to the purchase and sale of a residence, consider the following typical expenses incurred by an employee who sells his residence for $40,000 and purchases a residence at his new work location for the same amount:

Sale/purchase of residence expenses

Real estate commission (6 percent)	$2,400
Transfer tax (1 percent—each transaction)	800
Attorneys' fees	150
Mortgage fee (1 percent)	400
Title, notary, etc. fees	50
Total	3,800

These expenses will vary somewhat by State, but this remains a conservative estimate. Alone, these expenses exceed the $3,000 proposed limit without taking into consideration the cost of house hunting trips and temporary living expenses. On a nonreimbursed move, the new provision will only provide partial relief to the taxpayer. In this example (assuming the limit is reached on house hunting and temporary living expenses), the taxpayer has spent at least $5,300, of which only $3,000 is deductible (57 percent).

A significant number, if not the majority of moves, are reimbursed by the current or new employer to the extent of expenses incurred regardless of tax limitations. Code section 82 requires that all reimbursements of moving expenses must be included in income. To the extent the employee's expenses incurred or reimbursed exceed the deductible limitation, the employee must pay income tax on money expended to third parties by or for the convenience of his employer. Moreover, fictitious income is created which could throw the employee into a significantly higher tax bracket, therefore, further increasing his cost on a move for the convenience of the employer. To further complicate the matter, these reimbursements in excess of the deductible limits are subject to withholding taxes under section 3401. Thus, an employee transferred at the whim (and expense) of his employer is instantly out of pocket for these taxes which in some circumstances is a considerable amount.

Most employers in recognition of this inequity also reimburse the employee for the tax incurred, i.e., gross up his reimbursement to make the employee "whole." This of course, increases the employee's taxable income further while providing a correspondingly higher deduction to the employer. The net result of all this is the generation of considerable work for personnel departments, greater expense for the companies, complication of the tax return preparation process and increased anxiety on part of the employee, all without corresponding revenue gain (due to larger corporate deductions) to the Treasury. In fact, since the corporate deduction decreases income taxable at 48 percent and individuals are, generally, in significantly lower tax brackets, there is a net cost to the Treasury.

Recommendation

These costs and inconveniences, to the employer and to the Treasury, are being generated by limitations imposed on expenses which are by law (and regulation) clearly defined. The definition of these moving expenses are, in themselves, the limitation which is most realistic. We suggest, particularly in the case of reimbursed moving expenses and subject to the standard substantiation requirements, that these problems can be eliminated by removing the deductible limits. As an alternative, setting these limitations at a more realistic amount should be considered.

3. DEDUCTION FOR EXPENSES ATTRIBUTABLE TO BUSINESS USE OF HOMES (SECTION 601 OF THE BILL AND NEW SECTION 280 OF THE CODE)

The thrust of the House bill is to disallow all expenses for business use of the home unless a portion of the home is exclusively used for business and constitutes the principal place of business of the taxpayer. This is applicable both to employees and self-employed.

Numerous taxpayers realize substantially greater income because their homes are utilized in their business. Since they are taxed on their total income, it seems inappropriate to disallow the deductions that are associated with its production. The tax law should not dictate whether one conducts one's business solely out of a separate office or partially at the office and partially from a residence. The provisions could cause a particular hardship for authors or similar persons whose income is irregular even though such persons use their homes as their principal place of business.

On the other hand, the provisions relating to vacation homes is extremely complex and largely declaratory of existing law. The further complication of the Internal Revenue Code by these provisions does not appear justified.

4. CAPITAL LOSS CARRYBACK FOR INDIVIDUALS (SECTION 402 OF THE BILL AND SECTION 1212 OF THE CODE)

The House bill as reported by the Committee on Ways and Means contained a provision allowing capital loss carrybacks by individuals similar to those allowed corporations. It was deleted on the floor of the House principally in response to an argument that it would allow deduction for losses prior to 1975 and thus be a windfall to certain individuals.

The situation of the individual who has a large capital gain in 1 year followed by a major capital loss in the following year can cause a real hardship under present law since there is no way the taxpayer can recoup the taxes paid on the gain. Support is expressed for section 1212 with an amendment that would not make it retroactive to losses prior to 1975.

Section 1212 appears to be unduly restrictive in assisting only high bracket taxpayers since it cannot be applied to losses of less than $30,000. We would favor a much lower limitation and actually see no justification for any limitation at all.

5. DISCRIMINATORY TREATMENT OF EQUIPMENT LEASING AND REAL ESTATE VENTURES. (SECTIONS 101, 205 AND 301 OF THE BILL)

The bill contains numerous and complex provisions that would serve to deny access to capital from other than banks or financial institutions for the equipment leasing and real estate field. The continued recovery of the economy and the modernization of production facilities is best served by permitting free access of all potential borrowers to the widest number of potential lenders or investors. Measures inhibiting the access in the name of tax reform will have a depressing effect upon the economy.

(a) *Real Estate*

The provisions which if enacted would adversely affect the real estate industry are (1) LAL, (2) interest deduction limitations, (3) full recapture of depreciation on residential property, and (4) reduction of preference exemptions plus increase in minimum tax rate. One of the country's leading economists estimates that the combined effects of these four provisions will reduce real estate investment by $6.3 billion, reduce GNP by $11.2 billion, reduce U.S. tax revenues by $2.8 billion and reduce jobs by 280,000. (The Real Estate Tax Impact Model developed by Norman B. Ture, Inc., Washington, D.C.)

It is important that legislators understand that these adversities will impact upon small businessmen much more than larger corporations because the composition of the industry is small grassroots builder developers.

We urge that the present tax provisions adequately protect the revenue and prevent wholesale abuses. This is no time to pass laws disruptive to an industry so critical to our country's economy. The tax incentive provided by the present law were passed by perceptive legislators who saw the need to encourage the flow of capital to real estate. To reduce these incentives would place the industry in chaos at a time when the country's first priority should be better and less expensive homes, factories, office buildings and shopping centers.

The alternative of direct subsidy payments should be dismissed in light of the dismal failure of the Government in providing direct subsidy payments through HUD and FHA. Poor administration of many programs has generated "instant ghettos" instead of suitable housing for low income families throughout the country.

(b) *Equipment Leasing*

LAL proposals with regard to equipment leasing vary from the real estate proposals principally only as to the treatment of related investments. With real estate all investments will be considered as one, allowing new real estate shelters to shelter income from other real estate investments. Each piece of equipment on the other hand, is to be treated as a separate investment. Hence, no offsetting of income from any other equipment investments is allowed.

The real problem with the LAL equipment proposals is that they fix economic depreciation at the straight line rate. The actual economic decline in the value of equipment is often in excess of straight line. Highly technological equipment may decline in value at a rate even in excess of accelerated depreciation rates.[1] With such equipment accelerated depreciation rates[2] do not create artificial losses, but only reflect economic reality. Therefore, the proposals for equipment can actually be said to often create "Artificial Income."

These provisions do not apply to corporations, but to individuals. It appears that there is no economic reason for discriminating against individuals. Sales of the equipment industry qualify for the 10% investment credit. To limit equipment leasing merely to corporations will prevent a major source of capital from participating in this industry. This seems totally contrary to the stated goals of the Federal Government to aid equipment modernization.

6. LIMITATION ON NONBUSINESS INTEREST (SECTION 206 OF THE BILL AND SECTION 163 OF THE CODE)

A ceiling of $12,000 would be placed on the deduction of interest by individuals other than interest on loans incurred in connection with a taxpayer's trade or business.

The provision has a potential for creating a trap for the unwary. Two obvious examples are:

(a) Taxpayer has a sale of investment property and contends it is capital gain in 1977. The Commissioner contends it is ordinary income in 1976. The Commissioner wins and there is a deficiency in 1976 plus interest in excess of $12,000. There is a refund due for 1977 (plus interest). The interest income is taxed but the interest paid is partially nondeductible.

(b) Taxpayer has large loans on account of personal matters—serious illness, for example. He finally gets his affairs in order and pays off loan plus interest in arrears. A loan of only a small amount can add up to more than $12,000 when it is in arrears.

We suggest that interest on taxes be treated as interest on business loans. We further suggest that interest that is disallowed be carried back as well as forward and that the carryback-carryforward treatment be available for personal loans as well as investment loans.

7. PARTNERSHIP PROVISIONS (SECTION 210 OF THE BILL AND SECTIONS 704 AND 706 OF THE CODE)

Present law provides great flexibility for the formation of partnerships always subject to the limitation that special rules for allocating items of income and deductions must have economic reality. The House bill would greatly limit this flexibility by making it difficult for persons with different investment objectives to work together in partnership form.

We submit that many of the provisions regarding partnerships are inequitable and encumbering to small business operations. The specific recommendations are tabulated below.

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[1] Studies done by the Equipment Lease Exchange, Inc. on IBM 370 computers have shown that true economic depreciation on such equipment is in excess of sum-of-the years digits (currently the most accelerated form of depreciation) for the first two years.

[2] IRC ¶ 167(b).

(1) *Section 210(a)*.—All of subchapter K reflects the conduit concept that the partnership is not a taxpayer but the partners are taxpayers. The new recommendation vitiates that concept by stating the section 179 bonus depreciation limitation should be applied at the partnership level. This provision should be deleted.

Partnerships are the vehicle for investment by the little man. By denying this very modest deduction when investment is by a partnership appears discriminatory. In the case of small partnerships it is frequently difficult to determine whether an asset is owned by the partners or the partnership and this provision would cause litigation.

(2) *Section 210(b)*.—The chamber recommends that organization costs and syndication fees be amortizable in a manner similar to organization costs of corporations. Furthermore, the term "syndication fees" appears in the title but is not in the text nor is it defined. Also the term "amounts paid to organize a partnership" is vague if it is other than declaratory of present law.

(3) *Section 210(b)(2)*.—The fact that guaranteed payments are not automatically deductible is a well-settled tax principle. The need for such a statement in the code is questioned.

(4) The provisions regarding the manner and time in which income and loss and other items are to be allocated to partners are confusing and will precipitate considerable IRS and taxpayer controversy. The chamber believes these provisions should be deleted.

The intent of the House bill is to prevent tax-motivated allocations. One typical partnership is a partner rendering services and one furnishing capital. A special provision that allocates the loss to the investor-partner merely reflects the fact that it was his money that was lost. Any loss allocation formula should be acceptable as long as the loss is charged against the capital account of the partner to whom it is allocated.

Read literally, the House bill would apply these new rules to existing partnerships. This threatens to be disruptive to many business relationships without any particular advantage to the Treasury. The inability to enter into a business relationship with reasonable certainty that it may continue will tend to have a chilling effect on proposed relationships outside the immediate scope of this bill.

8. DISTRIBUTION OF ACCUMULATED INCOME OF TRUSTS (BILL SECTION 701 AND SECTIONS 644 AND 665–669 OF THE CODE)

Present law has detailed and complex provisions relating to the treatment of income accumulation by a trust in 1 year and distributed to individuals in a subsequent year. These detailed and complex rules were enacted in 1969 to replace provisions originally enacted in 1954 and which were deemed to be inadequate.

To a large extent the amendments proposed by section 701 are desirable since they would exclude from the application of the throwback rules many common cases in which tax motivation is extremely unlikely. On the other hand, they appear to be ill-considered insofar as they would provide special holding period rules for property transferred to trusts and in certain cases provide for double taxation of income without credit for tax paid by the trust.

In particular there are two problems that merit attention:

(a) The special 2-year holding period is not appropriate. An approach through subpart E would be preferable.

(b) The repeal of the refund section can deny a full credit to the beneficiary when there has been a trust-to-trust distribution before the distribution to the individual beneficiary.

9. INVESTMENT TAX CREDIT (SECTION 801 OF THE BILL)

We urge you to support the 4-year extension of the 10-percent investment credit and the $100,000 limitation on used property that continue the increases provided by the Tax Reduction Act of 1975 through December 31, 1980. It is our opinion that the continued need for this provision has been well documented and will be covered in depth by other interested parties in these hearings. It is important to note however that this matter should be dealt with on a priority basis so that the business community has the maximum period of time possible for the forward planning of its capital expenditures.

10. DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC) (SECTION 1011 OF THE BILL)

We recommend that the provisions of the Internal Revenue Code covering DISC's should be amended to provide for 100-percent deferral of qualified export income and that the current law should be amended to encourage entry of new firms into the export market. We believe that U.S.-exporting companies should be able to rely on their Government for support in their efforts to compete effectively in the international market where their foreign-based competition is receiving export incentives from vigorously promoted government programs. We are certain that you will be hearing from many other concerned organizations who will present lengthy economic justifications for the continuing need for the DISC provisions to which we wish to add our recommendation that the United States should not unilaterally abandon its major system for stimulating exports until such a time as effective international agreements are concluded which result in compensating actions by our foreign trading partners. Any other course of action would seem to seriously threaten our U.S.-exporting companies position in various world markets, the repercussion of which would be felt throughout our entire economy.

11. PROPOSED CHANGES IN THE TREATMENT OF FOREIGN INCOME (SECTIONS 1011–1053 OF THE BILL)

The U.S. tax system must be simplified in order to broaden the tax base by encouraging economic development and a mobile work force resulting in increased jobs, a more solid capital base and reduced prices. The tax burden must be equitably distributed in order to reach all segments of the public and all forms of economic activity. Conversely, the tax system should not restrict investments necessary for capital formation and the growth of job opportunities. Taxes on income from foreign sources should be imposed with due regard for the necessity of keeping the U.S. fully competitive worldwide.

A recent survey by the Emergency Committee for American Trade shows that 74 leading international manufacturing companies increased domestic employment by 36.5 percent during the 10-year period between 1960 and 1970 while all manufacturing firms enjoyed a 15.3-percent increase in employment.

To precisely cite the concern of our members, we respectfully submit the following capsulized points and petition tangentially that we are here in the interest of the "small businessperson" not the giants of industry.

(1) Generally, most foreign countries do not tax nonresident citizens on their foreign earnings. Under existing U.S. tax rules, income of a U.S. citizen or resident is taxed from whatever source derived unless a specific exclusion from income is provided. There is a limited exclusion for income from personal services rendered abroad by a U.S. citizen where certain physical presence or residence tests are satisfied.

A U.S. citizen employed abroad usually incurs additional expenses for housing, education and other routine living expenses in order to maintain the standard of living he was accustomed to in the United States. Usually, these additional costs are reimbursed by his employer and as a consequence are taxable compensation to the employee. To the extent the employee is not reimbursed by his employer for the additional U.S. taxes, he is out-of-pocket these additional taxes.

The earned income exclusion is an equitable means of mitigating the individual loss due to additional taxes which are not incurred by U.S. citizens working in the United States. The proposed repeal of this exclusion will eliminate countless job opportunities for many Americans and the additional cost to manufacture will have an inflationary impact on prices.

(2) To enact legislation which would impose a tax on the earnings of a controlled foreign corporation is inequitable and pierces the veil of separate corporate entities. To currently impose a U.S. tax on foreign earnings would place such corporations at a competitive disadvantage and doubtless precipitate retaliatory action by foreign countries.

(3) The foreign tax credit was enacted in order to insure the multinational development of the U.S. economy. The availability of the credit has stimulated the worldwide interest of U.S. companies. The repeal of the foreign tax credit or any substantial modification of it would be completely disruptive of the offshore operations of U.S. companies. It would drive American business from foreign operations and, in fact, provide a considerable competitive advantage to foreign companies. This legislation is not pro-American, it will adversely affect our economy and balance of payments.

(4) The DISC provisions of the law have provided a needed incentive to encourage U.S. exports and should be liberalized as previously explained.

(5) For almost 30 years, the "Possession Corporation" provisions of the tax law have served the national interest of the United States in encouraging the development of U.S. possessions including Puerto Rico. The national interest has not changed and neither should the "Possession Corporation" provisions.

(6) The development of trade in the Western Hemisphere continues to be an important aspect of the development of the U.S. economy. The Western Hemisphere Trade Corporation provisions of the present law provide desirable objectives and should be continued.

(7) A minimum tax on foreign source income should not be imposed since such a tax would result in double taxation which in turn will cause prices to soar in another inflationary spiral. The minimum tax would also restrict the ability of U.S. business to compete in foreign markets with foreign competitors.

(8) The "gross up" on dividends should not be extended to include operations in less developed countries.

(9) The advance ruling requirements of section 367 should be eliminated and taxable income generated by that section should be limited to amounts associated with a tax avoidance purpose. This needless regulatory concern (requiring an IRS ruling in advance of the transfer of property) inhibits the development of free commerce by U.S. multinational companies which has a dampening impact on all domestic business activity.

12. PROPOSED EFFECTIVE DATES FOR LIMITATION ON DEPRECIATION OF MOVIES (SECTION 207 OF THE BILL)

The bill has a number of provisions relating to movies. One of the provisions in section 207 of the bill limits the deductions in the case of certain investments to the amount at risk. Specifically, this provision applies to taxpayers engaged in the business of producing, distributing or displaying movies, raising or feeding livestock or raising or harvesting certain crops. It is obvious that the impact of this would be to restrict the investor from deducting any amount in excess of the money he actually invested plus the royalties that are used to pay the principal on the note. This would deprive the investor of the tax advantages that he anticipates under present law.

This proposal was first announced in a press release of the Ways and Means Committee dated September 11, 1975. Consistent with the press release of September 11, the statute as reported to and passed by the House of Representatives states that the amendment does not apply if "* * * (A) the principal production of the film or video tape began on or before September 10, 1975 (sec. 207(b)(2)(A)).

The Ways and Means Committee report contain the following statements (page 111):

> Under one special transition rule, the at risk limitation does not apply to a film or television tape if principal photography began on or before September 10, 1975, or if there was in effect on September 10, 1975 (and at all times thereafter) a binding written contract between the partnership and a lender for nonrecourse financing for part or all of the cost of the film. *In addition, this transition rule applies only in the case of taxpayers who held their interests in the film (or in a partnership which owns the film) on or before September 10, 1975.*

The confusion is that the underscored sentence is not reflected in the press release nor in the statute. Thus it is important that the Finance Committee report make it clear that the transition rule of paragraph 2 applies regardless of when the interest was acquired. An earlier draft of the statute did have a provision consistent with the committee report. The provision was not contained in the bill as reported and the bill passed the House as reported by the committee with the exception of unrelated floor amendments.

Thus the appropriate action is to ask the Finance Committee to conform its report with the statute. In the alternative, an appropriate limitation on the date the interest was acquired would be the date of Finance Committee action. Taxpayers should be able to rely on the effective date not being earlier than that in the House bill for the purpose of carrying on business activities while the bill is pending in the Senate.

13. PROVISION TO REQUIRE ALL FEDERAL AGENCIES TO WITHHOLD LOCAL INCOME TAX (SECTION 1205–06 OF THE BILL AND SECTIONS 5516, 5517 AND 5520 OF TITLE 5 U.S.C.)

The bill proposes to provide for withholding of State income taxes to members of the Armed Forces who request such withholdings. In addition, it would require withholding on compensation of the members of the National Guard and the ready reserve in certain instances. We do not see any justification for not applying the same rules to employees of the Federal Government that are applied to those in private employment. Therefore, it is proposed that the special exemptions applicable to Federal employees be deleted so that employees would be subject to withholding of local income taxes.

The following provision would be inserted immediately after the proposed amendment to sections 1106 and 1207 of title XII of said bill:

> Title V, section 5520(a) shall be amended by deleting the last sentence in such section and inserting in place thereof, the following:
>
> > The agreement shall require withholding of a city tax from the pay of an employee who is employed in the city, whether such employee is a resident or a nonresident of the State in which that city is located.

In addition to the above comments on the House bill, the following comments are submitted with regard to other proposals that we feel merit consideration:

1. TREATMENT OF BAD DEBT DEDUCTIONS IN COMPUTATION OF MINIMUM TAX ON CORPORATIONS

Lending institutions have currently been realizing extraordinary losses, particularly with respect to loans made to builders. Sound business practices have caused many lenders to deduct extraordinary amounts to fairly reflect losses from these loans. It seems both illogical and discriminatory to impose an additional tax on these businesses by reason of the deductions by them currently of these very real losses.

2. PROPOSED CHANGES IN TREATMENT OF MUNICIPAL BONDS

The House bill does not provide a change in the status of municipal bonds but it is believed that a number of suggestions for fundamental change will be submitted to the Committee on Finance. Basically, these changes would substitute subsidies to the municipalities in lieu of tax exemptions. Proponents of these changes base their argument on three assumptions:

1. The Federal Government is losing too much tax revenue through this exemption.

2. With taxable municipal securities at yield rates comparable with high-grade corporate bonds, municipalities would broadly increase their investment base by bringing in tax exempt organizations and institutions.

3. Municipalities could be reimbursed by the Federal Government for their increase in coupon rate. This reimbursement could be financed out of the additional revenues the Government would collect from the taxing of municipal securities.

Legislators apparently believe that the current financial plight of many large cities (and some States) is due to the shortage of available capital, when actually, the shortage of available capital is due to the irresponsible spending practices followed by numerous large cities. The cities have failed to match tax receipts with operating costs, and in desperation, have resorted to making up the deficiency through long term financing—a practice that no prudent corporation would follow.

Eliminating or reducing the current exemption for investments in municipal securities would not broaden the investment base, but would more than likely shift it from current taxable entities to exempt entities, such as pension trusts. Taxable individuals and corporations which now invest in municipals would shift their investments to high-grade corporate bonds if their municipal investments became taxable. This situation would have an even more unstabilizing effect on the already unstable financial conditions that currently exist in many large cities in the Nation. It is recognized that imminent action is requred by some large cities to stabilize their financial situation and this action must be in the area of greater local taxing efforts and prudent review of expenditures so as to bring revenues and outgo into line. When this approach is taken, the investors will gain greater faith in municipal investments because risks will have been lessened. Income tax of investments in municipal securities did not create the current financial trouble of cities, and modification of this tax treatment will not correct these troubles.

3. IMPLEMENTATION OF REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS (FILER COMMISSION)

The Filer Commission has submitted detailed recommendations that would strengthen the private sector in the charitable area. Secretary Simon has stated that the Treasury would take an active role in efforts to implement the suggestions.

We believe that the strengthening of the private sector of Philanthropy is vital just as we believe it is important to strengthen the private sector in business. In view of the detailed report and of hearings already held by the Foundations Subcommittee of the Finance Committee on specific subjects such as the minimum distribution rule for foundations and the excise tax on foundations, it is urged that the Commission recommendations be acted upon as part of the tax bill.

4. TREATMENT OF CONDOMINIUM MANAGEMENT OR HOMEOWNERS' ASSOCIATION AS EXEMPT CIVIC ASSOCIATION

The IRS has just issued two rulings relating to condominium management and homeowner associations. These rulings, Revise Rules 75-

370, 371, IRB 1975-35, 6, 7, are of particular interest in view of the position currently being taken by the service that such organizations do not qualify for exemption from Federal income tax under section 501(c)(4) as organizations operated primarily for the purpose of bringing about civic betterment and social improvements.

Homeowners' associations and condominium associations have become a part of the residential real estate industry and have drawn particular attention as a result of the special Federal income tax status which these associations try to achieve. It has now become common for planned unit developments (PUD) or Planned Residential Developments (PRD), which are concerned with the development of a large tract of land under a zoning ordinance which establishes the permissible uses, to establish homeowners' associations to own and maintain the common areas and facilities within housing developments. Similarly, condominium associations have been formed to provide for the maintenance and upkeep of common areas and facilities of a condominium.

If an exemption from Federal income tax is to be obtained for such organizations, they have to qualify under section 501(c)(4). Discriminatory treatment of these organizations is not justified and section 501(c)(4) should be clarified.

CONCLUSION

In the interest of brevity, many of the suggestions and comments have been presented rather succinctly. If any members of the staff are interested in amplification of any portions of the presentation, please call the undersigned at (215) KI 5-1234 and I shall be glad to place the caller in contact with the member with whom the suggestion originated.

Respectfully,

JOHN B. HUFFAKER,
Chairman, Federal Tax Committee.

STATEMENT OF LEONARD WOODCOCK, PRESIDENT, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW

We welcome this opportunity to present our views on the vital issue of tax reform. The federal tax structure is a far cry from what it should be—a system primarily intended to raise revenues and to raise them fairly, so that persons in similar circumstances with similar incomes and assets will be taxed alike, while those who have more will pay proportionately more than those who have less. An intricate web of tax preferences has made a mockery of the avowed progressivity in the tax code. The working man is aware that while he is being taxed on every penny he earns, the rich have little trouble escaping their fair share through the loopholes that have been built into the system. Substantial revenues have been lost in the process, but perhaps more important is the loss of trust in Government and institutions on the part of the average citizen. The inequities in the income tax laws are compounded by those in the estate and wealth tax laws, which have consolidated an extremely unequal distribution of wealth in the last 30 years.

Tax breaks for corporations in the form of credits, deferrals, exemptions and deductions have grown enormously and are in many instances at cross purposes with each other or with other avowed postures of the Federal Government. Each of these tax expenditures should be carefully examined to determine if the social benefits they generate are commensurate with their social costs.

H.R. 10612, the Tax Reform Act bill which passed the House last year after months of laborious discussions within the Ways and Means Committee is now before this committee. The bill represents a modest attempt to curb the most outrageous abuses in the tax code. Many of its provisions should be strengthened, its scope must be enlarged, and further reform added. Any provisions which would increase tax expenditures should be critically examined to see if they are really justified. But the bill does furnish a base upon which we can build a more equitable tax system. It is in that spirit that we urge this committee to make revisions to H.R. 10612. No attempt is made here to evaluate each aspect of that bill; instead, the following comments cover major tax matters urgently in need of reform.

CLOSING OF INCOME TAX LOOPHOLES WHICH BENEFIT THE UPPER INCOME HOUSEHOLDS

1. *Tax shelters must be dismantled.*—Many of the tax laws applicable to real estate, farm operations, oil and gas drilling ventures, and film and sports franchise property now used by rich professionals and executives to shield part of their income from taxes were enacted years ago for a totally different purpose. In the case of agriculture, cattle feeding and breeding, allowing the deduction of some costs of development assets when they were incurred rather than requiring the depreciation of such costs over time was intended to help the small farmer's recordkeeping. Now that farming and cattle raising are dominated by corporations, these special rules have clearly outlived their original purpose and benefit mostly the high-bracket taxpayers who use these accelerated deductions to offset their nonfarm income. The Ways and Means Committee recently published several actual tax returns of upper-income individuals—veritable horror stories exhibiting, among others, the case of a $150,000 a year lawyer who by using a cattle feeding operation as a shelter paid absolutely no income taxes.

Instances of real estate shelters also expose the gross loopholes offered by the system—like the example of an executive with $427,000 of income who legitimately paid less than 1 percent of his income in taxes; or that of another executive with a $632,000 income from whom the IRS got $22,000—a tax rate of 3.5 percent.

H.R. 10612 would pare the tax benefits embodied in certain features of tax shelters as they now stand to the tune of $505 million in 1976 and $1 billion in 1981 by disallowing artificial writeoffs now used to shelter other income. Although a step in the right direction, we urge further reform, such as applying the restrictions on a venture-by-venture rather than on a consolidated basis. This and other changes in current law could yield increased revenues of $1.8 billion in fiscal year 1977 and $2 billion in fiscal year 1981.

2. *Capital gains must be taxed at regular rates.*—Gains on the sale of capital assets held more than 6 months are taxed at roughly half the ordinary rates. This provision of the tax code flagrantly discriminates against income from work and therefore results in gross inequities. Responsible for a revenue loss estimated to reach $6.2 million in fiscal year 1977, it is the largest among the tax preferences which benefit households in higher income brackets almost exclusively: 85 percent of the benefits accrue to taxpayers with incomes of $20,000 and over; about two-thirds of the benefits are reaped by $50,000 and over returns.

The failure to deal with this tax preference is a glaring omission in H.R. 10612. We urge this committee to amend the bill in the direction of ending the capital gains loophole.

3. *The tax exemption for interest income from State and local bonds should be eliminated.*—This exemption originated in 1913 with lawmakers' beliefs that the Federal Government could not constitutionally tax interest from such sources. More recently the exemption has been justified as a means of fabricating State and local borrowing by lowering the yield that these governments have to pay in order to raise funds in the bond market. It is estimated that the Federal Government will suffer a $4.8 billion loss in fiscal year 1976 because of this exemption, a loss which will not be offset by the $3.6 billion corresponding savings by State and local governments in interest costs. Thus the Treasury spends $1 to deliver 75 cents in aid to States and localities through this means; the remaining 25 cents ends up as tax relief to investors, mainly commercial banks and wealthy individuals. Indeed, 88.2 percent of the tax break going to individuals accrues to returns with incomes of $50,000 and over.

Besides being an inefficient and inequitable method of transferring funds to States and localities, the system has proved to be unreliable as a stable source of funds. The borrowing power of State and local governments depends excessively on the fluctuations of monetary policy. Moreover, this dependence is not evenly distributed. It is the financially weaker governments which must rely mostly on bond financing that suffer the most in times of rising borrowing costs.

Moreover, the tax-exempt feature of State and local bonds is not attractive to banks and individuals with low effective tax rates, nor to some stable investment groups which are already tax exempt, such as pension funds or nonprofit institutions.

As the supply of tax-exempt issues increases without a similar increase in demand, States and local governments will have to offer rate increases, thus reducing even further the already shrinking "spread" between the yields on taxable and tax exempt securities, and the subsidy aid afforded to States and localities per every dollar lost to the Federal coffers.

An improved approach has just been reported out of the House Ways and Means Committee, in the form of a bill giving States and cities an option of issuing taxable bonds on which 35 percent of the interest would be reimbursed by the Federal Government. Such bonds would provide a more efficient way for the Federal Government to subsidize such borrowing, and would produce a more equitable tax system, since none of the Federal Government's cost would go to purchasers of the bonds. Since the reimbursement percentage serves a dual purpose—to provide a subsidy to the Government unit involved, and to encourage it to use the taxable bond option—it should be set at a level high enough to insure that.

4. *The maximum tax provision must be repealed.*—In the upside down world that our tax code resembles, the maximum tax on earned income was adopted to discourage the use of tax shelters. Rather than eliminating the shelters and increasing both equity and revenues, it was decided to protect earned income from high tax rates. By definition, virtually all of the tax savings resulting from this preferential rate—about $600 million in fiscal year 1977, accrue to taxpayers with $50,000 and over of income.

5. *The minimum tax must be strengthened.*—Currently an individual's tax preferences (shelters, capital gains, et cetera) are taxed at 10 percent after a $30.000 exemption and the taxpayer's regular income tax are deducted. This stipulation was enacted in 1969 to insure that every potential taxpayer contributed to the Treasury. However, it is notorious that there still are a number of rich individuals—622 above the $100.000 income mark in 1973—who legally avoid paying any taxes. Thus, the minimum tax does not constitute a fine enough sieve.

The best way to insure that every citizen pays his fair share is to kill tax preferences, as we have urged so far in this statement. Until that job is completed, the minimum tax rate should be increased, the deduction lowered, and the deduction for regular taxes disallowed. H.R. 10612 would raise an additional $920 million in 1976 and $1,204 million in 1981 by making a substantial start down that road.

Greater equity for low- and middle-income individuals

The continuing high rate of unemployment and low rate of industrial capacity utilization coupled with the fact that consumers have been carrying the business recovery on their backs makes it plain that we will need continuing fiscal stimulus in the last half of 1976 and possibly in 1977 if the expansion is to hold on and solidify.

The Tax Reduction Act of 1975—and its extension, the Revenue Adjustment Act of 1975—delivered tax relief to those taxpaying households which most needed it. We propose that a further step be taken by continuing such relief while providing some direct assistance to people making no or low incomes who do not necessarily qualify for present welfare and similar benefits. Many of the unemployed find themselves increasingly in such circumstances.

This could be accomplished by increasing the current $35 credit per exemption to $225, making it refundable, and eliminating the $750 personal exemption. A $750 exemption is worth $525 to a taxpayer whose marginal tax rate is 70 percent, but only $105 to someone in the 14 percent bracket. Thus, it would be most equitable to simply replace the exemption with the credit. However, given the current economic circumstances, we would agree to provide taxpayers with the option of taking the credit or the exemption. The refundable tax credit would supplant both the $35 credit per exemption and the earned income credit (which is only available for families of low earnings with children), but it would come in addition to an extension of the increases in the minimum standard deduction and the percentage standard deduction with its maximum. All of the tax relief from this proposal would accrue to households under $20,000.

Although a refundable tax credit would provide some relief from social security taxes, we do not intend it as a substitute for comprehensive reform of payroll taxation. Likewise, we do not regard the refundability of the credit as a substitute for welfare reform; rather it is meant as a step in that direction.

Revamping estate and gift taxes

Wealth is much more unequally distributed than income in this country—and its concentration has remained essentially unchanged in the post-World War II period. The top fifth of all families have almost 80 percent of total wealth, as compared with 43 percent of total income. (This is for income as defined by the Bureau of the Census; if we redefine income to include income received from wealth, the total income share of the top 1 percent of all households doubles from 5 percent to 11 percent.)

A majority of Americans would agree that this concentration of wealth is both unfair and dangerous, the former because it is rooted to a large extent in the inheritance of unearned privileges and the latter because it facilitates the abuse of economic, social and political power. Yet as pointed out above, taxes on capital gains are disproportionately low, and wealth taxes such as estate and gift taxes are largely illusory. The nominal tax rates on estates are very progressive, going as high as 77 percent of taxable estates in excess of $10 million. In reality, the estate gift taxes are riddled with loopholes and have practically no impact on the distribution of wealth. In 1965, for example, collections on estate and gift taxes were equivalent to an annual wealth tax of less than 0.2 percent. In 1972 there were 93 gross estates of $1 million or more on which no Federal inheritance tax was paid.

In addition to their impact on the distribution of wealth, these taxes can and should be used to raise substantial Federal revenues. Currently, the estate and gift taxes combined raise about $5 billion. At least 50 percent more could be added to the Treasury by ending the escape from taxes through generation-skipping transfers, and—more importantly in terms of revenues—by changing the treatment of capital gains at death or gift, which right now go totally untaxed. Persons holding appreciated capital assets at the time of death would be treated as if they had sold those assets just prior to death, with the tax rate the same as that applicable to assets sold during life. A deduction for that income tax liability would be allowed in determining the amount of property subject to the estate or gift tax.

Taxation of foreign income and DISC

Foreign-earned income tax reform must be placed high on the priority list by this Committee. The number of concessions—tax havens, tax deferrals, and special tax advantages—given to American-owned multinational corporations if they invest abroad, are legion. These giveaways provide high financial incentives which in many cases make corporate investment abroad preferable to investment at home. This is especially grievous when in our own country we are suffering from mass unemployment, and there seems to be so much concern about the need to stimulate capital investment.

Two substantial tax breaks are deferral of taxes on foreign profit and the foreign tax credit. Under the tax deferral provision, which has been estimated to cost American taxpayers over a half-billion dollars per year, profits of foreign subsidiaries of U.S. corporations are not taxed unless and until they are remitted to the U.S. parent corporation as dividends. They escape U.S. taxation forever if they are reinvested abroad. Withholding taxes on dividends levied by many countries further encourage such reinvestment.

H.R. 10612 would not effect enough changes in the area of deferrals. It would provide for the elimination, which we welcome, of preferences for Western Hemisphere trade corporations, China Trade Act corporations, and less-developed-countries corporations. Increased Federal revenues would amount to about $100 million. Again, rules in the foreign tax credit area would only be slightly modified by H.R. 10612. While recognizing that the tax problems raised by the multinational corporations are indeed complex, it is imperative that the abuse of excess foreign tax credits be eliminated. The UAW's position on foreign tax credits, shared by several public interest tax groups, has favored thorough reform, possibly treating taxes paid abroad as a deduction instead of a credit.

Reform in the allowance of foreign tax credits must be accompanied by repeal of the deferral provision if such reform is to be effective. The repeal of tax deferral on foreign profits would also eliminate the excuse that was used to secure enactment of the DISC legislation that defers taxes on part of the profit of U.S. export sales subsidiaries. The argument was that the DISC deferment would reduce the advantages of foreign over domestic production for U.S.-based corporations. In other words, a tax loophole was opened to offset the harmful effects of an existing loophole. Although the obvious solution was to close that loophole the Nation has instead been saddled with a costly and ineffective tax giveaway.

The revenue loss resulting from DISC has gotten totally out of hand. When enacted in 1971, the Treasury projected its cost to be $170 million; but current estimate reaches $1.5 billion for fiscal year 1977 and $2.4 billion in fiscal year 1981. Moreover, nobody has been able to prove that DISC achieved anything in the export field other than providing windfall profits to export-intensive, well-established industries.[1]

Its job creation effects have been widely advertised; yet a study by the Department of Labor estimated that DISC created 15,960 new jobs in 1974, at a cost to the Treasury which would have generated 120,000 jobs in health, 150,000 jobs in education, or 240,000 public employment jobs.

H.R. 10612 would modify DISC by allowing corporations to defer that portion of their profits resulting from the net increase in export sales over previous years. However, the way the base has been set is

[1] DISC is coming under fire not only at home but abroad, as the EEC is denouncing the tax subsidy as a violation of GATT. Thus, supporters are facing the dilemma of having to argue with domestic critics that DISC is effective in increasing imports, while underrating its achievements in Geneva.

totally arbitrary—obviously designed to give corporations something to show for all the efforts they poured into the battle to keep DISC. The taxpayer would end up the loser, as H.R. 10612 would only recover about one-third of currently lost revenues. This is not enough; we urge DISC be completely abolished.

Corporate taxation

Under the often-heard admonition that we need to stimulate capital investment, H.R. 10612 would extend for 4 years the raise from 7 to 10 percent in the investment tax credit. It would also maintain for 2 more years the reduction of the 22-percent tax rate to 20 percent on the initial $25,000 of taxable income, and the increase in the surtax exemption from $25,000 to $50,000. We urge this committee to delete these provisions, which would altogether cost the taxpayers almost $5.5 billion in fiscal year 1977. Capital spending will increase as soon as businessmen feel confident that the recovery is solid and durable, and credits and other tax breaks will not hasten this process. By fiscal year 1981, the investment credit would relieve corporations of $9.3 billion of tax liabilities. (Individuals would get a not inconsiderable $2 billion from this provision.)

In addition, the asset depreciation range enacted in 1971 should be repealed. As it stands, this allowance entails lost revenues of $1.6 billion in fiscal year 1977 and $2.1 billion in fiscal year 1981.

These are huge sums indeed, but even more important than to question their sheer size is to ask what are they buying and for whom; from our particular vantage point, we want to know what they are buying for the American worker. Across-the-board accelerated depreciation and investment tax credits appear to us as having little or no impact on investment and employment but a substantial effect on the balance sheets of corporations—which eventually will result in undesirable repercussions on the distribution of income and wealth.

By the same token, we urge that this committee take a close look at the legion of tax expenditures in our Federal tax code that favor business, or a particular industry or corporation, with the purpose of finding out what the subsidies are accomplishing, if anything, and at what cost. If it is ascertained that a particular activity is in the public good, and the Federal Government wishes to encourage it, it should do so by subsidizing it directly instead of hiding the subsidy away in a tax break. If the subsidies are out in the open in the form of direct grants, then they can be openly evaluated and reevaluated as to their aims and their effectiveness.

Excise taxes

The excise tax on trucks, buses, and trailers, and on truck parts should be repealed. It was increased as part of the effort to finance both World War II and the Korean war and has remained on the books even when its companion the auto excise tax was repealed several years ago. There is no current economic justification for this tax. On the contrary, provided the industry passes the full savings of excise tax elimination on to its customers, the lower price of trucks, trailers, and buses would attract a larger demand and offers the promise of increasing employment in the auto industry, where over 50,000 seniority workers are still on indefinite layoffs.

This committee has already responded affirmatively to the UAW's request for repeal of the excise tax on trucks and buses. The report of the committee on the bill which later became the Tax Reduction Act of 1975 contained such provision. However, repeal was abandoned in the final version. We urge that it be made part of the Senate version of H.R. 10612.

STATEMENT OF MID-CONTINENT SUPPLY CO.

Mid-Continent Supply Co. (Mid-Continent) is a Fort Worth, Tex., based company which is the largest U.S. independent oil field supplier. Its subsidiary, Loffland Bros. Co. (Loffland), based in Tulsa, Okla., is the world's largest oil and gas drilling contractor. Both Mid-Continent and Loffland operate in many foreign countries spread all over the world. Mid-Continent sells U.S.-produced technical equipment and supplies to the U.S. petroleum industry throughout the world and Loffland offers highly skilled services and drilling equipment worldwide to the same industry.

Both companies wish to comment on provisions of the proposed tax revision bill.

1. Repeal of section 911 exclusion of certain foreign earned income.—Mid-Continent and Loffland both send large numbers of U.S. citizens abroad for foreign service for extended periods of time. In order to persuade competent U.S. nationals to accept such foreign assignments, extra pay and tax incentives have been essential. The proposed phase-out of section 911 of the Internal Revenue Code will eliminate the tax incentive and put the full burden of providing incentives for work abroad on the U.S. employer, which will only increase his costs and put him in a noncompetitive position with foreign employees, with no corresponding benefit to the U.S. Treasury.

The United States is one of the few countries in the world which imposes its income tax upon the worldwide earnings of its citizens. Most countries tax their citizens only on income earned covering services performed or income producing activities conducted within the country. Section 911, enacted in 1926, was intended to partially compensate for this difference by exempting the first $20,000 of earned income of U.S. citizens who are nonresidents of the United States for prolonged periods. Its repeal will place citizens working abroad at an economic disadvantage with citizens of other countries who are employed outside their country of citizenship.

If Section 911 is repealed, U.S. firms would be inclined to employ more non-U.S. citizen employees since such employees would normally be salaried at a lesser figure than would be required by U.S. citizens in order to obtain a comparable "take-home" pay.

U.S. citizens are more likely to order or to influence the ordering of goods manufactured or produced in the United States for overseas use or consumption than nationals or third-country nationals. Accordingly, in order to maintain and/or increase the demand abroad for U.S. goods, some incentive should be provided for U.S. citizens employed overseas. We need U.S. citizens living abroad to protect U.S. interests in the countries where they are located.

The employment of U.S. citizens overseas assists in improving the U.S. balance of payments because a substantial part of the salaries and wages of U.S. citizens employed abroad either return to the United States as savings or stay in the United States in the first instance for upkeep of the U.S. home and family and as savings directly invested in U.S. institutions. In addition, dividends and profits from foreign operations help our balance of payments and, since these would be decreased by higher wage costs, there would be a decrease in the profit flow back to the United States with a negative effect on our balance of payments.

In many instances, U.S. citizens employed abroad are required to maintain two households, one in the United States and the other in the country of his employment, and some compensating benefit should be given him to offset this extra expense. Furthermore, in the countries where these companies generally send their employees it usually is far more expensive to maintain a standard of living which is considered comparable to U.S. standards than it is in the United States. Proponents of section 911 repeal say that taxpayers moving within the United States from one area to a more expensive area receive no tax compensation for this increased cost; but nowhere in the United States is an employee faced with the runaway inflation which continues in most nations abroad. Foreign tax credit alone does not provide sufficient relief to the expatriate employee because credit is given only for income taxes whereas a larger and larger portion of the tax burden in foreign countries consists of indirect taxes, capital levies, excise taxes, and value-added taxes for which no credit is available.

If the section 911 exclusion is repealed, Mid-Continent and Loffland will have no alternative but to replace their U.S. citizens working abroad with foreign born personnel. This result will follow for thousands of other similarly situated U.S. employers, and coupled with the loss of such employer's foreign income, will have a strong negative impact on the U.S. economy. There would be an immediate loss of foreign jobs by U.S. nationals and such persons would be returned to the United States and would either displace other employees from jobs in the United States or would go on the U.S. unemployment and welfare rolls. In addition the loss of the foreign markets would result in substantial cutbacks by the manufacturers whose products are sold by Mid-Continent, again resulting in a loss of more U.S. jobs. In addition, the employment of increasing numbers of foreign personnel and the necessary training of such personnel will mean a loss of U.S. technology to foreign countries without compensation. This exportation and loss of U.S. technology will eventually result in the elimination of any technological advantage which U.S. manufacturers and skilled technicians (such as Loffland) may still have.

When a U.S. citizen is employed overseas, he loses many of the benefits available only to persons living in the United States and which are paid for by U.S. taxes. Why is it not equitable to give some tax relief to U.S. citizens who are not getting the benefit of tax paid governmental services?

In the event section 911 is repealed, U.S. employers will be obliged to increase salaries or living allowances of their U.S. citizens employed abroad in order for such employees "take-home" pay to remain the same as it was prior to repeal of section 911. This increase in salaries or living allowances would result in additional deductions for U.S. corporate income tax, thus reducing the U.S. revenue and completely eliminating any increase in revenue resulting from the repeal of the section 911 exclusion. The proposed phaseout of section 911 is not in reality a revenue raising measure but just the opposite, since the U.S. corporate taxes of the employers will be decreased by 48 percent of their increased wage cost, while the additional income of the employees subjected to tax will be taxed at much lower average rates.

If the section 911 exclusion is repealed, U.S. firms operating abroad will be placed at a competitive disadvantage to non-U.S. firms whose employees do not have the same tax burden, making it ever more difficult for the U.S. to compete in foreign markets. This exclusion for income earned abroad has been around in one form or another since 1926. It is not a major tax loophole. If there are abuses under the present provisions of the law, the specific abuses should be eliminated instead of destroying this incentive to U.S. businesses operating overseas, damaging our balance of payments, endangering the foreign market for U.S.-produced goods and services and adding to our unemployment problems.

2. *Repeal of Western Hemisphere trade corporations provisions.*—A Western Hemisphere trade corporation is a domestic corporation which does all of its business in North, Central, or South America, or the West Indies, and has at least 95 percent of its gross income from sources outside the United States and at least 90 percent of its income from the active conduct of a trade or business.

The special treatment afforded these companies began in 1918 to encourage the use of domestic corporations for operations in the Western Hemisphere. There has been a long history of special tax treatment for income received by domestic corporations from sources within the Western Hemisphere. The lower tax to Western Hemisphere trade corporations was granted in 1942 to allow U.S. corporations to compete effectively with foreign local corporations and third-country foreign corporations doing business in the Western Hemisphere.

At present these corporations engage in export activities that provide a positive stimulus to our balance of trade. DISC status is denied to such corporations to preclude a double benefit. Retention of the existing provisions is necessary in order to continue the established avenues of trade with the countries in the Western Hemisphere to whom we are so closely tied. It is essential to our domestic economy and implementation of our international policy for the special tax incentive to continue. Since the promulgation of the Monroe Doctrine it has been a fundamental part of our foreign policy to recognize the special status of the other nations in the Western Hemisphere and to encourage trade between the United States and these neighboring countries. Why should this policy be changed? A loss of this tax benefit, in effect since 1942, will result in higher prices for U.S. products sold in the Western Hemisphere with a consequent loss of trade, a decrease in income subject to U.S. tax and a negative effect on our balance of payments. This committee should not do away with an important element of American foreign policy, in effect for almost 25 years, by eliminating the special deduction allowed to Western Hemisphere trade corporations. For no other reason, you should avoid a slap in the face of our Western Hemisphere allies at the very time that we are trying to improve and strengthen our relations with these countries.

3. *Repeal of less developed country exceptions to section 1248.*—The proposed elimination of the slight tax advantages presently given to U.S. corporations doing business in "less developed countries" is another example of changes in tax policy working against established U.S. economic and foreign policy. The present exclusions from the application of section 1248 of the code to "less developed country corporations" (LDCC's) is fully justified. All of the Common Market countries, most other European countries, and Japan are prohibited by the Trade Act of 1974 from being designated less developed countries. Existing tax provisions act as a barrier to private investment in foreign countries and such provisions must be mitigated to encourage investment in less developed countries because American firms must compete with firms incorporated in foreign countries which are taxed at lower rates than U.S. corporations. Treaties prevent less developed countries from using tax rebates as a device to attract American investment.

There are great commercial risks in investing in less developed countries but it is part of our fundamental foreign policy to encourage the development of these countries and incentives must be offered to induce U.S. firms to make such investments. Social unrest and political instability in these countries constantly pose the threat of discriminatory application of the laws, expropriation and civil strife, and preferential tax treatment is justified to stimulate private foreign investment, because of the U.S. role in foreign affairs. We want underdeveloped countries to take their place in the free world and to do so their national economies must be strengthened. An expansion of the economies of less developed countries is desirable because it results in higher standards of living and greater purchasing power in these countries and improved markets for U.S. exports.

The repeal of the less developed country exception, which excludes earnings accumulated while a corporation was a less developed country corporation from those earnings and profits which are subject to tax as a dividend if there is gain from the sale or exchange of stock in the controlled foreign corporation under section 1248 of the code, also would discourage investment in these less developed countries.

The proposed elimination of the tax encouragement given to LDCC's is a part of the blatant return to isolationism which is so apparent a part of the proposed tax revision bill. It is hoped that the Senate Finance Committee will not let itself become a party to action which will result in fundamental changes in foreign and economic policy under the guise of closing a supposed tax loophole.

4. *Restriction of benefits for domestic international sales corporations (DISCS).*—The establishment of special tax deferral provisions for DISC's in 1971 was part of a concerted governmental effort to encourage U.S. exports and to relieve our balance-of-payments deficit. Now that we have finally turned the corner on our balance of payments, why go backward? Why take an action which will discourage export trade and which could well put the United States back into a balance-of-payments deficit?

The special tax deferral given to DISC's in 1971 was recognized as a belated recognition by the Federal Government of the assortment of direct subsidies, quotas, and other devices used by foreign governments to restrict their imports and aid their exports.

Since 1971, U.S. exports have increased tremendously and much of it can be attributed to the incentive program offered to DISC's, which has provided thousands of U.S. companies with enough additional cash flow to finance the creation or expansion of foreign markets.

Many companies not previously in the export business have used the DISC to enter foreign market. This is particularly true of small businesses which previously avoided export business because of the startup expenses, the difficulty of locating markets and compliance with various domestic and foreign regulations. Use of the DISC's has stimulated employment and economic activity by manufacturers supplying the exporters, by service companies supporting export activity, and of course, by the exporters themselves.

H.R. 10612 by redefining the income to which DISC deferral would apply unnecessarily restricts the benefits of DISC operations. In attempting to "compensate" for the effects of dollar devaluation by creating an income base of 1972–74 DISC income, the bill cuts the effectiveness of DISC significantly. Those companies which used DISC's to increase their exports during those earlier years will be penalized and must move back and start again. Such a change would reduce the ability of many companies to continue their expansion of export markets.

With the success of the DISC program in encouraging exports, no change should be made to restrict its application and consideration should be given to eliminating the 50 percent restriction on DISC income which qualifies for the tax deferral.

5. *Conclusion.*—Mid-Continent Supply Co. and Loffland Bros. Co. have attempted in this presentation to show why certain proposed changes in the tax laws now before this committee would not be to the best interest of the U.S. economy, would be contrary to established U.S. foreign and economic policies and would, in fact, yield little or no increase in tax revenues. The proposals which these taxpayers are opposing would all result in higher costs to U.S. exporters, a reduction in U.S. export business, lower taxable income for exporters (resulting in lower taxes and loss of revenue to the United States) and would be a significant step in return to isolationism, a doctrine long since thought repudiated and abandoned.

It is hoped that due consideration will be given to these views and that the committee will repudiate these proposed changes in the tax law and act to encourage foreign commerce by U.S. companies rather than to discourage it.

TAX SECTION,
NEW YORK STATE BAR ASSOCIATION,
April 20, 1976.

Mr. J. MICHAEL STERN,
Senate Finance Committee,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: On behalf of the tax section of the New York State Bar Association, I enclose a report prepared by the section's committee on incentives concerning provisions of H.R. 10612 relating to tax incentives.

The report agrees with statements in the report of the House Committee on Ways and Means that there is a need for income tax equity at all levels, simplification, and improved administration. It concludes, however, that H.R. 10612 does not achieve these objectives. The report criticizes the excessive complexity of many of the provisions and points out numerous technical and administrative problems. Provisions discussed include those dealing with the limitation on artificial losses (in general and as they relate to specific types of proprety), the limitation of losses to amounts "at risk" for certain types of investments, interest deductions, the minimum tax, and investment credits for films.

The principal draftsman of the report was Kendyl K. Monroe, chairman of the section's committee on incentives. Other persons participating in the preparation of the report were Hugh Mr. Dougan, Andrew J. Friedland, Paul J. Goldberg, Stephen L. Golding, Edward H. Hein, Joseph P. Rogers, Jr., Philip Heyman, and Alan S. Rosenberg.

Sincerely,

PETER L. FABER, *Chairman.*

INCENTIVES COMMITTEE: TAX SECTION, NEW YORK STATE BAR ASSOCIATION

REPORT ON PROVISIONS OF THE TAX REFORM BILL OF 1975 RELATING TO TAX INCENTIVES AND TAX SHELTERS

Introduction

This report discusses certain of the provisions of the tax reform bill of 1975 (H.R. 10612) (the House bill) which deal with limitation on artificial losses (LAL) (title I), other amendments related to tax shelters (title II), the minimum tax (title III), and investment credit changes (title IV). The House bill was passed by the House of Representatives (the House) on December 4, 1975 and is presently pending before the Senate Finance Committee.

Virtually all agree that tax reform is needed if there is not to be an erosion of confidence in our tax system. It was with a spirit of utmost sensitivity to this compelling need that we have analyzed the means adopted by the House bill to achieve this objective.

In general, the provisions here under consideration deal with the complex interrelationships between tax incentives and taxpayer abuses. The underlying premise of these provisions is that the tax incentives in the present law should be retained but that the resultant benefits should be limited and should not be available to shelter other unrelated income.

We have examined this premise, and the provisions which implement it, in light of the major objectives of the House bill as set forth by the House Ways and Means Committee (the House committee) in its report (H.R. Rept. No. 94–658) (the House report). The House report states (p. 3) that the House bill is designed to achieve, among others, the following objectives:

(*a*) Income tax equity at all levels;
(*b*) Simplification; and
(*c*) Improved administration.

In separate parts of this report, we set forth detailed comments on the provisions of the House bill proposing amendments to the Internal Revenue Code of 1954 (the code) dealing with the following subjects:

(*a*) Limitation of artificial losses in general (pt. 1).
(*b*) Treatment of real property (pt. 2).
(*c*) Treatment of lease property (pt. 3).
(*d*) Treatment of oil and gas (pt. 4).
(*e*) Treatment of farming operations (pt. 5).
(*f*) Treatment of films (pt. 6).
(*g*) Investment credit for films (pt. 7).
(*h*) Interest deductions (pt. 8).
(*i*) Minimum tax (pt. 9).

In general, these comments indicate that the House bill does not achieve the stated objectives of the House report. The House bill, for example, does not foster income tax equity at all levels. Although the House bill will increase the tax liabilities of many who heretofore may have failed to carry a fair share of the tax burden, it does so in ways which create new inequities and perpetuate many of the old inequities.

The House bill is extremely complex—in direct conflict with the stated objective of simplicity. Moreover, complexity serves to subvert the stated objective of improving the administration of the tax laws. Although the high income taxpayers to whom these provisions are primarily directed may frequently have the means to engage highly skilled professionals to guide them through the complexities, the provisions apply equally to vast numbers of lower income taxpayers, such as small farmers and owners of two family homes, who have neither the access nor means to employ such professionals. Moreover, the employees of the Internal Revenue Service may not be able to deal effectively with such complexities. As a result, it is highly unlikely that the provisions will be administered efficiently or with a high degree of uniformity among taxpayers.

To a substantial extent the House has abdicated responsibility for the complexities it has created. The House bill contemplates that the Secretary of the Treasury will provide clarification by regulations. The recent experience in this regard with respect to ERISA makes this prospect a fearful one to contemplate. The difficulties and delays incident to the issuance of regulations under ERISA have thrown the entire area of pension plan administration into a state of turmoil. The House bill may have similar consequences for important segments of our national economy such as the oil industry, farming and real estate. Any significant period of uncertainty may cause a delay in investment decisions which, in turn, could have a serious impact on our economy.

The House report discusses (pp. 28–85) whether particular tax incentives can be justified from the point of view of public policy. Although it accepts the incentives in principle, the thrust of the House bill is to curtail the use of the incentives. We submit that before rational tax reform can proceed, the premises underlying the incentives must be examined. It may well be that as a result of such examination certain tax incentives would be eliminated entirely. This might be done, for example, on the ground that the objective for which the incentive was granted is no longer valid or can be achieved more efficiently by other means. In other areas, by contrast, the form of the present incentive, which might provide, for example, for the availability of deductions against unrelated income, may be the most effective way to achieve the objectives for which the incentives were granted.

The House bill makes selective changes in provisions of the law which are based on well-established principles, without adequate consideration of the broad implications the changes may have. The "at-risk" provisions of the House bill substantially alter the economic consequences of nonrecourse financing, and should not be adopted without further study. Nonrecourse financing is a well established financing medium. The tax consequences of nonrecourse financing are based upon the long standing precedent of the U.S. Supreme Court in *Crane* v. *Commissioner of Internal Revenue*. 331 U.S. 1 (1947). If the law based upon the precedent is to be repealed, it should not be done on a selective basis.

Another example is the proposal for an arbitrary limit on interest deductions. The deduction for interest has been in our tax law since the earliest revenue acts. The House report fails to reflect any detailed study of the implications of proposed restrictions of the deduction.

Finally, the increase in the minimum tax without corresponding basis adjustments erodes the principle of tax symmetry aggravating the prospects for double taxation—which has traditionally been considered at odds with concepts of tax equity.

Meaningful tax reform is urgently needed—for all the reasons set forth in the House report—but meaningful tax reform will require the reexamination of all the objectives the tax law seeks to accomplish and a careful weighing of competing considerations.

We submit that before meaningful tax reform can be achieved, the following questions must be faced:

1. Are the incentives in the present law necessary to attract investment capital into economic activities important to our national interests in amounts greater than would otherwise result from normal market forces?

2. Does the capital thus attracted to such economic activities in fact serve to achieve efficiently the objectives sought, with respect to output and cost?

3. Is there a more efficient means to achieve the objectives sought?

4. What impact will proposals have on the industries affected? Where industry practices have been based upon a tax structure of long standing, should there be a transition period to allow for adjustment to new tax rules?

5. When the objectives sought are examined in light of their real costs to the Nation at large (whether that cost be by way of lost revenue by reason of tax shelters or subsidizing classes of citizens who benefit from the economic activity encouraged) can the particular objectives be justified in terms of competing national goals and costs?

To date vast amounts of energy have been expended by Congress and others in an attempt to achieve the tax reform which virtually all agree is desperately needed. If the House bill were enacted, infinitely more energy would be required at every level to comprehend, administer, and interpret the law. Although a total revamping of our tax laws would initially require an even greater effort by Congress if real tax reform is to be achieved, it may well be a more efficient and effective alternative.

If the problems inherent in our existing tax system require some immediate temporary correction, pending the comprehensive review that we suggest, we would nevertheless recommend that the LAL concepts proposed by the House bill be rejected, and that the existing minimum tax for tax preferences be repealed. Instead, as an interim solution to the problem of tax shelters, we would favor some single simpler approach (such as that proposed by the Committee on Taxation of the Association of the Bar of the City of New York in its recent report entitled "Proposal for Limitation on the Use of Tax Incentives"), which would defer deduction of certain designated items arising from tax shelter activities, to the extent that they exceeded in the aggregate a stated percentage of an individual's taxable income (computed without regard to any such items).

As we note in detail in the suceeding parts of this report, there are numerous errors and inconsistencies between the House bill and the House report. Since congressional reports are perhaps the most significant source of guidance in interpreting legislation, it is imperative that these errors and inconsistencies be eliminated in the conference report on the final bill. Corrections in the Senate Finance Committee report may not be sufficient since they may serve to create a conflict between the Senate and House report and further obfuscate congressional intent.

PART 1: LIMITATION ON ARTIFICIAL LOSSES IN GENERAL

I. GENERAL DESCRIPTION

The premise of LAL is that the ability to utilize accelerated deductions from the various shelter activities against a taxpayer's unrelated current income results in an undesirable deferral of current tax liability not reflecting true economic losses, and encourages a lack of attention to the probable economic success of the activity in which the investment is made. (House report, p. 8) The LAL provisions seek to deal with this problem by limiting the availability of such deductions to the amount of the taxpayer's current net income from the activity in question.

The vehicle for this limitation is the concept of the "net related income" from the activity or property. Thus, for each of the major tax shelter areas, there is a definition of the property which the House committee believed constituted the subject of undesirable excesses or abuses. For example, not all real property is "LAL real property," but only that which is held for rental or for sale as inventory. Similar specific choices are reflected for each of the LAL shelter areas in proposed § 467(a).

Proposed § 467(b)-(g) contains a further definition of the class of LAL property, within each of the major areas, which in turn establishes the scope of "net related income" against which the various accelerated deductions may be claimed. The relative stringency of the limitation thus depends upon the breadth of the "class" of property for which "net related income" is to be computed.

Unfortunately, the House committee chose to vary the definition of "class" for each of the major areas. Thus, for example, all LAL real property of a taxpayer is one class, but each item of LAL lease property of a taxpayer is a separate class. The most narrowly defined class involves farm property of a farming syndicate. Here, each activity on each farm begun during each year is a separate class.

The LAL rules are applicable to individuals (which includes trusts and estates according to the House report, p. 33) holding interests in LAL property directly or through partnerships. The LAL rules do not apply to corporations, other than electing small business corporations, except with respect to farm property where the corporation does not use the accrual method of accounting and capitalize certain preproductive period expenses.

Proposed § 468 defines the various "accelerated deductions" applicable to each of the LAL areas. These are the deductions which the House committee considered to have been subject to excesses or abuse, and the availability of which is to be limited. With respect to each of the LAL areas other than farm property, the deductions which constitute "accelerated deductions" are applicable to all activities within the LAL area in question, and are not dependent upon the form of organization of the taxpayer. With respect to farm property, however, a variety of technical distinctions and exceptions are drawn which subject the same type of deduction to widely varying treatment, depending upon the nature of the crop or activity, the practices of certain taxpayers, and the form of organization of the taxpayer.

Proposed section 468(g) defines the concept of "net related income." In general, this is defined as the gross income from a class of LAL property, less deductions attributable to such class (other than the "accelerated deductions"). Certain special exceptions are prescribed for the computation, however. Thus, any excess of ordinary (i.e. not "accelerated") deductions over the income attributable to a particular item of property within the class is not to be taken into account nor is the computation to include any deduction for net operating loss, capital loss carryback or carryover, or the 50 percent deduction for long-term capital gains under code section 1202. Further special rules are provided for certain transactions involving oil and gas deductions (attributable to dry holes) and for processing income attributable to farming activities. These will be discussed in more detail in the subsequent parts of this report dealing with such activities.

To the extent that the accelerated deductions from a class of LAL property exceed the net related income from the current year of such class, the deductions are not currently allowed, but are placed in a "deferred deductions account," which is to be carried forward to subsequent years, as described in proposed section 466(b). These deductions are to be allowed in subsequent years only to the extent that the net related income from the class of LAL property in question exceeds the accelerated deductions attributable to such class, in the subsequent year.

A major exception to this limitation is the notion that the deductions so deferred should be taken into account without regard to net related income at the time that the taxpayer terminates his interest in the activity. This is deemed an appropriate time to measure true economic gain or loss.

It was, however, the House committee's judgment that in a variety of instances such a "summing up" procedure should reflect economic considerations different from those upon which the deferral was based.

Thus, the circumstances giving rise to this triggering event are defined in proposed section 469, by reference to "disposition classes" of LAL property. These define the scope of the activities within an LAL area which must be terminated in order to trigger deduction of the balance (or a portion thereof) in the deferred deductions account, without regard to net related income in the year in which such termination occurs.

Unfortunately, the House committee chose to establish different disposition classes for each of the LAL areas, and such classes are not identical in scope to the class giving rise to the deferral computation for each area. In some cases, they are broader, and in other cases, narrower. For example, LAL real property is favored with the broadest class for determining net related income, and the narrowest class for determining dispositions that trigger the allowance of previously deferred deductions. By contrast, farming syndicates are given the narrowest class for determining net related income, but the broadest class for determining dispositions that will trigger previously deferred deductions.

In addition, proposed section 469 provides a variety of special technical rules concerning certain types of transfers. In general, transfers by gift, by reason of death, or between related parties, in which gain or loss is not recognized in whole or in part, are not treated as dispositions, and the transferee succeeds to the balance of the transferor's deferred deductions account allocable to the transferred property. In the case of transfers to an heir or beneficiary (other than the estate) of a decedent, and in the case of transfers to persons not subject to the LAL rules, provisions are made for a basis adjustment instead of a carryover of the deferred deductions account. Installment sales for which the taxpayer elects to return income under code section 453 are not treated as dispositions, but the final payment or the disposition of the installment obligation is treated as a disposition.

Proposed section 470(a) contains definitions of certain terms required to apply the LAL rules, which are not elsewhere defined. Proposed section 470(b) contains a special exclusion designed to except farmers from the LAL rules if their nonfarm adjusted gross income for a taxable year does not exceed $20,000 (this exclusion is phased down for taxpayers whose nonfarm income exceeds $20,000, and becomes entirely inoperative at the $40,000 level). Special rules are contained in proposed section 470(c) which phase in the application of LAL as to different types of real property. In general, property for which construction began prior to January 1, 1976, is entirely excluded. Later phasein dates are provided for residential real property, and still later dates for low-income housing.

Proposed section 470(d) provides a variety of technical rules intended to coordinate LAL with other provisions of the code. For example, LAL is to apply only after the application of certain other limiting provisions provided in the House bill itself, such as the limitations on deductions for prepaid interest, and deductions in excess of the taxpayer's investment "at risk" in an enterprise. In addition, partners are treated as sharing proportionately in each item of partnership LAL property, and the disposition of a partnership interest is treated as a disposition of the partner's interest in the underlying property.

In addition, proposed section 470(d)(2) provides that items of income or deduction attributable to more than one class of LAL property shall be allocated among the same in accordance with regulations to be prescribed. This, however, leaves a major procedural gap in the LAL provisions, which does not appear to be filled either in the House bill or in the House report: when there is more than one item of property in a particular LAL class, no provision is made for determining which accelerated deductions are deemed allowed and which are deemed deferred, in a case in which there is some net related income (but less than the full amount of the accelerated deductions) for the current year.

By the same token, once deductions have gone into the deferred account, no procedure is specified for determining which of the deductions accumulated in the account are deemed to be utilized in a subsequent year in which there is sufficient net related income to absorb some (but less than all) of the deductions in the deferred account. Curiously, the House report discussing the LAL provisions on oil and gas property states, p. 58, that deductions are to be withdrawn from the deferred account on a LIFO basis. There appears to be no provision in the statute to such effect, however, nor is a similar statement made in the House report with respect to any of the other LAL properties. From the standpoint of minimizing the period for which extensive accounting records must be maintained, it would seem preferable to remove items from the deferred deduction account on a FIFO basis.

It is critical that the aforementioned gaps in accounting procedure for the deferred deduction accounts be filled since the "disposition" rules in many instances contemplate that the balance of deductions remaining in the deferred account (that is, not previously utilized) attributable to the item of property disposed of shall be currently allowed.

Section 101(b)-(d) of the House bill contains additional technical and clerical amendments (including a 10-year spread-forward of adjustments for farmers changing to the accrual method of accounting). Curiously, section 101(b)(1) of the House bill appears to be a mistake; it refers to an election to aggregate residential real property under proposed Section 467(b)(3). This must refer to a former version of the House bill since, as enacted, there is no proposed Section 467(b)(3) and all real property is treated as one class.

House bill Section 101(e) provides effective dates for the application of the LAL rules. Different dates are selected for different types of LAL property. In general, the rules apply to expenditures paid or incurred after September 10, 1975, in the case of lease property and film property, after November 4, 1975, in the case of sports franchises, and after December 31, 1975, in the case of real property, farm property, and oil and gas property. Additional exclusionary rules, however, are applied to lease transactions in place or under way prior to September 11, 1975, to film transactions in specified stages of progress before September 11, 1975, and to that part of a grove, orchard or vineyard planted before September 11, 1975. In addition, an attempted transitional rule for sports franchises appears to have been inadvertently mangled. The language of House bill Section 101(e)(7) indicates that the rules apply to franchises established or transferred after

November 4 "(or pursuant to a binding contract in existence on such date and at all times thereafter). . .". One surmises that transfers pursuant to an appropriate binding contract were intended to be excluded from the LAL rules, rather than included.

It is not clear why the exclusionary transitional rules for such transactions appear in the effective date provisions of House bill section 101 (e) rather than in proposed section 470, which contains the similar transitional exclusions for real property.

II. GENERAL EVALUATION

The procedures involved in the various LAL provisions do little to accomplish the major purposes of the House bill which, as professed by the House committee in its report, p. 8, are to "make the tax system simpler, more equitable, and more conductive to economic efficiency and growth". They also represent a substantial departure, which has not been fully thought through, from basic concepts of determining taxable income and loss on the basis of annual accounting periods and the cash receipts and disbursements method of accounting.

The impact of the LAL rules varies considerably among the classes of LAL property and in some cases from activity to activity within a class of LAL property. Although the portion of the House report concerning the LAL rules is voluminous, it does not explain why certain industries or activities are favored over others. Certainly the farmer whose crops do not fall within the exception to the LAL rules on preproductive period expenses or the individual producing motion picture films or leasing personal property whose property is subject to much more punitive class rules than the individual leasing real property will not easily be persuaded that the major purpose of the House bill is to improve the equity in our tax system.

The House bill removes incentives and creates new tax burdens on an industrywide basis. The "tax shelter" oriented investor in some of the affected industries provides only a small portion of the investment funds required by such industries. By failing to distinguish adequately between tax shelters and industry needs, the broad sweep of the House bill will create economic inefficiencies by widely discouraging investments by the non-tax-shelter-oriented investor in the affected industries.

To assert, as the House report does (p. 8), that the LAL provisions will make the tax system "simpler" seems absurd on its face. The provisions do nothing to simplify existing law. Instead, they add a labyrinth of new complexities that are likely to be misunderstood and misapplied both by taxpayers and the Service. Moreover, the LAL provisions will impose staggering new requirements for recordkeeping, and, as a major departure from the annual basis for determining taxable income, will require that such records be maintained (and be capable of substantiation) for a virtually indefinite period into the future. By the same token, in order to monitor the consistency of a taxpayer's reporting practices under LAL, the Service will have to maintain its records in accessible form for the same period.

The complexity, the uneven application, and the staggering recordkeeping requirements of the LAL rules will neither ease the Treasury's burden in administering the tax laws nor improve the taxpayer's desire to comply voluntarily with the tax laws. The Treasury will be required to draft a host of complex regulations for the guidance of the IRS and the taxpayer. Moreover, effective enforcement of the LAL rules will require IRS agents who both understand the rules and are able to devote sufficient time to conduct audits covering in each case all of the years in which the LAL property was held by the taxpayers as well as all of the years in which it was held by a person who transferred the property to the taxpayer in a transaction, such as a gift, in which the LAL deferred deduction account is transferred along with the LAL property.

Taxpayers may have great difficulty in substantiating deductions which have been deferred for years after the occurrence of the expenditures or transactions giving rise to the deductions, and they may, for all practical purposes, be unable to substantiate deductions in cases where they succeed to a deferred deduction account.

Part 2: Treatment of Real Property

I. DESCRIPTION OF THE PROVISIONS OF THE HOUSE BILL

Under the House bill, real property subject to LAL includes property held for rental and that held for sale as inventory, but does not include code section 1245 property.

In the case of real property, deductions to which LAL applies are accelerated depreciation in excess of straightline, and interest and taxes attributable to a construction period.

All LAL real property of a taxpayer constitutes a single class of LAL property for purposes of determining "net related income".

However, each item of such property is a separate class for purposes of triggering deferred deductions in the event of a "completed disposition".

In addition to the LAL provisions, section 102 of the House bill extends for 2 additional years the provisions of code section 167(k), relating to fast amortization of rehabilitation expenditures for low-income housing. Section 201 of the House bill tightens to some extent the existing rules on depreciation recapture for real property. With respect to the latter, the present percentage phaseout of recapture for conventional rental housing is wholly eliminated, and the phaseout for subsidized housing presently commencing after 20 months is revised to commence only after 100 months (as is presently the case with respect to code section 167(k) expenditures, which remain unchanged). As at present, straightline depreciation is not subject to recapture, nor are deductions other than depreciation (such as for construction period interest and taxes) made subject to recapture.

The House committee took the view (House report, p. 81) that the deduction for accelerated depreciation frequently did not reflect a true decline in value in the case of real property, and the allowance of such deductions currently against unrelated income of the taxpayer thus resulted in artificial current accounting losses, which effectively deferred other current tax liability for a substantial period of time. The House committee observed that this had produced "substantial dealing in 'tax losses'".

With respect to deductions for interest and taxes during the construction period of property, the House committee concluded that the current allowance of such deductions has also contributed to the development and distribution of tax shelters in real estate, designed primarily to take advantage of the tax benefits. These deductions, the House committee believed, achieve tax deferral through failure to match properly such expenses with the subsequent income presumably to be expected from the property. This was deemed a potentially significant tax advantage in view of the long period of economic usefulness that may be anticipated from real property improvements generally. In addition, the House committee observed that such deductions might result in the effective conversion of ordinary income into capital gain, since they may presently be deducted from ordinary income but need not be recaptured as ordinary income if the property is ultimately disposed of at a gain. In this latter respect, however, the House committee did not propose to change existing law.

In proposed section 470(c), transitional rules provide, in general, that real property of the types therein described shall not be subject to the LAL provisions if construction thereof is commenced before the date stated therein. The specified dates are January 1, 1976, for real property generally, January 1, 1978, in the case of residential real property, and January 1, 1981, in the case of low-income housing.

II. COMMENTARY ON THE HOUSE BILL PROVISIONS

A. Classes of LAL real property

At the outset, it may be questioned why code section 1245 property is excluded from the category of LAL real property, even though it may be held for rental or for sale. Presumably, the fact that depreciation deductions for such property are subject to recapture in full in the event of gain on ultimate disposition has a bearing on this exclusion. In addition, it may be that such real property has not heretofore been the subject of tax shelter syndication activity to any significant extent.

A more serious question concerns the inclusion of property held for sale. We are not aware that this type of property has been the subject of significant syndication offerings to tax-motivated passive investors. The deduction for depreciation does not apply at all to such property, nor do interest and taxes during construction provide any opportunity to convert ordinary income into capital gain with respect to such property. The only tax benefit here would appear to be a relatively brief element of deferral, arising from deductions for construction period interest and taxes.

This activity presents so little of the scope or extent of the tax shelter excesses sought to be restrained by the House committee that its inclusion does not seem appropriate at all. As a practical matter, its application is likely to be confined to noncorporate professional developers. It is true that a developer could obtain more extended tax deferral benefits through sales on the installment method, but this in turn requires substantial additional capital to carry the customer's credit. We doubt seriously that imposition of the proposed limitations on this activity is appropriate at the present time.

A further concern in applying the proposed rules to professional developers is the failure of the House bill to integrate such provisions with the deduction for net operating losses under code section 172. Housing has been a notoriously cyclical business. When interest rates climb and sales are impeded, situations may well occur in which current deductions (including construction period interest and property taxes) exceed current income, and the net operating loss carryback would otherwise provide needed immediate tax relief. By disallowing the excess "accelerated" deductions, including out-of-pocket expenditures for interest and taxes, the House bill appears to eliminate them from the deductions "allowed" for a taxable year (within the meaning of code section 172(c)) and thus from the computation of net operating loss eligible for immediate carryback. It would seem that the number of developers that have gone bankrupt in the past few years would have been much greater if such a limitation had been in effect.

B. *LAL real property accelerated deductions*

The deductions for interest and taxes to carry unimproved and unproductive real property are not affected by LAL, but the very same deductions (attributable to the land) are apparently subjected to LAL upon the commencement of construction of a building or other improvement on the land. We see no justification for this distinction.

The construction period ends with respect to each building or other improvement which is clearly a separate property when it is ready to be placed in service or "held for sale". (Footnote 10 in this section of the House report, p. 34, states, however, that property is not ready to be held for sale until it is ready to be placed in service by the purchaser.) This provision is ambiguous in several respects. The evident desire of the House committee to include interest and taxes attributable to land under improvement apparently led to the broad concept stated, relating to the "construction period for" (rather than simply the "construction of") the property in question. Yet the breadth of this formulation leads to extreme ambiguity as to such expenses attributable to a tract of land, where only one portion thereof is currently under development, and as to the development of a multiphase project (such as a shopping center) in which construction may involve progressive extensions of the structure rather than separate buildings. The same problem arises in the case of extensive renovation or improvement of an existing structure, in that LAL may literally require deferral of all existing interest and taxes relating to the structure, while such renovation or improvement continues.

To eliminate these problems of interpretation (and the LAL deferral provisions with respect to deductions attributable to the land itself), the definitional phrase of proposed section 468(a)(1) should be limited to interest and taxes attributable to "the construction of" such property.

A more fundamental question is whether the LAL real property deductions are "artificial" accelerated deductions in any sense. Real property has for some time proved remarkably able to adjust its value to offset the effects of inflation (and economic devaluation) of money. Absent the effects of such inflation (which the allowance for depreciation has never pretended to recognize on any replacement-cost basis for tax purposes), it may seriously be questioned whether accelerated depreciation fails to reflect a decline in value of real property, as the House committee asserted. Similarly, the concept of the annual accounting period is a central premise of our income tax system. As a matter of proper tax accounting, interest and taxes paid or accrued during the current taxable year have always been recognized (apart from prepayments) as proper expenses of such year, without regard to whether the borrowed funds were expended for the acquisition or construction of capital assets, or the taxes were occasioned by such transactions. The House committee, however, proposes to treat such items as a form of capital expenditure, on the theory that they create a benefit in future years, and that current deduction therefore fails properly to match expenses against income related thereto (House report, pp. 31–2). It does not adequately deal with the argument that interest on a loan to construct property is no less an annual cost of the borrowed funds during the period the property is under construction than it is during the entire period of the useful life of the property. If interest is to be treated as a capital expenditure on the ground that the borrowed funds were expended for a capital asset, then arguably all interest paid on such a loan should be capitalized, whether during the construction period or thereafter.

In short, if the tax accounting principles asserted by the House Committee in regard to interest and taxes were generally correct, then the House bill is not a proper application of them. Instead, the House bill selectively applies only to certain deduction items at certain times, in connection with only certain types of real property, and only in the case of certain taxpayers. As such, it appears not to reflect an application of any accounting principles, but is merely a selective effort to restrain certain abuses perceived to have arisen in connection with the marketing of tax shelter investment transactions. That being its purpose, it would be preferable to devise some legislative approach aimed more candidly and directly at restraining such excesses (such as the limitation of such deductions to a stated percentage of an individual's taxable income, as is mentioned in the introduction to this report), rather than to undermine generally understood basic principles of tax accounting. If the House committee's tax accounting assertions were sanctioned by enactment of the House bill, there might be administrative efforts to apply such supposed accounting principles in related areas not dealt with by the House bill, which presumably the House committee does not intend.

C. Net related income from real property

Under proposed section 467 (a)(1) and (b), all LAL real property of the taxpayer constitutes a single class of property, and under proposed section 468(g) the net related income is the excess of the gross income from such class over the sum of the deductions (other than accelerated deductions) attributable to such class.

A threshold problem not apparently considered by the House committe is that the effective date rules of proposed section 470(c) provide that the "subpart" shall not apply to real property the construction of which begins before the dates therein specified. Consequently, it literally appears that real property the construction of which commenced before the stated effective dates would not constitute LAL real property for purposes of proposed section 467(a)(1) or (b), and the income from any such property would accordingly appear to be excluded in computing net related income under proposed section 468(g). There is no clear statement in the House report that such a result was contemplated and intended. In some respects, such a result may be equitable—for example, in precluding discrimination in favor of those already established in real estate activities. It does not, however, seem to further the general theme of LAL to discourage the making of investments by persons not seriously pursuing the activity in question for the purpose of profit. And, as the effective dates approach, it could have a serious economic effect on all persons presently successfully engaged in real estate activities. Although alternate solutions to this problem are possible, it is not clear that the effects of the House bill on this issue are the product of any conscious choice, and the matter at least deserves specific consideration.

Although gross income from real property is not defined in the proposed code provisions, the House report indicates (p. 35) that it would include, among other things, rents from real property and fees or commissions earned with respect to real estate management or brokerage activities. In this respect, we see no particular purpose in including "fees or commissions" and excluding all other income from the active rendition of services in connection with the ownership or operation of real property. As a matter of commercial practice, the operation of an apartment building may give rise to numerous items of income attributable to the provision of services to tenants (such as parking facilities, utilities, maid service, etc.) which clearly ought to be considered related income, but which do not clearly constitute "rents from real property" or "fees or commissions."

Another example of "legislation by committee report" involves the rule stated in proposed § 468(g)(2)(A) that an excess of ordinary (that is not "accelerated") deductions over income arising from an "item of property" within an LAL class may be disregarded in computing net related income for the class. As applied to real property, however, footnote 11 to this section of the House report (p. 34) provides that for this purpose, an "item of property" may be no smaller than a building. By contrast, in its discussion of the rule of proposed § 469(b)(2) that disposition of an "item" of real property triggers the previously deferred deductions attributable thereto, footnote 12 of the House report (p. 35) states that for this purpose, an "item" includes a part of a building, or the taxpayer's entire interest in a building, but not a tenancy in common created by the taxpayer from his fee interest. Inconsistent distinctions of this type, if important enough to have, should appear in the statute rather than the House report, but in any event they are difficult to reconcile with the House committee's goals of achieving simplicity and equity.

D. Dispositions of LAL real property

In general, as noted above, each item of LAL real property is a separate class, for purposes of determining when a "completed" disposition of such property triggers the allowance of previously deferred deductions attributable thereto (without regard to net related income). In addition, proposed § 469(c)(1) provides that LAL real property is deemed disposed of if it ceases to meet the requirements of proposed Section 467(a)(1) or (2) in the hands of the taxpayer. Thus, for example, if rental property were converted to a business use other than for rental, it would be deemed disposed of.

Several problems are apparent in connection with such disposition provisions. For example, it is not clear what the requirement of a "completed" disposition signifies. Proposed § 469(e)(3) provides that in the case of a sale reported on the installment method, receipt of the final payment or disposition of the obligation shall be considered the disposition of the property. If property were sold on contract, however, and the seller did not elect the installment method of reporting, it is unclear whether the disposition would be deemed "completed" (at least as to a seller on the cash method of accounting) before receipt of final payment. Presumably, retention of title as security for payment of the price of transferred property would not affect the character of the transaction as a "completed" disposition, but that too is unclear.

A further problem arises in connection with the provisions of proposed § 469(d)(1)(A), (B) and (C), under which transfers of property by gift or in a transaction in which gain or loss is not recognized in whole or in part, or in a transaction between parties whose relationship is described in code Section 267(b), are not treated as dispositions. Proposed Section 469(d)(2) provides that in such cases, the transferee shall succeed to the deferred deduction account of the transferor with respect to the property in question. Although not discussed in the House report, it is apparent that such transaction may nevertheless give rise to recognition of some gain to the transferor. This could occur, for example, in the case of a gift of an interest in a partnership having substantial underlying nonrecourse debt, or in the case of an otherwise tax-free exchange of properties in which "boot" is received by the transferor. Read literally, the above provisions might be interpreted to require that the entire deferred deduction account of the transferor attributable to such property immediately prior to the transfer is to be shifted to the transferee, notwithstanding any gain recognized by the transferor upon the transaction. It is inconceivable that such a result was intended. Proposed section 466(c)(1) provides that deductions previously deferred are to be allowed in a subsequent year to the extent that net related income from the property for such subsequent year exceeds the accelerated deductions from the property for such year. In addition, the House report explains (p. 35) that in the case of real property sold during a taxable year, net related income includes the gross income and deductions attributable to such property, and gross income from real property is stated (among other things) to include gains from the sale thereof.

Thus, in the case of a transfer by gift, or in which gain is not recognized in part, it must have been intended that any gain in fact realized and recognized upon such transfer would constitute net related income of the transferor for such year, against which an equivalent portion of the amount in the deferred deduction account for such property would immediately become usable by the transferor. If so, the transferor's deferred deduction account would presumably be reduced by the amount of such gain, and only the remaining balance in such account would be shifted to the transferee. This treatment, however, should be clarified.

In addition, further consideration should be given to the effect of proposed section 469(d)(2), requiring a shifting of the deferred deduction account to the transferee in the case of a taxfree exchange. In particular, proposed section 470(d)(1) provides that any deduction deferred under LAL shall nevertheless be treated as though it had been allowed, for purposes of adjustments to basis under code section 1016. Thus, the adjusted basis of property will reflect all accelerated depreciation deductions, notwithstanding that a significant portion thereof may have been deferred under LAL. In the case of a taxfree exchange under code section 1031, however, a substituted basis rule applies—that is, the property received by a transferor in the exchange takes the same basis as the property which he transferred. This will produce a confusing mismatch between the basis of the property held, and the deferred deductions account applicable thereto. Thus, after the exchange, the transferor will hold property having a basis that reflects the prior depreciation deductions (which were deferred), but the transferee will have the deferred deductions account that contains such depreciation deductions. In any case in which a relatively older property is exchanged for a relatively newer one, this may be expected to produce outrageous results.

Thus, the transferee who succeeds to the large deferred deductions account attributable to the older property may receive a substantial tax windfall upon his eventual disposition of that property. The transferor, however, stands to recognize a substantial gain upon his disposition of the newer property, fully subject to recapture at ordinary rates to the extent attributable to the accelerated depreciation (by which his basis was reduced, even though no deduction therefor was allowed to him under LAL). Nor, upon recognizing such gain, will the transferor then be permitted to deduct the accelerated depreciation previously deferred, because the deferred deductions account embodying those items has been shifted to the transferee.

E. Effective dates

As previously noted, the LAL rules are to be phased in on a delayed basis for different types of property. In the case of residential real property, proposed section 470(c)(2)(A)(i) provides that the LAL rules shall not apply to such property if the taxpayer has acquired the site (or has a binding option to acquire the site) before January 1, 1977. The deferred effective date presumably recognizes both the social desirability of the activity in question and the likely adverse impact of the new rules. It is also designed to smooth the transition from the old rules to the new, in the case of persons who have planned their affairs in light of the provisions of existing law. Under these circumstances, and in light of the fact that developers may have undertaken speculative building projects before the effective date of the new rules, it seems inequitable to limit the exclusion only to "taxpayers" who have acquired the site prior to the effective date. The exclusion should apply instead to the project. Thus, any project that would qualify for the exclusion if held by the developer should equally qualify if held by any transferee of the developer up to and including the first user. In this case, the transferee should be permitted to assume the tax status of the developer. Similar considerations led to the Treasury adoption of a comparable position in Reg. section 1.167(k)–1(b)(1).

F. Conclusion.

On balance, it seems likely that the LAL real property provisions of the House bill would, if enacted by Congress, accomplish the intended purpose of discouraging purely tax-motivated investments in rental property by passive investors. In applying to property held for sale, however, and in certain other respects noted herein, the House bill is objectionable in principle. In addition, it is incomplete or defective in a variety of technical respects, as previously noted. The most pointed general comment on such provisions, however, is that they cannot achieve the House committee's stated goal of simplicity and equity in the tax law. The complexity and uncertainty of the rules, and the burdensome recordkeeping procedures that will be required to comply with them, are likely to discourage and impede economically viable projects as well as unsound ventures.

Although the House bill does not propose to apply any "at risk" investment limitations upon real estate transactions of the type subject to the LAL provisions, it is our judgment that the addition of "at risk" rules for such transactions would add nothing of practical significance to the changes effected by LAL. In addition, imposition of such rules would add another layer of timing and recordkeeping complexities to a subject already overburdened thereby under the LAL provisions.

Part 3: Treatment of Lease Property

I. DESCRIPTION OF PROVISIONS OF THE HOUSE BILL

A. General description

Under proposed section 467(a)(2), any code § 1245 property which is leased or held for leasing is LAL lease property. Proposed section 467(c) provides that each item of such property is a separate class of property for purposes of determining net related income.

Each such item of lease property is also a separate class, under proposed § 469(b)(1), for purposes of triggering previously deferred deductions attributable thereto upon a "disposition." As in the case of LAL real property, proposed § 469(c)(1) provides that it shall be deemed disposed of when it ceases to meet the requirements of proposed § 467(a) in the hands of the taxpayer.

The accelerated deductions with respect to LAL lease property are stated in proposed § 468(b) as all depreciation or amortization allowable for the taxable year in excess of straight line. For this purpose, straight-line depreciation is to be computed as though the taxpayer had used such method for each taxable year for which he has held the property, and the useful life is presumed to be the class life specified for purposes of ADR depreciation, but without the benefit of the 20 percent optional variance permitted thereunder.

In a related measure, section 210 of the House bill amends code section 179 (relating to additional first-year depreciation) as applied to partnerships, to provide that the dollar limitation on the allowable amount of such deductions shall apply first at the partnership level.

B. Reasons for change

The House committee believed that the accelerated depreciation deductions presently available in the case of personal property subject to lease did not reflect a true decline in the value thereof, and consequently reflected an "artificial" accelerated deduction. The House committee observed that such deductions were typically magnified in equipment lease syndications sold to passive investors, by reason of extensive nonrecourse financing, and stated that it had become a common practice to sell such syndications to investors on the basis of a promise of large tax losses which they could use to decrease the tax liability on their other income. The House committee believed that it was not equitable to allow such investors to defer tax on their other income through the use of artificial losses from equipment leasing transactions. It stated that the basic reason for such conclusion was that the transactions in question were a misapplication of the incentives (which were intended to encourage the acquisition of productive equipment), since the losses which create the deferrals arise from large early deductions in excess of the actual reduction in value of the equipment. (H. Rept., pp. 72–73.)

It might have been better if the House committee had simply stated that the trafficking in tax deductions, to passive private investors not primarily interested in the business merits of the transaction, was unseemly and should be curbed. It is possible that such a conclusion is well founded, and would be a sufficient reason for the change. Indeed, it may be closer to the real reason than the explanation given by the House committee.

It is questionable whether the explanation in the House report justifies the change. In particular, a central premise of that explanation is that accelerated depreciation deductions on personal property generally subject to leasing transactions substantially exceeds the true decline in value of such property. In many instances, particularly those involving equipment subject to technological obsolescence (such as computers), it seems quite doubtful that this is so. Second, if the premise is correct in many instances, it is not a phenomenon peculiar to equipment leasing transactions, but reflects more general judgments that Congress and the Treasury Department have reached concerning appropriate methods of capital recovery under our system of taxation. In theory, depreciation is intended to permit recovery (free of tax) of an amount of income equal to the cost of the asset which, in the absence of inflation, would be sufficient to replace the asset at the termination of its useful life. The changes brought about by ADR reflected a concern that existing methods of accelerated depreciation and guideline lives, by themselves, were not sufficient to provide for the replacement of obsolete or technologically inferior machinery and equipment on a basis that would enable American enterprise to compete effectively with foreign taxpayers.[1] If Congress now believes these considerations to be inapplicable, perhaps it is time for another reevaluation of our depreciation system. That question is far more serious than any restrictions relating to equipment leasing syndications. In short, if our depreciation system is as improper as the House committee suggests, the tax benefits available to an equipment leasing venture are merely a product thereof.

If it is assumed that the accelerated depreciation incentives are intended to encourage the acquisition of productive equipment, it is not self-evident (as the House committee implies) that equipment leasing syndications are an abuse of that incentive. Such transactions would

[1] Statement entitled "The Adoption of the Asset Depreciation Range (ADR) System," pp. 47–68, Treasury Department release, June 22, 1971.

not take place unless they served the needs of industrial lessees in some way that was more advantageous to them than direct ownership (with or without the benefit of pure debt financing). One reason why equipment leasing has proved a more attractive alternative to many businesses is stated in the House Report itself (p. 72)—leasing places less strain on the cash resources of the business. The "cash squeezes" of the past several years have doubtless made this an important consideration to many. There are other equally rational considerations that may favor the leasing alternative, which are not noted in the House Report. As compared, for example, with a straight debt financing of the equipment by the user, the tax benefits of property ownership available to the lessor may enable him to competitively to offer the lessee a lower annual effective cost than the lessee would incur on a pure loan. This is particularly true when the lessee's tax position does not permit him to make as effective use of the tax benefit as the lessor. In such cases, the transaction is accomplishing the acquisition of productive equipment as the law intended, under circumstances in which the law's purpose could not be achieved if it were dependent solely upon the lessee's ability to utilize the tax benefits of ownership of the property.

Thus, considered solely on its own merits, the House committee's explanation for the change seems questionable and is unpersuasive.

II. DETAILED DISCUSSION

A. Classes of lease property

By including in LAL lease property all code section 1245 property that is leased or held for leasing, proposed section 467(a)(2) covers an area far broader than the abuse sought to be corrected. The House report recognizes, p. 75, for example, that this definition includes intangible personal property. It seems probable that this inclusion is of little practical significance, in many cases, since intangibles are not typically eligible for accelerated methods of depreciation or amortization. However, the provision might apply to such normal business transactions as the licensing and sublicensing of patents, in which royalties are measured by sales or profits arising from the use of the property. How one could compute a hypothetical straight-line amount for such items is difficult to see. The definition would also appear to include property leased on an incidental or transient basis in the course of an active business, such as pleasure boats or golf carts.

We recommend that the definition of the classes of property in this case be thoroughly reconsidered, with a view to narrowing the definition. Some formulation should be found that is more closely related to the abuse to be corrected.

The House report states that each item of lease property which is capable of being leased separately is to be considered a separate class. It explains, however, that if various components of equipment make up one unitary machine—such as a computer—and are leased under a single agreement subject to the identical lease terms, the lessor may treat all such components as one item of lease property. The House report goes on to state, however, that if such a procedure is followed, but the components are subsequently leased separately under separate lease agreements, the lessor must at such time recompute accelerated depreciation for each such component, and reconstruct a deferred deduction account for each of the same (House report, pp. 75–6). The rule permitting aggregation of the components of a single machine seems desirable for the sake of convenience in accounting. The fact that the lessor may, however, subsequently be compelled to reconstruct separate accounts for the components in the event that they are leased separately at some future time seems likely to vitiate the benefits of the general rule—knowing that such reconstruction may be required, it seems likely that lessors would feel compelled to maintain records sufficiently detailed to permit such reconstruction if it were ever required. A more reasonable solution would be to permit the lessor to allocate some portion of the accelerated depreciation and deferred deduction account to any component subsequently leased separately, on the basis of relative fair market value at such time.

B. Net related income

The House report, p. 74, states that the gross income from the class of LAL lease property includes, among other things, fees or commissions earned with respect to property management or maintenance activities. As in the case of LAL real property, it would seem desirable to broaden this reference somewhat, to include all income from services rendered in connection with the operation of the property, whether or not such items of income may properly be described as fees or commissions.

C. Accelerated deductions

As previously noted, the only accelerated deduction in the case of LAL lease property is the excess of accelerated depreciation or amortization over straight-line depreciation. As the definition is stated in proposed section 468(a)(2)(A), the accelerated amount is referred to as the deduction allowable. The House report, p. 74, however, makes it clear that such amount is to be determined by reference to the cost recovery method that has in fact been selected for the property. Thus, the fact that selection of a different method might have resulted in a greater amount allowable to the taxpayer for the taxable year would be irrelevant.

The benchmark for comparison is the amount that would have been allowable if straight-line depreciation had been used for each taxable year for which the taxpayer has held the property. A special rule, however, is provided in the case of improvements made by sublessors. Proposed section 470(d)(3) provides that in such cases, rules similar to those provided in code section 1250(b)(2) shall apply. Under that section, the useful life for computing hypothetical straight-line depreciation, if based upon the lease period, is required to include all periods for which the lease may be renewed, provided that the inclusion of such renewal periods shall not extend by more than two-thirds the period on the basis of which the depreciation adjustments were allowed. Although proposed section 470(d)(3) is clearly modeled upon code section 1250, its purpose and justification are not very clear. In particular, code section 178 prescribes rules for the computation of depreciation of improvements by lessees. Under certain circumstances therein stated, an unrelated lessee is entitled to exclude renewal periods in computing the period for depreciation. Proposed section 470(d)(3) appears effectively to deny the benefits of code section 178, by requiring deferral of any depreciation so computed in excess of the amount that would have been allowable had the renewal periods been included in the calculation. If it is considered that code section 178 is not proper, it would seem more direct to amend that section.

A further complication under proposed section 468(b) is the provision that useful life, for purposes of computing the straight-line amount, is to be determined as if code section 167(m)(1) did not include the last sentence thereof, relating to the optional 20-percent variance permitted under ADR. This merely states that the 20-percent variance permitted under ADR shall be disregarded. The House report, p. 74, however, states that the hypothetical straight-line amount is required to be computed under the basic ADR guideline lives. Several observations are in order on this point. First, ADR is an elective system, and if the taxpayer can demonstrate a shorter useful life in his particular business, he is entitled to claim depreciation on that basis (Reg. § 1.167(a)-11(a)(1)). Requiring such a taxpayer to utilize a longer ADR life as a bench mark for determining straight-line depreciation is improper and inequitable. Second, the House committee's determination to treat the 20-percent variance as an element of acceleration apparently conflicts with the purpose of the variance, which is to recognize that some taxpayers within an industry may have shorter replacement cycles than the industry experience on which the ADR class is based.[2] Footnote 4 of the portion of the House report discussing these provisions, p. 74, states that other aspects of ADR, such as the first-year conventions and the repair allowance, are not to be considered as accelerated deductions. No reason is given for making this distinction.

D. Dispositions

As previously noted, if a property ceases to meet the requirements of LAL lease property in the hands of the taxpayer, that circumstance is treated as a "disposition" for purposes of triggering previously deferred deductions. The House report (p. 77) explains that to qualify for such treatment, however, the taxpayer will bear the responsibility of establishing that such property has irrevocably ceased to be leased property. Although some standard of proof of expectations is doubtless necessary to avoid abuse, it is difficult to see how any taxpayer could demonstrate such a fact "irrevocably."

E. Effective dates

Section 101(e)(3) of the House bill provides a series of intricate parallel and overlapping transitional rules designed to exclude from the operation of LAL certain transactions already underway at the time of the House committee's announcement of its tentative decision on this matter on September 11, 1975. In general, each of such rules is a partial treatment of the subject, the particulars of which are not explained or justified in the House report. In addition, even when combined, they do not appear appropriately to protect the transactions that deserve protection. Specifically, they are oriented toward the date of formation of the partnership, the date of acquisition of the taxpayer's interest therein, the date of placement in service of the prop-

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[2] Statement entitled "The Adoption of the Asset Depreciation Range (ADR) System," Treasury Department release, June 22, 1971.

erty, and other such technical considerations. It would be preferable to have a simpler (and fairer) rule exempting property ordered prior to the effective date of the House bill (which should not be retroactive from the date of enactment), in the hands of any person (including a partnership) who is the first user thereof.

STATEMENT BY JAMES J. NORRIS, CHAIRMAN, AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE, INC.

Mr. Chairman and members of the Senate Finance Committee, my name is James J. Norris and I serve as the chairman of the American Council of Voluntary Agencies for Foreign Service (ACVAFS). I am also the Assistant Executive Director of Catholic Relief Services, one of the 44-member agencies of the ACVAFS.

The constituency of the ACVAFS (please find a listing of the membership at the end of this testimony) represents the largest and most widely known voluntary agencies working in the field of humanitarian relief and development assistance overseas. They also represent a broad spectrum of the major religious faiths, ethnic groups and nonsectarian organizations in the United States.

On behalf of these agencies I wish to address myself to two tax matters: (1) a need to change the 1969 amendment to section 170(e) of the Internal Revenue Code, concerning contributions of inventory to charitable institutions, and (2) retention of a limited $25,000 exclusion from tax on income earned by overseas personnel employed by charitable institutions.

GIFTS OF INVENTORY

The ability of private, charitable institutions to work effectively in the field of international assistance, at times in concert with U.S. Government programs, depends to a great degree on contributions from the private sector. Not only does the charitable institution depend on its ability to stimulate cash contributions, but it must also depend on a wide range of gifts of commodities, equipment and medical supplies to help fulfill relief and development assistance needs overseas.

When a large quantity of a particular "gift-in-kind" item is required, the main source of supply is the manufacturer. The Tax Reform Act of 1969 limited deductions for contributions of inventory to the cost or other basis of the donated property. This amendment effectively constricted the flow of gifts of inventory to charitable organizations by removing the tax incentive which was present prior to 1969.

Currently, a manufacturer, having inventory items on hand which can be utilized by charitable institutions, can either throw them away and take a business deduction for cost, or give them to a charitable institution, without any significant change in tax result. In many instances, a decision to make a contribution to a charitable organization will be more costly than disposing of the commodity in other ways; generally, a manufacturer that gives goods to a charity also bears the costs of packaging and shipping the goods to the charity.

Our surveys of charitable organizations making use of contributions from inventory indicate that these kinds of gifts have fallen to half of their pre-1969 levels. Concurrently, additional staff time and effort have had to be expended to solicit a minimum of these kinds of supplies. In essence this means that charitable institutions are having to use more contributed funds for administrative costs to obtain minimum needed gift-in-kind items than was true prior to 1969. Private sector contributed funds which should be flowing into relief and development assistance programs overseas are being siphoned off to pay for more administrative costs to assure that needed contributions of inventory are available.

Member agencies of the ACVAFS support H.R. 12356, a bill introduced by a 13-member bipartisan group of the House Ways and Means Committee. This bill, which is technical and remedial in nature, would restore a limited tax incentive for contributions from inventory while at the same time providing necessary safeguards which we believe would eliminate any possibility that the deduction could be used as a tax loophole. We would urge that the provisions of this bill be added by the Senate to the pending tax reform bill (H.R. 10612), so that this badly needed legislation may be enacted before the present Congress adjourns.

Retention of Income Tax Exclusion for Overseas Personnel of Charities

We urge that the limited exclusion from tax now provided by section 911 of the Internal Revenue Code be retained with respect to income earned overseas by employees of charitable, religious, educational, and other organizations that are described in section 501(c)(3) and exempt under section 501(a) of the code.

The salaries of these employees are very modest. In a recent survey conducted by ACVAFS, it was determined that the average income of the roughly 2,000 U.S. citizens employed overseas by U.S. charities is a little over $12,000. Most of these employees are career employees. They and their families live under often primitive conditions to serve the sick, the hungry, and the needy of the world.

If the section 911 exemption were repealed, the taxes on the income of these employees would probably amount to less than $3 million per year. This sum is insignificant from the tax revenue point of view. It is a substantial sum, however, when measured against the limited resources of the charities that would be affected. Because employees' salaries are already as low as they can be, an added tax on these salaries would have to be paid by the charities themselves and taken directly out of program support. This would significantly diminish the assistance that the charities can provide overseas.

To take a specific example, one of our member agencies, CARE, estimates that removal of the section 911 exemption would cost that agency $421,500 annually. This would eliminate 562 schoolrooms accommodating 22,480 children from CARE's rural school building program; or, if the sum were taken from CARE's nutrition program, it would eliminate a year of daily food supplements to 98,670 undernourished people.

Removal of the section 911 exemption for employees of overseas charities would increase U.S. tax revenues by far less than the amounts taken from the program budgets of the charities. Most U.S. charities in less-developed countries operate under agreements with host governments that exempt their U.S. employees from local income tax. Repeal of section 911 for these employees would doubtless induce many governments to revoke these exemptions. Tax revenues would be shifted from the United States to the host countries by way of the credit for foreign taxes paid.

Increasing the taxes of employees of charities overseas would serve no public policy. These employees are few in number. They work in the public interest for modest pay. Repeal of section 911 for these employees would raise no significant tax revenues. It would, however, impede the work of the charities, and it would run counter to Congress strong current interest in increasing the role of voluntary agencies in overseas assistance.

H.R. 10612, as passed by the House, recognizes the special needs and unique circumstances of the overseas charities by retaining the $20,000 exclusion for employees of organizations described in section 501(c)(3) of the code. In the interest of simplification, however, the House eliminated the $25,000 exclusion now available under section 911 to employees who reside overseas for 3 years or more.

Although most overseas employees of charities earn much less than $20,000, items such as moving expense reimbursements and tuition expense reimbursements paid by the employer can well increase taxable income substantially. If an employee is transferred from one continent to another, his taxable income may be increased by several thousand dollars (without a corresponding moving expense deduction) as a result of the payment of his moving expenses by his employer—even though his salary check might not change at all. As the result of items such as these—all necessary concomitants of overseas service—as well as living allowances and differentials which have unavoidably increased in recent years to compensate for rampant inflation in many developing nations, there are every year some employees working overseas whose taxable incomes exceed $20,000.

It would appear that an exclusion at the $25,000 level for all employees of charities who reside overseas for at least a full tax year (or who are present overseas for 17 or 18 consecutive months) is not only more realistic, but also more equitable in view of inflation and other conditions overseas. We would urge, therefore, that the Senate Finance Committee take necessary action for the retention of the exclusion at the $25,000 figure.

Thank you, Mr. Chairman.

AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE, INC., NEW YORK, N.Y.

MEMBERSHIP LIST

American Council for Judaism Philanthropic Fund, Inc.;
American Council for Nationalities Service;
American Friends Service Committee, Inc.;
American Foundation for Overseas Blind;

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American Fund for Czechoslovak Refugees, Inc.;
American Jewish Joint Distribution Committee, Inc.;
American Mizrachi Women;
American National Committee to Aid Homeless Armenians;
American ORT Federation, Inc.;
Assemblies of God Foreign Service Committee;
Baptist World Alliance;
CARE Inc.;
Catholic Relief Services, U.S. Catholic Conference;
Christian Reformed World Relief Committee;
Church World Service;
CODEL, Inc.;
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Tolstoy Foundation, Inc.
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United Israel Appeal, Inc.
United Lithuanian Relief Fund of America, Inc.
United Ukrainian American Relief Committee, Inc.;
World University Service;
Young Men's Christian Association, International Division;
Young Women's Christian Association of the U.S.A.

Statement of the Retired Officers Association

(Presented by Col. George F. Hennrikus, Jr., USAF, Retired, Chief Legislative Counsel, the Retired Officers Association)

Mr. Chairman and members of the committee, I am Col. George F. Hennrikus, Jr., U.S. Air Force, retired, Chief Legislative Counsel of the Retired Officers Association (TROA), which has its National Headquarters here in Washington at 1625 I Street, NW., Our association has a membership of over 229,000 retired, former, and active duty officers of the seven uniformed services. I also represent the

Retired Enlisted Association (REA) whose headquarters is in Colorado Springs, Colo.

The opportunity to provide our views on those elements of the Federal income tax law which are of significance to the uniformed services retiree is very much appreciated. I intend to address three features being reviewed by your committee. They are retirement income credit, disability pay exemption, and the sick pay exclusion.

But before I do, I would like to note two significant problems and suggest ways in which this committee can help solve them.

Tax relief for older retirees

On three separate occasions, the Senate overwhelmingly approved Senator Hartke's legislation (S. 1969) to equalize the pay of those older military retirees who, as the result of the suspension, in 1958, and repeal, in 1963, of a 100-year-old law, now receive as much as 50 percent less in retired pay than current retirees of the same rank and time in service. Each time the legislation was blocked in the House. The fiscal constraints placed upon this 94th Congress have precluded consideration in either session.

Of the 800,000 retirees who would benefit from a one-time recomputation of pay under the Hartke compromise, there are 300,000 who retired prior to 1963 and before the active duty pay raises designed to achieve comparability with civil service pay compensation. The average annual retirement income of this group is $4,000. Many are over age 60, thus relatively unemployable, and most do not have the benefit of social security to supplement their income, since the military did not come under the social security program until 1957.

In order that this particular group be given some relief, we recommend that an exemption of $5,000 be granted all uniformed service retirees who retired prior to 1968. The year, 1968, is significant since markedly increased pay raises began in 1968. Although this would not effect pay equalization, it would certainly be of tremendous help until a final solution is approved.

Armed Forces health professions scholarship program

On March 22, 1976, the Treasury Department ruled that the moratorium under which participants in the Armed Forces health professions scholarship program (AFHPSP) could exclude tuition, fees and a $400 monthly stipend from gross income, would not be continued beyond January 1, 1976. Public Law 93-483 was amended to include a 3 year tax moratorium (1973-75) under section 117 of the code.

Since the stipend is the only money paid directly to the participant, and since medical training costs are high, the affect of this ruling will be a sharp reduction in the number of trained medical people entering the uniformed services. The Department of Defense has indicated that this program has been extremely successful and is essential to maintaining the military medical system. Until this latest ruling it had accomplished exactly what it had been designed to do—attract service—committed professional medical staff to relieve the critical shortage as the last of those professionals brought in by the doctor draft finish their commitments.

We request therefore that this committee appropriately amend H.R. 10612 to continue application of section 117 to scholarships under AFHPSP.

Retirement income credit

From its inception in 1954, through 1962, the retirement income credit provision corresponded approximately with the primary social security benefit. Since 1962, when the base amount was increased from $1,200 to $1,524, social security benefits have increased substantially. The current maximum social security benefit for an individual worker is $4,100 per year. Furthermore, present law prescribes automatic cost-of-living adjustments.

We strongly recommend, at the very least, that the retirement income credit base be increased to $4,100. A preferable alternative would be to fix the amount at $5,000, as proposed by Representative Bob Traxler in H.R. 16580 during the 93d Congress. This latter alternative would help the retiree cope with inflation and provide a cushion for projected increases in the social security maximum.

The revision of the existing retirement income credit provisions as passed by the House of Representatives, appears to replace the present law with a credit for the elderly which will apply only to persons over 65 years of age. However, it also retains the existing retirement income provision for persons under age 65 who are under a public retirement system. This appears to give a tax advantage to eligible retirees under age 65 which will not be available to persons over age 65.

Disability retired pay

Our associations support the tax exemption now applied to military disability retired pay under section 104(a) of the Internal Revenue Code. This entitlement has been a part of our tax law since 1942. Undoubtedly, our entry into World War II and the return of the first casualties from that war had a great deal to do with its enactment into law. The fact that our Armed Forces are not, at the moment, engaging an enemy does not change the basic principle underlying the exemption: To give material recognition to the individual whose career and life expectancy has been shortened due to military service.

Any consideration of military disability brings to mind allegations made a few years ago to the effect that the administration of the disability retirement system had become too liberal, particularly in the case of some senior officers. Whether these charges were true or not, I want to remind this committee that disability ratings are generally determined on a fair and equitable basis. Any misuses of the system represent rare exceptions in its administration, and should be dealt with on a case by case basis.

To place disability retirement in proper perspective, I'd like to review the program as it operated in fiscal year 1974, the last year for which we have complete data.

Of 58,800 military retired in fiscal year 1974, 5,798 were retired for disability. Average monthly retired pay for this group was $394. Averrage life expectancy was 53.7 years of age. Since the average age at retirement is 33.5, the average individual in this group will live 20.2 years in retirement.

As of fiscal year 1974, there were 159,639 military retired for disability. The great majority of these retirees consider the tax exemption an essential element in extending limited purchasing power. Almost all current disability retirees, of necessity, have based their financial plan for their entire life span on the beneficial provisions of the Internal

Revenue Code. Until recently, there has been no reason to believe that this entitlement would be denied them. Furthermore, many States have tax laws that parallel the Federal code. Consequently, for many people, elimination of this entitlement by the Federal Government would also cause an increase in State income tax, automatically.

Our immediate concern is for the older retirees. If the current tax benefit is taken away from this group whose retirement is based on pay scales in existence before the recent pay raises which were designed to achieve comparability with civil service, many more will be forced to seek relief from public welfare programs. For them, it will be tantamount to yet another breach of trust on the part of the Government.

Over 3 million veterans were discharged with service-connected disabilities who did not qualify for disability retirement. These veterans receive tax-free compensation from the VA. We feel the disabled retiree should have the same benefit.

H.R. 10612, as approved by the House of Representatives, repeals section 104(a), applying a grandfather clause for those presently retired for disability and those now on active duty who may be retired for disability.

In recommending repeal of this section before the House Ways and Means Committee, the Treasury Department offered only one argument: It had been used by generals and admirals as a tax shelter.

Generals and admirals enjoy no greater immunity from life-limiting and restrictive disabilities than their juniors. Under recently passed Public Law 94-225, all flag officer disability retirements must be approved by the Secretary of Defense thus providing added substantiation that such retirements are legitimate.

Thus, with the single impediment now removed, there should be no reason why this committee should not recommend continuation of section 104(a)(4).

Sick pay exclusion

We also strongly urge that the sick pay exclusion relating to amounts excluded from gross income under wage continuation plans not be reduced on the basis of adjusted gross income. Revenue ruling 58-43 clearly included the military disability retiree under a wage continuation plan for purposes of this exclusion. We feel that such a change would impose a financial hardship on those retired for physical disability during the difficult adjustment period between such retirement and the attainment of normal retirement age. Countless retirees have been helped through this relatively brief, though critical period, by the sick pay exclusion and to reduce or deny them this exclusion in a time of rapid inflation would constitute a reduction in income upon which their financial plans are based.

Summary

For all military members, active and retired, your action in these matters would have added significance in light of other actions that have either been taken or are being considered to reduce significant benefits and entitlements contained in the military compensation program. Health care has been reduced with further cuts threatened. Elimination of appropriated fund support of the commissary is being considered, and the question of eliminating the post exchange is about to be debated in the Senate. It would almost appear as if a decision had been made to renege on paying defense costs incurred in the past now that we are in a period of relative peace. If this trend is allowed to run its course, it could seriously affect our national security in the future. I predict that the term "service" will no longer have any meaning and we will no longer be able to attract and keep qualified people. The end result will be a mercenary Armed Force, probably unionized, and willing to engage the enemy only after added pay has been negotiated through collective bargaining.

In closing, I reaffirm that the current provisions of the Internal Revenue Code as they apply to military retirees are valid and ask that they be sustained.

Statement of Virgil L. Frantz

Mr. Chairman, members of the committee, I appreciate this opportunity to present to the committee my suggestions on minimum tax and capital gain revision as it affects patent royalties received by individual independent inventors who now qualify under the provisions of section 1235.

I am an independent inventor, and a substantial portion of my income is derived from patent royalties which qualify for capital gains treatment under the provisions of section 1235 of the Internal Revenue Code.

For reasons which will follow, it seems to me only fair and equitable that if any changes are made or proposed to the minimum tax on tax preferences or to capital gain tax rates based upon holding periods of different lengths that either of the following proposals be adopted, preferably, in the order listed:

(1) Section 57(a) (9) be amended to exclude from "items of tax preference" any gains from a transaction described in section 1235, or in the alternative, and at the very least, that

(2) Section 57(a) (9) be amended to exclude from "items of tax preference" any gains from a transaction described in section 1235 where such gains are received pursuant to a contract entered into prior to September 18, 1975, or in the alternative, that

(3) Any capital gains (not excluding section 1235 gains) received pursuant to a contract entered into prior to September 18, 1975, be subject to the provisions of sections 56, 57 and 58 as they presently exist without amendment thereto, or in the alternative.

(4) If capital gain rates are to be determined by reference to holding periods, allow the section 1235 patent holder the benefit of the minimum capital gain rate as may be established for the longest holding period, but in no event less than the life of a patent (17 years).

(5) Adopt the administration's proposals (statement of Hon. William E. Simon) with respect to minimum tax and capital gains except amend section 1235(a) to provide that a transfer thereunder "shall be considered the sale of a capital asset held for more than 17 years" (rather than 6 months, as presently provided).

Perhaps it would be safe to suggest that most contracts subject to the provisions of section 1235 are entered into shortly before or coincidental with the issuance of a patent. Thus, most patent contracts which qualify under section 1235 last for at least the lifetime of the patent (17 years) or until the product is no longer salable and no further royalties are forthcoming. When one enters into a percentage royalty contract for that long a period of time, it is indeed difficult to negotiate in advance a reasonable royalty that accounts for inflation or changes in the tax law.

In the Internal Revenue Act of 1969, capital gains relief was given to individuals and corporations who had entered into binding contracts (or options) on or before October 9, 1969. However, for reasons which are not clear to me, section 1235 gains were excluded from the benefit of this "grandfather" clause. Since the benefits of section 1201(d)(1) were specifically made inapplicable to "any gain from a transaction described in section 631 or section 1235," it appears that it was mistakenly assumed that no essential differences existed between contracts of disposal (sale) of timber, coal and iron covered by section 631 and patent sale contracts covered by section 1235. However, essential differences do exist between the sales covered by these sections.

Section 631 specifically provides that the sales occur as the timber is cut or the coal or iron ore is removed. These contracts are properly recognized as annual sales. Sales of patents by individuals covered by section 1235 are for a fixed term of years—generally, the period over which the patent extends, a true installment sale.

To qualify under section 1235, a complete sale of "all substantial rights" must occur on the date of the sale with a complete transfer of all right, title and interest recorded in the patent office with installment payments over the life or use of the patent.

Therefore, merely because sale payments covered by Section 631 are made as the timber is cut or the coal and iron ore is removed (that is, as ownership is transferred) and sale payments covered by section 1235 are made on a production basis through use of the patent hardly seems to be a justifiable reason for treating them as belonging in the same general category.

Also sections 631 and 1235 are entirely different because payments for timber, coal and iron ore (all of which are economic assets) represent a return on economic investment, whereas, payments under section 1235 represent primarily a return on personal effort, both physical and mental which in most cases extends over a long period of time prior to the granting of a patent.

The Constitution provides for a patent system and, undeniably, the intent of our founding fathers was to promote and protect the individual independent inventors. Yet, today, 95 percent or more of valuable patents are held by large corporations who generally require the prior assignment of inventions from their employees who, if they are lucky enough to receive more than a gold plaque, are not allowed to receive capital gain treatment on such payments. [Regs. section 1.1235-1(c)(2)]

Indeed, there is now pending proposed legislation that would subject the granting of all patents to an adversary proceeding with any interested corporation or individual being allowed to become a party thereby creating such a potentially expensive proceeding that the independent, individual inventor may simply fade away—leaving the patent field entirely to the captive corporate inventors.

If the United States is to maintain the incentive necessary for private inventors to be properly productive, it is important that Congress, neither directly nor indirectly through the tax laws, create disincentives for the inventor. Inventors should receive favorable tax treatment, but at a minimum the tax laws should not operate in a fashion that retards individual initiative.

The provisions of section 1235 which apply solely to individual independent inventors (and not corporations) should not in any way be further limited by any proposed changes in the Internal Revenue Code.

Statement of James D. "Mike" McKevitt, Washington Counsel, National Federation of Independent Business

Mr. Chairman, distinguished members of the committee, I am Mike McKevitt, Washington counsel for the National Federation of Independent Business (NFIB). I am glad to have this opportunity to share with you the views of NFIB on those sections of H.R. 10612 that have an impact on the Nation's small business community.

Since its creation in 1943, NFIB has grown into the largest single member business organization in the United States. At latest count it has nearly 445,000 member firms and a growth rate of approximately 2,000 members per month, making it the fastest growing national business organization.

Collectively, NFIB's member firms pack a very potent economic wallop. They employ well over 3.4 million American workers and have annual gross sales of more than $83.4 billion. More specifically, NFIB has 148,874 member firms in the 18 States represented by members of this committee. They employ more than 1.2 million of your constituents and contribute over $31.6 billion to the economy each year.

The federation's member firms range across a broad spectrum of the Nation's economy, from heavy manufacturing to retailing and, according to Government statistics, represent a true cross section of the American small business community. The majority of them are proprietorships and partnerships. More than 67 percent of these businesses employ less than seven people and over 75 percent have gross sales of less than $350,000 per year.

Small and independent business is treated inequitably by the tax laws of the United States and it is time for this committee to consider the problems and the potential of this important sector as an inseparable part of the committee's approach to major tax reform legislation. This need was forcefully pointed out in a recent statement before the House Committee on Ways and Means by Senator Gaylord Nelson, a member of this committee and the chairman of the Senate Select Committee on Small Business. In that statement he explained:

> We feel the evidence shows that new, small and independent business as a class perform essential economic functions, and remain the anchor of political democracy in this Nation.

Smaller business—97 percent, of the nearly 13 million U.S. enterprises—accounts for between 52 and 53 percent of private employment, 43 percent of the business output, and one-third of the Gross National Product. A study published by the Commerce Department concluded that individuals and small businesses produce more than half of the important industrial inventions and innovations.

Research done at the University of Wisconsin indicates that these businesses provide significantly greater support for the economic and social fabric of cities and towns across the country than large and particularly conglomerate corporations.

The pattern of effective tax rates established in the Small Business Committee's February, 1976 hearings clearly shows the extent to which larger corporations exploit their ability to employ the most expert lawyers, accountants, and advisers enabling them to take full advantage of every provision of tax law and regulations. Smaller firms are not able to match this capability.

In my view, practical distinctions should be established in economic policy and tax policy between the few thousand corporations which have achieved access to the bond markets, stock markets, and other large-scale aggregations of capital; and the millions of corporations and unincorporated firms which have not.

Otherwise, in spite of protestations of neutrality and equal treatment, the tax code will create discrimination and competitive disadvantage against new, small, and independent businesses.

H.R. 10612 extends two provisions of the Tax Reduction Act of 1975 that are very important to small business. These are the reduction of corporate tax rates and the increase in the investment tax credit. For the sake of brevity and clarity, I would like to confine my remarks to these two provisions.

The Tax Reduction Act of 1975 reduced the tax rate paid by small corporations to 20 percent on the first $25,000 in taxable income and 22 percent on the next $25,000. H.R. 10612 would extend these beneficial reductions for 1 year. NFIB believes that these changes should, at least for the present, be made a permanent part of the code. We feel that a simple 1-year extension discriminates against small corporations when viewed in relation to the suggested 2-year extension in the reduction of the investment tax credit, most of whose benefits go to big business.

NFIB feels that the changes made in the corporate tax rates and the investment tax credit are only a long overdue, first step in the right direction. The Federation believes that both can be strengthened further. This would allow the Nation to tap the huge potential of the small business community for creating jobs.

The tax Reduction Act of 1975 offered some help to small corporations and those small firms in industries that could easily take advantage of the investment tax credit, But this represents a very small part of the independent business community. Only 14 percent of all U.S. firms are incorporated, and the vast majority of our businesses operate in areas such as retailing, wholesaling, and professional and non-professional services which would not normally be able to use the investment tax credit. Therefore, NFIB believes that any future tax reform legislation drafted by this committee must treat these types of businesses, especially unincorporated ones, equitably.

Mr. Chairman, I want to thank the committee for giving us this opportunity to express our ideas on small business tax reform. If you have any questions about our statement, I will try to answer them.

JEB, Inc. Management Services,
April 20, 1976.

Hearings on the Tax Reform Act of 1976.
Hon. Russell B. Long,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

Dear Senator Long: This statement is submitted on behalf of JEB, Inc., a firm which furnishes association management services for nonprofit trade associations. There are two issues of the Tax Reform Act of 1976. I wish to address our positions—amendment to paragraph 512 of the Internal Revenue Code relating to advertising in publications of tax-exempt organizations, and deductibility of attendance of foreign conventions, section 6DZHR10612.

One association inhouse is international in scope which have delegates and alternates attend its functions and act as its governing body. These representatives originate from 51 separate not-for-profit chartered clubs in their repesentative state or province. All 3,000-plus members are sales persons in the automotive aftermarket industry. Nineteen of the 51 clubs prepare and circulate a magazine. In most instances, these publications were created to fill a void resulting from the absence of any other market area publications. These publications contain articles, announcements, and other information related to the local club activities. In many cases, the magazines contain commercial advertising related to the club's functions and its circulation's interest. The clubs accept this advertising in their publications because it is helpful and informative to their members. The revenues from advertising also defray a part, or sometimes all of the editorial and circulation cost of the magazine.

Associations and other nonprofit organizations do not pay Federal income taxes on their dues. However, if in addition to their exempt activity the club is engaged in an "unrelated business activity," it must pay income tax on such "unrelated business taxable income."

Under an amendment to the Internal Revenue Code enacted in 1969 net advertising income of a club is taxed as "unrelated business income."

The Treasury recently published advertising regulations that treat all or part of the membership dues of all associations as subscription fees allocable to association publications, whether or not any part of the membership dues is properly allocable to the magazine. In the typical case members are not assessed a subscription fee since no part of membership dues properly can be allocated to the publication subscription price.

The Treasury regulations will result in nonprofit associations, professional societies, and other tax-exempt organizations either: (1) paying taxes which divert money from their activities which the Congress has already determined to be worthy of tax exemption; or (2) reorganizing their publications into separate taxable corporations in order to be treated no worse than an ordinary commercial enterprise that charges no subscription price and is taxable only on advertising income in excess of editorial and circulation costs. Either of these results will cause disruption and distortion of the legitimate and intended functions of these tax-exempt organizations without any increase in revenue to the Treasury.

Attached to this statement as an appendix is a more detailed and technical discussion of this issue and a proposed legislative solution. Under our proposed legislation, most associations properly would be freed of the obligation to allocate membership dues to its publications since association publications are merely incidental to the association's primary functions. In cases where publication of the magazine is the major function, a portion of membership dues would be allocated. In those instances where the association performs no other significant service for its membership—apparently the abuse to which Treasury's regulations were really directed—all, or nearly all, dues received would properly be allocated to the subscription fee.

Our proposal is consistent with the underlying premise of the present law. Treasury's regulations, however, erroneously require every association to allocate dues (even though publication of the magazine is a minor and incidental part of total activities) and impose arbitrary rules which in many cases result in allocation of an amount of dues far in excess of what reasonably could be charged for the magazine. We strongly urge the committee to consider the legislative proposal as a reasonable and equitable solution to tax treatment of advertising income.

The second * * * deductibility of attendance of foreign conventions * * * we address ourselves for our manufacturing clients nonprofit trade associations whose purposes are to promote the common business interest of their industry, to educate the public as to the safe use and importance of their products, to encourage high standards of safety and quality control of their manufactured products. Some association members are U.S. subsidiaries of foreign based firms.

JEB, Inc. strongly believes that a provision dealing with deductibility of attendance at foreign conventions which was included in the House version of the tax reform legislation, H.R. 10612 to be both unnecessary and inappropriate.

Section 602 of H.R. 10612 provides a series of complex rules for determining whether the expenses of individuals attending foreign conventions are deductible. At a time when many are urging simplification of the present tax code, it is highly questionable whether new, highly technical amendments should be added to the code. This argument is particularly compelling when the need for the legislation is dubious.

You are aware that the purposes and goals of organizations is not to sponsor vacations for their members. Frankly, the problems facing this Nation do not allow them the luxury of this kind of activity . . . at least the associations we handle through this office.

What seems to have been lost in prior discussions of this topic is what motivates people to attend conventions, seminars, or similar meetings. The primary reason for attending a convention, seminar, or similar meeting is to have the opportunity to exchange ideas and experiences with other attendees. This exchange is enhanced by program topics, speakers, and panel discussions. Nevertheless, convention planners recognize that informal discussions among attendees with similar interests may be equally as important as a heavily structured program. Thus, while the location of the convention may influence the attendance by some taxpayers, studies show that the topics to be discussed and the speakers who will be present determine the success of the convention. This was confirmed by a study conducted by Opinion Research Corp. for the U.S. Chamber of Commerce dealing with the reasons why people attend conventions, et cetera, wherever the meeting is held.

I do not suggest that there are no abuses in this area. There are some, but the number of organizations sponsoring so-called junkets is exceedingly small. In our view, existing law is adequate to deal with these cases without regard to whether the meeting is held within or without the United States. The overwhelming number of conventions, seminars, and similar meetings—wherever held—are bona fide business meetings held for the education and benefit of the attendees.

The concern of proponents of S. 602 appears to be the deduction of what is essentially a vacation. This concern is not eliminated by the establishment of arbitrary standards of deductibility. More importantly, existing law already provides an adequate framework within which the perceived abuses can be regulated. The issue involved is whether the conference in question is directly related to the conduct of the individual's business. The House bill never reaches this issue, but merely establishes complex rules which exult form over substance. Thus, no more than two foreign conventions may be deducted in 1 year, without regard to the purpose of the meeting.

On the other hand, S 274(c) of existing law requires consideration of the business purpose of the convention. Under this approach, there appears to be no reason why the IRS could not publish proposed regulations which would establish guidelines as to the manner in which the requisite business purpose is to be established. This approach would allow taxpayers and sponsoring organizations to work with the IRS in establishing a reasonable format for complying with the requirements of S. 274(c). This would ease the audit burden of the IRS and permit taxpayers to comply with the requirements of this provision more readily.

The proposal to restrict conventions held outside the United States will have a serious adverse impact on U.S. air carriers and other U.S. businesses abroad, such as hotels. The plight of U.S. air carriers competing for the international travel dollar is well known to this committee and must be considered. Similarly, international hotels, controlled by U.S. interests will suffer if the proposed restriction becomes law.

Proposals to restrict foreign conventions are inconsistent with the trade policy established in 1974 by this committee. At a time when the emphasis is on freer trade and removal of tariff and nontariff barriers, we submit that the enactment of legislation will be viewed as an obstacle to achieving the freer flow of information, products and investment. What it does achieve is to invite foreign countries to retaliate. The State Department already has received objections from a number of foreign governments to the proposed restrictions on foreign conventions.

Further, we understand that the Department of Commerce and other agencies are making a significant effort to attract foreign visitors to the United States and that a particular effort is being made in connection with our Bicentennial. This committee should not enact legislation which will frustrate the efforts of other Government agencies.

In summary, proposals relating to foreign conventions do not address the primary purposes which induce a taxpayer to attend a convention or similar meeting. In an effort to curb foreign junkets (and with no concern for domestic junkets), these proposals will prevent most conventions from going abroad, thereby depriving U.S. members of the opportunity to draw on foreign resources for ideas which would be most beneficial. For example, soon the United States will move to the metric system. Europe has been on the metric system for many years. A meeting held in Europe to discuss with Europeans the practical considerations connected with such a change is certainly business connected, regardless of other arbitrary standards applicable to a particular taxpayer.

Another example of the arbitrary standards established under H.R. 10612 is that this bill establishes limitations on transportation expenses which are unrelated to the business purpose of the trip and which could induce convention sponsors to provide charter transportation services for attendees, to the detriment of existing regularly scheduled airlines.

Finally, the House bill establishes limitations on subsistence expenses geared to per diems allowable to U.S. civil servants. This standard is so unrealistic that it is not even followed by the Federal Government. At the present time, U.S. civil servants traveling abroad may be reimbursed for actual subsistence expenses, and not merely limited to a per diem.

In conclusion, I believe that the objectives which the committee wish to accomplish can best be achieved through a realistic compliance program, rather than through enactment of new legislation. I believe that such an approach will benefit the taxpayer and achieve the desired result without inviting foreign countries to enact retaliatory legislation. Abuses can, and should, be corrected without destroying the value of bona fide meetings held outside the United States.

Respectfully submitted,

James E. Bates,
President.

Appendix

Proposed Amendment to S. 512 of the Internal Revenue Code Relating to Advertising in Publications of Tax Exempt Organizations

Proper application of the "unrelated business tax" provisions of sections 512 and 513 of the code would treat the publication of a magazine by a club entirely separate from the general activities of the club and would tax advertising income only to the extent it exceeded editorial and circulation costs. This would be entirely appropriate for 99 percent of all tax-exempt organizations in which the publication is merely incidental to the organization's other traditional tax-exempt activities.

The Treasury regulations artificially fragment the functions of tax-exempt organizations and require allocation of membership receipts to publication activities without allowing corresponding deductions for the expenses of membership maintenance. Though it could be argued that such expenses would be difficult to allocate with any accuracy, this difficulty merely illustrates the problems of making such allocations at all—either with respect to receipts or expenses. The publication of a club magazine is an activity which stands on its own. Where the activity is carried on at a loss it may be subsidized by the association's general treasury. Except in extreme cases referred to below, no specific membership receipts reasonably can be allocated to the activity.

It is, however, recognized that in a very few cases (out of the many thousands of associations and other tax-exempt organizations), the Treasury may have a legitimate concern that the organization is primarily or wholly engaged in the publication of a magazine in a commercial sense and that the so-called membership "dues" in those cases are in fact a subscription price paid solely for the magazine. In these instances, the organization has no other significant activity and the "members" have no reason for joining and paying dues other than to receive the magazine. We believe that it was a concern with such isolated cases which motivated the Treasury to issue the regulations in question. This narrow problem does not justify the recently published regulations which penalize and disrupt ordinary trade association and other tax-exempt organization activities.

Proposed legislative solution

Present law provides ample authority for the Treasury to make the needed distinction between the ordinary trade association and the isolated abuse cases with which it is concerned. Since 1967, taxpayers have worked with the Treasury to provide a satisfactory solution, but to no avail. Regulations were proposed in 1971, but were so fraught with problems that no final action was taken. Taxpayers assumed that after 4 years the Treasury had recognized the impossibility of achieving a fair and equitable result through allocating membership dues to subscription price as had been proposed. But, without further notice, on December 18, 1975, Treasury published final regulations which not only repeated the technical deficiencies of the proposed regulations, but made matters worse by imposing an even more disruptive and totally arbitrary rule for allocating membership dues to subscription price.

Thus, a legislative solution is necessary to eliminate any concern of the Treasury about its authority to provide some other and reasonable solution under present law and to deal with the few abuse cases which are the sole cause for concern.

The proposed amendment to the Internal Revenue Code would provide as follows:

1. Associations and other tax-exempt organizations would be subject to unrelated business income tax only on net advertising income.

2. No amount of membership dues would be allocated to subscription price unless editorial and circulation costs of the magazine exceeded 50 percent of the organization's total annual expenditures for all purposes.

3. If such costs exceeded 50 percent, the maximum amount of membership dues allocable to subscription price would be as follows:

Editorial and circulation cost as percentage of total expenditures:	*Maximum allocable membership dues (percent)*
50 percent or less	0
60 percent or less	20
70 percent or less	40
80 percent or less	60
90 percent or less	80
100 percent or less	100

4. If a lesser allocation can be justified by reference to the subscription price charged to nonmembers or to other facts and circumstances, that lesser allocation would prevail.

STATEMENT BY JOHN W. SCOTT, MASTER OF THE NATIONAL GRANGE

SUMMARY OF TESTIMONY

Tax-loss farming

The National Grange is in support of legislation to amend the Internal Revenue Code to prohibit any substantial portion of farm operating losses being used as a tax deduction or writeoff against nonfarm income. An outline of the tax rules that encourage tax-loss farming and a description of the problem appear on pages 3–5. The effect of tax-loss farming is a distortion of the farm economy evidenced in two ways: (1) the attractive farm tax benefits available to wealthy persons have caused them to bid up the price of farmland beyond that which would prevail in a normal farm economy, and (2) the ordinary farmer must compete in the marketplace with these wealthy farmowners who may consider a farm profit unnecessary for their purposes.

The excess deductions account method included in the Tax Reform Act of 1969 only postpones the issue and strikes a bona fide as well as tax-loss farmers (p. 6).

The National Grange is in support of legislation similar to that proposed in 1969 by Senator Lee Metcalf and the then Representative John Culver. Under the proposed legislation, if the total of certain farm loss deductions is higher than $15,000 then the higher figure may be used without any reduction because of nonfarm income above $15,000. The dollar limitation is directed solely at the type of deductions that are artificially created through the abuse of the special farm accounting rules designed for farmers (pp. 6–7). Numerous safeguards to protect the family farmer are in the proposed legislation, as well as a provision for large commercial farming interests in cattle, citrus, and other farm specialty crops to be exempt from the provisions of the act if they follow standard accrual accounting methods (p. 7). However, the grange is opposed to making the accrual accounting method mandatory for income tax purposes for farmers if they received a major portion of their net income from their farming operations (pp. 7–8).

Invasion by conglomerates.—The elimination of "tax loss" farming is the first step in controlling conglomerate corporation invasion of agriculture. It would eliminate the financing of such mergers and takeovers by the American taxpayer by the use of "tax shelter" windfalls (pages 8–9 and 11–12).

Benefits from tax shelters.—We do not believe that the benefits of so-called tax incentives are worth the cost to the Treasury in lost revenue and the further economic loss to the family farm structure that is dependent upon profit for its very existence (pages 9–11).

OTHER TAX REFORM RECOMMENDATIONS

The National Grange supports.—(1) Exempting income from the forced sale of land from Federal income taxation; (2) raising the exemption allowance for individuals on Federal income tax returns to $1,000 and raising the percentage standards deduction to 20 percent; (3) the deduction of all medical expenses on individual Federal income tax returns; and (4) keeping the investment credit in force at least at the present 7 percent. The National Grange opposes eliminating Federal income tax deductions for contributions to religious, educational, charitable, and eleemosynary organizations and institutions (pages 12–13).

Mr. Chairman and members of the committee, I am John W. Scott, master of the National Grange, with offices at 1616 H Street NW., Washington, D.C. The National Grange is a farm and rural-urban community and family organization, representing 7,000 community Granges located in rural America. Our membership lives in rural-urban areas in 41 of the 50 States and has had a vital interest in the matter being considered by this committee over the long period of our 108 years.

We are in support of legislation to eliminate existing tax loopholes which benefit wealthy nonfarmers who enter farm loss operations and distort the agricultural economy, at the expense of legitimate farmers and the average taxpayer.

The Grange has a long history of interest in this particular area of income tax revision, as it has been of vital concern to our members since 1939. At the 73d Annual Session of the National Grange, held in Peoria, Ill., the delegate body adopted the following resolution:

> In order to discourage corporation farming and capitalists acquiring large acreage of farmland, we recommend that the Federal income tax be amended to provide that losses on agricultural operations can be deducted only from incomes derived from agricultural operations.

The policy of the National Grange, adopted 36 years ago, was a lone voice against the inequities contained in the Internal Revenue Code. The continuing validity of this objective has been subsequently recognized by action of the delegate body taken in 1963, 1965, and again in 1967, at the 100th anniversary of the founding of the National Grange.

At our 102d annual session held in Peoria, Ill., in November 1968, as we started our second century of service to rural America, the delegate body once more reaffirmed Grange position on this important and vital matter of great concern to family farms and rural communities.

The Taxation and Fiscal Policy Committee that considered tax revision resolutions made the following statement:

> The mounting concern of the family farm operator over the accelerating acquisition of agricultural lands by individuals and organizations for the purpose of building up a loss position from farming operations conducted on the land acquired and deducting such losses from income tax liability is indicated by the fact that resolutions to prevent this practice have been received at this Annual Session of the National Grange from eighteen of the 38 State Granges.
>
> Farmers and their families engaged in bona fide farming operations are being forced to leave the farm, as a result of net income being at a depressed level.
>
> Competition of nonfarm investors inflating the price of agricultural land and using loss on farming operations as a deduction against nonfarm income is a factor in this lower net farm income.
>
> *Resolved*, That the National Grange vigorously support amending the Internal Revenue Code to prohibit any substantial portion of farm operating losses being used as a tax deduction or writeoff against nonfarm income.

The delegate body adopted the above statement and resolution, once more raising their voices against the unfair competition such tax advantages provide for those nonfarm interests engaged in agricultural production, for the family and commercial farmers who are dependent upon the profit from agriculture for their livelihood.

THE PROBLEM OF TAX-LOSS FARMING

We do not presume to be tax specialists and we do not want to fill the record with information that is not based on pertinent data; therefore, we would like to quote from part 2, "Tax Reform Studies and Proposals, U.S. Treasury Department," which outlines the tax rules that encourage "tax-loss farming" and defines the problem far better than we would be able to do with our limited knowledge of the Internal Revenue Code.

Methods of Accounting.—There are two principal methods of accounting used in reporting business income for tax purposes. In general, those businesses which do not involve the production or sale of merchandise may use the cash method. Under it, income is reported when received in cash or its equivalent, and expenses are deducted when paid in cash or its equivalent.

On the other hand, in business where the production or sale of merchandise is a significant factor, income can be properly reflected only if the costs of the merchandise are deducted in the accounting period in which the income from its sale is realized. This is accomplished by recording costs when incurred and sales when made, and including in inventory those cost attributable to unsold goods on hand at year's end. Deduction of the costs included in inventory must be deferred until the goods to which they relate are sold, and deduction is not permitted when the costs are incurred. Thus, under this method of accounting, income from sales of inventory and the costs of producing or purchasing such inventory are matched in the same accounting period, thereby properly reflecting income.

Farmers, however, have been excepted from these general rules. Even in those cases where inventories are a material factor, they have historically been permitted to use the cash accounting method and ignore their yearend inventories of crops, cattle, et cetera. This results in an inaccurate reflection of annual income in situations when expenditures are fully deducted in the year incurred, but the assets produced by those expenditures (inventories) are not sold, and the income not reported, until a later year.

Capitalization of costs.—Farmers are also permitted another liberal tax accounting rule. In most businesses, the cost of constructing an asset (including maintenance of the asset prior to its being used in the business) is a capital expenditure which may not be deducted as incurred but may be recovered only by depreciation over the useful life of the asset. In this manner, the cost of the asset is matched with the income earned by the asset. Farmers, however, have been permitted to deduct some admittedly capital costs as they are incurred. For example, a citrus grove may not bear a commercial crop until 6 or 7 years after it has been planted. Yet, the farmer may elect to deduct as incurred all costs of raising the grove to a producing state even though such expenditures are capital in nature. Similarly, the capital nature of expenditures associated with the raising of livestock held for breeding may be ignored, and the expenditures may be deducted currently.

The problem.—These liberal deviations from good accounting practices were permitted for farm operations in order to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting.

However, some high-bracket taxpayers whose primary economic activity is other than farming, carry on limited farming activities such as citrus farming or cattle raising. By electing the special farm accounting rules which allow premature deductions, many of these high-bracket taxpayers show farm losses which are not true economic losses. These "tax losses" are then deducted from their high bracket nonfarm income, resulting in large tax savings. Moreover, these "tax losses" which arise from deductions taken because of capital costs or inventory costs usually thus represent an investment in farm assets rather than funds actually lost. This investment quite often will utlimately be sold and taxed only at low capital gains rates. Thus, deductions are set off against ordinary income while the sale price of the resulting assets represents capital gain. The gain is usually the entire sales price since the full cost of creating the asset has previously been deducted against ordinary income.

The existing "hobby loss" provision of the Internal Revenue Code is ineffectual in dealing with this problem. While that provision disallows deductions for continuing heavy losses in a trade or business over a period of at least 5 consecutive years, the fact of a loss and its extent are measured by comparing the expenses of the business with the total income from the business including the full amount of capital gain income although only one-half of that income is subject to tax. Thus, to escape the hobby loss provision, it is merely necessary that the taxpayer realize capital gain farm income at least once every 5 years. If the capital gain income just equals the farm expenses for a year. the hobby loss provision is inapplicable for 5 years even though the taxpayer will show a tax loss for that year equal to one-half his farm expenses.

Effect of tax benefits on farm economy.—When a taxpayer purchases and operates a farm for its tax benefits, the transaction leads to a distortion of the farm economy. The tax benefits allow an individual to operate a farm at an economic breakeven or even a loss and still realize an overall profit. For example, for a top-bracket taxpayer, where a deduction is associated with eventual capital gains income, each $1 of deduction means an immediate tax savings of 70 cents to be offset in the future by only 25 cents of tax. This cannot help but result in a distortion of the farm economy, and is harmful to the ordinary farmer who depends on his farm to produce the income needed to support him and his family.

This distortion may be evidenced in various ways: For one, the attractive farm tax benefits available to wealthly persons have caused them to bid up the price of farmland beyond that which would prevail in a normal farm economy. Furthermore, because of the present tax rules, the ordinary farmer must compete in the marketplace with these wealthy farmowners who may consider a farm profit—in the economic sense—unnecessary for their purposes.

We believe that this clearly demonstrates what has caused the problem and the scope and serious effect our tax laws have spawned in distorting the farm economy. In addition it pinpoints the competition this outside interest that farms for tax dollars presents to the family farm.

CORRECTION OF THE PROBLEM

The correction of the problem lies in eliminating the tax advantage high-bracket, part-time farmers have in using the generous farm accounting rules to reduce their tax liability on their nonfarm incomes.

The Grange each year has reaffirmed its opposition to tax-loss farming. In 1969 we worked hard to bring about the changes that are now a part of Federal income tax law regarding agriculture. We were not satisfied then that the problem of tax-loss farming was solved by the introduction of the excess deductions account (EDA) method. Therefore, each year since the passage of the Tax Reform Act of 1969, the delegate body of the National Grange has repeatedly called for further revision in Federal income tax laws as they pertain to agriculture.

The E.D.A. account approach does not strike at the heart of the tax-loss farming loophole, it only postpones the issue and strikes at all farmers—big and small, bona fide as well as the investor in agriculture who invests for a profit and, in doing so, includes the tax-loss investor in agriculture who is more interested in farming the Internal Revenue Code than the land.

The National Grange is still in support of legislation similar to the proposal that was before the Finance committee in early 1969, introduced by Senator Lee Metcalf of Montana. One problem with the present method of E.D.A. accounting is that losses caused by natural disasters count toward the E.D.A. account. This strikes unfairly at small farmers. If the E.D.A. is to be retained the amount allowable to be placed in the E.D.A. account should be increased. But the fault with raising the amount is that you raise it for the tax dodger.

Under the 1969 proposals the legislation in no event prevented the deduction of farm losses to the extent they related to taxes, interest, the abandonment of theft of farm property, or losses of farm property arising from fire, storm, or other casualty, losses and expenses directly attributable to drought, and recognized losses from the sales, exchanges, and involuntay coversions of farm property. Under the then proposed legislation, if the total of these deductions is higher than $15,000, then the higher figure may be used without any reduction because of nonfarm income above $15,000. In other words, the dollar limitation contained in the legislation is directed solely at the type of deductions that are artificially created through the abuse of the special farm-accounting rules designed for farmers.

This corrective legislation will affect only nonfarmers with large amounts of nonfarm income who invest in farming in order to secure tax losses which may be set off against the nonfarm income.

There are numerous safeguards in the previously proposed legislation to protect the family farmer who depends on his farm to produce the income needed to support his family.

We are confident that this type of legislation will not have a detrimental effect on legitimate farmers or nonfarmers who invest in farming to earn farm profits. The proposal is unique in that it is pointed directly at the abuse of the liberal tax accounting rules of the Internal Revenue Code, provided by Congress for ordinary farmers or those interests outside of agriculture that make investments in farming for a profit.

The proposal also provided for the large commercial farming interests in cattle, citrus, and other farm specialty crops to be exempt from the provisions of the act if they follow standard accrual accounting methods. Surely, such large privately owned agricultural interests or investors in agriculture that use either grove-management firms or cattle-management firms have available to them the accounting expertise to follow such accounting methods.

The delegate body of the National Grange passed the following resolution at their 108th annual session in November of 1974:

METHODS OF ACCOUNTING

Whereas, legislation has been proposed in Congress to make the accrual method of accounting for income tax mandatory for farmers; and

Whereas, a large number of farmers use the cash method of reporting income tax; and

Whereas, the accrual method adds the value of inventory to taxable income; and

Whereas, farm commodities are difficult to measure and price; and

Whereas, the accrual method is already available as an optional method for farmers who elect to use it; Therefore be it

Resolved, That the National Grange is opposed to any changes which would require farmers to use the accrual method for income tax purposes if they received a major portion of their net income from their farming operations.

The National Grange would be the last organization to support legislation to prohibit persons outside of agriculture from entering agriculture as full-time farmers or as investors supplying capital for those already engaged in agricultural production. We have insisted, however, and will continue to insist, that the rules for playing the game be the same. The enactment of legislation similar to that proposed in 1969 will equalize the rules and make farming a fair game for all interested in agriculture for profit.

INVASION BY CONGLOMERATES

We realize that the elimination of tax loopholes in the Internal Revenue Code as it applies to individuals and corporations investing or engaged in agriculture will not stop the conglomerate corporation invasion. It will, however, eliminate the financing of such mergers and takeovers by the American taxpayer by the use of tax-shelter windfalls.

The real control over conglomerate corporate invasion can be done by tightening of the antitrust laws, which we realize does not come under the jurisdiction of this committee. However, we feel that this intrusion into agriculture is part of the same kind of problem which the committee is considering today and perhaps is a far greater danger to the family farm structure of American agriculture. Curtailing tax abuse is the first step, and a necessary step, in controlling conglomerate corporation invasion of agriculture. We welcome this and similar tax legislation to take the tax profit out of such acquisitions by nonfarm interests.

BENEFITS FROM TAX SHELTERS

We, as responsible members of the agricultural society, would be remiss if we did not consider any possible economic benefit to agriculture and rural America of the so-called tax incentives provided in the Internal Revenue Code.

Those who are in opposition to plugging the Internal Revenue loopholes that permit tax-loss farming present the following arguments in favor of a continuation of the laissez faire:

1. They are not tax loopholes but are tax incentives to attract into agriculture outside "risk" money.
2. That outside capital investments in agriculture have assisted in improvement in livestock breeds.
3. That farmers have benefited by outside capital in that they can expand their operations, buy more cattle and more land, which in turn benefits rural America.

We cannot help but agree that outside capital has benefited certain individuals in agriculture as well as certain specific rural communities. However, we hasten to ask, is it worth the total cost to the Federal Treasury of approximately $145 million in lost revenue? The total increase in Federal revenue would be much higher since farm operations carried on by corporations usually are not separately reported on the corporation tax return. Consequently, data concerning the number of corporations and revenue effect with respect thereto are not available.

Thousands upon thousands of family farms, the backbone of rural communities, are adversely affected by the activity of a small percentage of individuals who are lucky enough to have benefited directly from outside "risk" capital.

Improvement in livestock breeds has been and continues to be a major research function of our land grant colleges. These institutions are supported by public funds and devote time, money, and labor to herd improvement by breeding as well as scientific feeding. We suggest that these laboratories of animal research have made major contributions to breed improvement, feeding improvement, and similar advancements in the livestock industry far in excess of contributions made from outside "risk" capital.

We submit to this committee that the interest of American agriculture and rural communities will be best served if the family farm structure does not have to compete with a select few individals who are deriving direct benefit from the loopholes in the Internal Revenue Code.

Three categories of people receive direct benefit from the abuse of the liberal provisions in the Internal Revenue Code created for the use of the ordinary farmer: the investor, the financial manager and the farmer who manages the livestock or agricultural crops in which outside risk capital is invested, this at a tremendous loss to the Federal Treasury and the further economic loss to the family farm structure that is dependent upon profit for its very existence. Gentlemen, can we afford this kind of "Cowboy Economics"?

CONCLUSIONS

The National Grange recognizes the importance of preserving and protecting the integrity of the owner-operator-manager farm, as a guarantee to the Nation of the efficient and abundant production of high-quality food and fiber at reasonable prices for the domestic and world market.

We seek to obtain for American farmers a return for their labor, management, risk and investment which bears a reasonable relationship to that received for these same economic factors in any other segment of our economy, as well as adequate compensation for their contribution to the general welfare.

The activities of conglomerate corporations and other nonfarm interests in agriculture are not consistent with long-range Grange objectives and have resulted in commodity market price manipulation, unrealistically high prices for farmland and increased farm real estate taxes, (which have made it increasingly difficult to pass farms on to heirs). The net result has been a loss in rural America of farm families. These farm families are frequently forced to migrate to urban centers and into situations for which they are ill-prepared, which further aggravates the explosive problem of our central cities and urban areas, including flooding of the labor market with additional unskilled workers.

If large corporations and nonfarm interests become predominant in agriculture, the need for many Main Street businesses, schools, churches, and municipal facilities will be eliminated. It will destroy job opportunities in rural America and will not be in the best interest of long-term national objectives.

This impact on community life makes the nonagricultural corporate farm invasion a human as well as an economic problem. It is a problem that should concern all Americans and demand their immediate attention.

TAXATION AND FISCAL POLICY

The National Grange adopted the following policy statements and resolutions at its last annual session in November of 1974:

Tax on Forced Sale of Land

Whereas many farm owners are forced to sell their land through condemnation proceedings for public uses, and

Whereas most of the time this will actually depreciate the remaining land value, and

Whereas it is nearly impossible to reinvest this money in like property; Therefore, be it

Resolved, That the National Grange work to have this type of sale exempt from Federal income taxation.

Federal Income Tax

Resolved, That the National Grange recommend that the exemption allowance for individuals on Federal income tax returns be raised to $1,000 and the percentage standard deduction to 20 percent.

Federal Income Tax Deduction Guidelines

Resolved, That the National Grange oppose any action which would abolish deductions for contributions to religious, educational, charitable and eleemosynary organizations and institutions.

The Grange in past years has adopted policy positions that relate to subject matters that are now before this committee. They are as follows:

Income Tax Deductions for Allowable Medical Expense

Whereas a proposal has been made to eliminate the Federal income tax deductions for allowable medical expenses, and

Whereas this proposal would adversely affect many elderly people; now, therefore, be it

Resolved, That the National Grange favor the deductions of all medical expenses on individual Federal income tax returns.

Investment Credit

Whereas, the restoration of the 7-percent investment credit has helped farmers and businesses develop and purchase modern machinery and equipment, and keep up with the ever-fast pace of the country: Now, therefore, be it

Resolved, That the Grange reaffirm its support to keep the investment credit in force at least at the present 7 percent.

We again express our thanks to the chairman and this committee for allowing the National Grange to present our views on this problem that is so vital to rural America and the preservation of the family farm structure of American agriculture.

Statement of Eugene Krasicky in Behalf of the United States Catholic Conference

SUMMARY OF POSITIONS

1. Tax reform must respect the principle of separation of church and state and should respect and further the principle of voluntarism.
2. The Catholic Church has a broad network of charitable agencies which fulfill the function of channeling contributions to the public and particularly to the needy.
3. The United States Catholic Conference is opposed to any limitation imposed on bequests to public charities.
4. We support section 301 of H.R. 10612 relating to a minimum tax on individuals in high brackets as adopted in the House of Representatives.
5. We strongly support legislation providing for making the declaratory judgment procedure available to 501(c) organizations, both in the Federal District Courts and in the Tax Court.
6. The United States Catholic Conference does not support H.R. 8021 or S. 2832 but does not specifically oppose such legislation provided that appropriate amendments are adopted.
7. The United States Catholic Conference strongly supports the retirement income credit provisions of H.R. 13720.
8. We do not support legislation which would establish Federal regulation of charitable solicitation.
9. The United States Catholic Conference supports the position taken by the American Council of Voluntary Agencies with respect to issues arising under section 170(e) of section 911 of the code.

My name is Eugene Krasicky. I am the general counsel of and submit this statement in behalf of the United States Catholic Conference. The United States Catholic Conference is an agency of the Catholic bishops of the United States. Its purpose is to unify and coordinate activities of the Catholic people and agencies of the United States in works of religion, education, social welfare, immigrant aid, civic education, and public affairs.

The history of our tax laws demonstrates the necessity for periodic revision and reform. Economic and social conditions change, creating the need for equitable adjustments in such matters as the tax treatment for the elderly and low-income families. Also, it is necessary to prevent the tax law from being structured in such a way that it will not redound primarily to the benefit of the wealthy. Tax avoidance loopholes must be closed. I submit, however, that the charitable deduction is not a loophole. It is not a tax mechanism designed for the exclusive benefit of the taxpayer. On the contrary, it provides an incentive and a method for channeling millions of dollars through voluntary agencies for the benefit of the people. In short, it is the unique institution developed by this country for effecting a redistribution of wealth in a manner consistent with our democratic principles. In no other country is private philanthropy as significant an aspect of national character as in the United States. Likewise, it is an extension of the principle of concerned charity which has been an essential part of the mission of religion for centuries.

With respect to the exempt organizations in general, and churches in particular, the positions that the U.S. Catholic Conference takes in this testimony rests primarily on three general principles:

(1) Tax reform must respect the principle of separation of church and state.

(2) The objective of tax reform legislation should be the elimination of inequities and abuses, not the reduction of the income of exempt organizations, much less the reduction of contributions to churches.

(3) Tax reform should respect and further the principle of voluntarism.

SEPARATION OF CHURCH AND STATE

The history of our country shows that fiscal separation has always been considered one of the most fundamental aspects of church-state separation. Government does not finance churches, and churches do not finance Government. The separation of church and state does not, of course, preclude Government from cooperating with the secular services of church-related institutions in such fields as education, health and housing on the same basis that Government cooperates with other exempt organizations. Nevertheless, it is fundamental in our system that Government cannot finance or tax religious activities, nor may Government become intimately involved in the internal affairs of churches.[1]

The most critical aspect of separation of church and state is governmental neutrality. Certainly with respect to churches and religious organizations the Government is committed by the Federal Constitution to a policy of benevolent neutrality. The U.S. Catholic Conference firmly believes that this principle of neutrality should be reflected in all areas of the Internal Revenue Code. It believes that the continuation of existing exemptions for churches and religious organizations is one of the best possible expressions of government neutrality toward religion. The aid that results to churches from such exemption is a byproduct of a policy of abstention, not the fruit of Federal favoritism. It may seem paradoxical, but tax exemption of churches has served the highest secular purpose: to keep the Government itself secular, neutral and uninvolved with the internal affairs of churches.

OBJECTIVES OF TAX REFORM LEGISLATION

Exempt organizations, including churches, have not been paying taxes, but they have been saving the American people hundreds of millions of tax dollars every year. In the educational, medical, welfare,

[1] *Murdock* v. *Pennsylvania* (1943), 319 U.S. 105; *Everson* v. *Board of Education* (1946), 330 U.S. 1, 15, 16; *People ex rel McCollum* v. *Board of Education* (1947), 333 U.S. 203, 210, 211; *Zorach* v. *Clauson* (1952), 343 U.S. 306, 312, 314; *School District of Abington* v. *Schempp* (1961), 374 U.S. 203, 222, 229; *Board of Education* v. *Allen* (1968), 392 U.S. 236; *McClure* v. *Salvation Army*, 406 F. 2d 558, cert. den. 93 S. Ct. 132.

housing and social services they sponsor, churches and other exempt organizations make contributions to the general welfare that would cost billions of tax dollars to replace. Since many exempt organizations, and especially churches, have dedicated personnel working at well below the market value of their services, a dollar in the hands of these organizations can and does produce much more benefit to the public than a dollar in the hands of a government compelled to purchase everything in the marketplace. It follows that any substantial diversion of exempt income used for governmental purposes represents a loss to the general welfare, not a gain. USCC is opposed to all tax reform proposals that have as their objective the substantial reduction of the income of exempt organizations, or the removal of church agencies from their traditional role of channeling donated dollars to the needy.

The Catholic Church has a broad network of charitable agencies which fulfill the function of channeling contributions to the public and particularly to the needy. At the present time, the Catholic Church is operating 761 hospitals in the United States which contain 169,302 beds (approximately 30 percent of the bed capacity for general hospitals in the country). In 1975 these hospitals had 29,670,269 admissions. The school system is of comparable size. In 1975 there were 8,539 parochial schools enrolling 2,599,227 students and 1,676 secondary schools enrolling 920,516 students. Additionally, there are 251 colleges sponsored by the Catholic Church with an enrollment of 422,243 students.

The institutional system in the welfare field is likewise substantial. For example, there are 79 protective institutions with 6,218 students; 118 special hospitals and sanitoria with a bed capacity of 10,745; 209 orphanages with 15,296 resident children. Additionally, there are 16,756 foster homes operated in connection with Catholic Charities. The Catholic Church maintains 463 homes for the aged with 51,386 residents.

Today, this institutional system is confronted with challenges in the fields of health, welfare, education, urban housing and civil rights—challenges which must be met. It will take a substantial amount of money in addition to contributed services of many volunteers and religious personnel adequately to respond to the increasing tempo of social challenge.

MAINTENANCE OF VOLUNTARY EFFORT

One of the invaluable and laudatory characteristics of Federal tax legislation is the underlying philosophy designed to encourage charitable contributions to voluntary agencies. In the various amendments to our tax law, Government has never deviated from this salutory principle. As a result of this philosophy, private agencies have played a significant role in the social welfare field. It has not been left to the sole province of Government. This dualism must be maintained for the benefit of welfare and for the benefit of our county. Accordingly, the USCC strongly urges that the Congress refrain from taking any action which would deviate from or minimize the philosophy of voluntarism.

ESTATE AND GIFT TAX LAW REVISION

Various proposals have been made suggesting a percentage limitation on the current law providing for a 100 percent deduction for bequests to charities. The USCC is opposed to any limitation on bequests to public charities for the following reasons:

A. It would result in the imposition of an excise tax on religion and church-related agencies.

B. It would defeat the equitable objective of fostering the redistribution of wealth for public purposes.

C. It would reduce an important source of funding for charities but would produce only a minimal revenue gain.

D. It would have an adverse effect on the voluntary effort.

A more complex issue involves the variety of proposals designed to impose a capital gains tax on unrealized appreciation at death. We are firmly opposed to the imposition of such a tax which does not exempt public charities for the following reasons:

A. A capital gains tax would be imposed on transfers to charities but would produce only a minimal revenue gain.

B. The flow of funds into the residuary estate would be reduced.

C. Bequests to charities would be discouraged.

The full rationale underlying these propositions is set forth in detail in the USCC statement submitted to the House Ways and Means Committee on March 25, 1976. This statement is attached hereto and made a part hereof.[3]

CONTRIBUTIONS OF APPRECIATED PROPERTY

Other proposals relating to the appreciated property would further limit the amount of such property that could be contributed to public charity. Some proposals would reduce the deduction ceiling from 30 percent to a ceiling of 20 percent, others would limit the deduction to one half of the market value of the appreciated property. Churches, and the institutions which they conduct, receive a substantial number of gifts of appreciated property. However, statistical data demonstrates that the majority of the large gifts of appreciated property are made to educational institutions and hospitals. As heretofore noted, the Catholic church operates a substantial number of these institutions. These public charities are dependent upon this form of giving consequently, it should not be discouraged. We cannot ignore the fact that an important social function is served by gifts of appreciated property to education as well as other charities.

The tax dollar secured by the imposition of a capital gains tax would not produce the same educational benefit, for example, that it would when given directly to a collegiate institution. Moreover, most Federal aid programs involving grants and loans to educational and charitable institutions must be matched by money from the institution. A significant amount of that money is derived from gifts which involve appreciated property and charitable remainder trusts. Tax equality is indeed a desirable goal, but the progressive achievement of this goal must be related to and integrated with a social policy of encouraging

[3] This document, previously printed, was made a part of the official files of the Committee.

voluntary effort, otherwise Government would have to move into the vacuum resulting from the inability of the private institutional system to meet the social demands. To a certain extent, Government has already done this and this is desirable for an effective partnership has been established between the Government and the voluntary system for the benefit of society. This cooperative effort can only be maintained if there is enough money for the private institutions to participate as an active partner.

TAXATION OF MINIMUM TAXABLE INCOME

Section 301 of H.R. 10612 relating to a minimum tax on individuals in high tax brackets was adopted after extensive consideration of competing proposals. For all practical purposes, charitable contributions would not be considered as a taxable preference. The impact on public charities would be minimal.

The competing proposals of an alternate tax on preference income modified by a full-charitable deduction was debated and defeated on the House floor. A principal objection urged against this approach was based on the mechanics of computation which indicated that under the terms of the ultimate tax the taxpayer would benefit from the charitable contributions only to the extent of 55 percent of their value. Certainly, this is a substantial benefit, but nevertheless, it could conceivably discourage large contributions to charities.

We do not take a specific position with respect to these various proposals. The USCC does, however, strongly urge this committee to develop a legislative approach which will refrain from including the charitable deduction in preference income and to develop a formula which will not have the indirect effect of limiting the charitable contribution. For example, in the case of the alternate tax, a full-charitable deduction after applying the 55 percent factor would completely protect the charitable contribution.

In making these observations, we realize that these proposals are designed to increase tax equity, a goal which we applaud. We trust, however, that this goal may be achieved in such a way that substantial contributions to charities will not be discouraged.

DECLARATORY JUDGMENT AFFECTING TAX EXEMPT ORGANIZATIONS

We strongly support legislation providing for declaratory judgment procedures with respect to various questions impacting tax exempt organizations including but not limited to the revocation of the statutes of a 501(c)(3) organization. That problem is becoming increasingly acute with respect to determination of the status of a charity or a church. New regulations and rulings have been promulgated which pose a direct threat to churches and schools. For example, if a school does not comply fully with the affirmative action requirements of Revenue Procedure 75-50, the IRS can rescind its tax exempt status and, if it is a parish school, the tax exempt status of the parish can be revoked under the terms of Revenue Ruling 75-231. Our institutions uniformly follow a racially nondiscriminatory policy, but it is conceivable that some might, on occasion, neglect to comply with the complex requirements of Revenue Procedure 75-50, and have their tax status revoked. The decisions of the Supreme Court in *Alexander* v. *Americans United*, 416 U.S. 752 (1974) and *Bob Jones University* v. *Simon*, 416 U.S. 725 (1974) clearly indicate that there is currently no real remedy for tax exempt institutions.

The House has passed a bill which is designed to remedy this situation. It would permit a charity, whose tax status has been revoked to avail itself of the facilities of the Federal district court as well as the tax court. We submit that both channels of relief should be open to tax exempt organizations and especially access to the Federal district courts. In short, tax exempt organizations should be guaranteed their day in court. This day in court should also include the opportunity for a 501(c)(3) organization to utilize the declaratory judgment procedure when the Internal Revenue Service gives a notice of suspension of advance assurance. In short, this provision of the bill should be amended to expressly provide that a suspension of revocation of advance assurance of deductibility is the functional equivalent of notice of revocation, and accordingly, should be accorded the benefits of the declaratory judgment provisions.

LIMITATION ON LEGISLATIVE ACTIVITY

On June 18, 1975, Representative Conable, together with several cosponsors, introduced H.R. 8021, a bill designed to amend the Internal Revenue Code of 1954, with respect to legislative activity of certain types of organizations. A companion bill was introduced in the Senate by Senator Muskie, with a substantial number of cosponsors. This proposed legislation has been before the Congress for at least 4 years. Quite frankly, it was introduced to accommodate the request of a few charities who were concerned with the asserted vagueness of the substantiality test in section 501(c)(3) and who felt that this vagueness precluded them from engaging in any significant amount of legislative activity.

We do not wish to examine all of the precise details of the proposed legislation. Essentially, however, the bills would impose a ceiling on the expenditures which could be made for legislative activity. Expenditures in excess of this percentage limitation would subject the exempt organization to a loss of its tax exempt status.

In earlier legislation, churches were included, however, in both H.R. 8021 and S. 2832, churches were excluded. In short, they may not elect to come within the provisions of the bill which impose a specific ceiling on legislative activity. On the contrary, churches and integrated auxiliaries of churches would be subject to the "substantiality" test of section 501(c)(3) to the extent that churches are subject to any restriction on legislative activity. The "substantiality" test is more appropriate for it admits to a degree of flexibility. Certainly, flexibility is necessary in the case of churches, because the whole issue is impacted by highly relevant church-State considerations. The term "substantiality" must be interpreted in light of these constitutional principles. In this connection, we call to your attention testimony submitted by the USC on May 9, 1972, in connection with H.R. 13720.

H.R. 8021 as introduced in June 1975, has now been revised as late as February 4, 1976. These revisions are highly significant and indicate a trend which frequently develops, namely, when a percentage factor is incorporated in legislation which in the eyes of Treasury constitutes a preference, then attempts are made to contract it and to limit the preference.

The February 4 revision does not specifically limit the expenditure test, but it does incorporate revisions which indicate an intention to further impose limitations on charities. Section 504(a)(2) of the bill contains a provision which would prevent any charity which loses its 501(c)(3) status from acquiring a 501(c)(4) status.

Also, it would adversely affect any charitable organization which is affiliated with a charity, which loses its tax-exempt status. In short, the penalty would be more than a revision of a 501(c)(3) status, it would amount to being closed out for all practical purposes from an exempt status.

Another new factor involves the imposition of an excise tax of 25 percent of the amount of the "excess expenditures" to influence legislation. This presumably would be the first step and then revocation. What was originally submitted as a bill to give charities a degree of certainty in their activities, is now being converted into a straitjacket. As evidence of this fact, section 4911(f)(C) relating to affiliated organizations, provides in effect that if one organization engages in excess lobbying expenditures, every affiliated organization would be subject to the same penalties. Fortunately, the Senate provision currently does not have all of these provisions, but there is no guarantee that it will not be subject to a similar amendment.

The position of the USCC with respect to H.R. 8021 as introduced on June 18, is, that, if certain amendments are made, it will not oppose the bill, but certainly it is not in favor of it. These amendments would have to at least include strong legislative provisions indicating that the principles applicable to elective organizations would have no effect on churches and could have no effect in determining substantiality. We would insist that the language, strong and unequivocal, limit Treasury in this respect. Moreover, there would have to be a provision clearly indicating that Congress is not ratifying the decision of the Court of Appeals for the Tenth Circuit in *Christian Echoes National Ministry, Inc.* v. *U.S.*, 470 F. 2d 849, cert. den. 414 U.S. 864.

Even with these amendments, the USCC would have to oppose the February 4 version of H.R. 8021 for the reason that it would impose unnecessarily restrictive provisions on charities operated, supervised, or controlled by or in connection with the Catholic Church, but which might not come within the definition of "integrated auxiliaries."

This whole definition is currently under consideration by Treasury. On March 29, the USCC as well as other charities and churches filed their comments on a proposed regulation of Treasury, designed to interpret integrated auxiliaries. The proposed regulation would sweep practically all of our charitable organizations out of the definition of integrated auxiliary and would expose them to the restrictions of H.R. 2021. Until there is an appropriate resolution of this definition, we feel constrained to oppose this legislation.

RETIREMENT INCOME CREDIT

The current provisions with respect to retirement income credit are very complex and in many respects inequitable. For example, under the present law, the income credit is only available to those over age 65 who receive retirement income (pensions) or who have investment income. The House provision has endeavored to eliminate this inequity by providing for the first time that low-income earners, age 65 or over, may receive a retirement income credit regardless of whether their income is based upon investments, pensions, or earned income. Since the credit is no longer limited to retirement income, it has been renamed "credit for elderly." Another major change which should be of assistance in this area, is the elimination of the cutback of the credit for earned income. The maximum amounts of the base for the credit are, according to the House provisions, reduced by one-half of the adjusted gross income in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return. ($5,000 for a married taxpayer filing a separate return). Under these provisions a credit would be available to a married couple up to $17,500 if both spouses are over the age of 65. This is a substantial improvement, however, we submit that the head of the household should be entitled to the same consideration as a married couple filing a joint return. Moreover, consideration should be given to an escalating provision which would increase the basis for the credit in accordance with the cost of living index.

We note that the House has eliminated the complex form which the elderly must file in order to secure an income tax credit. It is estimated that over half of the elderly who could claim a credit have refrained from doing so, because of the complex computations in the current form. The form set forth in the report of the Ways and Means Committee of the House on page 144 would seem to be a complete answer. It is simple and concise and the average elderly couple should be able to understand and execute this document.

REFUNDS OF EARNED INCOME CREDIT

One of the difficulties of current law involves the refund of earned income credit which is treated as a resource with consequent income tax complications. The House has included a provision requiring that amounts received under the earned income credit may not be considered income for the purpose of determining who is eligible to receive benefits or assistance or the amounts of benefits or assistance under any Federal or federally assisted program. Additionally, the bill provides that the amounts received pursuant to an earned income credit are not to be considered part of the individual's resources for the month during which he receives the refund. We heartily subscribe to this provision (section 402 of the bill), since it removes a basic inequity and a hardship on the poor.

FEDERAL POLICING OF THE SOLICITATION OF CHARITABLE CONTRIBUTIONS

Senator Mondale, as well as others, have introduced legislation providing for the Federal regulation of the fundraising activities of charitable organizations. It is important that these activities be subject to appropriate regulation. However, State governments already are policing the solicitation of charitable contributions. This matter was discussed extensively in the Filer commission but no hard data was collected demonstrating that it is necessary for the Federal Government to assume a new policing role in this area. On the basis of information available to it, the Filer commission stated that:

It believes that the vast majority of charitable solicitations are conscientiously and economically undertaken.[8]

Despite this conclusion, many taxpayers today feel that charity solicitations cost more than they should. It is easy to make a generalization on this subject. For example, in the initial years of solicitation it obviously costs much more to administer a program than in later years. Accordingly, there must be an averaging over an appropriate period of time. I submit that it is not necessary to have a new Federal bureaucracy in order to remedy this situation. Potential donors who have doubts about the efficiency of charitable solicitation can inquire directly of the organizations with which they are concerned, or they may contact State authorities. If they are not satisfied with the answers they receive, they have the most effective remedy of all: not making the contribution.

ISSUE ARISING UNDER SECTION 170(e) AND SECTION 911 OF THE CODE

The Catholic Relief Services is a subsidiary agency of the United States Catholic Conference devoted to overseas relief and related concerns. It has developed into one of the major agencies in this field and, consequently, it has a significant interest in the inventory contribution problem as well as issues arising under section 911 in connection with the taxation of income of citizens living abroad. USCC does not wish at this time to independently analyze the various issues. We do, however, associate this statement with that of the American Council of Voluntary Agencies of which Catholic Relief Services is a member.

STATEMENT OF FREDERICK E. DAUTERMAN, JR., COLUMBUS, OHIO

TAX REFORM—PRACTICAL AND THEORETICAL CONSIDERATIONS

Introduction

Generally, it seems that most tax reform proposals begin with measuring the effect on revenue. The merits of a proposal are either accepted or rejected on the basis of the effect on revenue. Since our system of taxation is a self-imposed one, and is essentially based upon the ability to pay, it would seem that true tax reform should attempt to find the most equitable tax base and then apply the necessary rates to this base to produce the desired revenue. Certainly practical considerations dictate that at times the tax law may be needed to influence economic activity. However, this should be done by changing the rate structure rather than by changing the tax base. The following is a discussion of the changes I believe necessary to make the tax base more fair and equitable from both a theoretical and practical standpoint. Tax reform should examine the rate structure, the exemption level, the merits of deductions versus credits, and the changes in income and deductions needed.

[8] Report of the Commission on Private Philanthropy and Public Needs, p. 172.

Tax rate

It seems that once an individual's tax rate exceeds 40 percent, he spends much time and effort seeking tax loopholes to reduce this rate. The maximum tax on earned income provision which was put into effect a few years ago did much to reduce the demand for so called "tax shelters". This provision, if retained, should be carried one step further and make all income subject to a maximum rate rather than just earned income. Also the rate should be kept at or about the 40 percent level. Naturally the effect on revenue may dictate a higher rate, but it should not exceed 50 percent.

To eliminate much of the time and energy that is expended minimizing taxes between corporate and individual tax-payers, especially in closely held situations, the maximum and only corporate rate also should be 40 percent. If this were coupled with a suggestion that will be explained later, many of the frustrating problems involved between corporate and individual taxpayers would be eliminated. A single rate table should apply to all individuals regardless of their status. This would eliminate head-of-household rates, joint rates, and various other rate tables provided.

Tax base and alternatives

The foundation of our tax system is taxable income. The determination of this key number has produced a jungle of exemptions, deductions, credits, and exclusions over a period of years which has resulted in complication rather than simplification. It has reached a point where an individual needs professional help in order to properly prepare his tax return. It seems in the past that simplification meant providing the individual with a multitude of alternatives in computing his taxable income. Just the opposite is true in that once an alternative is provided, then the individual must compute his taxable income under all the alternative methods in order to determine the lowest tax. An extreme example of this is in the computation of tax. At least five alternative ways of computing the tax must be used in order to determine the lowest possible tax. Provision is made for an individual to select between a deduction and a credit on certain items. He is given the alternative of itemizing deductions or taking a standard deduction which also has a minimum to calculate.

Simplification would be accomplished by eliminating the alternative tax, maximum tax, minimum tax, and the regular tax computation. The most equitable reform item enacted recently has been the income average method of calculating the tax and should be the only method under which an individual's tax should be calculated. A further simplification would be to eliminate the 120 percent rule used in determining averaging eligibility. This method of tax computation eliminates the tax inequity of an individual's income that fluctuates dramatically from one year to the next as opposed to the individual who has relatively stable income. It also tends to lessen the impact of capital gains tax since a large gain is spread over a period of years and thus is not subject to maximum impact of progressive rates. If rates are held to 50 percent or below, the need for the maximum tax provision would be unnecessary. The need for the minimum tax can be solved in other ways which will be explained later.

Exemptions

The exemption is the most effective tool in regulating the amount of income that should be made subject to taxation. It seems that it has been neglected as a tool in the past in favor of instituting complicated alternatives such as the minimum standard deduction and by increasing the standard deduction. The exemption had been at $600 for a number of years and has been raised to $750 recently. However, when taking into account inflation over the past few years, the increase in the exemption has not kept pace. An exemption puts everybody on an equal basis as opposed to a deduction which favors a high-bracket taxpayer. Take, for instance, the allowance of an interest deduction on a house. An individual in a 70 percent tax bracket is, in effect, being subsidized to the extent of 70 percent of his interest by the government whereas an individual in a 20 percent tax bracket is only being subsidized to the extent of 20 percent. Yet the individual in the 20 percent bracket is no doubt in greater need of the government subsidy than the individual in the 70 percent bracket. The exemption should be used as a base for determining a minimum amount of income an individual needs to meet a certain living standard. This living standard should be one of providing for the basic needs of food, clothing, the shelter. This need obviously increases as an individual's family increases. For instance, under today's living conditions a single individual probably should be allowed at least a $3,000 amount of income before he pays any income tax. If he is married, he should be allowed another $2,000 and if he has dependents he should be allowed an additional $1,000 for each dependent. If we wish to use the exemption for social influence, there should be a family maximum such as $10,000 and the special exemption for blindness and old age should be continued.

Deductions versus credits

The next step after determining the proper exemption base should be to determine which credits and deductions should be permitted an individual. As mentioned earlier, deductions favor the high bracket taxpayer. The credit, on the other hand, is of equal value to all levels of taxpayer. The credit could also be used as a vehicle for revenue sharing. For instance, rather than allowing state and local taxes as a deduction, they should be allowed as a credit against Federal tax. Obviously there would have to be a limit on the amount allowed as a credit, otherwise the States would tax the Federal government out of business. This limit may, for instance, be $1,000 per year. A second example of using a credit versus a deduction effectively would be in the medical expense area. We currently seem to be moving toward a national health plan. A way of instituting a type of national health plan would be to allow credit for medical expenses rather than a deduction. Again, a limit may need to be instituted or possibly only a certain percent of the expense should be allowed as a credit. For those individuals who do not pay tax or the credit exceeds the tax, the credit could be allowed as a refund.

Itemized Deductions

Itemized deductions can be broken down into two categories. One category would be the controllables such as interest, contributions,

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and miscellaneous; and the uncontrollables, such as medical expenses and taxes. Interest deductions should be eliminated and the increased exemption mentioned earlier should take into account necessary interest expense on an individual's residence and other purchases. This would also eliminate the inequity of not allowing the renter a deduction for a portion of his shelter cost. It would tend to discourage unnecessary borrowing of money since the taxpayer will not get an income tax deduction for it. The contribution deduction should be retained because it allows the individual to direct part of his funds toward social causes which otherwise would have to be government supported. The limit on contributions should be eliminated and the loophole of allowing contributions of appreciated property without recognizing the income from such appreciation should be eliminated. It may be desirable to provide for a certain amount of credit for contributions to certain organizations with the excess being allowed as a deduction. This would be an effective way for the Federal Government to channel funds into certain types of charities and causes which would relieve the government of its obligation. Such credit might be for contributions to welfare-oriented organizations. The uncontrollable expenses such as medical and taxes should be handled as indicated earlier by way of credit.

Standard deductions

The standard deduction has been made complicated with the institution of the minimum standard deduction and with special rules with respect to unearned income of dependent children. With the changes mentioned above whereby exemptions, credits, and itemized deductions would be revised and/or eliminated, the need for the standard deduction disappears. It seems that recent tax reform has been to increase and revise the standard deduction. This complicates rather than simplifies because the individual now must determine whether the minimum standard, the percentage standard, or the itemized deductions will result in the lowest possible tax. This is the kind of complication that needs to be eliminated from the Internal Revenue Code.

Income changes needed

Current consideration is being given to eliminating the $100 exclusion on dividends an individual receives each year. It seems that this is just the opposite approach that should be taken. From a purely theoretical standpoint, dividends should be eliminated from the tax base. From a practical and a political standpoint, such a proposal would have difficulty passing. However, some of the advantages that might occur if such a proposal were adopted would be:

1. There could be a substantial capital infusion into companies. This could be especially important to utility companies.

2. It would place equity funds in much more competitive position with loan funds. It should result in an easing of pressure on the need for borrowed capital and thus free this money for other uses.

3. With this possible lessening pressure on the money markets, it should have a positive effect on interest rates.

4. The argument between taxpayers and the Government with respect to reasonable compensation would be eliminated in closely held corporations since the individual would not have to worry about the double taxation effect of dividends.

5. The personal holding company question would be solved.
6. The hassle between the government and taxpayers on unreasonable accumulation of earnings would be eliminated.
7. There would be no need for all the complicated rules of Subchapter S.
8. From a purely theoretical standpoint, the income has already been taxed and should not be subject to a second tax.

The arguments against such a proposal would be the loss of revenue and the advantage to the wealthy. These arguments can be rebutted with the observation made earlier that the most equitable tax base must be determined first and then rates adjusted accordingly. Thus, any revenue loss should be made up by a revision in the rate structure. Secondly, corporate income would increase because many companies would convert debt to capital with the result that the interest expense would be converted to dividend expense which would be nondeductible. Thus, the tax would be shifted from the individual to the corporation at probably a higher rate than was being paid by the individual. In order to encourage such conversion and to be consistent with the proposal made earlier of disallowing interest as a deduction to individual, the corporate interest deduction could be eliminated or at a minimum limited. With respect to the second argument the wealthy no doubt would need outlets for additional funds saved from taxes which would result in additional investment in the economy, which in turn should provide for additional jobs and economic stimulus.

The preferential treatment of capital gains should be eliminated and full deduction should be allowed for capital losses. As indicated earlier if income averaging is used as the tax computation method, the need for preferential treatment on capital gains seems less important. There undoubtedly will still be some inequities in eliminating the capital gain exclusion entirely because of the inflation factor. Thus it may be advisable to provide that if an item is held for more than ten years the gain would be excluded from the tax base or possibly the gain could be averaged over the period the property was held. The elimination of the capital gains preference would eliminate much of the litigation with respect to determining whether an item is subject to the preferential treatment or is subject to the ordinary income rules.

The tax-free status of municipal income could be eliminated if this is coupled with the suggestion made earlier with respect to allowing an individual a credit for taxes paid to state and local governments.

Deduction changes needed

Tax shelter is an area that has received much attention over recent years with several proposals being put forth on how to solve the problem. The problem is viewed as one of unfair advantage the high bracket taxpayer has in being able to invest in so-called tax preference investments and thereby reducing his taxable income and tax. As indicated earlier, a further reduction in the rate level would be a step toward eliminating the popularity of tax shelters. All of the current proposals to date such as the limit on artificial accounting losses and others would be administratively complicated. The easier way to eliminate the impact of tax shelters on taxable income would be to take the following steps:

1. Interest and taxes during construction should be capitalized rather than being allowed as a deduction. This would eliminate much of the tax losses that are generated during the first two years of a project. If further limitations were desired, all costs during construction should be required to be capitalized. When a property is purchased, these costs are included in the price and no deduction is permitted. Therefore, why permit the deduction where the taxpayer constructs rather than buys?

2. The other item that creates the tax shelter is rate and method of depreciation. If Congress were to enact statutory lives rather than allowing them to be administered by general guidelines, much litigation and the tax benefit of aggressive depreciable lives selected by taxpayers would be eliminated. As an example, if a statutory life on apartment buildings were set at 25 years and the double-declining balance method and sum-of-the-year's digits method of depreciation were eliminated, tax shelter benefits would be substantially diluted. It is well grounded in accounting and in tax theory that an individual is allowed to recover his capital cost over a reasonable period of time. The 25 year period or a 4 percent rate with respect to real property would appear to be a reasonable period of time. Also full recapture of depreciation on real property should be enacted if capital gains benefits continue. This would eliminate the current complicated rules and put it on equal footing with personal property. If the elimination of capital gains treatment occurred, as suggested earlier, recapture would be unnecessary.

3. The other major tax shelter seems to be in the area of intangible drilling costs with respect to oil and gas wells. If it is desirable to eliminate the immediate impact of this writeoff, a practical solution be to allow the write-off of the intangibles only after the well is proven to be unproductive. It could be required that the intangible costs on productive wells be written off over the life of productive wells rather than being deducted immediately. From a purely tax and accounting standpoint, the immediate write-off of intangible costs on successful wells does not appear justified.

The above proposals would no doubt have a significant impact on tax shelters without getting involved in all the complications of the limited artificial accounting loss proposal whereby records would have to be kept on losses that were in excess of the allowable income limits and then would have to be carried over to future years.

The entertainment deduction is one that has been much litigated and much abused over the years. While Congress moved to limit these abuses with the changes of 1962, the application of these rules are still inconsistent from examination to examination. Also abuses continue to be prevalent in the record-keeping requirements which are followed haphazardly at best. In theory, the allowance of an entertainment deduction regardless of its purpose in effect is the government subsidizing an individual's entertainment. To carry it to the extreme, if an individual is allowed to deduct his country club dues, his yacht expense, or whatever other entertainment facility he might have, the government is subsidizing this expense. It seems unfair to allow an individual who is in a relatively high income tax bracket to have the advantage of the government paying for a part of his golf while the individual who works in the factory for a wage and plays golf on Saturday afternoon does not have the same benefit. It can be argued that the entertainment deduction should be eliminated completely regardless of its purpose. As an alternative, the customer portion of the entertainment expense could be reported as taxable income to him and allowed as a deduction to the payer. However, from an administrative standpoint, total disallowance would be more practical.

The auto expense deduction is also one that is inconsistently applied from taxpayer to taxpayer. For instance, a traveling salesman is allowed a car deduction because it is used in connection with producing his income. A self-employed person, such as a doctor, who drives from his office to the hospital is allowed a car deduction because it is used in the production of his income. Yet an individual who must drive to his job at the factory is not permitted any deduction. His expense no doubt is as necessary in the production of his income as it is to the doctor or the traveling salesman. The distinguishing characteristic it is argued is that such expenses are commuting expenses rather than for the production of income and the salesman or doctor is not allowed a deduction from his home to his office. In order to make all taxpayers equal in this area of transportation expenses, all individuals should be allowed to deduct 15 cents per mile to and from work. Even if they use public transportation they also should be allowed this 15 cents per mile. This proposal might encourage the use of public transportation since the individual will still be entitled to his 15 cents per mile, which would be a form of credit for using public transportation and may also stimulate the sale of cars since all individuals would now be entitled to deduct auto expenses.

Convention expense is another area that has been abused. The allowance of such an expense in effect is subsidizing the individual who generally is in a higher tax bracket for a partial vacation. True, much of the business that is conducted at the convention is beneficial to the individual in his business. To eliminate some of this abuse, only one-half of the travel to and from a convention for the individual could be allowed. Under no circumstances should any deductions be allowed for the wife's expenses. A deduction should be allowed for the conference fee and for only one-half of the lodging expenses. By allowing only one-half of the lodging expenses and travel, and requiring the individual to pay one-half out of his own pocket, it would recognize the vacation portion of the expense.

No food cost expense should be allowed for conventions, business lunches, or for any purpose because food costs should be provided for in the increased exemption mentioned earlier. It is unfair to allow an individual to deduct his food cost because he happens to be conducting business while eating. The lunch cost paid for clients should be reported as taxable to him or disallowed completely. Total disallowance again would be more easily administered.

Any reimbursement by the employer for entertainment, convention, or food cost should be treated as income to the employee.

Other Items

Prepaid expenses is an area that has been used by the taxpayer to create tax shelter advantage. Basically, these expenses have been used to increase losses in the early years of tax shelters in order to show the investor a larger return of his dollars through the tax deduction. This has been accomplished by prepaying interest first over a period in excess of one year and recently because of an IRS ruling for periods of one year or less. This also applies to points on which the Service has issued rulings saying that if an individual pays such points in cash on a residence purchase, they are deductible as interest expenses. This has been translated to mean that points in a business situation can also be deducted. Again, the way to cope with this problem would be to disallow the prepayment of expenses as a deduction regardless of whether a taxpayer was on a cash basis or an accrual basis. This would be more effective and less complicated than trying to limit the deduction by use of the limited artificial accounting loss rules that have been proposed.

We recently had major legislation in the Pension Reform Act of 1974. This bill has provided many improvements in the pension and profit-sharing system and eliminated many of the inequities. One area further consideration should be given is for self-employed retirement plans to be put on a same parity as corporate plans. This would include eliminating the $7,500 limit with respect to the self-employed retirement plan and allow the same contribution limit as in a corporate plan. Also, other provisions on vesting and distribution should be made comparable to the corporate plan. Such parity would eliminate much of the pressure on the individual to incorporate his business just to obtain the more liberal benefits available under a corporate plan. The major reason for incorporating by professionals has been to obtain the more liberal benefits under the corporate profit-sharing plan rather than the self-employed plan. This change would eliminate much of the litigation in the professional corporation area. This parity should also be extended to other provisions that make incorporating advantageous to operating as a partnership or as a self-employed taxpayer. These are the group insurance advantages with respect to the first $50,000 and the corporate medical plan deduction under Section 104. These benefits either should be eliminated from the corporate tax structure or should be permitted under other than a corporate tax structure. The individual retirement account limitation of $1,500 should also be made comparable to corporate limits.

Social Security

It seems that the popular trend is to attempt to solve a problem that applies to a small segment of the population by mushrooming the program to cover everyone. A way to solve the Social Security dilemma would be to exclude people from coverage of Social Security who have adequate corporate, individual, or other retirement plans including government plans in effect. It makes little sense to cover an individual with Social Security who is already receiving a substantial retirement through a corporate or government plan. It may be practical to allow the individual to choose between the Social Security program and his own personal retirement program. As long as he would pay toward an individual retirement program that provides benefits at least equal to or greater than what would be available under Social Security tax. For those currently retired individuals who have no adequate personal retirement program or are not covered by an adequate corporate plan, they would continue to receive benefits under Social Security. The funding of this part of the plan should be through general tax revenues rather than Social Security tax. This is merely another expenditure of government that should be provided for through the income tax structure. For working individuals not covered by their own plan or a corporate plan or an adequate plan, they would be required to continue to pay Social Security taxes. In addition for an individual who would want to continue the Social Security coverage in addition to his personal retirement program, he would continue to be assessed the Social Security tax. This required portion and voluntary portion of the program should be fully funded.

The above observations no doubt would need refinement. However, the basic idea would be to segregate the social problem of people with insufficient income and spread this cost over all taxpayers. The retirement portion should be funded on an actuarially sound basis just as a private plan. It is unfair to have excluded categories from Social Security tax such as government workers on the basis that they have a separate retirement plan. The same argument can be made for millions of other workers with private plans.

Summary

As mentioned earlier, these are practical and theoretical suggestions. More important than the specific changes outlined above is the approach to the changes that should be taken by our legislative bodies. That is, first the fairest tax base should be determined irrespective of the impact on any special interest group. Certainly the economic impact would then have to be measured. Possibly the changes would have to be phased in over a transition period. I believe that if we do not take such an approach and we continue our approach of making changes based on pressure and interest groups, the foundation of and confidence in our tax system may be in jeopardy.

Testimony of Stephen J. Rapp, Chairman, Citizens Committee on Tax Reform

Mr. Chairman: The adoption of our nation's first peacetime income tax in 1894 led one Congressional supporter to predict.

> The passage of the bill will mark the dawn of a brighter day [when] * * * good, even-headed democracy will be triumphant [and will] * * * hasten an era of equality in taxation and in opportunity.

Today, some 80 years later, the majority of the American people do not view our income tax law as a triumph of democracy, but rather as a cause for disillusionment in our whole democratic system. There is a sense that the tax code benefits the special interests more than it does the ordinary citizens; that it provides credits, deductions, exceptions, exemptions, and special rates to those with economic and political power, while it forces the rest of us to pay the bills.

It was in response to this feeling that our committee was formed. As citizens we wanted to study the tax law, consider proposed changes, and then seek to have an impact on the tax reform debate in the Congress. Our committee includes people from varied backgrounds—from banking, farming, law, homemaking, labor, accounting, education, and public service. We are all members of special interest groups, but we are all more importantly citizens of this country who believe that our taxes must be fair and be recognized as fair by a majority of Americans if our tax law is to have the people's compliance and if our political system is to have the people's confidence.

Our committee believes that our country would be better served by a tax system with sharply reduced rates and far fewer special breaks.

We recognize that the tax law is a useful tool of economic management, and that certain tax preferences can at times provide stimulus for investment, and employment, and economic growth. But we also note that many of these preferences often outlive their usefulness and benefit many who do not need the assistance. We therefore feel that tax preferences should be treated like appropriations with their benefits weighed against those of other public expenditures. As much as is possible they should be credits, like the investment tax credit, rather than deductions, and should have specific expiration dates.

We also recognize, that the tax system contains some disincentives to investment and places excess burdens on certain business activities. We favor efforts to eliminate the discrimination between debt and equity financing and are open to individual and corporate tax integration. We, however, oppose any tax changes that would shift the burden of tax off of large businesses and high-income individuals on to low-to-middle income Americans. If indeed, there is a potential capital shortage, we believe that this shortfall can best be met by federal budgetary restraint combined with across-the-board tax reductions. We reject trickle-down economics, and all efforts to redivide the American economic pie in favor of those at the top at the expense of all the rest.

Specifically, we would ask the Finance Committee to clear for the Senate a bill including the following tax reform proposals:

1. An increase of the personal exemption to $900, with an alternative $225 personal credit. The increase of the personal exemption is needed to compensate for past inflation, and the alternative of the personal credit will provide much needed relief to families making less than $20,000.

2. Provide for automatic future adjustment of the personal exemption, personal credit, standard deduction, and low income allowance to reflect inflation. Inflation is already hard enough on low-to-middle income Americans without the hidden tax increase that comes from it.

3. Repeal mineral depletion allowances, and foreign tax credits for foreign mineral royalty payments. Eliminate tax deferral through DISC's and eliminate deferral of income of foreign based corporations. Limit artificial accounting losses by requiring that accounting losses can only be taken against related income. These three proposals would close major loopholes that have provided little if any real benefit to the economy.

4. Toughen the minimum tax by eliminating the deduction for taxes paid, decreasing the exemption from $30,000 to $5,000, and by raising the rate to 14%. The famed "loophole catcher" is itself so full of loopholes that as many as 402 individuals making over $100,000 are completely escaping tax liability each year. It would be preferable to attack some of the loopholes themselves, but without such an effort, a strengthening of the minimum tax is clearly in order.

5. Provide at least a $900 personal exemption from the social security payroll tax. A majority of Americans now pay more in payroll tax than income tax, and the levy is notoriously regressive, placing a heavy burden on low-to-middle income wage earners. Some of that burden could be relieved by providing a personal exemption to be financed out of general revenues.

6. Provide local governments with the option of offering taxable securities and of receiving an interest subsidy. The current tax exemption of state and local bonds saves local governments $3 billion a year in interest but costs the federal taxpayers $4 billion—90% of which goes to people making more than $50,000 a year. Providing local governments with the option would not only save the local and federal taxpayers' money, it would also open the local government bond market to lower bracket taxpayers who do not currently find the tax exempt bond rates to be economical.

7. Provide a 10% credit up to $1000 on the income of the second breadwinner in a two-job family. Such a proposal would recognize the additional costs incurred by working spouses and substantially eliminate the "marriage tax" which leads some couples to avoid matrimony or seek divorce.

8. Increase the estate tax exemption to $200,000 and provide that only one-half of joint tenancy property can be taxed to the surviving spouse. Inflated property values have made estate taxes a crushing burden on the family farm or business. For a widow who must prove that she made monetary contributions in order to escape paying tax on the entire property, there is often little alternative but to sell out. These changes and others could be financed easily by ending the practice of stepping up the basis of capital gains property at death—a move that could include provision of a credit for estate taxes paid on the death transfer.

Taken together these proposals would substantially improve the fairness of our federal tax system.

We hope that this committee and the entire Congress would consider these changes and others, and adopt in this year of 1976 a comprehensive tax reform bill that will indeed mark "the dawn of a brighter day"—a day of greater tax justice, and a day of greater public faith and confidence in our system of democracy.

AMERICAN FARM BUREAU FEDERATION,
Washington, D.C., March 17, 1976.

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

DEAR MR. CHAIRMAN: Farm Bureau wishes to take this opportunity to comment on the provisions of the House-passed tax revision bill (H.R. 10612) which are of particular concern to farmers and ranchers—namely, the agricultural aspects of proposed changes in the DISC program, the proposed limitation on artificial accounting losses (LAL) from farming operations and the method of accounting for certain farming corporations.

For the record the American Farm Bureau Federation is the largest general farm organization in the United States with a membership of 2,505,258 families in forty-nine states and Puerto Rico. It is a voluntary, nongovernmental organization, representing farmers and ranchers who produce virtually every agricultural commodity that is produced on a commercial basis in this country.

DISC PROGRAM

Farm Bureau objects to the portion of the House bill which would drastically modify the Domestic International Sales Corporation (DISC) provisions of the tax law. We are particularly concerned with the provisions which would eliminate most agricultural and horticultural commodities and products from eligibility for the benefits of the DISC program. We would like to stress the following points:

(1) The United States should not unilaterally abandon the DISC program. Such a change should be made only in the context of effective international agreements which result in compensating actions by our foreign trading partners. In reality the DISC program is generally of much less aid to U.S. exports than the practices of other countries are to the exports of those countries.

(2) Agricultural exports should be afforded the same treatment as other products under the DISC program.

Increased commercial sales of U.S. agricultural commodities in world markets have shifted our national trade balance from a deficit to a surplus. A large surplus in our agricultural balance of trade has more than offset a negative balance of trade in the industrial section which reflects sharply higher prices for imported petroleum.

The continuation of a high level of agricultural exports is essential to the welfare of American agriculture and to the maintenance of a favorable national balance of payments. Any action which tends to restrict agricultural exports will endanger the economic health of our country.

(3) The DISC tax deferral program should not be turned on and off. If this program is to be a part of the tax structure, agricultural and industrial exporters alike should be able to rely upon it, should be able to base their forward sales planning on its continuation, and should not be faced with its discontinuation on short notice.

LAL AND ACCRUAL ACCOUNTING

The proposed limitation of artificial losses (LAL), as it applies to agriculture and the provision of the House bill which would require certain farming corporations to use accrual accounting, are closely related. The applicable portions of "Farm Bureau Policy for 1976" read as follows:

"We recommend that farmers, including farm corporations, continue to have the option of filing income tax returns on either the cash or the accrual basis."

* * * * * * *

"We support the present law with respect to capital gains treatment for sales of breeding livestock."

* * * * * * *

"We recommend an amendment to the Tax Reform Act of 1969 to limit further the opportunity of a taxpayer to offset farm losses against nonfarm income.

"We recommend that the cost of developing all orchards, groves, and vineyards be capitalized on the same basis as developmental expenses for citrus and almond groves."

As we understand it, the objective of the agricultural provisions of Section 101 of H.R. 10612, as passed by the House, is to curb the use of agriculture as a tax shelter by taxpayers with large nonfarm incomes without penalizing taxpayers who are farming for economic reasons rather than to shelter nonfarm income. We support this objective, and we do not find anything in the agricultural provisions of Section 101, as passed by the House, that appears to us to be adverse to the interests of taxpayers who are not trying to use farming as a tax shelter.

We are, however, concerned with respect to Section 204 of the House bill, which would require that corporations (other than "family owned" corporations and Subchapter S corporations) and certain partnerships use the accrual method of accounting and also capitalize the preproduction period expenses of growing or raising crops or animals.

As noted in our policy statement, we believe that all farmers, including farm corporations, should continue to have the option of filing income tax returns on either a cash or an accrual basis. We believe that the use of cash accounting for farming operations is fully justified by the nature of the farming business and the large amount of book work that is required to keep farm accounts on an accrual basis. Since the purpose of Section 101 (Artificial Accounting Losses) is to correct any abuses that may have resulted from the use of cash accounting to shelter nonfarm income, we do not think it either necessary or desirable for the Congress to move in the direction of restricting the right of any farmer to use the cash option.

We believe that the cost of developing orchards and vineyards should be capitalized, but we do not believe that farmers or farm corporations should be required to capitalize the preproduction expenses of growing or raising crops or livestock. The difference is that the preproduction period is generally much shorter for crops and livestock than for orchards and vineyards.

Your consideration of these matters as the Senate Finance Committee begins hearings on H.R. 10612 will be greatly appreciated.

We should appreciate your making this a part of your hearing record.

Sincerely,

JOHN C. DATT,
Director, Washington Office.

STATE OF NEW YORK,
LEGISLATURE OF ERIE COUNTY,
CLERK'S OFFICE,
Buffalo, N.Y., October 10, 1975.

TO WHOM IT MAY CONCERN:

I Hereby Certify, That at a Session of the Legislature of Erie County, held in the County Hall, in the City of Buffalo, on the Seventh day of October A.D., 1975 a Resolution was adopted, of which the following is a true copy:

Whereas one of the most important issues facing Erie County and the nation in times of high unemployment is the need to increase jobs and productivity using the private sector rather than resorting to more government spending, creation of new programs and public service jobs, and imposition of new controls, and

Whereas the relatively low level of private capital investment in business and industry during recent years is a principle cause of the high unemployment rate which, along with spiralling costs of raw materials and other factors, is at the heart of the current recession, and

Whereas while generating increased private capital investment is the key to avoiding dependency on government programs and grants, such increases cannot occur when government continues to take massive percentages of citizens' earnings through taxes and inflation, and

Whereas a system of selective reductions in government's tax demands on individuals and businesses has been proposed in the form of the Jobs Creation Act of 1975, H.R. 8053, which has attracted nationwide, bipartisan support of nearly 80 cosponsors in Congress, and

Whereas passage of this legislation, coupled with decreased federal spending, could result in immediate and direct stimulation to the sagging private economy, enabling greater capital investment and permitting the creation of new jobs, and

Whereas H.R. 8053 would among other things, enable a corporate income tax reduction of about 6 per cent; increase to 15 per cent and make permanent the investment tax credit; provide for employee stock ownership plan financing to give the work force a bigger stake in productivity, and

Whereas the primary goal of the legislation is to assure adequate investment of job-creating capital in plant expansions, home construction and equipment purchases, and

Whereas reduction of heavy tax burdens borne directly by corporations will ultimately benefit consumers by permitting lower prices, and wage-earners by enabling the creation or restoration of more new jobs, Now, therefore, be it

Resolved, That the Erie County Legislature hereby memorializes Congress and the President to approve and enact H.R. 8053, Jobs Creation Act of 1973, to permit increased private capital investment to stimulate the economy, accelerate productivity and enable creation and restoration of jobs in private industry, and be it further

Resolved, That certified copies of this resolution be sent to U.S. Senators from New York, Congressional Representatives from Erie County and the President.

WALTER J. FLOSS, Jr.,
Legislator, 16th District.

BEATRICE CHAMBER OF COMMERCE, INC.,
Beatrice, Nebr., January 16, 1976.

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

DEAR SENATOR LONG: We would like to be granted permission to have the following statement recorded in the permanent statement recorded in the permanent record of the Senate Finance Committee:

A STATEMENT—RE JOBS CREATION ACT H.R. 10538 AND TAX REFORM ACT

"We, the members of the Beatrice, Nebraska, Chamber of Commerce, believe that the Congress of the United States has before it a golden opportunity to resolve the dual problems facing our nation of inflation and unemployment. That in this opportunity, our gross national product can be increased substantially, would create new job opportunities throughout our nation (we might add—in the private sector) causing additional capital outlays being made, and of just as much importance, generating additional treasury revenue.

"We are referring to the 'Jobs Creation Act H.R. 10538 and the Tax Reform Act' now before your committee for discussion."

We are asking for your full consideration and support to incorporate "capital formation measures and the provisions of the Jobs Creation Act in the proposed Tax Reform Act."

Thank you for your cooperation and consideration.

Sincerely,

GEORGE H. BARBER,
Division Vice President, Public Affairs.

EARL HALL,
Lewiston, Idaho, March 6, 1976.

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

GENTLEMEN: Per the Report of the House Committee on Ways and Means, the Tax Reform Act of 1975 is designed to achieve a four fold objective. These objectives are worthwhile and should be pursued in any amendment of the Internal Revenue Code. However, it is my opinion that H.R. 10612, as passed by the House of Representatives, does not meet these objectives and would do serious damage to the integrity of the United States taxing system.

At the present time, the House Committee on Ways & Means is studying capital formation and the needs of the country for capital. The Internal Revenue Service is telling taxpayers the 1975 Form 1040 is more complex than last year's and one of the keys to a simpler tax return is a simpler tax law. President Ford and Secretary Simon are calling for major revisions in the law to eliminate much of the present law. In short, in the midst of a national indecision on the purpose and direction of U.S. tax laws, the House has passed a bill calling for substantial reform with little thought of the future consequences of that reform on other issues being raised and studied.

Assuming that political pressures are such that a reform bill must be passed this year, I would hope such reforms are of a permanent nature and reflect the problems facing the American economy over the long run.

On that assumption, I would make the following comments on H.R. 10612:

Title I is needlessly complex, both in its wording and in the execution of its provisions. The more complex a law, the less its understanding and acceptance. Thus, taxpayers in similar situations will be taxed differently based upon the understanding of the person preparing the return.

If the items creating artificial losses are deemed to create an inequity in the tax system, they should be disallowed to all taxpayers. If not, they should be retained for all taxpayers.

Especially troublesome are the provisions of Section 468(b)(2) classifying all depreciation over lives shorter than the lives called for in Section 167(m)(1) as accelerated depreciation for lease property even if the life used reflects economic reality and Section 469(d) and 469(e) which gives a corporate equipment dealer a stepped up basis for leased equipment traded in by a lessor who had taken accelerated depreciation resulting in an LAL.

If LAL is passed, the above two provisions should be carefully reviewed to see if the results produced are intended.

Title II has a mixture of good and bad provisions.

Bill section 201(a) will again extend the computations on the tax return and discriminate between owners of subsidized and non-subsidized housing. Bill Section 204 discriminates between corporations based upon ownership. Bill Section 205 discriminates between homeowners and non-homeowners. Discrimination between taxpayers was not one of the objectives of H.R. 10612. If these provisions should be enacted, they should apply uniformly.

In general, current legislation on distortion of income, accounting methods and accounting periods, if properly enforced, would serve to curb the abuses noted in Title II without adding to the length of the Code.

Title III would serve to increase the taxes on capital gains and thus dampen enthusiasm for capital investment. It would appear that this would widen the projected gap between capital needs and availability in the near future. As this problem is under consideration at the present time, adoption of Title III would appear to be premature.

Title IV should be considered in light of the anticipated budget needs of the country for the period under consideration. The rates should be set each year in light of budget needs.

Title V is basically sound with the exception of Bill Section 501. Taxpayers will be forced to compute the applicable amount of standard deduction and exemptions to compute tax if they do not itemize. Presently, they can stop at adjusted gross income. It would appear that expansion of tables based upon adjusted gross income would be simpler and more beneficial and understandable to the average taxpayer.

Title VI could be simplified to achieve the same objective.

Section 280(d)(1) should be amended to eliminate the dual time test. The maximum number of days under Section 280(d)(1)(B) would be 17 days. There are a lot of wordage and computations to let a taxpayer use a dwelling unit for three more days.

Bill Section 602 is very long for the number of taxpayers affected and would require any taxpayers so involved to check all commercial airlines to see whether Icelandic Airlines' fare that month was more or less than BOA's, or any other airline. The fact gathering process would be tremendous.

Title VII changes the effective tax rate on accumulation distributions from the lower of the trust or beneficiary's rates to the higher thereof. This is offset by the benefits of simpler tax calculation and availability of accumulation of income until age 21 with no throwback.

Titles VIII and IX should be given the same consideration as Title IV and no ending date should be put thereon.

Title X and Title XI do not affect my clients and, therefore, I am not in a position to evaluate.

Title XII is extremely confusing to me and is probably the provision of the bill affecting me the most.

Our C.P.A. firm holds itself out to our clients and the general public through our occupation as a tax return preparer. All tax returns get a minimum of two reviews, one detail and one general, prior to submission to the client. Our firm name is signed to the return and the firm assumes responsibility under the statement at the bottom of the form.

Bill Section 1201 defines a tax return preparer as a "person." As a partnership is not a "person," our procedure would be illegal. Regulations may resolve the problem but these would not have been issued by January 1, 1976. Therefore, if this section passes as written, most "tax return preparers" are in violation of the law.

In lieu of proposed Bill Section 1201, I would recommend a comprehensive revision of the law as regards tax return preparers. Having reviewed tax returns prepared by commercial tax return preparers, laymen, lawyers and accountants, I have found that the quality of the return does not depend on a person's profession but on his knowledge of applicable tax law.

To accomplish the goals of Bill Section 1201, I would recommend that a licensing procedure be established whereby any person preparing a tax return for a fee, regardless of profession, be licensed following a test given on knowledge of the tax law. Any firm or company preparing tax returns would have to have at least one individual who was so licensed and that individual would be required to review and personally approve any tax return bearing his license number, even if signed under a firm name.

Bill Section 1201(b) is a long needed provision in the tax code. Other sections appear to fall short of the goals strived for.

Bill Section 1207 appears to be impossible to enforce and inequitable if enforced. Taxpayers who consistently win $999 would be exempt from withholding while a taxpayer winning $1,001 once and losing that much, or more, would be subject to withholding. If greater control is desired in this area, information returns should suffice.

Bill Section 1212 is a welcome relief to taxpayers wishing private rulings but reluctant to publicly disclose confidential information.

Title XIII gives needed clarification to these technical areas where taxpayers presently are unfairly treated.

Title XIV should be examined closely for its impact on the capital formation problem.

Title XV contains needed provisions and I would urge its approval as written.

Titles XVI and XVII are outside the scope of my present knowledge and, therefore, I have no comment thereon.

Title XVIII should be eliminated. For a total tax credit of $7, this title is going to make liars out of half the taxpayers in the country and tax return preparers will be evaluating whether a hoe was purchased to weed a flower bed or a vegetable garden. The folly of the House of Representatives for passing this has been mentioned by many of my clients. I hope the Senate has more sense.

Title XIX is worthwhile and should be passed.

I have chosen as my career the service of interpreting and applying the provisions of federal and state tax laws to legitimately increase the amount of money my clients retain for their personal use and goals. As such, I suppose I should welcome H.R. 10612 as it, even more than the Tax Reform Act of 1969, serves as a justification of my occupation. However, increased complexity leads to less understanding which leads to less compliance. This procedure becomes even more pronounced when complex provisions of the Code are frequently revised.

I would urge a careful review of reform provisions in light of the long-term goals of the country and recommend a simpler Code to determine taxable income on a long-term basis with changes in the short-term economy of the country being reflected in the tax rates on that taxable income.

Very truly yours,

EARL HALL.

STATEMENT OF WILLIAM F. MCFARLANE, CLOVIS, CALIF.

I am William F. McFarlane, a farmer, from Clovis, Fresno County, California. As secretary of the Producer Steering Committee of the National Cotton Council, I am pleased to have this opportunity to present this statement in behalf of the Council.

The Council is the central organization of the American cotton industry, representing not only cotton producers, but also ginners, warehousemen, merchants, cooperatives, manufacturers and cottonseed crushers.

My five children and I own and farm 1250 acres of diversified crops in Eastern Fresno County. Our family's land has been acquired over a period of sixty years. We farm as a general partnership. Also, with four other Fresno County farm families we are a part of a relatively new farming enterprise in Western Fresno County. We five families pooled our resources to create a unit large enough to operate with maximum efficiency, then chose to use the corporate form of business structure for this operation. In our first year we made the Subchapter S election, which we gave up the second year. We are now in our third year of farming. I present this background to demonstrate that at home we have much more than a casual interest in the questions we are addressing. We will be seriously affected by the decisions made in this legislation.

The National Cotton Council presented a statement to the House Ways and Means Committee last October expressing its views concerning then pending tax reform legislation. This paper represents an extension of those remarks.

My statement will deal with, first, the principle of the cash method accounting option granted to farmers; second, a proposal that a new category of corporation be recognized, to be known as an "agricultural corporation"; third, some relaxation of requirements in the proposed legislation which apply to the Subchapter S corporation; and finally, suggested change in the ten years ownership requirement as to a family corporation owned by two families.

I. USE OF CASH METHOD

Various points underline the necessity of continuing to permit small organizations, in general, whether or not incorporated, to continue the use of the cash method of accounting. These considerations include the following:

A. The privilege of the cash method will not only preserve the relative simplicity of that method when compared to the accrual method, but will also provide incentive to farmers to engage in erosion control, insect control, land improvement, and other desirable cultural practices, without being forced to allocate costs to specific crops or seasons.

B. It is generally recognized that weather and wide fluctuation in market cycles cause wide variation in farm income and expense from year to year. In this respect, a farm operation conducted by one or several families (whether or not incorporated) is not comparable to larger enterprises engaged in commercial or manufacturing businesses. The flexibility of the cash method is a convenient and practical tool to level out income and taxes of family farmers over a period of years. That such is increasingly the philosophy of the income tax laws is shown by the expanded acceptance in recent years of net operating loss carryback and carryforward and of income averaging.

C. In many types of operations, the taking of inventory would be extremely difficult, or impossible, as in the case of the close of an accounting period coinciding with a harvest of fruit, or perhaps a cutting of alfalfa. Requiring inventories under these circumstances would merely give rise to a vast amount of guesswork.

II. AGRICULTURAL CORPORATIONS

The House Bill in general requires corporations engaged in farming to report income for tax purpose on an accrual method. However, the philosophy of the House Committee, as stated in the Committee report, was to avoid application of the new accrual basis provisions to "certain small or family corporations in order to continue the cash basis method of accounting essentially for all those but the larger corporations engaged in farming." In order to implement this philosophy, the House Bill does not require accrual accounting by an electing Subchapter S corporation, nor of a so-called family-owned corporation.

No reason of policy appears as to why a corporation otherwise eligible for Subchapter S status should not be allowed the same benefit under the legislation as a Subchapter S corporation, except for the fact that the corporation has not elected under Subchapter S, or had a trust for a shareholder. We therefore propose that another category of corporation, entitled to use the cash method, be recognized, to be known as an "agricultural corporation". Any corporation would be considered as an agricultural corporation if the shareholder test for a Subchapter S corporation were met, except that a trust would be permitted to be a shareholder if the beneficiary of such trust would himself be eligible to be a shareholder of a Subchapter S corporation. A trust should be allowed as a shareholder in order to avoid loss of status as an agricultural corporation on death of a shareholder whose estate is held in trust for his wife or child. This approach would retain the philosophy of the Bill that the Subchapter S corporation is a small corporation that should be eligible for the cash method, but, in determining status as an agricultural corporation, avoids the application of technical provisions of Subchapter S that are irrelevant to the purpose of this Bill.

If desired, a further test could be added that a certain minimum percentage of the gross receipts of the corporation, perhaps on the average for a period of years, should be from farming. The House has already adopted such a concept by requiring that no more than 20 percent of the gross receipts of a Subchapter S corporation be from income such as dividends, interest, and rent. It is common for various families or individuals to join forces in agricultural operations, especially in these days of high capital requirements. Such a provision would encourage, rather than discourage, individuals and families to engage actively in farming activities.

It would be possible, if Congress desired, to impose on such an agricultural corporation the requirement that not less than a certain percentage of the shares, such as one-half or two-thirds, be owned by or attributable to someone "actively participating in the management of any trade or business of farming." Such concept is applied already in the philosophy of the House Bill in other provisions.

III. SUBCHAPTER S CORPORATIONS

Subchapter S status can easily be lost, often inadvertently, as the result of transfer of shares, on death or otherwise. Such loss of status can occur retroactively to the beginning of the tax year of the corporation. Under these circumstances, a distortion would result unless the legislation further allows a period for continued Subchapter S status until agricultural commodities on hand and being grown at the date of the event in question can be disposed of in an orderly manner in accordance with past marketing practices for the farm.

It would seem that the 10-year transition for net adjustments, upon commencement of accrual accounting because of application of the new law, should also be applicable to the tax year and succeeding years when the election under Subchapter S of a corporation ceases. Such would be in accordance with frequent Treasury practice of disposing of controversies with taxpayers over items not clearly reflecting income, in cases of shifts to or from Subchapter S status.

We also urge the Committee to grant relief to those corporations, otherwise eligible to elect Subchapter S status, presently in the five year period during which an election is forbidden. When the new legislation becomes effective, such corporations should be permitted to re-elect Subchapter S on a special basis because of the change in circumstances, either during the present or immediately following tax year.

An analogy is presented by the consolidated return regulations which permit taxpayers to change their election as to consolidated returns when a change in law occurs.

IV. FAMILY CORPORATIONS

We see no valid reason that the proposed bill should require that, in the case of a family corporation in which two families are involved, the ownership of stock by each of the respective families must have continued for ten years prior to enactment of the Bill. No such requirement is imposed on the one family corporation. Two families should be allowed at any time to conduct joint farming operations in a family corporation on a cash method, as they can do in partnership, without regard to any ten-year requirement. Again, liberalization is needed here as a practical matter to allow families to join together in joint ventures for farming activities.

CONCLUSION

I hope the Committee will give serious consideration to these views. The suggestions are all aimed at the objective of assisting farm operations consisting of one or a few families—an objective which I believe to be important to the Congress. In this connection, my own advisors have termed the Bill as being one for full employment for accountants and lawyers, but they say also that they are already fully employed.

Farmers, and their legal and accounting advisors, are being seriously burdened by the increasing technicalities and details of tax legislation. The overwhelming accounting requirements which seem to be in the offing impose an overhead expense of doing business which is nothing less than punitive to a small operator. We urge this Committee to carefully avoid, wherever possible, the multiplication of detailed requirements in the law which will increase seriously the already heavy burden of compliance.

Mr. Chairman, separate and distinct from this testimony, the Council has prepared testimony relating to proposals to increase the estate tax exemption, and to legislation concerning the Domestic International Sales Corporation. I would like at this time to introduce our testimony concerning those two issues for the record.

I very much appreciate the opportunity to appear before you.

Statement of National Associated Businessmen, Inc., Homer E. Marsh, President

TAX REFORMS ESSENTIAL TO CAPITAL FORMATION

Fiscal laxity, according to Arthur F. Burns, Chairman of the Board of Governors of the Federal Reserve System, is a major factor responsible for the acceleration of inflation during the past ten years. His conclusion was based on the large tax reductions in 1964 and 1965 which were immediately followed by huge federal expenditures as were the reductions of 1969 and 1971.

Deficits have mounted and persisted in good years and bad. During the last five fiscal years, 1970 through 1974, the federal deficit has totaled more than $100 billion. What is more startling is that the federal government has produced a total surplus of only $24 billion in eight of the last 45 years. Deficits for the other 37 years exceeded

$312 billion. Now we are faced with consecutive deficits for 1975 and 1976 fiscal years on the order of $70 billion and $100 billion respectively.

Deficits of this magnitude create enormous demand for goods and services but add little to the Nation's capacity to produce. Accordingly, individual enterprise has been weakened through demand for governmental programs that transfer an ever increasing share of national output to those who are not productively employed. As a result, those who work are asked to pay more and more of their income in taxes and government spending continues to grow and grow. Presently more than 35 percent of the Nation's production is absorbed by government.

Furthermore, as the rewards of those who work have been taken, corporations have been excessively and unreasonably handicapped in their expansion programs by excessive taxation. The availability of investment capital has been insufficient to finance a vigorous expansion of capital investment. As a result, our industrial plant is deficient—fully two years older than that of Japan and Europe. The United States ranks 18th of 20 advanced economies, in terms of economic growth, according to the Organization for Economic Cooperation and Development.

Some years ago Secretary of the Treasury Dillon, in his statement before the House Ways and Means Committee, stated that "All of our citizens will benefit from modernization of our industry. A basic fact of economic life is that modernization and expansion are essential to higher productivity. Rising productivity will provide us with a rising level of per capita income, with resultant and widely shared benefits in the form of rising real wages and rising investment incomes. Rising productivity will also permit us to hold prices down." We face the same problems today.

The fall-off in corporate earnings and limited capital cost allowances on depreciation in recent years are the major reasons why business capital investment has been inadequate to maintain the long-term growth of productivity so necessary to the expansion of employment.

A recent study of the Joint Economic Committee showed that business investment in the United States amounted to only 15.7 percent of gross national output last year whereas it totaled 37 percent in Japan, 26 percent in West Germany, and 27 percent in France. That accounts for the greater economic growth in other nations and increased productivity and jobs.

Studies by the New York Stock Exchange indicate that capital formation will fall short $650 million during the next decade. Chase Manhattan Bank paints even a gloomier picture, placing the capital gap for the 10-year period at $1.5 trillion. Although these figures are questionable, they do show that new incentives are needed to close the gap.

Years ago capital investment was financed largely from retained earnings and depreciation reserves, but, more and more, corporations have come to depend on borrowed funds, mostly short-term which has weakened business' financial strength during recent adverse market conditions. With prospects of a deficit ranging from $70 billion this fiscal year to $100 billion next year, it becomes even more important to curtail government spending and stall inflation.

Ordinarily, the simple solution would be: Balance the budget and provide a currency that has value. In other words, provide stability in our monetary affairs. This we must do.

Our tax system should be used primarily for revenue purposes and, secondarily, to encourage the improvement and expansion of our economy by encouraging investment in production. It is quite apparent that we lack the self-discipline either to cut government spending or to raise revenues; therefore, it appears impossible to stop inflation without resorting to changes in our tax law to encourage capital formation. Jacob Viner, in an article 52 years ago, before the Great Depression, put it well when he stated in an article entitled *Taxation and Changes in the Price Levels:*

> Even though . . . absence in tax legislation of provisions for adjusting taxes to the changing conditions resulting from changing price levels is a source of serious inequities, . . . there is a strong presumption against adding further to the intricacies and complexities of taxation. In any case . . . why treat symptoms instead of causes? If changing price levels prevent ordinary tax laws from working well, why is this not rather an added argument for the search for the means of stabilizing prices . . .? The answer . . . turns, of course, upon the relative difficulty of stabilizing price levels as compared with adjusting tax laws. Until . . . stabilization of prices is more of a practical possibility than it appears to be at present, the possibility of adjusting taxation to changing price levels, even at the cost of further complication in tax laws, is at least deserving of more consideration than it has yet received.

It is obvious that the degree of inflation today far exceeds that envisioned by Mr. Viner.

Many of our problems, such as creating a desirable climate for capital formation, while affected by inflation and instability, can be corrected individually and possibly in the sum total entirely through tax reform. By correcting individual problems we may bring about the stability in government that we seek.

Tax barriers against investment in production facilities must be removed, individual savings and investment must be encouraged, and corporate earnings after taxes must be increased enough to make investment pay. In this way a tax environment more conducive to economic growth, modernization of production capacity, and effective competition at home and in world markets can be created. There must be incentive to expand productive capacity and to create individual and corporate savings upon which this advance depends. Only in this way can productivity be increased which is essential to the elimination of inflation.

DEPRECIATION MUST OVERCOME INFLATION

Inflation shifts command over resources from those whose income is relatively fixed to those whose income and assets move with the price level whether they be major corporations or widows and orphans. If business cannot raise prices to reflect increases in the cost of depreciable assets it cannot protect against inflation.

Cost recovery allowances and capital investment incentives are far more favorable in other industrial nations than ours. The United States is presently facing intense competition from modern, well equipped foreign industrial plants. In 1970, over two-thirds of Japan's steel industry, for example, was less than nine years old. At that time only about one-third of U.S. capacity was less than ten years old and much of the steel manufacturing plant was technically obsolete.

In this connection it should be noted that capital cost recoveries in Japan and most other industrialized nations in the first three years are much greater than in the United States. Japan permits a 34.5 percent recovery in the first year compared to 7.7 percent in the U.S. without investment credit.

Take some of our other competitors for example. Great Britian permits a 30 percent initial write-off on equipment and 15 percent on buildings running concurrently with normal depreciation. The Swiss have something pretty close to 5-year amortization—Sweden does have it. Even the Canadians are ahead of us.

It is recognized that many factors other than tax considerations have contributed to the rapid rise in investments, improvements in production, technology, and modernization in Western Europe and Japan. On the other hand, in these areas tax policies have been focused on creating a tax climate through cost recovery allowances and similar incentives more favorable to private investment in plant and equipment.

If the United States is to improve its position in international trade, domestic policy, rather than downgrading, must encourage increasing the efficiency of our industrial facilities. It must create the machines that lead to increased productivity which can alleviate unemployment. Maintaining our present position will not be sufficient.

In our present economic situation, depreciation is based upon original cost and does not begin to provide for the replacement of productive capacity at current price levels. Any portion of this loss which can be passed on in price results in income subject to tax. The situation has been somewhat improved by the investment tax credit and the speed-up in depreciation charges. It must be remembered, however, that such speed-ups do not result in the recovery of more than the historic cost over the life of the item depreciated. When an item is prematurely disposed of, no advantage results because of the recapture provisions in the law providing that all amounts of depreciation taken other than amounts which would result from the use of straight-line depreciation must be taken back into taxable income.

In 1970, the President's Task Force on Business Taxation stated that it is particularly vital that the expansion and modernization of the production facilities of the Nation not be discouraged by the tax system and that the long-range result of increasing the tax on business by curbing the growth of productive capacity through depreciation policy would hinder efforts to reduce or stabilize the price level. The Task Force went on to recommend the adoption of a simplified and liberal cost recovery allowance structure in place of the useful life depreciation deduction allowed by existing law. More specifically, the committee's recommendations called for (1) substituting conventionalized capital cost recovery for the present particularized depreciation. Conventionalized cost recovery would involve classifying all machinery and equipment into broad groups and assigning to each such group a standard recovery period which all taxpayers would be free to use in computing their cost recovery allowances without reference to their particular experience and pattern of retirement. The groupings proposed were those employed in present depreciation guidelines. This recommendation was adopted. (2) Allowance of full recovery of cost unreduced by salvage value, in a period 40 percent shorter than now permitted. The period was shortened approximately 20 percent. Further shortening in line with the Committee's recommendation and the elimination of salvage is recommended. (3) Permit use of longer recovery period if desired, and (4) write-off of unrecovered cost of asset prior to expiration of the recovery period. These are minimum recommendations if our industrial system is to become viable again.

Since inflation has become a way of life it is recommended that any cost recovery allowance deduction reflect at the end of each year for each item accumulated depreciation sufficient to replace the item as of that date.

Mr. George W. Terborgh of the Machinery and Allied Products Institute told the Tax Institute Symposium in 1958 that you can formulate a rule of thumb on when price level adjustment becomes necessary when he said:

> My observation of foreign experience is that the resistance among bureaucrats, accountants, and others, and the inertia perhaps of management, are such that so far as I know price level adjustments have not been made in any case where inflation has been short of 200 percent. However, after you get inflation of more than that, something has to be done about it.

Mr. Terborgh went on to say that we had about 100 percent (1958). The cost of living index since that time has brought our inflation up to more than 250 percent, rising from 48.8 percent in 1940 to 171.7 percent in 1974.

Numerous proposals have been advanced for price level adjustments in depreciation to recover purchasing power of original investment (replacement value) rather than historical cost. From a practical standpoint, these proposals would take effect on items purchased after the law was changed.

Any attempt to convert the annual depreciation by merely applying the increase in the price index from the previous year to the current index to secure the depreciation to be expensed against costs for the current year, of course, does not replace cost as of any given year since it ignores past depreciation. Much can be said for this proposal since it does secure the annual economic cost of operation. In other words, it merely converts the current year's depreciation to cost of replacement to be charged against that year's production, but in the sum total it will fall far short at any given time beyond a year to offset current costs.

To provide realistic cost of replacement of the original investment, depreciation must be computed for all years to date and the difference between this figure and the prior year's accumulation will establish the current year's depreciation necessary to replace the depreciated item at the current cost.

This has been demonstrated for the straight-line method of depreciation in the example below.

The computation would not be difficult to make and could be based on the U.S. Consumer Price Index or any other index reflecting the change in price level of the item being depreciated. The following example shows what would happen to an item costing $1,000 with a useful life of five years. The example assumes that the year of purchase is the base of the price index period and is adjusted to 100.0. Subsequent years can be computed for each item. The replacement cost in the example rises from $1,000 to $1,277. The depreciation rate each year is 20 percent and the accumulated rate rises to 100 percent at the end of the fifth year. To arrive at the amount of depreciation to be charged, compute the cost of replacement depreciation charge by applying the accumulated depreciation percentage to the replacement cost and subtract the total accumulated depreciation for the prior year to arrive at the charge necessary to bring depreciation in line with the cost of replacing productive capacity.

	Straight line					
			Depreciation			
Year	Consumer price index	Replacement cost	Annual rate (percent)	Accumulated rate (percent)	Replacement accumulated	Charged
1968	100.0	$1,000				
1969	105.4	1,054	20	20	$210.8	$210.8
1970	111.6	1,116	20	40	446.4	235.6
1971	116.4	1,164	20	60	698.4	252.0
1972	120.2	1,202	20	80	961.6	263.2
1973	127.7	1,277	20	100	1,277.0	315.4
Total						1,277.0

Although the adjustment for full cost of replacing productive capacity for declining balance depreciation and sum-of-the-digits depreciation would not be quite this simple, it could be readily computed. In countries that have adopted it, they have elaborate systems of blowup. The government establishes a set of multipliers, one figure or set for each prior historical year of acquisition. The assets are aged and the resulting figure applied against the acquisition costs, blowing up depreciation to current value.

This system should be accompanied by full recapture by the Treasury of any excessive cost recovery allowances realized upon the sale, exchange, or involunary conversion of facilities over the recoverable basis of such facilities.

INCREASE CORPORATE SURTAX EXEMPTION

The Tax Bill of 1975 liberalized the surtax exemption for a period of one year. This attempt to assist capital formation is not of sufficient benefit to obtain the expressed objective. It has been a number of years since the normal tax on corporate income was established at 22 percent on the first $25,000 of income and full taxation of all net profit above $25,000. The shift for one year provides that the small business corporation can save for a single time $7,000 in federal income taxes if it has earnings of $50,000 or more. The so-called liberalization of the act merely provides that the first $25,000 of corporate income will be taxed at 20 percent and the second $25,000 at 22 percent. All above $50,000 for the one year will be taxed at 48 percent. Although this savings in income tax would help small companies in many ways it does not reach high enough or last long enough to assist many others whose incomes have risen from $25,000 to possibly $150,000 during the inflationary spiral that has taken place.

These provisions should be made permanent so that the average small business corporation knows what it can depend upon in any expansionary move it may have for the future. The law should be changed also to provide that the first $50,000 of income be taxed at 20 percent and the next $50,000 at 22 percent and that the 48 percent corporate tax rate become effective only on incomes in excess of $100,000. Furthermore, these new amounts should be subject to change to reflect the rise or fall in the consumer price index each year or at intervals of five-year periods or some other applicable form of escalation.

If inflation can be stopped, programs calling for an escalation of tax rates will not result in any loss of revenue to the U.S. Treasury. The object in providing for incentive to capital formation is to increase such capital for investment in the tools of production and thus increase the productivity of our workers. Only if such productivity can be increased can there be any justification in wage increases.

RELAXED RULES ON "UNREASONABLE ACCUMULATIONS" OF PROFITS

In the past the Internal Revenue Code has provided a limitation on the so-called improper accumulation of surplus beyond the reasonable needs of the business. If a corporation unreasonably accumulated more than $100,000 a year the corporation was required to pay 27½ percent taxes on the first $100,000 of earnings unreasonably accumulated and 37½ percent on all amounts above $100,000. This has prevented small corporations and especially family-owned corporations from accumulating capital for future expansion when such expansion appeared desirable. The 1975 law liberalized this amount somewhat by making the line of demarcation between the two rates $150,000. This amount, however, does not reflect the inflation that has taken place since the original amount was established or the vital necessity of capital formation. The law has worked hardships on many small family-owned corporations and forced them to dispose of their holdings to larger corporations when some member of the family passed on.

A permanent extension of this amount to a minimum of $200,000 should be approved and the lower rate reduced to 15 percent. Above that amount a permanent rate of 25 percent might be warranted. The $200,000 unreasonable accumulation of earnings should also be subject to annual or periodic adjustment to reflect the increases in the price level. Again if the economy is stabilized by these reforms, this escalation of the amount freed from taxation would not result in any appreciable loss of revenue to the U.S. Treasury.

INVESTMENT CREDIT SHOULD BE CONTINUED

The 1975 law expanded the investment credit, increasing it from a top of 7 percent to 10 percent of the value of purchased equipment for a two-year period for most businesses and from 4 percent to 10 percent for utilities. Its purpose is to encourage corporations to acquire more equipment. While the investment credit is purely a subsidy to encourage business to expand by updating their equipment it is not overexcessive. The amount of the credit cannot exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. Credits, however, can be carried back three years or forward seven years. The increase in tax savings also will apply to qualified investment in used equipment up to $100,000 from the $50,000 of prior years.

The investment credit should apply to all new equipment and should be made a permanent part of our tax system. The rate of credit should be set at 12 percent instead of the present 10 percent providing that an additional 3 percent shall be allowed in the case of a corporate taxpayer, provided an amount equal to 3 percent of the qualified investment is contributed to an employee stock ownership plan. This would broaden stock ownership and thus encourage capital investment.

DOUBLE TAX ON DIVIDENDS SHOULD BE REMOVED

Our tax system should stop penalizing savings and investment which are so necessary to our economic growth. If individuals are to be encouraged to save their money and invest in capital issues they must receive a better cut of the corporation's earnings. This can be accomplished by removing the excessive taxation or double tax on shareholder dividends, preferably at the corporate level because it is at this level that corporate earnings are invested.

It would be unfortunate if the tax were removed at the individual level on reinvested dividends only because this would favor those in the higher income brackets and discourage the payment of greater dividends to all investors.

Double taxation results from the fact that the income of the corporation is taxed at a rate up to 48 percent and then dividends paid to shareholders out of the remainder are then taxed again to the individual at a rate up to 70 percent with no off-setting credit for the tax paid by the corporation other than the dividend exclusion of $100. Income from unincorporated businesses is taxed only once. This would appear to be discriminatory to the corporate shareholder. If these dividends were freed from tax at the corporate level it would revitalize stockholder investment and in turn business confidence. It would encourage people to save because it would enable the corporations to distribute a higher amount of their income as dividends. Only this prospect of receiving dividend income or an increase in the value of corporate stock will encourage capital investment.

Since interest payments are deductible and dividends are not, corporations are more or less forced into the bond market rather than seeking their new capital in the stockmarket. This helps explain the severe money market pressures and high interest rates of recent years and the weakening of some corporate capital structures.

ADJUST ESTATE AND GIFT TAXES

The estate tax has been referred to as a tax on capital. Although it does not destroy existing productive capital facilities, it reduces the rate at which the increase and renewal of such facilities can take place. In other words, these taxes mitigate against capital formation and in so doing probably reduce the wealth-creating capacity of the economy, (1) by reducing the incentive of many businessmen to make the fullest possible use of their capital and business abilities, (2) by forcing them to dispose of their businesses to larger corporations, thus fostering monopolistic conditions and (3) by channeling assets in taxes to the government that otherwise would have been invested in productive plant and equipment.

It would, therefore, seem imperative that our estate and gift taxes be brought in line with the situation that now prevails in our economy. They have not been revised since 1941, and in the meantime inflation has brought about a 250 percent increase in general price levels.

Even though a businessman may do little or nothing during his lifetime to prepare for the burden of his estate tax, his incentive to continue building and expanding his business is undoubtedly greatly reduced. He is disheartened by the fact he knows that the business may have to be sold later on at a sacrifice in order to obtain the funds with which to pay the tax. Thus, the limiting effect of the prospective estate tax on productive business endeavors causes a far larger loss to the economy than any benefit that the tax can yield the Government and the Nation.

The rates of the estate tax and gift tax should be greatly reduced and an increase in the specific exemption from $60,000 to $210,000 should be approved to reflect the inflation since the law was last amended. Since inflation may continue in the future, the exemption should reflect the increase in the price level in future years. Similar changes should be made in the marital deduction.

It is suggested also that the lifetime gift tax exemption of $30,000 be increased to $105,000.

These changes in the tax law would encourage small businesses of the family type and those closely held to continue operation upon the death of prominent principals. It would also be of extensive help to our small farmers who find it difficult to provide sufficient moneys to pay the estate taxes in order to keep their farms in the family. At the present time the estate tax is causing small family-owned business operations and farms to pass into publicly held corporations in order to achieve liquidity.

ELIMINATION OF OR REDUCTION OF TAX ON CAPITAL GAINS

There are many conflicting opinions on the proper treatment of capital gains and losses, both for individuals and for corporations. These run from one extreme to another. Some believe that capital gains should be taken into full account in computing annual income. At the other extreme are those who insist that capital gains or losses should not be taxed in any way since they do not represent income or income losses in any sense. Many take an in-between view which is difficult to justify on any basis.

Capital gains or losses should be removed from our tax laws in the interest of encouraging the free flow of funds and capital formation. This is the solution followed in some industrial countries. Barring the complete removal of the tax, however, capital gains should be reduced by the amount of increase in the price level that has taken place since the purchase of the individual security or property. It is rightfully argued that most of the increase in the price of property or securities held for any length of time represents, at this time, an inflationary increase and by no stretch of the imagination could be considered either income or capital gain.

Another solution that has been suggested that might have some merit is that all capital assets should be subject to tax-free roll-overs. In other words, no taxable income would result unless the sale of such property results in a reduction of capital investment.

Dan Throop Smith, Professor of Finance, Harvard Graduate School of Business, stated to the Ways and Means Committee in 1959 that "The capital-gains treatment available for profits on the sale of depreciable assets stands in the way of the liberalization of depreciation allowances which, next to a reduction in the very high and repressive individual income tax rates, is the tax reform most urgently needed." He suggested that not only should the maximum rate of 25 percent be reduced to 10 percent on the longest term gains but that the holding periods should definitely be extended.

Without doubt, the present $1,000 limitation on the deductibility of capital losses from ordinary income limits the willingness to take risks with one's capital. If one invests for income the tax law puts the taxpayer at a serious disadvantage with high taxes on any income that might be generated and minor relief for losses.

Rubin Clark, partner Wilmer and Broun, testifying before the same group as Mr. Smith made it abundantly clear when he stated "Certainly, in a period of inflationary price increases some capital gains are illusory in this sense, simply because conventional accounting techniques do not measure real income—that is current money income deflated by changes in the price level."

ADJUSTING INDIVIDUAL INCOME TAX

Inflation has constantly pushed individual taxpayers into higher tax brackets when they haven't had an actual increase in the purchasing power of their income. Social Security contributions also have been increased although theoretically larger benefits will eventually result therefrom. This is questionable in view of Congress' continued tinkering with social security taxes and benefits. As inflation increases tax rates it also diminishes the relative importance of personal exemptions and the standard deduction.

Tax brackets should be adjusted periodically to reflect the increase in the consumer price index. Similar adjustments should also be made in personal exemptions, the minimum standard deduction and the newly passed tax credit of $30 for each taxpayer, spouse and dependent.

To demonstrate, the present minimum bracket of $500 would increase to $550 if the price index increased 10 percent. The next bracket of $500 to $1,000 would increase to $550 to $1,100, and so on up the scale. Similarly, the personal exemption of $750 would increase to $825 and the new $30 tax credit to $33. The minimum tax credit would also rise from $1,600 to $1,760 for a single person and from $1,900 to $2,090 for joint returns. The percentage standard deduction would likewise rise from a maximum of $2,300 to $2,530 for a single person and from $2,600 to $2,680 for joint returns.

CORPORATE TAX RATE CUT

To further increase the incentives for "capital formation" a cut in the corporate income tax rate would be made periodically to reflect the increase in the price index. Thus, a rise in the price level would call for a reduction in the tax rate to a percentage computed to raise a constant amount of revenue. Thus, a 10 percent increase in the price level would reduce the 48 percent corporate tax rate to 43.6 percent, a 12.5 percent increase in prices would reduce the tax rate to 42.7 percent. The new tax rate may be determined by multiplying the old rate by the previous price index and dividing the result by the current price level.

A cut in corporate tax or individual tax does not necessarily mean a reduction in federal revenues. Two years ago, Canada cut its corporate income tax from 49 percent to 40 percent. As a result, capital spending plans showed jumps up to 20 percent. A deficit of $450 million was projected by the Finance Minister but the economic growth that resulted increased surplus by $250 million. These figures may seem small but we must remember that the entire Canadian budget is much smaller than ours.

The tax reduction was coupled to provisions to reduce the tax brackets to reflect any increase resulting solely from inflation. This indexing device discourages the government from deficit spending.

Taxation With Representation: Statement by Charles Waldauer, Ph. D., Professor of Economics, Widener College

INTRODUCTION

Sponsorship of testimony by outstanding tax professionals is one of the ways in which Taxation with Representation seeks to promote the public interest. The group's objective is to broaden the range of viewpoints and opinions available to tax policy makers. It seeks, in particular, to facilitate the presentation of testimony on tax matters by economists, tax lawyers, and accountants who have no axe to grind. This statement is one in a continuing series of public interest presentations.

Sponsorship of testimony by Taxation with Representation does not mean that the opinions expressed by a witness are necessarily those of the members, officers, or directors of the group. It does indicate, however, that the group regards a witness' views as worthy of serious consideration by those concerned with the improvement of the federal tax system.

Taxation with Representation is a nonprofit, nonpartisan, public interest taxpayers' lobby, founded in 1970. Its goal is to promote federal tax reform by representing the interests of ordinary taxpayers when tax issues are under discussion in Congress and in the Executive Branch.

Further information about Taxation with Representation is set forth in the group's descriptive brochure, which can be obtained by writing to the address shown above. Membership in Taxation with Representation is open to all who share the group's commitment to improving the federal tax system through more effective representation for the general public.

BIOGRAPHICAL NOTE

Charles Waldauer is Professor of Economics at Widener College. He is a former Economics Department Head and Chairman of Social Science. He received his B.Sc. in Economics from the City College of New York in 1957, and his Ph.D. in Economics from Syracuse University in 1969.

Professor Waldauer has published a number of articles and presented many papers in the area of public finance. He is currently engaged in research in intergovernmental fiscal relations, and the public financing of education.

ADDRESS AND TELEPHONE INFORMATION

Further information regarding the views expressed in this statement can be obtained by writing to Dr. Charles Waldauer, Department of Economics, Widener College, Chester, Pennsylvania 19103. He may be reached by telephone at (215) 876-5551.

The following views on the Tax Reform Bill passed by the House of Representatives (H.R. 10612) are submitted as written testimony to the Senate Finance Committee for its consideration.

INTANGIBLE DRILLING AND DEVELOPMENT COSTS (SEC. 208)

The change approved by the House is a step in the right direction but it falls far short of full-fledged tax reform. These costs should not be treated as current expenses, but as capital outlays to be included in the value of the oil/gas property and recovered through depletion or depreciation allowances (in the case of a dry hole, these intangible costs would be written off when the hole is completed). I strongly urge the Senate Finance Committee to eliminate this current expensing provision.

PLAYER CONTRACTS INCLUDED AS PART OF SPORTS FRANCHISE PRICES (SEC. 209)

No meaningful tax reform has occurred through the House-enacted change. The value of player contracts should *not* be treated as a depreciable asset, but as part of the franchise rights (the present value of anticipated monopoly profits)—similar to the treatment of goodwill. In addition, past practices have permitted more than 90 percent of the franchise price to be allocated to player contracts. The proposed change uses a 50 percent figure as a guideline, which I feel is generally excessive. I hope the Committee will disallow the allocation of these contracts to sports franchise prices.

SICK PAY EXCLUSIONS (SEC. 505)

The House change is a less than half-way measure to tax reform. There is no logical basis for excluding sick pay from taxable income, if this pay is fully provided by the employer. Such income is the same as wage or salary income and should be included as gross income. In economic terms, sick pay is identical to paid holidays or vacations. If the employee finances all or part of salary continuance plans, then the employee-financed portion of such sick pay should be excluded, with only the employer-financed portion being treated as taxable income (this is the present policy used in the tax treatment of retirement income). I request that the Committee eliminate this exclusion of sick pay from taxable income.

DOMESTIC INTERNATIONAL SALES CORPORATIONS (SEC. 1101)

Again, the change ratified by the House has a negligible impact on tax reform. The tax revenues lost through the preferential treatment of DISC enterprises are substantial, and there is no equitable reason why export activity should be favored over domestic sales. Such flagrant tax discrimination erodes taxpayer confidence in and compliance with the Federal tax system. The DISC program should be ended as of December 31, 1976, and I strongly urge the Committee to take this action.

Taxation With Representation: Statement of Edward H. Peeples, Jr., Ph. D.

CRITERIA FOR TAX REFORM

BIOGRAPHICAL NOTE

Edward H. Peeples, Ph.D., is an assistant professor of preventive medicine (Medical Sociology) at the Virginia Commonwealth University. He served as a member of the Joint FCNL/AFSC (Friends Committee on National Legislation and American Friends Service Committee) Task Force on Taxation and Distribution of Income in the U.S.A.

SUMMARY OF STATEMENT

This statement was originally a letter to Walter F. Mondale, D-Minn., chairman of the Senate Budget Committee Task Force on Tax Policy and Tax expenditures.

The tax system is grossly inequitable to the majority of Americans. Citizens are tired of subsidizing an economic system that rewards greed to the detriment of social welfare. Tax policy should be formulated with the following criteria in mind:

1. Recognition of the expenses necessary to maintain and improve an individual or one's family.
2. "Effective" tax rates which are truly progressive.
3. Recognition of the impact of all other federal, state and local taxes.
4. Tax incentives for personal improvements such as improvements in education and employment status.
5. Any tax incentives should be evaluated as to their effectiveness.
6. Recognition of the impact of personal disasters and crises.
7. Preferential recognition of the value of human resources over other capital resources.
8. Low income taxpayers should get the same help in dealing with the tax laws as those who can afford high-priced legal and accounting help.

ADDRESS INFORMATION

Further information regarding the views expressed in this statement can be obtained by writing to Dr. Edward H. Peeples at the Medical College of Virginia, Virginia Commonwealth University, MCV Station, Richmond, Virginia 23298.

MEDICAL COLLEGE OF VIRGINIA,
VIRGINIA COMMONWEALTH UNIVERSITY,
Richmond, Va., October 8, 1975.

Senator WALTER F. MONDALE,
Chairman, Senate Budget Committee,
Task Force on Tax Policy and Tax Expenditures,
U.S. Senate, Washington, D.C.

DEAR SENATOR MONDALE: I wish to apologize for failing to respond to your letter of August 7, 1975 asking for my commentary on the staff report on "Estimates of Federal Tax Expenditures". I was out of town when your letter arrived and returned much too late to meet your August 22 deadline. I suppose that it is just as well that I did not speak specifically to the paper you enclosed because my thoughts on it could hardly be described as directly relevant or constructive since I feel that the entire tax structure, despite various recent cosmetic reforms, continues to be grossly inequitable to the majority of Americans. Consequently, my concerns for tax reform are much more fundamental. In fact, I view any continued quibbling over what should or should not be deducted from one's gross income as quite beside the democratic point.

By this I mean to say that there are a number of tests which I think should be applied to the formulation of any tax law or policy. Eight such criteria are suggested below. There are, of course, many, many others. Enclosed items numbered 1 and 3 represent other criteria which I consider relevant. Item 1 refers to federal taxes while Item 3 relates to a local tax.[1]

Criteria 1

Any concept of taxation should include a sharp distinction between (a) personal and family "subsistence" which meets the costs of individual and household maintenance and improvement and (b) "capital" which represents essentially "surplus" resources. This is spelled out a bit more on page 1 of enclosed Item 2.

Comment

Unfortunately, current U.S. tax laws and policies do not adequately recognize the differences between the functional value of the first $6,000 to $20,000 dollars of a household's income as compared with income above this range which can be used for investment and speculation.

Criteria 2

Any fair tax imposed should result in an "effective" tax rate which is in fact progressive.

Comment

The effective tax rate (i.e., the dollars actually paid to IRS as a percentage of total income) is still far from progressive. For example in 1973, 622 individuals with annual incomes in excess of $100,000 paid *no federal taxes at all!*[2]

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[1] Enclosed Item 4 describes in more general terms the spirit underlying much of my commentary.
[2] People and Taxes, September 1975, p. 11.

Criteria 3

Any just tax should acknowledge and accommodate the cumulative impact of all other federal, state and local taxes.

Comment

Despite some recent reforms, federal taxes when combined with other U.S. state and local taxes (particularly income, wage, property and sales taxes) are still dramatically regressive.

Criteria 4

Any reasonable policy employing a tax incentive should reward individual and family improvement such as gains in educational achievement and employment status.

Comment

Corporations and partnerships are rewarded in a myriad of ways for growing larger and improving their profits, even if their product or service has no social value. Meanwhile, individuals cannot even receive a deduction for an educational expense which promises to upgrade them to a better job.

Criteria 5

Any tax incentive allowed should be required to demonstrate its capacity to bring about the kind of desired economic behavior predicted by the advocates of that measure.

Comment

The concept that tax incentives do in fact produce specific desirable investment and other economic behaviors is largely unsubstantiated. There are no stringent tests of the efficacy of tax incentives for big business and big banking such as is required in the likes of the food stamp, public assistance, or guaranteed minimum income programs. The cause and effect arguments in favor of these business incentives are instead founded on the folklore of free enterprise.

Criteria 6

Any humane tax method should acknowledge and absorb the impact of family and personal disaster and crisis.

Comment

Businesses and industries which experience natural or human-caused disasters and other losses enjoy a host of tax subsidies and other financial advantages. On the other hand, poor and middle class families and individuals who endure disasters, death, or catastrophic illness receive only a modicum of tax and credit relief since their ability to repay loans is so limited.

Criteria 7

Any justifiable tax system should treat human resources as the most critical form of capital.

Comment

Current economic policy and tax laws cower and grovel to nearly every whim of the big investor who menaces the government and the money markets with the threat that if conditions are not favorable, he "will pull out his money". At the same time, the pleading of millions of Americans for the resources to up-grade themselves to more productive and less dependent levels continues to be ignored.

Criteria 8

Any tax reporting system should provide citizens of modest and low income with the same advantages enjoyed by high income persons and corporations.

Comment

Corporations and rich individuals can amass lawyers, accountants and other skillful and clever warriors against the IRS, while low and middle income citizens do not have access even to the information necessary to defensively complete their IRS returns.

These are but a few of the complaints middle and low income Americans wish to have set straight.

My interpretation of the relevant national opinion surveys suggests that the tide of American attitudes on taxes has significantly shifted since 1972. Our citizens are disgusted with the irresponsible and unpatriotic behavior of U.S. corporations, banks, and large investors who have abandoned us, in many cases for foreign soil. They are sick of paying the high tolls of chronic unemployment, job security, rampant inflation, ravishment of our natural resources and environment, the decay of our great cities, and the violence and havoc brought on by all of this greedy plundering for profit. They feel that the President, the Congress, the courts and the law enforcement and intelligence agencies are all handmaidens in this conspiracy against the ordinary citizens. They are alienated and disenchanted and look angrily to Congress to implore—when will you stop this pillage?

A fundamental overhaul of the tax system which now so favors industry, commerce and banking is, of course, where a revitalization of economic democracy could begin. To ignore these precarious conditions is to welcome the prospect of exchanging one form of tragic unreason for another.

Knowing so well your reputation for justice, I trust that you are doing all you can to resolve these momentous problems.

Most sincerely,

EDWARD H. PEEPLES, Jr., Ph.D.,
Assistant Professor of Preventive Medicine (Medical Sociology).

TAXATION WITH REPRESENTATION: STATEMENT OF JOHN A. BAILEY

It is high time for "radical simplification", as Treasury Secretary Simon proposes. My study of tax reform over the last ten years convinces me that most experts on the subject agree. The elimination or reduction of tax loopholes, tax subsidies, tax preferences, and itemized deductions—combined with a substantial lowering of tax rates—is the direction in which we should be heading. Why not begin now? Real tax reform is long overdue.

Biographical data

John A. Bailey served as a trial attorney in the Tax Division of the Dept. of Justice from 1960 to 1965, and has practiced law in

Houston since that time. His articles on tax reform include the following: "Basic Tax Reform," 54 American Bar Association Journal 127 (February 1968); "Tax Reform and the Carter Report," 49 Boston University Law Review 658 (1969).

ROBERT E. TREESE, CPA

The "Tax Reform Act of 1975", H.R. 10612 should be renamed the "Economic and Energy Disaster Act of 1975."

The limitation on artificial losses (L.A.L.) provision under Title I is, first of all, entitled in a very misleading way. The losses are not artificial—they are very real, and they are incentives to invest. Investment is what we need in a time of inflation/recession such as we are in now. These investments reduce unemployment and tighten spending to slow inflation. Increased investments provide increased income tax to the Federal Government through productive means, not through artificial investment stifling.

L.A.L. will reduce oil and gas exploration. Is this what we need during an energy crisis? As oil and gas reserves around the world increase, a proposal like this, which will reduce U.S. investment and exploration is absurd.

The Internal Revenue Code has gone far beyond its original purpose of solely being a method of federal taxation. "Reforms" must be planned with this in mind. These shelters must be viewed from all sides and evaluated as to their total economic impact, not merely from the limited taxation revenue spectrum.

Tax shelters have, of recent years, been looked upon as being "bad"—using a tax shelter was almost cheating in some peoples eyes. Apparently they are seen as bad to some Members of the House of Representatives during the first session of the 94th Congress. This is short sighted.

We need increased investment in the United States. We have an economy that needs help. Help from investors. To get this help, incentives to invest are needed and needed now. That should be the primary objective of the Tax Reform Act of 1975. The 94th Congress should be providing investment incentives, not investment stiflers.

ROBERT E. TREESE.

C. LOWELL HARRISS, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY; ECONOMIC CONSULTANT, TAX FOUNDATION INC.*

CAPITAL FORMATION AND TAX REVISION

In the long run, despite an oft-quoted quip, we are *not* all dead. In the most humanly meaningful sense, life goes on. Many of us hope to be able to make for a better life because we look to years of life ahead and because our children and grandchildren have even more of a future.

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*Views expressed are the author's and not necessarily those of any organization with which he is associated.

Capital offers a means of improving the way we work and live.[1] By going without something in the near future, we can raise the level of living *permanently.*

A "*capital force*" can expand enormously the productive power of the labor force.

Despite propagandistic allegations that capital and labor are rivals, they *support* each other. All of us who work need productive tools—a "capital force" often of tens of thousands of dollars per person—to realize the potential of our abilities.

Mankind's history testifies to the power of capital to make for a better life. Better in what sense? Occasionally one does today see deprecatory remarks about changes the years have brought. Yet the vast majority of men and women given a free choice between life with today's capital and life when capital was less would, I am confident, choose the one with more capital.

Discussions of capital "needs" and (probable) "shortages" are dealing with numbers which now often reach the trillions. Such talk focuses on concepts more arid than human. Discussion tends to drift away from the way men and women and children will actually be living. A trillion is a thousand billion; a billion is a thousand million—an utterly incomprehensible magnitude. But more as against fewer billions of dollars to add to productive capacity (housing included) will mean much indeed for the quality of life. An important dimension of tax analysis concerned with capital adequacy should be the significance for human beings of more rather than less capital. The vital reality has two aspects. (1) One is a family's ability to build its saving account or to acquire shares of stock. (2) Another is the ability of business to get funds to add machinery and other facilities of production. The latter, the capital force, takes loads off our back, puts us in instantaneous communication with distant places, permits the manufacture of miracle medicines, and so on.

The skeptic, or antagonist, arguing against proposals to relax burdens on capital sometimes seems to think only of big corporations. He implies that benefits would go to huge and impersonal entities, not the men, women, and children who are consumers, employees, and owners, How can a more correct view be conveyed? Can we not defuse the adversary aspects of tax debate to emphasize elements of common interest?

Sometimes advocates of government spending cite compassion and a desire to help the common man. Helping others inspires admiration. "Public interest" activities reflect a desire to be of assistance. Recognizing the goal, what means are available to achieve benefits greater than the total sacrifices? More than good intentions are required. Do not high taxes hurt millions of families (1) by obstructing their ability

[1] I shall generally use the term "capital" to apply to physical productive facilities—plant's, machinery, public utility systems, housing, inventory and other goods in process, transportation equipment, and so on. Another usage should be noted: Funds used in financing the acquisition of capital goods and the conduct of business activity.

Application of the term "capital" to the productive capacity of human beings is now widely recognized. Some government as well as private expenditure may properly be classed as "investment in human capital." An advocate of higher taxes may argue that they could go for governmental programs which in fact would successfully improve human capital. Such might happen. But there is no assurance of such results. Labeling something as "social" or "human" does not make it worth the cost. Furthermore, the *taxes* might reduce private investment, human and material, of equal and greater value than the actually realized benefits of the governmental programs.

to save to get ahead and (2) by reducing the funds for investment which would aid their ability to produce? When government reduces a person's ability to accumulate for himself and his family, that fact should be made clear. And as taxes reduce the capital which the employer can use to improve the ability to produce, the damage falls on flesh-and-blood human beings, not merely on some industrial giant.

Discussions of "capital shortages"

Testimony before this Committee may already have been conflicting as regards a shortage of capital. Some economists with excellent credentials, reacting in recent months to earlier statements, have rather disparaged the assertions that "shortage" in a meaningful sense lies ahead. Some perspective may be helpful.

1. The time horizons of the projections differ. Some emphasize that in view of the underutilization of production capacity due to the recession few if any shortages will appear through, perhaps, 1977. These months will pass rapidly. Expansion of output using existing facilities and with almost no capital bottlenecks can give a false sense of security. Accommodating a growing labor force may be "easy" for a brief time but can then become quite a different matter.

Estimates extending through the rest of this decade must also be treated as "short run." The horizon of policy discussions involving capital should extend beyond half a decade. Perhaps none of us should claim competence to attach dollar numbers to what to expect in the next 10 to 15 years—a period not really long in a family's or a country's life. But one fact is clear to me: The American people will expect a level of living which requires capital in increasingly large amounts per person. A "tilt" of tax policy to aid private investment in production facilities can help to convert disturbing distress into a sense of satisfaction. And looking somewhat farther ahead—but fewer years than those since World War—the obligations already promised in the Social Security program will present strains we can yet sense only vaguely. Each worker may then be required to provide nearly 50 percent of the payments to a retired person—a heavy burden; the more capital available to assist the active workers, the less the weight they will feel.

Keynes quip, "In the long run we are all dead." has been cited in rationalizing a (strong) bias of the near-term over longer-run considerations. This saying with its element of plausibility, plus the argument from the Great Depression that saving and thrift by curtailing consumer demand can be an obstacle to capital formation, continue to exert influence. They distract from a more basic fact: Sacrifice now to build the capital base will enable "us." not only those who do the saving but their heirs indefinitely, to enjoy a better level of living.

2. *Some* economists and others scoff at the "laundry list" approach to capital needs—the adding of estimates for various industries, regions, energy, legally imposed outlays (notably for environmental and health-safety requirements), housing, and so on. Such a procedure does have defects. Nothing sacrosanct attaches to either the physical items envisaged in such lists of needs or to the presumed timing, e.g., 1979 as against 1982. But if the schedules are not met more or less as set out, there will be adverse consequences.

3. Market forces, we are told, will convert a prospective shortage into higher prices. Supply and demand will balance. True, but the issue of concern should be the results in terms of higher or lower rates of betterment of living standards. More capital means more real income.

Why not rely on free markets?

In thinging about capital adequacy, why consider involving "government"—tax policy—especially these days when tax relief brings condemnation as "tax expenditure?" Can we not expect results best suited to meeting human desires by relying on the freely made decisions of the persons involved? I believe that, subject to many exceptions, people acting through free choice in markets are more likely to do better for themselves than if the decisions are left to political processes and the compulsion of government. But taxes are necessary. They constitute one limit on what we can accomplish freely.

Although there are many points of debate about the results of government taxing and spending, one fact is beyond dispute: Political decisions have resulted in a reduction of the portion of personal and business income available for private saving.[2]

The tax system can be modified to reduce the obstacles to saving and to provide new incentives for doing so. Movements in this direction would, I believe, serve the public well. Yet efforts to predict the full results of specific tax changes present many difficulties. Some are discussed in the analysis which I attach for the record; it emphasizes the importance of restraining the increase in governmental spending to accompany tax revision in a program to enlarge the "capital force."

Another limitation on the effectiveness of free markets also bears upon issues of capital formation. Our children who are to be served by capital facilities cannot *now* express the very real desires they will have in the 1980's. Young people starting their working lives need capital facilities which can be available only if their parents and others provide in advance. The market system cannot reflect *now* desires which will come into being later on. People quite young, and some unborn, will want goods and services—and *good* jobs—which cannot be supplied without capital investment in advance. Often the lead-times are long. Parents, of course, try to make some provision for their children by accumulating capital. But by the time children are, say, age 22, how many parents can supply capital for much more than education. Business firms retain earnings to invest for the future. Yet with more or less typical jobs requiring $25,000 to $30,000 of capital each—often *much more*, when account is taken of the full back-up of production capacity—the dollar amounts are enormous.

Technological progress: Advance of knowledge

New capital facilities are often the means by which technological progress gets translated into actual benefits for mankind. Scientific advance in the broadest sense plays a vital role in economic progress. The fruits of technological success become usefully available, not when they are proved in the laboratory but only later when new equipment begins to operate. New products—hand calculators which utilize almost miraculous miniaturizations—and services—long distance tele-

[2] The rise of transfer payments paid by taxes has been putting more and more of the available flow of income and product into the hands of low savers.

phone dialing—often depend upon production facilities which are different from those formerly in existence. Improvements in fabrication, marketing, and servicing frequently rest upon capital goods which embody new invention.

Both *cost reduction* and *quality improvement* depend upon research and technological advance—and then capital investment.[3] A substantial portion of improvements in productivity—output relative to input—must be attributed to improving technology. New capital facilities are required to convert potentials of scientific research into practical realities.

Building the "capital force," private investment in new machinery and plants, serves us even more. It aids *productivity improvement*, and that stands high on the list of the real instruments for reducing inflation.

Savings used to pay for new capital goods, therefore, can bring advantages which are greater than the addition of *more* equipment. The new things tend to be the most advanced types, the *best* quality. As a result, savings invested in new capital facilities yield a "technological dividend" which exceeds the "more" of a higher ratio of capital to labor.

Much of man's hope for real progress in new products, in cost-reducing methods, in antipollution and other environmental improvement, all these, relate to the advance of knowledge. Businesses need capital funds to add the new equipment which is required for exploiting the potentials of technological achievement.

Who benefits from expansion of the economy's capital base?

Enlargement of the economy's capital base benefits everyone. The largest beneficiaries, relatively, will tend to be those who do not themselves do the saving and then own the new capital. But the points raised in trying to decide who benefits most are controversial. Debate about the "most" can be more diverting than fruitful. What defies denial is the reality that the benefits do spread widely—in rising employee productivity, more housing, energy sources, prevention of inflation, environmental improvement, stronger competitive position in world markets, and so on. Compared with the desirable results of income redistribution through government finance—sharing this year's pie—the longer-run fruits of capital expansion rank high indeed.

The current pressure to "reform" the tax system by means that would reduce capital formation gets support from the argument that costs of government would then be distributed more "equitably." A separate analysis, which I attach for the record, deals with some of the complexities which arise in trying to agree on "tax equity." One deserves note here: Expansion of the capital base benefits all, including those at the low end of the income scale.

Opponents of tax revision with a "pro capital" goal sometimes draw upon class-war, worker-vs.-employer rhetoric. The fact that big businesses would face fewer tax obstacles is held against the proposals. The biggest corporations are the largest suppliers to consumers, the largest of employers, and so on. Whatever the real comprehension and

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[3] The economy's effectiveness in international competition will rest in part upon the factors discussed here and earlier. Space limits preclude treatment on this occasion.

the true motives of persons now dredging up antibusiness rancor and suspicion, tax policy should rest upon an accurate understanding of the role of capital.

Restatement

To repeat for emphasis: Capital facility expansion permits the production of more real goods and services with less burdensome effort. Often new products and improved quality flow from more and better quality of capital. The counterpart of added real output are payments to producers—wages, interest, and profit—which go up. Some benefits of capital appear as interest and dividends. The family which has added to its savings account or bought some shares of stock gets higher income. It can build for the future or pay for more current consumption.

The beneficiaries of capital facilities number far more than the savers who receive interest or dividend income. As *consumers* all of us depend on the economy's capital base. Whether one looks at changes in living standards over centuries or merely the last decade, one must be struck by improvements beyond count and measure. These consumer advances rest heavily upon increases in capital.

Who gets most of the increases of money incomes? Human beings in their capacities as workers—"labor"—rather than as suppliers of capital! Two-thirds to three-fourths of additions to income go to people for their time and effort on the job.

Year in and year out as national income rises, most of the benefits go to labor. As industrial facilities are improved and enlarged, the suppliers of capital get a modest fraction of the fruits. In other words, additions to the production base raise the real income of laborers (broadly defined) much more than the incomes of those who supply the capital.[4] (How little "trickles up" to shareholders!)

The benefits of capital are *widely diffused*. They are by no means limited to the savers who get interest, dividends, or the capital gains from the reinvestment of taxed earnings. Some of the most important fruits of capital are not made obvious by traditional ways of thinking. How many employees are told, for example, that the employer can pay, say, $200 a week *only* because the capital with which the employee works enables him or her to turn out products for which consumers will pay enough to justify the wage?

Tax reform which looks to the future

The next stage of tax reform could benefit from taking account, openly and explicitly, of a basic characteristic of American life-rising expectations.

The performance of the U.S. economy does reenforce hope for continuing improvement. The productive system has made possible impressive advances in living standards. The production of the private economy generates most of the taxpaying capacity which enables governments to pay employees and to make transfer payments. What we accomplish will depend significantly on capital formation.

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[4] How do wage rates per hour plus fringes compare with those of the past? From 1947 to 1975 private nonagricultural hourly earnings rose 70 percent -after adjusting for inflation. Fringes, I expect, increased relatively more. Over longer periods the real income of workers has multiplied. What about the real returns to capital, not per hour at "work" but *per dollar per year*. Adjusting for inflation, (a) neither interest rates nor (b) dividend rates plus reinvested earnings seem to have risen appreciably over time.

No solid basis exists for deciding which balance between consumption and capital formation is "best" for the economy. Millions of people as individuals make decisions on the basis of their own situations—the sacrifice of consumption now to save for a better house or education, for retirement or security. The incentives facing each of us influence our actions. Incentives produce results.

The "greatest good for the greatest number" deserves respect as a goal. I suggest that today it calls for a tax system with greater concern for capital formation Whatever the reasons behind Congressional and Executive Branch decisions in writing and administering tax laws, the forces which have produced the present system have not given heavy weighting to concern about saving.

Features which are relatively favorable—the treatment of pension systems and interest accruals on life insurance reserves—do not, I believe, owe their origin to any announced desire to encourage capital formation.[5]

Personal and corporation earnings are taxed in full. Savings, therefore, must be made out of after-tax income. Then any income from investments is subject to tax before it can be used for consumption or more capital formation. There results a discrimination against saving compared with consumption.

At the margin, corporation earnings are generally taxed at 48 percent plus state taxes; then dividends (over $100) received by individual shareholders are taxed at personal rates. A large gap exists between (1) the productive capacity of capital goods financed by equity funds in corporations and (2) what a person with moderate or high income who supplies savings can actually utilize in consumption from the product of facilities his funds have paid for.

Capital gains from the reinvestment of taxed profits are taxed again when realized. And in measuring capital gains, no allowance is made for inflation. Per dollar of revenue, estate and gift taxes and levies on capital gains bear heavily upon private wealth.

Concluding comment

A heavy, oppressive legacy of popular misunderstanding hangs over us. Antibusiness attitudes create obstacles to the acceptance of tax changes which would aid the productive system to serve us and our children ever more effectively. Not a few persons (self) designated as "intellectuals" show more ignorance than understanding of economic reality. Disdain or envy or dislike of private saving can, I believe, be found lurking behind or slightly beneath some of the articulation of "tax reform" proposals. Yet the human goals which I believe we all seek can be approached more rapidly and surely with the aid of nonhuman instruments of production-capital.

"Knowledge itself is power"—if we use it. Although our knowledge about economic processes has gaps, we do know enough to guide in making better, rather than poorer, choices for the longer run. For broad, prevasive, widely diffused benefits, high priority should go to supporting the "labor" with a stronger "capital force."

[5] Local property taxes, except as they apply to pure land values, reduce the net (after-tax) benefits from capital.

[From the Journal of Corporate Taxation]

Effects on Capital Formation of Ending Double Taxation of Dividends

C. LOWELL HARRISS*

Capital formation, especially in business, would increase if the double (two-tier) taxation of dividends were ended. The major conclusion just summarized which seems intuitively correct is confirmed by economic reasoning. Thus, we have a solid basis for endorsing this general reform as a means of advancing economic progress.

The amounts, the forms, and the economic processes leading to more new investment would depend, of course, upon specific provisions of the tax revision—and upon many interdependent elements of a dynamic economy. Analysis, therefore, does present difficulties. (1) Initial amounts of tax relief might be $5 billion a year or $10 or $15 billion or more; the capital-formation results would certainly differ. (2) Some of the tax cut might be passed on to consumers by competition or by regulators setting utility rates; some might be bargained into higher labor costs. (3) Business actions which lead to capital formation depend upon many considerations and often have long lead-times. The inherent nature of the process of capital formation in business assures us that we cannot rely on observation of the immediate effects of a tax change for conclusions about results over the long run. Economic forces as they work out over the years take account of conditions--in this case more favorable opportunities—which cannot be exploited fully at once.

Reform might consist of relief (1) at the corporate level, such as deduction for dividends paid, corresponding to the treatment of interest and lease expenses; or (2) by allowing shareholders credit for tax paid by the corporation. This article will not undertake to examine the various possible features of the alternatives.

Treasury Secretary Simon for many months has been urging action to increase the country's rate of capital formation. On July 31, 1975, he made specific tax proposals designed to encourage savings and thereby

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additions to the country's productive base. He urged Congress to phase in over a period of years a series of tax changes which would favor (and reduce obstacles to) saving. They included two features to moderate the double tax on dividends.

Corporations would be allowed to deduct approximately half of the earnings distributed as dividends (as interest is now deducted as a cost). Shareholders (except nonprofit institutions, pension funds, and others exempt from tax) would be allowed to credit against personal tax half of the corporate tax paid on earnings from which dividends were paid. The details of this set of proposals are not the subject of this article.[1] The principles as they relate to capital formation are our concern.

Introduction: Outline of General Results

Probable results seem sufficiently clear to guide policy choices in broad outline.

(1) Relief at the corporate level would tend to increase the cash flow—dollars remaining in the company. True, the inducement to reduce tax by enlarging dividends would undoubtedly induce some increase in the distribution of earnings. But quite generally, I expect, corporations would be left with more funds. Such a rise in retained earnings, such a direct strengthening of equity capital, would permit both a speeding up and an enlargement of investment in capital facilities.

(2) After-tax yields of common stock—as dividends and capital gains—would rise, thus increasing the *incentive* to save for purchase of shares. Relief of present discrimination against saving, especially for equities, would enlarge the relative attractions of such saving as against current consumption. More of the fruits of productive facilities would remain for the suppliers of equity capital, less going for taxes. Higher rewards can be counted upon to affect behavior—positively.

(3) Saving would rise because the ability to save would rise. (a) Those who have supplied equity capital, who have indicated a desire for assets of this type, would be left with more income after tax. If individuals, pension trusts, and others do have more after-tax income—more ability to save and to invest—they can be counted on to use at least part of the tax-relief gain for additional investment. (b) As already noted, relief at the corporate level would probably result in net business saving as the tax cut exceeded any induced enlargement of dividends.

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[1] For an analysis of Secretary Simon's proposals, see Fox, "Washington Tax Watch," elsewhere in this issue.

(4) Equity financing of corporate business would get a special boost. (a) The relative competitive position of equity as against debt would improve. (b) A larger total of new saving would raise the available supply of funds for equity financing. (c) After-tax yields on equity would rise. (d) If relief were at the corporate level, computations of probable net return would show that more projects financed by equity would meet acceptable standards.

(5) Benefits to the economy in general would reflect the fact that capital facilities of corporations, including inventory and the related intangibles, are highly productive. Yields of 15 to 20 percent are common; often, much higher ones appear. Capital formation would increase in just the forms that are most productive.

Advocates of this tax reform have been hoping for, and predicting, such results.[2] The payoffs from adding such high-yield capital could be great indeed relative to the costs, to the alternatives sacrificed.[3]

Economic Results

Would the economy as a whole, really, be much affected? Federal budget realities would probably limit the early-year tax relief to amounts in the billions. (Half of the corporate tax which the budget document for 1976 projects for 1977 and 1978 would be $25 billion; a revenue

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[2] Whenever taxation is at issue, "fairness" gets a great deal of attention. Sometimes it seems to be a speaker's only concern. Unfortunately, the meaning and the measurement of fairness are themselves so debatable that citing this goal may do little to get agreement. Nevertheless, is there not an argument on grounds of fairness for reducing the overtaxation of dividends? In recent discussions of tax reform, however, persons often outspoken in appeals to fairness ignore any such unfairness in present taxation of dividends.

[3] My professorial concern for trying to be complete, and for recording qualifications and possible exceptions, tempts me to get "academic." Space limits prevent me from pursuing many issues, but three points will be made explicitly here. (1) The tax change would not, directly or indirectly, reduce services of specific benefit for corporations or for suppliers of equity capital. Neither the service functions nor the transfer payments of the federal government go in large measure for identifiable services to stockholders (as such) or to corporations. Therefore, the processes of production would not suffer from a drop in federal activities following the tax change. In other words, persons who are now relatively overtaxed are not getting special benefits from spending of the funds, benefits which would be withdrawn. (2) Fears of the 1930s that saving at high levels of national income would outrun the "need" for new capital facilities have no basis in reality. Demand for new capital goods will remain high enough to absorb all the funds supplied by new saving. Of course, there can be periods of a few months when markets are out of normal balance. But we shall be correct in assuming that the demand for capital will remain above man's ability to meet it. (3) State income tax change possibilities will not be considered.

reduction of such size seems unrealistic.) In an economy with the GNP then around $1.9 trillion, could a change of, say, $10 to $15 billion a year have much effect? Per dollar of tax change, the effects—benefits—would, I feel, be very much worth seeking.

Advocates of changes in economic policy may employ concepts such as "take-off" or "getting over the hump" or "economic breakthrough"—major discontinuities from a relatively small impetus. Dramatically high payoffs may be forecast. I am generally skeptical of the validity of such figures of speech. In this case, however, one can find justification for more than a little optimism. Results per dollar of initial revenue change might well be substantial. Multiplied benefits should result as forces of cumulation work through the economy from year to year.

Personal Saving

The effects of lessening the present discrimination against corporate equity capital, and especially dividend income (reducing the bias which now favors consumption over saving), would exceed the dollars of the tax change itself. Repeating earlier points, *incentives* to save for purchase of stock as well as the *ability* to do so would be enlarged. Common stock dividends before personal tax could be increased by one-fourth or more. People respond to rewards. What about the size of the saving rise due to the two elements, incentive and ability—$5 or $10 billion a year, or less or more? To the best of my knowledge, the statistical studies of past experience do not provide clear-cut bases for estimating the amount of saving under the new conditions of higher after-tax earnings from equity capital of corporations.[4]

One somewhat exceptional response which is consistent with rational policy might tend to keep the additions to saving below expectation.

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[4] The last time there was no "double taxation" at all was six decades ago. And essentially the present provisions of the tax structure and the level of tax rates, dating for the most part from World War II, have been with us for a third of a century. Conditions were so different in so many ways before World War I and between the wars that behavior patterns then (even if we had reliable figures) might not provide a good basis for judging the effects in the future of changes in the tax structure.

Comparisons among countries of rates of personal saving might be helpful. Inevitably, however, forces affecting the use of personal income from one land to another involve many differences beyond those of taxation. Perhaps there are techniques for relating variations in personal savings to dividend taxation in countries most like ours, techniques which would help in estimating for the United States. One should, however, be cautious in using such calculations for suggesting magnitudes here in the last quarter of this century.

Higher yields on shares held by pension funds may not have the "normal" result of stimulating the action which gets better rewards. Higher annual yields make it easier to accumulate a capital fund, or to provide for some set level of annual payments. At 10 percent, a smaller capital is needed to produce $1,000 a year than if the yield is 8 percent. Thus, if the goal is a target amount of income (or an annuity of yield plus return of capital), an increase in after-tax yield will reduce the capital sum needed.

When a fund has been built up, however, a higher yield reduces the need to consume capital. So capital preservation is easier.

Such considerations illustrate why statistical research presents more difficulties than might appear.

Benefits Would Be Substantial and Widely Diffused

Impressive economic benefits can be expected. They will be spread widely.

(1) First, I underscore a point which recent "tax reform" argumentation has ignored: Workers receive around three-fourths of increases as national income rises. Year in and year out, labor gets most of the benefits associated with output growth. As industrial facilities are improved and enlarged, the suppliers of capital get a small fraction of the fruits. In other words, additions to the production base raise the real income of laborers (broadly defined) much more than the incomes of those who supply the capital.[5] (How little "trickles down or up" to shareholders!)

For the next decade and beyond the persons with perhaps the greatest interest in capital formation, those who stand to benefit relatively the most, will be new entrants to the labor force. Moreover, the fruits of added capital are widely diffused in another way to all of us, and to Americans yet to be born, as consumers.

(2) Capital formation in industry adds productive capacity with high output per dollar. It raises the annual flow of real income. Once capital facilities have been added, they can produce year after year if

[5] After adjusting for changes in the purchasing power of the dollar, how do wage rates per hour plus fringes compare with those of the past? From 1947 to 1974, private nonagricultural wage rates rose nearly 70 percent. (And fringes also increased substantially.) Over longer periods the real income of workers has multiplied. What about the returns to capital? In *real* return per dollar at work a year neither interest nor dividends plus reinvested earnings—adjusting for inflation—has risen appreciably over time. I recognize that adjusting for inflation over long periods presents many problems. And, of course, training and other forms of investment in human capital account for some of the rise in real return of workers. My point here is that hours at work are remunerated better than in the past, but dollars invested do not get higher returns.

preserved through use of depreciation funds. The capital added in one year because of relief of double taxation may not seem large relative to the existing stock. But each unit of new capital would make later additions easier. And as the increments cumulate, impressive totals would improve the ability to raise more capital and the ability to produce.

(3) Equity capital supports debt. Although equity-to-debt ratios are not fixed and may vary for many reasons, the total capital formation in industry would reflect the fact that companies could expand their total capitalization by more than the increase in equity capital alone. The additions to corporate debt thus made possible by relief of double taxation would, of course, purchase productive facilities with high productivity.[6] The total of the new savings of the economy would go to the high-yield business sector.

(4) (a) As noted earlier, if reform were at the corporate level (deduction of dividend payments), calculations of after-tax profitability would presumably rise to reflect the change. A wider range of projects would then pass the screening. Demand for capital funds would rise. The upward shift would not be systematic, however. If corporate managements faced two sets of profitability, one for retained earnings and one for projects to yield dividends, the new possibility would add to the complexity of decision-making.

Relief at the corporate, rather than at the shareholder, level, economists have argued, would probably result in higher average productivity of the new capital investment because competitive market forces would have greater scope in allocating new capital funds. This argument is plausible. To illustrate: Corporation *A* where new capital would seem to have good prospect of yielding, say, more than 20 percent cannot as a practical matter bid for the undistributed earnings of Corporation *B* where new capital may offer little promise of bringing much over 10 percent. Nevertheless, such use of the marketplace does involve costs. Going to the capital market involves expenses not necessary in getting use of retained earnings.

(b) From the point of view of capital formation, one disadvantage might follow from relief at the corporate, as against the shareholder,

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[6] If the reform were at the corporate level, it would reduce the long-standing tax reasons for favoring debt over equity. Although the total amount of debt acceptable (other things being the same) would rise because of the increases in equity funds available, the *relative* amount of debt finance in corporate structures would drop. Capital structures would be strengthened. For individual companies and for the economy as a whole, "large" proportions of debt in financial structures increase the vulnerability to declines in business recessions, whether general or of more limited scope. And leverage associated with debt accentuates the swings of earnings, distorting impressions of the true size.

level. If dividends were larger, shareholders would not only pay more personal income tax but would also spend more on consumption. Actual results would depend upon specific features; generalization now about possible magnitudes would not be helpful. But it is true that relief from double taxation in a form which encourages dividend distribution will reduce somewhat the amount used for capital formation as compared with reform which grants relief to stockholders without pressure on corporations to enlarge their distributions.

An Aid to Technological Progress

A fifth reason for expecting benefits seems to me to warrant a special section even though to some extent it is embodied in the points already mentioned; it creates a solid basis for more than merely "average" optimism. New capital facilities are often the means by which technological progress gets translated into actual benefits for mankind. Scientific advance plays a vital role in economic advance. The fruits of technological success become usefully available, not when they are proved in the laboratory but only when new equipment (broadly conceived) begins to operate.

New products and services often depend upon production facilities which are different from those formely in existence. Improvement in fabrication. marketing, and servicing frequently rests upon capital goods which embody new invention. The dynamic, as against the static, portions of the economy are distinguished in large measure by the advancement and the application of knowledge. At any time, underexploited opportunities wait for utilization. New methods appear continually.

Both cost reduction and quality improvement depend upon capital investment. A substantial portion of improvements in productivity must be attributed to more than forward movements of proved research. New capital facilities are required to convert the potentials of scientific advance into practical realities.

Funds used to pay for new capital goods, therefore, bring advantages which are greater than the addition of more equipment. Additions are of the most advanced types, the best quality. The new capital facilities yield a "technological dividend" which exceeds the "more" of a higher ratio of capital to labor.

Much of man's hope for real progress in new products, in cost-reducing methods, in antipollution, and other environmental improvement—all these relate to the advance of knowledge. The American people can benefit more than may at first appear from tax reform which would make more capital funds available for industry to add the new equipment which is required for exploiting the potentials of technological achievement. This opportunity deserves support, it seems to me, from all who wish for themselves, their children, and others of all ages and conditions a better economic life.

If our lawmakers had recognized this reality, would they have biased the tax system *against* capital formation in corporations? Perhaps not. Today, such awareness can stimulate support for correcting a costly mistake made out of ignorance, not maliciousness or masochism. Logic and reference to history give confidence that the technological advance which characterizes a modern economy will create new opportunities.

Government Spending and Borrowing as Rivals for Capital

Adding machines and buildings, real capital goods, require not only dollars, but also labor and materials. Government also uses real resources, directly and indirectly. Tax relief to make dollars available for new capital goods in industry will enhance productive capacity only if the real resources are available. Federal spending and borrowing must also be taken into account as rivals for real resources.

To anyone looking at the affairs of a particular company or industry, greater availability of funds because of a tax change may appear to be enough. Yet, what seems to be solidly based in individual cases cannot always be extrapolated to the economy as a whole. Let us look at the adjustment processes and problems over the longer run during which resources will in general be fully utilized most of the time.

Federal Spending

One stubborn fact must be faced. The change in taxes would not be the only result. Treasury receipts would also drop. Something would have to be done in response to the decline in government revenues. Let us look at the possibilities and their relation to capital formation.

(1) The alternative most favorable to private capital formation would be a reduction of federal taxes (at the corporate or shareholder level) (a) without any offsetting increase in other taxes, and (b) without any enlargement of federal borrowing to absorb capital funds. Then federal spending would have to be reduced by the amount of the tax cut. Such action would reduce federal use of resources plus those federal transfer payments which in fact finance personal consumption. This combination would, in effect, free resources; some would go into capital formation and some would be used by shareholders for an increase in consumption.

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Is this set of conditions, notably the cut in federal spending, beyond the realm of possibility? It probably is. But some approximation could be attempted. The educational efforts leading to the reform could attempt to convince lawmakers of the desirability of encouraging capital formation. True, emphasis for years has been elsewhere. The stimulation of consumption has been supported as in itself a desirable end and also as a way to get fuller employment of resources.

In addition, the more articulate advocates of "tax reform" have identified "equity" with raising burdens on upper-income groups and reducing them on those with lower incomes. We should not, however, overlook other aspects of equity—rewards differentiated according to production, that is, to the contribution which a person and his capital make. And if one is concerned with human well-being, should one not give high priority to changes which would enable more people to improve their levels of living out of a more productive economy?

A policy of phasing in the tax change over a period of perhaps three or four years could "utilize" some of the revenue from normal economic growth. Much of the prospective revenue rise has already been "mortgaged." Yet spending has already risen so much—the 1976 federal budget calls for *per capita* spending of $344 *above* a decade earlier (in dollars of 1975 purchasing power)—one wonders about the urgency of programs not already financed. Some "package" of pro-capital tax relief without deficit increase seems to me worth working for.

(2) At the opposite extreme would be relief of double taxation but without reducing appreciably the burdens on capital, as by increases in taxes (a) on capital gains, (b) estates and gifts, (c) corporate earnings in general, or (d) on personal income where savings tend to be highest. The stimulus to capital formation would be dampened or entirely frustrated.

(3) The revenue loss might be made out of (a) a tax on value added, (b) a general increase in personal income taxes, (c) familiar types of consumption taxes, or (d) an expenditure tax. Such choices to fall predominantly on consumption do not seem politically realistic. This possibility does show that "in theory" capital formation could be increased without a decline in federally financed consumption.

(4) A fourth possibility would seem more likely. Tax relief which reduced revenue would not be matched by a drop in federal spending. Treasury borrowing would have to be greater than otherwise. Where could it get the dollars? The increase in its demands would "crowd out" others. Corporations would not escape the forces, but since the benefits from the tax reform would be directed toward the business sector, the ability of companies to compete with other users of capital would improve. Although the corporate sector's relative strength in

capital markets would go up, the rise in government borrowing would keep the benefits from the tax relief below those initially envisioned.

In short, the extent of the net increase for capital investment would depend upon the seriousness of purpose of Congress in trying to aid capital formation and upon its willingness to keep reigns on the growth of federal spending.

Short-Run Stimulus to Stock Rates

Would not tax relief boost stock prices? If so, would this change in itself affect new capital formation? Some of the present double taxation has been capitalized in stock prices. Present share prices must reflect present taxes and the expectations of their continuation. If tax conditions become more favorable, if after-tax yields are expected to rise, stock prices will go up somewhat.

Shareholders would become better off in terms of wealth. But every sale at a higher price with benefit for the seller would take that much more from the purchasers. In itself, a rise in stock prices would not put more dollars at the disposal of corporations. Yet in the short run there would be benefits for the companies. The sale of new shares would be somewhat eased as the market became more buoyant. In the broad perspective, however, such results would be of slight importance compared with the effect of a lowering of the governmental "take" from the total yield of capital.

Less Distortion (Excess Burden) in the Formation and Use of Capital

Greater economic efficiency in the sense of better resource allocation would result from reduction of double taxation. Economists whose orientations differ in many respects are likely to agree on one point: The present system of double taxation induces distortion in the use of resources. Decisions which in terms of the inherent productivity of resources would involve least cost and would best meet the priorities of consumers are sacrificed and less defensible decisions are made which tax considerations elevate to top position. The private sector suffers some loss which does not benefit the Treasury. Efforts go into planning tax-economizing arrangements which benefit taxpayers but not the Treasury. The result is an economy less truly productive than it could be. Excess burden results.

The tax reform would reduce the number of cases in which it is wise to depart from whatever would be most efficient as nearly as can be judged. There could be an improvement in the allocation of resources which would bring benefits in the private sector without a corresponding loss to the Treasury.

Foreign Capital

Foreign capital would find the United States somewhat more attractive as a place for investment if after-tax yields here were to rise. More capital originating here would remain. The actual results would depend upon many factors—present treaties and tax provisions here and in each country, and the details of our tax changes. Some deliberate effort to attract investment funds from abroad seems to me worthy of serious effort.

Conclusion

Reform of the taxation of dividends can contribute toward what looms increasingly as a major challenge for the economy—supplying capital to meet the aspirations and expectations of the American people. Growing awareness of the disturbing outlook for capital should improve the climate for statesmanlike analysis of the present practice and the alternatives.

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TAX EQUITY AND THE NEED FOR CAPITAL: WITH SPECIAL REFERENCE TO INCOME FROM CORPORATE SHAREHOLDINGS

C. LOWELL HARRISS

Equity in the sense of fairness has a prominent place in discussions of tax policy.[1] Yet how does one define "tax equity" with enough precision to give clear guidance on specific questions—such as (1) the two-tier (double) taxation of dividends and (2) the taxation of those capital gains which represent the reinvestment of taxed profit? Efforts to do so present such difficulties that changing the subject may seem easier. Inequity may appear easier to identify, and by any standards that I can think of the present arrangements for taxing the yields of equity capital have elements of unfairness.

Can we identify and reduce some existing unfairness (without creating new elements) while also acting to achieve other worthy objectives, notably capital formation more in line with needs which are increasingly evident? Would not the most straightforward method of moving toward both goals be a drastic reduction in tax rates on corporate earnings? This possibility has many attractions. Yet someone concerned with fairness might deplore the opportunity for some shareholders to accrue untaxed capital gains from reinvestment of low-taxed earnings. Another might wonder whether Federal spending would slow its rise substantially with the loss of revenue.[2] Or would other taxes or inflation impose new burdens with new inequities? And so on.

NOTES ON TAX EQUITY

Equity as an objective of tax, or other private or governmental, policy, has importance because it relates to human beings. Similarly, capital has importance because of its meaning for people. Human beings are served by capital, and a philosophy concerned with bettering the way people can live should recognize that capital is an overwhelmingly important element in our ability to produce and to earn income. Our tax system, however, has distortions in the taxation of income from ownership capital, especially dividends. Present conditions have developed (1) in part because of misguided notions about fair treatment of human beings as taxpayers and (2) in part because of misunderstandings about the role of capital as a paramount agency for improving human life. (3) Historical accident has also played a larger role than is appropriate for an enlightened society.

Bases for Taxing People Unequally

Government costs today are so high that people must be treated unequally. Since equality is impossible, what are bases for imposing inequality?

Income, consumption, and wealth can each serve. They overlap. There are "fairness" arguments for each. (But imagine yourself as a lawmaker trying seriously to combine two or all three to satisfy some sense of equity as among people!) To some degree the present arrangements for taxing corporate earnings and then the amounts paid to

[1] For this paper the term "fairness" seems to me preferable to "equity." The later also applies to another concern here, ownership capital. Although "justice" may have broader sweep than "fairness," in taxation it seems often to be used about the same as "equity." Where the coercive power of government operates, as in taxation, we seek justice in the sense of fairness, not merely compliance with the law (which may be inequitable to start with).

"Two-tier" seems to me slightly better than "double" when speaking of the taxation of dividends paid from taxed corporate earnings. The latter may imply twice in terms of amounts—burdens two times as heavy—when the more correct view is one time and then another, not necessarily equal dollar totals. Two-tier taxation applies, not only to dividends but also to capital gains which represent the reinvestment of taxed earnings. I shall occasionally refer to the latter.

[2] Considerations of (a) revenue and (b) Federal spending must obviously be integrated into any responsible discussion. Space limits preclude me from presenting my suggestions. But I am well aware of the issues and believe that I can make proposals which would permit net revenue reduction from changes in the taxation of dividends.

shareholders or realized as capital gain have, or may have, elements of tax on personal income, on consumption, and on wealth. Alas, however, we do not know with assurance who ultimately bears the burden—$56 billion Federal and state in 1974.

How can one possibly have an intellectually satisfying conclusion about the fairness and unfairness of the tax today without knowing more than at least I do about how the burden is distributed among us? How much falls on consumers as a hidden sales tax? How much do various suppliers of capital bear in the form of lower dividend and other yields and capital values? Do some people pay in some other capacities, perhaps as employees getting lower remuneration?

The most acceptable result of economic analysis, I believe, is that over the long run suppliers of capital generally (not merely those who provide equity funds) bear most of the tax. Some of the support for two-tier taxation of dividends (and capital gains) probably rests on the belief that this is a fair, or not egregiously unfair, way to tax suppliers of capital.

Who Supplies Capital?

This is not the place to summarize evidence available on the ownership of capital. Nor what they did to get it. Persons who try to think about the equity of tax differentials sometimes seem, perhaps only intuitively, to consider the "moral legitimacy" of how people got into various positions. As to dividend recipients, at one extreme may be some young, jet set, nonproducing rich who inherited through trusts which permitted escape of estate tax the property which ancestors acquired by passive ownership of land in the path of urban development or above rich mineral deposits. Two-tier, heavy taxation of their dividends may seem fair.

But let us look at other cases. Corporate shares are also owned by colleges, eleemosynary institutions serving the country's neediest, hospitals, art institutions. Although they are not subject to the two-fold tax, they suffer from the tax paid by corporations. If there are equity justifications for such a result, I do not see them.[3] Holdings by pension funds exist for persons whose situations differ enormously, but mostly present or past workers. And shares paying taxable dividends are held by individuals and families trying to prepare for future by saving out of income already taxed, and, of course, by persons retired. A tax at the personal level can differentiate among people on bases which can at least approximate rational concepts of fairness.

More considerations add to the reasons for criticism of present arrangements on grounds of tax equity. For example, intercorporate dividends are subjected to additional taxes. The tax rates on corporations differ according to size and some other factors. Preferred share dividends may not in fact be burdened at the corporate level because the tax on the corporation's earnings reduces, not preferred dividends but what is available for the common shares. And, of course, no uniform tax applies to the capital gains which result as taxed corporate earnings are retained instead of being paid in dividends.

Differences of Treatment

In recent years advocates of tax change have tended to focus on what they believe is undertaxation. "Reform" has been identified with raising taxes. Possible inequities of overtaxation of corporate earnings paid in dividends or realized as capital gains raise questions of what are "proper" bases for discriminating in tax treatment. Makers of tax laws have differentiated burdens on various bases. I cite three only. (1) One is type of receipt—municipal bond interest or Social Security benefits. (2) Taxes also differ because of characteristics which may involve debate about

[3] As a tax resting on suppliers of capital (as distinguished from being shifted to consumers), the corporate income tax on shares held by philanthropic institutions, universities, foundations, and so on, may have some of the most regressive elements in the whole tax system.

whether an element is truly "income" for purposes of sharing the costs of government—capital gain or loss or the value of owner occupancy of a dwelling. (3) In seeking some concept of "netness" as the base for income taxation, there must be decisions about the specific elements to deduct from gross—child care costs, union dues, or casualty losses. No lengthening of the list is necessary to make an important point: Some concept of fairness will usually be mixed with concern over nonrevenue results—plus no small element of what we call politics.

Even if there were clear agreement on tax fairness, it would not necessarily be controlling to the exclusion of other considerations. But any proposed change which is widely felt as unfair will not get far.

To the extent that taxation leads to less saving, then there are adverse effects on the others who would benefit from the capital facilities which are sacrificed. Here is a form of tax which may seem inequitable as hitting "innocent bystanders."

Contribution or Taking?: Putting into the "Pot" or Taking from It as a Basis for Tax Equity

Tax-equity considerations may call for taxing on the basis of what one takes from what others produce rather than on what one supplies to others. The goods and services that people get in spending for consumption, it may be argued, measure more accurately their relative circumstances than do the money receipts obtained as payment for their services and that of their property. Yet remuneration as "income" has become so embedded in American thinking as the "right" basis for taxation that any alternative—notably consumption—will usually be brushed aside.[4]

[4] Some of the rejection of expenditure taxation results from attitudes reflecting antipathy to the regressive nature of sales taxation. But expenditure taxation can be proportional or progressive with regard to its base. And, of course, expenditure taxation can fall on the use of receipts not reached by income taxation, *e.g.* municipal bond interest and consumption from tax-shelter income.

Unfairness, it seems to me, does result when two persons whose circumstances are essentially the same pay different taxes with the heavier burden on the one who produces more for others. Is it not inequitable to tax more heavily a person who works more hours a year? (The tax inequality results in a sense because leisure is not treated as a form of income.) Or the person who has foregone consumption out of taxed earnings and acquired assets which bring yield later? The differences in money received are important, not in themselves but because they give different commands over goods and services.

Perhaps a fairer basis for compelling one person to pay more than another toward the costs of government would be the goods and services he receives.

This line of reasoning goes back at least to Hobbes in the 17th century. But it is alien to the dominant lines of American thought on taxation. (To some extent Irving Fisher was a notable exception.) But tides of opinion do shift. We now see some recognition of possible acceptability. No sweeping reorientation seems likely. Yet familiarity with the argument may support moves to reduce burdens on saving.

A person who saves and makes (equity) capital available does something of benefit for others—one which continues as productive facilities produce year after year. Perhaps the fairness of taxing him for helping in production can be questioned. May it not be more equitable to require him to contribute to the costs of government only when he gets consumption benefits from the fruits of his saving?

Fairness of Discriminating Against Dividends

Are there defensible reasons on grounds of fairness for differentiating against (recipients of) dividends as such? The only argument I can think of is to deny that the two-tier tax does lead to discrimination. This position rests on the belief that the corporation tax does not burden the shareholder. To the extent that the tax has been shifted to others, presumably consumers, the double-tax criticism does not stand up.

But the position remaining has weaknesses. (1) On grounds of fairness the tax at the corporate level can be criticized for its "sales tax" effect. Does not equity call for reduction? Those most likely to be supporters of corporate taxation will not always be advocates of broad (regressive) consumption taxes. (2) However, economic analysis indicates that over the long run suppliers of capital will not in fact be able to shift any large portion of the burden to consumers. The fairness of what exists must, therefore, be examined to considerable extent as a tax on property in general.

Fairness of Discriminating Against All Types of Income from Property

The two-tier taxation of dividends, which leads to burdens on income from capital more generally by depressing yields, results in part from anti-business, and rather more general anti-capital, attitudes which have been evident in making tax laws. They underlie forces which explain the continuation of the arrangements we are now examining. I do not have time here to present my conclusions about how prevailing attitudes came into being.[5] One element of the ideology seems to be an attitude about fairness—that fairness calls (1) for taxing returns from factors of production other than human labor more heavily than wages[6] and (2) for taxing the ownership of property, not merely its yield.

Two taxes do apply to property in addition to its income—local taxes on property (including the real estate and machinery of corporations) and death and gift taxes. Each has characteristics quite different from personal or corporate income taxation. Whether or not there are good fairness arguments to tax both the source and the yield from property and only the yield from human beings, our tax system does so. To reach the equity capital of corporations it is not necessary to have in addition a two-tier tax on dividends and on the realized capital gains from taxed corporate earnings.

But let us note four possible arguments for some special income tax bearing especially on yields from capital. None seems to me to support the present system.

(1) Possession of an asset provides not only money income but also advantage in the form of protection or insurance. (a) The owner by liquidation can get command over resources. (b) Moreover, economic power can be given or bequeathed to others whereas no transfer of a person's own working characteristics is possible. To obtain this position, however, the owner (or his ancestor) will generally have saved out of income on which he paid tax. This argument would not, of course, support heavier taxation of corporate earnings paid out in dividends as compared with taxation of rent or interest.

(2) Owners of capital have a potential for building wealth through capital gains with the deferral of income tax,

[5] (a) High school teaching of history has probably played a part in emphasizing what has seemed bad in building the country. (b) Year in and year out, I believe, labor union advocacy has rested on misunderstanding of the role of returns to capital (profit). (c) Fiction writers and "intellectuals" have too often shown gross misunderstanding of economics. (d) The list of members of Congress who for decades have supported the present heavy, two-tier taxation of dividends would probably not include even one who would consider himself a Marxist. Yet the attitudes that resist revision of the taxation of corporate earnings reflect to some extent unrecognized acceptance of Marxian doctrines about profit; yet these were shown as wrong almost a century ago with the development of marginal productivity analysis. (e) "Bigness" confuses thinking; too often—in the halls of Congress, the news media, and, I expect, the classroom—notions of the propriety of taxing high personal incomes heavily are transferred to corporations as units without regard to the number of employees, customers, and suppliers of capital. Further discussion of how we acquired the present system appears in my *Innovations in Tax Policy and Other Essays* (Univ. of Hartford, 1972), pp. 1–30.

[6] The point usually appears as one differentiating "earned" from "unearned" income. The latter term seems to me to reflect a misconception of what goes into making capital funds and capital goods available.

Is there less real cost in some sense, less human sacrifice and burden per dollar, in getting dividend than wage income? This question opens a line of speculation which, to say the least, would not be rewarding.

whereas a person saving out of income must generally (Keogh plans being an exception) first pay income tax. (3) The possession of some forms of capital may provide hedge against inflation that an individual cannot possess in himself. Houses have done well in this respect. But common stock, once widely assumed to provide protection against inflation, has come off rather less than brilliantly.

(4) Heavy taxes on income from property have sometimes been supported as means of reducing inequality in the distribution of income for one or another reason. The record seems to show that despite decades with the present system relative distribution has changed little. "The reason," in the words of Norman Ture, "is not hard to find; in brief, the punitive taxes we levy on the returns to saving in order to finance income transfers to the poor rob us of additional capital which would more rapidly increase the productivity and real wage rates of labor and accelerate the expansion of jobs." [7] Ideological arguments for redistribution seem to me to get confused with those for a much more praiseworthy—and, of course, humane—objective: raising the incomes of the poor and everyone. And one means of achieving the goal of redistribution, heavy taxation of capital, will not only achieve little or nothing of this limited objective but also impede progress toward the broader goal of more for all.

Even stretching these arguments for discriminating against capital and putting them all together would not, it seems to me, justify today's practices on grounds of fairness.

Windfall Benefits as a Possible Reason against Change

The present system has existed for decades. Two-tier taxation must have been taken into account rather thoroughly and in effect capitalized in share prices. Would not reducing the burden give windfall benefits in higher stock prices? These could conflict with, rather than conform to, reasonable concepts of fairness. The point has merit.

A sudden and large tax reduction, depending, of course, upon the form of change, could lead to share price increases of more than incidental amounts. In practice, any change would probably be made through a transition period of some years and after considerable discussion. The size of stock price change at any one time would not necessarily (or probably) be large.

More Equitable System Possible

To achieve fairer treatment of individuals, the present two-tier system of taxing dividends (and capital gains from taxed corporate earnings) can certainly be improved upon. Burdens can be related more logically to some rational concept of fairness as related to personal condition. This possibility is an important reason for seeking change, but it is not the only one.

Fairness and Capital Availability: Preliminary Comments

Two-tier taxation involves human beings in other ways tied to fairness. Any method of taxation has nonrevenue aspects. They extend beyond the more familiar burdens. They affect people for good and ill.

Heavy taxation of ownership capital will reduce the funds available for plant, machinery, and inventory. (Equity capital itself finances the purchase of production facilities. Moreover, the equity funds support debt.) Disadvantages result beyond those of the money taxpayers must give up. Total burdens in the private sector exceed the dollars which the Treasury gets.

Benefits from Capital Widely Diffused

Capital facilities benefit not only the owner by providing him income. The size of the economy's capital base affects the well-being of all of us as con-

[7] In an address, "Inflation, Taxes, and Saving" prepared for the Tax Foundation Membership Luncheon, San Francisco, Sept. 1974. Implied criticism of possible tax changes which "would make the wealthy wealthier" do have emotional appeal and deserve respect. My reaction, however, is to say, "Let's seek changes that will make everyone wealthier."

sumers. Whether one looks at changes in living standards over centuries or generations or decades, one sees improvements beyond count and measure. To a large degree these consumer advances result from increases in capital.

Most of the fruits of rising power to produce appear also as money incomes—and chiefly to labor rather than to the suppliers of capital. Two thirds to three fourths of additions to income go to human beings for their time and effort on the job. Growth in payments for labor are a large multiple of what human beings receive for providing more capital. Although the person who saves and provides capital for business usually receives payments from what it produces, others get the lion's share.

Rising productivity—usually thought of as output per manhour—accounts for much of the advance in levels of living per capita. These increases result in part from improvements in the quality of labor and more effective human effort. But to a significant extent progress in productivity grows out of more and better capital equipment per worker. New products and services, and improvements in quality, constitute important elements of rising living standards. Often they require new types of capital facilities.

As the two-tier taxation of dividends reduces the amount of equity capital available, working men suffer in ways not one in a million will see. Is it sensible to try to judge whether or not such results—a depressant on improvements in real income—are unfair? Knowingly or not opinion-leaders and lawmakers have misled the public. Everyone suffers because taxes have needlessly bad results, bad in the most relevant human sense. In light of what I believe are generally desired goals of public policy—including consideration of human beings in ways that embrace the true elements of equity and fairness—"there must be a better way" than the present tax bias against ownership capital.

NEED FOR CAPITAL

"Need" for capital is a subject of high significance for human well-being. Yet the concept is vague and elastic. Even when not clearly defined, wishes and desires and goals are real. They give rise to needs. But all are human creations—and they are subject to change.[8] Difficulties of measurement are formidable.

Expectations

Americans—and our number will continue to rise—expect a level of living which requires "lots" of capital per person. To satisfy what seem to me to be generally prevailing anticipations—the living standards we more or less take for granted—the new capital called for will exceed by more than trivial amounts the net new savings which past behavior leads one to expect from the probable levels of national income. As a result, expectations will be disappointed. But man can influence his future. It could be improved by reducing the anti-capital and anti-business elements in the tax system and elsewhere.

My own observations over several years have rested on crude estimates of magnitudes of capital need relative to availability. They have seemed clear enough to support removal of as much bias against capital as Congress will approve.

More recently, far better statistical studies have provided more reliable estimates. They confirm that a gap is to be expected in that new savings will fall short of apparent requirements. Something must "give." If savings and equity capital do not rise faster than present conditions will permit, the world will not end. Advance in living standards can continue. But there will be shortfalls and disappointments.

Clearly, there is nothing sacrosanct about consumer expectations, nor even what are now designated as "entitlements." Our hopes for more and better goods and services, and more vacation

[8] Does a person "need" $9,000 income a year, or a bit more or less? The response will depend upon many things. Having decided on a figure, say $9,200, can we then specify that he "needs" $20,000, or more or less, capital to work with to earn such an income? The answer depends upon many things. Technological factors will be clearly important, but they will vary as conditions change.

time, have not been sanctified from on high. Americans could adjust their hopes to annual increases of, say, one rather than two percent a year per person.

One even hears of "zero growth;" whatever that may mean, it is not what I want for myself and certainly not to prescribe for others. In my vision of the good society, it provides increasing opportunity and expansion in the range of choices open. (Capital constitutes an important instrument for expanding opportunity.) Everyone should be free to choose among a widening body of alternatives, including those for higher or lower rates of change (progress)—and the "simpler life;" but he must then willingly accept the consequences, individually and as a member of any group—such as a labor union, college faculty, or local community—which makes decisions. The "claims" to be pressed should be consistent with the actions taken to prepare for the future. Otherwise, frustrations will make for disappointment even though conditions have improved.

Markets provide a mechanism for adjusting wants of various intensities to the ability and willingness to carry the costs. Day in and day out we act and respond, not only balancing output and consumption today but also in accumulating capital for the future. Individuals and families save for the years ahead. Businesses buy and install new capital goods in anticipation of production possibilities and consumer demands over the longer run.

Environment and Energy: New Capital Needs

The process has worked and is working. Why any special concern? Perhaps the most compelling reason is that capital "needs" in the years ahead must reflect calls for increases much above what would have been considered normal not so long ago and in excess of what "normal" market forces can produce. (1) Environmental requirements have been added. (Some companies will find health and safety regulations having somewhat the same result.) They present problems which go beyond the large amounts in themselves. The commands have been issued without anything approximating either a collective decision or a set of personal decisions which will balance expected benefits with capital costs. Obligations have been imposed to achieve good things. To do so, lots of capital will be needed. "The people," presumably, have decided through political processes (government) that corporations must use large amounts of capital for environmental purposes. But no matching actions have been taken (a) to step up savings or (b) to make more equity or debt funds available to business by taking from other uses such as housing or government spending. Desirable as many of the results will be, rather few, I believe, will produce either cost reduction or salable output for business.

(2) A major change in the energy outlook requires capital in large amounts, not to raise the standard of living but to prevent a decline and to help protect against what might be serious disruptions. Demands for capital have been added without any corresponding increase in the ability and willingness of Americans to save—or hope for compensating benefits in the form of observable improvements in living standards.

These two developments add to the reasons for aiding capital formation in business.

Capital for Good Jobs

Other considerations deserve note in a discussion of providing capital for the future as distinguished, for example, from providing shoes or bread for the weeks ahead. The market system cannot reflect now all of the desires which will exist in 5 and 10 years. People quite young, and some unborn, will want goods and services—and (good) jobs—which cannot be supplied without capital investment now. Parents, of course, try to make some provision for their children by accumulating capital. Business firms retain earnings to invest for the future. With more or less typical jobs requiring $20,000 to $30,000 of capital each—often much more, when account is taken of the full back-up of production capacity—the growth of the working force will require capital in the tens of billions each year if earnings are to approximate expectations.

Few young people can themselves supply the capital which they implicitly expect to have available for their jobs. The additons to the capital base must come in advance of employment. Although a worker may save later out of his earnings, the production facilities must be in place when he starts. Someone else must have provided the funds, whether debt or equity. Election campaign promises will not do so. Though government may occasionally help with the financing of businesses, it must generally get the funds by taking dollars from others ("crowding out" someone), not as a rule in the form of printing-press dollars or by the easy expansion of bank loans.

Those with much at stake are not only young persons seeking good jobs. In addition all who wish for higher incomes dependent on improved productivity, might well consider as their best of friends the people who provide the capital for industry—capitalists. As the two-tier taxation of dividends reduces the availability of equity capital and raises its cost, workers will be disadvantaged.

Leadership Role

Let us look at another aspect. The "true" wishes of workers and consumers of the future cannot be reflected in markets today. My wishes for fish and belts and gasoline today are shown as well as I can by what I do. Who of us, however, is revealing now what he will be wanting in 5 or 15 years? And who will act now to make available the (equity) capital required?

I doubt that even a tiny minority of the present labor force or those who claim to speak for them recognize the role of equity capital which offers a truly constructive opportunity. At present, alas, it holds little promise of popular acclaim or votes at elections. But education can help people free themselves from hidden burdens of misguided tax policy. Government can perhaps do rather little positively to advance capital formation in business. It can, however, reduce the obstacles which tax laws impose.

Yields as Indicators of Capital Needs

Another approach to estimating capital need is to look at present yields. In the corporate sector what are the returns which market processes now provide on new plant and equipment? Although inflation complicates calculations which always have uncertain elements, new capital facilities often prove highly productive. Pre-tax net yields of 20 to 30 percent appear to be common. Yields are much above what savers can obtain from owning debt instruments. Here, then, is evidence of what I would call substantial need for more equity capital than is available.

The tax which corporations must pay on earnings plus the tax on dividends drives a big wedge between the worth of what capital produces and what the suppliers of the capital receive. The large gap between what the capital facilities produce and what corporate owners can get after taxes deprives the economy of fruits of productive investment which would amply justify their cost. Capital needs in the sense of production opportunities well worth their costs will be unmet.

An oversimplified illustration may help. Let us assume that in some sense the "normal, real" long-run rate of interest with some allowance for risk is around 6 percent a year and that the corresponding yield of equity capital, allowing for risk, would be perhaps 8 percent, *i.e.*, a debt instrument is more attractive than stock producing less than 8 percent in dividends plus capital gains (reinvested earnings). Whatever the exact figures, the productivity of capital would provide demand for all the funds (and real resources) supplied at these rates. Federal and state governments impose taxes on the earnings of corporate equity capital—frequently, 50 percent or more on incremental yields.[9] Thus only projects producing at least 16 percent can offer the equity investor 8 percent. As a result corporate investment undertakings which require equity finance and which yield 15 or 14 percent or less will not be attractive. A whole range of investments for which there is "need" as evidenced by productivity—pre-tax yields over 8 but less than 16 percent—will not be attractive to equity finance.

CONCLUDING COMMENT

Evidence of rising concern for the availability of capital leads naturally these days to the question "What can government do?" or, more accurately, "What can we the people do through the processes of politics and operations of the civil service to make for a better future for ourselves and our children?" Tax revision offers opportunities. Some of that revision, reducing the two-tier taxation of dividends (and capital gains from taxed corporate earnings), would also reduce inequities.

[9] For most corporations the rate will be around half of this figure. Although "small" companies are important in the economy, corporations with earnings over $100,000 account for most jobs, most of the goods and services we get for consumption, and most investment. Thus, the 50 percent marginal tax rate applies very widely.

Statement of the Chicago Association of Commerce and Industry

The Chicago Association of Commerce and Industry representing substantially all major business in the greater Chicagoland area respectfully submits the position of the Association regarding Federal tax proposals including tax reduction, the double taxation of dividends, investment tax credit, liberalization of depreciation, tax treatment of pollution control facilities, capital gains taxation, taxation of foreign income and the federal estate and gift tax exemption.

With respect to tax reduction, the Association favors continuation through December 31, 1976 of the tax reductions scheduled to expire June 30, 1976 but opposes at this time any further tax reductions for 1976 and subsequent years.

The Association continues to endorse the principle that there should be no double taxation of dividends and favors the elimination of double taxation of dividends along the lines of the proposal under which the corporation would be allowed a deduction equal to 50 percent of the dividend it pays and the shareholder would pick up 50 percent of the dividend in gross income and be allowed a credit against tax equal to the gross up.

With respect to the investment tax credit, the Association urges that (1) the invesment tax credit be increased to 12 percent for all business; (2) that the basis of the property should not be reduced by reason of the credit and (3) that the credit should be allowed in all cases as a full offset against any tax liability rather than 50 percent of tax liability as under present law. The Association favors amendments which will increase the usefulness of the additional 1 percent investment tax credit now allowed to a taxpayer who contributes such amount to an Employee Stock Purchase Plan, including amendments which will permit a second-tier subsidiary to acquire stock of its grandparent and which will permit the taxpayer to recover its contribution to an Employee Stock Purchase Plan if the 1 percent investment tax credit is subsequently recaptured.

The Association also reaffirms its strong support for legislation which provides for the refund of earned but expired investment tax credit after the close of the year in which the credit expired.

With respect to rapid depreciation, the Association continues to support the adoption of a liberal cost recovery system in place of the present useful life system, or in the alternative that taxpayers be allowed depreciation deductions in a period 40 percent shorter than would be allowed under the guidelines for determining useful life. We also support legislation which would provide for the allowance of depreciation as expenditures are made rather than when property is placed in service.

In connection with pollution control facilities the Association urges the enactment of provisions for an election to immediately write-off the cost of pollution control facilities and for a more liberal definition of pollution control facilities than we provided under the now expired provisions permitting a five-year write-off of pollution control facilities.

With respect to capital gains, it is the position of the Association that assets held for six months to one year be taxed as capital gains at the rates now applicable to such gains and that there be a graduated reduction in the rate of tax on property held over one year. We also favor a provision for increasing the amount of capital losses deductible against other income.

The Association reaffirms its position regarding the taxation of foreign income to the following effect:

(1) Continue present law with respect to the treatment of earned income of U.S. citizens working abroad.

(2) Continue present law with respect to the computation of the foreign tax credit.

(3) Continue present law with respect to the taxation of dividends from less-developed country corporations.

(4) Continue present law covering DISCS.

(5) Continue present law with respect to the tax treatment of Western Hemisphere sales corporations.

(6) Oppose converting the foreign tax credit into a deduction.

(7) Oppose further proposals to tax currently undistributed earnings of foreign subsidiaries.

(8) Support the decision of the Ways and Means Committee to eliminate advance rulings in situations involving otherwise tax-free transfers of assets or stock among controlled groups of foreign and domestic corporations.

(9) Support full exclusion from foreign base company sales income for sales income from foreign manufactured products.

(10) Affirm the opposition of the Association to legislation which would make it more difficult for American business to compete abroad.

With respect to estate and gift taxes, the Association supports legislation which would increase the federal estate and gift tax exemption to reflect the effect of inflation since the present level of exemptions was established. The Association opposes any change in the present law which provides for valuing property held by a decedent at its fair market value upon his death (or the alternative valuation date) and also opposes proposals to tax the appreciation in some manner at the decedent's death or to carry over the original basis of the property in the hands of the decedent's heirs.

The Association respectfully requests favorable consideration of the position herein summarized.

Statement of the American Iron Ore Association

SUMMARY

Demand for iron and steel products has been and will be increasing in unprecedented proportions throughout the world. In terms of value, iron ore is the third largest commodity moving in international trade. Iron ore productive capacity is increasing and will continue to increase primarily outside of the United States where the higher quality reserves are located. Mining investments must necessarily be made in the countries in which the ore deposits exist. Our nation's iron ore industry must be able to compete on an equitable basis with its foreign counterparts which are receiving various forms of foreign governmental tax incentives and subsidies. At the present time as the result of more favorable taxation systems, many of the domestic industry's foreign counterparts reflect a better financial return on investment. For economic reasons, therefore, as well as for reasons of general national interest and security, the United States should aggressively encourage capital formation in its domestic iron ore industry.

Capital formation and improved cash flow go hand in hand. The Federal income tax system is one of the most important contributing factors influencing cash flow in our free enterprise economy. The international competitive position of our iron ore industry should not be impeded through a more restrictive tax policy, but rather, tax legislation should be directed towards encouraging investment in this industry, which in turn will ultimately result in higher levels of economic activity, employment, and tax revenues.

As a means of encouraging further investment by domestic iron ore mining interests in the most economically available deposits, wherever located, and to promote the national interest by assuring the industry a more dependable source of cash flow through the Federal income tax system, the following recommendations are made by the American Iron Ore Association:

1. Permanently establish the investment credit, with no basis reduction, at 12 percent applicable to expenditures as made; allow the full credit on plant and equipment for which capital recovery allowances are available; and extend the provisions to property acquired in the United States for use in foreign iron ore operations owned by United States taxpayers.
2. Retain iron ore percentage depletion in its present form and at its present rate.
3. Treat expenditures for pollution control, whether with respect to new or existing facilities, as deductible expenses in the year incurred, with the taxpayer having the option to defer deductions over a longer period. Any such write-off should not penalize the percentage depletion computation.
4. Repeal the minimum tax for corporations. At the very least, however, the effectiveness of percentage depletion should not be impaired by this tax.
5. Provide for outright deductibility, without limitation, of foreign exploration expenditures.
6. Continue present flexibility to the taxpayer for deduction of mine development expenditures.
7. Provide for similar depreciation treatment between domestic and foreign assets.
8. Establish a flexible capital recovery system to replace the present depreciation system.
9. Restore the deferral of taxation provisions on foreign earnings which existed before the Tax Reduction Act of 1975.
10. Preserve the foreign tax credit and general deferral of tax on foreign earnings system, but the credit should not be limited by segregation of income into types as is now required by Internal Revenue Code Section 901(e). If Section 901(e) is not repealed, then we recommend that carryback and carryover provisions be enacted.

STATEMENT

The American Iron Ore Association is a trade association representing companies which mine over 95 percent of the iron ore produced in the United States and Canada, as well as a large percentage of the iron ore produced in the free world. We endorse the statement of the American Mining Congress which was presented to your committee by Mr. Dennis P. Bedell on March 26, 1976. Because of the extreme importance to the American iron ore industry of several facets of the tax reform possibilities which are now under consideration by your Committee, we submit the following statement.

CAPITAL FORMATION

Overview

The challenge of future capital formation is a national problem of immense proportions. It is not peculiar to any particular industry. According to Dr. Charls E. Walker, "The U.S. will need the incredible sum of $4.5 trillion in new capital funds in the next ten years—three times the $1.5 trillion of the past decade".[1] The New York Stock Exchange has pointed out that the capital shortage is "no longer a threat for the future but a fact of the present".[2] Certainly the business community has already experienced an intense competition for capital, and the iron ore industry is no exception.

Capital requirements for iron ore and steel industries

In this country the initial capital cost of bringing a typical low-grade iron ore project on stream is now over $50 per annual ton of capacity. This cost has increased from about $35 per annual ton at the beginning of this decade, and present indications are that it will reach $75 per annual ton by the end of this decade. Also, it should be noted that in many instances such projects are not economically attractive unless plant capacity approaches several million tons per year. Recently it was estimated that $1 billion had been committed to new iron ore projects in the United States, and this is just a sample of what is taking place throughout the world. Looking ahead to further increases in demand, this universal expansion of iron ore mining capacity is not behind us by any stretch of the imagination. Our domestic industry cannot relax now if it is to be competitive in future global iron ore trade and if it is to provide a representative share of the employment opportunities which will be created as a direct result of this worldwide expansion.

The major use of iron ore is its conversion to steel. There is anticipation of a very sizeable world-wide increase in steelmaking capacity over the next few years, with some estimates exceeding 500 million tons. Considering our past history of leadership among world steel producers, the United States' increase of 30 million tons in raw steel capacity by the early 1980's, as projected by the American Iron and Steel Institute, appears rather modest in terms of the expected total

[1] Statement of Dr. Charls E. Walker, Chairman, American Council for Capital Formation, before the Subcommittee on Financial Markets of the Senate Finance Committee, Feb. 18, 1976.

[2] "The Capital Needs and Savings Potential of the U.S. Economy" (Publication of The New York Stock Exchange), September 1974.

world increase.[3] (Raw steel production in the United States is now about 19 percent of the world total, down from 39 percent just twenty years ago.)[3] It is also estimated that iron ore capacity must increase by approximately 30 million tons by 1980, or shortly thereafter, just to satisfy the domestic steel industry demand.[3]

It has been reported by the National Commission on Materials Policy that the capital cost in 1973 for each new ton of raw steel capacity in the United States was $400 as compared to $300 per ton in Europe and $200 per ton in Japan.[4] Considering the unit cost requirements for increased domestic steel capacity, together with those for additional iron ore capacity, it is estimated that approximately $14 billion of capital will be required in the relatively short-term future. This is in addition to the requirements for replacement of existing facilities, installation of pollution control facilities for existing plants and other miscellaneous expenditures which the American Iron and Steel Institute has estimated will cost the steel industry alone approximately $3.5 billion per year over the next eight years.[3] Considering the magnitude of these cash requirements in light of an internal cash flow shortage and the limited availability of cash in conventional markets, it becomes dramatically clear that the capital crunch is truly upon us. The American Iron Ore Association believes this awesome challenge should be met head-on and the pressure at least partially eased in vital areas through a properly directed Federal tax policy.

Need for a national compass

It has begun to appear that our country's investment needs have exceeded its savings, and that there is a genuine need to divert funds from consumption to investment. We have also been alerted for a number of years to the fact that our advance of productivity is not keeping pace with that of other leading industrialized countries; and we are vulnerable to further erosion as the result of an increasing labor force which is growing faster than the plant and equipment necessary to employ it. The primary attraction for new capital, whether it be debt or equity, is the potential for a financial return on investment. Private investment as a percent of gross national product in the United States is woefully behind that of our international competition. For a variety of factors, the trend toward capital shortfall has been building up for some time. It is therefore compelling that there be recognized and accepted the fact that capital formation constitutes the very essence of the national prosperity we have already attained.

Need for a stable tax policy

Iron ore investments are a particularly long-term commitment. Once the original capital is invested, the operator is ordinarily committed to a specific location for a minimum of 25 years. Investment payback is a very slow process in our business, and heavy fixed capital investment, plus immobility of resource deposits, preclude any thought of moving an operation to another location. With factual conditions such as these, it is essential that governmental attitude toward iron ore development (wherever located) be clarified, stabilized and commonly

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[3] "Steel Industry Economics and Federal Income Tax Policy" (Publication of American Iron and Steel Institute), June 1975.

[4] The final report of the National Commission on Materials Policy, June 1973.

understood. An industry which by its nature is so uniquely durable and permanently dependent upon governmental policy should be granted assurance that the original rules not be changed arbitrarily after capital investments and financial commitments are made. This is particularly important as to the tax treatment of foreign mining income of domestic mining companies.

WORLD IMPORTANCE OF IRON ORE

Iron and steel must be available

It is axiomatic that a healthy steel industry is a major factor contributing to a country's economic prosperity. The United States is the world's best example with annual per capita demand for iron and steel in this country totaling 1300 lbs.[5] It should be recognized in this new era of international competition that our continued prosperity will be dependent to a significant degree upon the relative strength and vitality of our steel industry. Steel production is fundamental and essential to a wide variety of products. As demand increases for these products through expanded population and rising world living standards, it will be taken for granted by consumers that the necessary steel production facilities will be available and in a sound state of repair to produce the required goods without delay or ecological disruption.

Future steel demand cannot be disassociated from a host of seemingly unrelated consumer requirements. For instance, the food industry must rely on farm equipment, containers, chemicals and fertilizers; and these are all a part of the steel picture. The same is true with the construction and transportation industries. The mining industry itself could not survive without a dependable level of steel production. Consider the thousands of additional mining machines and railroad cars for the coal industry alone. Project Independence must also depend upon a reliable source for steel, and moreover, steel is needed for the drilling equipment, casing, pipelines and refining equipment necessary for a higher level of oil production. (In just one offshore drilling platform there is required up to 25,000 tons of steel.) It is very clear that we must provide the additional raw materials to move forward in order for this nation to remain economically viable.

With world steel production approaching a billion tons per year, iron ore today is more than ever at the foundation of the world economy. It cannot be denied that the world has experienced in just two centuries an unprecedented number of astounding technological and scientific achievements. These achievements have occurred in the age of iron and steel substantially as the result of capital formation; and indeed, the United States (the center of capitalism) has been in the center of the action.

The United States alone cannot legislate the future course of world commerce any more than it can recast the pages of history which have given rise to our current problems. Like it or not, we are caught up in an internationalized industrial community, and we must learn

[5] Annual Report of the Secretary of the Interior under The Mining and Minerals Policy Act of 1970, May 1975.

to survive with new standards. We should be cautious at this most crucial time in world economic events not to further retard the international strength this country has already acquired. Such a retardation could occur rather easily by failure to recognize the vital role which will be played by iron ore and other critical natural resources in the future course of civilization. It should also be noted that development of iron ore projects requires a lead time of at least five to ten years. If a potential new property is not ready when needed, our consumers will be forced to seek out sources beyond the sphere of U.S. economic control.

Foreign and domestic sources of iron ore are both needed

Our recent experience with foreign manipulation of oil prices and supply is reason enough to guard against excessive dependency upon foreign sources for our iron ore supplies. Furthermore, we must take very serious note of the nationalization of iron ore properties by Chile, the acquisition of control of iron ore properties by Venezuela, and the very recent formation of an association of eleven iron ore exporting nations. Throughout the world the economic battle lines are being drawn. If the movement of United States capital into iron ore projects (appropriately divided between domestic and foreign locations) is not encouraged and pursued, it follows that the United States economy will be the unfortunate victim in the final analysis.

Large international trade in iron ore is a relatively recent phenomenon and is directly related to the growth and development of the iron and steel industry throughout the world. (United States production is now about 90 million tons per year, which is approximately 10% of world production.)[6] The decline in quality of our domestic reserves (with crude ore production now averaging less than 25 percent Fe content) and the availability of high grade deposits (with Fe content exceeding 50 percent) in other parts of the world have set the stage for economically sound development of foreign properties. Except for American ingenuity and risk capital which gave rise to the beneficiating and pelletizing of low grade ores, we would have found ourselves today almost entirely dependent upon foreign iron ore. The beneficiating and pelletizing processes, which are both necessary to upgrade domestic deposits and produce an acceptable product, are extremely expensive. Furthermore, it takes large-scale plants operating around the clock and throughout the year in order to compete with foreign ores. In spite of this disadvantage, however, there are enough low-grade deposits in this country to maintain the present healthy supply situation wherein approximately two-thirds of the iron ore demand of our domestic steel industry is supplied by domestic sources. Preserving this present balance will also contribute significantly to the vitality and growth of steelmaking facilities in the midwest United States. With steel wages in the United States far above those of our foreign competition,[7] this delicate balance is being preserved by the economics of transportation in addition to certain tax incentives which are discussed herein. Under present and foreseeable world economic conditions there is no conceivable way low-grade Lake Superior District

[6] Statistics published by U.S. Department of the Interior, Bureau of Mines.

[7] Statistics published by American Iron and Steel Institute and U.S. Bureau of Labor Statistics.

iron ores, having to be transported in relatively small vessels, can compete in markets outside the midwest United States and Canada.

Iron ore is one of the most abundant minerals on the earth's crust, but the highest grade deposits are now located outside the United States. As is indicated by the projected increases in world steel demand, it is imperative that the United States iron ore industry continue to involve itself in the development of foreign deposits. Iron ore deposits must obviously be developed where the ore is found. In addition to providing a supplement to our domestic requirements in cases where the economics so justify, it is also recognized that all the best foreign deposits *will* be developed by other than United States interests if we do not assert ourselves. Development of foreign deposits by United States interests is actually a net gain to our economy whether or not the product moves to this country. Iron ore projects, wherever located, require a significant investment in equipment and materials. If originated by Americans, much of the technical expertise, design requirements, and equipment is provided by other Americans: and initial business creates additional business as ongoing services and replacements are required. Borrowing is often arranged through Eurodollar and Eximbank arrangements, and many other services are furnished by Americans. The net result is the simulation of business on a broad front in the United States, the gainful employment of Americans, and the flow of income to the United States. Ultimately, there is further stimulation to the United States' economy through the creation of additional jobs which are made possible by remittance of foreign earnings to this country.

Employment peculiarities of the iron ore industry

Although the domestic iron ore industry provides employment for less than 30,000 persons,[8] it represents the foundation for a vast number of dependent and interrelated positions in other industries. On a per-employee basis the industry is enormously capital intensive and the value added is huge. With initial capital costs totaling more than $300,000 per employee, it is at the top of the list in this regard. These heavy capital requirements and the sophisticated design of plants to process low-grade ore generate employment across a wide spectrum of the business community. In addition, it should be noted that every ton of iron ore that moves forward into steel, and from there on into the stream of construction and consumer products, provides a countless number of additional jobs—from the steel industry itself (which employs over half a million persons) to the hardware stores, grocery stores, automobile dealerships, etc.

Employment security and area stability are a prerequisite to a healthy iron ore industry. This industry, like most extractive industries, conducts its operations in remote areas where it is the dominant employer. Without stability and a reasonably satisfactory standard of living, the industry would be unable to fulfill its requirements for a staff of technical personnel whose talents and expertise are so essential in this age of specialization to the production of quality output on a sustained basis.

Unemployment in the iron ore mining industry is not a matter of plant closings for a few weeks or months. Once it occurs, area depres-

[8] Statistics published by U.S. Bureau of the Census.

sion sets in for years, and a rather permanent effect is made on other industrial and commercial pursuits as the economy adjusts to the newly shrunken base. Just as in Appalachia, severe economic conditions can last for years, even decades. For instance, it was truly a matter of good fortune for the iron mining regions of the entire Lake Superior District that an expansion of the industry through construction of beneficiating and pelletizing facilities utilizing low-grade ores began to occur in the mid-1950's as the result of technological and mechanical innovations. Extensive layoffs begun in the 1950's and the downward trend was continuing as more and more uneconomic natural ore mines were closed. Only after many years of economic slide and pronounced readjustment for nearly two decades through family relocations and personal retraining did the region regain its health.

CASH FLOW AND TAX INCENTIVES

Importance of the tax system

The impending shortfall of capital formation in the United States is genuine and most alarming, and the need for a fair, equitable and stable tax policy which can be relied on by the iron ore industry is imperative. The American Iron Ore Association believes that there is wide appreciation for the problem throughout the governmental, private, educational and business sectors in this country. However, there is understandable confusion about the roles to be played by these sectors in correcting the problem. A fair, equitable and stable Federal tax policy will have a significant impact on the existence and direction of capital formation. In past years of lesser international competition and more available capital in the United States, the influence of tax policy was certainly important; but it was never so much a deciding factor as it is today.

Since it is now generally accepted that this nation's future well-being rests in great part upon increased capital investment, we must now do all that we can through the tax system to provide that capital where it is needed most in order to make possible the required increased production, at least in those industries which are most critical to our national interest and fundamental well-being.

Free enterprise means profits and profits produce tax

Capital formation is a by-product of profit in the business sector of a free enterprise economy. However, corporate profits in 1974 were at their lowest point in a decade as measured by Commerce and Treasury Department statistics. As Treasury Secretary Simon has noted, a 71 percent overall increase in corporate profits from 1965 to 1974 was actually a 50 percent decline when adjusted for the current value of capital used in production and when the effect of inflation on inventory values is eliminated.

Income and other taxes flow from business activity and the earnings produced thereby. Consequently, if proper tax incentives are directed toward our vital industries—and this Association believes that this most certainly includes industries producing critical natural resources such as iron ore—capital investment will be properly channeled so that expanded production will generate tax dollars as well as profits and increased employment. Also, it should be kept in mind that as our basic industries provide raw materials to satisfy the demand for consumer products, there is created a ripple effect throughout the economy. Additional employment opportunities in other industrial and commercial pursuits, expanded business activity, and greater tax revenues are the result.

Cash flow through the tax system

The income tax system and its rate structure are inseparable from the capital formation/cash flow shortage in our free enterprise economy. If it is the will of Congress to stimulate business cash flow, there should not be concern for a slight reduction of effective corporate tax rates. Such rates were never designed to equate with those which apply to personal income, and a comparison between the two serves no meaningful or useful purpose unless consideration is given to many other complex aspects of our entire tax law.

Capital formation can be encouraged and cash flow to business made available rather quickly through the tax system in accordance with national interest and national priorities. If there is a reasonable consensus on the designation of national interest and our ranking of priorities, we can dependably rely on our tax system to provide immeasurable assistance to us in meeting the problem of capital shortage. The American Iron Ore Association believes that the development of iron ore mining projects at home and throughout the world by United States interests with United States capital ranks very high on the chart of national priorities.

TAX RECOMMENDATIONS

A permanent investment tax credit is crucial

The investment tax credit is a cash flow stimulant to business investment which is operating effectively through the rate structure. It applies to individuals as well as to large and small corporations, and there is no distinction in its application between corporations and individuals; but there is an element of purposeful distinction as between those taxpayers who are in business as opposed to those who are not. Taxes are permanently reduced for *all* business taxpayers who invest in qualified business assets under the proper conditions. This is an excellent example of encouragement of capital formation and cash flow through the tax system. The credit has contributed greatly to the very expensive transition to domestic beneficiating and pelletizing plants by the American iron ore industry. The national interest is being served through immediate stimulation of employment to provide business plant and equipment, and it is also being served through the expansion and modernization of plant facilities which will provide additional or continued employment in the future. The American Iron Ore Association wholeheartedly supports the investment tax credit as an important and permanent feature of our tax law, and additionally, in light of the critical need for business cash flow stimulation throughout the foreseeable future, it is our recommendation that serious consideration be given to a permanent increase in the rate to 12 percent with no basis reduction; that the credit extend to all plant and equipment for which capital recovery allowances are available; and that it extend to property acquired in the United States for use in foreign iron ore operations owned by United States taxpayers.

Percentage depletion should not be altered

The percentage depletion rate for iron ore is 15 percent of the product value at the mine; but, as in the case of all other natural resources, the amount can never exceed 50 percent of net income from each iron ore property. Consequently, the deduction is not available in any year in which the property is operated at a loss. The 15 percent rate grew out of a study made many years ago when it was felt that a more workable substitute should be found for discovery value depletion. The American Iron Ore Association believes the rate is fair and equitable, and there is no question that percentage depletion has in the past made a vital contribution to the cash flow requirements of the iron ore industry. It is only one element, but a very critical one indeed, in the chain of economics which produces a reasonable return on investment to our iron ore industry and enables it to develop new reserves as old ones become exhausted.

The American iron ore industry is in competition throughout the world; and although it is true that many other countries do not have percentage depletion as a part of their tax structures, other cash flow benefits are available instead. Our percentage depletion deduction is just one part of an entire taxing system which we believe is rather delicately balanced and operating reasonably well.

Percentage depletion was originally an American tax concept, and it has served its purpose over the years as is borne out by the fact that Congress has periodically reviewed its effectiveness and confirmed its propriety. One might think if percentage depletion is so important to our cash flow and return on investment, the American iron ore industry would have the competitive advantage over its foreign competitors. This is not so, however. In a comparative study of taxing systems involving "model" iron ore and other mining ventures in various foreign countries which was undertaken two years ago and updated recently by Coopers & Lybrand at the request of the American Mining Congress, it was determined that the United States iron ore industry ranked sixth out of nine in terms of return on equity investment.[9] Coopers & Lybrand has further determined that loss of percentage depletion on foreign iron ore income would cause the United States' ranking to slip from sixth to eighth.

For many years Congress has felt that continued economic strength and development of the iron ore industry should be sustained, and the industry has reacted accordingly. Assuming there is a Congressional consensus that a healthy United States iron and steel industry remains in the national interest and on the priority list, any lessening of percentage depletion on iron ore would be most inopportune. Even partial removal of this essential element from our cash flow picture now would introduce a serious handicap in our efforts to satisfy our national objectives.

Pollution control expenditures should be immediately deductible

Pollution control facilities by their nature are not productive, and the American Iron Ore Association believes that our tax laws should recognize a greater distinction between them and productive plant and

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[9] "A Comparative Study of Tax Systems and Their Effect on Foreign Mining Investments as of May 12, 1975" (Prepared by Coopers & Lybrand and sponsored by American Mining Congress).

equipment. Expenditures for pollution control equipment, whether with respect to new or existing facilities, should be treated as deductible expenses in the year incurred, with the taxpayer having the option to defer deductions over a longer period. Any write-off of pollution control expenditures should not penalize the percentage depletion computation.

Repeal minimum tax for corporations

It should also be noted that percentage depletion is a preference item for purposes of computing the minimum tax. To the extent there is assessed a minimum tax on member companies of American Iron Ore Association, there is an impairment of the percentage depletion deduction, an upward adjustment of the corporate effective tax rate, and thus a resulting drain on urgently needed cash flow. Having in mind the origin of the minimum tax proposals as a means to correct a problem of individual income taxation, we think that the effect on the iron ore industry (as well as most other industries) was not intended and that steps should be taken to eliminate this result. The iron ore industry has not been and is not now a tax shelter area for individuals, and it should not be burdened with this additional tax. As a simple but logical solution to the problem, we suggest that the minimum tax be repealed for corporations. At the very least, percentage depletion should be removed from the list of preference items for corporations.

Other important recommendations

There are other important matters of tax significance to the iron ore industry. Our position on these specific areas of taxation are also motivated by our principal concern—i.e., cash flow is desperately needed in vital industries to create capital formation therein and provide the wherewithal to supply a necessary resource and to meet our foreign competition on an equal footing. Following is our position on these matters:

1. Exploration expenditures incurred outside the United States should be immediately deductible, without limitation, but subject to recapture as are domestic exploration expenditures. Most exploration work of any consequence for iron ore is done on foreign properties, and in reality, the rather modest $400,000 limitation in current law was completely utilized many years ago by our affected member companies.
2. Flexibility to the taxpayer in claiming his deduction for mine development expenditures should be continued.
3. Foreign asset depreciation should not be more restrictive than domestic asset depreciation.
4. A flexible capital recovery system should replace the present depreciation system. Under such a system latitude would be granted to the taxpayer to determine his deduction up to a maximum percentage; and all machinery, equipment and buildings used in a particular business wherever located would be included. Rates should be at least as favorable as the maximum permitted under the present Class Life System.
5. The deferral of taxation provisions on the earnings of foreign corporations controlled by United States persons which were repealed by the Tax Reduction Act of 1975 should be restored.
6. The foreign tax credit and general deferral of tax on foreign earnings system should be preserved as a fair and equitable arrangement

to avoid unjust and confiscatory levels of double taxation, and the credit should not be limited by the segregation of income into types as is now required by Internal Revenue Codee Section 901(e). If Section 901(e) is not repealed, then we recommend that carryback and carryover provisions be enacted.

PIZZAGALLI CONSTRUCTION CO.,
South Burlington, Vt., April 14, 1976.

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

DEAR MR. STERN: I would like to offer my comments concerning tax reform legislation presently pending before the Committee on Finance. As general contractors and real estate developers, we are vitally interested in a number of matters which I believe are being considered by the Committee.

CAPITAL RECOVERY

The Investment Tax Credit is a significant benefit to construction contractors in ameliorating, albeit to a limited extent, the losses which we have suffered because of rapidly escalating equipment costs. At present, the reserve for depreciation on equipment purchased just a few years ago, but at much lower prices, is inadequate to provide for the purchase of replacement equipment. Our equipment costs are high, the useful life of our equipment is very short and the equipment must be used under rigorous conditions. I hope that you will consider increasing the Investment Credit to 12 percent and increasing the asset depreciation range to a 40 percent range.

In addition to assisting our depressed industry, the foregoing changes will also stimulate other industrial activity as purchases of capital goods by contractors increase.

TAX TREATMENT OF REAL ESTATE

As contractors, we are very interested in the tax treatment of real estate projects. Furthermore, since we are also real estate developers, we are directly affected by any changes which you might make in current laws. Changes in the treatment of prepaid interest and in rules with respect to limitation of losses will raise the cost of capital. This, in turn, will discourage investors, will lead to higher ultimate occupancy costs for building users and will lessen the demand for new construction.

As you are no doubt aware, building costs have risen dramatically in the past couple of years. Any change in income tax laws which has the effect of discouraging investment in new construction will make it even more difficult for new buildings to compete with old. Accordingly, these adverse tax rules will discourage much needed new construction and related employment.

New construction of commercial or industrial real estate development can only take place when the return on investment is commensurate with the risk assumed. If adverse changes are made in the tax laws, when coupled with the already higher interest rates, greater returns will be demanded by investors, and this will necessarily result in increased occupancy costs with a consequent lessening of demand for our services.

TAX CREDITS AND INCOME EXCLUSIONS

American contractors are already at a serious disadvantage when competing abroad for construction projects. Our foreign competitors are frequently subsidized heavily by their governments, and wages paid by U.S. contractors to American employees stationed abroad tend to be much higher than those paid by non-American contractors.

An American individual working abroad does not receive as much for his tax dollars as the citizen who chooses to work in America. Thus, it seems only logical that some adjustment should made in his income taxes to compensate for the reduced level of services which that individual receives. This can be achieved by continuing the income exclusion.

Changes in the tax law which are detrimental to contractors will only serve to improve the competitive advantage of foreign contractors and will further erode the market for U.S. contractors working abroad. This will result in loss of jobs to Americans working abroad and will further aggravate American balance for payment problems. In addition, and most significantly, a loss of jobs in the United States will also result for it has been clearly demonstrated that American engineering and construction firms working abroad generally specify American-made materials and equipment.

TAXATION OF CAPITAL GAINS AND LOSSES

I hope that your Committee will not eliminate the distinction between capital gains and ordinary income or increase the rate of taxation on capital gains. Any such change will only lead to arbitrary decisions by investors to retain property which would otherwise be sold.

The periodic sale or exchange of property is a stimulus to the economy, frequently results in construction projects for renovation or modernization and is a healthy economic activity. Any change in present law along the lines outlined above will only serve to interfere with these worthwhile objectives.

In addition, many apparent gains do not result from increases in the real value of property but are nothing more than the products of inflation. Such gains are not profit, and the structure of the capital gains tax should reflect this reality.

DOUBLE TAXATION OF CORPORATE PROFIT

The present tax arrangement whereby a double tax is imposed on corporate profits is a serious inequity which raises the cost to corporations of capital. This leads to increased prices since, in one way or another, costs of capital must ultimately be borne by the consumer. It is a myth to believe that the tax burden is borne by the corporation itself as, eventually, the ultimate user of the goods or services produced by the corporation must pay the bill.

Furthermore, the present system tends to force corporations to raise capital through debt instruments instead of equity securities and this, in turn, leads to higher interest rates.

It is widely recognized that a serious capital formation problem is likely to exist in our country over the next decade. We have enormous needs for industrial facilities, energy production installations, housing and many other projects, and inflation has greatly increased the cost of such undertakings. Thus, it is essential that our taxing system encourage capital formation.

I appreciate the opportunity of making these comments to you and the Committee.

Sincerely yours,

JAMES PIZZAGALLI,
Vice President and Counsel.

STATEMENT OF J. J. JONES CONSTRUCTION CO., WRITTEN BY TOM MCDINE

This statement is in regard to tax reform currently being considered by the Committee on Finance of the U.S. Senate. I am writing on behalf of J. J. Jones Construction Company, a large construction company headquartered in Charlotte, North Carolina. We are a general contractor doing work in the United States and overseas.

As you are aware, construction is a significant portion of the country's total gross national product. Also, millions of people gain their livelihoods either directly or indirectly from our industry. The direction tax reform takes will have a significant effect on construction activity. Since the industry has already suffered severely from the recent economic recession, further setbacks will have an extremely adverse effect on the country's economic health.

The recommendations which follow, we feel will stimulate construction activity. This has the effect of benefiting the entire economy.

CAPITAL COST RECOVERY

A prime area of importance to all capital intensive businesses today, is the cost recovery allowed by tax law. If our present economic recovery is to continue, additional plant capacity and modernization of existing capacity will have to take place. Improved capital cost recovery, we feel, is the spur needed for increasing capital spending. U.S. industry will cease to be competitive in the world market if this capital spending does not take place.

The investment credit has been a valuable incentive toward industry embarking on capital spending programs. It could become even more valuable, if industry could be assured of the permanence of the investment credit. In addition, the percentage should remain stable. We believe a permanent 12 percent investment credit would create the needed stimulus for increased capital spending.

The other area of capital cost recovery is depreciation. We believe ADR has been a tremendous aid in this area. In view of modern technology, et cetera, a shortening of the ranges would be in order. Thought should also be given to the restoration of full accelerated depreciation provisions to industrial buildings and plants.

As you are aware, many older plants are faced with the major cost of pollution abatement equipment if they are to continue operating. As an incentive for industry to keep these plants operating, we recommend the allowance of a writeoff for this cost in one year.

FOREIGN TAX CREDITS AND INCOME EXCLUSIONS

Of prime concern to our Company are proposals for the elimination of the present overseas compensation exclusion of $20,000 or $25,000 and the elimination of the foreign tax credit on a per country basis.

The involvement of U.S. construction in overseas work creates extremely favorable effects for the U.S. economy. This is true for the following reasons:

1. Profits from construction projects are ordinarily returned to the United States immediately. This creates a favorable balance of trade payments for this country.
2. United States made equipment and materials are predominately used on overseas projects. Our domestic economy is greatly benefitted by these purchases.
3. Jobs are created for U.S. citizens. The skills of our people are needed for the more technical aspects of a construction project.

As you are aware, we are in competition with foreign countries for this overseas work. These companies have an advantage in receiving direct Government subsidies and tax benefits significantly better than ours. The elimination of the present overseas exclusion and foreign tax credit on a per country would place the United States construction industry at a further competitive disadvantage.

We would also ask the committee to consider adding an additional exception to the Internal Revenue Code Section 48(2)(B) for new construction equipment bought within the United States by United States construction companies for use predominantly outside the United States. The addition of this exception would permit the taking of investment credit on the purchase of construction equipment for use predominantly outside the United States.

The logic for the addition of this exception is as follows:

Quoting directly from Sec. 101(C)(1) of the Revenue Act of 1971 (Public Law 92-178)

"In general—It was the intent of Congress in enacting, in the Revenue Act of 1962, the investment credit allowed by Section 38 of the Internal Revenue Code of 1954, and it is the intent of the Congress in restoring that credit in this Act, to provide an inventive for modernization and growth of private industry."

The purchase of new construction equipment in the United States would be fulfilling congressional intent for growth of private industry as stated in the Revenue Act of 1971 (Public Law 92-178).

CONCLUSION

While we are vitally interested in other proposals for tax reform, the areas covered above have the potenial for dealing severe setbacks to our already hurt industry.

On behalf of J. J. Jones Construction Company, I thank you for the opportunity of expressing our views.

Statement of the American Life Insurance Association

The American Life Insurance Association, a division of the American Council of Life Insurance, has a membership of 377 life insurance companies which have in force approximately 90 percent of the life insurance written in the United States and hold 99 percent of the reserves of insured pension plans.

This statement is being submitted for consideration by the Senate Finance Committee in connection with its public hearings on H.R. 10612, the Tax Reform Bill of 1975.

Discussion of Specific Provisions of H.R. 10612

I. TAX SIMPLIFICATION IN THE INDVIDUAL INCOME TAX

A. Sick pay exclusion (section 505 of the bill)

Section 505 of H.R. 10612 limits the applicability of the sick pay exclusion (section 105(d) of the Internal Revenue Code) to individuals retired on long-term disability and, even for these people, would phase it out for those with incomes in excess of specified limits. The ALIA strongly opposes any such contraction of the present sick pay exclusion—either as it applies to short-term or to long-term disabilities. The present exclusion, which is available for short-term illnesses in prescribed situations and is not affected by the taxpayer's income, has furnished great stimulus to the growth of employer financed plans for providing income to employees during periods of sickness or disability—a time during which, if anything, their income needs grow rather than diminish. These programs are clearly in the public interest and the limited tax exclusion allows employees to realize the maximum benefit from these programs in terms of after-tax dollars. In this regard, we wholeheartedly endorse the statement of the Health Insurance Association of America on this subject.

We wish to note that we strongly endorse efforts to simply the tax laws and recognize that the existing sick pay rules are complex, particularly as they apply to the first 30 days of an illness. These rules can be simplified, however, in a manner which will not curtail the existing scope of the exclusion as is currently proposed. For example, removal of the of the special limitations applicable during the first 30 days would do much to simplify the current rules without restricting the benefits of the exclusion.

Retirement test should be deleted.—If section 505 of H.R. 10612 is to be retained in principle, the ALIA strongly urges that it be revised so as not to condition the exclusion on an individual being "retired". (See proposed section 105(d)(1)(B)).

In this regard, there is no uniformly recognized "retirement" status in the case of disabled employees.* For example, many employers continue one or more fringe benefit coverages, such as life insurance and

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*In fact, the proposed definition of "permanent and total disability explicitly recognizes, through the 12-month requirement, that an employee may recover from his disability and presumably return to work.

health insurance, for employees who are permanently disabled within the meaning of proposed section 105(d). These coverages may continue for a specified number of years, perhaps related to the employee's length of service, or, in some cases, until the employee reaches retirement age under the pension plan. Also, the employee may continue to accrue benefits under the pension plan while permanently disabled.

It would appear that the proposed "retirement" test is predicated on a situation where an employee qualifies for a disability pension under the employer's pension plan. The current trend, however, is to provide disability income under policies or through funds outside of the employer's pension plan, and, thus, there is no "retirement" event under the pension plan on which to trigger application of the sick pay exclusion. If there is to be a test beyond "permanent disability", we believe it should be in terms of an employee who is no longer rendering services for the employer. This would parallel the statutory and regulatory framework under section 79 of the Internal Revenue Code where an employee is not taxed on any employer financed group term life insurance after he "has terminated his employment with such employer" and "is disabled". (Section 79(b)(1)). The regulations provide that an employee has "terminated his employment" for this purpose "when such individual no longer renders services to that employer." (Section 1.79-2(b)(2) of the regulations.)

B. Deduction for accident and health insurance premiums

We note that the Administration, in the statement submitted to you by Treasury Secretary Simon on March 17, 1976, proposes elimination of the present separate income tax deduction for health insurance premiums. Under present law, a taxpayer may deduct one-half of his health insurance premiums up to a maximum deduction of $150. The excess, if any, may be aggregated with his other medical expenses and deducted to the extent the sum exceeds 3 percent of his adjusted gross income. Under the Administration's proposal, which is included as part of its simplification deduction package, the entire amount of a taxpayer's health insurance premiums would be deductible only under the latter alternative, thereby eliminating the deduction completely for many taxpayers.

Although the House Ways and Means Committee had included such an amendment in prior years' versions of its tax reform bill, it did not do so in H.R. 10612. For the following reasons, we support the Ways and Means Committee's action in this regard and urge that your Committee not adopt the Administration's proposal.

First, the present deduction (outside the medical deduction floor) for one-half of a taxpayer's health insurance premiums was added in 1965 in order to equalize to some degree the tax treatment as between an individual who purchases health insurance and one who chooses to self-insure. Without this deduction, it is likely that the taxpayer who purchases health insurance would never qualify for a medical expense deduction since his medical expenses are essentially averaged out over a period of years and will usually fall below the medical expense deduction floor. On the other hand, the medical expenses of taxpayers not covered by insurance tend to be concentrated in particular years, thereby making it likely that they will exceed the medical expense deduction floor in these years and qualify for a deduction. It was felt by the Ways and Means Committee, in 1965, that such a disparity in tax treatment "may have the effect of discouraging the provision of insurance protection against future medical bills." (See Ways and Means Committee Report on H.R. 6675, 89th Congress, page 137.) For this reason, the existing deduction was added in 1965. And it would seem even more important, in view of the rising health costs, that it be maintained at this time.

In this regard, national health insurance proposals are being actively debated, and the need for upgrading and broadening health insurance coverage is universally recognized. To destroy the present incentives in the tax law for the purchase of health insurance as part of a tax reform or simplification bill, while considering the best health insurance coverage, is contradictory. The Treasury and the public would be better served if Americans provided more, rather than less, health insurance for themselves.

To argue that the increased taxes on those persons providing their own defenses against the catastrophic financial impact of major illness will be partially offset by a uniform deduction for all is no answer to those adversely affected.

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

We further note that according to the latest published Internal Revenue Service figures, this deduction is basically a benefit for those in the middle and lower income brackets.

If the Committee wishes to further simplify the return, we suggest the elimination of the existing limitation (50 percent of the premium or a maximum of $150). This would not only help those individuals who provide their own health insurance protection, but would simplify both the preparation and the audit of the return. Particularly it would simplify the return for the person who now has to make two computations instead of one.

In making this statement, we join with the Health Insurance Association of America.

II. CHANGES IN THE TREATMENT OF FOREIGN INCOME

Contiguous country branches of domestic life insurance companies (section 1043 of the bill).—Section 1043 of H.R. 10612 amends the Internal Revenue Code to remove the U.S. tax impediments to U.S.

life company operations in contiguous countries. For the reasons set forth below, the ALIA supports the amendments contained in section 1043.

Most of the foreign operations of domestic life insurance companies are in Canada, where U.S. companies have been doing business since around the beginning of the century. At present, these Canadian branch life insurance operations are subject to a U.S. income tax under the provisions of the Life Insurance Company Income Tax Act of 1959 (sections 801–820 of the Internal Revenue Code), and this tax currently exceeds the comparable Canadian taxes payable by competing non-U.S. life insurance companies.

This U.S. tax treatment of Canadian branch life insurance operations is inequitable in at least two important respects. First, the income that is taxed is essentially generated by Canadian capital (derived from the premiums paid by Canadian policyholders), investments, and other activities. Moreover, the burden of the higher U.S. tax inevitably falls on the Canadian policyholders. In other words, the present tax structure has the effect of taxing foreign source income of non-residents.

Second, the added cost to U.S. companies (as compared to foreign insurers) resulting from the U.S. tax places these companies at a competitive disadvantage. In this regard, the U.S. companies' share of the Canadian market has steadily declined over a period of time.

The objective of Section 1043 is to remove those inequities by providing tax neutrality in the case of a U.S. life insurance company's branch operations in contiguous countries. In this regard, the Internal Revenue Code would be amended to exclude from the computation of a mutual company's taxable income all of the items relating to contracts insuring risks in connection with the lives or health of residents of contiguous countries through branches in those countries. The ALIA supports this provision.

III. INDIVIDUAL RETIREMENT ACCOUNT AMENDMENTS

Limited employee retirement accounts (section 1502 of the bill).—Section 1502 of H.R. 10612 expands the individual retirement savings deduction established by ERISA by permitting an employee who is an active participant in a qualified plan to make a deductible contribution to an individual retirement account (IRA) or to a limited employee retirement account (LERA) if, and to the extent, the benefits provided under his qualified plan are less than he could provide for himself by establishing an IRA. Under the current rules, an employee who is a participant in a "thin" qualified plan cannot make up the difference through deductible contributions to either an IRA or the plan.

The ALIA strongly endorses legislation to encourage the growth and expansion of the private retirement system. Thus, we agree with the objective of the IRA amendments in H.R. 10612. However, we believe that this objective can much more effectively be attained by allowing tax deductions for the full amount of employee contributions to qualified plans. In this regard, we believe that, to be effective, measures to encourage the establishment of new plans stimulate action by smaller firms since they represent the major area of inadequate private pension coverage. Tax deductible employee contributions will, by encouraging employees to share in the costs of pension coverage, make it possible for many such employers to establish new plans and improve benefits under existing plans where they otherwise would be unable to pay the full cost of the plan or benefit improvement and, thus, would be deterred from taking any action.

If the Committee decides not to adopt our suggestion of full deductibility of employee contributions, then we urge that the concept in H.R. 10612 of allowing participants in "thin" plans to make deductible contributions to an IRA or to the plan (through a "limited employee retirement account") be retained. However, we believe that the creation of a LERA, subject to the various rules and restrictions in H.R. 10612, as the vehicle for allowing employee contributions to be deductible, is much too complex. In this regard, an account can qualify as a LERA only if it is maintained separately within a trust forming a part of a qualified plan and the assets allocable to the account are accounted for separately. This separate accounting is the vehicle for applying the special IRA limitations to the deductible employee contributions. We do not believe that these special limitations are of sufficient importance to justify the added administrative cost and complexity of the separate accounting, which will be particularly heavy for defined benefit plans. In fact, these requirements probably would discourage employers from establishing such accounts thereby defeating the purpose of the legislation.

We appreciate having the opportunity to participate in the tax reform hearings and would be glad to attempt to furnish any additional information which might be thought helpful.

Statement of James H. Rademacher, President, National Association of Letter Carriers (AFL-CIO)

Mr. Chairman, my name is James H. Rademacher, and I am the President of the National Association of Letter Carriers.

We appreciate the opportunity to present the concerns of the NALC involving several provisions in the House version of the tax reform measure.

We are particularly disturbed with the seeming indifference to the economic plight of our retired members that has been evidenced in the House revision of the Retirement Income Credit provisions of the tax code.

We do not need to dwell overly-long on the cruel impact of inflation on those former members of the active work force of this nation who are now subsisting on pensions that are universally too small to meet their needs. It is too true to bear much repetition that retirement incomes, from the beginning of retirement years, are usually fixed at not much more than subsistence levels.

Any impact on those minimal incomes is major in its effects and the proposal of the House to establish a phase-out of the credit available on the basis of adjusted gross income has precisely such an impact. Therefore, we oppose that provision.

However, we reserve our strongest objections to the failure of the House bill to deal constructively with the basic inequity of the Retirement Income Credit, itself. As originally proposed and enacted by Congress, the intent of the RIC was to reflect the amount of social security benefits then being paid in order to treat other retirees in terms of taxation of their annuities in the same manner as Social Security annuitants.

However, since 1962, the date of enactment of the RIC, it has not been increased one cent though Social Security annuities have increased approximately 84 percent.

Accordingly, simple equity would seem to dictate that the RIC ought to be increased in a similar manner to reflect the original intent of Congress that these annuities be treated identically as to taxation with Social Security annuities.

Efforts to redress this obvious inequity have occurred by the introduction of various Bills now pending. Some seek to equalize this disparity by increasing the exemption from taxation of annuity income to $5,000.

Though we appreciate those efforts, we prefer the solution proposed in S. 2870 by Senator Joseph Montoya of New Mexico. S. 2870 reasserts the original intent of the RIC. Thus, Federal Retirement Income, to the limited extent, Federal Retirement Income does not exceed Social Security Income under Title II of the Social Security Act.

Such a proposal not only restores to this issue the formula originally intended by Congress, but has the added attraction of being self-implementing and not requiring periodic enactment of "catch-up" legislation.

SICK PAY EXCLUSION

We are also very troubled by the House revisions in the present method of treating disability income.

Under present law, the disabled person is entitled to $100.00 a week up to $5,200 a year tax free income while off of work due to disability.

We believe if any change had been warranted, it should have been in the direction of increasing the weekly exemption to reflect the enormous increase in medical costs and other living expenses that have occurred since 1954, the date the $100 figure was established.

Instead, by including an adjusted gross income limitation and by lowering the age of entitlement to 65, instead of 70, as is the case for Federal Employees, the House has decreased sick pay in most instances rather than increase it, as should have been the case.

We similarly, question the merit in the House revision of the statutory definition of "disability". The expanded definition of "permanently and totally disabled" is designed to eliminate many from the rolls of those now benefitted from this provision. We believe such an application would be grossly unfair.

We remain troubled by an increasing perception that the most onerous impact of the House Tax Reform Bill is on those least able to assume the burdens of increased taxes.

We sincerely hope the Senate in its proper zeal to make the tax laws of this Nation more equitable in their application will not pursue a course of increasing the tax burden on those least able to bear such an increase, the retirees and the disabled.

Statement of William F. Bates, McCulloch Oil Corp.

Mr. Chairman and members of the committee, my name is William F. Bates. I am Vice President, Drilling and Production of McCulloch Oil Corporation and I am pleased to have the opportunity to describe to the Committee the problems of financing the development of significant geothermal power.

A great deal of information has been submitted to the Congress concerning the potential and the problems of developing significant geothermal power. Much pertinent information was contained in the materials inserted into the *Congressional Record* on November 4, 1975, by Senator Fannin when he introduced S. 2608. I would like to present more specific facts to point out the great need for a tax incentive program to attract capital to finance the development of significant geothermal power.

My company, McCulloch Oil Corporation, in partnership with Geothermal Kinetics, Inc., has been very active over the past several years in geothermal activities and between us we have spent almost $8 million in exploration, lease acquisitions and drilling and, to date, Geothermal Kinetics has one commercial well in the Geysers area that they drilled before we formed our partnership. However, we have made what we believe are major improvements in exploration techniques and are quite hopeful that our success ratio will be high. We also have accumulated a sizable inventory of prospects, all of which had an appreciable expenditure for exploration prior to leasing the land. The problems is to raise the money to drill the wells.

Last year my company attempted to sell a $15 million investors program to raise money for geothermal drilling. Even with the inclusion of very favorable acreage in the Geysers Field, we sold less than $1 million worth (which allows us to drill the Geysers well). The reason for this failure is very obvious: the brokerage houses were only lukewarm in their attempts to sell the program because of the uncertainty of the tax incentive program. In our prospectus we had to disclose that the IRS had written us that they would not allow exhaustion allowance or intangible drilling write-offs, even in the Geysers area where the 9th Circuit Court of Appeals had ruled that geothermal did deplete and therefore was allowable.

Geothermal, unfortunately, in many people's minds is classed along with solar and exotic fuels as an energy source and is something far in the future, if at all, and therefore very great risks of failure and, unless there is a real tax incentive, they are unwilling to risk any dollars.

We are fully aware that any program to attract the investor's attention must be viable but this is not enough; if many investors are to be attracted, then they must have exposure to geothermal development through the brokerage houses as a tax incentive investment.

Although we are very hopeful that the government guaranteed loan program for geothermal drilling will soon be forthcoming, we are convinced because of the magnitude of the dollars involved and the delay (5 years) from initial drilling until the generating plant is placed on-stream and hence income is produced that other financing is mandatory. For example:

We are drilling a geothermal well in S. W. Utah. We have probably expended more effort (and dollars) on exploration work on this well than any other geothermal well in the world. We like our chances, but to develop 300 megawatts of power will require the expenditure of an additional $21,000,000 (plus the generating plant and power lines) before any income is forthcoming. We have three other prospects ready to drill; one in the Geysers (in addition to the one that is now drilling under our 1975 Investors Program) and two in the Imperial Valley. To develop a 55 megawatt plant at each of these locations will require another $27,000,000. As the proposed limit for the government guaranteed loan program is $50,000,000, one can readily appreciate that we would have this amount committed during the first year. However, we still have an outstep well to drill in connection with our Geysers Investors Program, as well as another prospect in the Geysers and three prospects in Utah, all of which we would like to drill during 1976. To drill these exploration wells and two confirmation wells, only (not the development wells), will require another $9,000,000. This is the amount of an investors program we would like to sell this year, but we know we have *no* possibility of doing this unless we (and the brokerage houses) can attract the investor's attention with a tax incentive program.

The foregoing is just the beginning. We must follow up the foregoing exploration wells in 2 to 3 years with development wells and wells for additional generation plants. We also have at least 12 more good prospects that will be ready for exploration drilling in 1976 and 1977. We also believe that our prospect we are now drilling in Utah may be able to support a total of 2000 megawatts. The complete development of this and other blocks that we believe will be productive will require about 519 wells, costing at $500,000/well or $260,000,000, and these wells will develop about 4010 megawatts of power. We think this is achievable within the next ten years by us alone if we can raise the money to do it! We know there is little chance of raising over $25,000,000 per year for the next 10 years unless we attract investors and we know we cannot do that unless there is a tax incentive program.

In summary, we believe we have improved exploration techniques to the point that we can attract investors insofar as geothermal being a viable investment, but know we cannot proceed at the development pace that is warranted without the tax incentive program.

Last year, investors funded oil programs totaling $322,000,000. We suggest a great deal of this could be funneled into geothermal if tax incentive measures for geothermal are adopted by Congress.

Without the investors' support to go forward at the pace suggested, our partnership must drastically curtail our exploration efforts which now run about $1,400,000 per year, exclusive of any drilling costs.

The foregoing covers our plans and problems. However, there are many other small geothermal companies that are facing the same problems as we are and they, too, would be able to drill more wells if there were a favorable tax incentive program to attract investors.

Needless to say, we believe the major oil companies also would be far more interested in accelerating their geothermal activity under favorable tax incentive programs.

The rate of exhaustion of geothermal resources is debated pro and con at great lengths. However, the 9th Circuit Court of Appeals in 1972, on the basis of clear scientific evidence, concluded that geothermal energy is an exhaustible resource.

Dr. Ramey, who is a professor in the Petroleum Engineering School at Stanford University and is engaged by PG&E to study the Geysers reservoir, maintains that there is a decline that is occurring in the Geysers and that he predicted it several years ago and the decline is following his predictions.

To me, there is no question that there is a decline in geothermal resources. The proof is that hard rock mining deposits are indeed old geothermal prospects that have cooled. The question really is the length of the commercial life of a geothermal prospect rather than whether it has any decline. I would think that there would be a great variation in the useful life of various geothermal resources as there is in oil and gas fields.

The producing of 2000 megawatts of power from a hot water system means that one is producing 145 million pounds of water per hour. This works out to be over 3 billion bbls. of water per year or for a 15 year life, this is over 45 billion bbls. of fluid. If this were oil, it would indeed by a *very* large oil field. Of course, this water is reinjected into the earth but this volume of water would have an enormous cooling effect on the formation; therefore, our current thinking is that injection wells would be in areas outside the productive strata or areas.

In our discussions with utility companies, their biggest worry is whether a hot water geothermal field will last 15 years. There is no way anyone really knows until fields have been producing for 3 to 10 years. After geothermal has been established and it is found that a geothermal field does last 50 or more years, then it is conceivable that it would be appropriate to reduce the exhaustion allowance but without the allowance now our geothermal exploration and development activities will have to be drastically curtailed.

Statement of C. A. "Mack" McKenney, Director of Legislative Affairs, Non-Commissioned Officers Association of the United States of America

SUMMARY SHEET OF COMMENTS AND RECOMMENDATIONS

The following is a summary of comments and recommendations by subject heading of those prepared by the Non-Commissioned Officers Association of the USA (NCOA) in the attached statement.

A. Retirement Income Credit (Exhibit "A")

Comment: Social security annuities have been adjusted six times in the past 12 years. Those drawing government or State annuities have not received comparable tax relief. Costs of living are continually rising and older Americans are finding it difficult to cope with budget increases. They cannot survive with the present retirement income credit.

Additionally, it is believed that retired military personnel should be permitted to exempt a portion of retired pay to cover contributions made to their retirement system. Military personnel have contributed an "implied" amount, but unlike federal employees cannot deduct retirement contributions from gross income.

Recommendation: Increase retirement income credit to $2,500 for singles and $3,750 for couples, and raise exempt earnings limitations to $2,100 for persons aged 62 to 71, $1,200 for persons under 62, and $2,100 for the $1 for $2 reduction base.

Second, to authorize military retirees to credit 6.5 percent of their military retired pay against adjusted gross income, and if further qualified, continue to compute retirement income credit.

B. Sick Pay Exclusion and Disability Pay (Exhibit "B")

Comment: There are inequities in the sick pay exclusion and disability pay exemption provisions, but there is no justification for Congress to change a 21-year-old law. To do so would perpetrate other injustices on veterans and military retirees who were disabled as a result of service in the U.S. Armed Forces. In fact, those entitled to veterans compensation and military disability retired pay should not be penalized for the privilege of being disabled and drawing disability pay. Congress cannot abandon those whom it called to serve in peace and war. All faced the grim prospect of death, and many were disabled for life as a result of their service to this Nation.

Recommendation: That present sick pay exclusion and disability pay exemptions be retained in law, but amend the applicable provisions so that all military disabled retirees have one common "retirement age"; that military retirees not eligible to receive disability pay from the Armed Forces, but are entitled to and in receipt of VA compensation of 30 percent or more, be authorized to apply sick pay exclusions to the balance of retired pay; and that military retirees not eligible to receive disability pay from the Armed Forces, but have a disability of less than 30 percent, be authorized to exempt that percentage of retired pay from federal income tax.

C. Moving Expenses (Exhibit "C")

Comment: The Tax Reform Act of 1969 accidentally perpetrated an injustice against members of the Armed Forces. This was and is recognized by the Department of Defense and the Internal Revenue Service. The provisions failed to consider that the military member moves more frequently than his or her civilian brother or sister, and has little to say about such moves. The member cannot decline without suffering certain ramifications under the military justice system. In addition, military members are subject to moves within a 50-mile limit and/or the 39-week requirement; move overseas without dependents who are moved to other locations and are not offered a tax deduction for expenses realized in moving those dependents; are forced to vacate quarters prior to a move, but cannot deduct expenses involved; and cannot determine "in-kind" reimbursements since neither the Department of Defense nor the Services are equipped to provide this information to the individual member.

Recommendation: In view of the number of moves involved in a 20- to 30-year career in the Armed Forces, military personnel should be permanently exempt from the requirement to report moving reimbursements and expenses on annual tax returns. It is recommended that Congress adopt the language of section 2, P.L. 93–490, as permanent provisions of title 26, United States Code.

D. Withholding Federal Income Tax (Exhibit "D")

Comment: Because retired military personnel are considered recipients of a wage instead of a retirement annuity, they must file a TD Form W–4 with their military Service. If almost entirely reliant on income from retired pay and entitled to retirement income credit, the military member cannot under present regulations lower his withholding tax to a sum nearer his annual obligated tax. As such, the federal government uses a part of the retiree's pay without the payment of interest, and CPI increases only trigger raises in the amount of taxes withheld.

Recommendation: That the U.S. Armed Forces be directed by Congress to accept Form W–4P from any military retiree who qualifies for the retirement income credit, and to adjust the retiree's withholding tax to an amount closest to his or her estimated obligated tax.

E. Individual Retirement Accounts

Comment: Certain members of the U.S. Armed Forces do not realize vested interests in the military retirement system.

Recommendation: That certain reserves and national guardsmen, and certain regular enlisted personnel of the U.S. Armed Forces, be authorized to established Individual Retirement Accounts.

Statement

Mr. Chairman and Members of the Committee: I am C. A. "Mack" McKinney, Sergeant Major, U.S. Marine Corps (Retired), Director of Legislative Affairs for the 150,000-plus members of the Non Commissioned Officers Association of the USA (NCOA).

On behalf of our President, Mr. James O. Duncan, and the International Board of Directors, I extend appreciation for allowing our representative to appear today before this distinguished panel.

Basically, the membership of this Association—the largest of any enlisted military organization—is concerned with five topics related to the Tax Reform Package. They are:

1—Retirement Income Credit, as noted in Exhibit "A";

2—Sick pay exclusion and disability pay, as referenced in Exhibit "B";

3—Moving expenses as applied to military personnel, and as entered in Exhibit "C";

4—The withholding of certain federal income tax, as referred to in Exhibit "D"; and

5—Allowing certain members of the U.S. Armed Forces to establish Individual Retirement Accounts (IRA). (See Exhibit "E")

It is our belief that because of the circumstances surrounding each of the topics, as they relate to military personnel in particular, and commented thereon in each of the Exhibits or in our opening remarks, this Committee should carefully review the contents and adopt the recommendations offered.

For example, retirement income credit was originally adopted to bring tax relief to those government and State annuitants who were entitled to little or no social security benefits. However, because of frequent increases in social security payments, the retirement income credit is now far from providing an equitable tax relief. We have therefore recommended that the credit be increased.

Additionally, a recommendation is offered that would, if adopted and enacted, provide a retirement credit to military retirees who are not now authorized to exempt any portion of their nondisability retired pay, as presently provided for federal employees, when computing annual gross pay for tax purposes. Contrary to popular belief, military members have contributed an "implied" amount of their wages toward retirement.

In the area of sick pay exclusions and disability pay exemptions, we believe that no rationale exists that will justify the repeal or tightening of the provisions in order to penalize those who now or will be recipients of either veterans compensation or military disability retired pay. If anything, the provisions should be broadened to correct certain existing inequities.

The requirement to report moving reimbursements and expenses by members of the Armed Forces should be repealed. The unusual commitments and inconveniencies forced upon military personnel as a result of movement orders, or on the Department of Defense and the individual Service Departments as a result of certain provisions related to "in-kind" reimbursements, are certainly contrary to the intent of the original law. To apply the law to military personnel would be a grave injustice—one that has already been recognized by the Department of Defense, the Internal Revenue Service, and Public Law 93–490.

And last, we offer a recommendation to amend the regulations so that military retirees living primarily on their military retired pay may adjust their withholding taxes to a more realistic and compatible level. At present, they must use the W–4 Form, which causes the Services to withdraw in certain cases more tax than the retiree's obligated tax at the end of the calendar year.

In closing, I would like to quote the remarks of the Honorable Lee H. Hamilton, M.C., from Indiana. I believe they are not only fitting for any occasion, but particularly more so today when we are considering tax reforms that will be applicable to our veteran and military communities:

"We must never permit the passing of time to obscure or minimize the extent of our gratitude to *all* our veterans. Our country exists today, proud, free and unafraid because of their sacrifices. We have an obligation to them, an obligation recognized by Teddy Roosevelt when he said: 'No other citizen deserves so well of the Republic as the veteran. They did the one deed which, if left undone, would have meant that all else in history went for nothing. *But for their steadfast promise*, all our annals would be meaningless, and our great experience in popular freedom and self-government would be a gloomy failure'." (Italic supplied.)

Thank you for your time and patience, and I will be happy to entertain any questions from the chair or members of the panel.

EXHIBIT "A"

RETIREMENT INCOME CREDIT

The Retirement Income Credit was adopted in 1959 to provide certain retired annuitants with comparable tax relief such as that received by social security beneficiaries.

Payments under the social security program are, of course, exempt from federal income tax. Government pensioners and others with little or no social security benefiits can receive similar tax relief by claiming the credit on retirement income, such as pensions, annuities, interest, dividends, and rent.

The maximum amount for computing this retirement income credit is now 15 percent of $1,524 for single aged persons and $2,286 for elderly couples. However, these amounts have not been updated since 1962 and 1964 respectively. As a consequence, the credit is no longer equivalent to its original benefit.

On the other hand, social security annuities have been adjusted six times during this period to protect certain older Americans from the biting effects of a cruel inflation. Thus, there is a compelling need to improve and update the Retirement Income Credit for retired teachers, policemen, firemen, government annuitants, and certain military personnel so that it might be comparable to the tax relief now offered social security annuitants.

For older persons fighting to stay alive on low or moderate incomes, a new credit level would be most welcome, especially since their purchasing power has been dramatically reduced by soaring costs of living over the last few years.

In a 3-year period, 1971–1973, prices rose an average of 26.2 percent. In 1974 it was 12.2, and it is anticipated that inflation will add another 11.3 percent during 1975. As such, low income consumers, particularly those living primarily on retirement incomes, have found it extremely difficult to cope with budget increases.

For example, we offer a true-life look at the income of a single, enlisted military retiree who lives almost exclusively on his military retired pay, and is entitled to retirement income credit.

In 1972 his adjusted gross income was $3,547 and he paid no federal income tax. The following year his income increased to $3,669, but was now obligated to pay $17 in tax. In 1974 his income moved up to $4,265 and his tax obligation was $117.

What happened was simply this: In a two-year period, his income increased $718, or just a fraction over 20 percent; however, the cost of living jumped 25 percent and his taxes soared from 0 to $117.00. As a result, our retiree came out the loser by some $179 in cost of living increases. (See Figure 1 below.)

FIG. 1

Tax year	Adjusted gross income	Federal tax paid	Percent of inflation rate	Income needed to offset inflation	Amount of reduction in purchase power [1]
1972	$3,547	0	NA	NA	NA
1973	3,669	$17	6.2	$3,760	$108
1974	4,265	117	12.2	4,219	71

[1] Col. 5 minus sum of cols. 2 and 3.

However, if we consider the Consumer Price Index, the purchasing power of the retiree's 1974 income is $188 less than his 1972 income—plus the $117 he lost in tax obligation.

Our retiree's case is just one of many. Older Americans, especially couples, are faced with staggering food and medical costs. They cannot survive with the present Retirement Income Credit. It badly needs updating as quickly as Congress can act.

Therefore, the Non-Commissioned Officers Association of the USA (NCOA) recommends that the Retirement Income Credit be increased from $1,524 for singles to $2,500, and for couples $2,286 to $3,750. This will provide an additional $146 in tax relief for singles and $220 for couples.

Further, the NCOA recommends that the exempt earnings limitation be raised so that, when maximum base is computed for Retirement Income Credit, the ceilings would be:

1—For retired persons aged 62 to 71, $2,100;

2—For persons under 62, $1,200;

3—And for the $1 for $2 reduction, $2,100.

Additionally, the NCOA seeks to provide equity for the military retiree by recommending a change to the present law. We believe that military personnel retired for nondisability reasons should be allowed a Retirement Income Credit equal to 6.5 percent of their military retired pay.

Contrary to popular belief, the Service member contributes just as fully to his or her military retirement as do other government workers. This misconception is fostered by the different methods employed by Congress to obtain retirement contributions from the two groups.

For example, government workers contribute directly to their retirement fund. However, in considering the contribution Congress increased the workers' wages accordingly so there would be no actual loss of pay. In short, the government hiked the workers' pay so that the increase would take care of the contribution.

Military personnel, on the other hand, do not contribute directly to a retirement fund. In their case, Congress set the military members' base pay at a level that "implied" a contributing factor.

Although military members' contributions are not visible, they are just as real as those of any government worker. Anyway you study the two retirement systems, it is obvious that both are completely funded by the federal government.

There are also other differences in the two systems:

1—Government workers may draw their contributions from the fund under certain circumstances; and

2—Retired government workers are not taxed until the full amount of their contributions is returned in retired annuities.

In light of this inequity, the NCOA urges Congress to authorize military retirees to credit 6.5 percent of their military retired pay against adjusted gross pay, and if further qualified, continue to compute the effective Retirement Income Credit as allowed under Section 37, Title 26, U.S. Code.

(Note: All figures have been rounded to nearest $1.)

References: Congressional Record, Vol. 120, No. 4, Thursday, January 24, 1974, pp S 436—S 437. The Washington Post, February 10, 1975 ("Taxes Lead List of '74 Price Rises"). Recession, Inflation, and How to Overcome Both, a study by the Task Force on the Economy of the Coalition for a Democratic Majority. SMSgt. USAF (Retired) (Name supplied upon request). The World Almanac 1975.

Exhibit "B"

SICK PAY EXCLUSION AND DISABILITY PAY

In 1954, Congress recognized the necessity, and perhaps an obligation, to provide tax relief for those who are and were disabled as a result of personal injuries or sickness.

For military personnel, the tax law either:

1—Excluded amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces, pursuant to section 104, title 26, United States Code; and/or

2—For those who retire for reasons of disability, but choose their disability pay to be computed on the basis of years of service instead of percentage of disability, to exclude up to $100 per week of the taxable portion of retired pay as "sick pay" until they reach retirement age, pursuant to section 105 of the same title.

Additionally, section 105 authorizes the exclusion of up to $100 per week for active duty personnel who receive pay for periods of absence from duty by reason of injury or sickness after being in that status for a minimum of 30 days.

In determining the sick pay exclusion for disablement, military personnel must actually be retired for reasons of disability (a minimum of 30 percent) regardless of years of service. Their retired pay must be partially subject to taxation. They must not be employed by the federal government, and they must not have reached retirement age.

Retirement age, however, might be anywhere from 47 to 62, a spread of 15 years, dependent upon the military grade attained and the branch of Armed Forces the member had served in at the time of disablement.

For example: All enlisted personnel, except those having served in the U.S. Coast Guard, reach retirement age as soon as their active service plus retired time equals 30 years. The Coast Guard uses the age of 62 as its retirement age.

In item 2, a young man with less than one year of active service may, upon receipt of an honorable discharge, apply for a VA disability rating, receive 10 percent in compensation, and not have to report such pay on his federal income tax return.

Yet, a military member can be retired with a 10 percent disability, which is not considered a disability per se by the Armed Forces, receive retired pay based on years of service, and not be entitled to claim 10 percent of his retired pay as tax exempt, or apply the sick pay exclusion.

Although we have called attention to a few injustices, the Non-Commissioned Officers Association of the USA (NCOA) does not advocate either the repeal of the provisions covering sick pay exclusions or the tax exemption of disability compensation and disability retired pay, or an amendment that would place the veteran or retired military member in a higher income bracket for tax purposes simply because he or she is in receipt of disability payments.

If Congress should act on either of the two possibilities, further injustices will be perpetrated against deserving veterans and military retirees. First of all, the purchasing power of the two groups will drop dramatically and with dire ramifications, particularly during this period of inflation. Costs of living rose higher in 1974 than in any previous year since 1947. And Labor Department statistics show that the average worker had $4.90 a week less income in September, 1974 than a year earlier—despite wage increases.

To add to the dilemma is the decline of the purchasing power of the dollar. By late 1974, it was worth less than 67 cents in terms of 1967 dollars. In fact, between 1972 and 1974 alone, the dollar value dropped more than 13 cents.

Suppose Congress had done away with the disability pay tax exemption and the sick pay exclusion in 1974. What would have happened?

For other grades the Service departments consider retirement age as follows:

Grade	Army and Air Force	Navy and Marine Corps	Coast Guard
Warrant officers	30 yr or age 62 with 30 yr service.	30 yr or age 62 with 20 yr service.	30 yr or age 62 with 20 yr service.
Male commissioned officers	40 yr or age 60 (with certain exceptions).	40 yr or age 62 (with certain exceptions).	Age 62.
Female commissioned officers	40 yr or age 50	30 yr or age 62	Do.
Commissioned nurses	do	31 yr or age 62	NA.

Almost immediately we recognize an injustice in the regulation covering retirement ages. However, there are other inequities that need to be brought to the attention of Congress. These are:

1—The application of the law pertaining to nondisabled retired members of the Armed Forces who are eligible and receive VA compensation for service-connected causes; and

2—Preferential treatment provided certain veterans over retired military personnel.

For example: In item 1 above, we have a member retiring from the Armed Forces with a 10 percent disability, which is not sufficient to warrant receipt of disability pay. Upon retirement he applies for and subsequently receives a 60 percent disability rating and compensation payments from the Veterans Administration. His retired pay is then reduced by the amount of VA compensation, but is still subject to taxation without application of the sick pay exclusion.

On the other hand, another member of the same grade and years of service may retire with a 30 percent disability, elect to have his disability pay computed on the number of years of service, and then claim 30 percent of that pay as tax exempt, and normally, if in the enlisted or lower officer grades, apply the sick pay exclusion to the remainder of that pay. Therefore, he will pay no tax on his total retired pay.

In the case of a 60 percent disabled military retiree with 2 dependents, who was drawing $7,950 in retired pay and approximately

$16,600 in wages in 1974, he paid some $2,340 in federal income tax and $488 in State (Virginia) income tax. If required to add the full amount of disability pay to his adjusted gross income, his federal and State taxes would have nearly doubled. For federal income tax it would then be $4,466, or $2,126 more, and for State income tax it would be $971, or nearly $483 more. In relation to both incomes, our member would have been penalized almost 34 percent of his retired pay for the privilege of being disabled as a result of service to this Nation.[1]

Nothing could be more unjust except that which might happen to a disabled military retiree entitled to a disability of more than 60 percent but less than 100 percent, who finds employment based on the use of his mental faculties in lieu of physical abilities, has retained himself, and is now the recipient of a fairly decent wage.

The NCOA believes that any disabled person, particularly one who has become so disabled by virtue of service in the U.S. Armed Forces, should continue to have the respect and appreciation of this Congress and all Americans everywhere.

We cannot sympathize with nor understand the rationale of those who would take from our disabled veterans and retired military personnel instead of closing the many tax loopholes that appear to be offered to the Nation's private corporations. If Congress enacted tax reform that provided for an increase in corporate tax equal to that which has been levied upon individual taxpayers, the federal treasury would realize more than $10 billion yearly in additional revenue.

Our Nation and our congressional members cannot abandon those who were called to serve at the will of Congress, or who served or are serving voluntarily to man the defense ramparts, and who subsequently became or become disabled because of that service.

Section 8, Article I of the Constitution provides that: "The Congress shall have power . . . To raise and support armies . . . To provide and maintain a navy . . . To provide for calling forth the militia to execute the laws of the union, suppress insurrections and repel invasions."

And because of congressional actions pertaining thereto, all our veterans and military retirees (some with three wars to their credit) faced the grim prospect of death. Many returned from combat and hostile environments disabled for life.

Can we now turn our backs and ignore their devotion and sacrifices?

And let us not forget that Congress has already reduced the retired pay of military personnel twice in 12 years.

The first time was in 1963 when the recomputation of retired pay law was repealed, and in 1974 when pay increases for active duty personnel were reduced by Public Law 93-419, thereby automatically and simultaneously reducing retired pay for future military retirees.

It appears to the NCOA that Congress should allow the present disability exemptions and sick pay exclusions to remain. However, it is recommended that some of the inequities be removed by amending the provisions of the applicable law to:

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[1] All figures rounded to nearest $1.

1. Establish a 40-year service retirement age for all military personnel drawing disability retired pay under section 105, title 26, United States Code;

2. Allow any military retiree drawing nondisability retired pay, who subsequently receives a 30 percent or more disability from the Veterans Administration and accepts VA compensation in lieu of a portion of his military retired pay, to exclude from his or her gross retired pay a maximum of $100 a week, as now provided in section 105, title 26, United States Code; and

3. Allow any military retiree drawing nondisability retired pay, but having less than a 30 percent disability for the purpose of establishing eligibility for disability retired pay, to declare that percentage (of disability) of his retired pay as tax exempt, pursuant to section 104, title 26, United States Code.

References: 1975 Uniformed Services Almanac. United States Code Service (Lawyers Edition). The World Almanac—1975.

Exhibit "C"

REQUIREMENT TO REPORT MOVING REIMBURSEMENTS AND EXPENSES OF MEMBERS OF THE U.S. ARMED FORCES

The Tax Reform Act of 1969 accidentally perpetrated an injustice against members of the U.S. Armed Forces.

In developing provisions to increase tax revenues related to moving expenses, Congress failed to consider the extraordinary commitments made upon military personnel by their individual Services. The provisions produced inequities that have been recognized by the Department of Defense and the Internal Revenue Service.

The Act of 1969 provided that:

a. Employer contributions to assist an employee to move, whether cash or in-kind, would be treated as taxable income; and

b. Deductions for moving expenses would be limited to moves of at least 50 miles to jobs which are held for a minimum of 39 weeks.

Although the provisions could be compatible with moves made by privately employed persons, who are normally restricted to infrequent movements of households, it created the following injustices for military personnel:

1. *"In-Kind" reimbursements received are not always ascertainable, and are nearly impossible to obtain from the Services.*—Last year DoD noted that: "To set up the administrative machinery necessary to monitor moving expenses would be nearly impossible and would cost $1.8 million with annual operating costs of $6.2 million." (Quoted from Navy Times, August 8, 1974.) Where military personnel are concerned, noted former Congressman Joel T. Broyhill in his Extensions of Remarks published in the Congressional Record of November 15, 1973, "the exact amount allocable to an individual move is not always ascertainable, particularly where transportation of the member, his dependents, household goods, and automobile is provided by government-owned or government-procured facilities, such as Military Airlift or Military Sealift Command." Mr. Broyhill also reported that: "To further compound this problem is the fact that there is not now

a system in existence within the Department of Defense for collecting this data which must be reported to the Internal Revenue Service, with the costs of installing such a system not only considerable but prohibitive when consideration is given to the fact virtually no tax revenue to the U.S. Treasury will be realized through implementation of this system."

2. *No deduction is authorized for expenses incurred for moves under 50 miles.* Military personnel, by virtue of their occupational speciality or the availability of housing, are subject to many moves limited to under 50 miles. For example, a Navy enlisted man may be transferred from sea duty to shore duty in the Norfolk, D.C., or San Diego areas, and his moves might be less than 50 miles. If his dependents are living on one base and he is transferred to another 25 miles away, he must vacate his quarters and move off-base. If he is unable to obtain government quarters on the new base, he may be forced to rent a home nearby, and then move again when base housing becomes available. So, we can have a possible household move three (3) times in a single year, all within 50 miles, and the member must report all cash or in-kind reimbursements as gross income, but is unable to deduct any expenses involved. To allow such an inequity to continue without congressional action, might force the Services to ascertain transfers of personnel over 50 miles so that they would not be penalized under the present law.

3. *No deduction is authorized for expenses incurred under the 39-week requirement.*—Here, the military member suffers again. For example, if a new enlistee is transferred to recruit training and subsequently reassigned to basic and advance schooling in a particular occupational specialty, he could be moved three times in one year and not be afforded the opportunity to deduct expenses involved. In another case, we might find an enlisted man returning from an overseas station, where he was not permitted to take his dependents, assigned to duty under instruction at one U.S. military installation for less than 39 weeks, and transferred at the completion of the course of instruction to another base 3,000 miles in the opposite direction. If his family joins him at the interim installation, he cannot deduct moving expenses. For a better understanding, consider a young Marine corporal, married with one dependent child, who has over 4 years of service. He was stationed with the 3rd Marine Division on Okinawa where his wife was not authorized to accompany him. While overseas, his wife returned to her home town of Indianapolis, Indiana. On orders, transferred back to the United States and to Twentynine Palms, California, to undergo advance schooling for a period of 30 weeks, and then onto Camp Lejeune, N.C. for duty with the 2nd Marine Division. Since his wife and child have not been with him for 13 months, and he will be at Twentynine Palms for another six months, she and the child move to California to be with him. At the end of 30 weeks, he receives his permanent change of station orders to North Carolina. The family moves with him. Under the law, he is directed to report all in-kind and cash reimbursements as gross income. However, he is not permitted to deduct expenses incurred in moving himself or his family to Twentynine Palms, nor will the Service reimburse him for his wife and child's travel to Twentynine Palms. He loses coming and going simply because he is doing what the Marine Corps ordered him to do.

4. *No consideration was made for unaccompanied tours of duty overseas where dependents are moved to a place approved by the Service Secretary, then moved again to join the Service member upon his return to the United States.* As noted above in the example of the young Marine corporal, he was ordered overseas. His wife and child were authorized to move to Indianapolis while he was on Okinawa. After his return, his wife and child subsequently moved with him to Camp Lejeune. Since the Service will move dependents and household effects at government expense from his old duty station to Indianapolis, and upon his return from Indianapolis to Camp Lejeune, he must report the reimbursements as gross income. However, the law does not permit him to deduct expenses involved in both moves related to his dependents.

5. *No deduction is allowable for expenses incurred prior to a move.* It is not inconceivable, and often occurs, that a military member will have to vacate his quarters or lodging prior to the effective date of his transfer. This may happen when base housing is critical, or when a lease terminates. If the member must move to a motel, he is not permitted to deduct expenses even though he is forced to pay extra monies for food and lodging.

Earlier it was noted that the Department of Defense and the Internal Revenue Service recognized the inequities of the law as it applies to military personnel. In fact the IRS has in the past years applied temporary moratoriums so that Congress might react to proposals to change or repeal the law. In 1974, Public Law 93–490 extended the moratorium to January 1, 1976.

In view of the extensive number of movements made by the average military member over a 20- to 30-year career with the U.S. Armed Forces, the Non-Commissioned Officers Association of the USA (NCOA) recommends that the 94th Congress act now to adopt the language of Section 2, Public Law 93–490, as permanent provisions of Title 26, U.S. Code.

The NCOA has reviewed other proposed changes to the law, but believes that because of the unique commitments made upon the military, such changes might perpetuate further injustices.

For example: Would military personnel under orders have to report in-kind and/or cash reimbursements if they are assigned to a hostile area or a combat zone for more than 39 weeks?

References: U.S. Code Service (Lawyers Edition). Congressional Record, Nov. 15, 1973 pp E 7348–7349, Congressional Record, Nov. 29, 1973 pp E 7589–7590.

Exhibit "D"

WITHHOLDING FEDERAL INCOME TAX

In reviewing the method of withholding federal income tax, we find that government pensioners and others in receipt of pensions or annuities are treated in a different manner than military retirees.

The latter group is subject to withholding taxes while the first two groups are not.

Under section 31.3401(a)–1(b)(i) and (ii) of the Employment Tax Regulations, amounts received as retirement pay for service in the

U.S. Armed Forces are wages subject to withholding, unless such pay is excluded from gross income as compensation for injuries or sickness under section 104(a)(4) of the Internal Revenue Code of 1954, or is taxable as an annuity under the provision of section 72 of the Code.

As such, a military retiree drawing nondisability retired pay must file a TD Form W-4 with his or her military Service's finance center. This is the only form a military retiree can submit, and it is used as a basis for determining the amount of withholding tax.

In many cases, there are military retirees living exclusively on their military retired pay with little or no income from other sources. Because of the regulation noted, the retiree is subject to a greater tax withholding than that which he or she would be obligated to pay at the end of a taxable year.

Although the retiree needs the extra few dollars, particularly during these inflated times, there is no way he or she can reduce withholdings to a level comparable to his or her obligated tax. This is true even when the military retiree is entitled to a Retirement Income Credit under the provisions of Section 37 of the Internal Revenue Code of 1954.

For example: If a qualified, single military retiree was in receipt of an annual 1974 taxable retirement income of $3,933, he was entitled to a tax credit of $228.60. However, because his pay is subject to withholding tax, he will have temporarily contributed an amount two to three times greater than his obligation at the end of the taxable year.

He cannot submit a TD Form W-4P to reduce the amount of withholding tax because that form is strictly for the use of annuitants who request federal income tax withholding from their pension or annuity payments. On this form, annuitants can tell their annuity payer the exact amount they wish to have withheld each month. This same form may be used also by an annuitant to reduce the amount of withholding tax requested at an earlier date.

Because of this quirk in tax regulations, our military retiree must continue to use the TD Form W-4. He can claim a special withholding allowance, but the amount is still greater than his tax obligation.

For example, our military retiree in 1974 was obligated to an annual tax of approximately $120, or $10 a month. However, his minimum withholding tax was $23. This reduced his average monthly taxable pay of $321 to a $298 income that should have been $311.

True, the excess withholding tax will be returned at the end of the taxable year. Our retiree could apply this amount to his next annual income, thereby trying to offset the continued excess tax withheld for calendar year 1975. However, there are two inequities that are compounded by this action:

1. The federal government uses part of the military retiree's pension without paying any interest; and

2. As the retiree's pay increases through CPI adjustments, more and more tax is withheld. (For example, for the taxable year 1974, the retiree's withholding tax amounted to 130 percent more than his tax obligation. As of January 1975, it had increased to an estimated 180 percent.)

In light of the inequities created by the tax treatment of retired pay of military personnel, the Non-Commissioned Officers Association of the USA (NCOA) recommends that the U.S. Armed Forces be directed by Congress to accept Form W-4P, Annuitants' Request for Federal Income Tax Withholding, from any military retiree that qualifies for the Retirement Income Credit, and to adjust that retiree's withholding tax to an amount closest to his or her obligated tax.

(Note: All monetary figures above have been rounded for easier comprehension.)

References: Internal Revenue Service. SMSgt. Armando P. Pasquini USAF (Retired), Milton, FL.

Individual Retirement Accounts

The Association invites the panel's attention to SEC. 1502 of H.R. 10612, page 375, describing the limitations and restrictions on Individual Retirement Accounts. Under proposed Section 220(b)(2). "No deduction is allowed . . . for an individual for the taxable year if for any part of such year he was an active participant in a plan established for its employees by the United States . . . etc."

Under the interpretation, it appears that all military personnel have a vested interest in a retirement plan established by the federal government. In the case of regular and certain reserve commissioned and warrant officers, this can be a true adaptation. Most are entitled to certain financial benefits (severance or readjustment payments) once they have performed a minimal but designated period of continuous active duty as prescribed by law. However, reserve and national guardsmen (excluding certain technicians under civil service/military statutes), both officer and enlisted, and all regular enlisted personnel (except those without component) have no more than a promise that they will be entitled to a vested retirement plan. Reserves and national guardsmen must reach their 60th anniversary to be entitled to retired pay. Regular enlisted personnel must serve a minimum of 20 years of active duty. Other than disability retired pay for regular enlisted personnel, which is not affected by existing law, these men and women of the Armed Forces may be removed from their Service at any time before meeting retirement eligibility and not be entitled to any pension whatsoever. Therefore, we believe that these members of our military services should be authorized the entitlement to establish their own voluntary Individual Retirement Accounts. The NCOA urges this panel to amend the proposed legislation so that reservists and national guardsmen (receiving drill pay and/or retirement credits) and regular enlisted personnel would be entitled to establish IRA's under the purview of SEC. 220 of H.R. 10612.

Statement of the American Hospital Association

Mr. Chairman, the American Hospital Association represents some 7,000 hospitals and other health care institutions and over 20,000 personal members. The great majority of our member institutions are nonprofit hospitals. We appreciate this opportunity to place before you and the members of your Committee our views and recommendations with regard to some of the provisions of H.R. 10612 that relate to charitable contributions to the nation's nonprofit health care institutions. We shall also urge amendment of Section 501(e) of the

Internal Revenue Code for the purpose of accelerating the formation of cooperative hospital service organizations, and we will comment on a number of other tax issues we understand the Committee is likely to consider that could affect charitable giving to health care institutions.

Hospitals and the Delivery of Health Care

In our and other civilized societies, hospitals are the primary resource for care of the sick and are centers of health care in their communities. Nations have met their obligation with respect to the development of hospital facilities and hospital care in different ways. Some have developed systems that are the complete responsibility of the government. The government builds the hospitals, operates them, and appropriates tax funds to pay for their operation. Nothing is left to the voluntary efforts of individuals. However, in the United States, we have followed a different approach—a pluralistic approach that includes development of nonprofit hospitals and other health care institutions, as well as facilities that are owned by Federal, state, or local governments, and for-profit (investor owned) institutions.

According to *Hospital Statistics, 1975*, over 86 percent of the nation's 6,787 non-federal hospitals registered that year are nonprofit institutions. These 5,887 nonprofit hospitals provided 94 percent of the total hospital beds in the country. They provided the services for 92 percent of the 33,665,575 admissions and over 95 percent of the 201,799,022 outpatient visits reported by non-federal hospitals for 1974. The predominant role of community service general hospitals in providing health care to the people of the nation is clearly evident.

The Role of Philanthropy in the Development of Nonprofit Health Care Facilities and its Continued Importance

Most of the nation's hospitals were originally organized, constructed and equipped, either wholly or in part, with charitable contributions from the public. This has been true from the very beginning of our country. In fact, the initial impetus for establishing hospitals was the need to provide care for the poor. The first incorporated hospital in America, Pennsylvania Hospital in Philadelphia, was founded in 1751 to treat patients that were referred to it from the first almshouse established in America. Benjamin Franklin, who believed in a collective voluntary approach to meet community needs and problems, played a key role in the hospital's establishment and in raising funds to support it. In the early 1800's charitable gifts were often solicited from the public in the form of organized fund drives to support churches, schools, and hospitals, and for the relief of paupers. Local giving to support local hospitals serves to strengthen community self-determination and this provides a sound ideological reason for encouraging such philanthropy.

Nonprofit health care institutions throughout the country, which constitute the vast preponderance of our health care resources, continue to rely on charitable contributions not only to help meet the increasingly large capital expenditures required to build and equip hospitals, and to provide for care of indigents, but also to help finance health manpower training, medical research, and health education and promotion programs. I would point out, too, that governmentally owned and operated hospitals often receive charitable donations that supplement the tax funds provided such hospitals and enable them to provide more adequate care.

Private philanthropy, in the case of hospitals, not only helps to assure that health care facilities and services will be available when needed, but also that the cost of services will be less than if the hospitals had to rely entirely on debt financing without any donated funds. The cost of government programs such as Medicare and Medicaid would also be higher if hospitals and other health care institutions received no charitable gifts and bequests.

Another principal focus or private philanthropy in the health field is to provide venture capital to support new and innovative projects and ideas. To quote a recent health study completed for the Filer Commission on Private Philanthropy and Public Needs, "A new idea stands a better chance of survival in a social system with kinds of initiative and decision." Some ideas stand a better chance of success and growth in the nonprofit sector. The Report continues, "The development of the early types of both health maintenance organizations and the physicians' assistants (paramedical aides) programs would never have survived if they had required public sector consensus and support."

In some instances, the limits of authorizing laws and government spending policies preclude the use of tax dollars for innovative projects and experiments in the health care field, and the need for private philanthropy for such purposes may well grow in the future.

I must also cite the fact that when nonprofit hospitals incur operating losses, particularly hospitals serving poor and medically indigent patients who have no private or government health insurance coverage, it often becomes necessary for such hospitals to look to public donors to provide funds to keep the hospital financially viable and enable it to maintain its services.

As you know, the Filer Commission on Private Philanthropy and Public Needs submitted its report entitled "Giving in America" to the Congress and the Secretary of the Treasury just last December. Based on over 75 research studies the Commission found that, allowing for inflation, charitable giving in America is off and has not kept pace with the growth of the economy in the 60s and 70s. According to a Commission-sponsored study, philanthropy dropped 15 percent between 1960 and 1972 as a proportion of personal income. The Report concludes that virtually every barometer indicates that philanthropy is in serious trouble.

Government Policies to Encourage Private Philanthropy

Congress has recognized that charitable contributions from the public serve to remove a burden from government. Only four years after the first income tax became law, provisions were put in the tax laws to encourage the generous impulses of society through establishment of deductions from taxable income for contributions made by taxpayers in support of religious, charitable and educational activities. Through the years, numerous changes have been made in the income tax laws, but incentives to charitable giving have been maintained.

The charitable contributions deduction provided in our tax laws is not a "tax loophole." It is quite different from most other tax deductions and tax preferences. Other deductions generally relate to expenditures the taxpayer makes for his own benefit, such as, interest paid on a mortgage or other loan, medical expenses, state taxes, union dues and business and professional expenses. On the other hand, charitable contributions do not inure to the benefit of individuals, and the donor's tax saving is always less than the amount of his charitable contribution. Thus, the taxpayer is always ahead financially by not making a charitable donation.

Should Congress act to reduce tax incentives for charitable giving or impose a transfer tax on gifts or bequests to charitable organizations, this would in effect constitute an indirect tax on such organizations—organizations that have already been found by the Internal Revenue Service to meet the requirements for tax exemption in the public interest. Any such actions would be a drastic reversal of the policies of the Federal government over the past 60 years.

I wish now to comment on three specific issues or proposals that relate to charitable donations or bequests.

The Charitable Contribution and Minimum Taxes

Last year, the House, in passing H.R. 10612, reject the Treasury Department's proposal for a new alternate minimum taxable income program (MTI) and voted instead to continue with some revisions the existing minimum tax, which is an additional tax Congress enacted in 1969 to ensure some taxes are paid on tax preference income. It affects mainly individuals with high incomes. Since the changes H.R. 10612 would make in the present minimum tax do not include any requirement for allocation of deductions between taxable and non-taxable income and do not eliminate deductions of the full fair market value of "appreciated property" donated to public charities, it appears the bill leaves incentives for charitable giving to hospitals and other public charities largely unchanged.

The MTI proposal the Treasury Department made in 1973 did not allow for deductions of charitable contributions and this would surely have a significant adverse effect on charitable donations by reducing or eliminating the incentive the deduction provides. The House Ways and Means Committee, in 1974 when it made a tentative decision to adopt the MTI concept, voted to put charitable deductions entirely outside the scope of MTI. The Treasury Department, last year, stated its acceptance and support of that House Committee action to retain the full charitable deduction under the MTI concept, citing the dire financial position in which inflation has left so many private charities.

As stated, the House has now, with its approval of H.R. 10612, voted to modify the existing minimum tax instead of adopting the alternate MTI concept. When he testified before your Committee on March 17 this year Treasury Secretary Simon recommended enactment of a modified MTI plan that he said completely avoids all impact on charitable contributions. We believe on the basis of preliminary computations that the Secretary is correct in stating that "under no circumstances can the MTI adversely affect contributions," except, of course, to the extent that a taxpayer subject to the alternate tax would have less income remaining to contribute to charitable organizations.

Our concern with regard to the modification of the existing minimum tax or adoption of the MTI concept is ~~that~~ full deductions for charitable contributions be preserved.

Recommendation: That full deductions for charitable contributions be preserved in connection with any modification of the existing minimum tax or the adoption of the MTI concept.

Proposals to Tax Unrealized Appreciation of Property Donated to Charities

Under present law, taxpayers are permitted in preparing their income tax returns to deduct the fair market value of property donated to a nonprofit hospital or other public charity. In many cases the owner's original acquisition cost of the donated property is less than its current market value. Such gifts of land and other "appreciated property" are frequently of special importance to hospitals in terms of the gifts themselves, and as pace setting gifts or "seed" money to encourage other gifts or funding assistance.

If Congress were to change the existing law and allow, in such cases, a charitable deduction that is less than the fair market value of donated property, the result could well be that many individuals who otherwise might make such gifts would simply decide not to do so and thus severely diminish philanthropic support for hospitals.

Recommendation: That the deduction allowance for property donated to public charities continue to be the fair market value of such property.

Proposals to Limit the Estate Tax Deduction for Charitable Requests

Present tax laws also allow deduction of charitable bequests to hospitals and other public charities in computing the gross amount of an estate for purposes of the Federal estate tax. Placing a limit on such deductions would surely decrease the total amount of charitable bequests to hospitals.

Further, with regard to suggestions that a tax be imposed on the appreciated value of property upon the owner's death, we wish to note that without an exemption from such tax for property passing to hospitals or other nonprofit charitable organizations, hospitals would suffer a double blow from the tax. That is, the amount of funds available to hospitals from charitable bequests would be less as a result of the tax itself, and we fear there would also be a reduction in the size and number of such bequests.

Just as the charitable contributions deduction in computing income taxes is a spur to philanthropy, the charitable bequests deduction in computing Federal estate taxes is an impetus to bequests to hospitals. Preserving philanthropy in the health field will help nonprofit hospitals to meet their responsibilities to the communities they serve and to survive in a system that permits private citizens to participate in decisions affecting their health care.

Recommendation: That no limit be placed on the allowance for charitable bequests in connection with determination of Federal estate taxes.

Mr. Chairman, our testimony to this point constitutes an urgent plea and appeal that no changes be made in the tax laws that would weaken incentives for charitable donations and bequests to health care institutions.

Amendment of Section 501(e) of the Internal Revenue Code

The American Hospital Association has for many years urged hospitals to share services in order to hold down capital expenditures and otherwise achieve a more economical operation. The meaning of the term "shared services" in the hospital field is widely understood to be services that are provided as the result of two or more hospitals or other health care institutions combining their resources to better serve their patients. Such shared services can encompass both administrative and clinical functions. What we are talking about is simply two or more health care institutions acting jointly to provide better or more economical health care services. Let me emphasize that the rationale for such shared services is the resultant improvement in the accessibility and quality of care and the economics of scale that can be attained through such joint activities. Cost-savings thus made can help to restrain charges to self-pay hospital patients and third party payors, including the government as the purchaser of services for beneficiaries of the Medicare and Medicaid and other Federal programs.

In 1968 Congress enacted legislation to accord tax-exempt status to cooperative hospital service organizations that are operated solely to perform certain services on a centralized basis for their nonprofit hospital members. The purpose was to encourage formation of such organizations to provide cost-savings and other benefits to such hospitals and their patients. The provision, which became Section 501(e) of the Internal Revenue Code, was included in the "Revenue and Expenditure Control Act of 1968." As originally approved by the House of Representatives, the provision would have authorized such cooperative hospital services organizations to perform for their members any service the members could perform for themselves in exercising or performing the purpose or function constituting the basis of their tax-exempt status.

In the Senate questions were raised about the effect of the provision on laundries in some parts of the country and a compromise was worked out to exclude laundry services from the activities 501(e) organizations may perform.

Pursuant to Section 501(e) cooperative hospital service organizations have been established throughout the country to perform a variety of services for hospitals. Group purchasing of medical and surgical supplies and accounting and bill collecting services have been particularly successful shared services activities, but the list includes many other categories of services. The benefits hospitals have derived from membership in such organizations include: (1) a savings of capital funds; (2) lower operating costs through greater efficiency; and (3) better quality and improved availability and accessibility of services. In a number of cases, such organizations provide services that are, in fact, not available from regular commercial sources and must therefore be provided by each hospital for itself or through a cooperative arrangement with other hospitals.

A shared services organization which provides a variety of services including a credit and collection program to six hospitals has reported estimated savings of $173,000 from that program alone for one year. Another shared services organization reports savings of $614,000 for its 21 member hospitals for the period 1972–75 through its purchasing programs that include pharmacy supplies and intravenous solutions. The third example I will cite is an organization that achieved estimated savings of approximately $300,000 yearly for its four hospitals through group purchasing and shared training, education, and equipment contracts. In addition, this organization has recently spent $500,000 to initiate a shared brain scanner service for the hospitals in its area. Three hospitals in the area had been exploring the establishment of their own brain scanner service, and the action of the shared service organization thus avoided the potential expenditure of $1 million in start-up costs, will provide annual savings in operating costs.

Although not permitted under Section 501(e), central laundries to serve hospitals and other health care institutions are generally recognized as offering many benefits and advantages over individual hospital laundries, and over many commercial laundries that, if available at all, may not provide the type and quality of specialized service that hospitals require. The benefits health care institutions derive from an efficiently managed central laundry include the avoidance of capital expenditures for unnecessary duplication of facilities, the freeing of space for other use in each hospital that does not have to maintain its own laundry, reduced operating costs through the greater efficiency of a large laundry as compared to smaller individual hospital laundries, and improved sanitation and quality controls. Relieving hospital officials from responsibility for operation of a laundry, which is a job more appropriate to business trained personnel that large central laundries can afford to employ also leaves hospital officials more time to devote to patient care. These considerations, together with the unavailability in some areas of commercial laundry service that meets hospital standards, have led to formation of cooperative hospital laundries in some localities under the regular cooperative or other provisions of the Internal Revenue Code. Such non-501(e) organizations may be liable for sizable state and local taxes.

We are confident that excluding laundry services from Section 501 (e) and the liability for state and local taxes that may accompany this exclusion have slowed the growth of cooperative laundries to serve hospitals. Amending the law to include laundry services would, in our view, be in the public interest by accelerating the formation of cooperative laundries to serve hospitals and helping them to deliver better health services more economically.

Recommendation: That Section 501(e) of the Internal Revenue Code be amended to include "laundry services" among the activities cooperative hospital service organizations may perform for their members.

Questions have been raised as to whether certain activities that are customarily referred to as "clinical services" are activities that 501(e) organizations are permitted to provide their members. Clinical services are those services that are normally involved with the direct delivery of patient care. Apart from referrals and purchased services, a group of health care institutions may find it mutually advantageous to jointly control and operate a shared service program involving a few or many of a rather long list of clinical services. As examples, let me cite computerized head and body scanning devices such as the brain scanner service I referred to earlier which involves the use of very expensive equipment; multiphasic screening; electroencephalography; radiotherapy and chemotherapy; and pharmacy and physical therapy services.

From the legislative history of Section 501(e) we understand that Congress intended to permit a comprehensive range of both administrative and clinical activities to be performed by 501(e) organizations, but to exclude laundry services. Amending the law to specifically include "clinical services" would clarify and remove uncertainty as to whether some kinds of clinical services such as I have cited are activities that 501(e) organizations may perform for their members. Such an amendment would encourage greater use of cooperative organizations to provide a wider range of clinical services and thus more effectively implement the original aim of Section 501(e).

Recommendation: That Section 501(e) of the Internal Revenue Code be amended to include "clinical services" among the activities cooperative hospital service organizations may perform for their members.

A further change we are seeking in Section 501(e) relates to skilled nursing facilities. As your Committee is aware, the Social Security Act in Section 1861(j) defines in great detail the term "skilled nursing facility" for purposes of the Medicare program. Such facilities. even if they are 501(c)(3) nonprofit institutions, may not, under present law, participate in 501(e) organizations. We think such nonprofit skilled nursing facilities should have the same opportunity that nonprofit hospitals have to achieve savings in their operations and to improve the quality of their services through participation in 501(e) organizations. Again, such an amendment would ultimately benefit the patients of such facilities and the public.

Recommendation: That Section 501(e) of the Internal Revenue Code be amended to permit skilled nursing facilities as defined in the Social Security Act that also are nonprofit institutions to participate in 501(e) organizations.

Our recommendations for amending Section 501(e) of the Internal Revenue Code can be carried out by simply adding the words "laundry services, clinical services," after the word "food," in 501(e)(1)(A); and by inserting after the word "hospitals" in 501(e)(1)(B) the clause "or skilled nursing facilities as described in Section 1861(j) of the Social Security Act that are also organizations described in subsection (c)(3) and exempt from taxation under subsection (a)."

With regard to various other issues we anticipate the Committee is likely to consider, the Association offers the following comments and recommendations.

Declaratory Judgments for Exempt Organizations

We fully support Section 1202 of H.R. 10612 to provide a declaratory judgment procedure for court determinations of the status of organizations seeking tax-exempt status under Section 501(c)(3), status as an eligible charitable contribution donee, or status as a private foundation or private operating foundation.

At present, organizations do not have the right to seek court review of a denial or revocation of such exempt status except in the highly unlikely circumstance that the anti-injunction provisions of the Internal Revenue Code do not apply. The Supreme Court, in the *Bob Jones University* and *Americans United, Inc.* cases, readily recognized the injury (loss of donations as well as liability for tax payments) that can befall an organization whose application for exempt status is denied or revoked. Surely a timely judicial review procedure should be afforded as a remedy in such case, but as a practical matter, no such remedy is now available.

Further, giving organizations that seek such declaratory judgments access to Federal district courts as well as the U.S. Tax Court (as is provided in Section 1202 of H.R. 10612) would ensure reasonable geographic accessibility of the remedy for organizations that are located away from Washington where the Tax Court sits. Many charitable organizations depend on current contributions from the general public to carry on their charitable activities, and litigation concering an organization's eligibility to receive deductible charitable contributions will, of course, likely slow down or even bring to a halt such contributions. Therefore, we also support giving limited protection to the deductibility of contributions made to an organization during any period of litigation that follows revocation of its exempt status, as is provided in the House-passed provisions.

Recommendation: That the Committee approve Section 1202 of H.R. 10612 as passed by the House of Representatives.

Extension of Transitional Rule for Charitable Remainder Trusts

The Association supports legislation along the lines of Senator Curtis' bill, S. 2602, to extend for two years a transitional rule under which certain charitable remainder trusts may be amended or modified to conform to the strict requirements of the Tax Reform Act of 1969. Congress has already recognized that applying those requirements to wills and trusts drawn without contemplation of the 1969 Act would likely decrease the flow of philanthropic gifts to 501(c)(3) hospitals and other public charities, despite the clearly expressed desire and intent of the donors in their wills and trusts. Public Law 93-483 which was enacted in 1974 created a transitional rule that permitted, until December 31, 1975, amendment or revision of charitable remainder trusts drawn before September 21, 1974, in order to bring them into compliance with the 1969 requirements. This rule has now expired, but there are no doubt many such nonconforming wills and charitable remainder trusts not yet discovered. Also, the fact that the Treasury Department did not issue proposed regulations for implementing the transitional rule (Sec. 2055(e)(3) of the Internal Revenue Code) until December 1975, just prior to its expiration, has we are told, served to postpone and delay revision of such trusts in some cases. We believe an additional two-year extension of the transitional rule is appropriate to help ensure nonprofit hospitals and other public charities receive the benefits intended for them under certain wills and trusts.

Recommendation: That Section 2055(e)(3) of the Internal Revenue Code be amended along the lines of S. 2602.

Non-taxation of Forgiven Student Loans

A number of Federal and state programs aimed at increasing the supply of health manpower and helping to correct the maldistribution of health care personnel contain provisions for forgiveness of student loans in whole or part for service in medically underserved areas by the student after he completes his training. Some nongovernmental loan programs established by charitable foundations contain similar provisions. The International Revenue Service has ruled that any amount of a student loan that is forgiven must be treated as taxable income by the loan recipient. This ruling, it seems to us, is hardly in accord with the purpose and spirit of the forgiveness provision. Accordingly, the Association favors enactment of legislation to exclude from taxable income the amount of any student loan that is forgiven for the rendering of health care in a medically underserved area. The purpose of such forgiveness is, of course, to help attract health manpower to those areas, both urban and rural, that do not have sufficient health manpower resources for the delivery of adequate health services in their area. Such health manpower shortage areas are designated from time to time by the Secretary of Health, Education, and Welfare. The amendment we are recommending would merely serve the same purpose as the basic forgiveness provision, and would not involve any substantial loss of tax revenues.

Recommendation: That the Internal Revenue Code be amended to exclude from taxable income the amount of any student loan that is forgiven when the student following completion of his course renders health services in a medically underserved area as designated by the Secretary of Health, Education and Welfare.

Reduction of Excise Tax on Investment Income of Private Foundations

The Association recommends a reduction of the current 4 percent excise tax on investment income of private foundations to a rate that more realistically reflects the actual costs to the Treasury Department of regulating and auditing such foundations. Such was the original purpose of the tax, according to our understanding. The Treasury Department has reported that the 4-percent rate has produced revenues far exceeding such costs and the Department therefore is supporting a tax rate of 2 percent as adequate for this task. Such a change would enable private foundations to provide more support for charitable activities. Further, we urge that the funds derived from this tax be recorded and compared to the cost of regulating and auditing foundations, in order that Congress can arrive at a more accurate determination of what the excise tax should be in the future. Senator Hartke's bill, S. 2348, embodies these changes and we support it.

Recommendation: That Section 4940 of the Internal Revenue Code be amended to reduce the excise tax on investment income of private foundations from 4 percent to 2 percent; also that the Treasury Department be required to advise Congress annually the amount of taxes derived from this provision and the cost of regulating and auditing foundations.

Modification of Charitable Distribution Requirements Imposed on Foundations

The Association supports the modifications proposed in Senator Curtis' bill, S. 2475, with regard to the mandatory distribution requirements imposed on foundations by the Tax Reform Act of 1969. That bill would amend Section 4942(e) of the Internal Revenue Code by superseding the "minimum investment return" provision of the Code for purposes of the tax on failure to distribute income, which is defined as a specified percent of the net fair market value of the foundation's investment assets. This percentage was originally set at 6 percent in 1970 and has since been maintained at that rate by the Treasury Department. Experience has shown that this figure is too high and that a rate of 5 percent would be appropriate as a means of inhibiting private foundations from accumulating rather than distributing their incomes to charitable donees. Further, we believe that the authority of the Treasury Department to determine the mandatory distribution rate should be withdrawn. A payout requirement that is too high poses a threat to the viability of private philanthropic foundations and thus hurts charitable organizations that look to these foundations for support. In our view, this is a matter over which Congress should retain control.

Recommendation: That Section 4942 of the Internal Revenue Code be amended along the lines provided in S. 2475.

We appreciate the opportunity to present this testimony on various tax issues and will be pleased to respond to any question from the committee concerning the Association's views and recommendations.

Taxation of Foreign Source Income

Statement of Tom C. Frost, Jr., Chairman of the Board, Frost National Bank, San Antonio, Tex.

I am Tom C. Frost, Jr., chairman of the board of Frost National Bank of San Antonio, Tex. I appreciate the opportunity to submit my statement to this committee in support of provision 1041 of H.R. 10612 exempting from income tax the interest paid on deposits by commercial banks to nonresident aliens not doing business in the United States. This provision also exempts these deposits from estate taxes.

This legislation is important not only to the individual banks in the major money centers and in locations bordering Canada, Mexico, and the Caribbean who receive the deposits, but also to the economies served by these banks. As evidence of the significance of this, the American Bankers Association in testimony before the House Ways and Means Committee in support of this legislation on July 9, 1975, estimated these deposits at approximately $6½ billion. I personally can testify to the significance of these deposits to the economy of San Antonio and south Texas. During my 26 years of banking experience in this market and through conversations with bankers in other areas such as Florida, Arizona, and other money centers, I have observed that these deposits have been a good stable base for the extension of credit to domestic customers.

This exemption from taxes has been in effect since 1921 and was on a permanent basis until 1966. For the last 10 years Congress has recognized repeatedly the benefit of these funds to our domestic economy and the need to maintain this exemption to protect this source of deposits by several extensions of the law.

Previous congressional action is consistent with the conclusion that these deposits would not remain deposited with domestic banks in the United States without this exemption since other countries whose banking systems and economies are attractive to the potential depositors do grant similar exemptions. I refer to the United Kingdom, Canada, the Bahamas, Switzerland, Belgium, Germany, and the Netherlands as examples. Legislative action has supported the position that if the normal withholding taxes are extended to the interest earned on these deposits and estate taxes are levied on them upon death of the depositor that a significant amount of these deposits would leave this country and their benefit would be lost to us. In considering the extension of this law on previous occasions, Congress has also concluded that the outflow of these funds would cause a significant adverse affect on the balance of payments.

Ten years of repeated extensions have caused the depositors of these funds to be aware of these expiration dates. These deposits are now more sensitive than before to this exemption from taxes. Our bank

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has had direct experience with depositors who are carefully renewing their time deposits to mature within the present expiration date, December 31, 1976. In conversations with other bankers, similar experiences are occurring. It can be seen that a good and continuous stable deposit source has been affected adversely.

Many depositors are carefully reconsidering the redeposit of these funds because of the expiration of this law. These moneys then must be treated in a different light by the bankers who receive them. We in San Antonio and many banks in Texas have had a stable and normal source of funds from citizens in Mexico and have used these deposits to finance needs in the local economy. Under the present circumstances with the exemption from taxes on these deposits not on a continuous basis, we may have to look upon them as less permanent and stable. Thus they might not be used for the same long-term beneficial credit purposes if the exemption from taxes is not made permanent.

It is my opinion and the opinion of many other bankers involved in dealing with these funds that little additional revenue, or none at all, may be gained by taxing this source. First, a significant amount of the deposits would leave and would not be subject to any tax whatsoever. Second, the banks which handle these deposits could not gain a profit on those deposits which were withdrawn thereby reducing the taxes which might be paid by the recipient bank.

Next, any jeopardy of these funds penalizes the smaller banks without offshore operations to a greater extent than those larger banks in the major money centers who could entice their depositors to transfer these funds to a foreign branch in a country which does grant the exemption on a continuous basis. Foreign branch funds currently are not recycled to the domestic economy but are lost to the United States. The result would be an inequity favoring the larger banks.

It is my understanding that this committee may be asked to consider a proposal to exempt from taxes the income from certain other portfolio investments such as stocks and bonds held by nonresident aliens. I would like to point out that my remarks are directed to the making permanent an exemption which has existed since 1921 on the passive and short-term vehicle of commercial bank deposits only.

I should like to submit to you for your records as additional information in support of provision 1041 of H.R. 10612 a letter dated November 28, 1975, from Max Mandel, chairman of the executive committee of the Laredo National Bank, Laredo, Tex., to Senator Russell B. Long, chairman of the Finance Committee.

In conclusion, I ask that you agree that provision 1041 of H.R. 10612 is beneficial to the general domestic economy of the United States and that this provision be adopted by the Senate as passed by the House so that the exemption is on a permanent basis without an expiration date. I would also respectfully suggest that reasonably prompt action is needed since the present exemption expires December 31, 1976. At this time banks are experiencing a reluctance on the part of depositors to extend time deposits to mature after this date.

I will be happy to attempt to answer any questions or obtain any additional information which you might desire. Thank you for the privilege of appearing before you.

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

DEAR MR. CHAIRMAN: This letter is submitted as a written statement for the record of the public hearings before the Committee on Finance, relating to H.R. 10612.

Section 960 of the Internal Revenue Code of 1954 should be amended so that the "deemed-paid" credit provided thereunder is extended to foreign taxes paid by third-tier foreign subsidiaries.

Congress, when it enacted section 960 as part of the Revenue Act of 1962, intended the provision to be consistent and parallel with section 902, as regards the level of foreign corporations to which the "deemed-paid" foreign tax credit would be available, as well as the required percentage of ownership in such corporations. At that time, both sections extended the credit no further than second-tier foreign corporations. In 1970, however, section 902 was amended to permit, in the case case of actual dividend distributions, a credit for foreign taxes paid by third-tier foreign subsidiaries and the required percentage of ownership was changed. No conforming amendments were made to section 960.

All of the reasons relied upon by Congress in 1970, when it extended the section 902 credit to the third-tier, are equally applicable to section 960. To restore the intended consistency to the law and provide equity for similarly situated taxpayers, the American Institute of Certified Public Accountants has recommended that section 960 be extended to third-tier foreign subsidiaries to conform to section 902.

Failure to extend the section 960 credit to the third-tier constitutes not only an unintended penalty on subpart F income, but also a selective penalty applicable only to those U.S. companies with third-tier foreign subsidiaries and not to others with equal or greater amounts of subpart F income. Because of business considerations not within their own control, many U.S. companies find themselves with the loss of substantial foreign tax credits because they are forced to operate through third-tier foreign subsidiaries.

Failure to allow a foreign tax credit at the third-tier places artificial limitations upon U.S. companies that can adversely affect the ability of U.S. companies to enter or maintain foreign markets. For a variety of reasons, U.S. companies are increasingly finding it necessary to enter new foreign markts through third-tier forign subsidiaries. In doing so, U.S. companies must compete against companies of other countries which either: (i) exempt foreign earned income from domestic taxation; or (ii) provide a "deemed-paid" foreign tax credit regardless of the number of intervening foreign corporations between parent and foreign subsidiary.

For all these reasons, the present technical deficiency in the Internal Revenue Code should be corrected by an amendment to section 960 to permit a "deemed paid" foreign tax credit for foreign income taxes paid by a third-tier controlled foreign corporation with respect to subpart F income, subject to the same percentage of ownership requirements as now contained in section 902.

Respectfully submitted.

PETER L. BRIGER.
ERNEST S. CHRISTIAN, Jr.

STATEMENT OF INTERNATIONAL BUSINESS MACHINES CORPORATION

SUMMARY OF KEY POINTS

1. IBM invests abroad to serve overseas markets. Our choice is to invest abroad or forego the bulk of the overseas marketplace to foreign computer manufacturers. Foreign investment does not displace domestic investment, since it would not be feasible in most cases to serve foreign markets entirely through exports from U.S. factories. IBM, like most other U.S.-based international corporations, continues to be a net exporter from the United States—in the amount of $343 million in 1975. These exports support substantial U.S. employment, estimated last year at one of every five jobs in IBM's domestic manufacturing facilities.

2. IBM has also contributed substantially to the U.S. balance-of-payments. The company's income from direct investment abroad, including royalties and fees, exceeded investment outflows by $5.7 billion from 1965–74.

3. During the past decade, IBM paid $11.0 billion in taxes to the United States and foreign governments on pretax earnings of $22.8 billion—an overall tax rate of 48.4 percent. In the United States, including State and local income taxes, IBM's effective tax rate is 55.5 percent; and if payments of State and local property taxes are included, the effective rate in the United States is 62.7 percent.

4. IBM's foreign operations result in substantial taxes collected by the U.S. Government. Examples: IBM has paid cash dividends of about $3.7 billion in the period from 1971 through 1975, more than half of which was supported by overseas earnings. Taxes paid by our stockholders on these, plus income taxes paid by IBM employees working on exported products results in substantial tax revenues for the U.S. Treasury.

5. Replacing the foreign tax credit with a deduction would raise domestic tax rates on the overseas activities of U.S. firms to about 75 percent and would destroy the ability of these firms to compete internationally. Repeal of the overall method of computing the credit would add about $20 million annually to IBM's tax burden and would tend to cause business investment decisions to be unduly influenced by tax considerations.

6. Elimination of tax deferral would result in an additional $50 million a year initially and more later in IBM tax payments. The change in U.S. tax laws would infringe on existing tax treaties and result in a sharp increase in dividend withholding taxes imposed by foreign governments. As a result, virtually all of the additional taxes paid by IBM and other companies would go to foreign government treasuries; almost none would go to the U.S. Government.

7. Either of these proposed changes would seriously weaken the ability of IBM and other U.S. firms to complete successfully in the international marketplace. No other country imposes such penalties on its international companies; indeed, all others seek to encourage the effectiveness of their commercial enterprises abroad.

IBM Views on Proposals Affecting Taxation of Foreign Income

As the Senate Committee on Finance completes its consideration of H.R. 10612, the Tax Reform Act, International Business Machines Corp. is pleased to submit the following statement regarding proposed modifications in the taxation of foreign source income.

Economic Role of International Firms

The Finance Committee is well acquainted with numerous studies—most notably the 1973 Tariff Commission and Commerce Department surveys—which prove conclusively that U.S.-based international firms are net assets to both the United States and international economies. We believe that by any objective analysis, IBM's performance illustrates the benefits of foreign operations to the U.S. economy and American workers.

Our experience in international trade has taught us one very important point—the economies of the world's industrial democracies are interdependent. Whether the reason is dependence on imports of raw materials, food, fuel, finished products, or technology—or on exports of these—interdependence is an economic fact of life.

No major economic event can fail to have an effect on the United States. Conversely, none—including congressional actions—can fail to affect other nations. If IBM were forced to manufacture solely within the United States for export abroad, foreign governments would inevitably retaliate against our overseas business. In the simplest economic terms, our trading partners simply would not have the U.S. dollars to pay for that level of imports.

Today, IBM does business in 127 foreign countries. This includes 21 overseas manufacturing facilities and 10 laboratories. Each plant overseas has a counterpart in the United States, and all of our research and development activities are centrally coordinated in the United States. This structure not only permits us to serve U.S. and overseas markets effectively, but also illustrates the need for technology-intensive firms such as IBM to utilize the scientific skill and know-how available in all countries.

Our financial performance bears out these conclusions. In 1975, the company reported gross income of $14.4 billion and net earnings of almost $2 billion worldwide. Operations abroad contributed $7.3 billion in gross income and $1.11 billion in net earnings (over 55 percent). But more importantly for the Finance Committee's purposes, these activities yielded a number of tangible benefits for the United States.

First, IBM's overseas investments contribute substantially to America's trade balance.—Our overseas operations do not meet all of the foreign demand through local manufacturing. In fact, our affiliates there purchase a great number of U.S.-origin IBM products. Over the last 5 years, IBM's net exports contributed over $1.6 billion to the U.S. merchandise trade balance. And since 1960, our net exports have grown from $52 million to $343 million in 1975—almost a sevenfold increase.

Second, overseas operations create American jobs.—Translating the dollar value of our U.S. exports, we estimate that one of every five jobs in IBM's domestic plants last year was accounted for by our export business.

Third, IBM and other international firms contribute positively to the Nation's balance of payments.—According to the Commerce Department's Survey of Current Business, income from direct investment abroad, including royalties and fees, exceeded outflows by a net $14.6 billion in 1974. In its 1975 report, the Council on International Economic Policy finds that income from direct investment abroad has exceeded direct investment outflows every year since 1950. For its part, IBM has contributed a net $5.7 billion inflow in the 10-year period from 1965 to 1974.

And, finally, IBM's worldwide business activities generate tax revenues for the U.S. Government.—These revenues are generated both directly and indirectly. For example, IBM's domestic operations have generated over $1.6 billion in net exports over the past 5 years. Last year, our profit on our export business amounted to more than $100 million which was subject to U.S. tax. Also, IBM paid its stockholders nearly $1 billion in dividends last year, and more than half of these payments were made possible by our earnings abroad. While precise calculations are impossible, these stockholders paid taxes on their dividends.

It is highly significant, we believe, that during the past decade (1966–75), IBM has paid $11 billion in U.S. Federal and foreign income taxes on $22.8 billion of net earnings before taxes. This represents an average worldwide income tax rate of approximately 48.4 percent.

In 1974 IBM paid more taxes to the U.S. Government than any other corporation. But in addition to Federal income taxes, we pay a number of other taxes in this country such as State and local income and franchise taxes, excise taxes and property taxes. When State income taxes are added to our Federal income tax payments, our effective tax rate in the United States is increased to 55.5 percent; and when State and local property taxes are included in the calculation, our effective rate in this country becomes 62.7 percent.

There is a widespread misconception that certain aspects of the U.S. tax code (such as the foreign tax credit and the so-called deferral provision) permit international companies to reduce the tax payment to the U.S. Government on their domestic earnings. Indeed, some claim that international companies manage to escape taxation both in this country and abroad. The record of IBM in the United States and overseas clearly refutes this unfounded charge.

The Competitive Situation Abroad

The U.S. Government must be careful to avoid policies which will place American companies at a substantial disadvantage vis-a-vis their foreign competitors. This is particularly true in light of the fact that foreign governments clearly view their industrial enterprises as national assets and take aggressive steps to assist them in their domestic and international operations.

In March 1973, appearing before the International Trade Subcommittee of the Senate Finance Committee, Mr. Gilbert E. Jones, vice chairman of IBM's board, spelled out many of the ways in which foreign governments assist their corporations, particularly those in high-technology fields. These methods include tariff and nontariff barriers as well as direct support and subsidization for national computer manufacturers. American firms are increasingly hard pressed to meet this Government-assisted competition from foreign companies. While IBM does not seek assistance from the U.S. Government, we feel strongly that our Government must avoid unwise tax penalties which would hamper the ability of U.S. firms to compete effectively overseas.

IBM asks for nothing more than U.S. tax laws which are sensible and allow us to maintain our international competitiveness. In particular, we ask Congress to work for a U.S. tax policy compatible with that utilized by the other major industrialized countries.

In this regard, we believe it is significant that no industrialized country imposes taxes on foreign earnings by its corporations which are more burdensome than those imposed by the United States.

Taxation of Foreign Income

IBM believes the present U.S. system of taxing corporate foreign income is fair—and neither penalizes nor provides incentives to the major industrial companies based in the United States. America's basic practices in taxing foreign income—the tax credit and tax deferral—are in line with the methods used by the governments of our major trading partners. In fact, some of these, like the Netherlands and France, impose no tax on the foreign earnings of their corporations. Others, like Belgium, tax foreign income only on a limited basis. None taxes any income before it is remitted to the home country.

The Foreign Tax Credit

The foreign tax credit prevents double taxation on foreign earnings and thus is fundamental to tax fairness. It constitutes neither a tax loophole nor an incentive to overseas investment. Indeed, the principle of avoiding double taxation is universally recognized in international tax treaties.

In the Ways and Means Committee report on H.R. 10612, the committee noted:

> Some countries avoid double taxation by exempting foreign source income from tax altogether. For U.S. taxpayers, however, the foreign tax credit system, providing a dollar-for-dollar credit against U.S. tax liability for income taxes paid to a foreign country, is the mechanism by which double taxation is avoided.

DOOLEY & KNUTSON,
CERTIFIED PUBLIC ACCOUNTANTS,
Newport Beach, Calif., February 25, 1976.

Re Senate Finance Committee of Tax Reform.

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

DEAR MR. STERN: The House passed provisions of H.R. 10612 expands section 1491 of the Internal Revenue Code to include transfer of all appreciated property to a foreign trust, foreign corporation and foreign partnership. While such an excise tax is required to prevent tax evasion through the gift of appreciate property to a foreign entity, the expanded section 1491 would create an unfair double tax on legitimate sales for an installment note or a private annuity to foreign entities.

While it is true that the house version of the expanded section 1491 does allow relief from the excise tax if the taxpayer obtains a ruling that the transfer does not have as one of its principal purposes the avoidance of Federal income taxes, such an administrative procedure takes time and costs the United States resident additional legal fees. Such additional time delays and legal fees will discourage the ordinary business sales and exchange between the United States resident and foreign buyers.

In addition the average United States taxpayer who will be unaware of the expanded Section 1491 may find that the sale of his property to a foreign entity is subject to an additional tax of 35% unless he retains a tax attorney to plea his case.

One must suspect that the net revenue generated by this provision will not be significant after allowing for the additional administrative burden on the Internal Revenue Service, the additional professional fees borne by the United States resident, and the loss of foreign investors in United States property.

In summary, Section 1491 should be expanded to only include gifts or contribution to capital to foreign trusts, foreign corporations, or foreign partnerships.

Respectfully yours,

BRIAN DOOLEY.

STATEMENT ON BEHALF OF FRANK A. AUGSBURY, JR. AND FRANK A. AUGSBURY III,

This statement is made by Chase Troxell, a partner in the law firm of Burke & Burke, Daniels, Leighton & Reid, New York City, on behalf of Frank A. Augsbury, Jr. of Ogdensburg, New York, and his immediate family, who own all of the stock of Hall Corporation Shipping Ltd. of Montreal.

The Tax Reduction Act of 1975 contains a provision which has a devastating and, we believe, completely unintended effect on Hall Corporation and its owners. We urgently plead with the Committee, as we did with the Ways and Means Committee last summer, to provide relief.

1. TAXATION OF FOREIGN BASE COMPANY SHIPPING INCOME

The provision has to do with shipping income earned by foreign corporations owned by Americans.

a. Law prior to Tax Reduction Act of 1975

Prior to the Tax Reduction Act of 1975, such income was exempt from Subpart F of the Code. U.S. shareholders of foreign shipping companies were not taxed until the income was remitted to them as dividends or until they sold their stock.

b. Law under Tax Reduction Act of 1975

As part of the Tax Reduction Act of 1975, however, Congress enacted a provision, effective for 1976 and later years, under which shipping income is taxed currently to U.S. shareholders except to the extent that the foreign shipping company invests its income in additional ships and shipping assets.

2. REASON FOR CHANGE IN LAW

About 94 per cent of American imports and exports are carried on foreign-flag ships, which pay no taxes to the U.S. and provide no jobs for U.S. seamen. U.S. multi-national corporations control a good bit of this tonnage. I believe Congress felt that by taking away tax deferral it might force these integrated companies to begin to move their fleets away from "flags of convenience" to U.S. registry, or at least penalize them for not doing so.

I do not want to take issue with the general purpose of the new law. I want only to point out that the law as it is now written strikes not only foreign-flag businesses which could operate under the U.S. flag, but also businesses that operate under foreign incorporation and registry because they are forbidden by law to do otherwise. The provision will probably have the effect of demolishing these legitimate, non-runaway businesses—which would serve neither American labor nor our tax revenues, quite apart from the effect it would have on the owners and the seamen employed by these businesses.

3. CABOTAGE (COASTING) LAWS

Few people outside the shipping industry have ever heard the term "cabotage." It means coasting, carrying passengers or goods between points within a single country.

Many countries have cabotage laws which restrict the coasting trade to vessels which are registered in that country and which are owned by citizens or corporations of that country.

The United States has had a cabotage law since 1920. No foreign ship can pick up goods in New Orleans and deliver them to Baltimore, for example.

Canada has a cabotage law too, forbidding, for example, an American ship from carrying goods between Montreal and Toronto. Only Canadian-flag ships owned by Canadian corporations or Canadian or other British Commonwealth citizens may do so. Consequently, if an American wants to engage in this trade he must do so through a Canadian corporation.

4. HALL CORPORATION SHIPPING LTD.

Hall Corporation Shipping Ltd. is a Canadian company headquartered in Montreal which ships grain, ore, coal and petroleum products on the St. Lawrence River and the Great Lakes. It is wholly owned by one American family, the Augsbury family who live in the small St. Lawrence valley city of Ogdensburg, New York, and who have owned the company since it was formed fifty years ago.

About 70 percent of Hall's income comes from coasting in Canada. The remaining 30 percent is from shipping goods—primarily Labrador iron ore—between Canada and the U.S. Since each of Hall's ships earns a significant part of its income from coasting, each must be registered in Canada and owned by a Canadian corporation.

Hall is not part of a multinational group. It is an independent company and all of its trade is with unrelated persons.

Hall is not avoiding high labor costs or taxes by being Canadian. Its crewmen are all members of the Seafarers International Union of Canada, AFL/CIO, whose wage rates are very comparable to U.S. union rates. Moreover, Canadian tax rates are comparable to ours.

Hall is, therefore, not the sort of runaway operation which, we believe, the shipping income provision of the Tax Reduction Act was aimed at. Nevertheless, under the act, Hall is treated no different from the offshore oil company subsidiary that runs Liberian-flag tankers from the Persian Gulf or the Caribbean to U.S. refineries—companies which could be incorporated in the United States and operate U.S.-flag ships with U.S. crews but choose not to.

5. EFFECT OF TAX REDUCTION ACT RULES ON HALL

The stockholders of Hall received a ruling from the Internal Revenue Service in December 1975 that any shipping income it earns in 1976 will not be subpart F income because Hall was not formed or availed of to avoid tax. The ruling was issued under a general escape-valve section which was part of the original subpart F when it was enacted in 1962.

If it were not for the ruling, the effect of the shipping income provision would be this: Hall would either have to pay out most of its income as dividends in order to enable the Augsburys to pay U.S. and State income taxes or purchase additional shipping, whether or not economic conditions justified such purchases.

The dividend alternative would strip the company of working capital.

The reinvestment alternative is impractical for two main reasons:

1. Strikes, collisions, weather along the St. Lawrence and in the grain-growing areas and governmental actions, as well as rises and falls in the general economy, make profits very unpredictable. A shipping company cannot project profits at the beginning of a year with anything like the certainty of a manufacturing company, so it cannot hope to time ship purchases, which must be committed for long before delivery dates, in such a way as to match profits.

2. The purchase of shipping depends not only on the availability of current cash flow but also the availability of loans and shipyard berths and in many cases the concurrence of existing creditors and the host government.

As a practical matter, the act would either force the sale of Hall to foreign interests or drive the company out of business.

The ruling saves Hall from this result for 1976, and we would hope that the Service would renew the ruling from year to year.

However, our situation is so completely free of tax-avoidance and fair wage-avoidance motives that we feel justified in asking Congress to exempt us by statute from subpart F.

6. HOUSE BILL

Section 1024 of H.R. 10612 as passed by the House last fall would give substantial relief since it provides that income from the coasting trade and from the sale of ships, to the extent that they have engaged in that trade, is not "foreign base company shipping income." However, it does not remove from that category the income that Hall's ships derive from carrying goods between Canada and the United States, and we feel that this income too should be exempt because:

1. No ship may operate in the U.S.-Canada trade under U.S. flag and ownership unless the ship is taken out of the Canadian coasting trade, since Canada bars the coasting trade to non-Canadian vessels;
2. Taking any ship out of the Canadian coasting trade would deprive it of such a large amount of business that it could not come close to operating profitably unless some new source of business were substituted;
3. None of Hall's ships could coast in the United States because coasting here is forbidden to foreign-built ships;
4. Ships such as Hall's fleet of dry-cargo vessels (called "lakers"), which are designed for the Great Lakes and the St. Lawrence River service, are shallow-draught and of reduced strength criteria and therefore cannot operate in the open ocean. Because of their small size (5,000 to 12,000 deadweight tons), its tankers are limited to distribution of refined products from local refineries on the lakes and river. They are not economically viable for ocean operation, where tankers ten or twenty times their size are commonplace and even larger tankers are not unusual; and
5. There is not enough Canada-U.S. business available in the St. Lawrence-Great Lakes for an independent fleet to operate in that trade alone.

As a result, Hall can only operate as it now operates, and, if the House version of section 1024 of the present bill is enacted, almost a third of Hall's income will be Subpart F income regardless of the fact that it must be Canadian and is not avoiding taxes or unionization by being so.

We feel that Congress did not have our type of business in mind when it passed the Tax Reduction Act and that the relief provided in the House version of H.R. 10612 does not protect us adequately from the unintended harm that the Tax Reduction Act will do to us.

7. RECOMMENDATION

It is requested that the House version of section 1024 of H.R. 10612 be modified to exempt from "foreign base company shipping income" any income derived from the operation or sale of ships which engage, regularly and to a substantial extent, in the coasting trade within a foreign country if the laws of that country prohibit ships owned by U.S. corporations and citizens from engaging in that trade.

Not a single job which an American seaman could fill would be lost through such an exemption and any revenue loss would be temporary and miniscule. It would, on the other hand, avoid the needless and, we believe, unintended destruction of a major family business which has benefited people on both sides of our northern border for 50 years.

MORRISON-KNUDSEN COMPANY, INC.,
Boise, Idaho, November 24, 1975.

Hon. FRANK CHURCH,
U.S. Senate, Senate Office Building, Washington, D.C.

DEAR FRANK: As you are probably aware, as a part of its so-called tax reform measure, the House Ways and Means Committee is again tampering with Section 911 of the U.S. Tax Code, and have proposed that the $20,000 per year exclusion for construction workers will be allowed to remain in effect for the years 1976, 1977 and 1978 only. Presumably, the exemption will expire at the end of 1978.

In order to impress upon the House Ways and Means Committee the contribution that the American construction industry makes to the balance of payments of the nation, as well as contributing to the number of jobs in the United States by reason of the construction industries operations, the attached survey was presented to that committee. This survey is made up of actual figures for 1974, and partially actual and partially estimated figures for 1975, from the records of the companies reporting.

It appears to me that this is a very impressive series of numbers and one which would certainly justify the position of the construction industry in attempting to continue to have this exclusion. The problem is that, if the exclusion is not continued, then the cost to the construction industry to get competent, capable employees to go overseas would endanger our competitive position. We believe that the figures demonstrate that the relatively small amount of wages in the exempt category compared to the overall good done for the economy of the United States justifies our position, I certainly hope that we can count on your support in our efforts to retain this exclusion.

Best regards,

JIM.

SCHEDULE A

SURVEY OF 30 MAJOR U.S. ENGINEERING-CONSTRUCTION COMPANIES—FOREIGN ACTIVITIES IN 1974 AND 1975

	1974 (actual)	1975 (estimated)
1. Value of U.S. goods purchased and exported to foreign projects	$1,112,571,000	$1,613,273,000
2. Number of U.S. jobs created due to foreign projects:		
A. Manufacturing industry	22,708	30,951
B. Design engineers	4,034	5,513
C. Administrative and other	1,345	1,838
Total	28,087	38,302
3. Number of U.S. citizens on foreign assignment	7,643	9,533
4. Total wages paid U.S. citizens employed abroad	$169,301,000	$245,171,000
Less nonexempt wages	71,064,000	104,054,00
Net foreign wages subject to sec. 911 exclusion	98,237,000	141,117,000
5. Revenue from foreign construction	4,629,053,000	6,326,890,000

NOTES

The number of jobs created in the United States as a result of the U.S. engineering-construction firms' foreign contracts was computed utilizing published statistical data as follows:

(a) *Manufacturing industry.*—U.S. sales per manufacturing employee were $48,995 in 1974 and $52,123 (estimated) in 1975. The 1975 estimated sales per employee is based upon 7 months' actual experience annualized. Figures were compiled using "Survey of Current Business," (vol. 55 No. 8) published August 1975, by the U.S. Department of Commerce. The number of U.S. jobs created was determined by dividing value of U.S. goods exported by sales per employee for the manufacturing industry.

(b) *Design engineers.*—U.S. jobs created in 1974 and 1975 were determined from the contract awards in foreign engineering design and construction as reported by "Engineering News-Record," Apr. 10 and May 15, 1975. Contract awards on foreign contracts for design engineering in 1974 were $360,000,000 or 3.1 percent of the $11,700,000,000 foreign construction awards. The number of U.S. jobs created was determined by applying the 1974 average billings per professional employee ($35,575) of the top 500 engineering design firms to the estimated design portion of revenue from foreign construction.

(c) *Administrative and other.*—Experience of certain U.S. engineering-construction firms indicates that nontechnical employees (administrative, accountants, and clerical) are required in support to employees engaged in foreign work at a rate of 1 employee for every 3 engineers.

SCHEDULE B

List of 30 Major U.S. Engineering-Construction Companies Reporting Foreign Activity in 1974 and 1975

Guy F. Atkinson Co.
The Austin Co.
The Badger Co., Inc.
Bechtel Corp.
Brown & Root, Inc.
Chicago Bridge & Iron Co.
Daniel International Corp.
Dillingham Corp.
Ebasco Services Inc.
Fluor Corp.
Foster Wheeler Corp.
J. A. Jones Construction Co.
Kaiser Engineers
The M. W. Kellogg Co.
Peter Kiewit Sons' Co.
The Litwin Corp.
J. Ray McDermott & Co., Inc.
Morrison-Knudsen Co., Inc.
The Ralph M. Parsons Co.
Perini Corp.
H. C. Price Co.
J. F. Pritchard and Co.
Procon Inc.
Raymond International Inc.
The Rust Engineering Co.
Santa Fe International Corp.
Stearns-Roger Corp.
Warren Brothers Co.
Williams Brothers Co.
H. B. Zachry Co.

NATIONAL CONSTRUCTORS ASSOCIATION,
Washington, D.C., March 22, 1976.

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

DEAR MR. CHAIRMAN: As your committee approaches its consideration of tax reform in the area of foreign source income, I am forwarding to you a paper which explains the NCA's position on Section 911.

The NCA is composed of 46 international engineering and construction companies, engaged primarily in the design, engineering and construction of heavy industrial facilities, such as fertilizer plants, steel mills, chemical plants and waste treatment facilities. Our membership's international work was, in 1974, responsible for 200,000 jobs and $4 Billion worth of economic activity within the United States. The enclosed paper explains in some detail this benefit to our economy and the impact Section 911 has on it. If you have an opportunity to read it, I am certain you will find it most informative.

The Association requested an opportunity to testify before your committee to explain our position in even greater detail and to respond to any questions you may have regarding our paper. However, due to the large number of witnesses who wish to testify and the short amount of time available, we could not be scheduled for oral presentation. However, if you or any member of your staff have any questions or comments, or if you require clarification of any of the points in the paper, please contact me at your convenience.

I hope you find our position on this matter helpful to you in your deliberations on this most complicated, and most important topic.

Very truly yours,

MAURICE L. MOSIER,
Executive Vice President.

Summary of Contents

I. The incentive contained in Section 911 of the Internal Revenue Code is critical for the engineering-construction industry. Many highly technical employees are required to work overseas on these projects, and repeal of Section 911 would significantly increase the costs of maintaining an expatriate overseas. This additional cost will be approximately $15,000 per individual.

II. The expatriate employee realizes no personal gain from the existence of 911; this section merely permits his employer to keep his after tax income whole without making unreasonable additional expenditures.

III. Competition for overseas contracts is intense, with other industrialized countries vying for projects. Japan, Italy, Great Britain, France and West Germany, among others, support, through a system of preferential taxation of foreign source income, the efforts of their companies to obtain this work.

IV. The U.S. needs these contracts. NCA members in 1974 created 200,000 full time jobs within the boundaries of the U.S. as a result of their overseas work. Repeal of Section 911 would reduce the $2.25 billion worth of goods procured and the $1.8 billion in services performed in the U.S. This would occur because our prices would rise as a result of necessarily increased compensation packages, a cost which is passed on to the client. Result: reduced competitive position.

V. Existence of Section 911 is a bargain for all U.S. taxpayers. Full repeal would yield only $48 million in additional tax receipts. At the same time, repeal would cause a substantial loss of overseas work, reducing the number of jobs available as expatriates with U.S. companies, the number of domestic jobs with U.S. companies in direct support of expatriates, the number of jobs in the industries which manufacture goods for export, as well as production in those industries. This would significantly shrink the general tax base, both for individuals and companies, and would increase unemployment and the compensation thus required. A marginal increase in these factors could easily off-set the $48 million gain.

Earned Income Exclusion from Sources Without the United States (Section 911)

The original congressional intent which resulted in the Section 911 exclusion was to provide a special inducement for American Citizens to hold employment abroad, therefore better enabling United States companies to obtain a healthy share of overseas markets. Congress recognized that American citizens employed abroad were at a competitive disadvantage with the nationals of other countries for a number of reasons, including the fact that many nations did not tax their nationals on income earned outside their boundaries.

As is the case with many tax incentives, it worked well in theory, but was subject to abuse. Many citizens in very high income brackets fled the U.S. so that their income could be covered by the exclusion, which, when first in existence, was unlimited. This kind of tax avoidance became so popular that it prompted the Congress to impose an annual ceiling on the amount that both a bona fide foreign country resident and a person present in a foreign country could exclude, finally reducing it to a $20,000 maximum in 1953 under the "present in a foreign country rule" and to a $25,000 maximum in 1963 for a bona fide foreign resident. This seemed to solve the main problem with Section 911.

The existence and popularity of this abuse in no way detracted from the basic usefulness of the exclusion. This resulted in a lower cost to the company per employee stationed abroad, thus assisting the company to become more competitive in their quest to capture a share of overseas markets as against other nations. The U.S. share of these markets increased.

The power of the maximum $20,000 incentive has eroded to a significant extent since 1953 due to the effect of inflation and, more recently, the Internal Revenue Commissioner's interpretation of the treatment of certain kinds of expenses in relation to Section 911. In Revenue Ruling 75–84 the Commissioner created income for employees moving abroad where none previously existed after disallowance of a portion of moving expense deductions.

Inflation has also taken its toll on Section 911. To take an example from our own companies' experience, the income of engineers sent overseas in the 1950's and early 1960's seldom approached either the $20,000 or the $25,000 limit on the exclusion. Therefore, their total earnings were virtually excluded from domestic taxation, and American companies were on a firm competitive footing as against foreign companies. This is no longer the case. Even the average base salary of expatriate engineers exceeds the limit by several thousand dollars, even before the consideration of incentive allowances, housing and education allowances and similar benefits. If the amount of the exclusion were to have kept up with inflation taken place since 1953, it would be approximately $45,000.

The trend of inflation has been to partially repeal the exclusion over the years, permitting foreign firms to increase their competitiveness as their technical expertise increases and our prices also increase. And yet, the reasons for 911 which existed at the time of its inception still exist today, and are indeed, possibly more critical now.

The members of the National Constructors Association are dependent on Section 911 for pricing purposes. Our members design and build large industrial facilities such as steel mills, fertilizer plants, and chemical plants. There is no choice as to where these facilities can be built, since their location is determined by the client and the location of raw resource material. Except in other highly industrialized nations, there are few foreign nationals with the engineering and management experience and sophistication required to design, engineer and construct highly automated, technically complex large scale industrial facilities. Such individuals are non-existent in many areas of the world. In lesser developed nations, where industrialization is only just now beginning, there are very few, if any, individuals with such qualifications. So, we must use Americans on projects built in these countries. We have no choice.

When our companies work overseas, we are in direct competition with the companies of other highly industrialized nations, such as

Japan, Great Britain, France, West Germany and Italy. There was a time when we could compete on the basis of superior technology alone. Many clients would pay a premium for the superior product produced by American companies. We had better processes to sell, better equipment to install, superior construction methods, and greater technical experience, all of which contributed to a more efficient and more reliable plant. We are no longer so far ahead of our competitors. They, too, have developed sophisticated technologies and are now competing nearly equally in that category. Price has become a critical factor.

Our competitors can hold their prices down for a number of reasons, not the least of which is enthusiastic support of the export effort by their respective governments. Specific examples of this support by various countries will demonstrate the surprising differences between the U.S. Government's attitude toward exports and that of other industrialized nations.

Japan is an enthusiastic supporter of exports. Non-resident Japanese citizens are not subject to tax on foreign source income. They do not tax foreign subsidiaries. Foreign losses are totally deductable. They supply special deferrals of domestic income related to the production of exports. They give tax incentives for exports. They do not enforce intercompany pricing rules. They will finance an export effort at interest rates of 7.5 percent and will cover as much as 64 percent of the transaction at that rate. And finally, they will provide insurance against commercial, political and production risks, as well as against currency fluctuations. This combination, used in conjunction with a non-existent anti-trust policy for export related activities, is very helpful to Japanese companies.

West Germany taxes foreign branch income at one-half the usual 51 percent rate. Non-resident West German citizens are not subject to tax on foreign source income. Taxation of foreign subsidiaries is far more lenient than our own system. Foreign losses are fully deductable. Domestic income is deferrable for losses of foreign branches whose income is tax exempt, for losses of foreign subsidiaries, and for profits realized upon exchanges of property for stock in foreign corporations. Their value added tax, usually 11 percent, is reduced to zero for exports. Government owned companies receive additional tax reductions. Financial assistance comes in the form of loans at rates of 10 percent and cover up to 77 percent of the contract value. Production, commercial, and political risks and currency fluctuation are insured up to 95 percent.

France permits an election of tax treatment. Companies can choose to exempt the income of both foreign subsidiaries and foreign branches. 95 percent of foreign source dividends are exempt. Domestic income can be deferred for losses of foreign businesses, for the cost of investment in certain businesses in lesser developed countries, and for export credit extended to foreign buyers. Non-resident French citizens are not subject to tax on foreign source income. Intercompany pricing rules are not enforced against exporters. The value added tax, usually between 20 and 33 percent, is zero for exports. Accelerated depreciation, exemptions from local business taxes, and reduction in registration taxes all apply to exporters. 7.5 percent long term loans of up to

90 percent of the contract value are available. Insurance is available for up to 95 percent of production, commercial and political risks, for currency fluctuation, for market penetration expenses and for exhibition expenses. This is a very attractive package for a French exporter.

These are not unusual tax incentive packages. Italy, Great Britain, Belgium, Holland and other nations have similar packages to help expand exports.

The United States' treatment of exporters is in sharp contrast. Foreign branch income is fully taxable. Foreign subsidiary income is taxable under Subpart F. Foreign source dividends are fully taxable. Only 25 percent of taxable income may be deferred under DISC, and that is currently under attack. Intercompany pricing rules are strictly enforced, with no special treatment for exporters. An 11 percent interest rate applies to long term loans and cover anywhere from 30 to 70 percent of the contract value. Insurance is available only for commercial and political risks, and this is also being phased out with OPIC.

So, the posture of U.S. companies operating overseas is an attempt to compete without significant government support, assistance or encouragement, against foreign companies whose governments provide a wide variety of tax and non-tax incentives for the export effort. We compete less effectively.

In the face of this already overwhelming advantage held by foreign companies as a result of enthusiastic government support, the U.S. Government has increased the interest rate charged by the Export-Import Bank, initiated a phase-out of the Overseas Private Investment Corporation, which provides reasonably competitive insurance, although covering a narrower variety of risks, and has failed year after year to apply the Webb-Pomerene anti-trust exemption to exporters of services. Now, the House Ways and Means Committee has proposed a tax bill which would reduce the effectiveness of the DISC deferral program and will phase out Section 911. Our foreign competitors no doubt fully support this continuing program of erosion of our few remaining export incentives.

The support by governments of the efforts of their companies to export goods and services is no mere exercise in national pride and world influence. The share of the international marketplace translates directly into domestic production and domestic jobs. This is obviously recognized by other governments. The example set by the member companies of the National Constructors Association is enlightening.

The last year for which reliable figures are available is 1974, when our member companies performed a combined total of $8 billion worth of engineering and construction work overseas. Procurement of goods, materials and services was done all over the world.

A total of $4.05 billion worth of goods and services were procured or performed in the United States. This translates into jobs for American Workers. Data from the Bureau of Labor Statistics indicate that this procurement, the result of our overseas work, is responsible for the creation of approximately 409,288,000 man hours of work, or 196,770 full time jobs in the domestic market.[1]

[1] See Appendix.

NCA members employ about 4,000 U.S. expatriates, each of whom requires three domestic employees for direct support, plus additional indirect support personnel. NCA international work is therefore responsible for a total of 200,000 full time jobs for U.S. citizens. The impact of foreign work on the domestic economy becomes even more startling when it is remembered that the NCA is composed of only 46 companies, one half of which perform little or no international work.

The repeal of Section 911 will reduce the amount of overseas work which we perform. The effect would be devastating, and would reduce our overseas markets to those areas where we have a virtual monopoly on the technical expertise required.

For example, if an employee's after tax income is to be kept whole, which is essential to retain qualified professional individuals, one U.S. company's cost of maintaining one expatriate employee would increase by approximately $11,000 in a country where no incentive payments are required, and by approximately $14,000 where living conditions require a 25 percent incentive. The additional cost to the client, including payroll additives to cover employer-borne taxes, insurance, and other employee benefits, could be as high as $16,000. It has been estimated by one of our member companies that the cost of the design, engineering and construction of a nuclear power plant in a high expense area, an enormously complex project requiring many years and several hundred highly technical, professional U.S. employees, would be increased by approximately $20 million. Few clients will pay such a premium when comparable work can be obtained from other industrialized nations.

These figures are by no means extraordinary, and the amounts would be substantially greater were more extreme examples cited. A survey of our member companies yield the following as a fairly typical example of an international compensation schedule:

a. Average base salary of employees stationed abroad	$23,000
b. Average incentive, 25 percent	5,750
c. Cost differential allowance	5,400
d. Average education allowance per family unit	4,000
Total employee wage/benefit package	38,150

These figures vary from country to country. The incentive figure can vary from 15 percent to 40 percent. Twenty-five percent is the average. The education allowance can be as much as $4,500 per year per child. The fair rental value of housing in many areas can increase an employee's taxable income anywhere from $12,000 to $24,000 per year. In Tokyo, for example, $2,000 per month is required to maintain adequate housing. The $20,000 exclusion is therefore insufficient to cover even the additional income imputed to the expatriate for housing.

It is evident that a repeal of Section 911 will substantially increase our costs by making it necessary to pay significantly higher gross compensation in order to maintain the present after tax level which includes incentives for overseas service. These costs, yielding unavoidably higher prices, will reduce our competitiveness. We will obtain fewer contracts. We will purchase fewer goods. We will perform fewer services. The expatriates, domestic engineers, and other workers will find themselves without jobs.

It is difficult to ascertain a reason for repealing Section 911. Repeal does not make sense even from a purely revenue-raising point of view. It will be more expensive to the Treasury to repeal Section 911 than to retain it. The excluded income, as reported in the recently published "Finance Committee Report Under the Congressional Budget Act", if taxed, would yield only $48 million in additional annual tax receipts when the repeal of Section 911 is fully effective. The precise number of contracts which will be lost due to a repeal of 911 is difficult to quantify; however, any reduction in contracts awarded would result in an increase in the number of unemployed workers, who then would no longer be paying taxes but would be drawing unemployment benefits, and a reduction in domestic manufacturing with an appropriate reduction in the amount of taxes paid. Loss of only a very few large contracts could easily off-set the gain realized by taxing formerly excluded income.

In summary, it seems clear that Section 911 should at least be retained, if not increased to keep pace with inflation. The exclusion is beneficial in the areas of revenue raising, domestic employment, domestic production, positive balance of payments, and foreign market penetration and influence. A repeal of that section would have adverse effects in all of these areas. Instead of looking for more hurdles to place in the path of those competing for international work, the member companies of the NCA respectfully suggest that this committee and the entire government search for new incentives which are as economically sound as and beneficial to our economy as is Section 911.

Appendix

Domestic Employment Attributable to Procurement of Goods and Materials and Performance of Services in the Construction Industry

The chart reproduced below is from the Bureau of Labor Statistics, Bulletin 1832, *Factbook for Estimating the Manpower needs in Federal Programs* (1975).

The figures therein indicated are adjusted to reflect changes in the value of the dollar and productivity in the various industries. It is also adjusted to reflect the lower employment which results when the physical construction process, takes place overseas.

The "Industrial" column was used, and item #13 was not considered in making these calculations.

Table D-1. Industry manpower factors — Continued

[Employment requirements per billion dollars of expenditures, by industry, calendar year 1972]

Industry number and title	Type of construction: Residential buildings: Single-family	Multi-family	Nonresidential buildings: Industrial	Office and commercial	Educational	Hospital and institutional	Public utility structures: Telephone and telegraph	Electric	Water	Sewer	Local transit	Highways and streets
Agriculture, forestry, and fisheries:												
1. Livestock and livestock products	176	156	90	89	93	93	79	89	63	73	52	75
2. Crops and other agricultural products	1,044	886	197	228	302	272	201	232	116	217	100	176
3. Forestry and fisheries	413	221	35	57	88	47	88	190	18	103	28	64
4. Agriculture, forestry, and fishery services	256	203	73	78	92	79	81	107	51	72	44	80
Mining:												
5. Iron ore mining	38	51	56	63	61	78	34	75	106	58	52	80
6. Copper ore mining	53	70	80	72	114	50	565	101	57	25	31	28
7. Other nonferrous metal ore mining	33	43	52	64	67	57	207	70	63	41	39	33
8. Coal mining	115	126	119	129	116	141	87	132	191	160	64	156
9. Crude petroleum	187	198	157	207	165	169	233	201	131	156	209	465
10. Stone and clay mining and quarrying	546	541	444	495	517	533	278	446	472	820	305	1,761
11. Chemical and fertilizer mining	20	20	21	21	20	22	25	26	17	17	24	17
Construction:												
12. New residential building construction	33,648	33,648	–	–	–	–	–	–	–	–	–	–
13. New nonresidential building construction	–	–	~~20,987~~	20,987	20,987	20,987	–	–	–	–	–	–
14. New public utilities construction	–	–	–	–	–	–	18,130	18,130	18,130	18,130	18,130	22,636
15. New highway construction	–	–	–	–	–	–	–	–	–	–	–	–
16. All other new construction	–	–	–	–	–	–	–	–	–	–	–	–
17. Maintenance and repair construction	332	321	316	290	289	279	280	292	273	263	180	334
Manufacturing												
18. Guided missiles and space vehicles	3	3	3	3	4	5	3	7	3	2	-12	3
19. Other ordnance	6	9	12	11	17	10	6	18	15	8	9	5
20. Food products	140	113	114	104	102	107	88	92	86	82	60	92
21. Tobacco manufacturing	2	2	2	2	2	2	1	1	1	1	1	2
22. Fabric, yarn, and thread mills	121	245	95	121	120	116	142	99	48	56	63	84
23. Miscellaneous textiles and floor coverings	91	314	70	100	89	106	81	53	20	28	31	25
24. Hosiery and knit goods	18	23	17	17	17	17	16	16	12	10	11	14
25. Apparel	75	69	76	71	78	72	73	79	61	47	48	71
26. Miscellaneous fabricated textile products	25	40	30	32	33	40	19	32	14	19	14	12
27. Logging, sawmills, and planing mills	2,779	1,481	219	372	575	298	580	1,270	100	686	307	419
28. Millwork, plywood and other wood products	3,371	1,207	279	490	666	544	1,077	1,852	128	2,002	215	231
29. Household furniture	598	819	17	22	56	16	16	22	8	17	14	9

Table D-1. Industry manpower factors — Continued

(Employment requirements per billion dollars of expenditures, by industry, calendar year 1972)

Industry number and title	Type of construction											
	Residential buildings		Nonresidential buildings				Public utility structures					Highways and streets
	Single-family	Multi-family	Industrial	Office and commercial	Educational	Hospital and institutional	Telephone and telegraph	Electric	Water	Sewer	Local transit	
Manufacturing — Continued												
30. Other furniture	93	45	197	300	138	27	81	35	12	10	36	6
31. Paper products	314	341	331	370	371	338	256	242	175	207	177	177
32. Paperboard	121	127	130	158	141	134	114	126	90	77	64	71
33. Publishing	199	201	206	196	196	195	185	183	170	149	115	180
34. Printing	229	231	239	223	232	218	202	212	193	173	137	208
35. Chemical products	341	336	391	362	374	420	502	367	257	257	606	342
36. Agricultural chemicals	27	24	12	12	14	13	13	12	37	11	11	11
37. Plastic materials and synthetic rubber	103	108	149	115	198	154	291	126	47	56	50	52
38. Synthetic fibers	40	108	34	43	42	45	44	29	14	16	14	16
39. Drugs	8	8	8	8	8	8	8	7	6	6	8	7
40. Cleaning and toilet preparations	14	15	17	17	13	13	12	12	13	15	10	14
41. Paint	154	147	379	101	74	93	50	78	82	78	42	113
42. Petroleum products	113	121	151	128	98	101	147	125	63	88	137	311
43. Rubber products	100	175	171	188	175	153	138	185	129	181	167	126
44. Plastic products	424	306	624	444	960	835	266	324	134	126	118	113
45. Leather, footwear, and leather products	13	17	10	32	12	40	11	14	12	10	7	9
46. Glass	155	134	162	150	214	154	59	121	101	86	75	58
47. Cement, clay, and concrete products	2,872	2,682	3,194	2,005	1,939	1,849	820	1,361	2,761	5,212	.525	2,930
48. Miscellaneous stone and clay products	552	686	571	973	671	678	392	1,978	146	961	156	157
49. Blast furnaces and basic steel products	800	1,156	1,278	1,444	1,146	1,785	670	1,736	2,518	1,274	1,216	1,908
50. Iron and steel foundries and forgings	213	277	394	308	292	345	214	365	7,072	339	451	201
51. Primary copper metals	22	29	33	29	48	18	253	42	19	8	10	7
52. Primary aluminum	44	62	86	94	94	105	159	105	113	87	64	46
53. Other primary and secondary nonferrous metal	30	49	56	58	82	57	318	82	65	37	38	35
54. Copper rolling and drawing	79	106	127	103	104	42	453	90	26	19	22	15
55. Aluminum rolling and drawing	95	130	180	199	212	244	373	274	219	189	133	97
56. Other nonferrous rolling and drawing	118	173	159	173	774	111	5,408	664	52	42	88	33
57. Miscellaneous nonferrous metal products	43	54	84	75	75	79	39	72	104	33	43	31
58. Metal containers	29	27	45	25	22	23	21	24	21	21	20	27
59. Heating apparatus and plumbing fixtures	702	731	904	537	762	710	146	89	57	78	33	28
60. Fabricated structural metal	1,113	2,571	4,254	4,634	3,010	2,956	1,350	4,736	5,993	5,441	3,573	2,459
61. Screw machine products	172	238	277	349	486	270	386	499	216	163	192	140
62. Other fabricated metal products	764	870	618	906	917	1,428	772	814	668	468	626	571
63. Engines, turbines, and generators	33	40	59	63	42	49	42	328	57	50	59	.56

Table D-1. Industry manpower factors — Continued

(Employment requirements per billion dollars of expenditures, by industry, calendar year 1972)

Industry number and title	Type of construction											
	Residential buildings		Nonresidential buildings				Public utility structures					Highways and streets
	Single-family	Multi-family	Industrial	Office and commercial	Educational	Hospital and institutional	Telephone and telegraph	Electric	Water	Sewer	Local transit	
Manufacturing — Continued												
64. Farm machinery	6	7	8	7	6	7	6	9	25	8	17	71
65. Construction, mining, and oilfield machinery	58	76	138	113	86	104	159	243	244	308	1,228	328
66. Material handling equipment	30	76	728	439	42	507	123	60	49	49	41	43
67. Metalworking machinery	81	105	149	147	240	153	104	164	294	104	156	86
68. Special industry machinery	44	41	47	45	38	45	34	44	101	32	34	25
69. General industrial machinery	188	182	468	406	267	401	156	436	367	192	193	114
70. Machine shop products	77	95	147	121	114	131	192	150	602	88	108	176
71. Computers and peripheral equipment	18	13	20	20	19	19	15	19	19	16	13	16
72. Typewriters and other office machines	6	7	8	9	8	8	6	7	7	6	8	6
73. Service industry machines	71	214	328	523	272	195	120	70	34	30	24	22
74. Electric transmission equipment	113	158	180	217	1,814	185	154	1,557	92	43	87	58
75. Electrical industrial apparatus	120	169	241	259	300	314	117	278	332	125	134	107
76. Household appliances	181	79	46	66	63	37	32	40	17	11	13	11
77. Electric lighting and wiring	323	617	666	1,133	850	870	474	854	375	26	724	332
78. Radio and television sets	7	9	10	10	15	12	11	23	8	7	15	8
79. Telephone and telegraph apparatus	23	37	39	36	40	34	37	41	23	15	38	18
80. Other electronic communication equipment	21	24	37	30	115	149	52	358	18	13	838	71
81. Electronic components	71	96	127	134	323	222	105	344	84	50	539	76
82. Other electrical machinery	53	64	52	67	62	52	136	86	33	46	25	63
83. Motor vehicles	10	12	16	16	15	14	25	18	19	10	11	15
84. Aircraft	39	46	58	60	63	64	35	71	52	44	59	38
85. Ship and boat building and repair	74	96	133	129	101	98	62	129	145	132	100	69
86. Railroad and other transportation equipment	7	9	11	14	11	11	7	14	13	10	9	8
87. Miscellaneous transportation equipment	4	6	5	8	3	4	2	5	6	5	4	14
88. Scientific and controlling instruments	171	179	284	212	895	868	90	87	47	31	37	70
89. Medical and dental instruments	14	15	14	14	18	16	13	15	15	12	13	10
90. Optical and ophthalmic equipment	7	7	8	8	10	8	8	9	6	7	5	6
91. Photographic equipment and supplies	28	27	34	33	38	30	23	41	25	23	23	31
92. Miscellaneous manufactured products	106	115	85	148	106	91	103	94	66	56	30	194
Transportation, communication, and public utilities												
93. Railroad transportation	1,129	978	844	795	774	723	731	809	671	714	357	812

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Table D-1. Industry manpower factors — Continued

[Employment requirements per billion dollars of expenditures, by industry, calendar year 1972]

Industry number and title	Type of construction: Residential buildings: Single-family	Residential buildings: Multi-family	Nonresidential buildings: Industrial	Nonresidential buildings: Office and commercial	Nonresidential buildings: Educational	Nonresidential buildings: Hospital and institutional	Public utility structures: Telephone and telegraph	Public utility structures: Electric	Public utility structures: Water	Public utility structures: Sewer	Public utility structures: Local transit	Highways and streets
Transportation, communication, and public utilities — Continued												
94. Local transit and intercity bus transportation	90	95	95	97	93	109	72	80	87	79	59	85
95. Truck transportation	1,275	1,247	2,133	1,812	1,620	1,372	1,056	1,664	1,133	1,205	735	1,777
96. Water transportation	103	68	81	80	75	69	108	92	75	75	49	131
97. Air transportation	349	368	362	356	387	382	297	321	311	301	229	378
98. Other transportation	83	83	109	95	77	76	81	85	63	68	63	148
99. Communications, except radio and TV	1,015	1,043	1,070	1,009	1,007	1,025	863	902	976	838	805	801
100. Radio and TV broadcasting	65	65	67	63	63	63	60	59	54	46	34	54
101. Electric utilities	213	216	223	200	210	214	217	202	242	207	117	192
102. Gas utilities	103	105	116	105	100	102	100	97	131	118	63	111
103. Water and sanitary services	46	47	47	43	41	48	44	34	33	30	20	42
Wholesale and retail trade:												
104. Wholesale trade	3,308	3,388	3,403	3,164	3,186	2,975	3,227	2,858	2,703	2,600	2,056	2,818
105. Retail trade	7,051	5,599	3,937	3,673	3,902	4,757	1,910	2,425	2,148	1,300	1,370	2,433
Finance, insurance, and real estate:												
106. Finance	344	343	443	319	334	332	280	289	297	274	156	276
107. Insurance	422	435	419	417	417	428	438	494	606	544	481	645
108. Owner-occupied dwellings	—	—	—	—	—	—	—	—	—	—	—	—
109. Other real estate	319	317	312	295	292	299	258	263	246	236	206	315
Services:												
110. Hotels and lodging places	218	232	233	224	227	248	177	195	200	193	149	210
111. Other personal services	79	90	106	103	93	92	68	100	103	91	69	72
112. Miscellaneous	1,373	1,404	1,394	1,376	1,379	1,389	1,242	1,363	1,332	1,441	1,301	1,418
113. Advertising	75	74	76	72	72	72	69	67	62	53	39	67
114. Miscellaneous professional services	2,184	2,705	2,650	2,639	2,662	2,802	2,443	2,456	2,587	2,610	2,568	4,444
115. Automobile repair	285	282	282	262	260	286	184	207	200	204	166	232
116. Motion pictures	35	35	36	34	34	34	32	31	29	26	19	30
117. Other amusements	54	54	52	60	51	53	41	43	42	39	30	45
118. Health services except hospitals	32	32	29	28	28	29	23	31	30	32	28	38
119. Hospitals	4	4	4	4	4	4	4	4	3	3	3	4
120. Educational services	14	15	15	13	13	14	11	11	8	13	8	11
121. Nonprofit organizations	174	185	185	164	104	176	129	134	94	178	66	129
Government enterprises:												
122. Post office	285	292	307	287	279	292	240	270	252	232	248	284
123. Commodity Credit Corporation	—	—	—	—	—	—	—	—	—	—	—	—
124. Other Federal enterprises	83	75	68	62	64	68	54	54	67	46	55	63

Table D-1. Industry manpower factors — Continued

(Employment requirements per billion dollars of expenditures, by industry, calendar year 1972)

Industry number and title	Type of construction											
	Residential buildings		Nonresidential buildings				Public utility structures					Highways and streets
	Single-family	Multi-family	Industrial	Office and commercial	Educational	Hospital and institutional	Telephone and telegraph	Electric	Water	Sewer	Local transit	
Government enterprises — Continued												
125. State and local government enterprises	210	216	217	198	201	203	205	196	185	206	205	240
Imports:												
126. Directly allocated imports	–	–	–	–	–	–	–	–	–	–	–	–
127. Transferred imports	–	–	–	–	–	–	–	–	–	–	–	–
Dummy industries:												
128. Business travel, entertainment, and gifts	–	–	–	–	–	–	–	–	–	–	–	–
129. Office supplies	–	–	–	–	–	–	–	–	–	–	–	–
130. Scrap, used and secondhand goods	–	–	–	–	–	–	–	–	–	–	–	–
Special industries:												
131. Government industry	–	–	–	–	–	–	–	–	–	–	–	–
132. Rest of the world industry	–	–	–	–	–	–	–	–	–	–	–	–
133. Households	–	–	–	–	–	–	–	–	–	–	–	–
134. Inventory valuation adjustment	–	–	–	–	–	–	–	–	–	–	–	–

Application of the tax credit is relatively simple. In recognition of the accepted principle that primary tax jurisdiction should be assigned to the country where income is earned, the tax credit provides a dollar-for-dollar credit, up to a limit, for taxes paid to foreign governments. The credit can neither exceed the amount of U.S. income tax applicable to the foreign income, nor offset taxes on domestic income.

Repeal of the foreign tax credit, advocated by some, would result in a tax on the foreign earnings of American companies at a rate approximately 50 percent higher than that paid by their foreign competitors. Repeal of the credit would result in a tax rate for IBM on its foreign income of close to 75 percent, which is clearly prohibitive. The foreign tax credit allows a return on investment without penalizing the source of that investment and income.

Under the tax reform bill passed by the House, H.R. 10612, the foreign tax credit would be modified by removing the option for a company to compute its credit limitation on a country-by-country basis. The administration has not objected to per country repeal, and indeed, IBM would not be affected adversely by the modification. However, it is clear that such a change could prevent some firms from selecting the limitation method which most closely corresponds to conditions in their industry. The current option to select either method simply allows some firms to compete more effectively in face of advantages offered by other governments to firms headquartered within their territory.

Another proposed limitation on the foreign tax credit—fortunately rejected by the House—would eliminate the overall method of computation. This unwise approach could severely impair the international competitiveness of many firms. We estimate that the added tax burden to IBM would be about $20 million per year, and the impact on other companies would be substantially greater.

Most foreign business transactions of U.S. companies cannot conveniently be split into independent separate country taxable events. No company manufactures in each foreign country, and companies commonly establish centralized support and service centers to handle their overseas business. Accordingly, a per-country limitation on the foreign tax credit would create pressure on firms to realine their operations in order to offset any tax loss. We oppose any measure that encourages international firms to make decisions on where to invest largely on the basis of tax considerations.

Such a tendency would obviously be inconsistent with the goal of avoiding tax-related distortion of investment decisions. Clearly, repeal of the overall limitation would not be in the country's best interest.

In short, IBM believes that the foreign tax credit is an essential instrument employed to insure tax fairness, and that it should be retained with as few technical changes as possible. Without the foreign tax credit, U.S. firms will not be able to compete abroad.

Tax Deferral

Another proposal is for Congress to tax the unremitted foreign earnings of corporations, contending that these firms keep earnings overseas to avoid U.S. tax obligations, and that this proposal would raise new revenues for the U.S. Treasury. This view is mistaken on both points: First, it fails to recognize the absolute necessity of maintaining sufficient levels of reinvested earnings to promote economic growth. And second, while the tax obligations of U.S. firms would increase, foreign treasuries, not the U.S. Treasury, would benefit.

IBM does not keep funds overseas to avoid paying U.S. taxes. On the contrary, it invests abroad, expecting to earn a profit for the parent company and its stockholders.

This is evident in the pattern of our investment. Since the tax credit allows a credit against U.S. tax for each tax dollar paid to foreign governments, deferral makes a difference in U.S. tax liability only for those countries with lower rates than our own. We have noted that IBM does business in 127 foreign countries. The overwhelming proportion of this business is conducted in developed countries which have statutory tax rates similar to our own.

After income taxes are paid to the foreign government, IBM and other companies determine what portion of their net after-tax profit is to be reinvested abroad in new plant and equipment, and what portion is to be returned to the parent company. That portion which is repatriated is subject to a withholding tax by the foreign government in most of the countries where we do business.

Generally, for IBM, the average withholding tax abroad is about 10 percent of the dividend paid. The effective tax rate is, therefore, much higher than the statutory corporate income tax rate. In virtually every instance, we find that the combination of the high statutory rate and the additional withholding tax equals or exceeds the U.S. corporate income tax rate of 48 percent.

For countries where the effective rate equals or exceeds the American tax rate, no U.S. tax is levied since the foreign tax credit is fully applicable. Thus, repeal of the deferral provision would bring little or no additional revenue for the U.S. Treasury.

While no additional taxes will be received by the U.S. Treasury, foreign treasuries would enjoy substantial revenue increases if the U.S. repeals deferral. There are several reasons for this—all linked to how foreign governments could be expected to react to such an American change of policy. Taxation of foreign subsidiary earnings by the United States before remittance of the basis of a presumed remittance would lead host countries to apply their withholding taxes to unremitted earnings. It would also lead to increased withholding taxes on dividends remitted to the U.S. parent company. And it would likely encourage foreign governments to block additional funds from being repatriated to the United States.

A number of countries have already acted to block more funds from being repatriated. Some, like Canada, have enacted statutory limits on payment of dividends. In these countries, dividends remitted by the local subsidiary are limited by law in relation to a selected base period.

In other countries, like Brazil, funds are blocked on a more technical basis. In Brazil, we already pay a 30-percent statutory income tax plus a 25-percent withholding tax on dividends. If a 100-percent remittance were required through repeal of deferral Brazil's graduated withholding tax system for dividends would force our effective rate of taxation upward to about 75 percent. Obviously, laws such as exist in Brazil make increased repatriation extremely difficult and costly, assuming no agreement is reached between the U.S. Government and the governments which have blocked funds laws. A representative list of national blocked funds laws is attached to this statement.

In one respect, business transactions which take place entirely within the United States already receive more preferential treatment than those between a U.S. company and its overseas subsidiary. Presently, intracompany transactions entirely within the United States are not taxed on a current basis. In a consolidated return, any intracompany profit is eliminated for tax purposes since the company has not yet received any customer payment. Income is taxed only when the finished product is sold to a customer.

This is not the case for transactions between U.S. parent firms and their foreign subsidiaries. These subsidiaries are treated under U.S. tax laws as separate taxable entities; thus, exports from U.S. firms to their overseas subidiaries are taxed. IBM, for example, generates over $100 million in taxable income through such sales.

Repeal of deferral, as proposed by some, would compound these differences, resulting in a gross inequity. Even an intracompany transaction between two overseas affiliates would be taxable. Thus, if IBM Germany were to manufacture and sell a system to IBM United Kingdom for sale in the United Kingdom, the income IBM Germany realizes from that transaction would be immediately taxable by the United States. Currently, that income would be taxable only when it is repatriated.

For a rental business like IBM's, repeal of deferral would cause a further and serious inequity. Profit realized by IBM Germany, for example, on transfer of equipment to IBM United Kingdom represents an expense to IBM United Kingdom which it, in turn, must charge to its customers. On a straight sale by IBM United Kingdom, the expense is charged to the customer at the time of the sale. In a rental business, however, the expense is charged over a period of years. If deferral were repealed, IBM would be required to pay a current U.S. tax on the profit shown by the German subsidiary as a result of the intracompany sales transaction, even though IBM United Kingdom—(and, indeed, the company as a whole)—had as yet realized no income from customers on the rental of the equipment. Thus, repeal of deferral would represent accelerated taxation for us. Furthermore, since the money we pay in taxes could be put to alternative uses—at a minimum, deposited at prevailing rates of interest in an appropriate money market instrument—the effect would be to diminish the earning power of this money paid out in advanced taxes.

Finally, the nature of international monetary fluctuations makes repeal of deferral undesirable for international firms. Repeal would force IBM and other companies to pay U.S. taxes on the current dollar equivalent of unremitted earnings. Yet, if when we repatriate these earnings the value of the dollar has declined, we will actually receive a lower dollar amount than was previously taxed. Even under our present system, if the dollar's value increases, we pay more taxes since it is worth more at the time of repatriation.

In a sense, deferral repeal could be looked at as a double penalty. First, our foreign profits lose some of their earning power since they are taxed early, and second, in the event of devaluation, the dollar we receive upon repatriation is worth less than when it was taxed.

Repeal of deferral, as indicated, would cost IBM $50 million. The long-term effect is more disturbing. Such additional costs would substantially weaken our competitive position abroad with a subsequent diminishing of our future earnings. As the Ways and Means Committee noted in its report on the 1962 Revenue Act:

Testimony in hearings before the Committee suggested that the location of investments in these countries is an important factor in simulating American exports to the same areas. Moreover, it appears that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.

Conclusion

The IBM company believes the Nation's present system for taxing the foreign income of American corporations is fair and equitable. While certain parts of the system may require some adjustment and fine tuning, the overall concept found in the Internal Revenue Code is sound. Major modification of the foreign tax credit and deferral mechanisms would, we believe, result in severe disruptions in our ability to conduct business and a loss of America's leadership in worldwide business competition.

We believe that a company can help America's income and employment pictures by operating as a responsible investor in international commerce. This contribution can, however, be damaged through enactment of punitive and ill-advised proposals such as those addressed in this statement.

APPENDIX—BLOCKED FUNDS PROGRAMS

Country	*Dividends blocked or restricted, 1976*
Argentina	Limited to 12.5 percent of registered capital if a contract is signed with the Government. Otherwise, there is no limit on dividend remittances but the dividend withholding rate would be 40 percent.
Belgium	Dividend remittance frozen at 1975 level.
Bolivia	Limited to 14 percent of the registered foreign investment.
Brazil	Dividends are remittable but subject to an additional withholding tax of 40 to 60 percent on the net amount of remitted dividends whenever the average dividend for a consecutive three year period exceeds 12 percent of registered foreign investment.
Canada	Cannot exceed the dividends paid in a 12-month base period. The base period can either be the 12 mo. ended December 31, 1974, or Oct. 14, 1975.
Chile	Limited to 14 percent of registered foreign investment and must be remitted in 4 yearly installment payments under current exchange regulations.
Columbia	Limited to 14 percent of the registered foreign investment.
Denmark	Dividend remittance frozen at 1975 level.
Dominican Republic	Limited to 18 percent of registered capital.
Ecuador	Limited to 14 percent of the registered foreign investment.
El Salvador	Limited to 10 percent of registered branch investment.
Peru	Limited to 14 percent of the registered foreign investment.
Spain	Dividend remittance frozen at average of 1974 and 1975 level.
Venezuela	Limited to 14 percent of the registered foreign investment.

Statement of Gerald D. Morgan of Hamel, Park, McCabe & Saunders

This statement is submitted on behalf of our client, Freda R. Caspersen of Venice, Fla., who after May 21, 1974, made an irrevocable transfer in trust to a foreign situs trust with U.S. beneficiaries. Under that trust she transferred property for all time, beyond recall, reserving to herself no control, dominion, or direction whatsoever, and retaining no interest, present or future, vested or contingent in the property transferred or in the income therefrom. A significant U.S. gift tax was paid in 1974 on account of such transfer, and the withholding tax of 30 percent of the dividends paid by U.S. corporations to the foreign trust is currently being withheld.

The tax reform bill, passed by the House and presently being considered by the Finance Committee of the Senate, contains provisions—(section 1013–1015)—under which U.S. grantors of foreign trusts having U.S. beneficiaries are to be taxed currently on the income of these trusts.

Our client strongly opposes this provision on two grounds:

(1) It is plainly unconstitutional as applied to trusts such as that created by her; and

(2) It is unconscionable in its being made applicable to trusts created after May 21, 1974.

PROVISION IS PLAINLY UNCONSTITUTIONAL

Foreign trusts are already subject to all of the "Clifford" rules, and trust income is taxed to the grantor whenever the grantor retains any interest in the trust or retains any dominion or control over the trust or its beneficial enjoyment or any dominion or control over its administration, or whenever the trust is used to discharge a debt or other obligation of the grantor. Mrs. Caspersen's trust has none of these elements. Sections 1013 to 1015 of the bill will tax her on income from property that does not belong to her, never will revert to her, and over which she has retained no dominion or control, and with respect to which she has retained no powers of administration; and will tax her on income that is not used to pay any of her obligations and whose beneficial enjoyment she cannot direct or influence. It is patently clear that the attempt to tax such income violates the fifth amendment of the Constitution. It was so held by the Supreme Court in the case of *Hoeper* v. *Tax Commission of Wisconsin*, 284 U.S. 206, 52 S.Ct. 120, 76 L. ed. 248 (1931), wherein the State of Wisconsin attempted to fix the rate of tax on the husband by reference to the separate income of his wife. The Court (at p. 215) stated the principle succinctly:

> We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a State to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the 14th amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income.

The Court has also held that what is prohibited to the State by the 14th amendment is prohibited to the Federal Government by the fifth amendment. *Heiner* v. *Donnan*, 285 U.S. 312, 52 S.Ct. 358, 76 L.ed. 772 (1932).

In the *Donnan* case, the Court said (at p. 327):

> Plainly, this is to measure the tax on A's property by imputing to it in part the value of the property of B, a result which both the *Schlesinger* and *Hoeper*

cases condemn as arbitrary and a denial of due process of law. Such an exaction is not taxation but spoliation. "It is not taxation that Government should take from one the profits and gains of another. That is taxation which compels one to pay for the support of the Government from his own gains and of his own property." *United States v. Baltimore & Ohio Railroad Co.*, 17 Wall. 322, 326, 21 L.ed. 597, 599.

There is no possible way of lawfully attributing the income of the Caspersen Trust to Mrs. Caspersen. None of the rules of income attribution that have been developed by the courts or that are presently contained in the Internal Revenue Code can possibly be treated as applying to the Caspersen Trust income or to Mrs. Caspersen. Mrs. Caspersen could be destitute and would still be powerless to require the use of any of the trust income, now or ever, for the purpose of enabling her to discharge her tax liability under sections 1013–1015. In short, the income is income of the trust and not income of Mrs. Caspersen, and the *Hoeper case*, supra, holds that it is contrary to the Constitution to tax that income to Mrs. Caspersen.

In the consideration by the Ways and Means Committee of foreign trusts, the suggestion was made by the staff that some of the money being transferred to foreign trusts by U.S. persons was "dirty money." Although the staff backed away from this suggestion in the ensuing discussion, we feel that the mention of "dirty money" substantially affected the committee's decision. The fact that some of the money being transferred to foreign trusts by U.S. persons may be "dirty money" cannot lawfully justify the Congress in treating innocent grantors in the manner provided in sections 1013–1015. In the *Donnan* case, supra, the Court said (at p. 328):

This is very near to saying that the individual, innocent of evasion, may be stripped of his constitutional rights in order to further a more thorough enforcement of the tax against the guilty, a new and startling doctrine, condemned by its mere statement and distinctly repudiated by this court in the Schlesslonger's Case (270 U.S. p. 240, 70 L.ed. 564, 43 A.L.S., 1224, 46 S.Ct. 260) and *Hoeper's* case (284 U.S. p. 217, ante, 248 52 S.Ct. 120), cases involving similar situations. Both emphatically declared that such rights were superior to this supposed necessity.

The section of taxation of the American Bar Association, in its report on H.R. 10612, characterizes sections 1013–1015 of the bill as "penal in nature," as "punishing the settlor of the trust," and as "unduly harsh." The report does not discuss the constitutional issue, but gives examples of a number of anomolous results to illustrate that these characterizations are well supported. These examples in turn demonstrate that sections 1013–1015 are clearly unconstitutional as written.

RETROACTIVE APPLICATION UNCONSCIONABLE

Sections 1013–1015 of the tax reform bill, in addition to being unconstitutional, are made application to foreign trusts created after May 21, 1974. May 21, 1974 was the date that the Ways and Means Committee approved a similar provision in connection with its consideration of the 1974 tax reform bill, but that bill was not enacted into law. It died at the end of the 93d Congress.

Taxpayers, some of whom were aware of the committee's action, as well as some who were completely ignorant concerning it, continued to rely on the law then in existence and on the fundamental principle that a person cannot be taxed on income that is not his and over which he has not one iota of dominion or control. Mrs. Caspersen was one of those taxpayers, and on December 27, 1974, created, and transferred property to, an irrevocable foreign trust by which she put that property and the income therefrom forever beyond her control.

She now finds that the provisions contained in sections 1013–1015 of the bill not only violate this fundamental principle, but violate it retroactively by applying the violation to trusts created after the date on which the Ways and Means Committee first adopted a similar provision that failed of enactment.

We assert that making a novel principle of taxation retroactive—and taxing a person on income which does not now, and never will, belong to him and over which he does not now, and never will, have one iota of control is certainly a novel principle—is unconscionable, and should be eliminated from the bill.

If the retroactive feature alone is eliminated, the bill will then be only prospective in nature, and, although plainly unconstitutional, by scaring to death prospective grantors as to the tax consequences to them of creating foreign trusts, doubtless will prevent the creation of any trusts in the future. If it is not eliminated, however, the unconstitutionality of attempting to tax one person on another person's income will doubtless be asserted in court by a grantor of a foreign trust created after May 21, 1974, and prior to the bill's enactment. In that event we confidently predict that the Court, on the basis of *Hoeper* and *Donnan*, supra, will hold sections 1013–1015 of the bill unconstitutional, and that the supposed "foreign trust loophole" will, despite the desires of the supporters of the foreign-trusts provision of the bill, become a permanent part of our tax system, resulting in a reduction of tax revenues in the future.

We urge the elimination of sections 1013–1015 of the bill because they are obviously unconstitutional. In the alternative we urge that these sections be made to apply only to foreign trusts created after the bill's enactment because of the unconscionability of doing otherwise as well as the practical results to which we have adverted.

Statement of the Chase Manhattan Bank, N.A.

On Eliminating U.S. Withholding Tax on Bank Deposit and Other Interest, and on Dividends Paid to Foreigners

SUMMARY

The purpose of this statement is to urge the Senate Finance Committee to act as to two aspects of the 30-percent withholding tax on interest and dividends paid to foreigners:

1. *Bank deposit interest.*—The exemption from the 30-percent withholding tax for bank deposit interest is now scheduled to expire December 31, 1976. The House-passed tax reform bill (H.R. 10612) would make that exemption permanent. It is important to act quickly because foreigners are becoming concerned about the possibility of U.S. tax applying to the interest they would receive on U.S. bank

deposits held after December 31, 1976. As the expiration date approaches they can be expected to start withdrawing more and more of the $18 billion in interest-bearing bank deposits they now hold in U.S. banks. Legislation should be enacted by June 30, 1976 because at that time it will become difficult to sell 6-months certificates of deposit to foreigners. If Congress decides that H.R. 10612 cannot be enacted by June 30, 1976, we believe that separate legislation making permanent the bank deposit exemption for foreigners should be enacted. As in the case of the individual tax cuts, the expiration of this exemption would adversely affect our economic growth (and international position) at the wrong time.

2. *Other interest and dividends.*—Most recently on April 13, 1976, the Treasury urged the repeal of the 30-percent withholding tax on all interest and dividends paid to foreigners. We strongly support that recommendation as one of the most effective ways to attract more capital to the United States during the time when the United States is projected to have a serious capital shortage. In addition, this would strengthen the international position of the dollar. However, if, because of concern for the loss of revenue or otherwise, Congress is not prepared to accept the Treasury proposal in full, we urge that at least the 30 percent withholding tax be eliminated for portfolio interest. That would cost only $15 million per year—rising over 5 years to $35 million per year—in withholding tax, and when the resulting increase in economic activity is taken into account will probably result in a net increase in total revenue.

DETAILED DISCUSSION [1]

Exemption for bank deposit interest

For over 50 years the withholding tax has not applied to interest paid to foreigners on bank deposits. As part of the Foreign Investors Tax Act of 1966 it was decided to apply the tax to bank deposits, but was not put into effect at that time. Since then neither Congress nor the administration has felt that it would be in the best interest of the country actually to apply the tax. The 1966 act originally provided that the tax on bank deposits would not be effective until 1973, and two subsequent delays in the effective date have prevented the tax from applying. The most recent extension of the effective date is scheduled to expire December 31, 1976.

At the present time there seems to be wide agreement that it would now be appropriate for the United States again to make permanent the exemption for interest on bank deposits of foreigners, and the House bill so provides. As to such legislation, timing is a significant element.

Even now a foreigner cannot buy a 1-year certificate of deposit from a U.S. bank and under existing law feel confident that all of the interest will be exempt from withholding tax. If legislation is not enacted by July 1 of this year, a foreigner acquiring a 6-month certifi-

[1] This discussion deals with the withholding tax on interest. As current law provides, it is assumed that there will be an estate tax exemption for individuals where there is a withholding tax exemption.

cate of deposit of a U.S. bank will be in the same position. Moreover, if the United States imposes for the first time a 30-percent withholding tax on bank deposit interest paid to foreigners, then foreigners could conclude that foreign investments are not welcome in the United States with adverse effect on other forms of U.S. investments.

Of course, freedom from taxation in the United States does not mean freedom from all taxation. The foreigner will generally be subject to the taxes imposed on the interest by his or her home country. The jurisdiction to tax bank deposit interest properly should be that of the recipient's home country. In the same way that interest on foreign deposits in the United States should be free from U.S. withholding tax, but subject to tax at home, so should U.S. deposits abroad be free from foreign withholding tax, but subject to tax in the United States. There is no withholding tax on interest on bank deposits of U.S. depositors in the United Kingdom, Germany, the Netherlands, Luxembourg, the Scandinavian countries, Belgium, Singapore, Panama, the Bahamas, the Cayman Islands, and the Netherlands Antilles. In Japan and Canada there is no withholding tax on U.S. currency bank deposits of U.S. depositors.

As stated in the summary, the Treasury Department statistics indicate that there are about $18 billion of non-governmental foreign deposits in the United States which bear interest. As the expiration of the exemption approaches, the risk increases that such deposits will be withdrawn. While it is recognized that some of the deposit interest would be protected from tax by treaty exemptions, there is no way to tell what part now are so protected. Moreover, even those taxpayers who enjoy a treaty exemption often prefer to put their money in a form which is automatically tax-free.

Experience gained relative to withholding tax on non-bank deposit interest (discussed below) makes it evident that little revenue could be expected from withholding taxes on bank deposit interest. A withholding on bank deposit interest would merely induce foreigners to withdraw their deposits from the United States.

Exemption for interest and dividends

In his testimony before the Senate Finance Committee, Secretary Simon, both on March 17 and April 13, 1976, made a persuasive case for eliminating the U.S. withholding tax on all interest and dividends. We support the proposal and endorse Mr. Simon's reasoning. In this statement we will focus on eliminating the withholding tax on interest paid on portfolio investments in the United States, a step which we believe is justified in and of itself.

The elimination of withholding tax on interest is discussed from four points of view:

The need of the United States for capital;

The positive effect on the international position of the dollar;

The effect which the action would have on the United States as a financial center and the resulting boost to U.S. jobs, and

The traditional considerations of tax policy.

1. *The need for capital.*—The need for capital in the United States and the projected shortfall under present policies has been well documented in recent years. We call your attention to our statement filed with the House Ways and Means Committee on July 30, 1975, a copy of which is attached. Under current policies that statement estimates a capital shortfall for the United States over the next 10 years of $1.5 trillion and suggests four approaches for dealing with the shortfall, including the encouragement of foreign investment through elimination of the withholding tax on interest and dividends.

All indications, including our frequent contacts with potential foreign investors, point to the fact that eliminating the withholding tax on interest, especially portfolio interest, would help bring substantial long-term foreign capital to this country.

While the traditional investors in the United States have been from countries with which the United States has treaties that eliminate or reduce the rate of withholding tax on interest, substantial funds are now being accumulated in countries with which we do not have treaties. While this new accumulation to a significant degree is in governmental hands and is not, therefore, generally subject to withholding tax, much is in private hands. Some of these funds are already here in the form of bank deposits, but if the withholding tax were also eliminated for portfolio interest—and dividends—the existing, and additional, funds might well be more permanently invested in the United States.

The elimination of withholding tax would make it possible for U.S. corporations to raise funds by the sale of obligations to foreigners. The Eurobond market has developed as a tax-free market. International public offerings are not successful unless they are free of withholding tax. All treaties do not fully waive the withholding tax on interest. Further, even investors not themselves subject to withholding tax because of treaties or the governmental exemption seek tax-free obligations, as only such obligations can have an active secondary market.

As with most countries, the United States does not subject interest or other kinds of income paid to foreign governments to withholding tax. In a world where large investments are made by governments, it is difficult to justify continuing a withholding tax on private investments. Should the United States welcome government investment and at the same time retain barriers to private investment, especially when we need to remove all barriers to capital accumulation?

Interest is most sensitive to a withholding tax. This proposition is borne out by the fact that the U.S. withholding tax on interest on portfolio investment has not served as a significant source of revenue, but undoubtedly stands as a barrier to foreign investment in U.S. interest-bearing securities and thus results in reduced economic activity and lower net revenue. The total collection by the United States in 1973 from its withholding tax on interest was only $17 million of which $15 million was on portfolio investments and the rest on direct investments.

Experience gained during the period when the United States, in support of balance-of-payments efforts, freely permitted U.S. corporations to issue withholding tax-free bonds to foreigners is instructive. The following table shows the amount of such long-term debt issues floated from 1965 through 1973 by U.S. companies.

	Millions
1965	$191
1966	594
1967	446
1968	2,144
1969	1,030
1970	822
1971	1,181
1972	2,003
1973	1,223

While such foreign borrowings resulted in large part from the compulsions of the U.S. balance-of-payments controls, this experience does show what can be done. Perhaps we cannot expect $2 billion of American international issues just by eliminating the withholding tax, but it is evident that there is a large potential for sales of U.S. debt issues abroad, certainly enough to result in capital flows sufficient to more than compensate for the initial annual revenue loss of $15 million.

Looking at the matter from the point of view of the breath and depth of the international debt markets, the elimination of the U.S. withholding tax would allow absorption of more foreign capital from a wider range of participants, allowing U.S. companies unrestricted access to foreign sources of debt capital. It would also stimulate competition in the capital markets both here and abroad, which in the long term might well bring down the costs of borrowing.

Various proposals have been made to encourage capital formation. Possibly the small cost—$15 million to $35 million per annum—of eliminating withholding tax on portfolio interest of foreigners makes this proposal a prime candidate for immediate adoption, especially since it would result in an infusion of new capital into the United States rather than a shift of capital already in the United States.

A number of other countries have made it possible for their borrowers to issue obligations free of withholding tax. For example, Australia in 1973, Japan in 1975 and Canada in 1975 enacted laws to exempt interest on long-term international bonds. Also a similar result is reached under the laws of Austria, Denmark, France, Finland, the Netherlands, Norway, Sweden, and the United Kingdom.

2. *A positive effect on international position of the dollar.*—Foreign investment in the United States helps meet our capital shortage. However, it is important to note that it helps meet the shortage in an especially desirable way. When capital comes from abroad, it also helps maintain the international position of the dollar by soaking up the huge amounts of dollars accumulating abroad. To the extent that dollars are absorbed in this country on a more permanent basis through sales of long-term bonds—and stocks—to foreigners, this helps keep a high value for the dollar and a higher standard of living for Americans.

3. *United States as a financial center and U.S. jobs.*—In the past decade the position of the United States as the preeminent international financial center has diminished. The elimination of the withholding tax on interest (and dividends) would help to reverse the trend, thereby having a positive effect on the U.S. economy and employment.

4. *Tax policy.*—In addition to the other reasons already given, on tax policy grounds a good case can be made for eliminating withholding tax, especially on interest.

The principal purpose of nonregulatory taxation is to collect revenue. Therefore, if such a tax does not bring in any significant revenue, it is not accomplishing its primary purpose. It seems pointless as a policy matter to retain a tax which does not bring in significant revenue and also discourages the very type of economic activity we need—the accumulation of capital.

Elimination of U.S. withholding tax on interest and dividends does not mean freedom of foreigners from taxation. As in the case of bank deposit interest, most foreigners would be subject to tax at home.

Further, as a policy matter, tax law should be simple to administer. The United States has a network of some 25 treaties of which provide for an exemption for withholding tax on interest. Moreover, there is a governmental exemption which is rather broad. Each of these exemptions is justified, but when the remaining fabric of taxable transactions becomes small, it seems that it is time to consider removing the tax on the remainder of the transactions. The problems of administering a tax where the exceptions prevail are just too great, especially when little revenue is involved.

Statement by Jack N. Behrman, Professor of International Business, University of North Carolina

COMMENTS ON PROFESSOR MUSGRAVE'S REPORT TO THE U.S. SENATE SUBCOMMITTEE ON MULTINATIONAL CORPORATIONS

The study by Prof. Peggy D. Musgrave on "Direct Investment Abroad and the Multinationals: Effects on the U.S. Economy" prepared for the Senate Subcommittee on Multinational Corporations has already been the basis of hearings by the Church committee and has been discussed further before the Senate Finance Committee under the chairmanship of Senator Long. The analysis and conclusions of the report require careful assessment since policy recommendations are being drawn from them. The author has been working in the field of an international taxation and investment for some years and has faithfully employed the theoretical tools of economics in her study. These tools frequently employ only partial analysis, however, leaving out many relevant factors. Even for the more simple analysis, Professor Musgrave is careful to note that the data are not adequate to support the theory completely. But in her summary, she derives recommendations which are not adequately supported from her own cautious analysis.

Her model of foreign direct investment is one which involves only a few selected changes as the result of direct foreign investment, despite the fact that there are multiple changes which can and are likely to occur both domestically and in the external economy through the flow of direct investment funds. For example, she does not take into account the likely reactions of other countries to the recommendations that she makes for changes in U.S. tax and foreign investment policies. In sum, the report is still quite incomplete and requires not just new information but the reformation of her analytical model.

I. The model

The theoretical model which Professor Musgrave employs has been used by economics for decades in showing the relative distribution of benefits as between capital and labor as a result of capital investment.[1] It is a model which applies to a particular institutional setting and which was developed without reference to the multiple movement of factors—capital, management, and technology—which accompany foreign direct investment. In its simplest form, the model asserts that if capital flows out of a given national economy, it becomes scarcer within that economy, raising the returns to capital and therefore decreasing at least the relative returns to labor. Professor Musgrave complicates the model only slightly by demonstrating how this result occurs under assumptions of full employment and flexible exchange rates.

These two assumptions have not applied for most of the period in which U.S. foreign direct investment has taken place, and at least one does not apply currently. The conclusions she reaches are not appropriately applied to policy, therefore.

The model itself traces a change in a single factor—an increase in foreign investment—in terms of its effects in the domestic economy and abroad and through the balance of payments. This results in a single-factor analysis which is simply inadequate for determination of policy. For example, any attempt to reduce the outflow of U.S. capital funds will be felt immediately in either the current account—trade and services—or in other items of the capital account through a reduced flow of funds back into the United States. Foreign countries cannot continue to generate funds for payment into the United States unless they are received from the United States. A reduction of U.S. foreign direct investment is likely to mean a reduced inflow of capital from abroad, because the outflow of U.S. funds will have raised interest rates temporarily in the United States—at least relative to those abroad—attracting an inflow of funds. The prevention of an outflow of U.S. capital would tend to lower U.S. interest rates—again, at least relatively—with a consequent repelling of foreign capital.

As one adds this capital flow analysis to the picture, Professor Musgrave's conclusion that foreign direct investment displaces domestic capital investment—that is, occurs at the cost of a domestic investment not taking place—is seen to be an inadequate conclusion. Not only is it conceivable that the dollar funds are simply recycled through the balance of payments back into the United States but also that these inflows can go directly into investment in the United States or indirectly through receipts by exporters into corporate savings and investment.

Finally, though Professor Musgrave does not stress the point, she recognizes that assessment of national interest may be different from that of international interest. These flows of capital funds are presumably guided by criteria of the most efficient use of capital around the world and, therefore, would tend to achieve the highest growth for the aggregate of countries involved.

Other inadequacies of the model and its use require more specific assessment, as in the following sections.

II. Foreign investment in the United States

Professor Musgrave argues as though all of the U.S. foreign direct investment could have been placed in the U.S. domestic economy

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[1] See my own similar analysis 15 years ago in Mikesell, R. F. (ed.), "U.S. Private and Government Investment Abroad," Eugene, Oreg.: University of Oregon Press, 1962, pt. II.

and that it is appropriate to make a calculation of the effects of such a diversion. She excludes completely from her statistical data base foreign direct investment in the United States. Even analytically, but much more so in the real world, she should take into account that restrictions on U.S. capital outflows would lead to restrictions on the part of other countries. Therefore, we could not assume that we could retain all other investment and merely divert U.S. foreign direct investment into domestic outlets. We would likely also lose foreign investment coming into the United States—both direct and some portfolio investment.

On this account alone, her estimates of the impact of displacement would be cut in half. That is, the impact would be the result of only the net outflow of U.S. funds after the subtraction of the inflow of foreign funds. (These inflows would obviously produce reverse impacts.)

The relevant data on private direct and portfolio investment for the years 1970–74 are as follows:

[In billions of dollars]

	1970	1971	1972	1973	1974
Direct U.S. investment abroad	75	83	90	104	119
Portfolio (long term)	21	24	28	28	29
Total long-term outflow	96	107	118	132	148
Direct foreign investment in the United States	13	14	15	16	22
Portfolio	25	30	39	37	28
Total long-term inflows	38	44	54	55	50

As can be seen from these figures on cumulative inflows and outflows for each year (as reported by the U.S. Department of Commerce), roughly 40 percent of the U.S. outflows are offset by inflows into the United States.

Therefore, Professor Musgrave's conclusions as to impact of displacement must be substantially modified.

III. Displacement of Domestic Investment by Foreign Direct Investment

The assumption of displacement—that the entire foreign direct investment could be turned inward and thereby reverse the unfavorable impact on labor—is wholly unrealistic. If one looks at the composition of U.S. foreign direct investment, one can readily see that much of it simply could not be made internally without altering substantially the structure of the U.S. economy—leaving it impossible to determine the impact on any one of the factors either absolutely or relatively.

Outstanding U.S. foreign direct investment can be separated according to major categories, demonstrating the above point:

U.S. FOREIGN DIRECT INVESTMENT BY SECTORS

[Billions of dollars]

	1972	1973	1974
Petroleum	24	27	30
Manufacturing	38	44	51
Other [1]	28	32	37

[1] Public utilities, transportation, financing, insurance, etc.

These figures show that over 25 percent of the outstanding investment is in petroleum, the absence of which would have meant substantially higher prices for petroleum inputs into the U.S. economy, decreasing substantially the productivity of labor. Such a decrease would mean a fall in the total product much greater than any increased demand for labor inputs, so that the returns to labor would be substantially less.

Some of the investment in manufacturing is also in processed resources and semi-finished inputs for U.S. industry. The investment in food products, primary metals, and paper-pulp constitutes 20 percent of the total U.S. foreign direct investment in manufacturing. If these products were not offered on the world market, some of which flow back into the United States to support U.S. industry, total world demand and the demand for U.S. exports would be less, with the returns to labor falling consequently.

In none of these investments would U.S. domestic investments substitute adequately without running into increased costs.

If we, therefore, reduced Professor Musgrave's analytical impact by 35 percent of the outflow—which is not displacing U.S. domestic investments—and then net the remaining 70 percent against foreign investment inflows into the United States, we have the small figure of 30 percent of a total foreign investment—a sum of $25-billion rather than $80 billion in 1968—which might have the impact which she ascribes to it. Given her own doubts about the applicability of the data, it is probably not worth worrying about the small impacts which would result—even under her analysis.

IV. Gains From Abroad

Although Professor Musgrave concludes that "investment abroad is in substantial degree in displacement of domestic investment," she interprets the data to suggest "that only a small net loss results" since "gains from increased foreign earnings largely offset the loss of the domestic output" (p. IX). However, her calculation of this net effect is again inadequate. She arrives at this result through an allowance for the role of profits taxation in the United States and abroad. She also makes no allowance for other returns to the investor which are in effect tied to the total package of assets transferred—profits on exports, royalties, et cetera. And she assumes that the returns to investment in the two economies are commensurate, which is highly unlikely.

On the role of taxation, she reiterates an old argument, drawing on John Maynard Keynes' assessment of foreign direct investment; in her words: "Taxes paid abroad are lost to the United States because they reduce the foreign income which the United States receives, whereas taxes paid on U.S. profit to the U.S. Treasury are merely a transfer to other parts of the U.S. economy." She stresses that this loss of income through foreign taxation is "one of the major reasons why, on balance, our estimates show a net loss." This calculation must be examined rather carefully.

To be useful, the calculation must attempt to determine the relative profitability of the domestic investment which would have been made by the firm, or which would have been available in the U.S. economy, with that of the investment abroad. Since Professor Musgrave wishes to couch her argument in aggregate terms (not confining herself to the particular domestic investment which a given company would make), the appropriate comparison in her analyses is between the earnings on the investment abroad and the marginal investment in the United States. This is an appropriate comparison in view of the fungibility of capital funds and her desire to make a comparison of economic rather than company decisions.

Obviously, for an entire economy, the least attractive investment would be dropped off if funds were to be invested abroad rather than at home. In the fully employed situation which Professor Musgrave hypothesizes, the marginal investment could be as low as zero net return. Whatever its level, it is likely to be lower than the earnings expected from the project abroad undertaken by the foreign investor. In this calculation, one does not compare the marginal investments in the domestic economy with the marginal investment in the capital-receiving economy, because the company does not receive the earnings on marginal investment abroad but those from the specific project undertaken. All that is required for the undertaking to be a gain for the U.S. economy is that the earnings abroad be double those of the marginal investment in the United States. Since, on an economy wide basis, the latter is probably near zero under the conditions stipulated, it is highly likely that all foreign investment provides a net gain, even after foreign taxes. Obviously, not every foreign direct investment makes profit—but then neither do all investments in the United States. Theoretical analysis breaks down in the face of empirical data.

This example shows the inapplicability of the assumptions made under her economic analysis. The appropriate comparison, under conditions of displacement, is between the specific domestic investment not undertaken by the company and its project abroad. The displacement assumption presumes that no U.S. investor picks up a similar project to the one which the company does not undertake. If some other company does, and only because the first company invested abroad, then the marginal analysis above is more appropriate. Again, it would require a 100-percent differential between the foregone domestic investment and the foreign investment of the company to break even for the U.S. economy. Professor Musgrave does not like to make this comparison, because she recognizes that the marginal investment for a U.S. company in the U.S. economy may frequently drop to zero or become negative, especially under oligopolistic conditions that exist in many of the sectors which spawn foreign investors.

But, only if the U.S. companies were forced to pay out 100 percent of earnings and dividends, letting potential new investors bid for the savings, would the funds be forced to be fungible enough to make the marginal analysis of the previous paragraph applicable. Since companies do have retained earnings at their disposition, the decision factors they employ as to where to invest are the relevant ones for policy analysis. Companies frequently require a risk premium for going abroad, and the expected returns from foreign operations are likely to be higher than those in the United States.

These expectations are not always fulfilled, of course, for reasons of company errors or shifts in external factors. One of these shifts, which again is an old argument repeated by Professor Musgrave—(p. XVIII)—is that the new investments at the margin in the capital-receiving countries reduce the return to capital and affect all of the infra-marginal earnings from past foreign direct investments. This argument concludes that the returns to any new investment overseas should, therefore, be reduced by the cuts in current returns to past capital investments. While this reduction is realistic in one sense, it is only half of the picture, again; for a similar reduction would have to be made for the U.S. economy, if the investment were made there, rather than abroad. An investment at the margin in the United States expands the capital base within a sector, reducing the returns to existing capital, raising the tax base for the U.S. Treasury by less than the return to the new investment. The adjustment, if made, must be made on both sides of the comparison; it merely reinforces the significance of the inadequacy of the data rather than being a useful adjustment.

In any comparison of returns, the earnings from abroad must also be increased by the returns for licensing of patents and know-how, the allocation of head office expenses, and the profits on exports of capital equipment, semifinished goods, and final products which would not have occurred in the absence of the investment itself. And the use of patents and know-how abroad does not displace their use in the United States. These returns cannot be legitimately aggregated into a total "return to capital" as is sometimes done by critics of foreign direct investment who demonstrate annual returns of 200 to 600 percent to equity. But they are returns to the U.S. national economy as a result of the foreign investment package. Although some such returns could have been gained without the investment, a substantial portion would not. And these are not taxed as income by the host country. Therefore, another significant adjustment must be made to Professor Musgrave's comparisons of returns to the U.S. economy from foreign versus domestic investment.

Finally, as noted earlier, if one takes into account the foreign investment made in the United States, the net effect of taxation is substantially reduced. The U.S. tax rate is higher than that in many of the foreign countries and lower than several others, netting out the impact at somewhere around zero for equivalent earnings before tax. A differential exists only in the different volumes of investment by the United States and by the other countries in the U.S. economy and different rates of return; again, the data are not adequate.

V. Balance-of-payments effects

In an assessment of short-run effects on the U.S. economy, Professor Musgrave asserts without qualification that "investment abroad increases the supply of dollars and thus adds to the balance-of-payments deficit."

This assumes that nothing is to be done with the dollars and that they simply pile up overseas burdening the foreign banks; she adds that they force a deterioration of the exchange rate, eventually raising U.S. exports and cutting real resources available to satisfy labor's needs. Obviously nothing of the sort is necessarily the case, for the dollars may simply flow back through one of the many channels in the balance of payments.

She states that further balance-of-payments effects may result as follows:

1. The sales by affiliates abroad may displace exports thereby worsening the balance of payments.

2. Foreign investment may be a substitute for domestic investment. If so, reduced domestic investment, together with reduced exports, will lower the level of income and hence imports, thus providing some offset to capital outflow and declining exports. This of course may not result in stabilization policy as used to maintain employment.

3. In the longer run, balance of payments effects of initial capital outflow will be reversed to the extent that foreign earnings are repatriated (p. XIII).

The tentativeness of these statements should be carefully noted. The use of the word "may" implies also that the opposite "may" occur.

There has been a great deal written over the past several years on the displacement of American exports by companies investing abroad. None of it has been definitive enough to settle the question, simply because of the fact that one cannot say what would have happened in the absence of the investment. However, considerable evidence exists that substantial sales of American companies located abroad could not have been served through exports.

The following table indicates the sales abroad by majority-owned foreign affiliates of U.S. companies during 1969–73:

[In billions of dollars]

	1969	1970	1971	1972	1973
Total	134	156	184	212	292
Extraction	4	4	4	3	4
Petroleum	36	42	53	59	91
Manufacturing	68	78	91	108	141
Trade	18	22	25	30	39
Services	8	9	11	12	17

Among these, it is quite clear much would not be substitutable by exports from the United States: for example, the minerals extracted from foreign mines, the petroleum, the commercial investments which facilitate U.S. exports (or draw on locally manufactured goods which are noncompetitive), and services supplied locally. Some of the goods sold through the trade sector could be conceivably exported, but the data indicate that between 35 and 50 percent of sales by these affiliates could not originate in the United States. In addition, some of the manufacturers' sales are semifinished goods coming into the United States for further processing—particularly the paper and pulp investment in Canada. Therefore, somewhere around 50 percent of the total sales of U.S. affiliates abroad are not substitutable by exports even conceptually. Of the rest, much would be stopped by the trade barriers in the developing countries and by competitive pressures in developed countries. If the developing countries removed their trade barriers they would have fantastically large balance-of-payment problems. The sales of U.S. affiliates in the developing countries amounted during the above years to $32, $35, $42, $48, and $74 million, respectively. These countries could not have financed such voluminous imports. Therefore, while sales by affiliates abroad may displace exports, this would occur in only insignificant amounts.

As to item 2 in the quotation above, the assumption that stabilization policy would not be used to maintain full employment is, of course, borne out by recent policies of the administration, but this is not the fault of foreign investment. Rather, it results from an inadequate domestic policy. The inadequacy of domestic full employment policies frequently raises questioning about foreign investment; when there is relative full employment, the agitation declines.

As to item 3 above on the payback of capital outflows, the evidence has been amply produced that this does not occur only in the longest run but in a relatively short period—on the order of 2 to 3 years. The present large inflows of earnings from abroad which have kept the U.S. balance of payments in relatively good health would certainly not have existed without the outflows of the past decade. Any move to reduce the present outflow is a move to increase balance-of-payments pressures within 3 to 5 years.

VI. Employment and price level effects

Assuming that there is a displacement of exports or of domestic investments, Professor Musgrave moved to the conclusion that the social cost of foreign investment is increased and a primary burden falls on labor, if a stabilization policy is not adopted by the Government and if the economic situation is such that this (displacement) results in a decline in the level of employment. Her conclusions rest on conjecture and lead her to a recommendation on foreign invest—rather than, more appropriately, to employment and stabilization policy. It is not sound economics to recommend policies in one area merely because of poor policies in another area of the economy.

Even so, Professor Musgrave's "ifs" need a probability analysis. U.S. companies do not lightly substitute foreign for U.S. operations. There is strong competition for capital investment funds by domestic product divisions, and there is a general preference for production within the United States as compared with production overseas, given the difficulties of management and the attendant risks. Therefore, there are few situations in which U.S. employment declines as a direct result of willful substitution of foreign labor for U.S. labor and fewer if indirect effects of increased U.S. employment are taken into account.

VII. Effects on real income and factor shares

When Professor Musgrave gets to the longer term effects, she readily admits that estimating these magnitudes is an exceedingly difficult task partly because of the lack of necessary data and partly because of the inherent complexity of the problem. She has not made her own analysis complex enough, however, because she still assumes here that all direct investments accumulated abroad by 1968 could have been made domestically—whereas this has already been shown to be not the case.

Obviously some domestic investment could have been undertaken with this capital, but quite different outputs other than the minerals or petroleum and paper pulp that were imported would have required substantial changes in the structure and production of the U.S. economy and in income distribution. This is already being seen as Arab States take over our investment in petroleum and African States the minerals investment.

In addition, these adverse effects noted are offset substantially by the existence of foreign investment within the United States; and U.S. tax revenue is increased by this foreign investment, which otherwise would be withheld as the United States withheld its funds from abroad. The consequence of significant distributional effects working to the detriment of the labor share are simply not evident. They are rather quite insignificant.

VIII. Foreign taxes

Once again, Professor Musgrave concludes that the absence of data puts her findings under some suspicion—"due to the complexity of the problem and the dirth of data, our empirical conclusions are tentative but they are supported by conclusions that derive from general economic reasoning" (p. XIX). It is the burden of much of the above argument that the general economic reasoning employed by Professor Musgrave is inadequate. It is based solidly on the assumption of displacement and on a partial analysis which is by no means complex enough to present the factors which must be taken into account.

For example, when she concludes that the after-tax of return on foreign investments was less than before-tax rate of return on domestic investment by about 3 percentage points in 1968 and by larger amounts in other years, she does not take into account the return to exports through these affiliates nor royalties nor the increase in U.S. taxes from the allocation of headquarters expenses or R. & D. costs to foreign affiliates. (There are longer run problems of "hostage" impacts and diplomatic differences, but these are not the subjects of Professor Musgrave's report.)

A much more careful analysis would have to be made than she has made here—whether or not the data are refined.

IX. Policy implications

When Professor Musgrave comes to the policy implications of her study, she demonstrates quickly that she is concerned only with economic (efficiency) considerations. Policies toward foreign investment can hardly be made on such a narrow base nor should tax policy be aimed simply at neutrality as between investment in the United States and foreign investment. We are involved deeply in the world economy; equity in competition among international companies and revenue distribution among countries should be determined by considerations considerably wider than efficiency. This conclusion is reinforced by Professor Musgrave's own skepticism concerning growth policy that "the longer run net effect on distribution cannot be readily predicted."

Her comment that the substitution of free trade for the free movement of capital should reduce tensions among countries because "free trade does not pose the problems of political friction and concern such as may arise from foreign investment especially in its direct form" is a gross misreading of history. A book written in 1901 on the American Invasion of Britain was concerned principally with the flow of imports into the economy, rather than with the direct investment which has occurred even at that time. And national passions have repeatedly been raised by trade problems. Her prescription of free trade is not likely to be readily received in lieu of local production in host countries.

While indicating that her data do not provide adequate support for precise conclusions, she enunciates some rather gratuitous ones to the effect that trade is less disturbing than investment since "it may well be that commodity trade does not share the same internal distribution effects as we have noted in the case of foreign direct investment. Combining all hese considerations, it is only reasonable to combine skepticism regarding the prevailing tendency to encourage foreign investment with support for promotion of freer commodity trade."

Professor Musgrave's limitation of her model to economic factors (and a too simplistic economic model at that) plus her obvious preference for a world which fits the economist's theories of trade (rather than a much more complex relationship under direct investment) seriously reduce the usefulness of her recommendations.

One can look at the world in two quite different fashions and still come to a conclusion that the continuation of and even support for U.S. foreign direct investment is highly desirable from the standpoint of national interests. One way is to look at the world from a competitive viewpoint and the other from a cooperative one. From the competitive viewpoint, the United States will find that a reduction of its foreign investment activities will rebound in the favor of Europe, Japan, and Russia—each seeking to obtain greater security of supply in raw materials around the world. In manufacturing areas, it is commonly considered in Latin America that the United States is losing out to Japan and Europe, the companies of which are more ready to make a variety of bargains which seem unacceptable to U.S. companies. If the United States is to be competitive in the field of international production (as distinct from international trade, which even so increasingly results from international investment) tax equity should be applied as between and among international companies who are operating in the various markets of the world rather than as between U.S. domestic and foreign investment. No new tax incentives need be provided, though they were probably needed and desirable some 10 years ago; but any attempt now to change the tax laws in ways contemplated by Congress would put U.S. companies at a serious disadvantage. The other nations are simply not going to move in this direction. The United States would be gradually isolated, reducing its capacity to lead.

If U.S. policy is based on a more cooperative view of the world, then substantial effort needs to be made to achieve international industrial integration. This can be done not solely through trade but also significantly and probably principally through the movement of factors of production, which have been seen not as a substitute for trade but as a (political) condition of its expansion. National governments would be increasingly insistent that their resources and factors be used effectively—through the import of factors they do not have rather than through trade specialization.

The major problems facing the international economy are not readily resolved through increased trade. They require different forms of cooperation and frequently a significant role for international companies. For example, the ownership and control of natural resources, the development of the seabed, the location of industrial activity around the world, the development of adequate food resources and appropriate nutrition, and the development of improved transportation and communication facilities will involve substantial roles for the international companies. These roles will not be analyzable under trade theory.

Rather, what is needed is a new set of rules—ordering principles—which includes a substantial role for foreign direct investment. The forms, organization, control techniques, and guiding principles have yet to be worked out so as to resolve efficiently and equitably the international economic problems facing us.

The U.S. Government should not act against the international companies until it knows what kind of international order it is seeking, the rules for ownership and control of resources, of services, and transport facilities. Nor should it alter manufacturing relationships until it knows what it seeks in terms of the structure of international industrial integration. Therefore, much more work needs to be done before changes are recommended in the tax structure or other policies involving foreign investment.

TIDEWATER MARINE SERVICE, INC.,
New Orelans, La., April 20, 1976.

Re amendment of section 954(f) of the Internal Revenue Code.

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

DEAR SENATOR LONG: I am John P. Laborde, president and chairman of the board of Tidewater Marine Service, Inc. In connection with the Senate Finance Committee's consideration of H.R. 10612, I urge the adoption of an amendment to section 954(f) of the Internal Revenue Code which would relieve the offshore oil service industry from current taxation of the undistributed income of certain foreign affiliates.

My company furnishes transportation and supply services to unrelated oil companies and drilling contractors engaged in exploring for, developing, or producing oil or gas in offshore locations throughout the world. We are in direct competition abroad with other American firms and a growing number of foreign-owned companies. As explained in greater detail below, the foreign subsidiaries used by our industry, which are necessary in order to compete with the foreign-owned firms, should not be categorized as "tax haven" operations and subjected to the current U.S. tax imposed by subpart F. We pay foreign income taxes to virtually every foreign country in which we operate. In addition, our services are rendered exclusively to unrelated parties, and therefore, our foreign subsidiaries do not constitute the type of "base company" at which the subpart F provisions were directed.

The Tax Reduction Act of 1975, denominates "shipping" income derived by foreign subsidiaries as "subpart F income" which is taxable to a controlling U.S. shareholder on a current basis except to the extent that such earnings are reinvested in qualified shipping assets. These provisions were adopted by the conference committee in response to a Senate floor amendment which would have eliminated the deferral of U.S. tax with respect to the earnings of all controlled foreign corporations. The conference committee rejected that sweeping proposal, and instead, expanded the provisions of subpart F (which provide that certain types of income of controlled foreign subsidiaries is taxed currently to a U.S. shareholder of the company). These changes included the repeal of "minimum distributions" and reducing the permitted de minimis amount of "tainted" income from 30 to 10 percent of the foreign corporation's gross income. The conference committee also amended the code to treat all shipping income earned by foreign corporations owned by U.S. persons as constituting subpart F income. Unlike the base company services provisions, shipping income is treated as subpart F income even where such services are rendered to unrelated persons. The shipping income provisions adopted by the conference committee, were generally the same as the provisions in H.R. 17488 which was reported by the Ways and Means Committee in 1974.

The decision to currently tax the U.S. owners of foreign shipping companies on the earnings of those companies (to the extent such earnings were not reinvested in qualified shipping assets) is certainly open to question. The U.S.-owned foreign-flag shipping industry ("flags of necessity") contributes to U.S. defense capabilities. This industry is extremely competitive and investment decisions will be responsive to this increased U.S. tax burden. Taxing only U.S. owners of foreign-flag ships will make it economic for such vessels to be owned by U.S. persons. Foreigners will be able to continue to operate ships in international commerce virtually free of tax, and, consequently, will eventually become the owners and operators of all foreign-flag shipping. In the long run, this change in ownership will benefit neither the U.S. Treasury nor American industry.

Whatever the merits of the provisions requiring current taxation of U.S. owned foreign flag shipping, it is obvious that they were aimed at shipping corporations, operating on the high seas which pay little, or no tax to any country. As described in the committee report accompanying H.R. 17488 this results because most countries—including the United States—do not tax the profits from shipping into and out of their ports, and most shipping corporations are based and incorporated in countries which do not tax foreign income from shipping operations. However, the Tax Reduction Act of 1975 includes within the definition of shipping income operations which do not involve the transportation of persons and property between ports in different countries.

For example, there are a substantial number of U.S. owned foreign flag vessels engaged in support transportation for the offshore oil industry on a worldwide basis, hereinafter referred to as "offshore service companies." When the vessels utilized by these offshore service companies are assigned to foreign areas, they are generally based in such areas for a period of years. The vessels are usually operated out of the foreign countries on which the continental shelves of the offshore oil installations are located and, generally, are operated by controlled foreign subsidiaries incorporated under the laws of or registered to do business in those foreign countries. Indeed, such local incorporation or registration of the operating entities is generally a condition precedent to being permitted to operate there. The operating companies are thus subject to the laws of the foreign countries including their tax laws. In order to permit these vessels to be transferred from one area to another and to avoid the practical and legal problems which would be involved in registering the vessels locally, such vessels are usually chartered by another foreign affiliate of the offshore service company to the ultimate customer—for example, the oil company or the drilling contractor. A separate contract is entered into simultaneously with the local subsidiary of the offshore service company to operate the vessel. These vessels are normally used by the offshore service company only between a base in the foreign country and the offshore installations, which, under 638 of the code, are usually deemed to be within such foreign country for U.S. tax purposes.

These U.S. owned offshore service companies have substantial competition from foreign-owned enterprises. Prior to the adoption of the Tax Reduction Act of 1975, the deferral of U.S. tax permitted with respect to shipping income—both charter income and operating income—of foreign subsidiaries permitted the U.S. owned offshore service companies to compete with foreign-owned vessels and operators throughout the world. It is submitted that without reinstituting the deferral of U.S. tax, U.S. owned offshore service companies will no longer be able to compete with foreign-owned companies because of the increased tax burden.

As noted above, one of the stated purposes of the shipping provisions in H.R. 17488—which were adopted in the Tax Reduction Act of 1975—was to end the shipping income exclusion from subpart F for companies engaged in transporting persons or property into and out of ports in different countries because they paid little or no tax to any country. The offshore service companies described above are not normally engaged in this type of activity since they operate primarily between points in one country—generally between a local base and the offshore drilling rigs on that country's continental shelf.

The tax Reform Act of 1975, H.R. 10612, passed by the House in 1975, provides that for purposes of subpart F, base company shipping income, does not include income derived from the operating of a vessel between two points in the country in which the vessel is registered and in which the corporation owning the vessel is incorporated. This provision is obviously intended to eliminate some of the inequities in the taxation of foreign shipping income under the Tax Reduction Act of 1975. However, the proposed amendment does not go far enough since the support vessels utilized in the offshore oil industry may not, for the reasons given above, be owned by locally incorporated corporations. Also, local registration of each vessel in every country in which it is operated by the offshore service company would be impractical and, in some cases, impossible. Furthermore, it is not always possible to supply all of the requirements of an offshore oil installation from a local port in the contiguous country.

It is respectfully submitted that an additional exemption to the subpart F definition of shipping income is necessary to permit American-owned offshore service companies to continue to compete abroad. Income derived from the ownership or operation of vessels providing services to unrelated persons in connection with the exploration and exploitation of natural resources in submarine areas should be excluded from foreign base company shipping income under section 954(f). This exemption would not apply to the actual transportation of minerals, that is, oil tankers.

Sincerely yours,

JOHN P. LABORDE,
Chairman of the Board and President.

STATEMENT BY DR. PHILIP HANDLER, PRESIDENT, NATIONAL ACADEMY OF SCIENCES

This statement is in response to your notice of February 5, 1976, concerning the committee's hearings on proposed revisions in the U.S. Internal Revenue Code and extension of expiring tax cut provisions, and is submitted for the record by the National Academy of Sciences (NAS) on behalf of U.S. citizens employed by the International Institute for Applied Systems Analysis (IIASA) located in Vienna, Austria, and U.S. employees of the Radiation Effects Research Foundation (RERF) located in Hiroshima, Japan.

The views presented herein relate specifically to those provisions of the House-passed tax revision proposals contained in section 1011 of title X of H.R. 10612, a bill entitled, "The Tax Reform Act of 1975." Section 1011 deals with modifications in the current tax treatment of foreign earned income of U.S. citizens and, with certain exceptions, would phase out the annual exclusion of $20,000 (or $25,000 in certain cases—of income earned abroad by U.S. citizens who live and work abroad. Exemptions for certain allowances for overseas employees of the U.S. Government would not be changed, and the $20,000 income exclusion would continue for U.S. citizens who are the overseas employees of U.S. charitable organizations that meet the requirements of section 501(c) (3) of the Internal Revenue Code of 1954, as amended [IRC 501(c) (3)]. While the legislation does not affect the income tax status of U.S. citizens employed by international treaty organizations, the competitive relationships of the salary levels of other organizations to the salary levels of these international treaty organizations would be of concern to those institutions whose U.S. citizen employees are directly affected by the amendments proposed in H.R. 10612.

In the interest of providing equal tax treatment for all U.S. citizens, your attention is called to another category of U.S. citizens who are employed abroad in furtherance of the purposes and objectives of U.S. charitable organizations, but whose tax status would be adversely affected by these provisions of section 1011 of H.R. 10612. This category includes those U.S. citizens employed by private, nonprofit organizations incorporated under foreign laws for purposes similar to U.S. charitable organizations. The specific concerns of NAS are with respect to the impact of the discontinuance of the $20,000 exclusion on U.S. citizens employed by IIASA and RERF, both of which were created at the initiative of the U.S. Government.

In 1972 the National Academy of Sciences, along with the Royal Society of London, the Academy of Sciences of the U.S.S.R., and selected learned societies and academies from other countries, established the International Institute for Applied Systems Analysis in Vienna, Austria. The Institute engages in studies and research, using the analytical methods of systems analysis, on large complex global problems of international significance and impact such as energy, environment, urban and regional development, and biological and medical systems. The Institute staff is composed of outstanding scientists drawn from the United States, United Kingdom, Canada, the U.S.S.R., the Federal Republic of Germany, and other countries.

Because of the nongovernmental status of this international Institute, which was incorporated under Austrian law, legislative action was taken by the Austrian Government to grant certain privileges normally allowed only to international organizations established by treaty arrangements, including exemption from income tax, customs duties and other import taxes. IIASA is supported by contributions from the supporting member organizations and from private sources, including U.S. foundations. As a corporate member of this Institute, the National Academy of Sciences makes an annual contribution for support of the Institute from grants provided by the National Science Foundation. The Academy, under arrangements with the National Science Foundation, also augments the salary levels of U.S. citizens employed at IIASA to provide for equivalency with comparable U.S. salaries as a means of assuring that U.S. scientists of the highest caliber will participate in the Institute's program.

The House committee report on H.R. 10612 points out in connection with retaining the $20,000 exemption for overseas employees of U.S. charities that:

> Quite often the host country encourages the presence of these individuals by not subjecting them to tax. If a U.S. tax were imposed on their income, there would generally be no foreign tax credit available and the U.S. charities would have to reimburse the employee for the U.S. tax, making it more expensive for the charity to retain the employee overseas.

This is precisely the situation at IIASA. Non-Austrian employees of IIASA are not subject to Austrian income tax and thus U.S. citizen employees of IIASA would not be entitled to a tax credit on their U.S. income tax. Discontinuance of the current $20,000 exclusion would necessitate further augmentation by the National Academy of Sciences of salaries paid U.S. citizens employed at IIASA.

The Radiation Effects Research Foundation—RERF—a Japanese nonprofit corporation, is the successor to the Atomic Bomb Casualty Commission—ABCC—established by the National Academy of Sciences in 1946. The ABCC was established by the Academy at the request of President Truman to study the long-term effects on the survivors of the atomic bombs dropped on Hiroshima and Nagasaki in 1945. RERF's research mission is of critical worldwide importance since the populations of Hiroshima and Nagasaki offer the only opportunity to study at first hand the effects of radiation on the human population, and to learn about its cancer-inducing potentialities, genetic risks, effects on aging, and other radiation effects on man. The foundation is governed by a board of directors having equal representation from Japan and the United States. Funding is provided by the U.S. Energy Research and Development Administration through a contract with the National Academy of Sciences and by the Japanese Ministry of Health and Welfare. The Academy has a continuing responsibility for monitoring the foundation's scientific program.

The U.S. citizen employees of RERF receive salaries from the foundation which are subject to Japanese income tax. As in the case of IIASA, the Academy also augments the salaries of U.S. citizen employees using funds from the ERDA contract to make the salaries comparable to U.S. salaries. If the current U.S. earned income exclusion is eliminated, further increases in the salary augmentation level may be necessary.

Upwards of 20 U.S. citizen employees of IIASA and 10 U.S. citizen employees of RERF currently qualify for the $20,000 exclusion in any 1 year. Discontinuance of this exclusion would, in our view, place an inequitable penalty on these individuals and make it more difficult to continue to attract outstanding U.S. scientists and scholars to these activities without a further augmentation in salary levels. Such augmentation would have to be as an increase in U.S. Government support or, alternatively, through private foundation grants, neither of which is assured.

The committee also should be aware that IIASA and RERF are not isolated examples and that there are other foreign nonprofit scholarly research institutions which are supported in part by U.S. foundations and which also employ U.S. citizens. For example, there are a dozen agricultural research centers and programs around the world concerned with food crops and animal production in the developing world that receive support from U.S. foundations. The Internal Revenue Service should be able to supply further information to your committee on the aggregate number of U.S. citizens who are employed overseas by such international nonprofit scientific institutions.

In view of the considerations set forth above, I respectfully urge that your committee give favorable consideration to the continuation of the $20,000 earned income exclusion for U.S. citizens who are employed abroad by private, nonprofit scientific organizations that are incorporated under foreign laws for purposes similar to U.S. charitable organizations and that receive financial support from such organizations.

No U.S. charitable organization should be penalized under the foreign earned income exclusion provisions because it is more feasible or appropriate for certain of the organization's international activities to be carried on through cooperating foreign nonprofit organizations than through its own employees. And while it is not within the scope of this letter to specifically address IRC 501(c)(3) activities other than scientific research, I note that the committee may wish to consider the application of the proposal set forth above to foreign nonprofit organizations engaged in religious, charitable, or educational activities in similar situations whose U.S. citizen employees may be equally deserving of the committee's consideration.

AMERICAN CYANAMID CO.,
WAYNE, N.J., *April 28, 1976.*

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

DEAR SENATOR LONG: Because of our great concern over the impact that this legislation would have upon our business and our employees, American Cyanamid Co. has conducted a detailed study of the effects of current proposals before the Senate Committee on Finance which would alter methods of taxing foreign source income and would impose new energy taxes.

Because of the extreme negative consequences of these proposals, especially the changes in foreign income taxation which would eliminate more than 3,000 jobs, I am attaching a copy of our position for your review.

Our analysis shows that had the proposals to eliminate foreign tax credits and DISC and to tax unremitted foreign earnings been in effect during our fiscal year ended last December 31, Cyanamid would have paid $37 million more in income taxes. Corporate earnings would have been reduced by 26 percent. More important, however, we would have had to take immediate steps to withdraw from most of our overseas markets where we have direct equity participation. Further, in our company as well as many others, there would have been a serious dislocation in domestic employment, and in manufacturing and distribution patterns.

Should this legislation be passed, Cyanamid will be faced with a U.S. work force reduction of 3,000 to 4,000 jobs which are now dependent on our global business; most of them in geographical areas already hard hit by unemployment and the recession. Our 1976 plans for capital spending amount to $275 million will have to be restudied, and our pricing will be reviewed based on new costs of production and other changed economic factors.

Therefore, may I invite the attention of members of your committee and its staff to the enclosed statements, and to similar representations submitted to both the House and the Senate by other corporations during the course of the debate on tax law reform.

Cyanamid appreciates this opportunity to express its views on this legislation, and will be pleased to consult with the committee or its staff during the course of your deliberations.

Sincerely,

JAMES G. AFFLECK,
Chairman and President.

POSITION OF AMERICAN CYANAMID CO., WAYNE, N.J.

EFFECTS OF TAX LEGISLATION PROPOSALS AFFECTING FOREIGN-SOURCE INCOME

Summary

Proposals to enact major changes in the method of taxing international business of U.S. companies now being considered by the U.S. Congress would treat foreign income taxes as deductions rather than credits against U.S. taxes, tax unremitted foreign earnings and repeal Domestic International Sales Corporaton (DISC) provisions.

Despite the immediate attraction of the proposed tax revisions from a revenue point of view, the long-range effect would be a reduction in total tax revenue to the United States from foreign business activities of American companies. As a result of these changes, international earnings of U.S. companies would be reduced to the point where their total U.S. taxes will be considerably less than they are now.

Cyanamid believes the total combined effect of these new taxes would be so severe that it could be forced out of direct participation in most international markets. Based on 1975 sales, the total increased cost of these new taxes to the company would be $37 million per year. Most of this added tax would result from the loss of foreign tax credit and current taxation of unremitted foreign earnings.

This new tax burden would severely reduce profits of the company's foreign subsidiaries and threaten their continued viability. Since international sales currently account for more than 40 percent of the company's global sales, a substantial loss of the company's business would be inevitable. The effect on operations within the United States would:

1. Force elimination of more than 3,000 production, research, and management jobs which directly support foreign operations.
2. Endanger the jobs of an additional 1,000 key people, including managers, scientists, and production workers whose functions might no longer be supportable without the broad economic base supplied by international sales. Some 400 to 600 jobs now held by outside suppliers and vendors also would be at risk.
3. Increase the cost of many products to American industry and to American consumers.
4. Halt new investment in plant and equipment in the United States intended to supply foreign subsidiaries.
5. Weaken the position of the United States as the leading discoverer of new products and technology.
6. Render U.S. companies vulnerable to foreign competition both in the United States and abroad because of the competitive edge provided to foreigners by continued access to world markets.
7. End the company's continuing high level of contribution to the positive side of the U.S. balance-of-payments: $272 million in 1975 alone.
8. Eliminate the economic flexibility provided by international markets which helps the company to ride out periods of business downturns in the United States.
9. Reduce the level of corporate earnings and dividends distributed to some 110,000 Cyanamid stockholders.

The impact upon Cyanamid is not unique. Similar results can be expected for most American companies which have substantial direct foreign investments.

Enactment of these tax provisions would have a massive negative impact on the U.S. economy. Thousands of jobs related both directly and indirectly to international business would be eliminated. The most significant contribution to the positive side of the U.S. balance-of-payments—that of the U.S. multinationals—would be endangered. Foreign earnings to finance capital investment and research and development within the United States would be shut off.

And, loss of international business would reduce the income of millions of American citizens who own stock in U.S. multinational companies, as well as the taxes they pay to the U.S. Treasury on those earnings.

EFFECTS OF PROPOSED TAX LEGISLATION

American Cyanamid Co. appreciates the opportunity to present its views on three major proposals affecting foreign-source income, now under consideration by the Congress. The proposals are to:

Treat income taxes paid to foreign governments as deductions rather than credits against U.S. corporate income taxes;

Impose U.S. taxes on unremitted foreign earnings; and
Repeal authorization of the Domestic International Sales Corporation (DISC).

Company background

Cyanamid is a diversified business enterprise active in four major business segments: consumer, medical, and agricultural products and specialty chemicals. The company, with 1975 net sales of $1.9 billion, is ranked 107th in the Fortune 500 list of American industrial firms.

While the company's principal market continues to be the United States, there has been a growing demand for its products and technology throughout the world. As a result, 40 percent of 1975 sales were made in more than 125 foreign countries. Total exports in 1975 were valued at $235 million, more than half of which were in the form of raw materials, intermediates, and bulk materials shipped to Cyanamid's foreign affiliates.

Cyanamid's gross plant investment worldwide was $1.5 billion at the end of 1975, of which foreign plants accounted for $170 million, or 11 percent. Cyanamid employs about 24,000 persons in the United States and 14,000 abroad. It operates 59 U.S. plants and 64 sales offices in 29 States. Outside this country, Cyanamid has 43 manufacturing plants in 20 countries, and 49 sales offices and other facilities in 34 countries.

Cyanamid now manufactures and markets some 2,500 products worldwide. The company entered foreign markets early; first as an exporter, then as a licensor, distributor, and finally with direct equity investment. In 1975, Cyanamid's foreign operations resulted in a net dollar inflow to the United States of $272 million. During the past 15 years, this return has totaled more than $1.4 billion. During this same period, foreign operations contributed approximately $400 million to net after tax earnings.

1975 financial data and effects of proposals

For fiscal 1975, ended December 31, Cyanamid reported the following:

	Millions
Consolidated income before taxes	$244
Taxes on income	101
Consolidated after-tax income	143

Company studies have shown that, had all three tax proposals been enacted and in force in 1975, the effect on performance would have been:

	Millions
Additional tax on unremitted earnings	$7
Repeal of the foreign tax credit	$11
Enactment of both of the above (increases over sum of separate proposals by taxing unremitted earnings without foreign tax credit)	$33
Repeal of DISC	$4
Total new taxes	$37
Reduction of earnings (percent)	26

As can be seen, a 26-percent drop in earnings would have both an immediate and long-term effect. The company's dividend rate certainly would be reduced—($71 million to 108,000 U.S. shareholders in 1975)—and its overall financial resources would be seriously impaired.

Perhaps even more important, however, would be the long-range effects. There is no question that enactment of two of these proposals, loss of credit and taxation of unremitted earnings, would force Cyanamid to dispose of most of its direct foreign investment.

For 1975, Cyanamid paid income taxes at an effective tax rate of 41.3 percent including $53 million in Federal and State taxes and $48 million in foreign income taxes. If the two provisions were in force—but DISC still operable—the total effective tax rate on Cyanamid's foreign operations would be about 75 percent, placing the company at a severe disadvantage with most foreign-owned competitors which pay 45 to 50 percent.

Assuming enactment of these provisions, and the forced departure of Cyanamid from world markets, what would be the consequences to Cyanamid and to the U.S. economy?

Employment

Of Cyanamid's 24,000 U.S. workforce, company studies show that a minimum of 3,056 jobs depend directly on international operations, and an additional 1,000 are partially dependent. Phasing out international operations would eliminate these 3,056 jobs, which include 1,182 production workers, 1,134 management and administrative positions, and 740 research and development personnel—see following page for plant/State locations affected.

States with high unemployment would be most seriously affected by this reduction: New York, New Jersey, and Connecticut. In addition, U.S. contractors, suppliers, and others outside the company's direct employ but who service its international business would suffer from a "ripple effect." Within the company, the 1,000 employees whose duties are indirectly involved in international business would be at risk and some of these jobs inevitably would be lost.

Plant locations affected by loss of international business

Location	Number of jobs eliminated	Location	Number of jobs eliminated
Connecticut:		New York:	
Danbury	334	Glendale, Long Island	7
Stamford	107	Pearl River	1,228
Wallingford	65	Ohio:	
Florida: Santa Rosa	66	Evendale	70
Louisiana: Fortier	15	Marietta	5
Mississippi: Jackson	1	Texas: Fort Worth	18
Missouri: Hannibal	20	West Virginia: Willow Island	32
New Jersey:			
Bound Brook	157	Total[1]	3,056
Clifton	300		
Princeton	63		
Warners	89		
Wayne	483		
Woodbridge	1		

[1] Includes 1,182 hourly and 1,874 salaried jobs.

Capital investment

In addition to a major cutback in jobs, Cyanamid would face other severe problems. Capital spending—$204 million in 1975—largely in the United States, and planning for plant expansion and modernization would be seriously retarded. Certainly, major new projects now planned to provide added capacity to service both U.S. and foreign markets would be deferred until the company could fully assess the real impact of market losses abroad and the demands on its financial resources.

Without access to international markets, several current major construction projects in the United States would not have been undertaken. Should these tax restrictions be imposed before they are operational, it is likely further construction would be halted until it could be determined whether markets could be served from existing plants in the United States, or elsewhere, particularly those which may lose their own local market due to strengthened foreign competition vis-a-vis a weakened U.S. affiliate. In many cases new jobs based on new facilities would not materialize, nor would satellite industries or services and the jobs related to them.

Research

Another major constriction would occur in research. Cyanamid is a high-technology, research-oriented company which depends heavily on scientific innovation for its market position. Research operations are concentrated largely in the United States and are organically part of the American scientific community. Income from international operations contributes significantly to the R. & D. budget—$67 million in 1975—supporting both basic and applied research in medicine, agriculture chemicals, and consumer products.

Loss of foreign-income funding for research probably would eliminate certain high-risk but socially desirable projects, such as some in pharmaceuticals and environmental protection, and would delay scientific innovation as well as new product development. The effects would not only weaken the company's competitive position in U.S. and world markets compared to major European and Japanese industries, but would contribute to a further decline in American technological leadership—a trend widely noted in recent years.

Balance of payments

U.S. multinationals have been the Nation's most consistent contributors to the positive side of U.S. payments balance. The $14.6 billion in surplus between payments and receipts abroad which was brought back to the United States in 1974 by multinational corporations helped offset large foreign expenditures caused by the huge increases in oil prices.

Cyanamid was a contributor to this positive performance and in fact, has returned $1.4 billion to the United States during the past 15 years.

U.S. price levels

Loss of international markets would reduce the number of product lines, product variety, and marginal products now manufactured by the company. Benefits of economies-of-scale in certain processing and manufacturing operations would be lost, increasing per-unit production costs, and, inevitably, causing higher prices charged to industrial customers and to the public in the United States. Since Cyanamid is a basic supplier of many chemical products further manufactured by others, the add-on effect of such increases would be felt in hundreds of industries and product lines which eventually reach the American consumer.

Foreign competition in the United States

As American multinationals are weakened and foreign multinationals grow stronger, the domestic U.S. market will become more attractive to foreign firms. This trend is already apparent, and while it presents no real threat to U.S. industry as yet, it should be noted that foreign companies aided by increased penetration of world markets will be able to increase R. & D., expand plant capacity, and otherwise use their market strength to develop better products faster and at lower prices than ever before to capture larger shares of the American market. Those U.S. companies already in a weakened position due to foreign competition—textiles, electronics, glass, shoes, et cetera—will be immediate targets for the U.S. subsidiaries of foreign multinationals, or for strengthened import competition.

Foreign competition outside the United States

As the share of the market of U.S. foreign affiliates declines, the foreign affiliates of other industrially advanced nations will immediately move to fill the vacuum created. This will be especially the case where there are established European and Japanese subsidiaries and joint ventures in developing nations. These subsidiaries will be able to extract more favorable terms for technology transfer and other arrangements with local partners and for their own direct investment, because their marketing opportunities will be enhanced.

While political considerations are outside the scope of these comments, it should be noted that loss of U.S. commercial leadership and even presence in traditional U.S. foreign markets—such as Latin America—will have many political and social consequences for U.S. foreign policy in the future.

Taxing unremitted foreign earnings

The individual effect of taxation of unremitted foreign earnings would vary in each country abroad; however, the cumulative net result on the company would be to endanger the profitability, and hence, the continued existence of many inter-related overseas operatings.

> The proposal ignores these considerations, among others: Not all overseas profits can be remitted to the United States, thus, companies would be taxed by the U.S. Government on foreign-generated earnings which may never leave the foreign country. India, Brazil, Spain, Venezuela, Colombia, Argentina, and others legally restrict the percentage of earnings which can be repatriated. Brazil, for example, would tax remittances to the United States from a Brazilian subsidiary at 60 percent if they pass the limit of 25 percent of local registered capital. Other countries also impose similar punitive taxes on what they consider excessive repatriation.
>
> Increased U.S. tax revenue gains would be more than offset eventually by U.S. taxes lost. Cyanamid estimates that it would be forced to pay an additional $7 million in income taxes if it is forced to receive a full dividend payout of foreign subsidiaries' income. However, $5 million would be payable to foreign countries, and only $2 million to the U.S. Treasury.
>
> It can be anticipated that foreign countries unhappy with U.S. repatriation policies will change their laws so that the United States may not be able to recover even the $2 million.

U.S. foreign subsidiaries would no longer be able to retain earnings to finance growth, capital spending, and market expansion, do local research, provide additional jobs, or perform the other functions which made them attractive investors to the host country initially. Stripped of this ability to internally fund their own growth, they not only risk losing their market position to foreign competitors, they will be less welcome investors in the eyes of foreign governments since their ability to bring the benefits of multinational enterprise to the country will be in doubt.

Deductions rather than credit for foreign taxes

The immediate results of the loss of a tax credit by Cyanamid and other U.S. companies would make them noncompetitive with foreign multinationals and local businesses. Since Cyanamid pays a tax rate on earnings of 45 to 50 percent in most foreign markets, the added burden of an additional U.S. tax on these same profits would increase the effective tax rate on this income to about 75 percent.

The competitive posture of Cyanamid and other U.S. companies would be further crippled because other industrialized nations recognize and encourage the economic benefits generated for their domestic economy by corporate foreign operations. They know that their overseas affiliates cannot effectively compete in foreign markets if they are to carry a higher tax burden than local or third-country competitors. Thus, several advanced countries exempt foreign-source income from domestic taxes completely, and many others grant credits comparable to the present U.S. system. None imposes a heavier tax burden than that currently levied by the United States.

Repeal of the foreign tax credit would result in a combined U.S. and foreign tax rate of about 75 percent for foreign operations in most nations. This would reduce by more than one-half the present earnings received from abroad by U.S. companies, and clearly, would pose a massive problem for the continued viability of U.S. companies competing against companies paying no tax to their home country.

Further, repeal of the credit would overturn a longstanding U.S. tax policy of neutrality between domestic and foreign income. It would, in effect, impose double taxation in violation of basic principles of equitable tax treatment.

Finally, and most important, the cumulative impact of this proposal would be to restrict U.S. foreign investment and eventually force U.S. companies out of foreign markets.

Faced with such high income tax levels, these companies would no longer have the capital for investment and expansion of foreign operations. They would be replaced in overseas markets by foreign companies.

One measure of the potential consequences is the loss of American jobs attributable to U.S. international business. The Department of Commerce study on U.S. multinational corporations, published in March 1972, estimated that more than a half-million jobs would be lost if there were no U.S. foreign direct investment. The study estimated that 250,000 people, mostly production workers, would be unemployed; that another 250,000 positions would be eliminated in the home offices of U.S. multinationals associated with foreign direct investment; and that an additional 100,000 jobs for supporting workers would be lost. This finding was corroborated by a U.S. Tariff Commission report which estimated that American multinational corporations created a net gain in total U.S. employment and manufacturing of some 500,000 jobs.

Cyanamid would not oppose certain changes in the foreign tax credit such as terminating the election which permits taxpayers to obtain credit for foreign taxes paid up to the amount of the U.S. tax on income from each foreign country to which taxes are paid—the so-called per country limitation.

Cyanamid does strenuously oppose any proposal which would change the well-recognized concept of offsetting foreign taxes paid against U.S. taxes. It is estimated that the cost to Cyanamid of such a proposal would be $11 million based on operations for 1975. Furthermore, if this provision were coupled with the proposal to tax unremitted earnings, the combined tax penalty would exceed $33 million, a sum which would soon make it uneconomic to engage in foreign business.

The Domestic International Sales Corporation (DISC)

Cyanamid supports retention of the DISC provision in view of the economic benefits to be derived by the United States from increased exports. If amendments are to be made, consideration should be given to increasing the tax deferral to 100 percent from the 50 percent currently in effect.

Proposals to end DISC fly in the face of efforts to increase domestic employment and U.S. exports. DISC has proved to be an effective instrument in helping U.S. companies meet foreign competition in world markets.

Cyanamid's experience under DISC parallels that of American industry overall. The company's exports in 1975 of $235 million have more than doubled since the DISC provision was adopted. The incentive provided by DISC has served to increase markedly the number of Cyanamid workers in the United States whose jobs are related to exports. Further, loss of this incentive would place U.S. companies at a competitive disadvantage with multinationals from countries which do provide export incentives.

There is considerable evidence that DISC has significantly helped to increase U.S. exports. Secretary of the Treasury William Simon testified before the Senate Finance Committee in April 1976 that DISC will help expand exports by at least $9 billion this year. Earlier Treasury reports, covering the year ended June 1973 showed that 41 percent of U.S. exports amounting to $21.9 billion were DISC related. For this period, DISC exports grew by 33 percent while all U.S. exports increased by 23 percent.

Second, DISC has served to create jobs in the United States which otherwise would not exist. Secretary Simon has estimated that more than 300,000 such new jobs will be created this year, estimating that 35,000 to 70,000 additional U.S. jobs are created by each $1 billion in export sales. Cyanamid's experience has been similar, and its ability to create export-related jobs in the United States has been enhanced by the DISC program.

Third, although the cost of lost tax revenue under DISC is increasing, the stimulus to the private sector to enter export trade and to create the U.S. jobs and resources to do so far outweighs such tax losses when they are balanced against other tax benefits created.

Cyanamid believes the evidence clearly supports retention of the present DISC tax provision as beneficial to the United States and its industries competing in foreign export trade.

American Cyanamid Co., Wayne, N.J.

POSITION ON ENERGY TAX LEGISLATION

The Energy Conservation and Conversion Act of 1975 (H.R. 6860), as passed by the House of Representatives, amends subtitle D of the Internal Revenue Code of 1954 to levy a new excise tax on petroleum and petroleum products used as fuel "in a trade or business." When fully effective, the tax rate would be 18 cents per thousand cubic feet on natural gas, and $1 per barrel on crude oil and other petroleum products. Certain uses are excepted, such as mining, farming, aviation, and residential properties; however, the tax burden would fall heavily on industrial and manufacturing operations.

American Cyanamid Co. is strongly opposed to this tax to be applied to U.S. industry as counterproductive to its stated title of "Encouraging Business Conversion for Greater Energy Saving."

While the act provides some incentives for industry conversion to coal and solar energy, it serves to penalize those industries which cannot convert and it fails to recognize that greater energy savings could be accomplished by the market system to develop new sources of energy and more efficient energy availability.

Industrial conversion from oil and gas fuels can be accomplished most effectively, not by punitive taxation, but by fostering the availability of more efficient and dependable energy sources at reasonable cost. Penalty taxes, such as those provided for in H.R. 6860, would competitively injure whole industries, and companies within industries, whose processes or lack of capital make massive shifts to nonpetroleum or natural gas fuels impossible.

The tax would do nothing to address the problem of finding new energy sources applicable to American industry, or of increasing the availability of oil and natural gas at acceptable price levels—which should be the dual themes of a national energy policy for the United States.

Cyanamid favors Federal legislation and executive policies which will encourage domestic exploration and development of U.S. petroleum and other energy resources; and the enactment of tax incentives to foster industrial use of energy-efficient processes and equipment.

The proposed excise tax would not meet these ends. It is a punitive and unrealistic tax which fails to recognize the continuing dependence of some segments of American industry on petroleum and natural gas energy.

Cyanamid, therefore, is opposed to the energy tax provisions of H.R. 6860 and any similar measure which may be considered by the Senate in its current review of tax legislation by the Senate Finance Committee.

AMERICAN CHAMBER OF COMMERCE OF VENEZUELA,
Caracas, Venezuela, April 16, 1976.

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

DEAR SENATOR LONG: On behalf of the American Chamber of Commerce of Venezuela, I submit the following statement for inclusion in the record of your committee hearings on H.R. 10612, the Tax Reform Act of 1975.

We urge the retention of the present section 911 of the Internal Revenue Code and the corresponding deletion of section 1011 of H.R. 10612.

I thank you for this opportunity to express our views to you and your committee.

Very truly yours,

THOMAS L. HUGHES, *President.*

STATEMENT OF THE AMERICAN CHAMBER OF COMMERCE OF VENEZUELA

The following is submitted as a statement of the views of the American Chamber of Commerce of Venezuela with respect to section 1011 of H.R. 10612, the Tax Reform Act of 1975, presently under consideration by the Senate Finance Committee.

INTRODUCTION

Who We Are

The American Chamber of Commerce of Venezuela includes 854 members representing 365 business firms operating in Venezuela. The chamber, which has been in existence for 24 years, has as its primary goals: (1) To encourage increased commerce between the United States and Venezuela, and (2) to promote friendly business relations between the peoples and governments of the two countries through cooperative assistance in solving mutual problems.

Our organization is associated with the Council of the Americas, the Chamber of Commerce of the United States, and the Association of American Chambers of Commerce in Latin America.

Our chamber addresses itself solely to that part of the proposed legislation which modifies section 911 of the Internal Revenue Code so as to phase out the present exclusion for income earned abroad by U.S. citizens living or residing abroad. We urge the Senate Finance Committee not to adopt section 1011 of H.R. 10612 for the reasons hereinafter set forth.

A. *Present law.*—Under present section 911 of the Internal Revenue Code, those U.S. citizens living or residing outside the United States for prolonged periods of time are entitled to exclude from their U.S. taxable gross income $20,000 or $25,000 annually of their foreign earned income.

B. *Proposed law.*—H.R. 10612, as passed by the House of Representatives, provides in its section 1011 for the repeal of section 911 over a 4-year period, with certain limited exceptions. The excludable amount would be reduced proportionately each year, reaching zero in

1979. Citizens employed abroad would be allowed a special deduction of not more than $100 per month for certain school expenses. The bill also provides that the value of certain municipal-type services provided by an employer for a U.S. citizen living and working abroad would not be included in the income of the U.S. citizen. As a special rule, for employees working on the construction of a permanent facility in a foreign country, the exclusion would remain at the full $20,000 during the phaseout period.

It should be noted that in drafting the proposed Tax Reform Act, the Ways and Means Committee deferred, pending further study, any decision as to a similar amendment to section 912 of the present law, which section excludes from taxation certain cost-of-living, housing, education, travel, and similar allowances paid to U.S. Government employees living abroad.

C. *Legislative history of section 911.*—Originally enacted in 1926, the exclusion under section 911 was an unlimited exemption of foreign earned income for citizens spending 6 months a year outside the United States. It was intended as an incentive to encourage Americans to live overseas and sell U.S. products abroad. The House committee report of the time clearly indicated that the language first proposed was meant to benefit export salesmen and thereby increase U.S. foreign trade.

The provision as enacted was not limited to export salesmen, being broader in scope. Over the years section 911 has undergone a series of modifications, introducing concepts of bona fide foreign residence, physical presence abroad, and limitation on dollar amounts excludable, all designed primarily to curb abuses by those who could arrange their employment abroad so as to take advantage of an opportunity to avoid U.S. taxes.

D. *Reasons for retaining section 911.*—Our chamber feels that there is a national interest in having U.S. citizens living abroad and strong arguments for the retention of the present language of section 911. In our opinion, the most impelling of these arguments are:

(*a*) Creation of markets for U.S. exports:

The Congress recognized in 1926 that U.S. citizens living and working abroad had a strong impact in increasing U.S. exports. This, in our opinion, is as true today as it was then. The foreign trade of the United States is of paramount importance to the economic health of the country and is highly competitive.

A U.S. citizen residing abroad generates U.S. exports, whether he be an engineer ordering U.S. equipment for the job on which he is engaged or the factory in which he is employed, whether he is a manager or purchasing agent charged with purchasing components for assembly operations in a developing country embarked on an import-substitution policy, or whether he is an importer expressing a preference for American-made goods.

Few exports are generated without some U.S. foreign presence. In many cases that presence consists of a U.S. company or subsidiary marketing U.S. goods or importing components for further local processing. Some of the proponents of the elimination of the foreign income exclusion argue that the success of American companies abroad cuts down the number of jobs available at home, that these companies are in effect "exporting jobs". The fact is that in most countries of the world, faced with economic nationalism, import-substitution policies, and trade barriers, U.S. companies must go abroad if we are to hold and expand markets for American exports. We must get inside the border, or give up the market entirely for U.S. goods.

There are those that argue that if section 911 is repealed, U.S. enterprises abroad can simply raise the salaries of its executives, technicians, or other personnel enough to compensate for the extra taxes such persons will have to pay and this will just be an additional cost of business which will have to be absorbed. We feel that taxing U.S. citizens employed abroad would hurt the competitive position of U.S. companies in world markets, since the United States is one of the very few countries which tax nonresident citizens on their foreign source earned income. None of the major trading nations—the United Kingdom, Japan, Germany, Italy—do so.

It must also be remembered that many U.S. residents abroad do not work for large multinational companies, which might be more able to absorb, on a worldwide basis, these additional costs. There are many entrepreneurs, small businessmen abroad, U.S. citizens loyal to their known sources of supplies, who would be the real sufferers under such a change in the U.S. tax structure. The non-U.S. businessman does not have a loyalty to U.S. products and services and, therefore, would be more likely to depend upon plant installations, equipment, and supplies from European, Japanese, or other sources. This has a multiplying effect as once a plant is set up using equipment manufactured from a particular country, it follows that replacements, spare parts, supplies, technical services, et cetera, will come from that same country.

(*b*) Generation of U.S. receipts for transfer of technology:

Intimately linked in many cases with the creation of markets abroad for U.S. products, it should be noted that in 1974 U.S. firms earned $3.6 billion from foreign-located companies and individuals in the form of royalty and fee payments for the use of U.S. technology. Approximately $2.8 billion of those came from investment-related technology transfer and $0.8 billion from non-investment-related royalties and fees. Although in some cases such fees may be generated by the licensing of patents alone, in most cases they are coupled with or dependent upon U.S. management, know-how, and technical experience rendered in the foreign country by U.S. citizens. These receipts are the same as exports, since they add to our balance-of-payments earnings and are extremely important to the total U.S. balance-of-payments position. The 1951 amendment to the Internal Revenue Code was intended, in large part, to encourage U.S. technicians to seek employment abroad, and the proposal to take away the exclusion would discourage such employment and, in our opinion, decrease receipts from technology transfer fees.

(*c*) Ambassadors of good will: Most U.S. citizens and their families living abroad are unofficial ambassadors of good will for the United States. Often the only American that the people of a foreign country will get to know is the local manager of an American company. It seems utterly inconsistent for us to stimulate people-to-people exchanges, while causing the withdrawal of those citizens who have already formed friendships and have, in many cases, integrated themselves into community life abroad. Frequently a better understanding of the feelings and politics of the host country can be obtained from these long-time residents than from the State Department official rotated through the foreign country on a 2- or 4-year tour of duty.

American representatives of American companies living abroad often have many years of experience with the language, customs, laws, and techniques of the foreign country in which they live and are invaluable. They often have the irreplaceable managerial and technical skills, which have never been available in sufficient numbers, and upon which the maintenance of the American business and the American image must depend.

E. "*Yankee Come Home*" *or, why the Yankees will go home if the exclusion is withdrawn.*—If you should ask a U.S. citizen living in Latin America—or in other underdeveloped or developing countries—whether he would be willing to live and work here instead of the United States if his net income after taxes were the same or less, we doubt that you would find many who would say "Yes." We are not movie stars basking on tropical beaches. Almost all came to Latin America under employment agreements with companies engaged in the extractive industries—oil and iron ore, vital to U.S. economy—or in the sale and distribution of U.S. products, until recently almost all imported, now being produced in greater quantities by local branches or subsidiaries as a result of import restrictions.

These U.S. citizens who come to Latin America on behalf of U.S. industry—or stay here to run their own enterprises—demand some additional financial reward to compensate them from the following:

(1) Inconveniences: We lead, in the United States, what is probably the most comfortable life in the world; we are the "affluent society." Telephones cover the Nation, as do power facilities; the existence of laundries and dry cleaning establishments is taken for granted; service companies of every type abound; supermarkets and department stores offer every variety of food and merchandise at reasonable prices; no linguistic problems exist. In less-developed countries, on the contrary, most or all of these goods and services are not readily available in the same quality, or are available only at prices which would make them luxury items in the States. We do not contend that all underdeveloped or developing countries are "hardship posts," but life for most people who work abroad is not as comfortable as in the United States and is considerably more expensive.

(2) Education and Governmental services: Educational facilities are, in general, inferior to or far more expensive than comparable schools in the United States. Many Federal and municipal services which we take for granted in the United States, such as interstate highways, sewage disposal, water, fire protection, and so forth, are not available in many areas. (By proposing special exemptions for cost of tuition and value of municipal-type services rendered by employers, the proposed bill itself recognizes the nonexistence of these facilities). To pay U.S. taxes, without receipt of such services from the U.S. Government, also seems manifestly unfair.

(3) *Health:* Medical statistics indicate that the less developed countries are not as healthy as the United States or Western Europe. The life expectancy is shorter, and U.S. life insurance companies apply a higher premium rate for those U.S. citizens residing in Latin America.

Medical specialists and well-equipped hospitals are not as readily available. There is clearly a health risk in living in many countries abroad.

(4) Political and economic risks: Many U.S. citizens living in Latin America have been through revolutions, attempted coup d'etats, street riots, etc. In many countries U.S. citizens living abroad are subject to physical danger, as kidnapings and terrorist acts occur. U.S. citizens living abroad run the risk that their possessions and savings may be confiscated—Cuba—or devalued—most South American countries. What is earned in one year may be lost in the next. In most countries, a U.S.-style standard of living is considerably higher than it is in the United States.

(5) Dislocation factor: Normally, some financial compensation or incentive must be offered to persuade a family to uproot itself, abandon its known surroundings, set off into the unknown, learn new languages, disrupt children's schooling, etc.

To compensate U.S. citizens for these risks and inconveniences, something must be offered, or the Yankees will have to go home, as the slogans painted on the walls so often urge. You cannot sell family men on the sheer adventure of living abroad, at least on anything other than a short-term basis. In Latin America the incentive to live abroad must be (a) higher pay, or (b) greater net income after taxes.

F. *Lost revenues.*—It has been estimated by the Treasury's Office of International Tax Affairs, in its analysis entitled "Tax Treatment of Foreign Earned Income of Private Employees" prepared in March 1976, that net revenue again if the excluded income were to become taxable would only be $60 million in 1976.

RECOMMENDATIONS

For the reasons expressed above, our chamber respectfully recommends:

The retention of the present section 911 of the U.S. Internal Revenue Code and the corresponding deletion of section 1011 of H.R. 10612.

BRIGER & ASSOCIATES,
ATTORNEYS-AT-LAW,
New York, N.Y., April 22, 1976.

Re Written statement for record of public hearings on H.R. 10612.

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

DEAR MR. CHAIRMAN: This letter is submitted as a written statement for the record of the public hearings before the Committee on Finance relating to H.R. 10612. The letter summarizes the reasons supporting an amendment of those provisions of the Federal income tax law dealing with the taxation of unrepatriated earnings of controlled foreign corporations—in general, sections 951 through 964 of the Internal Revenue Code—commonly referred to as the subpart F provisions.

The subpart F provisions were enacted as part of the Revenue Act of 1962 and represented a compromise effected between two conflicting points of view. One point of view sought a change in the law that would impose current U.S. taxes on the entire amount of unremitted earnings of controlled foreign corporations, attributable to their U.S. shareholders. The other point of view was that no U.S. tax should be imposed upon the earnings of controlled foreign corporations until such earnings were actually remitted to the United States.

The subpart F provisions emerged as a highly complex set of rules, pursuant to which current Federal income tax was levied solely upon; (i) passive income; (ii) third-country sales and service income; and (iii) foreign earnings, effectively, but not technically, repatriated to the United States.

The law originally contained a number of broad exclusions, which eliminated subpart F treatment where: (i) there was only a relatively small amount of such passive or tax-haven income, sec. 954(b)(3)); (ii) such earnings were invested in less developed country corporations, sec. 955; or (iii) based upon the overall or individual results of controlled foreign subsidiaries, if an appropriate percentage of foreign earnings were distributed as dividends, as determined by the effective foreign tax rate, the subpart F provisions would not be applicable to the unremitted earnings of controlled foreign corporations, sec. 963. These provisions were eliminated or substantially curtailed pursuant to the Tax Reduction Act of 1975.

The experience of the Treasury Department and the Internal Revenue Service in administering the subpart F provisions indicates that they have not generated any significant increase in tax collections from international operations of U.S. owned business. However, the provisions themselves are inordinately complex from an administrative standpoint. Furthermore, recent studies completed by the Congress and the Treasury Department further reflect that the total elimination of deferral would not produce any significant amount of additional tax revenues, and might, in fact, after a short period of time, result in an actual decrease of U.S. tax revenues.

Since the enactment of the subpart F provisions 14 years ago, there has occurred a significant change in the economic priorities of the United States and other industrialized countries. The importance of maintaining existing, or penetrating new, foreign markets has been increasingly recognized by the United States and other industrialized countries, not only as an important means of earning additional reserves to pay the increased costs of imported raw materials, but also as an important factor in maintaining economic production and employment in the domestic economy of competing industrialized nations.

Because of the intensive studies conducted by the Congress over the last 5 years regarding the role and function of international activities by U.S. owned companies, much has been learned regarding the overall contribution that such activities make to the domestic economy. In this respect, the maintenance of overseas facilities by U.S. owned companies can be said to contribute to a greater level of exports from the United States and export related jobs.

The competition among companies from industrialized countries to maintain, or secure new, foreign markets has increased substantially since the enactment in 1962 of the subpart F provisions. It would appear that there is an increasing sentiment that no change be made regarding the taxation of foreign income if such change were to place U.S. companies at a competitive disadvantage with foreign rivals. On the other hand, it is also clear that the tax laws should continue to tax pure tax-haven operations on a current basis. Thus, there is a legitimate concern, that when foreign subsidiaries of U.S. companies no longer are using foreign income in active business operations, this would be an appropriate time for U.S. taxes to be levied upon such foreign earnings.

It is believed that, in light of the changed economic and competitive circumstances, as well as the greater insight which the Congress and the Treasury now have regarding the international operations of U.S. companies, it would be appropriate for Congress to draft new rules that could more effectively and simply deal with the taxation of earnings of foreign subsidiaries of U.S. companies.

There are various ways in which the law could be changed. However, the basic principle that, it would appear, should be embodied in such an amendment is foreign earnings could be retained abroad without the incidence of current Federal income taxation, provided that such earnings continued to be employed in the active conduct of a business. When such funds were no longer used in the active conduct of a business, but were used in purely passive investment activities, such retained earnings would be subject to current Federal income taxation.

One means by which this result could be achieved is through retention of the existing subpart F framework, but eliminating subpart F treatment in the case of foreign base company sales and services income, sec. 954(d) and (e). In addition, the definition of foreign personal holding company income could be changed to exclude income derived from active business operations conducted by foreign affiliates of the U.S. company. Clear-cut rules could be adopted regarding what constitutes the utilization of retained foreign earnings in the active conduct of a business.

Such a provision would be relatively self-executing as regards the taxation of foreign earnings, which were not reinvested in active business operations. It is believed that the adoption of such a rule could greatly simplify and rationalize the administration and operation of those provisions of the law dealing with the taxation of controlled foreign corporations. Moreover, the law could be drafted to take into account current economic realities. Furthermore, the amendment could be effected in such a manner that would not lead to a significant loss in revenues. In fact, by placing U.S. owned companies on a more competitive basis with foreign rivals, it could result in increased U.S. tax collections and simplication of the administration of the law.

Respectively submitted.

PETER L. BRIGER.

STATEMENT OF PYRAMID VENTURES, INC.

Pyramid Ventures, Inc., a U.S. corporation based in Morgan City, La., submits this statement for inclusion in the record of the Finance Committee's hearings on tax revision in support of section 1021 of

H.R. 10612, amending section 956 of the Internal Revenue Code to permit foreign corporations to invest in U.S. property without adverse tax consequences so long as the investment is not in a related U.S. person. Pyramid urges that the committee allow taxpayers to elect to apply section 1021 of the House bill to investments in U.S. property made after May 21, 1974, the date on which the Ways and Means Committee first announced its tentative decision in favor of this change in code section 956.

Pyramid organized two foreign corporations in 1970 and 1972, respectively, to carry on a shipping business by time chartering vessels to transport bulk cargo between U.S. gulf coast ports and foreign ports. The charters expired in mid-1974 and neither subsidiary has engaged in the shipping business since then.

Both foreign subsidiaries then invested the funds remaining after cessation of the shipping business in publicly traded shares of unrelated U.S. companies. These investments were made between August 15, 1974, and January 30, 1975.

Under present law (Int. Rev. Code § 956), though Pyramid was not aware of it at the time, these U.S. investments are technically treated as dividends taxable to the U.S. parent, Pyramid, simply because the investments were made in U.S. property—the shares of U.S. corporations—rather than foreign property, even though the corporations were unrelated to Pyramid.

On May 21, 1974, some 3 months before Pyramid's foreign subsidiaries made their first investments in U.S. securities, the House Ways and Means Committee issued a press release announcing a tentative decision to amend section 956 to allow controlled foreign corporations to invest in U.S. property without dividend treatment to their U.S. shareholders so long as the investment is not in a related U.S. person. The committee did not announce an effective date for the change at that time. The change was made because section 956 has been a trap for those not familiar with its existence; it has encouraged foreign investment rather than U.S. investment to the detriment of the U.S. economy; and the investment does not in fact resemble a dividend if it does not represent funds furnished to the parent stockholder or its affiliates.

H.R. 10612, passed by the House in December 1975, contains such a provision in section 1021, applicable to taxable years beginning after December 31, 1974.[1] The new rules may be applied in prior years at the election of the taxpayer but only with respect to investments made after enactment of the 1969 Tax Reform Act in property situated in or used exclusively in connection with the Outer Continental Shelf or in shares of stock of a domestic corporation substantially all the assets of which consist of such property. The 1969 act contained a new provision specifying that the Continental Shelf was part of the United States for tax purposes.

The new rule in H.R. 10612 can in a few cases be more restrictive on taxpayers than the present law, and hence it seems likely that when

[1] The Ways and Means Committee's report uses Dec. 31, 1975, instead of Dec. 31, 1974, as the cutoff date; the earlier date in the bill is apparently an error. See H. Rept. 94-658, 94th Cong., 1st sess. (1975) at 217.

passed it will bear a general effective date of years beginning after December 31, 1976. However, since the amendment is in most cases favorable to taxpayers, since it is remedial legislation that eliminates a trap and since it encourages U.S. investment, it should at least be effective at the taxpayer's election as of some date earlier than January 1, 1977. Pyramid urges that the new rule be effective at the taxpayer's election as to investments made after May 21, 1974, the date when the Ways and Means Committee announced the change without specifying an effective date.

The amendment to Code section 956 made by section 1021 of the bill can be made effective as of May 21, 1974, at the election of the taxpayer by the addition of about a half dozen words to section 1021(d)(2) of the House-passed bill, as noted below—italics added:

(2) At the election of the taxpayer—made within 1 year after the date of the enactment of this act and in such manner as the Secretary of the Treasury or his delegate prescribes—the amendments made by this section shall apply to taxable years of foreign corporations beginning before January 1, 1975, and to taxable years of the taxpayer within which or with which such taxable years of such foreign corporations end to the extent that such amendments if applicable to such periods would exclude from the definition of "United States property" *(i) any* investments made after *May 21, 1974, or (ii) investments made after* the effective date of section 638 of the Internal Revenue Code of 1954—added by section 505(a) of the Tax Reform Act of 1969, relating to Continental Shelf areas—in property situated on, or used exclusively in connection with, the Outer Continental Shelf—as defined in the Outer Continental Shelf Lands Act—or in stock or obligations of a domestic corporation substantially all of the assets of which consist of such property. No such election by a taxpayer shall be effective with respect to a foreign corporation unless the election is made by every person who has at any time been a United States shareholder—within the meaning of section 951(b) of the Internal Revenue Code of 1954—of such foreign corporation.

Statement of Aerospace Industries Association of America, Inc.

On behalf of the Nation's major manufacturers of aircraft, aircraft engines, avionic equipment, related components and other high technology products in demand around the world, the Aerospace Industries Association of America, Inc., welcomes the opportunity to comment for the record on three proposed changes in the tax treatment of foreign source income: (1) The Domestic International Sale Corp.; (2) Exclusion for income earned abroad by U.S. citizens living or residing abroad; and (3) Treatment of foreign income subsequently earned where foreign losses are offset against U.S. source income.

The aerospace industry is at the forefront of high technology industry, employing an average of 942,000 men and women in 1975, approximately 250,000 of which were employed in the export area. High technology exports accounted for more than 7 percent of all U.S. exports in 1975. The aerospace portion of the balance of trade was $7.1 billion in that year.

DOMESTIC INTERNATIONAL SALES CORP.

The aerospace industry followed carefully the lengthy consultations in 1970 between Congress and leading economic, trade and tax experts concerning the DISC concept. When the DISC was finally enacted as part of the Revenue Act of 1971, many of our manufacturing members, some on their own initiative and some at Government urging, created DISC's to aid in the conduct of sales business abroad. This was accomplished at considerable expense to industry and was predicated on the assumption that DISC was and would continue to be permanent, as originally intended.

The DISC has been in effect only 5 years, far less than the time necessary to demonstrate its full potential. In view of the long lead times inherent in areospace manufacture, aircraft being exported today largely reflect investment decisions that our manufacturers made well before 1971. Indeed, many aircraft being exported today represent orders placed before 1971. Thus, from the standpoint of the aerospace industry, the export stimulus provided by DISC is now barely apparent in sales. The DISC program, in fact, has barely had a chance to get started in our industry.

Although the statistics are still being compiled and by themselves are not definitive proof of incremental increases in exports due solely to the existence of DISC, they show an increase in revenues to the Government, rather than the often discussed $1 billion decrease. Increases in output and resulting taxes from workers attributable to the existence of DISC have been set as high as $2.2 billion, offsetting the initial $1 billion in deferred taxes by $1.2 billion.

Companies with DISC's report that the availability of the DISC option was crucial in their decision to build additional plant capacity and retain existing capacity in the United States, rather than overseas. Furthermore, the required reinvestment of tax-deferred profits in export-related activities has provided the industry with a partial means of financing such assets as inventories of U.S. products for foreign sale, receivables arising from financing foreign sales of such products, machinery and equipment used in the United States for the manufacture of products for export and necessary research and development to adapt our products to the peculiarities of the foreign markets, all of which have resulted in an increase in available jobs in the United States. Companies have also used tax-deferred profits to set up long-range marketing programs abroad which are expected to generate and support a healthy and growing export level in coming years. It must be understood that the battle of the U.S. aerospace industry to maintain its position of dominance in the world market will be difficult, at best, particularly in competition with the united European industry which is rapidly developing the required technology. Because of the structure of the DISC legislation, DISC profits are at work for the United States.

It might be added, furthermore, that the export promotion activities of U.S. companies are still encountering formidable and substantially increasing competition abroad, notably in the form of foreign government subsidies to indigenous competitors. In their pursuit of foreign currency, foreign governments are often more than generous in granting tax rebates, liberal export financing, insurance, bilateral trade, and reciprocity agreements, even direct subsidies and other advantages to their domestic industries. A recent Treasury Department comparison of DISC with tax incentives provided by other countries, using the tax cost of capital index, showed that even at their low rates, DISC taxes are greater than taxes imposed by most other countries on their own exports. Such conclusions would tend to support a strengthening of the DISC rather than its modification or cancellation.

Other assumptions which underlie recent recommendations that DISC be tampered with are equally faulty. Notable among them is the notion that floating exchange rates will solve the basic problem of keeping the supply of dollars and demand for foreign exchange in equilibrium. In reality, a plethora of tariff and nontariff barriers seriously distorts that picture. Further, exchange rates do not float freely. They are managed, which results in persistent overvaluation and undervaluation. To the extent that the float is allowed to fluctuate, it creates additional uncertainties for exporters. In sum, rather than normalizing the world of the exporter, the Smithsonian agreement has multiplied his troubles. In other words, the DISC is not rendered obsolete by floating exchange rates—it is a major counteracting force to this unpredictable and unappealing aspect of world trade.

As you are undoubtedly aware, American industry's thirst for capital will sooner or later be taking on heroic proportions. By 1985 there may be a gap between capital requirements and capital availability of $650 billion. As the aerospace industry can attest, the capital requirements of technology intensive industries will probably account for a significant percentage of such gap.

The cost of technology has reached the point where foreign markets are crucial. Sales abroad are needed to offset the staggering and still growing costs of research and development and to create jobs in these high paying areas. While advanced technology products at present offer the United States a pronounced advantage in world markets, thereby providing a vital balance against comparative disadvantages in certain raw materials areas, they will not continue to do so without an expansion of the export base. DISC is only one of the many export stimulants which will be needed.

For all of the foregoing reasons, we oppose cancellation or even modification of the DISC concept. Particularly disturbing is the House-passed ban on the use of DISC for military exports. Company-to-foreign Government military exports are a legitimate, highly regulated area of foreign trade providing the same economic inputs as exports of any other product or commodity. To exclude such exports from the use of DISC is a wholly inappropriate and discriminatory approach to a political controversy. Certainly the tax code is no place for such treatment. If a problem even exists, it should be dealt with in the Foreign Military Sales Act and, in fact, commercial military exports were dealt with severely indeed in the International Security Assistance and Arms Export Control Act of 1976, which was recently passed by both houses of the Congress. To further single out military exports in the context of DISC is not only gratuitous, but totally unnecessary.

We therefore urge you to reject both the House modification of DISC and its totally inappropriate prohibition with respect to military products.

EXCLUSION FOR INCOME EARNED ABROAD BY U.S. CITIZENS LIVING OR RESIDING ABROAD

We would also oppose any action to eliminate or reduce the exclusion for income earned abroad by U.S. citizens living or residing abroad, as now provided by section 911 of the Internal Revenue Code. Instead, we strongly urge the committee to consider increasing the section 911 exclusion to offset the adverse effects of devaluation and inflation.

The original purpose of section 911 was to aid in increasing our foreign trade by placing all Americans working abroad in an equal position with their competitors. Thus, Congress exempted the foreign source earnings of Americans from income tax. The Revenue Act of 1953 provided a ceiling limitation of $20,000 per year in order to prevent certain abuses.

In order to maintain the aerospace industry as one of the country's largest exporters, we must maintain a sales force to market our products and overseas service organizations to provide technical assistance and other customer support, thus encouraging future sales. Future sales, of course, provide increased jobs in the United States where the manufacturing is performed. Without these sales, U.S. unemployment is increased, something this country certainly does not need.

If the section 911 exclusions are eliminated and companies are required to incur greatly increased costs, the competitive position of U.S. companies vis-a-vis their foreign counterparts, which presently receive many tax incentives for operations outside their respective countries, would be further reduced. The elimination of the section 911 exclusion simply burdens the U.S. companies in their employment of people here at home.

Nearly all U.S. companies provide some type of tax protection to their employees working abroad. Hence, it is a mistaken view that the section 911 exclusion is simply a tax benefit to individuals. The elimination of the exclusion would fall most heavily on U.S. companies as a result of their tax reimbursement policies.

While the section 911 exclusion does provide tax equality or protection for many Americans working abroad, 22 years of inflation and other adverse economic factors have seriously eroded the benefits of the exclusion. Even with the exemption in its present form, U.S. business is increasingly forced to bear a heavier share of the costs in providing tax equality or protection to its American employees working abroad.

The section 911 exemption has continually been monitored by Congress and has met the tests of economics and tax equality, at least until the recent inflationary trend. It should not be reduced or eliminated. If anything, it should be raised to assist our competitive position as was its original intent.

It is interesting to note that, apparently at the urging of Secretary Kissinger, the elimination of section 912 of the code has been tabled and is presently under consideration by the special interagency task group and also by a special Ways and Means task group. Section 912, of course, permits Government employees to exclude from their gross income certain foreign area and cost-of-living allowances. Therefore, there is no sound reason to hasten action on eliminating the exclusion for private employees while the exclusion for Government employees is retained and under study. At the very least, no decision regarding the elimination of section 911 should be made pending the decision on section 912.

TREATMENT OF FOREIGN INCOME SUBSEQUENTLY EARNED WHERE FOREIGN LOSSES ARE OFFSET AGAINST U.S. SOURCE INCOME

Also under consideration is a provision to require that any foreign losses which offset U.S. income be recaptured in future years when foreign income is earned. Apparently, the objective is to reduce foreign source income for purposes of computing the allowable foreign tax credit.

If adopted, this proposal could cause serious hardship to taxpayers. For example, a taxpayer using the completed contract method of accounting, but electing to deduct his general and administrative expenses as a period cost, would incur losses in the early years under the contract. Later, when the contract was completed, his income would be correspondingly increased. His losses are foreign source and would be used in the prior years of offset other foreign-source income. If the proposal is adopted, he may be forced to offset foreign-source income a second time by allocating those losses against the income to which they are specifically attributable.

Further, a taxpayer may incur the loss in a foreign country which does not have a net operating loss carryover provision. He would pay foreign tax on the income reported in the later year without an offset for losses from prior years. However, the proposal would, for U.S. tax purposes, reduce the foreign source income by the losses and, hence, possibly preclude the recovery of the foreign taxes paid as a tax credit.

We respectfully recommend that the committee not adopt this proposal and, in fact, we urge careful consideration of the negative ramifications of all three proposals.

STATEMENT BY NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC., WASHINGTON, D.C., ON BEHALF OF THE TAX FOUNDATION

TAX FOREIGN-SOURCE INCOME: THE ECONOMIC AND EQUITY ISSUES

I am Norman B. Ture, president of Norman B. Ture, Inc., economic consultants in Washington, D.C. My statement is submitted on behalf of the Tax Foundation. The views presented in this statement are my own and are not necessarily those of the Tax Foundation or of any of my past or present clients.

The tax policy issues in the present tax treatment of foreign-source income

With the growth of U.S. private investment abroad over the past decade, the U.S. Federal income tax provisions pertaining to foreign-source income have been increasingly targets of tax reform. Those who urge increasing the U.S. tax on foreign-source income argue that the present tax treatment (1) is inequitable because it imposes a lower U.S. tax burden on foreign income of U.S. companies than that levied on the income of domestic U.S. corporations, and (2) subsidizes investment abroad by U.S. multinational companies at the expense of domestic U.S. investment, production, and employment.

Neither the equity nor the economic case for increasing the U.S. tax on foreign-source income is analytically correct. The basic tax reform proposals—for reducing if not eliminating the foreign tax credit and for requiring current payment of U.S. tax on undistributed foreign earnings—would neither enhance the equity in the taxation of those who bear these tax burdens nor contribute to greater productivity and efficiency of the U.S. economy. On the contrary, these tax changes would aggravate the inequities in the corporation income tax; they would differentiate corporation income tax liabilities on the basis of the location of the economic activity giving rise to corporations' incomes, without regard to the differing economic situations of those who actually bear the corporation income tax burden. They would, moreover, distort the allocation of capital resources and impair the productivity and efficiency of the U.S. economy.

This statement is addressed to both the equity and economic issues involved in determining the appropriate treatment in the U.S. income tax of the foreign earnings of U.S. companies. My analysis urges that on the score of both equity and economics, not only should the basic reform proposals be rejected, but foreign earnings—or losses—should be completely excluded from the U.S. tax.

The equity issue

The standard equity argument against the existing provisions is that they violate the equity requirement that persons with equal incomes should pay equal taxes. This results because the present provisions allow a credit for foreign taxes against U.S. tax liability but only a deduction from income for taxes paid to a U.S. tax or local government. Why, according to this argument, should taxes paid to a foreign government receive better Federal income tax treatment than taxes paid to a State or local government in the United States?

This equity argument rests on the personification of corporations for purposes of the law, a concept upon which the separate income taxation of corporate business is based. Since it is a widely accepted and intuitively appealing view that persons with equal income should pay equal taxes, corporate persons with equal incomes, presumably, should also pay equal taxes. The identity of the jurisdiction to which the corporation pays taxes, according to this argument, is irrelevant; taxes paid to a foreign government on a given amount of income should be treated as deductions in the same way as taxes paid to a State or municipality and should not be credited against the U.S. tax.

This argument, however, presumes that the income taxes paid by corporations come to rest only on the corporate entity itself. But things can't pay taxes; only people do. If we recognize, as we should, that the burden of the corporation income tax falls on individuals as savers and investors and, insofar as the amount of saving and capital is less than it otherwise would be, on workers whose productivity, hence real wages, are less than otherwise, then the argument that corporations with equal income should pay equal taxes is substantively vacuous. The amount of taxes paid by any two corporations with equal incomes has no systematic bearing on the amount of the tax burdens on the individuals who supply the saving and capital generating the corporations' net incomes. Unless one assumes, grossly contrary to fact, that individual shareholders are identical with respect to their marginal tax brackets and portfolio composition, equal corporate income tax liabilities on two corporations almost inevitably mean disparate tax burdens on their respective shareholders. Applying the conventional equity criterion to corporations, in fact, necessarily involves violating the same equity criterion for real persons.

To be useful for purposes of corporate taxation, an equity criterion should be addressed to considerations that are pertinent to corporations in their functions of organizing and undertaking production activities. A logically satisfactory equity criterion would require that equal tax liabilities be levied on businesses imposing equal opportunity costs on the economy, where opportunity costs are deemed, in an efficiently operating market economy, to be adequately measured by the value of the production inputs used by the business, hence denied to alternative production uses. To be completely satisfactory in this respect, the tax should be imposed on the total of such costs a business imposes, that is, on the total payments it makes for all of the production inputs it uses. If only the payment for capital services, that is, profits, is to be taxed, the basic principle should nevertheless be adapted to that tax.

If this principle were implemented, no U.S. tax would be imposed on the foreign-source income of U.S. business since the production activity generating that income has imposed no cost on the United States. These costs are imposed solely within the foreign jurisdictions whose real production inputs are used. The mere fact that the foreign operation is undertaken by a U.S. company should have no bearing on the determination of the jurisdiction which should impose taxes; there is no more reason for the U.S. tax to apply to the foreign income produced by a U.S. company's subsidiary, division, branch, what have you, than there is for the United States to impose its tax on any company of any other nationality operating in the foreign jurisdiction.

This is not to say that the investment by the U.S. company in the foreign subsidiary is costless to the United States. In real terms, financing such investments requires an equal amount of U.S. production for exports in excess of imports since, by definition, net foreign investment is equal to the net export of goods and services. The production in the United States of the goods for export, of course, imposes real costs, but the income payments made to these production inputs are subject to U.S. income tax (although tax on the payments for capital input—profits—may be partially deferred under the DISC provisions). The costs imposed in the United States to finance, in real terms, the foreign investment, therefore, do give rise to U.S. tax liability just as if the exported goods were produced for use in the United States. Income generated by foreign companies in the United States should, for the same reason, be fully subject to U.S. tax, irrespective of the foreign jurisdiction's tax provisions pertaining to its nationals' foreign-source income, since this income generation necessarily imposes costs on the U. S. economy.

In the light of this principle, the appropriate tax reform in the interests of greater equity is not to tax the foreign-source income of U.S. companies as if the income had been earned in the United States but, on the contrary, to exclude foreign-source income—and losses—entirely from the base of the U.S. corporation income tax. Moreover, the no-U.S.-tax prescription should apply whether or not the foreign earnings are shifted from one foreign jurisdiction to another or returned to the United States. Should the repatriated earnings be reinvested in the United States, the domestic income generated by this investment would, as a matter course, be subject to U.S. tax.

It is difficult to perceive how the tax reform proposal for the elimination of so-called "deferral" squares with the conventional equity standard that equally situated taxable entities should receive equal tax treatment. In the case of domestic U.S. companies, shareholders are not required to include in their incomes the undistributed profits of the corporations whose shares they own. The tax reform proposal to impose U.S. tax liability on a U.S. company with respect to its share of the earnings of its foreign subsidiaries in the year in which those earnings are realized rather than when they are distributed to the U.S. company clearly would differentiate tax treatment among U.S. corporations solely on the basis of the location of their income-generating activity.

Present law differentiates tax treatment in other respects on the basis of the location of the income. Foreign subsidiaries of U.S. companies cannot claim the investment tax credit nor use the asset depreciation range system in determining their depreciation deductions. Neither can losses of these foreign subsidiaries be offset against the U.S. parent company's income. If it were meaningfully and consistently applied, the equity argument for elimination of the foreign tax credit—the same tax treatment should apply to taxes paid by foreign subsidiaries as to the taxes paid by domestic companies to States and localities—would call for eliminating the other differentials as well, changes which reform advocates oppose on grounds having little to do with their view of equity.

The present foreign tax credit closely approximates the no-U.S. tax prescription when the effective foreign tax rate is the same or greater than the effective U.S. income tax rate. It fails to meet this equity standard when the foreign rate is less than the U.S. rate since some U.S. tax then is imposed with respect to costs which the United States does not sustain.

The economic issues

The tax reform argument for increasing U.S. income tax liabilities on foreign source income is that the present tax provisions subsidize investment by U.S. multinational companies in foreign operations. This tax subsidy, it is claimed, shifts investment that otherwise would be undertaken in the United States to foreign sites. As a result, so it is argued, there is less capital in the United States and more capital abroad than would be the case if the U.S. tax fell equally per dollar of return on domestic U.S. and foreign investment. The consequence of this alleged tax-induced shift of U.S. capital to foreign locations is less output, employment, and income at home than otherwise.

Those who view foreign investment by U.S. companies as reducing or "displacing" domestic investment, also argue that such investment (1) shifts production from the United States to foreign sites, therefore directly transferring output and employment from this country to other nations, and (2) transfers U.S. technological advantages to other nations, thereby increasing their productivity relative to that of the United States and weakening the competitive position of U.S. business; the consequent increase in U.S. imports and reduction in its exports, it is argued, necessarily impairs the balance of payments and means a loss of domestic output and employment.

On the basis of these arguments, the present tax treatment presumably should be changed to eliminate the alleged subsidy to investment abroad by taxing foreign source income as if it were earned in the United States. This tax change, so it is argued would result in a return to the United States of substantial amounts of the capital of U.S. companies now situated abroad. The overall economic consequences of this repatriation of U.S. capital would be, ostensibly, the reverse of the effects attributed to the alleged present subsidy of foreign investment, as described above.

Several basic questions are raised by these tax reform arguments. One of these is whether the present tax provisions do indeed subsidize foreign investment by U.S. companies. Another is whether the consequences of the existing tax provisions for U.S. domestic capital formation, productivity, total output, employment, and income are as claimed by advocates of increasing U.S. taxes on foreign-source income. A corollary question is whether the proposed revisions would produce the favorable economic effects ascribed to them by these advocates, and the implications of these revisions for U.S. international trade.

1. Do the present tax provisions subsidize foreign investment?

The overall thrust of these tax reform proposals is that foreign investment by U.S. companies is excessive. It is axiomatic that trade, freely entered into, increases the economic well-being of the participants; it allows them to use the production capability at their disposal to obtain a greater amount of valuable goods and services than if they had to produce themselves all of the goods and services they use. Trade, in short, is a means of increasing productivity. The exchange of production capability, freely entered into, similarly increases productivity. Decisions as to the best place in which to locate production facilities clearly are impelled by determinations of where the use of the facilities will be most productive—where the flow of income they produce will be the greatest. If a given amount of machine tools manufactured in country D, for example, can be more productively used in country F, that is, if the present value of the increase in income the use of these tools will afford is greater in F than in D, surely it is to the advantage of D to have the machine tools used in F. D will need to use less of its production inputs to produce exports to F to pay for the output of the machine tools than it would need to use to produce the same output in D. The production resources saved in D by this arrangement then may be used in D to produce those goods and services in which D is more efficient. In short, the allocation of the capital represented by the machine tools to F increases D's production capability, as it does F's.

Presumably there should be little argument on this score. The issue should be confined to whether the amount of foreign investment undertaken by U.S. companies is so large that at the margin the present value of the income flow on such investment which the U.S. economy may claim is less than it would be if the marginal investment were made at home. This would result if because of some institutional factors, for example, U.S. tax laws, the foreign investment were subsidized. If it were shown that the present tax provisions do not subsidize such investment, presumably the issue should thereby be resolved; we should conclude that the magnitude of that investment at least roughly approximates the optimum amount; that is the amount which maximizes the real income the U.S. economy can obtain from the use of that amount of capital.

The most critical issue, therefore, should be whether the present law tax provisions subsidize foreign investment by U.S. companies.

The validity of the assertion that the present tax provisions subsidize foreign investment clearly depends on what a subsidy is. Subsidies take a multitude of forms but their common characteristic is that they reduce the costs of—or increase the prices received for—the subsidized activity relative to alternative activities. If the present tax provisions are deemed to subsidize foreign investment by U.S. companies, they must reduce the cost of foreign relative to domestic investment—or equivalently, increase the returns on foreign relative to domestic investment, compared with the relative costs or returns that would prevail in a neutral tax environment.

A neutral tax is one which does not alter the relative prices of goods, services, activities, production inputs, and so forth, in the private sector. As a practical matter, of course, perfect tax neutrality is never achieved; as a policy criterion, neutrality calls for taxes with the least possible effect on private-sector relative prices. With respect to the tax treatment of foreign-source income, perfect neutrality in the respective tax systems of two countries would mean that relative prices in the private sectors in each country would be unchanged by the taxes, hence would differ from each other in the same way as if no taxes had been imposed in either. If the nationals of either country choose to engage in income-generating activity in the other, such activities should be governed solely by the opportunities and constraints which the other's price structure present. But if one country imposes a tax on its nationals' income produced in the other, it clearly will alter the relative prices its nationals' confront compared to the prices they would confront if exposed only to the foreign jurisdiction's taxes. Neutrality, therefore, requires that each country impose no tax whatever on the income its nationals derive abroad, leaving such income fully exposed to the taxation of the country within whose jurisdiction it is generated.

The view of neutrality advanced to support the tax reform proposals is quite different. This tax-reform concept is that neutrality requires U.S. tax treatment which maximizes U.S. real output and income. According to this so-called national neutrality criterion, the required tax treatment is that which will insure "* * * that the total U.S. returns to capital, which are shared between the U.S. Government in the form of taxes and the net-of-tax return to American investors * * *" is "* * * the same whether the capital were located at home or abroad. Equality of total returns * * * would be achieved if U.S. firms paid the same current rate of tax to the U.S. Government no matter where earnings arose."[1] On this view, taxes paid by U.S.

[1] Gary C. Hufbauer, "A Guide to Law and Policy," "U.S. Taxation of American Business Abroad," American Enterprise Institute for Public Policy Research, Washington, D.C., Hoover Institution on War, Revolution, and Peace, Stanford University, Stanford, Calif., 1975, pp. 2–3.

companies to a foreign jurisdiction on their income subject to that jurisdiction's tax laws should not be credited against U.S. tax, but merely deducted from the company's foreign income to determine the amount of that income subject to U.S. tax. "For example, if a firm domiciled in the United States earned $180 in Mexico and if Mexican taxes were $80, the firm would pay a U.S. tax of $48—48 percent of $100." [2] In this case, the company's total tax on the income generated in Mexico would be $128.

In contrast, under present law—ignoring the foreign tax credit limitation—it would pay a U.S. tax of $6.40 on the Mexican income—48 percent of $180 less the foreign tax credit equal to the $80 paid to the Mexican Government—its total tax would be $86.40, the same as if the $180 had been earned in the United States; its after-tax earnings would be $93.60, the same as if earned in the United States. Under the so-called national neutrality tax rules, in other words, the company would pay an effective tax rate of 71.1 percent, almost half again as high as the rate of the same amount of U.S. income and 60 percent higher a rate than that imposed by Mexico on the income earning in its jurisdiction. From the company's viewpoint, this type of tax treatment is highly discriminatory against investment in Mexico; it is a substantial negative subsidy on foreign investment by U.S. companies. Such investment in Mexico could not be undertaken unless the pretax return were at least $324, that is, $144 or 80 percent greater. Clearly, there are likely to be far fewer investment opportunities which would afford these greatly enlarged returns. Hence, foreign investment by U.S. companies would be discouraged. Companies of other nationalities, subject to less punitive taxes, then would confront less competition for investment opportunities in Mexico. The proposed change in the U.S. tax treatment of foreign source income, in other words, would subsidize the investment in Mexico by foreign companies.

From the point of view of the U.S. Government, according to the advocates of this type of tax treatment, this curtailment of foreign investment is desirable. Limiting investments abroad to those which would afford these much higher returns would insure that the total of the returns claimed by the U.S. Government and the investing company would be the same as if the investment had been made at home. In this example, the Mexican Government would receive $144 of the $324 of pretax Mexican earnings, leaving $180 for the U.S. Government and the investing company to share.

Hinging this type of tax treatment on how much of the returns to capital both the U.S. Government and the owners of the capital receive has perverse results. It makes the acceptability of foreign investment depend on how severely the United States taxes capital income, hence on how severely it constrains its growth in capital relative to labor inputs, hence the growth in its total output and the productivity, real wage rates, and employment opportunities of its labor force. The higher the effective rate of the U.S. tax, the scarcer capital becomes in the United States, the fewer the acceptable—by this standard—investments abroad and the higher must be their yield. Thus, foreign uses of capital which are far more productive than U.S. domestic

[2] Ibid., p. 3.

uses and which would augment U.S. real income become unacceptable by the national neutrality standard merely by virtue of decisions here and abroad as to the effective capital income tax rates.

The "national neutrality criterion" is a highly arbitrary notion. The effects of its practical application—eliminating the foreign tax credit and permitting only a deduction for foreign taxes—depends on the effective U.S. tax rate and those of various foreign jurisdictions in which U.S. companies might wish to invest. For example, if the Mexican Government—pursuing the example—were to increase its effective tax rate to 48 percent—the same as assumed for the United States, then an investment by a U.S. company in Mexico would be just as "good," by this neutrality criterion, as the same investment in the United States only if its yield rose to $346. In some other country choosing to tax corporate income at a rate of, say, 24 percent, a U.S. company's investment would be just as "good" if it yielded $237. By the same token, an investment according a gross return of $300 in Mexico is less productive than the same investment providing a gross yield of $240 in another country and less productive than an equal investment yielding only $180 in the United States. In other words, the same investment—the same commitment of real capital—is equally productive as in the United States only if it produces widely disparate gross returns, depending on the tax rate, hence on the extent of the tax-induced scarcity of capital in the foreign jurisdiction.

If the U.S. effective rate were 40 percent instead of 48 percent, as in the preceding examples, and if U.S. domestic investment increased so that pretax returns decreased to $156—the level at which the same after-tax return of $93.60 would be provided—then the same investment in Mexico would become as productive, by this standard, if it were to yield $281; in another country with a 24-percent tax rate, a pretax return of $205 would now make the investment just as productive as the same investment in the United States.

It is obvious that the implementation of this neutrality criterion would produce a grossly distorted allocation of capital between domestic and foreign jurisdiction—one which would override considerations of the real costs of capital resources and the real returns thereupon by the differences among the jurisdictions' tax rates. Surely it is a peculiar concept of neutrality which holds that a given investment is more valuable if it produces $180 than if it produces $300.

The tax reform argument that the present tax treatment of foreign source income subsidizes investment abroad by U.S. companies depends on an arbitrary concept of neutrality which more likely than not would be rejected by the advocates of the proposed tax reforms in other situations. There is a virtually universal consensus that the optimum allocation of any production resource results when the pretax return per unit of that resource is the same—when adjusted for differences in risk—in all alternative uses. One of the principal arguments in the standard tax reform arsenal is that so-called tax preferences, loopholes, or what-have-you, result in disparate pretax returns to alternative uses of production resources and that the differences in these pretax returns is one useful measure of the extent of the distortion in the allocation of resources resulting from these tax preferences. Insofar as this reasoning is valid for purposes of tax reform aimed principally at domestic tax situations, it surely should apply with equal force in the tax treatment of foreign-source income.

The present tax provisions provide much more nearly neutral tax treatment of foreign source income than would the proposed revision. Where the tax rate abroad exceeds the U.S. rate, the foreign tax credit, in effect, leaves the income of the U.S. company's foreign subsidiary exposed only to the tax of the foreign jurisdiction in which the income was earned. Where the foreign tax rate is less than that in the United States, however, the present tax provisions improperly; that is, nonneutrally, expose the foreign source income to U.S. tax. In the first example above, the United States collects a tax of $6.40 on the $180 of income earned in Mexico; this additional tax discriminates against the U.S. company in Mexico compared with Mexican companies and compared with companies of other nationalities whose foreign source income is not subject to their country's tax. In other words, in these cases, the present U.S. tax treatment distorts the costs of and returns to investment by U.S. companies compared to other companies in the foreign jurisdiction.

2. Do the present tax provisions adversely affect the U.S. economy?

Based on the assertion that the present tax provisions subsidize foreign investment by U.S. companies, the tax reform proponents assert that the subsidy results in: A shift of investment from the United States to foreign sites; hence a smaller stock of capital in the United States and a larger amount abroad than otherwise; less output and income available for use in the United States than otherwise; a shift in production from the United States to foreign sites; a transfer of U.S. technological advantages to other nations, increasing their productivity relative to that of the United States and weakening the competitive position of the United States in international trade; hence an increase in U.S. imports and a reduction in its exports; hence a loss in U.S. production and employment.

At issue are the questions (a) whether foreign investment by U.S. companies occurs at the expense of domestic U.S. investment and (b) whether there are losses in U.S. output, employment, and income either associated directly with the capital in foreign sites put in place by U.S. investment or indirectly with the alleged adverse balance of trade effects.

The analytical and factual answer to these questions is that the foreign investment undertaken by U.S. companies, given the existing tax provisions, do not entail the adverse economic consequences for the U.S. economy asserted by tax reform proponents; indeed, the U.S. economy would gain from eliminating foreign source income—and losses—entirely from the U.S. tax base; on the other hand, the proposed tax reform would prove injurious to the U.S. economy.

(a) Does foreign investment by U.S. companies reduce investment at home?

The answer to the first of these questions obviously is critical to evaluation of the economic consequences for the United States of foreign investment and of the desirability of changes in the tax provisions pertaining thereto. The view that foreign investment displaces domestic investment is based on superficial analysis of the impetus for and constraints upon private capital formation and on a highly mechanistic treatment of national income account relationships and identities. A more careful and thorough analysis urges that tax provisions may indeed distort the international allocation of capital, as illustrated above; the principal distortion, however, derives from the excessive tax on income that is saved and invested. The severity of this antisaving, anticapital tax bias differs from one country to another and is reflected in differences in amounts of capital relative to other production inputs and in the proportions of income saved and invested. The more severely the United States taxes the capital income of its nationals, irrespective of where that income in generated, the less the amount of capital and the slower the rate of its growth will be in the United States. To the extent that the tax law depresses investment in the United States relative to that abroad, it is the set of basic antisaving tax provisions applicable to domestic income which is responsible, not the provisions pertaining to foreign source income. Increasng the severity of application of the latter provisions will not increase domestic investment, although it certainly will depress foreign investment by U.S. companies.

Basic to the tax reform argument that foreign investment occurs at the expense of domestic investment is the assumption that the total amount of an economy's saving, hence its total domestic and net foreign investment, in a given period of time is completely insensitive to the cost of saving and is otherwise determined, say by current or permanent income. However convenient this assumption may be for some econometric exercises, it is analytically untenable. Since saving and consumption exhaust current income and since an increase in the relative cost of one necessarily means a decrease in the relative cost of the other, if saving is zero elastic with respect to its cost, so too must be consumption. But suppose that at a given income level, the cost of consumption is increased while that of saving is reduced—for example, by substituting a retail sales tax for an income tax, with no change in total revenue. Then if saving, hence consumption, is completely inelastic with respect to its relative cost, total consumption outlays must increase and total saving must fall by the amount in response to an increase in its relative cost while saving decreases when its relative cost falls, is absurd in itself; even if it were accepted, it clearly denies the notion that saving is zero elastic with respect to its cost. Indeed, the zero-elasticity assumption is a logical impossibility.

Paradoxically, the view that an increase in net foreign investment is at the expense of domestic investment because total saving is unresponsive to its cost necessarily implies that the allocation of saving is responsive to risk-adjusted differentials in these costs—or equivalently, rates of return. In other words, according to this view total saving is insensitive to its cost, but its allocation, in contrast, is responsive to differentials in the cost of saving among alternative uses. Together these propositions hold that households—and businesses acting as their agents—attempt to maximize the amount of future income to be obtained from any given reservation of their current income from consumption, but that no matter how much or how little of their current income must be so reserved to obtain a given amount of future income, they will save the same amount.

Recognizing that the total amount saved and invested out of a given amount of income in fact is responsive to changes in the cost of saving relative to the cost of consumption leads to quite different conclusions about whether foreign investment displaces domestic investment. To see this, and in order to keep the analysis no more complicated than it need be, let us begin by assuming a two-country world with no taxes and using the same monetary units. Further, let us assume that there are no nonmarket barriers to intercountry movements of products or produciton inputs. Finally, let us assume that initially each country's export and imports are in balance and that there are no capital flows between the two. This implies equilibrium in the sense that capital has been allocated between the two countries, by the nationals of each, in such amounts relative to the other production inputs in each that the rate of return on the capital is the same in each.

Now, let us suppose that a technological innovation in one of the countries, D, results in reducing the real resource cost of producing any given quantity of capital goods. We may simplify the analysis without loss of generality by assuming that capital goods in both countries consist of a single type of facility, say machine tools. Assuming some elasticity of substitution of the machine tools for other production inputs, the immediate consequence of the implementation of this technological innovation is to increase the aggregate real production potential of country D, as well as to reduce the relative price of machine tools. In the ordinary case, investment in the new machine tools by machine tool users in D will displace some investment that otherwise would have been made in older, less advanced tools; total investment, however, is likely to rise, since, by hypothesis, the cost of capital has been reduced.

If production resources in D are fully employed, the increase in investment in D must be offset by an equal reduction in some other expenditures on domestically produced goods and services. In all likelihood, domestic consumption would be reduced, since the reduction in the cost of capital is equivalent to a reduction in the cost of saving relative to consumption. In short, the technological innovation results in a shift in the composition of full-employment output—from consumption to capital formation. If resources were less than fully employed, total output would increase. In any event, however, the proportion of output allocated to capital formation would rise.

Machine tool users in country F will also want to import some quantity of the new machine tools, and unless the new capital goods are a perfect substitute for other production inputs which F imports from D, F's total imports will increase. Since the balance of payments must balance, F's increase in imports—equals D's increase in exports—must be exactly matched by (a) F's increasing its exports—equals D's increasing its imports, (b) investment by D's nationals in F in an amount equal to F's trade deficit, or (c) some combination of both.

The increase in D's exports implies either an increase in total production in D, if there are idle production resources, or an equal reduction in some other domestic production if resources are fully employed. In the latter case, according to the tax reform argument, the offsetting reduction in domestic output would be in the form of reduced domestic investment. This assumption derives from the view that the total amount of saving, therefore total domestic and foreign investment, is fixed at any given income level. Then in this view, because resources are fully employed, income is not increased by the increase in exports, neither is saving, and therefore, neither is the total of gross domestic and net foreign investment. If imports are unchanged, an increase in exports is by definition an increase in net foreign investment. Hence, this view argues that the increase in exports in our example must result in a decrease in domestic investment, under conditions of full employment.

The result, to repeat, depends critically on the assumption that saving is completely inelastic with respect to its cost. But on the contrary assumption, that saving is responsive to changes in its cost, the increase in D's exports equal to its foreign investment in F need not occur at the expense of domestic investment. Indeed, it is not likely to displace domestic investment at all.

The hypothesized reduction in the real resource cost of producing capital goods in our example is equivalent to a reduction in the cost of future income. Even if one assumes that the elasticity of demand for future income is quite low, the effect on the amount of current saving is likely nevertheless to be significant. Total saving, in other words, will increase, and this increase in total saving will result in an increase in domestic and foreign investment in proportions determined by a number of basic economic factors. In our example, it is unlikely that the increase in D's net export: that is, in its foreign investment will result in any offsetting reduction in domestic investment. On the contrary, domestic production of consumption goods and services is likely to fall while domestic production of capital goods for domestic use and for exports increases.

Consider next an opposite kind of change in D—something which increases rather than reduces the cost of saving. For example, suppose D imposes a capital income tax of, say, 50 percent, limiting the applicability of the tax to domestic income. Obviously, the tax makes it more expensive for those subject to it to save and invest—they must give up a larger amount of consumption uses of current income to obtain any given amount of future income. If it is assumed, as the tax reform argument does, that total saving is unresponsive to its costs, then the imposition of the tax in D will not affect total saving there nor the sum of D's domestic and foreign investment. But then the net return on saving and investment in D must fall by 50 percent. To pursue the tax-reform view's reasoning, analogous to the preceding case, investment by F in D will decrease. This means that F's exports to D—equals D's imports—will decrease in equal amount. Then D realizes an export surplus. This export surplus—necessarily equal to D's net foreign investment—will be balanced, presumably, by a decrease in D's domestic investment.

The tax reform argument produces the paradoxical result that whether the cost of saving in D rises or falls, net foreign investment increases at the expense of domestic investment.

If, more realistically, it is assumed that D's total saving, hence the sum of its domestic and foreign investment, will decrease as the cost of saving is increased by the tax, different results follow. As saving and investing in D decreases, as capital therefore becomes scarcer, the pretax return—and at a constant tax rate, the net return—will increase. By how much will the net return have to rise—how much must the stock of capital decrease?

The decrease in capital in D will halt when the aftertax return has risen to equality with that in F. The critical question then is what happens to saving and investing in F in response to D's imposing its capital income tax. The answer is that unless savers and investors of both D and F are willing to accept lower returns for any given amount of saving or equivalently are willing to save more at any given cost, D's tax will not increase saving and investment in F. Hence, the rate of return in F will not change. Then the reduction in saving in D must be sufficient to raise the aftertax return there to the unchanged rate in F. The pretax rate of return in D, in other words, will have to double.

When this adjustment is completed, the amount of capital in F will be the same as if D had not imposed its tax, but the amount of capital in D will have fallen. The extent of the reduction in saving and capital formation in D required to attain the new equilibrium will depend on the responsiveness of saving to changes in its relative cost, the conditions of supply of noncapital production inputs, and the substitutability of capital for other inputs.

If fundamental savings proclivities were to change in response to the imposition of the tax in D, so that savers-investors would accept lower returns on any given amount of saving, the decrease in capital in D would be less while the total amount of capital in F would increase.

The change in the percentage allocation of capital between the two countries, it may be seen, results from D's imposing a tax on capital income. To the extent that people increase their saving at any given cost in response to the tax—a peculiar assumption indeed—some shift in investment from D to F will occur. To repeat, it is D's taxing capital income that impels any such shift.

This illustration, it will be readily recognized, involves a tax situation which goes beyond the present U.S. provisions pertaining to foreign-source income: D exempts foreign-source income entirely from its tax.

Does it make any sense to characterize D's tax as subsidizing foreign investment by its nationals? If D finds the results of its tax distasteful—other countries save and invest more—the remedy is obvious, viz., D should reduce the burden of its tax on capital income. If D deems other tax policy considerations to be determinant and persists in penalizing saving and investment uses of its income and production capacity in favor of public and private consumption uses, it is difficult to understand why it should seek to extend this punitive effect to other nations whose tax systems more single-mindedly pursue economic progress.

The proposed tax reforms are properly seen as a manifestation of late 20th-century mercantilism. As discussed earlier, they would preclude the optimum international allocation of capital on the belief of their proponents that making it more expensive to invest abroad will increase investment at home. As we have seen, this belief is mistaken;

it is derived from the misapprehension that an increase in foreign investment displaces domestic investment.

(*b*) *Does foreign investment by U.S. companies reduce U.S. output employment, and income?*

As noted earlier, the tax reform issue should focus on determination of whether foreign investment by U.S. companies is subsidized by present tax provisions. In fact, however, the issue appears to have been enlarged to include the question whether any such foreign investment, subsidized or not, is injurious to the U.S. economy. This latter question, therefore, warrants separate examination.

To address this question, let us return to our case of the two-country world without taxes. Again, assume that technological advances lead to the production in D of less costly, more productive machine tools.

Suppose that companies in D decide to undertake manufacturing operations in F, using the new machine tools which will be imported from D. As in the prior case, their investment in F must be matched initially by an equal increase in D's net exports to F. In this case, of course, their investment in F is financed, in real terms, by the increase in D's exports to F equal to the value of the new machine tools used in the manufacturing operations in F.

Clearly, the investment by D's companies in F does not result in any immediate loss of domestic production in D, and it may result in an increase if there are idle production inputs in D. To repeat, in real terms the net investment by D in F must be financed by an increase in D's net exports to F. If D has idle production inputs, total domestic output will increase as a consequence of the increase in exports, irrespective of whether the additional exports are matched by additional imports, investment in F, or some combination of the two.

But won't the manufacturing operations undertaken by D's companies in F displace similar domestic production in D, either because such output in F substitutes for imports by F or because such ouput in F is exported to D as substitutes for products otherwise produced and used in D? In other words, doesn't the foreign investment by D's companies result in a subsequent loss of domestic production in D?

The answer, of course, stems from an elementary proposition of international trade. In the first place, companies in D would not undertake the investment and manufacturing operations in F unless they anticipated that the present value of the returns on the use of the machine tools in F would at least equal that in D. If the investment occurs, then, it must be that the real costs of production in F are lower than in D. But if this is so, it is to the advantage of D to have the machine tool's output produced in F, since it will cost less in terms of real input requirements to obtain any given amount of such output; for example, D need use less of its production inputs to produce exports to F to pay for the output the machine tools produced in F. In short, the foreign production increases D's production capability, which is the fundamental occasion for trade. To be sure, the composition of output in D must change under these circumstances, and it must be recognized that there are some real transitory costs in reallocating production inputs to other uses. But beyond the transition period, the total amount of real output which D can claim clearly will be greater if, under the postulated circumstances, the new machine tools are used in F and the production inputs with which they would otherwise be used in D are reallocated to other more rewarding kinds of production.

The displacement of production in D, it is clear, does not depend on D's investing in F but rather on D's exporting the new machine tools to F. If the displacement is deemed to be intolerable, accordingly, D must ban the exports; focusing concern on the foreign investment is closing the barn door after the horse has gone.

Moreover, the displacement in D resulting from the use of the new machine tools in F is merely a special case of the general rule that trade necessarily involves a different allocation of production inputs from that which would be made in a closed economy. Thus, suppose D's nationals invest in a subsidiary in F which engages in operations requiring no production inputs exported by D. By hypothesis, if the investment is made, it is because the real costs of the particular production activity are lower in F than in D, implying necessarily that some change has occurred in F in the conditions of supply of some production inputs, in the technical conditions of production, and/or in the state of the industrial arts, that is, some change in the real terms of trade. Such foreign investment must be advantageous to both D and F, putting aside the transitional costs of any real resource allocation which may be required. Various economic entities in D may be temporarily disadvantaged by the displacement resulting from the new or expanded activity in F, but if such disadvantages are to be avoided altogether, D must refuse to import from F, that is, must refuse to engage in trade at all. Moreover, any such temporary disadvantages of trade-caused displacement in D does not depend on whether the particular production activity in F is undertaken by D's nationals or F's. Displacement, therefore, does not depend on D's nationals investing abroad unless it could be shown that they alone could undertake the operations in F, that is, enjoyed some monopoly control over an essential production input or process.

To repeat, the companies in D would not have undertaken the investment in F unless they anticipated that the present value of the returns on the use of the machine tools in F would at least equal that in D. The form of payment for the use of the machine tools, the time pattern of these payments, and the particular place where the payments were made, that is, in D or in F, would be of no consequence so long as the present values (adjusted for such risks as might be involved) were equal.

With respect to any of these alternatives, it is clear that both D and F are advantaged. When adjustment to the implementation of the technological innovation is complete, both D and F will have a larger stock of real capital, hence greater production potential, then they would have had otherwise. In the new equilibrium, moreover, the capital-labor ratios in both countries will be greater and capital formation will be a larger share of total output than otherwise. The marginal product of labor, hence the real wage rate, is likely to be greater than otherwise. And the rate of return on any given amount of additional capital in D and F will be the same; savers in each country will be indifferent regarding the allocation of their marginal saving between the two countries. Both countries realize an increase in real production potential. From D's point of view, each of the alternative forms of payment for the additional exports must be of equal present value and equal to the present value of the incremental real income which the exported machine tools would produce if instead of being exported they were used in D.

Would anyone insist that D loses by exporting the additional machine tools—real capital—and importing an equally valuable amount of F's output? Would anyone argue that D loses anything if D's machine tool exporters chose, instead, to receive from F's machine tool importers claims on F's future income the present value of which is equal to that of the exported machine tools if used in D? The latter, which is D's incremental investment in F, must be equal in value to the exported machine tools and to the imports from F. It must also be equal to the value of any alternative investment (of equal risk) which might be made in D.

But suppose that the D investors in F choose never to repatriate any of the earnings on their investments in F; hasn't D then permanently lost an amount equal to the present value of the income stream which the exported machine tools would have produced if they had, instead, been used in D?

In fact, D suffers no loss from failure by its nationals to repatriate earnings on their investment in F. Since the foreign investment, by definition, equals the excess of D's exports over its imports, the initial real income produced in D in the production of the new machine tools is the same irrespective of where the tools are sold, in D or to F. They will be sold to F, clearly, only if the price there is at least equal to their price in D, and the optimum allocations of the sales between D and F, obviously, will be such that the price per machine tool is the same in both D and F. Then irrespective of the form of the payment for the exported machine tools, its present worth to D must equal the price of the machine tools sold in D which in turn must be equal to the present value of the product or income generated by the machine tools in D. Then D must be indifferent whether an additional machine tool is sold domestically or to F and equally indifferent as to the form of payment—that is, imports from F or claims on F's future income—for the machine tool sale. Moreover, D must also be indifferent as to the time pattern of the claims on F's future income or whether F satisfies those claims as they arise by exports to D or by making deposits to D's accounts in banks in D or in F, so long as the present value of the claims is equal to the price of the tools.

If D insists on repatriation, on the mistaken belief that its claims on F's future income are valuable only if the earnings are repatriated, then it must somehow or other prohibit any trade surplus, hence any foreign investment. D cannot have a trade surplus and a full repatriation policy at the same time. All repatriations of earnings on D investment in F require equal trade deficits by D as the repatriations occur. Since by assumption the present value of those claims to F's future trade surpluses—equals D's trade deficits—as it repatriates earnings to D must also be equal to D's initial surplus. Insisting on repatriation is equivalent to insisting on a zero trade balance. But if D's initial trade surplus is deemed to have increased D's domestic product, then by the same token D's subsequent trade deficits must reduce D's domestic product. On the other hand, if D's initial trade surplus involved no change in D's total domestic production but merely a change in its composition—that is, more export goods and less, say, domestically sold consumptions goods—then neither need the subsequent trade deficits, arising as repatriation occurs, affect total domestic output. Neither does failure to repatriate involve any such reduction, but merely differences in the composition of a given volume of output.

Apart from the direct displacement effects, just discussed, indirect displacement effects of foreign investment allegedly result from the resulting transfer abroad of U.S. technological advantages. This view implies that U.S. companies do, indeed, have advantages over those of other nations—that they exercise some monopoly control over the production inputs or processes involved in technolgical advance and innovation. Were this the case it might be argued that restricting U.S. investment abroad would not simply change the nationality of the foreign investment but also reduce its aggregate volume. In turn, this would ostensibly reduce the rate of growth of foreign production capacity and the alleged adverse impact of that increase in foreign production on U.S. output and employment.

Apart from the fact that both theory and data show that expansion of worldwide production capacity and output enlarges the trade and productivity of all the trading partners and that restricting this expansion adversely affects them all, this argument also reduces to the untenable proposition that trade iself is injurious to the U.S. economy. For unless the technological advantages to which this argument refers are exclusively in tangible form, for example, specialized managerial abilities or technical skills, or unless exports are carefully restricted, the alleged superior technology is conveyed abroad by the very act of exportation. Every 747 aircraft added to a foreign airline, every numerically controlled machine tool sold to a foreign manufacturer, every advanced-generation computer licensed or leased for use abroad conveys the technological competence which, presumably, is exported by the foreign investment of U.S. multinational companies. The use by foreign producers of technically advanced U.S. exports surely must be just as disadvantageous to U.S. production and employment as the use of the real capital in the same foreign jurisdiction by subsidiaries or branches of U.S. companies. In logic, if the foreign investment by U.S. companies is to be restricted on these grounds, then U.S. exports should be restricted to technologically antique commodities.

Suppose the technological advantage is deemed to be found in the superior executive, management, and technical skills of U.S. company personnel assigned to foreign subsidiaries. Might it then not be argued that restricting the foreign investment which requires these foreign assignments would result in retaining these technological advantages within the United States?

The answer is much the same as that already provided. It must be assumed that the use of these personnel abroad is more productive than in the United States. As a consequence, the United States must be advantaged; the present value of its total income claims are greater than if these skills were confined to the United States. Moreover, if this view cannot be accepted, a necessary implication is that the United States must shut off yet another kind of export—that of training and education by barring foreign students from its universities and technical institutes.

As the preceding analysis shows, the arguments that foreign investment by U.S. companies reduces U.S. employment, output, and income basically are objections to the U.S.'s engaging in international trade, rather than objections either to tax provisions which would neutrally treat foreign income or to the foreign investment generating that income.

Consider, for example, the first of these arguments, that foreign investment shifts production from the United States to some other jurisdiction. To be sure, insofar as trade surpluses are matched by real investment abroad, rather than merely by the accumulation of financial claims, some additional production activity in the foreign jurisdiction is likely to occur. The question, however, is why this real investment is made. Clearly, the reason must be that such investment is more profitable than equal domestic investment. Whether this greater profitability is attributable to lower input costs, more efficient technology, a more genial tax environment, or some other factors is simply not relevant. For unless this greater profitability is available only to the U.S. company or equivalently U.S. companies enjoy some advantage over companies of other nationalities in investing abroad, tax or other restrictions on foreign investment by U.S. companies will not reduce the amount of such investment but merely change the nationality of the investing companies. Irrespective of the nationality of the foreign investing company, the impact on U.S. domestic production and employment is the same.

The type of foreign investment situation which appears particularly offensive to some tax reform proponents is that in which a U.S. company organizes a foreign subsidiary, either investing the retained earnings of other foreign subsidiaries or raising the required capital by foreign issues in foreign currencies, and relying on foreign production inputs, raw materials, and so forth. Insofar as these foreign operations produce products which are also produced in the United States, it appears that they necessarily involve a reduction in domestic U.S. production, without even the offsetting gain—at least partial—of requiring an increase in U.S. exports to finance the initial investment in real terms.

This is, however, the very type of foreign investment for which no reasonable case can be made to expose the income it generates to U.S. tax. The foreign subsidiary in this case is a U.S. entity in name only. By hypothesis, no U.S. real resources were required for its organization or its operations; the investment, in this sense, is costless to the United States, whatever the cost it imposes on the economy of the foreign jurisdiction. The effects of this subsidiary's operations on U.S. output and employment can differ in no material respect from those which would be generated by any other company of any other nationality undertaking the identical investment and production. Applying U.S. taxes to this company's income in order to inhibit the investment, therefore, is merely restricting competition for the real foreign resources required for the investment and production activity, to the obvious benefit of foreign firms free of similar tax burdens.

It is the opportunity for more profitable production in the foreign jurisdiction than in the United States, not the real foreign investment by U.S. companies, which may affect U.S. output and employment. But these differences in production advantages among countries are the fundamental basis for international trade. The United States cannot be sheltered from the output and employment effects of changes in these comparative advantages by inhibiting foreign investment by U.S. business but only by withdrawing from international trade.

3. Would the proposed tax reforms increase U.S. employment, output, and income by repatriating U.S. foreign investment?

To address this question, it is useful to begin by examining the effects of the existing tax treatment—notably the allowance of a credit against U.S. tax liability on foreign-source income for the taxes paid to the foreign jurisdictions. For this purpose, let us return once again to our two-country world, this time assuming that D imposes the same capital income tax on its nationals' foreign-source income as it imposes on capital income earned at home. Suppose that D allows a foreign tax credit against its tax. If F imposes no tax, then D's tax will apply fully to the income on its nationals' investment in F. Obviously, the amount of such investment will decrease. If initially D's investment in F represented a substantial fraction of the total investment in F, then the decrease in such investment will tend to raise the pretax returns on capital in F. In response, F's nationals will increase their saving and investment in F, partially substituting for the decreasing investment by D's nationals. Total investment in F, however, will decline in the general case. In effect, D's imposing its tax on the foreign-source income of its nationals leads to displacement of its nationals' foreign investment by the investment of others. If these adjustments result in a higher equilibrium rate of return in F, as they are likely to do, investment in D will be lower than if D had not imposed its tax on the foreign source income of its nationals.

If F were to impose the same tax as D on capital income earned in its jurisdiction, D's nationals would continue to invest the same amount as before F levied its tax, provided D allows a foreign tax credit for F's taxes on the income from such investment. In this case, investment by F's nationals will also decrease, just as investment in D declined in response to D's imposing its tax. The result will be a reduction in total investment in F.

Contrary to the assertion of the tax reform proponents, the present-law treatment of foreign-source income does not expand foreign investment by U.S. companies at the cost of domestic investment. The culprit responsible for the loss of domestic investment in the United States is the excessive taxation of saving, hence capital formation, compared to consumption uses of income. The application of one of the sources of this excessive tax—the corporation income tax—to foreign-source income, even where foreign taxes may be credited against U.S. tax—in no way reduces this U.S. tax bias against saving and domestic investment. It serves, rather, merely to restrict the bias against foreign investment to about the same degree as that imposed on domestic investment.

Suppose that D permits its nationals only to deduct taxes paid to F on their incomes in F, instead of allowing a credit for such taxes. Would this tax change increase investment in D?

If F has no tax, D's nationals will invest in F only if the return there is equal to the pretax return in D. This means that if the investment is to be made in F, the return on investment in F must increase from 10 percent to 20 percent. But the return on investment in F will double only if total capital in F declines enough relative to other production inputs in F to double the marginal product of capital. More realistically, as D's nationals reduce their investment, F's nationals will increase their investment in F, partially replacing D's investment. Total investment in F will probably decline, however. To the extent that any such decline in F's stock of capital relative to its other inputs occurs, F suffers the consequences of a reduction in production potential, just as if it, too, had imposed a capital income tax.

If F does in fact impose the same tax as D, then D's nationals will further reduce their investment in F, if F's taxes may only be deducted against income instead of being credited against D's tax liability. In our example, the pretax return on D's nationals' investments in F would have to quadruple if the after tax return in F is to equal that in D. Obviously, far fewer investments in F will prove attractive to D's nationals under these conditions. The effect on total investment in F will depend on how large a proportion of the investment was made by D's nationals; the larger the proportion, the greater the reduction in total investment.

In either case D's extending its tax to its nationals' income on investments in F reduces total investment in F.

In other words by imposing its tax on returns to foreign investment by its nationals, D exports its tax and its adverse effects on production capacity and output to F. In what reasonable sense can neutrality mean that if D chooses to be poorer, F must also be impoverished?

The consequences of D's taxing the foreign-source income of its nationals is to accentuate the sacrifice of production potential and the attendant reduction in labor's productivity, real wage rates, and employment opportunities resulting from its tax on domestic capital income. As a corollary, taxing the foreign source income further distorts the allocation of production resources in D. Output will not only shift away from adding to production capacity, it will also shift from exports to private and public consumption production.

At best, therefore, D's imposition of a tax on returns on investment in F will change the composition of domestic real output from export to private or public consumption goods production. And the total amount of this production, irrespective of the shift in its composition, will be less than it would have been if D had not imposed the capital income tax in the first place. Moreover, both D and F must lose by D's taxing returns on investment in F. F loses the gain in its production capacity and domestic product which would have resulted from the higher level of investment by D in F. And even if D can uninterruptedly maintain a constant rate of domestic resource utilization, its production inputs will be less productively employed by virtue of the curtailment in trade resulting from D's taxing returns on investment in F.

The argument for D's taxing the foreign source income, in logic, calls for restricting its exports. The argument is that lacking these tax provisions, D's nationals may use real resources to finance investment in F where the real marginal return is less than that in D. For example, suppose that without these tax provisions D's nationals would invest $100,000 in a subsidiary in F. Suppose this investment would yield $10,000 per year in F, when F imposes no tax, but $20,000 per year pretax in D. According to the tax reform argument, the correct tax provisions should inhibit the investment in F unless it, too, yields $20,000 per year. In real terms, financing this investment requires an equal $100,000 increase in exports over imports. Suppose these additional exports are capital goods. On this criterion, why should D allow the export to F of $100,000 of its capital, irrespective of whether the export finances, in real terms, the investment in F? After all, if the capital is used in D, it will produce $20,000 per year pretax, while in F it produces only $10,000. Then the export of $100,000 of capital involves D's foregoing a pretax income stream the present value of which is $200,000 in exchange for either imports or claims on F's future income with a present value of only $100,000. To be consistent, then, with the reasoning upon which it decided to tax the foreign-source income, D should embargo all sales of the capital to F at any price less than $200,000. Alternatively, D should impose an excise tax of $100,000 on the export of the capital.

The same line of reasoning that calls for taxing foreign source income, in other words, also calls for control of exports irrespective of their form, to insure that the present value of the payments made for them at least equals the present value of the pretax returns on domestic investment in an amount equal to the exports.

CONCLUSION

This discussion has been cast, deliberately, in abstract and hypothetical terms. The reason for doing so is to try to expose the fundamental analytical issues involved in determining the best tax treatment of foreign-source income. I hope that this purpose has been served.

This by no means is intended to deprecate the importance of actual business evidence as it pertains to these issues. Such evidence has been abundantly supplied. It shows that foreign investment by U.S. subsidiaries does not displace the parent companies' investment at home; indeed, U.S. companies whose foreign subsidiaries are most rapidly expanding the scale of their operations are for the most part, investing domestically at rates exceeding those of purely domestic companies in the same industries. It shows, further, a direct, positive connection between the foreign investment in these subsidiaries and the expansion of parent company exports. It shows a return flow to the United States of earnings on foreign investments which exceeds each year the additions to the stock of capital in the foreign subsidiaries and which, on the average, is over half of the net earnings of the subsidiaries. At the more aggregative level, changes in net foreign investment show no correlation with changes in the unemployment rate. Nor is the strong growth of such investment in the last decade or so associated with any change in the labor share of national income originating in business or with the growth in the dollar amount of that share.

The data and factual evidence from business, I believe, strongly confirm the arguments I have advanced against the alleged deleterious effects of the existing tax provisions and against the proposed tax reforms. I should like to think that evidence will be more persuasive if presented in a framework of analysis similar to that in my discussion.

Even more, I hope that my discussion, together with the evidence from business experience, will prove useful in stemming the current thrust toward neomercantilism. One would have thought that the benefits of trade would become increasingly evident as the economies of the world become increasingly open. By the same token, one would have thought that the benefits of international capital flows, unimpeded by nationalistically-inspired tax obstacles, would be obvious. As this discussion has been at pains to show, however, the thrust of the tax reform proposals is to erect new barriers to the efficient allocation of capital, to the disadvantage of everyone.

Adopting the proposed tax reforms will not expand U.S. domestic investment. It will not increase U.S. employment and output. It will not increase U.S. national income. Indeed, by impairing our trade and distorting the allocation of capital, as it must, it will reduce the efficiency and productivity growth of the U.S. economy.

Statement by H. Lawrence Fox on Behalf of the Sun Oil Co.

The following comments are submitted on behalf of the Sun Oil Co. for consideration by the Committee on Finance in response to the Committee on Finance press release dated February 5, 1976, announcing hearings on tax revisions.

Section 601 of the Tax Reduction Act of 1975 added section 907 to the Internal Revenue Code of 1954. In general, this section applies a strict limitation on the use of foreign tax credits from foreign oil extraction income and foreign oil-related income. Section 907(f) provides rules for the recapture of foreign oil-related losses. When enacted, Congress believed that by providing an effective date of January 1, 1976, the statute would operate prospectively. However, in some cases, it effectively operates retroactively because of the unintended requirement of section 907(f) that a taxpayer which relied upon existing law must recapture, to its detriment, losses incurred pursuant to binding contractual obligations entered into with foreign governments or their national oil companies well before the Tax Reduction Act of 1975.

This inequity should be alleviated by providing a transition rule for losses incurred before January 1, 1979, provided they are pursuant to binding contracts entered into before July 1, 1974. Such a rule would be consistent with Congress' general policy of insuring prospective application of new tax laws. In a similar situation, the conference committee recognized the fairness of this type of binding contract transition rule—section 604(b)(2) of the Tax Reduction Act (relating to the investment credit on drilling rigs used outside the northern part of North America).

On behalf of the Sun Oil Co. we urge the Committee on Finance to adopt an amendment alleviating this unintended hardship. Such an amendment would be consistent with the historic congressional policy of providing equitable transition rules in the case of changes in the tax law.

Statement of Dana Corp.

The tax reform bill (H.R. 10612) currently before the Senate Finance Committee would, over a 4-year period, repeal the longstanding provisions of the Internal Revenue Code relating to Western Hemisphere Trade Corporations (WHTC's). This action will have an adverse effect on the competitive position of U.S. business in relation to its foreign competitors in Western Hemisphere countries and would be in the interests of the United States.

Dana Corp.'s experience shows that the WHTC provisions continue to serve the interests of the U.S. economy by promoting domestic employment and exports, as well as a favorable trade balance—advantages which far outweigh the relatively small tax cost of the WHTC rules. The WHTC statute has worked well over its more than 30 years of existence and we urge the committee to retain it, perhaps modified to assure, that the benefits accrue only to those firms utilizing WHTC's to support their exports from the United States to Western Hemisphere countries.

DANA'S WESTERN HEMISPHERE OPERATIONS

Dana Corp. is engaged in the manufacture and sale of automotive and truck parts. For the fiscal year ending in 1975. Dana's domestic production totaled about $1.5 billion, of which approximately 12 percent went to export sales. Dana's sales have a positive overall effect on the U.S. balance of trade of approximately $85 million.

Eighty percent of Dana's export sales are to Western Hemisphere countries and this major segment of Dana's export business has grown significantly and continues to grow. Nearly 2,100 U.S. jobs are involved in producing the $124 million in projected Western Hemisphere sales for fiscal 1976. Nearly 1,100 of these jobs are in plants in Indiana; 370 in Michigan; 240 in Ohio; 200 in Wisconsin and 150 in Pennsylvania.

WHTC AS AN EXPORT INCENTIVE

In general, a WHTC is a domestic corporation which conducts essentially all of its business in Central or South America and Canada and which derives substantially all of its income from sources outside the United States in the course of its conduct of an active trade or business. Under current law, a WHTC is allowed a deduction which reduces its applicable corporate income tax rate by up to 14 percentage points.

The WHTC provisions were originally enacted in 1942 for the purpose of insuring that U.S. corporations did not operate at a disadvantage in competing with foreign corporations in the Western Hemisphere (S. Rept. No. 77-1631, 77th Cong., 2d Sess. 34). At that time, there was a strong desire to encourage U.S. businesses to conduct their foreign operations directly through U.S. companies rather than through foreign subsidiaries of U.S. companies.

During the past 10 to 15 years the WHTC provisions have functioned primarily as an export incentive. This function has long been recognized by the Congress, the Treasury Department, and the U.S. business community.

In large measure, the WHTC was the forerunner of the DISC. The availability of DISC, however, does not mean that WHTC is no longer needed.

One reason advanced in support of repealing WHTC is that, to the extent export incentives are needed DISC is more appropriate. It seems, though, that whether one incentive is more appropriate than another is not susceptible to such generalizations but depends on the circumstances of the particular business. In Dana's case, we have relied on our WHTC for more than two decades in stimulating and developing our large volume of exports to Western Hemisphere countries. The WHTC rules have enabled Dana to meet effectively the challenge of foreign competition in Western Hemisphere markets and Dana's share of these markets has increased accordingly.

Both WHTC and DISC are beneficial to the U.S. economy and both are needed. The fact that DISC may be an alternative to WHTC in certain cases does not justify repeal of WHTC since there are companies, such as Dana, for which WHTC is more beneficial.

Another important reason for retaining WHTC is that the WHTC rules were in existence prior to the General Agreement on Tariffs and Trade. Consequently, unlike DISC, members of the European Community may not properly raise any objection to their existence. It would seem unwise for the Congress to drop the WHTC rules in view of the fact that other countries have not abandoned the export incentives they provide to their corporate nationals. Depending on the results of the upcoming GATT negotiations, removal of WHTC from the code might produce consequences even more serious than would otherwise occur for the international competitive position of U.S. companies.

RESPONSES TO OTHER REASONS ADVANCED FOR WHTC REPEAL

Several other reasons have been advanced in support of the repeal of WHTC. These reasons are either insubstantial or could be remedied by modifications to current law such as we suggest below.

One of the reasons given is that the increase in taxes imposed by Western Hemisphere countries has had the effect of limiting or nullifying the benefit of WHTC and thus the WHTC deduction merely adds to the complexity of the tax return without providing corresponding benefits. This contention simply does not fit with the facts. Dana Corp., like other companies, has continued to use WHTC only because it has proven beneficial; it is clear that whatever complexities may exist under these rules have not discouraged companies from claiming the WHTC deduction.

The report of the Ways and Means Committee states that the IRS' broad interpretation of the WHTC rules allows taxpayers to obtain the benefits of the WHTC deduction for goods made outside the United States and that such treatment is inappropriate (H. Rept. No. 94–658, p. 260).

As noted previously, goods which Dana sells through its WHTC are made in the United States and, as such, Dana has not claimed the WHTC deduction for income to which the rules arguably were not intended to apply. Rather than repeal WHTC, it would seem more appropriate and fair to modify current law to limit the WHTC deduction to income derived from the export sale of goods made in the United States.

Such a modification might take the form of a definition of qualifying "export property" for the purposes of the WHTC rules which would include only goods manufactured in the United States with respect to which no more than 20 percent of the fair market value is attributable to articles imported from outside the United States. The current DISC provisions contain a somewhat less stringent content rule (§ 993(c)(1)) and the adoption of a similar concept for WHTC's would not only deal with the situation cited in the Ways and Means Committee report but also might further reduce the already minimal revenue loss attributable to WHTC.

SUMMARY

The experience of Dana Corp. illustrates the fact that the WHTC provisions have been a definite stimulus to exports to the Western Hemisphere with consequent stimulus to U.S. employment, balance of trade, and balance of payments. We estimate that 2,100 U.S. employees at Dana work on exports which are encouraged by these tax provisions.

The benefits of the WHTC rules have enabled Dana to effectively compete in the Western Hemisphere with foreign manufacturers and our share of this market has steadily increased. Repeal of WHTC would adversely affect Dana's competitive position.

WHTC is a highly effective export incentive whose benefits far exceed its cost. The committee should retain the longstanding WHTC rules of the code, perhaps with an amendment which insures that this incentive is limited to exported products manufactured in the United States.

Statement of the Association of American Chambers of Commerce in Latin America, by Gordon J. Cloney II, Executive Secretary

One of the less widely understood tax provisions under congressional review is section 911—the foreign source earned income exclusion—the provision which excluded from Federal taxation the first $20,000 to $25,000 of income earned abroad by U.S. citizens who have been foreign residents for 18 months to 36 months respectively. As executive secretary of AACLA, I want to share with you, on behalf of the U.S. businessmen resident in Latin America, viewpoints supporting retention of section 911.

BACKGROUND—BENEFICIARIES

In Latin America, section 911 benefits over 15,000 U.S. businessmen. Of these, perhaps 80 percent are employed by U.S. firms or their subsidiaries. The balance are employed by local companies. A smaller number of private sector individuals also benefiting from the 911 exclusion are employed by nonprofit organizations principally as educators and religious personnel.

Within the U.S. business community in Latin America, the overwhelming majority are persons who earn middle and upper middle incomes as upper- and middle-level managers, specialized technicians, engineers and salesmen. We feel it important, although perhaps unnecessary, given the section's $20,000 to $25,000 ceiling on income excluded, to stress that the great majority of the beneficiaries of section 911 are not wealthy individuals. Rather, they are professionals living abroad upon commensurate levels of income.

The repeal or curtailment of section 911 would increase the tax burden borne by these people—a situation which would (1) jeopardize U.S. national economic interest in Latin America and (2) provide less than equitable tax treatment to these U.S. citizens.

U.S. ECONOMIC INTEREST

The increased individual tax burden created through the abolition of section 911 would decrease expendable income in direct proportion to the amount of tax increase. This would have a negative impact upon U.S. economic interests in Latin America with some individual variation depending upon whether the individual is (1) employed by a U.S. subsidiary or (2) employed by a local company.

In the case of individuals employed by U.S. companies, the firm would face two alternatives. The company would either stand to lose professional personnel who may choose to return home in light of decreased expendable income, or it would have to increase their salary proportionately, in effect absorbing the additional tax cost to insure that the individual employee does not suffer a loss of expendable income as a result of the increased taxation.

Both situations described would affect the U.S. company's ability to compete in Latin markets. If U.S. citizen employees return home, a company would lose professional personnel who are essential to the sale and servicing of technologically complex U.S. products and whose skills are not otherwise available in a given Latin country. Competitive efficiency would decrease accordingly.

In the event the company chooses to absorb the additional tax cost and so keep its U.S. personnel in the field, the company would, in turn, be forced to pass this increased personnel cost on in the form of higher prices for products and services. What may appear to be a relatively small increase in total product cost caused by the increased personnel cost resulting from the abolition of section 911 could cripple the ability of U.S. firms to compete.

Higher product prices will mean (1) fewer sales of traditional U.S. products and (2) reduced ability to compete in the intensively competitive process of bidding for contracts to design and build growing numbers of industrial complexes in Latin America—projects in industrial fields such as petrochemicals and steel which require large numbers of specialized personnel and generate large markets for imported machinery. We stress that such weakening of the competitive position of U.S. products in Latin America will cost this country present- and long-term product sales. Damage will be caused to U.S. economic interest by: (1) reducing the U.S. share of U.S. exports which enter existing Latin markets; (2) seriously damaging our ability to enter the emerging market for the major industrial projects which are in the advanced planning stage in much of Latin America; and (3) reducing the number of jobs here at home which are generated by manufacture of export products.

We would further stress that the employment loss to be caused by loss of U.S. exports to the Latin American market is unlike situations in the U.S. domestic market where business lost by one U.S. company can be expected in most cases to be obtained by a competitor U.S. firm with the jobs involved being, in a statistical sense, simply transferred from one U.S. company to another. In stark contrast, export opportunities which the U.S. firms lose in Latin America will be gained by companies from competitor nations. The jobs necessary to produce these export products will in turn go to workers in these nations and not to U.S. labor. Such competitor countries, which, incidentally, do not tax the income of their citizens resident abroad, include: Japan, Canada, Germany, the United Kingdom, France, Italy, the Netherlands, Belgium, Denmark, Sweden, Norway, Finland, Spain, Portugal, Switzerland, Australia, and South Africa.

Special mention should be made about the impact of section 911 abolition on the minority of U.S. businessmen in Latin America who are employed by local companies. These individuals compete with other foreign professionals for job opportunities in the country of residence. As other industrialized nations do not tax the income of their citizens residing abroad, the U.S. professional, if his income is fully taxed, would require a higher salary than his competitors from Europe, Canada, and industrial Asia to maintain current purchasing power. As Americans become more expensive, they would, to some degree, be less widely employed, being replaced by less expensive professionals from other industrial countries. To the extent this takes place, it would mean that the orientation of local companies toward U.S. products and machinery would be proportionately reduced. This would contribute to loss of present and future export markets and the loss of jobs in the United States.

TAX JUSTICE

U.S. citizens who reside and work abroad are by definition a group set apart from U.S. citizens resident in the United States. Living outside the United States is a special physicial circumstance which requires the appropriate tax treatment now provided by section 911.

It is apparent that U.S. citizens abroad cannot receive the great majority of Federal services enjoyed by the U.S. taxpayer at home. We feel it to be a reasonable premise that Federal taxation implies receipt of roughly equitable Federal services by taxpayers of equivalent income levels. As the nonresident U.S. citizen cannot possibly receive the level of direct and indirect Federal services delivered by the Federal Government to his U.S.-resident counterpart, it seems only reasonable that a reduced tax burden, as provided by section 911, be maintained for nonresident citizens.

In this regard, we stress that section 911 is not a carelessly written tax provision. The section is the result of 50 years of legislative development. The exclusion is carefully circumscribed by (1) strict residency requirements which must be met before income can be excluded from Federal taxation, and (2) a fixed ceiling set upon the amount of income excluded. Nonresident citizens pay U.S. income tax on personal income in excess of the ceiling and in such cases have rather narrowly drawn exemption or deduction privileges.

If section 911 were abolished, to continue to provide minimal tax justice for nonresident citizens, it would be incumbent upon the Congress to make specific provisions that would recognize by tax credit or deduction from gross income, certain circumstances caused by foreign residence, circumstances which the present section now recognizes in broad fashion.

One such circumstance is that government revenue generating procedures, certainly in Latin America, are nowhere close to being carbon copies of the United States. Latin tax codes are significantly different from the United States Code with respect to how taxes are levied and to what degree. Hence, special provision would have to be made in the United States Code to allow the nonresident to credit local taxes were section 911 abolished. In addition to permitting federal tax credit for foreign direct taxes such as income taxes, sales taxes, gas taxes, et cetera, there should be provision to allow credit for indirect taxes such as customs duties, excise taxes and turn-over taxes.

Such indirect taxes constitute a heavy tax burden in Latin America—an indirect tax burden which is vastly larger relative to the average professional income than is the case for the same income in the United States.

For example, in Latin America, imported autos, appliances, furniture, et cetera, face customs duties varying from country to country but which almost without exception can fall in a range of 100 percent to 200 percent to 300 percent. The same is true for imported components of goods manufactured locally. This indirect tax burden is not limited to major consumer items but is carried within the local cost of very minor items— door hinges in Venezuela are dutied at over 200 percent ad valorem.

By way of further example, where present, local turn-over taxes, which are levied at each stage of sale from raw material to manufacturer to retailer to consumer, can produce a substantial indirect tax burden. In Mexico a turn-over tax ranging from 4 percent to 10 percent may add 20 percent to 25 percent to the over-the-counter retail price of a simple consumer item—for example, children's clothing.

Were section 911 abolished, the United States Tax Code should, in the interest of avoiding double taxation, make provision to credit such presently non-creditable foreign indirect taxes against personal income tax. Procedurally, however, we feel this would be an impossible undertaking in Latin America as (1) indirect taxes such as those noted are hidden in product price and are consequently difficult to quantify, and (2) few if any Latin countries have current tax data readily available in a form which would make it possible for the IRS to prepare current indirect tax quantification schedules. Even if the data were available, such crediting would involve the IRS in tax credit computations based upon more than 100 countries around the globe. The administrative burden upon both tax collector and nonresident taxpayer would under such circumstances be enormous and, we would suggest, probably unworkable.

Another special circumstance related to the nonresident U.S. citizen which should be given specific tax consideration if section 911 were abolished is the "incremental cost" of maintaining U.S. equivalent living standards while residing abroad. These incremental costs include:

The cost of providing U.S./equivalent primary and secondary education to dependents;

The cost of health care including private clinics, and travel outside the country of residence for treatment when local facilities are not available;

The cost of physical security which can range from employment of watchmen to protect residential property when local police services are inadequate to, in some cases, private guards to protect against physical abuse;

The cost of travel for reasonable home leave which is generally recognized as necessary not for vacation purposes—which can be taken locally—but for maintenance of dependent orientation to U.S. culture and society, and to periodically adjust families to the psychological stress almost always a result of extended foreign residence;

The cost of housing in countries where housing is more expensive than equivalent U.S. housing.

Logically, such expenses, or the corresponding allowances when provided by the employer, should, in our judgment, be specifically deductible from personal income if the general 911 exclusion were abolished. As such incremental living costs vary from country to country, it would seem that individual country incremental living cost schedules would be in order. This implies another multicountry administrative burden for both nonresident taxpayer and Federal tax collector.

IN CONCLUSION

The circumscription and the simplicity of section 911 coupled with what would seem to be almost insurmountable administrative problems if alternate tax procedures were sought to replace the section's provisions, argue forcibly in favor of the section's retention and against its abolition.

We are, in fact, not aware of specific, studied arguments which favor such abolition. Certainly, there has been no evidence offered in public testimony or congressional staff studies that suggest abuse of the section by those who now receive its exclusion provision.

In conclusion we would also suggest that no meaningful revenue gain would result from section 911's abolition and whatever revenue gain might occur would be offset to some degree by loss of tax revenues otherwise earned from taxation at all stages of the export manufacturing process—tax revenues which could be lost as a result of the reduced U.S. exports to Latin America which we submit could be one consequence of the section's abolition.

We, therefore, would once more commend to your attention the basic merit of section 911 and urge its retention.

Statement of the Electronic Industries Association

TAXATION OF FOREIGN-SOURCE INCOME

We welcome this opportunity to present the views of the American electronic industries on the taxation of foreign-source income. These industries have an annual production volume of $35 billion. They employ 1.3 million Americans directly, and at least that number again indirectly. Of that $35 billion, over $5 billion is exported. This means that over 200,000 direct jobs in our industries alone are attributable solely to exports.

Much is said about the magnitude of electronic imports. Just to set the record straight: In 1974, $4.6 billion worth of electronic was imported. But, $5.2 billion was exported. Our country's balance of electronics trade was $600 million on the plus side * * * and continues to be favorable. You should know that we are proud to be so successfully involved in world trade.

With this record, we must ask what is so bad about competing abroad and getting business? We must be allowed to operate in the real world as it exists. Foreign corporations are here, vying for a share of the American market through imports and the ownership of American facilities. We are out there, vying with them for a share of the world market. The competition in electronics is intense. That is the reality.

Competition is in the consumer's best interest. Merchandise for consumer markets is always price-sensitive. Radio and TV are mass markets, here and overseas, and the technology is no longer new. Foreign competitors have had it, even in TV, for at least 25 years.

If valid and tested provisions on taxing foreign-source income are repealed * * * we can expect serious effects on our ability to stay competitive.

I. REPATRIATION OF FOREIGN EARNINGS

If the law were changed so as to tax foreign earnings currently, instead of deferring taxation until those earnings are repatriated, a study of the U.S. economy as a whole—not just the electronic sector—shows a relentless decline of investment, of employment, and of production here in the United States of America over the 5 ensuing years.

The cited study utilized the DRI long-term model of the U.S. economy. DRI is Data Resources Inc. Government often uses this, Otto Eckstein's model, to measure economic impact. Its figures were derived from a broad range of American industries; 313 different companies in all sorts of product lines contributed the data used. Entitled, "Tax Impact Project Report," this study is important because it quantifies what would happen if certain changes were made in our existing tax law.

The results of a quite separate study were contained in the March 29, statement of Prof. Robert Stobaugh, Harvard Business School, to your committee. Since the American electronic industries are now emphasizing the need to remain competitive in order to maintain employment in the United States of America, we cite these of Prof. Stobaugh's conclusions:

> If the United States were to place a tax on unremitted earnings, then U.S.-owned foreign corporations (i.e., subsidiaries) operating in countries with lower

tax rates than the United States would be placed at a competitive disadvantage vis-a-vis their foreign competitors, which would continue to pay only local taxes on their retained earnings.

The foreign competitors of U.S. companies operating abroad are primarily multinational firms headquartered in Europe, Japan, and Canada. These foreign multinationals on the average are both larger and growing more rapidly than their U.S. counterparts.

For instance, in 1971 American companies ranked first in worldwide sales in seven of the nine industries that account for over 90 percent of U.S. foreign direct investment in manufacturing, but by 1973 they ranked largest in only four of the same nine industries.

Other countries do not tax the current earnings of foreign affiliates of their corporations. If the United States were to eliminate the so-called deferral, none of them would follow suit; they would gratefully accept the United States of America's action as a windfall widening of their competitive advantage.

The advocates of forced repatriation have the narrow objective of increasing the revenue of the U.S. Treasury. They would override our traditional system of taxing shareholders, whether individuals or corporations, on the earnings of their investments only when those earnings are distributed as dividends.

Furthermore, they overlook the ramifications. Most countries levy a withholding tax—averaging about 25 to 30 percent—on profits or dividends being transferred out of their country. If the United States of America were unilaterally to force more such transfers, the other countries would retaliate by raising their withholding taxes. As a consequence, many American parent companies would elect to avoid crippling withholding taxes by leaving foreign earnings overseas, for reinvestment or local debt retirement; they would simply draw on American capital to pay the U.S. taxes.

This sort of capital levy would be an indirect result of any modification, let alone repeal, of tax deferral. Certain countries would raise their withholding taxes; others would lower a limitation they have on the repatriation of dividends—presently on the order of 15 percent; still others have blocked currencies and would simply disallow dollar transfers. Under any of those, externally imposed, circumstances, U.S. parent corporations might find themselves obliged to use U.S. capital to pay U.S. taxes—instead of actually repatriating earnings.

Is that desirable? No, it is not. Later in this statement, we will raise the already critical problem of capital formation.

II. DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

Many electronic companies have DISC's. They are valuable. We urge you to keep the DISC law just as it is, because it is accomplishing the purposes for which it was put into the tax structure: It does encourage exportation; it does help afford the development of products that can be exported; it does go far toward offsetting the export incentives provided by other governments; it does help U.S. exports overcome the barriers protecting many foreign markets. Consequently, it does support employment here in the United States.

Let us also assure you that a lot of electronic companies are just starting to export, and are just discovering DISC. Although it has only been in effect for a few years, DISC has become a reason why a number of our companies are taking the expensive risk of expanding into the world market.

It takes capital to build exports. Electronic companies are making use of DISC-generated funds:

1. To develop products for the export market—products for which there is no domestic market.
2. To expand into new marketplaces where the sales potential would not otherwise be sufficient to warrant penetration.
3. To cover accounts receivable from overseas customers. Exports cannot be expanded on the erstwhile cash-in-advance basis.
4. To permit the offering of credit terms-of-sale to the extent that Eximbank does not cover.

The electronic industries are represented on four of the industry sector advisory committees—ISAC's—consulting with the President's special trade representative—STR. At Geneva, the GATT organization has formed a special working group on DISC. It has done so largely because our major trading partners have come to recognize that DISC is effective; obviously, the nations of our leading competitors would like DISC to go away. Of course, they would much prefer it if the U.S. Congress would repeal DISC; however, failing that, they rather hope that the U.S. negotiators will trade it away during the multilateral trade negotiations or, alternatively, will subscribe to an International Code of Conduct on subsidies which would somehow eradicate DISC.

Meanwhile, nevertheless, many nations in the GATT working group persist with their own practice of levying border taxes on imports—in addition to customs duties—on the grounds that imported merchandise was not subjected to their internal value-added tax system. The GATT organization has not ruled out border taxes.

DISC was originally conceived as a means whereby American exporters could offset these border taxes and, hence, compete pricewise in nations having different internal revenue systems than ours.

We applaud the recent testimony of Treasury Secretary William Simon wherein he informed your committee that DISC will help expand U.S. exports by about $9 billion in 1976, that such expansion means about 300,000 new jobs in the United States this year, and that these figures "* * * provide persuasive arguments not only for the continuation of DISC, but also for making no changes in DISC at this time."

III. FOREIGN TAX CREDIT

If "Foreign Tax Credit" were repealed, the aggregate effect on the U.S. economy would be negative. Real GNP would within 5 years drop off by an amount five times greater than any increase in tax revenues—over what would have been collected under present tax law. U.S. employment would suffer accordingly—a possible loss of more than 1 million jobs.

It is ironical that the United States has, for decades, been trying to convince other nations that the foreign tax credit system is the best way to avoid the unfairness of double taxation. Now, having convinced a number of others, the United States is contemplating changing its treatment of taxes paid to foreign countries by U.S.-owned companies abroad. Such unilateral change would certainly erode the ban on double taxation now widely observed among nations.

Without foreign tax credit, the profits earned by the foreign operations of U.S. firms would, simply because of the additive effect of double taxation, quickly disappear.

To convert the foreign tax credit into a business deduction for purposes of calculating U.S. tax would be counterproductive. Prompt advantage would be taken of an American retreat; foreign markets would be left to competitive companies from other nations. U.S. jobs would be lost. Our economy would be poorer.

IV. EXCLUSION FOR AMERICANS ABROAD

Our electronic companies have had lots of experience with putting Americans on foreign station for long periods of time.

Take, for example, electronic products having very high technological content, being immensely complex and expensive—like air traffic control systems, ground stations for satellite communications, and navigation systems. When a foreign government buys that sort of thing, it also buys the American company's technicians to see that the equipment is installed properly and, then, maintained for several years. It takes all of 2 to 3 years to train local technicians to take over.

Similar provisions appear in contracts of sale to the U.S. Government when oversea installations are involved.

The Office of International Operations of the U.S. Internal Revenue Service has advised that about 278,000 U.S. nationals—not including the military—filed returns on income of U.S. source earned while residing and/or working abroad. After deducting for retirees, expatriates, et cetera, we estimate that there are roughly 70,000 civilians in the engineer/technician category whose jobs could be in particular jeopardy if the "exclusion" in the present tax structure were to be withdrawn.

Mark you, skilled technicians must be induced to go. To pay income tax to the foreign country and tax on the same income to the United States—is hardly an inducement to them. So, American companies would wind up paying higher wages to Americans going overseas—to offset their double taxation.

Please do not accept such consequence as a matter of course. What would be the ramifications of it?

First, American companies would inevitably begin to lose contracts of great value because of noncompetitive quotations—the impact of which would be far greater than any gain in tax revenue to the U.S. Treasury. Second, such higher wages might merely increase the tax take of the foreign countries where those technicians are working. Third, those higher wages would soon become a significant premium attached to the use, outside of America, of Americans; a global switch to the use of European and Japanese technicians would relentlessly occur.

Seen in this realistic light, do understand that the existing exclusion for Americans working abroad, the so-called 911 provision, sponsors jobs for Americans. Is there a single more important accomplishment expected of the 94th Congress than maintaining employment?

The existing $20,000—or $25,000—exclusion operates, in practice, as compensation for the additional costs of living abroad under short-term conditions over the cost of living at home. These costs include tuition for school-aged children, home leave, the many goods and services that are high priced abroad, and various forms of foreign taxation that are noncreditable. For many Americans working abroad, the aggregate of these costs exceeds the amount of tax benefit that can be ascribed to the exclusion.

Tuition for English-language grade and high schools open to Americans—other than U.S. Government employees—generally exceeds $2,500 per child. No real relief for this necessary cost is provided by H.R. 10612; the small benefit allowed there can be characterized as very inadequate.

Whereas reimbursement of home-leave expenses is presently tax-free to U.S. Government employees and their families, it is not for others working abroad. The exclusion helps those other Americans to obtain some relief on this score.

Many foreign countries rely heavily on indirect taxes, such as value-added tax, to raise revenues. While Americans working abroad must pay these taxes, which are as high as 25 percent of the value of goods purchased, such amounts may neither be credited against U.S. income tax nor taken—as is the case for State sales taxes—as a deduction.

Finally, living costs and inflation rates are generally higher outside the United States. For instance, a family apartment in Tokyo costs nearly $1,000 per month more than comparable housing in the United States.

It is sometimes asserted that the exclusion provides a windfall for individuals working in countries having low direct taxes, such as income tax.

However, any advantage is illusory for an American working abroad and residing in such a country. These, typically, are high-cost countries; Americans residing there generally find themselves obliged to use all their tax saving resulting from the exclusion simply to maintain a constant standard of living. Thus, eliminating the exclusion would work an unfair hardship on them.

The exclusion has been largely whittled away by previous legislation, and its $20,000—or $25,000—allowance has been eroded by inflation. We not only support retention of the exclusion but also the lifting of its dollar limits to a more equitable level.

V. TAXATION VERSUS CAPITAL FORMATION

There is an obvious temptation when reforming tax policy to zero in on corporate profits. However, profits are the most basic building block in the formation of capital for industrial expansion. Hence, the more industry's profits are diminished by taxation, the less industry can afford expanding its capacity and its work force.

So, capital formation must be regarded as yet another ramification of U.S. tax policy and is, of itself, so important that your committee is giving it separate attention. Accordingly, the Electronic Industries Association is submitting a statement on capital formation separately from this statement on the taxation of foreign-source income. Nevertheless, since profits are fundamental to capital formation, and since foreign-source income has become so significant a profit-source, we allude to capital formation here, too.

The overseas operations of U.S. companies have significantly benefited the domestic economy by earning profits abroad, that is, by providing external means of affording domestic industrial expansion.

Distinction must be made between the formation of equity capital from profits, and the situation wherein domestic expansion is financed with debt capital. Borrowing, while enabling the replacement or modernization of existing plant, is not conducive to the true expansion of plant and employment. That is because loans cost so much; interest rates often exceed the rates of return-on-investment. Equity capital, on the other hand, does have direct impact toward expanding output, jobs, and income.

Capital formation is something that concerns small business, perhaps more than big business. Distinction by size is more illusory than real. A strong economy requires health business of all sizes.

All known forecasts agree that there will be very substantial capital requirements in the coming decade—not only to maintain some growth of productivity, but also to afford mandated environmental and personal safety standards and get a start on energy self-sufficiency. We are going to have to fuel the production process with increased amounts of net new investment just to stay even in terms of living standards and employment rates.

To the degree that Federal tax policy could encourage the accumulation of profits, i.e., the formation of equity capital, it would be providing more employment for American workers. To the degree that your committee could see fit to continue the valid and tested provisions on taxing foreign-source income, you would be giving some encouragement to capital formation. On the other hand, any imposition of punitive taxation on foreign-source income would be counterproductive to our own domestic economy and, hence, should be avoided.

SUMMARY AND RECOMMENDATIONS

Allow American companies to operate in the world as it is today: Competitive.

Ponder the ripple effect on our total economy before changing the laws in today's tax structure.

Just to force the current repatriation of foreign earnings, and to deny the crediting of foreign taxes paid * * * could within 5 years cut 2 million of the U.S. jobs presently related to foreign business.

EIA strenuously opposes any forced repatriation scheme.

EIA further recommends retaining the existing DISC law, the present "Foreign Tax Credit", and the exclusion for Americans working abroad.

EIA recommends—rather than the modification or repeal of the foregoing—that reform take the direction of restructuring Federal tax policy so as to encourage capital formation.

NEW YORK STATE BAR ASSOCIATION,
April 13, 1976.

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

DEAR SENATOR LONG: Enclosed is a report prepared by a special committee of the tax section concerning the income taxation of foreign trusts. The report agrees that tax reform in this area is needed, but disapproves of the approach followed by H.R. 10612, which would tax the U.S. settlor of a foreign trust with U.S. beneficiaries under a proposed new "grantor trust" rule as if he owned the trust assets. Instead, the report recommends that such trusts be taxed in the same manner as domestic trusts. A substantial excise tax on the value of property transferred to such trusts (not just on appreciation, as now provided in IRC § 1491) is proposed unless the United States is adequately secured for the payment of future tax liabilities.

The principal draftsmen of the report were Harvey P. Dale, M. Carr Ferguson, and Leo L. Schmolka.

Sincerely,

PETER L. FABER, *Chairman.*

STATEMENT OF THE SPECIAL COMMITTEE ON INCOME TAXATION OF FOREIGN TRUSTS OF THE NEW YORK STATE BAR ASSOCIATION

INTRODUCTION

During the 94th Congress, the House Committee on Ways and Means proposed far-reaching changes in the taxation of income of foreign trusts established by U.S. grantors. H.R. 10612, the "Tax Reform Bill of 1975," which contained these reform provisions, was passed by the House of Representatives in December 1975 and is now being considered by the Senate Finance Committee.[1] The bill contains far-reaching provisions bearing on the income taxation of foreign trusts.[2] Though we support the view that current tax reform should encompass the income taxation of foreign trusts, we believe that certain aspects of the approach taken in the bill should be changed.

BACKGROUND OF PROBLEMS UNDER CURRENT LAW

Subchapter J of the Internal Revenue Code currently treats all trusts, other than those falling under the "grantor trust" rules, as separate taxable entities, essentially taxable as individuals on all their undistributed income. Trusts established, funded, and administered abroad have been treated as nonresident-alien individuals. Accordingly, such trusts have been subject to U.S. income tax, collected by withholding, at the flat rate of 30 percent—or lower treaty rate—on their fixed or determinable annual or periodical U.S. source income, and have been taxed on a net basis only on their income effectively connected with a U.S. trade or business.

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[1] H.R. 10612 is referred to in this report as either "1975 TRA" or the "bill."

[2] The term "foreign trust" is "defined" in § 7701(a)(31) as a trust, the foreign source income of which is not includible in gross income unless effectively connected with the conduct of a trade or business within the United States.

Until 1962, there was no distinction in treatment of such foreign trusts on the basis of the citizenship or residence of their grantors or beneficiaries. Thus, a foreign accumulation trust established by a U.S. grantor for the benefit of U.S. beneficiaries was treated in the same manner as an accumulation trust established by and for U.K. or Swiss domiciliaries or residents. By selection of a foreign jurisdiction with little or no local income tax, it was thus possible to avoid any current income taxation on the fiduciary's accumulated non-U.S.-source income even though both grantor and beneficiary were U.S. persons. Further, since non-U.S.-source income arguably was not gross income of the trust, it might not generate distributable net income (DNI) upon which the beneficiaries could be taxed either on current or—under the throwback rule—delayed distributions. The tax-free compounding of income accumulated in foreign trusts over many years and its potential tax-free status on distribution offered a tempting opportunity for highly taxed individuals with funds suitable for foreign investment.

In 1962 Congress moved to end the unintended preferences of foreign accumulation trusts over domestic trusts. First, all foreign trusts were required to treat as part of their DNI gross income from sources without the United States, net of disbursements allocable to such items, and income from sources within the United States that were accorded tax emeption under treaties.[3] Further, foreign trusts created by U.S. persons were required to treat capital gains as part of DNI.[4] Finally, in the case of foreign trusts created by U.S. persons, an unlimited throwback rule was adopted, denying accumulation distributions for 1962 and subsequent years the very substantial exceptions to throwback inclusion which were then available to the beneficiaries of domestic trusts.[5]

The 1962 amendments only partially discouraged establishment of foreign accumulation trusts, however. In many situations, the doomsday rule of the unlimited throwback provision was more than offset by the advantage of the tax deferral. With the extension of the unlimited throwback rule to domestic trusts by the 1969 Tax Reform Act this comparative disincentive to the use of foreign accumulation trusts disappeared completely. Indeed, presumably through oversight, the unlimited throwback rule for foreign trusts was left more beneficial to them than the corresponding rule for domestic trusts created by U.S. persons: Beneficiaries of domestic trusts were forced to include all accumulated ordinary income items for all prior years before any capital gain items were deemed distributed,[6] while distributees of accumulation distributions from foreign trusts were permitted a ratable mix of capital gains and ordinary income treatment on a year by year basis.[7] Even income from U.S. sources sometimes can be converted

[3] §§ 643(a)(6) (A) and (B). Because "gross income" only includes "effectively connected" foreign source income, § 872(a)(2), there is a technical defect in the statute which would allow an argument to be made that, notwithstanding the addition of §§ 648(a)(6) (A) and (B), foreign source income of a foreign trust is not generally includible in the trust's DNI. Compare IRC § 555(a), but see Regs. § 1.648(a)-6(b), example (1), ¶ (8).

[4] § 648(a)(6)(C). For purposes of the capital gains inclusion in DNI, the § 1202 capital gains deduction, of course, was also denied, since it would be taken into account in the taxable income of the trust or the beneficiary.

[5] See § 665(a), as it read prior to its amendment by Public Law 91-172, and § 665(e)(2). A special definition of foreign trusts created by U.S. persons is found in § 648(d).

[6] See § 665 and § 669 and regs. § 1.669(a)-1A(a).

[7] § 648(a)(6)(C), by including capital gains in DNI, makes them part of the trust's undistributed net income by which the § 665 accumulation distribution is measured.

into income which may be accumulated in these trusts tax free, for example, by placing the U.S. investment in a third country entity having access to favorable treaty provisions which eliminate such items from taxable dividends, interest, or other payments.

The tax-free compounding of reinvested income from foreign accumulation trusts provides a benefit which is not offset by ultimate application of the throwback rule when the funds are finally distributed to U.S. beneficiaries. First, even where the throwback rule does apply fully, the quantity of income ultimately available from a foreign trust will be greater than the income distributed from an identical U.S. trust which can only reinvest after payment of current U.S. fiduciary income taxes. Second, application of the throwback rule to all economic enjoyment of the trust is by no means certain. The mere existence of large amounts of potentially taxable trust accumulations invites schemes for defusing the throwback rule. For example, loans or accommodations to the grantor or members of his family—whether or not specified as beneficiaries—may be made by foreign trustees operating under less scrutiny than domestic trustees. Sales may be made of appreciated assets to the foreign trustee in exchange for a private annuity or a promise to make deferred payments. Exchanges may be made of like kind property which similarly may permit channeling of desired trust assets into the hands of U.S. persons, in return for undesired assets, which—upon transfer to the foreign trust—may be sold free of U.S. capital gains taxation.

Finally, the grantor or members of his family may retain informal but nonetheless powerful management powers through a letter of instructions or an advisory committee which controls the investment and management of the fund itself. The Treasury Information Form 3520, which must be filed by any U.S. grantor or beneficiary establishing or acquiring an interest in a foreign trust, simply does not put the Government on notice of such abuses. No U.S. fiduciary income tax return is filed by the nonresident alien trust itself, and the U.S. participant in the kinds of indirect benefits described above normally provides no clue as to the nature of the transaction on his own return.

In sum, foreign accumulation trusts not only provide insulation from current U.S. taxation but also are subject to beneficial enjoyment by the grantor or his family in ways that appear to frustrate both the grantor trust rules and the throwback rules. These tax advantages have tempted some enterprising taxpayers to attempt tax avoidance through complex transactions using one or more foreign trusts as an integral part of this structure. The Internal Revenue Service has responded with increased audit and litigation efforts. For these reasons we endorse the inclusion of foreign accumulation trust taxation as a proper subject for current tax reform.

THE 1975 TRA PROVISIONS

The 1975 proposals involve five significant changes in the taxation of foreign trusts:

(1) *Grantor trust rule: Proposed § 679.*—The U.S. settlor of a foreign trust with one or more U.S. beneficiaries would be taxed, under the "grantor trust" rules, on the trust's income as though he owned the trust assets.

(2) *Section 1491 excise tax.*—The excise tax applicable to transfers to foreign trusts would be broadened in scope, and the rate of tax would be increased.

(3) *Throwback rule: Interest charge.*—A nondeductible interest charge would be imposed on taxes due as a result of an accumulation—or throwback—distribution from a foreign trust.

(4) *Throwback rule: General changes.*—Modifications of the so-called throwback rules applicable to all trusts, both foreign and domestic, would subject capital gains of foreign trusts, but not those of domestic trusts, to the throwback rules and would also deny foreign trusts the benefit of an exception to the throwback rules proposed for domestic trusts with respect to accumulations while a beneficiary is younger than 21.

(5) *Throwback rule: Characterization.*—Accumulation distributions from all trusts, foreign and domestic, would be treated without tax characterization. Thus, in combination with the change in (4), the capital gain character of accumulation distributions from foreign trusts would be converted into ordinary income.[8] Undistributed net income at the close of the last taxable year ending on or before December 31, 1975, would be recomputed to take the section 1202 deduction into account.

Our comments on these proposals follow:

I. GRANTOR TRUST RULE: PROPOSED § 679

The feature of the income tax treatment of foreign trusts that, in the view of the Ways and Means Committee, most fosters the potential for abuse—and thus the need for reform—is the opportunity for tax-free compounding of accumulated income:

> The rules of present law permit U.S. persons to establish foreign trusts so that funds can be accumulated free of U.S. tax. Further * * * the trusts generally are administered through countries which do not tax such entities. Thus, these trusts generally pay no income tax anywhere in the world. Although the beneficiaries are taxed * * * upon any distributions * * * nevertheless the use of foreign trusts permit [sic] a grantor to provide a tax-free accumulation of income while the income remains in the trust. Your committee believes that allowing this tax-free accumulation of income is inappropriate and provides an unwarranted advantage to the use of a foreign trust over the use of a domestic trust.[9]

If the essential problem is viewed as the ability to accumulate income free of current tax, the solution clearly lies in taxing the income currently. Less clear is the selection of the appropriate party to pay the current tax. There are only three choices: the grantor, the beneficiaries, or the trust.

The 1975 TRA would add a new section 679 to the code.[10] Under that new section any U.S. person who transfers property to a foreign trust having or thereafter having any U.S. beneficiary would be treated as an owner of the trust under the "grantor trust" rules and accordingly would be taxed currently on the trust's items of worldwide gross income. We believe this alternative is the least desirable of the three choices for reasons discussed below.

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[8] As far as capital gains are concerned, this change would have no substantial effect on domestic trusts, for their accumulation distributions would not generally include capital gains.

[9] H. Rept. No. 94–658, 94th Cong., 1st sess., p. 207 (1975).

[10] 1975 TRA, sec. 1013(a), hereafter referred to simply as "sec. 679."

The alternative of beneficiary taxation, which would parallel existing patterns of current taxation to the U.S. beneficial owners of the income of foreign entities, has been fully considered and rejected by this committee. We reject this alternative for two principal reasons:

(1) Beneficiary taxation raises complex technical problems in attributing undistributed income within a class of discretionary beneficiaries or contingent future distributees.

(2) There is a widespread perception of fundamental unfairness in the possibility of imposing tax liabilities on those who may never receive trust distributions.

OUR PROPOSAL

Since we have concluded that neither grantor taxation nor beneficiary taxation is an acceptable solution to the problem, we propose the following alternative:

Income tax

1. Foreign trusts created by a U.S. person for the benefit, in whole or in part, of any U.S. person—or for a class which includes or may be expanded to include any U.S. person—would be covered by our proposal.

2. The taxable income and the tax liability of such a foreign trust would be computed in the same manner as in the case of a domestic trust.[11] The liability for the tax and the requirement of filing a return would be imposed upon the trustee. If the tax is not currently paid, it can be assessed and collected, with interest and appropriate delinquency penalties, against and from any actual distributee of trust assets, or, if within reach, assets of the trust itself.[12]

Excise tax

To increase the probability of collecting the current tax, a special excise tax would be imposed on transfers to such foreign trusts, as follows:

(a) The rate of tax—which we suggest might be 70 percent—would be imposed on the gross value—not merely appreciation in value—of all property or assets—including cash—transferred to the trust.

(b) For this purpose, transfer would include transfers as defined in section 679 unless the transferee trustee agrees to subject the trust to the taxing jurisdiction of the United States, agree to file appropriate tax returns, and secures payment of future taxes in one of the following ways: posts a bond, satisfactory to the Commissioner, to secure future income tax liability to the United States; or maintains sufficient assets in the United States to secure that liability; or otherwise secures that liability to the satisfaction of the Commissioner.

The transferee trust would receive an additional to basis—as under section 1015(d)—for the excise tax.

Returns

Each beneficiary receiving any distribution—whether claimed to be nontaxable or taxable—would be required to file appropriate tax or information returns.

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[11] However, the usual rules regarding withholding tax as source (ch. 3 of subtitle A, sec. 1441 et seq.) should continue to apply and any tax thus collected should be allowed as a credit.

[12] In the latter case the trust's liability may be enforced currently through the assertion of in rem jurisdiction. If the trustee fails to file the return and pay the tax, any beneficiary who receives a distribution from the trust will be a transferee of a tax delinquent and will then be subject to enforcement procedures.

Comparison of section 679 and our proposal

As between the grantor and the trust, we believe the trust is more appropriately subject to current taxation for the following reasons:

(*1*) *Conceptual departure.*—Doctrinally and historically the existing grantor trust rules, sections 671–678, are an aspect of section 61, the generic gross income section. Income—including appreciation—from property normally is taxed to the property's owner. If property is transferred in trust, the grantor trust rules operate on the premise that the incidence of income taxation on the transferred property should not be shifted where, by reason of a continued relationship with the transferred property, the transferor still is regarded as the owner. Historically the grantor has been treated as continuing owner of the trust property for income tax purposes only where the grantor or the grantor's spouse has a direct beneficial interest in the property or where specifically delineated powers over the beneficial interest are held by the grantor or a defined class of other persons. Sections 671–678 do not tax income to the grantor in the absence of such a continuing interest or power.

Under Section 679, the grantor would be taxed not as a result of any economic relationship to the transferred property that, as a matter of tax policy, is regarded as significant, but rather as a result of the random factor of a beneficiary's citizenship or his migrations from one country to another. This approach to reform seems to us to be a questionable and unnecessarily radical departure from established tax principles of long standing. We also think it may have unintended ramifications many of which have not yet been perceived.

(*2*) *Fairness.*—By defining taxable income of a foreign trust in the same manner as that of a domestic trust, our proposal would afford the trust a deduction for amounts currently required to be paid or paid in fact to a beneficiary and would require the beneficiary to include such amounts in gross income currently under the standard scheme of subchapter J.[13] To the extent the trust accumulates items of gross income—including capital gains and other items allocable to corpus and not included in distributable net income—our proposal would place the current tax burden upon the trust. Any such tax paid by the trust would be treated as a tax imposed on the trust within the meaning of sections 665–667 so that the subsequent actual distributee would receive a credit against his own tax liability in the usual way through application of the throwback rules.[14]

Under our proposal taxes are imposed on the trust and are payable by the trustee in the ordinary course on the trust's accumulated income. Contrast the position of the grantor under section 679. The U.S. grantor will be taxed on all the trust income—not just accumulated income—even though he has no right, eligibility, or hope ever to receive any distribution from the trust at any time and even though he has permanently and completely divested himself of the trust property and its income.

To implement section 679, the 1975 TRA would amend section 6048 to impose the responsibility for making a trust information return on the grantor under section 679 and would amend section 6677(a) to

[13] Secs. 651, 652; secs. 661, 662. Both deduction and inclusion would be subject to conventional distributable net income limits.

[14] A beneficiary who pays the tax, interest and penalties as transferee would have rights of contribution and recoupment. See p. 27, infra.

impose a penalty for failure to make the return of 5 percent of the entire trust corpus—not just the value of the property transferred to the trust by the section 679 grantor—or $1,000, whichever is less. We think this proposal is unfair too, because it is questionable whether a grantor has standing as a matter of local law to compel disclosure of trust information.[15] By contrast, our proposal places the burden of filing returns on the trustee. If he fails to file, a beneficiary upon whom liability is imposed would have a right to compel the trustee to account and thereby disclose trust information. Again, our proposal is more equitable. It is no answer to say that the grantor may gain access to information by so providing in the trust agreement. He may just as easily make provision directly requiring the trustee to file all necessary returns.

One might claim that since the grantor creates the problem he should be the one to suffer the tax consequences. In our view such a contention is pure retribution and is beside the point. Once the grantor has created the trust, there is no measure within his control that might sever the attributed ownership status imposed by section 679. Under our proposal, only a beneficiary who actually receives distributions pays tax on them. While a beneficiary might, as a transferee, eventually be exposed to liability for amounts in excess of his share of the tax on trust income, his liability cannot in any case exceed the amounts actually distributed to him. Moreover, he would have rights of recoupment from the trust and trustee and of contribution from the other beneficiaries.[16] As a last resort, a beneficiary who is potentially exposed to tax libility on amounts in excess of his share of the tax on trust accumulated income may release or renounce his interest or, barring a prohibition under local law or the governing instrument, he may alienate his interest.

It might also be claimed that the grantor is able to protect himself against attributed ownership status by making appropriate provisions in the trust document. This suggestion will be of no help to the unwary grantor who has been trapped by section 679. Moreover, the unwary grantor—or unwary grantor's adviser—aside, we note again that the knowledgeable grantor may include provisions in the trust to protect the beneficiary just as easily as he could to protect himself, simply by requiring the trustee to file the return and pay any tax due or, alternatively, by requiring the trustee to distribute to any beneficiary against whom any tax liability—including penalties and interest—is assessed an amount sufficient to reimburse the beneficiary fully.

Given the choice of taxing the grantor who never has any hope of receiving a distribution from the trust or taxing the trust, we think it is more fair to tax the trust.

(3) *Overkill and inadequacy.*—Section 679 at the same time goes both too far and not far enough in dealing with the problem. While the congressional goal is to subject income accumulations to current

[15] Information returns are presently reuired of, for example: U.S. shareholders of a foreign personal holding company (form 958); organizers of or investors in 5 percent or more of the stock of a foreign corporation (form 959); and U.S. shareholders of a controlled foreign corporation (form 3646). In each case, however, there is a direct stock relationship which perhaps led the Internal Revenue Service to assume the taxpayer would have a right of access to the necessary information. Whether or not that assumption is correct, as noted, the grantor would have no such right of access.

[16] See p. 27, infra.

tax, the Congressional proposal atributes to the grantor not only income accumulated in the foreign trust but also income distributed currently to the trust beneficiaries. In that respect, section 679 is excessive. On the other hand, the grantor's attributed ownership status ends with his death and never arises in the case of a foreign testamentary trust.[17] Once the creator of the trust is dead, section accomplishes nothing and the advantage of taxfree compounding of accumulated income is fully available. Our proposal is subject to neither of these deficiencies, for it imposes on the trust a current tax liability only on accumulated income and does so during the entire existence of the trust whether the grantor is living or dead.

(4) *Simplicity.*—Apparently on the theory that persons engaging in ordinary commercial transactions with a foreign trust should not be regarded as grantors (with resultant adverse tax consequences), section 679 would provide that a person is not treated as a grantor by reason of a sale or exchange of property at fair market value in a transaction in which the transferor's gain is fully realized at the time of transfer and is either then fully recognized or returned under section 453.[18] While we think this exception is desirable in the context of section 679 as proposed, the very presence of the exception to the general rule creates complexity and, further, will breed disputes over whether a sale or exchange takes place at fair market value. Also, the exception is too narrow. Assume that A, a U.S. person, creates a foreign trust having U.S. beneficiaries. B sells IBM stock, having a value of 10 and a basis to B of 11, to the trust at a price of 10—fair market value. B would be treated as an owner of the trust under section 679 because he will have realized no gain in the transaction. If B's basis had been 9 rather than 11, he would not be treated as an owner because his gain would be fully recognized. If the transaction is reversed and B buys the IBM shares from the trust at 10—fair market value—he would be treated as a section 679 grantor, for he will have transferred property—cash—to the trust in a sale or exchange in which he recognizes no gain. These results are plainly wrong, but correction of the problem may be achieved only at the expense of further complexity in the statute or regulations. Our proposal does not suffer from these defects, for it requires no transactional exceptions.

(5) *Conceptual deficiency.*—We believe that section 679's resort to attributed ownership status under the grantor trust rules is conceptually inappropriate to deal with the problem of foreign trust income accumulations. By causing items of gross income, deductions, and credits to be taken into account directly on the grantor's income tax return, section 679 may produce distorted results due to the variety of items that depend upon the nature or quantity of other items.[19] Similarly, items of foreign trust income will, we think inappropriately, be subjected to State and local taxation if the grantor resides in a jurisdiction—e.g., New York State and New York City—that defines the

[17] H. Rept. 94–658, n. 9 supra, p. 209.

[18] The Ways and Means Committee sought to exclude private annuity and open (*Burnet v. Logan*) transactions from the exception to sec. 679. While our proposed alternatives to sec. 679 would not impede such transactions, our suggestion of an excise tax of 70 percent of the gross value of the property sold to the trust would.

[19] Deductions for medical expenses, charitable contributions, interest on investment indebtedness; the extent of preferential items subject to minimum tax; and the computation of earned income subject to maximum rate treatment under sec. 1348 are but a few.

taxable base for State and local income tax purposes by reference to Federal adjusted gross income. Again, in the case of a grantor who is unable to gain timely access to the requisite information,[20] omission of substantial items of trust gross income from his return may gratuitously and unfairly extend the statute of limitations applicable to his return from 3 to 6 years under section 6501(e). New opportunities for tax avoidance may be created.

A U.S. person could create a foreign trust with entirely foreign beneficiaries to whom the income would currently be distributed. In a year in which it was expected that the trust would realize losses on its investments, the losses could be "channeled" to the U.S. taxpayer by having one or more of the foreign beneficiaries reside in the United States during that year. Again, the U.S. grantor might be able to remove shelter properties from his gross estate for estate tax purposes without sacrificing the benefit of current income tax deductions. Similarly, it might be possible to have income from property taxed to a U.S. corporate grantor—since corporations may be treated as owners under the grantor trust rules—that has losses available to absorb the income or lacks assets to pay the tax.[21] Trust gross income might be absorbed without tax in years in which an individual grantor has substantial losses or other tax deductions.

Our proposal avoids these difficulties by computing the thrust's taxable income, as in the case of a domestic trust, on a basis independent of the grantor and the beneficiaries. The trust would be a separate taxable entity to the extent of any income accumulations.

(*6*) *Caprice.*—Proposed section 679 may be expected to operate whimsically and harshly. It would impose a tax upon a U.S. grantor—including a tax upon prior years' undistributed income—[22] if, for example, a foreign beneficiary becomes a U.S. person, even in circumstances in which the U.S. settlor could not reasonably have foreseen or controlled that change of status. Again, it would impose a tax upon a U.S. grantor if his U.S. individual trustee becomes a resident of a foreign jurisdiction—assuming, as we believe might be the case, that this might convert the previously-domestic trust into a foreign trust. Finally, it would impose a tax upon a U.S. citizen who, as a long-time resident of a foreign jurisdiction, established a trust there with his local bank for the benefit of his children. In each of these instances, taxation of the grantor would stem from random factors not associated with tax avoidance and over which the grantor has no control. Our proposal places the burden on the thrust and, ultimately, on the trust beneficiaries who received distributions from the trust.

Policy and further notes on our alternative.—We assume—although the committee reports were silent on this point—that it was decided to tax the grantor of a foreign trust, rather than the trust itself, at least in part because it was felt that traditional geographical limiations on taxing jurisdiction make it impossible to tax the foreign trust directly.[23] Put another way, if the perceived evil is the tax deferral possibilities of foreign trusts, current taxation of the foreign trust

[20] See p. 17.
[21] But see H. Rept. 94–658, n. 9, supra, at p. 209, n. 10.
[22] Sec. 679(b).
[23] E.g., *United States* v. *Harden*, 41 D.L.R. 2d 721 (Can. 1963) (U.S. tax judgment not enforceable in Canada).

income to the trust would eliminate this tax avoidance possibility as surely as taxing the grantor. However, collection difficulties possibly were thought to pose such a substantial obstacle to taxing the foreign trust that the alternative route of taxing the grantor was selected.

These difficulties should not be permitted to obscure the basic choice. As between the grantor and the trust, we think that sensible tax policy dictates taxing accumulated income to the trust in the manner suggested on the grounds that:

(1) The trust which earns and accumulates income is taxed. If the Government is unable to collect the tax from the trust, the tax nevertheless will be collected in the end—with appropriate interest and penalties—from the beneficiaries, but only those who actually received distributions from the trust.[24]

(2) The trustee and where necessary the beneficiary, rather than the grantor, has all required information or a right of access to all required information.

(3) No statutory assignment of income is involved.

(4) Current taxation would be accomplished for the life of the trust, not just the life of the grantor.

In determining whether a trust is covered by our proposal, statutory rules would be needed to determine whether the foreign trust has or may have a U.S. beneficiary. To ascertain the identity of the beneficiaries and to eliminate only nominal beneficiaries: (1) the trust agreement should be deemed to include any instructions to the trustees, any letters of intent, or the like, and (2) a statutory definition of the class of persons who may be considered beneficiaries would be provided. Further, appropriate attribution rules should be adopted to deal with cases in which trust beneficiaries are entities, for example, foreign corporations or the like. We note that section 679 contains an entirely new set of attribution rules. There are already more than a dozen different sets of attribution rules in the code. Each raises problems that have been the subject of a considerable body of precedent and literature. We question whether a still further untested set of attribution rules should now be added to the code in the absence of a strong and clearly demonstrated need. In the interest of simplicity, without any sacrifice of efficiency, we recommend that an existing set of rules be used for this purpose.

We suggest that any beneficiary who pays a tax that should have been paid by the trust and who pays interest and penalties on the trust's liability be granted a federally created right of recoupment from the trust, in addition to any local law right of contribution against other beneficiaries, very much in the same manner as that now prescribed by section 2205 in the case of the estate tax.

Annual returns, identical to the returns required of domestic trusts, would be required under a section 6012(b)(4) that would be amended expressly to require the filing of the trust's tax return by the foreign trustee. Each beneficiary receiving amounts from the trust—whether or not claimed to be taxable—would be required to file appropriate tax or information returns.

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[24] Even if the beneficiary is not taxable under the throwback rules, the tax, interest, and penalties would be collectible from him on a transferee basis.

Retroactivity

We note the decision of the House to make the current reform proposals retroactive in that, for example, section 679 and the amendments to section 6048 and section 6677 would apply to taxable years ending after December 31, 1975, which would encompass taxable years beginning as early as February 1, 1975, with respect to trusts created or transfers made after May 21, 1974, the date of the original 1974 proposals. 1975 TRA section 1013(f)(1).

On August 4, 1975, the tax section of the New York State Bar Association transmitted to all members of the House Ways and Means Committee, the Senate Finance Committee, and various Treasury and Internal Revenue Service officials the report of its Committee on Tax Policy on the retroactivity of tax legislation.[25]

That report was critical of retroactivity in general and suggested that it be limited exclusively to rare and unusual cases in which failure to apply legislation retroactively would prevent governmental action or produce permanent dislocations in the tax system. We believe that the reform proposals now under consideration do not warrant retroactive application to trusts already irrevocably created. We recommend that the legislation, whatever its final form, be made to apply only to trusts created or transfers made after the proposed new method of taxing foreign trusts is enacted.

II. SECTION 1491 EXCISE TAX

The committee described the proposed changes in excise taxation as follows:

> Your committee's bill increases the excise tax imposed under present law (sec. 1491) on certain transfers of property to foreign trusts, foreign corporations, and foreign partnership [sic] from 27½ percent to 35 percent. In addition, the scope of the tax has been altered. First, that tax is to apply to transfers of all types of property rather than only to transfers of securities. Second, the tax is to apply only to the amount of gain which is not recognized by the transferor at the time of the transfer.[26]

Although section 1491 has been part of the Internal Revenue Code for decades, it has been the subject of very few rulings, cases, or articles. This silence of itself leads us to question whether a revised and expanded section 1491 tax is the best way to serve the intended legislative purpose of discouraging tax avoidance motivated transfers to foreign entities. Its efficacy aside, we believe the proposal has two principal defects: uneven application and exposure to double taxation.

Uneven application.—The purpose of section 1491 to prevent avoidance of a tax on gains derived from the sale by a foreign entity of property transferred to it for that purpose by a U.S. person.[27] The tax was intended as a substitute capital gains tax to be imposed where the normal capital gain tax might otherwise be avoided through transfers to foreign entities.[28] Section 1491 currently applies only to transfers of

[25] Published in The Tax Lawyer, vol. 29, No. 1 (Fall, 1975), p. 21.
[26] H. Rept. No. 94–658, n. 9, supra, at p. 213.
[27] Gains of a nonresident alien individual who is neither present in the United States for at least 183 days nor derives any income effectively connected with the United States during the taxable years are not subject to income tax. Sec. 871 (a), (b).
[28] H. Rept. No. 708, 72d Cong., 1st sess. (1932), pp. 51–52.

stock and securities. These normally would be capital assets in the hands of the transferor yielding capital gain upon a sale. The proposal, if adopted, would apply the section 1491 tax to transfers of any kind of property, whether or not the transferor would have been taxable upon a sale or exchange of the transferred property at capital gain, rather than ordinary income, rates.[29] Because the section 1491 tax is imposed at a flat rate irrespective of whether the transferred property is a capital asset or property held for sale to customers, it will operate unevenly and arbitrarily. As a function of the tax's original premise, the 35 percent rate is intended to reflect maximum capital gain rates, but the theory of the tax is not implemented in practice when applied to property that would be taxed at ordinary income rates in the transferor's hands. Moreover, even as a substitute capital gain tax section 1491 is defective, for it fails to reflect the nature of long-term capital gain as an item of tax preference subject to tax under section 56.

Double taxation.—The proposed section 1491 tax would apply to donative transfers as well as sales or exchanges, but payment of the excise tax would not increase the basis of the transferred property in the hands of the recipient. As a result, in the case of all donative transfers covered by section 679 the same appreciation in value will be subject to double taxation, once at the 35 percent excise rate of section 1491 as amended, and then again at the applicable income tax rates of the party upon whom the ultimate burden of income taxation falls.[30]

Transfers involving sales or exchanges normally will afford the transferee a new basis in the transferred property equal to fair market value, but that basis adjustment will not necessarily eliminate double taxation of the same appreciation. Section 1491, as amended, will apply to any transaction—including sales for deferred consideration in so-called private annuity transactions or pursuant to an installment reporting election—even if full value is paid or to be paid for the property transferred. Yet, as proposed, section 1491 would exclude from the excise tax only the portion of the gain that is recognized by the transferor at the time of the transfer. Thus even in certain nondonative transactions, the same gain may be taxed twice, once at the time of the transfer under section 1491—at the proposed 35 percent rate—and then once more as gain is recognized by the transferor under the installment reporting rules or under the rules governing recognition of gain in private annuity transactions. This result seems unduly harsh. Not only is the same appreciation taxed twice, but also the burden may fall on the same taxpayer.[31]

In view of the above problems, we reaffirm the recommendation of the tax section, made in 1971, that section 1491 should be abandoned. At that time, the tax section supported an approach along the lines reflected in existing section 367 for transfers of property to foreign

[29] 1975 TRA sec. 1015.

[30] That is, either the beneficiary who receives a current or accumulation distribution, or, under proposed new sec. 679 (discussed above), the grantor.

[31] As indicated above, this would also be true in the case of all donative transfers under proposed sec. 679. The Internal Revenue Service has ruled, we believe incorrectly, that the sec. 1491 excise tax applies to a transfer even if the transferor is treated as an "owner" of the transferee trust under the grantor trust rules. Rev. Rul. 69–450, 1969–2 Cum. Bull. 168.

corporations.[32] However, we suggest that, in lieu of imposing an excise tax under section 1491, transfers of property—whether appreciated or not—to foreign trusts that are subject to our proposed alternative to section 679 should be made subject to a special excise tax that, as detailed earlier,[33] would have the following suggested features:

(1) The rate of tax—which we suggest might be 70 percent—would be imposed on the gross value—not merely appreciation in value—of all property or assets—including cash—transferred to the trust.

(2) For this purpose, transfer would include transfers as defined in section 679 unless the transferee trustee: (a) Agrees to subject the trust to the taxing jurisdiction of the United States and to pay any U.S. tax liability of the trust that may thereafter be determined to be due, (b) agrees to file appropriate tax returns, and (c) secures payment of future taxes in one of the following ways: (i) Posts a bond, satisfactory to the Commissioner, to secure future income tax liability to the United States, (ii) maintains sufficient assets in the United States to secure that liability, or (iii) otherwise secures that liability to the satisfaction of the Commissioner.[34]

(3) The transferee trust would receive an addition to basis, as under section 1015(d), for the excise tax paid.

In the case of donative transfers to foreign trusts, the recommended special excise tax would not affect imposition of the existing gift tax; both taxes would be imposed on the transfer and would effect an adjustment to basis. Similarly, in the case of a transfer of appreciated property to a foreign trust in a nondonative transaction, the excise tax would be imposed whether or not gain is recognized by the transferor in the transaction. Exceptions should be provided to exclude ordinary commercial transactions to which the trust is a party.

The excise tax would be neutral insofar as the transferor's selection of a trust as a dispositive medium is concerned. The tax should, however, serve as a substantial disincentive to the creation of a foreign trust rather than a domestic trust. Moreover, while the tax would not guarantee the collection of income taxes from the foreign trust on a current basis, it would operate as a palpable incentive to the transferor to structure the transfer in such fashion as to give substantial assurance of collectability. In those cases where such substantial assurance is not forthcoming, the tax would be paid by the transferor and, in an economic sense, might be regarded as an advance, nonrefundable deposit on account of the trust's future income tax liabilities.

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[32] A report of this section's committee on sec. 367 policies dated Dec. 15, 1971, unanimously approved by the executive committee of the tax section on Dec. 14, 1971, and transmitted to the entire membership of the tax section and, among others, Hon. Johnnie M. Walters (then Commissioner of Internal Revenue), Hon. Edwin Cohen (then Assistant Secretary of the Treasury for Tax Policy), Lincoln Arnold, Esq. (then Deputy Chief of Staff of the Joint Committee on Internal Revenue Taxation), Hon. Barber Conable (then and now of the House Ways and Means Committee), and K. Martin Worthy (then Chief Counsel of the Internal Revenue Service), stated the following: "We recommend that this unintended double tax be eliminated, and the Code simplified, by substituting for secs. 1491–94 a section or sections comparable in effect to sec. 367(d), so that a transfer of stock or securities to a foreign trust or a foreign partnership would be treated as an exchange of such property for property having a comparable value, subject to appropriate exceptions under regulations and rulings if the contribution does not result in a substantial possibility that Federal income taxes will be avoided."

[33] Supra, p. 13.

[34] The committee reports should make clear that none of these steps, singly or in the aggregate, would cause the trust to be a domestic trust or to be regarded as engaged in a trade or business within the United States or would in any way affect any other trust of which the same trustee is serving.

If, contrary to our suggestion, section 1491 is retained, we recommend that the potential for double taxation discussed above be mitigated through the adoption of two measures:

By providing that the basis of the transferred property in the hands of the transferee will be stepped up to reflect payment of the section 1491 tax.[35]

By affording a credit in respect of the section 1491 tax paid against any income tax payable as a result of the recognition of gain on the transfer of the same property to a foreign trust.

III. THROWBACK RULES: CHANGES OF GENERAL APPLICABILITY

The 1975 TRA makes a number of substantial changes in the so-called throwback rules of existing section 665 to 669. In general, under the 1975 TRA:

The exact method of computing the beneficiary's tax on an accumulation distribution would be eliminated in favor of a modified short-cut method. In general, the beneficiary would compute his tax attributable to the accumulation distribution through a 3-year averaging procedure taking into account his 5 preceding taxable years and discarding those 2 years in which his taxable income was the highest and the lowest.

The capital gains throwback rule of present section 669 would be repealed, as would the definitions of undistributed capital gain—present 665(f)—and capital gain distribution—present section 665(g).

The indicated changes would apply to all trusts, both domestic and foreign. In part due to these changes and in part due to certain other changes discussed below, the treatment of accumulation distributions from domestic trusts would be substantially more favorable than those from foreign trusts. For example, income accumulations occurring before a beneficiary is born or before he attains the age of 21 would be exempt from application of the throwback rules in the case of a domestic trust. No such exception would be made for a foreign trust.

We generally support the changes outlined above that are applicable to all trusts—elimination of the capital gains throwback rule and simplification of the tax computation procedure. We also concur in the general objective of treating accumulation distributions from foreign trusts less favorably than those from domestic trusts. There are, however, two further changes in the proposed throwback treatment of foreign trusts on which we comment below:

(1) The imposition of an interest charge on additional taxes due.

(2) The conversion of all gross income items, irrespective of character, into a single undifferential category of ordinary income, excluding only income exempt under section 103.

IV. THROWBACK RULES: INTEREST CHARGE ON ACCUMULATION DISTRIBUTIONS

Under the 1975 TRA, in the case of distributions from a foreign trust—as opposed to distributions from a domestic trust—the bene-

[35] There is a precedent for this suggestion. Sec. 1015 was amended (Public Law 85-866, sec. 43(a), effective Jan. 1, 1954) to effect an upward adjustment of basis to reflect the gift tax on donative transfers.

ficiary would pay not only the tax due, but also a nondeductible simple interest charge on such tax computed from the year in which the income distributed was first accumulated by the foreign trust. The total of the tax and interest would be limited to the amount of the distribution.

The interest charge is imposed, according to the committee, because it is felt that "allowing this tax-free accumulation of income is inappropriate and provides an unwarranted advantage to the use of a foreign trust over the use of a domestic trust." As one Treasury official has put it, the use of foreign trusts which do not pay current tax may be viewed as an interest-free loan of the otherwise-payable tax by the U.S. Government.

We agree that the imposition of a cumulative interest charge is responsive to the perceived policy. However, if our proposed alternative to section 679 is adopted, this additional interest charge would be superfluous with respect to foreign trusts covered by our proposal. Interest would accrue on the trust's unpaid tax liability from the due date and would eventually be collected from the beneficiary as a transferee, whether or not he is taxed under the throwback rules.

If our proposed alternative to section 679 is not adopted, we support the imposition of the proposed interest charge, but we believe that making it nondeductible is inappropriate. If the interest charge reflects a fair cost for the use of money—as we suggest it should—then any additional penalty—such as nondeductibility—does not serve the stated policy but rather seems only harsh and punitive. Since it will apply even in cases in which the use of a foreign trust would be viewed as reasonable by all concerned, including the usual situation in which the foreign trust was created by a foreign citizen residing in a foreign jurisdiction, no fiscal policy would be served by nondeductibility.

Accordingly, if our proposed alternative to section 679 is not adopted we recommend that a fair interest rate be imposed but that it be treated for all purposes as interest and that it accordingly be deductible.[36]

V. THROWBACK RULES: CHARACTERIZATION OF DISTRIBUTIONS

Under present section 643(a)(6)(C), capital gains of a foreign trust created by a U.S. person are included in the trust's distributable net income. As a result, any such DNI which is accumulated, and thus becomes undistributed net income, is and will be taxed to the U.S. beneficiaries under the throwback rules when the accumulation distribution is finally made. That is, the U.S. beneficiaries of a foreign trust receive a mixture of ordinary income and capital gains when they receive distributions, including accumulation distributions, from a foreign trust created by a U.S. person. Since capital gains normally are excluded from DNI of a domestic trust under section 643(a)(3), they are ordinarily not included in undistributed net income. Due to the proposed repeal of the capital gains throwback, the domestic trust would thus usually be the final taxpayer on its capital gains. As indicated, distributions of accumulated capital gains would be taxed to the U.S. beneficiaries of a foreign trust.

[36] Proposed sec. 1014 of the 1975 TRA would impose a 6-percent fixed interest rate, as opposed to the variable rate provision of sec. 6621(b). We approve a fixed rate concept in the interest of simplicity.

However, a change proposed in 1974 that was rarely commented upon then and that has been carried into TRA 1975, would change the characterization of all gross income items on their distribution by a foreign trust. The proposal apparently would convert the character of any undistributed capital gains included in DNI into ordinary income and would compress all other income items into a single undifferentiated ordinary income pool in a manner completely destructive of character and source.[37]

While the amendment would strike at all trusts regardless of situs, insofar as its impact on capital gains is concerned it would—due to the repeal of the capital gains throwback rule—for the most part apply only to foreign accumulation trusts—which must include capital gains in DNI by virtue of section 643(a)(6)(C).

This change is not mentioned or discussed in the committee reports on the foreign trust amendments, and the policy behind it in that context is unclear. We doubt that it would serve any good policy, or raise any revenue.[38] As applied to foreign trusts it seems to us ill-conceived and gratuitously distortive of tax character. We recommend that distributions from foreign trusts retain their character in the hands of the beneficiaries.

Statement of Stroock & Stroock & Lavan, Representing United Merchants & Manufacturers, Inc.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

(a) Section 1032 of H.R. 10612 applies to nearly all foreign losses of a U.S. taxpayer. Such was not the intent of this provision. The loss attributable to an unprofitable foreign subsidiary terminating all activities abroad does not give rise to the abuse which the provision is designed to remedy. A third exception should be added to the existing provision excluding from recapture the loss of a U.S. taxpayer which has in effect suffered a one-time economic disaster abroad.

(b) The proposal applies notwithstanding the complete absence of the double tax benefit at which it is primarily aimed. It has always been recognized that no abuse occurs where loss carryover provisions in foreign tax laws achieve the same result as recapture. The proposal fails to take account of this important factor among others. It is recommended that the proposal be deleted from the bill unless it is appropriately modified to narrow its scope.

(c) The foreign loss recapture should not apply to that portion of an economic loss which occurred before the effective date of the provision.

(d) The provision applies to losses incurred in taxable years beginning after December 31, 1975. In equity, this effective date should be extended at least 1 year.

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[37] This would be accomplished by an obscure parenthetical clause drafted into proposed sec. 667(a). See sec. 701(a)(1) of committee print of Tax Reform Act of 1975 (Oct. 21, 1975).

[38] The ability to "launder out" unfavorable tax characteristics would make such a rule an unintended tax avoidance device. Illustrations would be erasure of the passive investment income taint under sec. 1372(e)(5) and avoidance of source rules where undesirable. For example, U.S. source income cycled through a Canadian trust might become eligible for a foreign tax credit regardless of the absence of true foreign source income. Cf. Rev. Rul. 55–414, 1955–1 C.B. 385.

DISCUSSION

Section 1032 of H.R. 10612 amends Internal Revenue Code section 904 by providing for the recapture of certain foreign losses. The bill would accomplish the recapture by treating foreign source income in years subsequent to the loss as U.S. source income, to the extent of the foreign loss, and by denying a foreign tax credit or any deduction with respect to taxes paid on such foreign income.

This is not a new proposal. A similar provision was contained in the tax reform bill of 1969 passed by the House of Representatives.[1] The provision was deleted from that bill as reported by the Senate Finance Committee, principally because it did not take adequate account of the differences in foreign tax systems to which U.S. operations are subjected and the inequitable treatment which would result therefrom.[2] In 1975, section 907(f) was added to the Internal Revenue Code to deal with the recapture of foreign oil related losses.

From the legislative history dating back to the tax reform bill of 1969, it is apparent that the proposal now before this committee is intended to put an end to the practice whereby U.S.-owned corporations may obtain the benefit of tax losses abroad as a reduction of U.S. tax liability while subsequently paying little or no U.S. income tax on foreign operations in profitable years, through the operation of the foreign tax credit. Clearly, the situation sought to be remedied was the "heads-I-win, tails-you-lose" game in which the taxpayer obtained a double tax benefit.[3] The example invariably cited is that of an operation with losses in 1 year and profits the next; the loss would be allowed in reduction of U.S. taxes; the U.S. foreign tax credit would subsequently eliminate the U.S. tax on the profits.

Implicit in the example and the nature of the abuse sought to be remedied is the continuation over a period of years of a foreign business with fluctuating income, the U.S. Treasury being regularly shortchanged on tax revenues. Also indicative that the proposal is aimed at a continuing operation are the two exceptions made for extraordinary foreign losses. These exceptions cover (1) foreign expropriation losses and (2) losses from fire, storm, shipwreck, or other casualty—losses which are unlikely to give rise to any future income. A third exception should be made where a U.S. corporation has in effect suffered an economic catastrophe aboard. Such a situation would occur where a foreign operation has suffered large losses with the result that its activities abroad have ceased or been terminated. It seems highly doubtful that the legislative draftsmen intended to force a foreign loss recapture on this type of one-time economic disaster.

It is also essential to differentiate between a situation where a double tax benefit may exist and one where there can be no double tax benefit. For example, assume a profitable foreign subsidiary in a high tax

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[1] Sec. 431 of H.R. 18270.

[2] Report of the Senate Finance Committee on H.R. 13270, S. Rept. 91-552 at 303 (Nov. 21, 1969).

[3] Report of the House Ways and Means Committee on H.R. 13270, H. Rept. 91-413 at 116 (Aug. 6, 1969); report of the Senate Finance Committee on H.R. 13270, S. Rept. 91-552, individual views of Senator Albert Gore, at 321 (Nov. 21, 1969); statement of George P. Shultz before the House Ways and Means Committee on Apr. 30, 1973, and Treasury explanation at 170 et seq. on the tax reform bill of 1973; report of the House Ways and Means Committee on H.R. 17488, H. Rept. 93-1502 at 67-69, 147 (Nov. 21, 1974); report of the House Ways and Means Committee on H.R. 10612, H. Rept. 94-658 at 225, 228.

country which has been remitting large dividends to the U.S. parent. Little or no U.S. income tax is payable as a result of the foreign tax credit. A loss deduction, when the operation turns sour, would arguably result in a second tax benefit. Assume instead, however, that a subsidiary located in the same foreign country has never achieved more than marginal profitability and has not paid a dividend to its U.S. parent company in a quarter century. If this subsidiary were to fail there could be no double benefit on the loss allowed the U.S. parent since the parent has never obtained its first U.S. tax benefit from the subsidiary. Section 1032 in its present form would subject the parent company in the two cited cases to the same recapture treatment, notwithstanding the complete absence of any double tax benefit in the latter instance. As such, the provision in its present form is a clear case of overkill, a sweeping and imprecise response to a specific problem.

Another example of the excessive scope of the proposed section 1032 is the failure to provide for its inapplicability where loss carryover provisions in foreign tax laws achieve the same result as recapture. This was the major reason the Senate Finance Committee deleted the recapture provision contained in the House-passed tax reform bill of 1969.[4]

Throughout the proposal's legislative history, it has been recognized that no double tax benefit occurs when the foreign tax system takes into account losses for computing taxes in later years.[5] The U.S. foreign tax credit is automatically reduced when foreign income taxes are reduced through recognition of prior years' losses. As now written, however, the proposal ignores this extremely important factor and U.S. taxpayers are subjected to the same recapture treatment whether or not they pay substantial U.S. taxes as a result of foreign loss carryovers.

The tax laws of many countries contain loss carryover or similar provisions. The failure to take such provisions into account is thus a major shortcoming of the proposal. For this reason, as well as the reasons discussed above, we think section 1032 should either be deleted from the bill, as was its predecessor from the tax reform bill of 1969, or its scope much more narrowly defined.

The committee should also consider whether it is fair or appropriate to require a complete foreign loss recapture where all or part of the economic loss occurred before the effective date of the provision. For example, a U.S. corporation invests $10x in the stock of a foreign subsidiary; the subsidiary loses money so that its net worth is reduced to $2x; at that time, the law is changed and subsequent to the effective date the subsidiary loses $2x; the U.S. corporation then realizes a $10x worthless stock loss. It is suggested that only $2x of the foreign loss should be recapturable since the real economic loss of $8x had occurred before the effective date of change in the tax law.

Under section 1032(c)(1) of the bill, the foreign loss recapture amendments would apply to losses incurred in taxable years beginning after December 31, 1975. In equity, it seems to us, this effective date should be extended at least for 1 year.

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[4] See note 2, supra.
[5] See note 3, supra.

Statement by Frank W. Schiff

TAX TREATMENT OF U.S. TAXPAYERS MARRIED TO NON-RESIDENT ALIENS

My name is Frank W. Schiff. I greatly appreciate the opportunity to submit this statement to your committee. I am currently vice president and chief economist of the Committee for Economic Development and have previously served as Deputy Undersecretary of the Treasury for Monetary Affairs. My statement, however, is made in a purely personal capacity. It relates to a very serious inequity in the present tax treatment of U.S. taxpayers married to nonresident aliens.

My basic case is very simple. Under present law, a married couple may not file a joint return if either the husband or wife was a nonresident alien at any time during the taxable year. Particularly since passage of the Tax Reform Act of 1969, this provision has meant that couples affected by it may be taxed at much higher rates than other married couples and even than single individuals with the same total taxable income.

Section 1012 of H.R. 10612 would remedy this injustice by giving a U.S. citizen married to a nonresident alien the option of filing a joint return, provided the nonresident alien spouse is in effect treated as a resident alien for purposes of the income tax laws and that both taxpayers are subject to U.S. tax on their worldwide income for the taxable year. I strongly support these proposed revisions in the law. They represent a very fair and workable solution to the problem. However, since the severity of the penalties which the existing law imposes on taxpayers married to nonresident aliens was enormously increased through several provisions of the Tax Reform Act of 1969—provisions which Congress never intended to have such an effect—I also urge that section 1012 be made retroactive to the time when the 1969 act became operative, at least to the extent that this is possible without opening individual income tax returns otherwise closed by the statute of limitations.

Let me illustrate the inequity of the present law by citing my own experience. I was married to a German citizen in Germany in June 1974. My wife immigrated into the United States in July and became a U.S. resident. She had no income of her own during the year except a modest salary she earned prior to our marriage in Germany as an employee of a bank. We naturally expected to be able to file a joint return at the end of the year. Solely because she had been a nonresident alien for part of the year, however, I was required to file as "married filing separately." The result—and I must admit I could hardly believe it when I saw the figures—was that our tax for the year was 25 percent higher than it would have been had we filed jointly on the basis proposed in the House bill—that is, with my wife's foreign earnings included as part of our joint income. The tax was also nearly 15 percent higher than what I would have had to pay as a single person.

How was this possible? There were two principal reasons:

First, the tax rate schedule applying to the "married but separate" category is much higher than the joint return schedule. It is the same as the schedule for single persons that was in effect until 1969; at some income levels the tax liability under this schedule can be as much as 42 percent higher than the joint return level. The 1969 act reduced the single schedule so that tax liabilities for single persons cannot be more than 20 percent greater than those on joint returns with the same taxable income. But since there was no such reduction for the "married but separate" category, taxpayers who are required to file under that category have since 1969 been substantially worse off than both single taxpayers and married couples filing jointly.

Second, the 50 percent maximum tax on earned income which the 1969 law introduced for singl a swell as joint return taxpayers does not apply to married persons filing separately. As a result, the tax disadvantage suffered by married taxpayers who are required to file separately because one spouse had been a nonresident alien for part of the year can in some cases actually be far greater than that which my wife and I experienced in 1974.

The striking feature of this story is that there are perfectly understandable reasons for each of the separate legal provisions cited, but that none of these provisions was ever intended to produce the present utterly unfair tax treatment of U.S. citizens married to nonresident aliens. Here are the pertinent facts:

1. The original prohibition against filing joint returns when one marriage partner has been a nonresident alien during any part of a taxable year dates back to the Revenue Act of 1938. At that time, only one tax rate schedule applied to U.S. taxpayers on a nationwide basis, and joint returns could only be filed in the eight States that had community property laws. Hence, the provision cited had far less significance than it acquired in later years. The reason for the provision given by the Ways and Means Committee at the time was that it would be impossible to compute an aggregate income for the couples involved because "nonresident aliens are taxed on a different basis than residents."

It is still true that nonresidents are taxed differently on U.S. income than residents. Today, however, it seems entirely feasible to resolve the problem through the technique embodied in the 1975 House bill—that is, giving the couples involved the option of being taxed as if both spouses were residents. In contrast to the procedure under separate filing, this means that the foreign-source income of the nonresident partner will also be taxed. Presumably, Congress did not consider this possibility in 1938 because the chances of obtaining accurate information about foreign earnings of nonresidents looked dim. At the time, the United States had almost no reciprocal tax treaties with other countries and general war was close at hand. By contrast, such tax treaties are now in effect with most major countries and the information needed to determine the total tax liability of both spouses should generally be obtainable. Moreover, the House bill specifically provides that if adequate information is not available, the Treasury can refuse to grant the couples involved the option of filing joint returns.

2. The fact that the 1969 act reduced tax rates for single persons but did not change the tax schedule for married persons filing separately is mainly explained by the circumstance that filing separately

is usually an option for married couples. In most cases, married couples benefit by filing joint returns, but under some conditions—for example, when one spouse has very large medical deductions—they may do better by filing separately. However, the tax law is not intended to give couples a tax rate schedule advantage if they report separate incomes; to prevent the possibility of such an advantage, the tax brackets for couples filing separately were kept exactly half as wide as the brackets for joint returns. What was clearly not considered in connection with the 1969 act was the large increase in the relative tax disadvantage that the act produced for married couples who are required to file separately because of the outdated provision relating to nonresident aliens.

3. The report of the Ways and Means Committee accompanying the 1969 act contained a single phrase to explain why married couples filing separately were not made eligible for the 50 percent maximum tax on earned income: to prevent manipulation. But this phrase, too, was closely intended to apply only to couples who had the option of choosing between filing jointly or separately; there is no possibility of manipulation in cases where statutory provisions prevent a couple from filing jointly. The inequity of depriving taxpayers in this position of the benefits of the maximum tax was apparently not considered by the Congress when the 1969 act was passed.

To summarize, the existing law regarding the tax treatment of U.S. citizens married to nonresident aliens represents an almost classic example of a "Kafkaesque" or "Catch-22" situation in which various legal provisions that are each reasonable by themselves combine to produce entirely unreasonable effects on a particular group of taxpayers. As far as I know, there is no dispute about the inequity of the existing provisions, nor about the fact that it was the 1969 legislation which quite unintentionally made the prohibition against the filing of joint returns by couples that include a nonresident alien far more damaging than before.

The Treasury Department fully agrees with this assessment, as indicated in the attached letter to me by Assistant Secretary Charles M. Walker dated April 8, 1976. Mr. Walker's letter also states explicitly that the Treasury Department would not object if section 1012 were made retroactive to taxable years beginning after December 31, 1972. While the Treasury apparently agrees that retroactivity to 1970—the year when the Tax Reform Act of 1969 came into force—would be justified in principle, it notes that such a provision would create administrative difficulties to the extent that it requires the opening of individual tax returns otherwise closed by the statute of limitations.

In the light of the circumstances set forth above, and in view of the fact that the revenue losses would apparently not be very significant, I very much hope that your committee will approve the proposed section 1012 and make it retroactive to at least 1973, that is, to taxable years beginning after December 31, 1972. Moreover, since the Treasury's concern over extending retroactivity back to 1970 appears to relate only to returns already closed under the statute of limitations, it would seem appropriate to allow retroactivity to 1970 in cases where this statute still permits the filing of refund claims.

DEPARTMENT OF THE TREASURY,
Washington, D.C., April 8, 1976.

Mr. FRANK W. SCHIFF,
Watergate South,
Washington, D.C.

DEAR Mr. SCHIFF: Thank you for your letter of March 23, and your proposed submission to the Senate Finance Committee. The Treasury Department agrees that present law imposes an inequitable burden on taxpayers married to nonresident aliens. As you point out, the burden was inadvertently compounded by the Tax Reform Act of 1969 which contained a new rate schedule for married persons filing separately.

Section 1012 of H.R. 10612 corrects the inequitable burden for taxable years beginning after December 31, 1975. Although section 1012 does not redress the problem for earlier taxable years, administrative difficulties would arise if the provision were made retroactive as far back as 1970, the year when the new rate schedule for married persons filing separately took effect. The Treasury Department would not object if section 1012 were made retroactive to taxable years beginning after December 31, 1972. Assuming section 1012 is enacted in 1976, a December 31, 1972 effective date would provide substantial relief without opening individual tax returns otherwise closed by the statute of limitations.

Yours sincerely,

CHARLES M. WALKER,
Assistant Secretary.

STATEMENT OF NATOMAS CO.

BACKGROUND

Last year the Congress determined that there was a difficulty in ascertaining whether payments made to foreign producing countries were taxes or royalties, and concluded that this difficulty led to a distortion of the foreign tax credit mechanism in the foreign oil and gas area. Accordingly the Congress enacted a provision which limited the foreign taxes on oil and gas extraction income which can be used to offset U.S. tax on foreign income to a tax rate just slightly higher than the U.S. rate. Therefore, to the extent that foreign taxes on oil and gas extraction exceeded that limit, they may not be used to offset U.S. tax on other low-taxed foreign income. Section 907 of the code.

PROBLEM

Although the new percentage limitation of section 907 was intended to limit the amount of high-rate foreign taxes of an oil or gas production operation which could be used to offset other low-taxed nonproduction income, it also operates, in certain unusual cases, to limit the amount of creditable foreign taxes which can be used with respect to low-taxed production income, even where such income is solely from one country. This unusual result occurs where the tax laws of the United States and a foreign country provide different rules as to the timing of when income and deductions are taken into account. Thus, in 1 year a foreign producing operation can have a very high effective rate of tax—because U.S. tax concepts provided deductions not available in the producing country—and in the following year have a very low effective rate of tax—because the foreign country's alternative cost recovery system produces little tax on large amounts of income. It should be emphasized that this problem arises solely with respect to extraction income from the same country, and does not involve using foreign extraction tax credits to offset other types of income, that is, shipping, or income from other countries.

Production sharing contracts are particularly vulnerable to these timing differences, since they employ completely different concepts of cost recovery than are used in the United States. The major disparity between the United States and foreign taxable income concept in a country employing production sharing concepts is that for U.S. purposes, intangible drilling costs are deductible when incurred, whereas under the production sharing contract, such costs are not deductible but instead are compensated for by adjusting, increasing the U.S. producer's share of future production. Therefore, in a year in which the taxpayer incurs large exploration and development costs and, in the same country, has significant extraction income, the foreign tax paid on the extraction income, without any deductions, translates into a high rate of tax under U.S. concepts which permit deductions to reduce taxable income. As a result, the percentage limitation deems a significant portion of the foreign taxes for that year to be noncreditable. In a subsequent year or years, the opposite occurs, since in latter years the taxpayer is awarded cost oil—nontaxable in the foreign country—to compensate for the previously incurred expenditures. This cost oil is taxable in the United States and included in U.S. taxable income, which results in a determination that the foreign tax rate is imposed solely on an annual basis, it does not permit the distortions created by the mismatching of income and deductions to be ameliorated.

HOUSE AMENDMENT

Ordinarily, U.S. tax law resolves differences in the timing of income and tax by carryover and carryback rules. In fact, the foreign tax credit provisions contain such an averaging provision—sections 904 (d) and 904(e). However, the existing provisions of the new percentage limitation of section 907 have not not been conformed to the foreign tax credit carryback and carryforward rules. There is no policy reason for not applying the new percentage limitation in concert with the carryback and carryforward rules, provided the basic objective of limiting the foreign tax rate to a certain percentage is maintained.

The tax reform bill as approved by the Committee on Ways and Means and passed by the House of Representatives provides a special carryback during the transition period to any taxable year ending in 1975, 1976, and 1977. This carryback is to be computed by using the normal foreign tax credit carryback rules, section 904(c). Thus, a carryback is to be allowed only to the two proceeding taxable years from which the tax is carried. Second, the extraction taxes which may be carried back may only be carried back against extraction income in the same country to which the extraction taxes were paid.

The amount which may be carried back to any taxable year is limited to the net U.S. tax liability on the extraction income from that country for a year after taking into account the foreign tax credit. Thus, the amount allowed as a carryback may not exceed an amount equal to the amount of the foreign oil and gas extraction income for the year multiplied by the sum of the normal tax and surtax rates for the year, less the amount of any creditable taxes which are paid or accrued with respect to the foreign oil and gas extraction income against which the credits are to be offset. The amount carried back is to be deemed tax paid or accrued on income from the extraction of foreign oil and gas in the year to which carried. For purposes of this provision, extraction taxes which may be carried back are the income taxes paid or accrued during a year with respect to foreign oil and gas extraction income which would be allowed as a foreign tax credit but for the special percentage limitations on foreign oil and gas extraction income.

REQUESTED ACTION

It is respectfully requested that the Senate Committee on Finance approve the above described House amendment.

STATEMENT OF THE PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION, SUBMITTED BY CARSWELL H. COBB, CHAIRMAN, TAX COMMITTEE

SUMMARY

1. *The Problem.* The problem faced by our industry today is our increasing difficulty in competing in world markets, a problem which will be greatly magnified by the added tax cost in this Bill.

2. *The Impact of the Repeal of Sec. 911:*

A. *Foreign Marketplace.* The increased tax cost to employees will have to be borne by the manufacturer and passed on to the consumer in the form of higher prices. Inability of U.S. products to meet foreign competitive prices will result in loss of foreign sales and service revenue.

B. *U.S. Employment.* The loss of foreign markets and the increased costs of maintaining U.S. citizen-employees abroad could result in the loss of 20–25% of the jobs in this industry.

C. *Costs to U.S. purchasers.* The reduction of foreign markets will result in higher unit costs for equipment to U.S. purchasers. Exports currently support large amounts of overhead and research and development.

D. *PESA Recommendation.* Sec. 911 should not be repealed.

3. *Impact of Taxation of Foreign Housing Costs.* The Internal Revenue Service and recent cases hold that housing provided to foreign based employees is taxable income to employee.

A. *Additional Increased Cost.* U.S. manufacturers must absorb these additional costs which will further increase prices of U.S. products.

B. *Loss of Foreign Markets.* Loss of foreign sales will be followed by reduction in employment and increased costs to domestic purchasers.

C. *Increased Foreign Tax.* Foreign governments will increase efforts to tax housing payments. Results will be additional revenue for foreign governments with little or no increase in U.S. tax revenues due to the credit for the increased foreign taxes.

D. *PESA Recommendation.* Payments for foreign housing should be excluded under Sec. 124 proposed in Bill Sec. 1011(c), within the limitations contained therein.

4. *Facilities and Services Provided Abroad by Employer.* Sec. 1011 (c) of the Bill should be expanded to allow an exclusion for municipal-type services "paid for" by the employer, as well as "furnished" by the employer as now drafted, since small businessmen cannot afford to set up and furnish facilities.

Statement

Petroleum Equipment Suppliers Association (PESA) is a trade association with approximately 180 member companies which supply about 85 percent of all the equipment and services used by the oil and gas producing industry. Our members include manufacturers of drilling machinery and production equipment, supply companies which distribute and service such equipment, and service companies that perform the highly specialized services which are essential to the exploration, drilling and production activities of the oil and gas industry. In other words, we are the industry which supplies the hardware, the skilled services and the supplies to the U.S. oil industry in its search for and the production of oil and gas, both in the United States and abroad. Our companies are small, medium and large and we act as vendors to both the independent and the major oil companies. PESA members employ approximately 200,000 people, most of whom are U.S. citizens. A large percentage of these employees are stationed in various parts of the world. At these worldwide locations we support the sale and service of products which are produced primarily in the United States and exported. It is because of our substantial stake in foreign markets that we are concerned about the legislation under consideration.

THE PROBLEM

Over the years our industry's technological leadership and the reliability and superiority of its products have made it possible for us to penetrate foreign markets. As a result our industry has generated substantial sales of U.S.-manufactured equipment which has created jobs in the United States and aided in our Nation's balance of payments position. Unfortunately, our foreign competitors have made rapid technological advances both in the field of technical design and manufacturing capabilities. As a result we are no longer able to rely on our technological superiority to assure us of success in the foreign markets. We are rapidly approaching the stage where our competitive price position will determine whether we will secure foreign sales. We see the provisions now under consideration by this committee as adding substantially to our cost of operation to the point where we will no longer be competitive in foreign markets, and we will lose these sales to foreign companies. The result of this will be a loss of exports from the United States, the elimination of jobs in the United States and abroad, and an ultimate loss in tax revenues through the loss of tax on U.S. manufacturing profits, as well as foreign profits. These results would be immediately noticeable by our companies and the ripple effect would result in similar losses by our suppliers of components and raw materials who will be forced to cut back production as a result of our loss of these markets.

THE NEED FOR EXPORTS

In our view exports are vital to the economy of the United States in general, and our industry in particular. Exports create jobs for American workers and help to support research and development which is vital to maintaining the U.S. position in the world markets. In the oil and gas industry technology has rapidly increased in recent years. A very large percentage of the equipment and services now offered by our industry were not available ten years ago. In view of the technological advancement in other countries there is additional pressure on American industry to develop new products and technologies in an attempt to stay ahead of foreign competition. As a result, PESA members spend a substantial amount on research and development each year. Without export sales the domestic market would have to absorb the total burden of R&D. This would vastly increase the cost of the search for and production of oil and gas in the United States. By increasing exports, on the other hand, the cost of R&D can be spread over a larger volume of sales, thus reducing costs in the United States.

The members of this industry were urged in recent years by another branch of the government to be prepared for increased exploration activities because of the energy crisis. We were urged to take all possible steps to insure that no shortages in equipment and service would develop. As a result of cooperating with this governmental request, many of our members increased the capacity of their plants. If foreign markets are lost the total burden of paying for this excess capacity will have to be absorbed by a substantial increase in the cost of their products and services to the U.S. purchasers.

Exports are particularly important to our industry because there is a direct relationship between our activities abroad and the capacity of our members to service the domestic oil and gas industry. By providing equipment and services on a world-wide basis, our member companies have access to a wide variety of operating problems and subsurface reservoir conditions. New and improved techniques which are being developed to meet the conditions existing in the North Sea, for example, have been of benefit in offshore domestic production. Equipment required to resist the highly corrosive effects of the high sulphur content wells currently being drilled in the United States was developed, tested and put into service in Canada and the Arabian Gulf. Equipment necessary to complete wells on the ocean floor was tested and used at an early date by the French oil companies in their operations in Algeria and Gabon, and the benefits of these improvements are now available to our domestic industry.

FOREIGN MARKETPLACE

Our industry must face strong foreign competition in every marketplace. Other developed nations offer numerous aids or incentives to its business which place a U.S. company without such incentives at a distinct competitive disadvantage. A brief review of several developed countries shows the incentives offered by such countries:

1. Foreign income excluded:
   A. France.
   B. Netherlands (as a result of treaties).
2. Foreign income taxed at a reduced rate: A. Belgium.
3. Foreign subsidiary income not taxed currently:
   A. Belgium.
   B. France.
   C. Germany (unless not taxed in base country).
   D. Netherlands.
   E. Japan.
   F. United Kingdom.
4. Favorable intercompany pricing allowed to aid exports:
   A. Belgium.
   B. France.
   C. Japan.
5. Export financing at favorable rates:
   A. Belgium.
   B. France.
   C. Germany.
   D. Netherlands.
   E. United Kingdom.
   F. Japan.
6. Credit insurance on foreign transactions:
   A. Belgium.
   B. France.
   C. Germany.
   D. Netherlands.
   E. Japan.
   F. United Kingdom.
7. Special tax reserves for foreign activities:
   A. France.
   B. Japan.

In addition to these specific incentives, there are numerous incentives benefiting all business including exports such as reduction in real estate taxes, investment credit allowances, and tax incentives for developing depressed areas.

In view of the myriad of laws assisting our competitors, the members of our industry cannot understand the lack of support for exports by our Government since such exports are so vital to the economic well-being of our industry and the United States in general. In light of the foregoing, we would like to discuss certain specific items.

THE IMPACT OF THE REPEAL OF SECTION 911

Section 1011 of the bill phases out the exclusion of income earned abroad which now appears in section 911 of the Internal Revenue Code.

This exclusion for income earned abroad, which has been around in one form or another since 1926, has been made to appear as a major tax loophole. We are strongly opposed to the elimination of this exclusion and suggest that if there are abuses of the present provisions the specific abuses should be eliminated instead of destroying this incentive to exports.

It has been the experience in our industry that the only way to make a substantial penetration in a foreign market is to have salesmen active in and servicemen available in the foreign areas involved. We must provide service facilities at or near the well site and we must be present to install, repair, and maintain our products promptly when needed. Downtime in oil and gas drilling is expensive and we must maintain stocks and personnel which are immediately available to shorten that downtime as much as possible. Our experience has also proven that American expatriates are better trained, more dependable, more experienced, and, last but not least, more loyal to the U.S. company than local nationals.

It is axiomatic that oil and gas seems to be located in some of the most unattractive areas on the Earth. More often than not it is less desirable financially for a U.S. citizen to work in these areas. Good employees simply will not leave their relatives and friends and the comfort of living in this country to work in the jungles and deserts of the world without some incentive. The tax exclusion is such an incentive. In the areas where this industry sends its employees it usually is expensive to maintain a standard of living which is considered even adequate by U.S. standards. Critics of the exclusion assert that taxpayers moving within the United States from one area to a more expensive area receive no tax compensation for this increased cost. However, nowhere in the United States is an employee faced with the rampant inflation which continues in most nations abroad. Furthermore, the foreign tax credit alone does not provide sufficient relief to the expatriate because credit is given only for income taxes whereas a larger and larger portion of the tax burden faced abroad consists of indirect taxes, capital levies, and excise taxes on so-called luxury items and similar taxes for which no credit is available.

A typical employee in our industry who is married and has two children will be required to pay an additional $6,200 per year in tax if the exclusion is eliminated. A single man will have to pay about $7,200 additional. In order for the members of our industry to secure qualified employees at their foreign locations, we have only one alternative with regard to this increase in expense, and that is to increase the employee's compensation to cover it. The increase in compensation will likewise be taxable and the pyramid effect will result in a substantial expenditure by service and supply companies. The only source for the extra expense by the employers is the selling price it secures for its products. Therefore, the end result of the elimination of the exclusion will be to substantially increase the cost of United States manufactured goods and services in the foreign marketplace. This will make it more difficult than ever to compete in the highly competitive foreign markets.

If the Sec. 911 exclusion is repealed our members will have no choice but to replace expatriates who are American citizens with foreign born personnel. This factor, coupled with the loss of foreign income, will have a disastrous impact on the U.S. economy. Obviously, there would be an immediate loss of foreign jobs by U.S. nationals. Such persons would be returned to the United States and in many instances they would then displace other employees from jobs in the United States. In addition the loss of the foreign markets would result in substantial cutbacks in manufacturing, again resulting in loss of more U.S. jobs. It is estimated that the loss of foreign markets and the increased cost of maintaining U.S. citizen-employees abroad could result in the loss of as much as 20–25% of the jobs in this industry.

One result of the replacement of U.S. citizens by foreign nationals could have consequences more far reaching than realized at the present time. The employment of increasing numbers of foreign personnel and the necessary training of such personnel is a method of exporting technology to foreign countries without payment therefore. There is no way to recover technology which has been implanted in the minds of foreign personnel. This exportation of United States technology will in the long run completely eliminate any technological advantage which the United States manufacturers may still have.

We urge that the earned income exclusion be retained and in view of the worldwide inflation and the substantial increase in non-creditable taxes in foreign countries that consideration be given to increase the exclusion.

Should the Committee not agree with this recommendation, we request in the alternative that consideration be given to removing the exception "(other than an oil or gas well)" contained in Sec. 1011(e)(3) of the Bill. This section provides that employees working on a construction project in a foreign country for the erection or installation of a permanent facility will be entitled to the full $20,000, exclusion during the phase out of the earned income exclusion, if the employees' employer is unrelated to the person for whom the facility is being erected or installed. We see no reason why our employees who are engaged in the erection or installation of an oil or gas well in a foreign country should not be entitled to the same treatment that employees working on other construction projects receive.

THE IMPACT OF TAXATION OF FOREIGN HOUSING COST

In view of the position of the courts and the Internal Revenue Service that sums paid by an employer to provide housing for an employee represents taxable income to the employee, we strongly recommend that an exception be provided in the Internal Revenue Code to exclude from taxable income sums paid by an employer for foreign housing Sec. 1011(e) of the Bill provides for a new Sec. 124 which allows an exclusion for payments for municipal-type services. We recommend that this exclusion be enlarged to cover payments for housing.

In a recent case, *Stephens* v. *Commissioner* (Docket No. 9060-73. TC Memo 1976-13. Filed January 20, 1976), the employer transferred Stephens to Tokyo. Because of the enormous cost of housing in Tokyo and in order to provide the employee with a reasonably adequate dwelling, the employer was required to rent an apartment for $10,299.55 for one year. The employer charged the employee a portion of his salary, $3,024.64, as rental for the apartment. The Commissioner determined that the excess rental paid by the employer over the amount paid by the employee was additional taxable compensation to the employee. While the Tax Court was very sympathetic with the problem resulting from the inflated rents in Tokyo, it upheld the Commissioner's determination and the employee was required to pay a substantial additional tax on the excess rental paid by the employer.

Because of the unusual locations where our industry is required to station its employees, we can cite numerous instances of inflated rents similar to that involved in the Stephens case. For example, some of our members have reported the average housing costs in the following locations:

Location	Average total salary	Annual housing rental
Nigeria	$16,000	$16,000
Iran	16,774	9,000
Norway	16,680	7,680
Indonesia	18,456	14,824
Malaysia	14,527	12,106
England	14,472	7,805
Dubai and Abu Dhabi	19,700	12,000
Gabon	23,892	16,740

These amounts represent rentals paid for what the Tax Court described in the Stephens case as reasonably acceptable quarters, which were less comfortable, less attractive, and smaller than typical homes in the United States. It is impossible to convince an employee that he has been benefited by the payment of this large sum by his employer when he does not receive quarters even as comfortable as he is used to in the United States. It should be emphasized that living in a foreign country is quite different from passing through as a tourist. Quarters which may appear adequate will be found on a day-to-day basis to lack electricity for hours at a time, to have inadequate cold and hot water, heating and air conditioning, and have poor garbage collection, elevator services, and equipment servicing.

We do not propose that because a United States citizen is working abroad he is entitled to tax free housing. On the other hand, we do not consider it fair to penalize a citizen for the run-away inflation in other countries, countries in which he is living for the benefit of his employer. He would not choose to live in Nigeria, Gabon, or Indochina. He is there at his employer's request and on his employer's behalf.

Many of our companies which furnish housing to employees abroad require them to pay a percentage of their base pay to the company as rental for the housing. Surveys made by some of our companies indicate that the average amount an employee would spend for housing in the United States is about 15% of his base pay. Thus, by requiring an employee to pay rental of approximately 15%, the same amount he would pay in the United States, he has paid for his housing to the extent of its fair value to him. The fact that the employer must pay a larger amount for adequate housing does not in fact benefit the employee, because he had adequate housing in the United States for the amount of the rental he is required to pay.

We urge the Committee to consider an additional exclusion in Code Section 124 to exclude from the taxable income of U.S. expatriates the value of housing furnished or the amount of rental paid by an employer in excess of a standard percentage of base pay, which standard may be determined by the Commissioner by regulation. The Commissioner has available the resources and statistics of many government agencies from which he can determine the average amount paid in the United States for housing. In addition, based on the various foreign service statistics available from the State Department, the Department of Defense, and other agencies with foreign service employees, the Commissioner may determine a maximum amount for various locations in the world to prevent abuse of this exclusion.

One method of avoiding abuse of this exclusion would be to make it subject to a limitation similar to that contained in Sec. 1011(c) of the Bill involving facilities and services provided abroad by the employer. This section allows an exclusion for municipal-type services "furnished in a foreign country on basis which does not discriminate in favor of officers or highly compensated employees". A provision such as this would eliminate situations in which companies might be tempted to provide luxury type quarters for the managing staff in foreign locations.

As in the case of the exclusion of foreign earned income, if employees are taxed upon the excess rental payments, as was held in the Stephens case, the end result will be an enormous additional expense which must be borne by the employer. He is already being required to pay exorbitant rentals to provide barely adequate housing in which his employees will agree to reside. In addition, if the employee is required to pay additional tax it will be necessary for the employer to increase his compensation to cover the tax and the tax on the tax, etc. The end result of this is obviously a sharp increase in the expense of doing business, which expense must be passed on to the consumer. To do this means raising prices on United States manufactured products and services which are already being priced out of the market by foreign competitors.

The addition of the amounts paid for foreign housing to U.S. taxable income will undoubtedly give ideas to the local foreign taxing authorities. Many of these taxing authorities require copies of the U.S. tax return or information regarding income reported for United States tax purposes. They will then require the employees to include in their taxable income for foreign tax purposes the amounts included as housing allowance for U.S. tax purposes. As a result the employee's foreign tax will increase giving him a larger tax credit to be applied against his U.S. taxes. Thus, the ultimate consequence of including the housing allowance in taxable income will be an increase in the tax revenues of the foreign governments and little or no increase in United States tax revenues.

FACILITIES AND SERVICES PROVIDED ABROAD BY EMPLOYER

Under Sec. 1011(c) of the Bill it is proposed to insert a new Sec. 124 which provides for an exclusion from gross income for municipal-type services "furnished" by the employer of the taxpayer in a foreign country on a basis which does not discriminate in favor of officers or highly compensated employees. Many of our members are too small to be in a position to maintain such services and furnish them to their employees. In addition in many locations it would not be economically feasible for an employer to provide these services on its own. As drafted this provision would appear to favor a few large corporations and discriminate against the smaller employer who cannot provide such services.

It is strongly recommended therefore that the words "paid for" be added to the statute so that it would cover "any item furnished or paid for by the employer of the taxpayer". This change would not alter the purpose of the statute, but would make it possible for all taxpayers such services to their employees where necessary instead of just a few large corporations.

CONCLUSION

In conclusion, we desire to express our appreciation for the opportunity to submit our statement of position to this Committee. In the interest of brevity we have not gone into detail on the other items of interest to our members. We would like to say generally that we are opposed to any changes placing an additional tax burden which must be passed on to our consumers. While we do not require as many incentives as our foreign competitors are used to, we believe it is to the benefit of the United States to encourage foreign commerce by United States companies.

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