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

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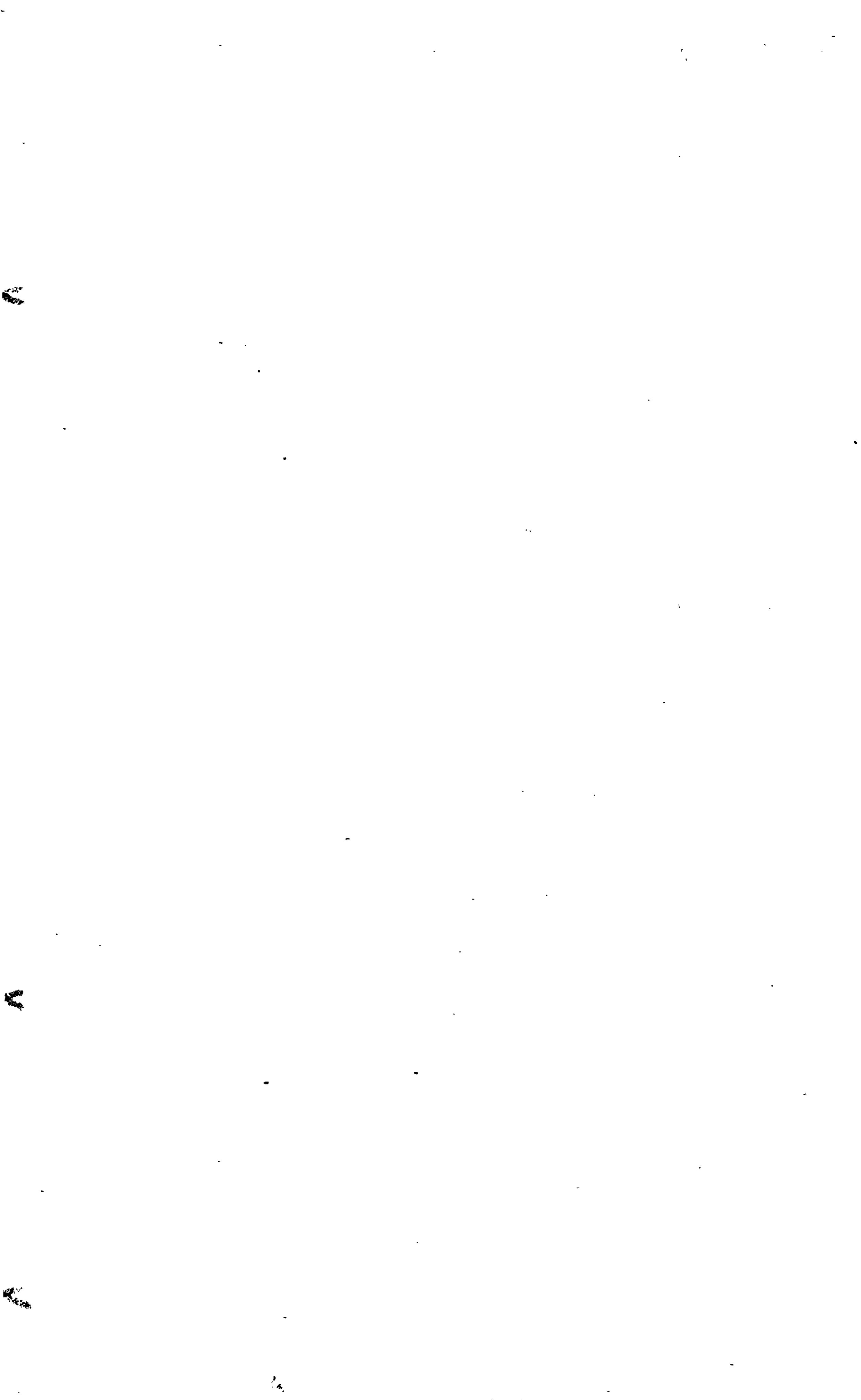

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Estate and gift taxes	3619-3772
Possessions' corporations in Puerto Rico	3773-3788
Charitable contributions	3789-3820
Tax shelters	3821-3832
Deduction of expenses attributable to business use of homes, rental of vacation homes, etc	3833-3839
Domestic international sales corporations (DISC)	3841-3864
Advertising and publications of tax exempt organizations	3865-3871
Private foundations	3873-3877
Cooperatives and condominiums	3879-3883
Premiums on guaranteed renewable health and accident insurance policies	3885-3890
Employment taxes	3891-3898
Personal holding companies	3899-3902
Bank holding company amendments	3903-3919
Mortgage interest tax credit	3921-3923
Value-added tax	3925-3930
Percentage depletion	3931-3937
Retirement income credit	3939-3940

Tax Treatment of Prepaid Legal Services

Statement of the National Consumer Center for Legal Services

This statement is offered on behalf of S. 2051, a bill which would grant to prepaid legal programs essentially the same tax treatment that accident and health plans now enjoy. This legislation will remove the last major obstacles to the delivery of legal services as an employee fringe benefit, a goal upon which Congress embarked more than three years ago with the amendment of Section 302(c) of the Labor Management Relations Act of 1947 (the Taft-Hartley Act), adding legal services to the list of subjects of collective bargaining. S. 2051 would amend Sections 105 & 106 of the Internal Revenue Code in order to exclude from employee gross income both the value of the benefit received through such legal service plans, and the amount contributed to the plan on the employees' behalf by the employer.

A brief legislative and legal history of prepaid legal services

The following short history and summary of the current status of prepaid legal services is offered as background. The first such plans originated in California where groups desiring to assist their members to obtain legal services contracted with law firms to provide free advice and consultation and reduced-fee services in return for the group's channeling its members' business to that firm. Nearly a thousand such plans are now registered with the California Bar Association.

A series of Supreme Court cases beginning with *NAACP* v. *Button* in 1934 and ending in 1971 with *United Transportation Union* v. *State Bar of Michigan* established the First Amendment right of groups to band together in order to secure high quality, low-cost legal services for their members.[1]

Involved in those cases were railroad unions which had established legal aid departments to assist their members in securing competent counsel for filing claims under the Federal Employers Liability Act, and other unions providing similar services out of union dues. In 1971, the same year as the UTU decision, the Laborers International Union, Local 229 in Shreveport, Louisiana instituted an experimental legal services program with the cooperation of the Ford Foundation and the American Bar Association. Later, with the *UTU* decision in mind, and after the demonstrated success of the Shreveport plan, proponents of these new legal service plans determined to seek an amendment to

[1] *NAACP* v. *Button*, 371 U.S. 415, 9 L.Ed.2d 405, 83 S.Ct. 328 (1963); *Brotherhood of Railroad Trainmen* v. *Virginia ex rel. Virginia State Bar*, 377 U.S. 1, 12 L.Ed.2d 89, 84 S.Ct. 1113 (1964); *United Mine Workers* v. *Illinois State Bar Association*, 389 U.S. 217, 19 L.Ed.2d 426, 88 S.Ct. 353 (1967); *United Transportation Union* v. *The State Bar of Michigan*, 401 U.S. 576, 28 L.Ed.2d 339, 91 S.Ct. (1971).

the Taft-Hartley Act so that legal services could be a subject of collective bargaining. In 1973, Congressman Frank Thompson and Senator Harrison A. Williams introduced bills to accomplish this purpose. The National Consumer Center for Legal Services, the AFL-CIO, the American Bar Association, the consumer movement and a large part of the insurance industry supported the bills, and the amendment of section 302(c) of the Taft-Hartley Act was signed into law late in 1973. Congress was aware at that time of the tax problems created by the amendment, and it was expected that a speedy resolution would follow.[2]

Unfortunately, 1974 proved to be a year of considerable economic and legislative turmoil, and although bills were introduced, there was not sufficient time left for the 93rd Congress to act on the tax problems.

Legislation similar to S. 2051 was introduced in the House of Representatives last year by Congressman Joseph Karth (Democrat-Minnesota), as H.R. 8579. Hearings on H.R. 8579 were held before the full Committee on Ways and Means on July 14, 1975. The committee has taken no action yet concerning the legislation.

Late last year, Congress passed comprehensive legislation affecting pension and other employee welfare benefit plans, including legal service plans. The Employee Retirement Income Security Act of 1974 extended reporting and disclosure requirements and stiff fiduciary standards to legal service plans. The effect of that legislation has been to encourage the negotiation of legal service plans, now secure in a regulatory framework.

There are now better than fifty negotiated legal service plans operating through a joint trust as provided in the Taft-Hartley Act, and a smaller number of nonnegotiated but employer-financed plans not subject to Taft-Hartley. Their tax situation is chaotic.

A SIMILAR DESCRIPTION OF THE PROBLEM

Sections 105 and 106 of the Internal Revenue Code currently provide for the exclusion from employee gross income of premiums and benefits provided under accident and health plans. S. 2051 would amend Sections 105 and 106 so that parallel exclusions would exist for contributions paid to and benefits received through legal service plans.

Labor and management representatives interested in establishing a legal service plan face two distinct problems, both of which primarily concern the taxability of legal services contributions and benefits to *employees*. With respect to contributions made to legal service funds

[2] **Hearings Mar. 22, 1973, on H.R. 77 before the Special Subcommittee on Labor, House Committee on Education and Labor, produced several witnesses who took note of related tax problems, including: Robert J. Connerton, General Counsel of Laborers' International Union of North America (at 222-231); Report of the Special Committee on Availability of Legal Services, New York State Bar Association (at 262). Similarly, hearings Apr. 10, 11 and 16, 1973 on S. 1423 before the Senate Subcommittee on Labor of the Committee on Labor and Public Welfare, produced witnesses to the tax difficulties such legal service plans would face, including: Robert Connerton (at 23); Dr. Lee Morris, Vice President of Insurance Company of North America (at 264); Russell M. Tolley, President, National Association of Professional Administrators, (at 295-6); National Association of Manufacturers (at 304).**

on behalf of employees by the employer, considerable unclarity exists as to whether or not these contributions would constitute income. Despite the fact that a number of plans have filed requests for revenue rulings, none have been issued on which plans feel they may safely rely. Careful reading of revenue rulings on related questions suggests that the Internal Revenue Service would not consider these contributions to be taxable income to the employee because the employee has no vested right in the funds at the time the contribution is made. However, S. 2051 would remove all question by granting an explicit exclusion granted in Section 106 of the Internal Revenue Code to contributions to health and accident plans.

Second, with respect to the taxability to the employee of the value of the benefits received under such plans, the Internal Revenue Code language is clear: "Gross income includes income realized in any form, whether in money, property, or services." Treasury regulation 1.61-1-(a)). Thus, without amendment, employees would be liable for taxes on the value of services received by them under a legal service plan. S. 2051 would amend Section 105 of the Internal Revenue Code to avoid this grave result, granting to beneficiaries of legal service plans the same exclusion from taxability as is currently enjoyed by accident and health plans.

It should be made absolutely clear at this point that the tax treatment of the *employer* is not an issue here. Employer contributions to legal service plans are deductible as "ordinary and necessary expenses" of doing business under Section 162 of the Internal Revenue Code. Nor are we dealing here with the tax status of the funds themselves, although there are perplexing problems unresolved in that area. S. 2051 pertains solely to the tax consequences to the employee.

AMENDMENT OF SECTION 105, INTERNAL REVENUE CODE

Without amendment of Section 105, an employee might receive several thousand dollars in legal services benefits and face the prospect of having to pay taxes on those benefits as income. This could have a serious effect, particularly since prepaid legal service plans typically cover people whose earnings are between $5,000 and $15,000 per year. Employees would have to ask themselves whether they can afford to take advantage of their legal services benefit program. A recent study by the American Bar Foundation makes clear the fact that without some kind of legal service plan or other assistance, middle income people ordinarily seek legal services only in the most dire emergencies.[3] Amendment of Section 105 to exclude for employee gross income the value of legal services received through such plans *would eliminate the harsh prospect of taxing employees of modest income for this benefit.*

There is also a more practical consequence of amending Section 105: It avoids the difficult problem of assessing the value of services which may be provided by a panel or staff attorneys who do not bill on a fee-for-service basis. Even more difficult valuation problems loom with

[3] Curren, Barbara A. and Spalding, Francis O., *The Legal Needs of the Public*, American Bar Association and American Bar Foundation, Chicago: 1974.

services which are related to legal services but do not constitute legal services *per se*, such as paralegal assistance, marital counseling and so on. Since the Supreme Court's recent decision in *Goldfarb*, it is unlikely that there will be any bar association minimum fee schedules on which to base such valuations. Furthermore, the valuation problem is not merely one of plans which do not bill for services provided, (i.e., one where members are entitled to a limited number of prepaid hours of service for staff attorneys) but even more seriously, of plans whose delivery mechanisms enable them to deliver services far less expensively than prevailing legal practice. The use of a market valuation system would now produce real injustices.

Finally, our experience suggests that both employers and employee organizations have some reluctance about participating in a program whose tax consequence to the employee are potentially so harsh. This result would defeat the very purpose of the Taft-Hartley Amendment and frustrate the intent of Congress to improve access to legal services.

AMENDMENT OF SECTION 106, INTERNAL REVENUE CODE

As indicated, Section 106 similarly requires amendment. Treasury regulation 1.61–1(a) defines gross income to be "income realized in any form, whether in money, property, or services." It is presently unclear whether the employer contribution to a legal service fund on the behalf of the employee constitutes gross income to the employee. Although there are Revenue Rulings which suggest that the answer depends on whether the employee's rights to the assets of the fund or to contributions made to the fund had vested or were non-forfeitable, the uncertainty should be ended by amending Section 106 to explictly exclude such contributions or premiums from gross income, along lines parallel to the exclusion granted to health and accident plans.

An additional benefit of such an amendment to Section 106 would be the guarantee of equal treatment between negotiated legal service plans and those paid for unilaterally by the employer or through individual insurance contract plans. In other words, amendment of Section 106 would accomplish equal tax treatment for employees, regardless of whether the legal service benefit is provided through collective bargaining, as an employer-instituted benefit, or by employer-purchase of individual legal instance contracts for employees.

REVENUE LOSS

This section attempts to touch briefly on the question of possible revenue loss, although it is an area subject to widely differing estimates. Employer contributions for comprehensive legal services range between $40 and $75, the bulk of them probably approximately $50. Tax counsel advise that these amounts would probably not now be considered income to the employee since the employee has no vested right in the fund at the time of the contribution is made.[4] Therefore,

[4] See the tax memorandum attached as Appendix A, prepared by John Hendricks, at the request of the Special Committee on Prepared Legal Services of the American Bar Association.

if this advice is correct and if such amounts are not presently taxable, the simple *clarification* of their status in S. 2051 will not generate any revenue loss.

As to benefit limits, most plans use either dollar amounts or hours-of-service averaging 50 or fewer hours of service per year. Whether measured in dollar amounts or in hours, no plan now operating offers more than an equivalent of $4,000 in benefits per year.[5]

Figures from the Shreveport Laborers' plan, the oldest legal service plan currently in operation, suggest more accurate data for illustration.

SHREVEPORT LEGAL SERVICE PLAN

Year	Number of claims	Utilization rate	Average claim
1971	30	5	212
1972	56	9	223
1973	65	11	243
1974	92	15	211

The utilization pattern for Shreveport seems to be fairly typical for new plans, although the first year utilization rate is low. Most plans average 8–10 percent use the first year. An established plan seems to average 15–20 percent utilization. For example, the Ohio Legal Services Fund serving employees of the City of Columbus, Ohio reported 8.5 percent utilization in its first 8 months of operation, averaging slightly more than $180 per claim. The Laborer's Council (Washington, D.C.) plan, which handles 85 percent of its cases on a staff basis, and refers 15 percent to outside attorneys, pays an average of $210 per case to the outside attorneys. Cases handled on a staff basis probably average $150 per case.

Thus, in a hypothetical plan covering 100 workers (which is in actuality too small to effectively support a plan), assuming a 20 percent utilization rate, an average claim of $200, and a tax rate of 20 percent, the revenue loss if expressed on a per employee basis would amount to $5.25 per employee. The figures could actually be lower or higher. Thus, for the 125,000 workers currently covered by such legal service plans, the revenue loss could be between $656,250 and $1,000,000.

All prepaid legal service plans now providing services limit benefits in some way. A worker who takes advantage of every possible benefit under a plan can still usually only receive services valued between $2,500 and $3,000. Thus fears of excessive usage are unwarranted. Further, most plans contain the standard ethics code language which allows attorneys to decline matters that are "frivolous or without merit." Even if they do not, attorneys serving the plan remain bound by the ethical code.

It is significant that income levels for the workers served by the plans are generally low, only rarely exceeding $15,000, and frequently

[5] Such limits would be reached by a beneficiary only in the usual situation where the employee claimed all possible benefits allowable in a claim year. For example, under a plan using a schedule of benefits, the employee would have to be divorced, sued by his neighbor, involved in a traffic accident, arrested for drunk driving, default on a loan, buy or sell a house and request a will, etc., etc.

ranging between $8,000 and $10,000 annually. Most workers served by these plans are married, with children. A sizeable proportion, therefore, will pay nominal or no taxes and thus would not contribute to a revenue loss at all.

The revenue loss question is complicated by the major uncertainty about the popularity of legal services as a fringe benefit. Bargaining in a recently depressed economy offers no real clue in answering the question. More sophisticated analyses must await the attention of the Joint Committee on Internal Revenue Taxation, or perhaps the Treasury Department.

V. SUMMARY OF SUPPORT

S. 2051 has the endorsement and support of the American Federation of Labor and Congress of Industrial Organizations, the United Auto Workers, the International Brotherhood of Teamsters, the Amalgamated Clothing Workers of America, the Amalgamated Meatcutters and Butcher Workmen of America, the International Ladies Garment Workers Union, the Laborers' International Union of North America and other national and local unions.

S. 2051 also has the strong support of the American Bar Association, and particularly its Special Committee on Prepared Legal Services and the General Practice Section. Attached to this statement is a detailed memorandum in support of H.R. 3025, prepared by the tax counsel to the American Bar Association's Special Committee on Legal Services. Because many State bar associations have established legal service plans to meet the needs of moderate income citizens, they too support H.R. 2051. State bar associations, including Georgia, Wisconsin, Michigan, New York, Ohio and Oregon have recently endorsed this legislation.

Life and Health Insurance

STATEMENT OF NATIONAL ASSOCIATION OF LIFE COMPANIES IN SUPPORT OF S. 2759

The National Association of Life Companies (NALC) is headquartered at 550 Pharr Road, N.W., Atlanta, Georgia 30305. Our association was organized in 1955 to provide progressive life insurance companies with a forum, both for internal communication of ideas and for joint commentary on items of mutual interest. NALC began with a membership of 43 companies: today its membership is nationwide, with over 225 companies represented. NALC companies have more than 143,000 home office and field employees, over 340,000 stockholders, and more than 40,000,000 policyholders. Most of our members are small and medium sized life insurance companies.

NALC supports the enactment of S. 2759, introduced on December 9, 1975 by Senator Fannin, and cosponsored by Senator Curtis. As precisely described by Senator Fannin when introducing the bill (See, 121 Cong. Rec. S 21417 (daily ed. Dec. 9, 1975)), S. 2759 would amend Section 809(d)(5) of the Internal Revenue Code to clarify the original Congressional intent that premiums on guaranteed renewable health and accident insurance policies qualify for the 3 percent of premiums deduction provided for therein. This Committee and the Senate previously approved legislation producing a result identical to S. 2759, but, unfortunately, the Conferees for the House objected on the stated grounds that they did not have sufficient time to explore its technical aspects—not because of any fundamental disagreement with its provisions.

A substantial portion of the business of NALC's member companies is health and accident insurance. Life insurance companies which write a significant amount of health and accident insurance often issue three basic types of policies. These policies may be described as follows:

1. *Noncancellable* policies are policies under which the insurance company is obligated to continue or renew the insurance coverage at a guaranteed premium.
2. *Guaranteed Renewable* policies are policies under which the insurance company is obligated to continue or renew the insurance coverage and may not cancel the policy or change the nature of the risk covered, but may, after complying with relevant State law, adjust premium rates by classes (not by reference to an individual policy) in accordance with its experience with the entire class.
3. *Cancellable* policies are policies which the insurance company may cancel for any reason at the renewal date.

As is evident from the above descriptions, noncancellable and guaranteed renewable health and accident insurance policies are very similar in that they both involve the insurance of long-term risks (*i.e.*, they may not be unilaterally cancelled by the insurance company).

Indeed, this fact has been recognized by the Internal Revenue Service. Rev. Rul. 71-367, 1971-2 C.B. 258. The only difference between noncancellable and guaranteed renewable policies is the fact that under a guaranteed renewable policy the insurance company has a limited right to adjust premiums by class in accordance with its experience with the class. Cancellable policies, on the other hand, differ from the other two types of policies in that they involve the insurance of relatively short-term risks, since they may be individually cancelled by the insurance company for any reason at the renewal date.

Section 809(d)(5) provides a deduction in an amount equal to 10 percent of the annual increase in reserves for nonparticipating policies, or in an amount equal to 3 percent of the premiums received on nonparticipating policies which are issued or renewed for periods of five years or more, whichever is greater. When, as with many of NALC's member companies, a life insurance company's business includes a substantial amount of noncancellable and/or guaranteed renewable health and accident insurance, as compared to nonparticipating life insurance, the 3 percent of premiums deductions is often significantly larger than the 10 percent of reserve increase deduction. Consequently, many of NALC's member companies have consistently claimed the 3 percent of premiums deduction with respect to their guaranteed renewable health and accident insurance policies.

In so claiming the 3 percent of premiums deduction, these companies have acted consistently with the original purpose of Section 809(d)(5), which was to permit life insurance companies issuing nonparticipating policies insuring long-term risks to compete on an equal basis with life insurance companies which issue participating policies insuring long-term risks.[1] Companies issuing participating policies are able to charge a premium on these policies which exceeds the actual cost of providing insurance coverage, and they may retain a portion of the excess premium as a cushion against the long-term risks insured. Section 809(d)(5) was intended to provide companies issuing nonparticipating policies with a similar cushion against the long-term risks insured.

Nevertheless, and in the face of the legislative purpose of section 809(d)(5) (and the express provision of section 801(e)), the Internal Revenue Service has consistently refused to allow the 3 percent of premiums deduction on guaranteed renewable health and accident insurance policies. The Service agrees that nonparticipating noncancellable accident and health policies are eligible for the 3 percent of premiums deduction under section 809(d)(5), and that cancellable accident and health insurance policies are eligible for the 2 precent of premiums deduction under section 809(d)(6). However, the Service has taken the position that nonparticipating guaranteed renewable policies are *not* eligible for *either* the 3 percent of premiums deduction *or* the 2 percent of premiums deduction. The Service maintains

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[1] The action of these companies in claiming the 3 percent of premiums deduction on their guaranteed renewable health and accident insurance policies has also been entirely consistent with section 801(e), which was enacted contemporaneously with section 809(d)(5) and expressly provides that, for purposes of the taxation of life insurance companies, guaranteed renewable health and accident insurance shall be treated in the same manner as noncancellable health and accident insurance.

that, on nonparticipating guaranteed renewable policies, life insurance companies are limited to the 10 percent reserve increase deduction under section 809(d)(5)—which often is significantly less than even the 2 percent of premiums deduction under section 809(d)(6) available for short-term cancellable policies, and, of course, is also often less than the 3 percent of premiums deduction under section 809(d)(5). Rev. Rul. 65-237, 1965-2 C.B. 231; Rev. Rul. 71-368, 1971-2 C.B. 259.

The life insurance industry generally has successfully sustained its entitlement to the 3 percent of premiums deduction for guaranteed renewable policies under section 809(d)(5) in the Court of Claims. See, *United American Insurance Co.* v. *United States*, 475 F.2d 612 (Ct. Cl. 1973); *The Lincoln National Life Insurance Company* v. *United States*, No. 521-69 (Ct. Cl. January 4, 1974); and *Central States Health & Life Company of Omaha* v. *United States*, No. 276-74 (Ct. Cl. October 30, 1975). The Tax Court reached the same conclusion (48 T.C. 118 (1967)), but was reversed by the Ninth Circuit. *Pacific Mutual Life Insurance Co.* v. *United States*, 413 F.2d 55 (9th Cir., 1969). Obviously, life insurance companies will continue to resort to the courts, if necessary, to sustain their entitlement to this deduction.

However, resort to the courts should not be necessary to establish a taxpayer's entitlement to a deduction which Congress so clearly intended to provide. This Committee already has concluded "that it was the intent of Congress in the Life Insurance Company Income Tax Act of 1959 to treat guaranteed renewable contracts in the same manner as noncancellable contracts," and that guaranteed renewable contracts should be eligible for the 3 percent of premiums deduction under section 809(d)(5). See, S. Rep. No. 92-1290, 92d Cong., 2d Sess. 6-7 (1972). NALC urges the committee to reach the same conclusion again, and to report S. 2759 favorably so that its member companies' entitlement to the 3 percent of premiums deduction under section 809(d)(5) for guaranteed renewable health and accident policies will be clarified once and for all, and so that no further resort to litigation will be necessary.

OCCIDENTAL LIFE OF CALIFORNIA,
Los Angeles, Calif., April 8, 1976.

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

DEAR MR. STERN: I enclose a suggested statutory clarification of subsection (h) of new Internal Revenue Code Sec. 819A(h) in Sec. 1043 of the Tax Reform Act of 1975 (H.R. 10612) relating to the tax treatment of contiguous country branches of United States life insurance companies. I respectfully request that this letter and the suggested statutory clarification be included in the record of the hearings now being held by the Committee on Finance on the Tax Reform Act of 1975 for the Committee's consideration when it is reviewing the bill.

Presently, the Canadian branch business of U.S. life insurance companies is subject to both Canadian and U.S. income taxes whereas

their Canadian competitors are subject only to the lower Canadian income tax. While a foreign tax credit is allowable for Canadian taxes, U.S. taxes on Canadian operations currently exceed allowable credits.

U.S. life insurance companies doing business in Canada price their policies and pay dividends to Canadian policyholders by taking into account the higher U.S. income tax whereas their Canadian life insurance company competition take into account only the lower Canadian income tax. Subsections (a) through (g) of the new Internal Revenue Code Sec. 819A allow a U.S. mutual life insurance company, by making the election described therein, to exclude from the computation of its U.S. taxable income all of the items relating to its Canadian branch business. This will neutralize any U.S. tax effect of having a Canadian branch operation. Thus, after the election is made under Sec. 819A, a U.S. mutual life insurance company will be able to price its policies and pay policyholder dividends without taking into account U.S. taxes in the same manner as its Canadian competition.

Subsection (h) of new Code Sec. 819A applies to U.S. stock life insurance companies and allows them to transfer Canadian insurance policies and related assets to a Canadian corporation with the same tax effects accorded U.S. mutual life insurance companies upon their election with respect to their branch operations. However, subsection (h) in its present form is incomplete in not providing for full tax neutrality from U.S. tax to a Canadian life insurance company subsidiary of a U.S. stock life insurance company.

To carry out the intent of new Code Sec. 819A to allow U.S. life insurance companies to operate in Canada free of U.S. tax, the enclosed statutory clarification of subsection (h) of Sec. 819A provides for the exclusion of the ownership of the Canadian subsidiary of U.S. stock life insurance companies from their U.S. tax computation in the same manner that U.S. mutual life insurance companies exclude the ownership of their Canadian branch operations. The enclosed clarification of subsection (h) also makes technical changes to bring the statutory language into accord with the purposes of the section as stated in the House Ways and Means Committee Report.

The Occidental Life Insurance Company of California has operated in Canada since 1928, and its Canadian operations constitute a substantial part of its total business. Like other U.S. life insurance companies, we have found it increasingly more difficult to compete with Canadian life insurance companies because we must take into account in pricing our Canadian policies and paying dividends to our Canadian policyholders the effect of U.S. taxes. Because of state regulatory obstacles, we must hold the Canadian life insurance company through which we will conduct part of our Canadian operations as a subsidiary of Occidental.

It is requested that the Senate Finance Committee in its consideration of Sec. 1043 amend new Code Sec. 819A(h) so that Occidental and other U.S. stock life insurance companies can do business in Canada through Canadian subsidiaries free of U.S. tax burdens. Under such amendment the Canadian subsidiary will be able to price

its Canadian policies and pay dividends to its Canadian policyholders free of U.S. taxes as does its Canadian competition.

Respectfully submitted.

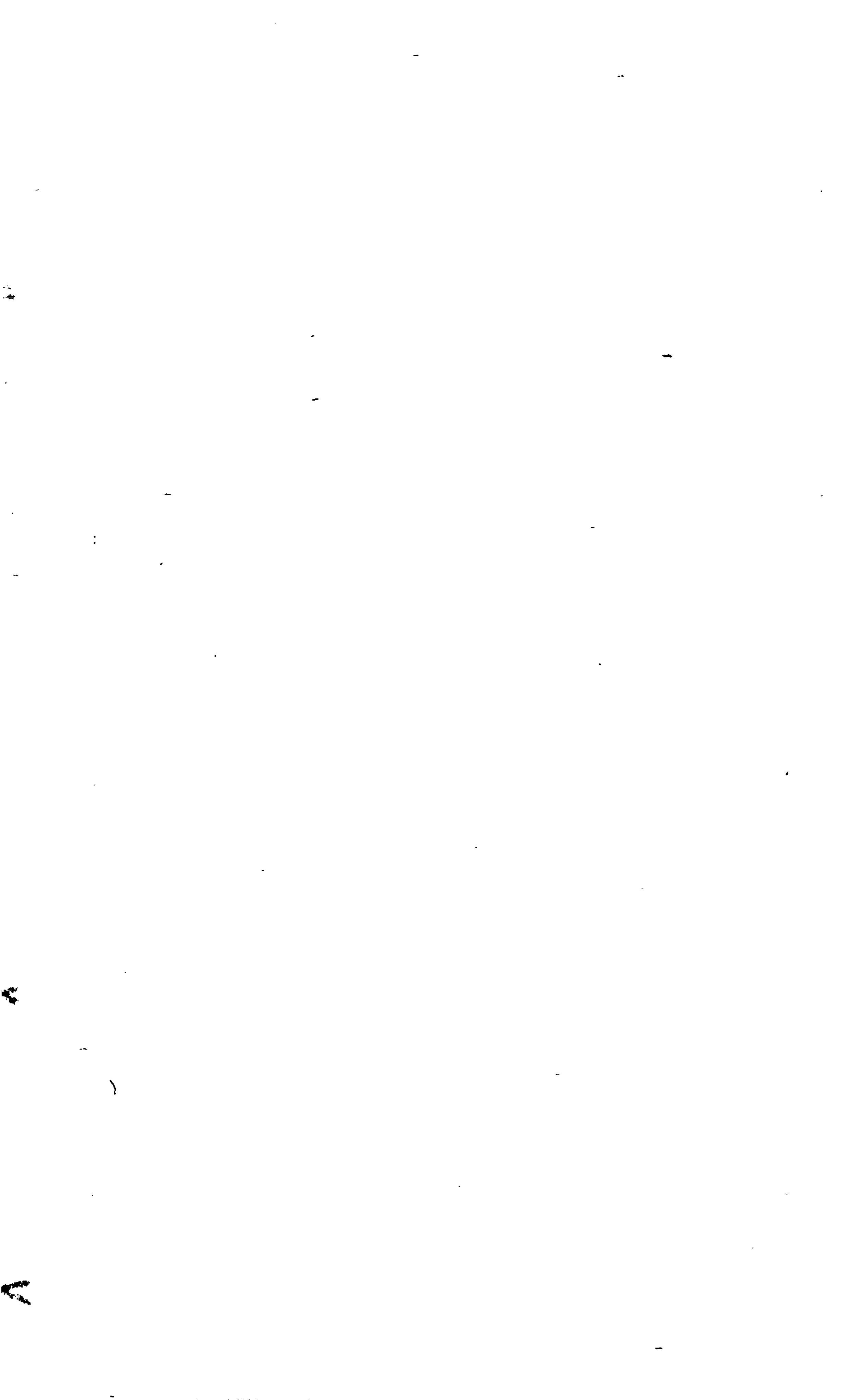
O. L. FROST, Jr.

Enclosure.

SUGGESTED STATUTORY CLARIFICATION OF PROPOSED SEC 819A(h) OF THE INTERNAL REVENUE CODE INCLUDED IN SEC. 1043 OF THE TAX REFORM ACT OF 1975 RELATING TO THE TAX TREATMENT OF CONTIGUOUS COUNTRY BRANCHES OF DOMESTIC LIFE INSURANCE COMPANIES

"(h) Special Rule for Domestic Stock Life Insurance Companies.—At the election of a domestic stock life insurance company which has a contiguous country life insurance branch described in subsection (b) (without regard to the mutual requirement in subsection (b)(3), assets of the branch may be transferred to a foreign corporation organized under the laws of the contiguous country without the application of section 367 or 1491; subsection (a) shall apply to the stock of such foreign corporation as if such domestic company were a mutual company and as if the stock were an item described in subsection (c); and, dividends paid to such domestic company by the foreign corporation shall be treated as an addition to which subsection (e)(2) applies. The insurance contracts which may be transferred pursuant to this subsection include only those which are similar to the types of insurance contracts issued by a mutual life insurance company. Notwithstanding the first sentence of this subsection, if the aggregate fair market value of the invested assets and tangible property which are separately accounted for by the domestic life insurance company in the branch account exceeds the aggregate adjusted basis of such assets for purposes of determining gain, the domestic life insurance company shall be deemed to have sold all such assets on the first day of the taxable year for which the election under this subsection applies and the net gain shall be recognized to the domestic life insurance company on the deemed sale, but not in excess of the proportion of such net gain which equals the proportion which the aggregate fair market value of such assets which are transferred pursuant to this subsection is of the aggregate fair market value of all such assets."

Capital Loss Carryovers of Regulated Investment Companies



Statement on Behalf of the Investment Company Institute

CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

This statement is submitted by the Investment Company Institute in support of Section 1403 of H.R. 10612 which would amend Section 1212(a)(1) of the Internal Revenue Code to extend the net capital loss carryover for regulated investment companies from 5 years to 8 years. In so doing, Section 1403 would partially correct a serious inequity existing between the treatment of net capital loss carryovers for regulated investment companies as compared with individual taxpayers and other corporations.

The Investment Company Institute is the national association of the mutual fund industry. Its membership consists of 383 mutual funds, and their investment advisers and principal underwriters. Its mutual fund members have over 8 million share holders and assets of approximately $48 billion, representing about 93 percent of the assets of all U.S. mutual funds. The average investment of each shareholder is thus about $6,000.

Mutual funds, referred to in the Internal Revenue Code as "regulated investment companies," provide a medium for large numbers of persons to pool their investment resources in a diversified list of securities under professional management. The regulated investment company represents, in general, an intermediate layer between the investor and the entities whose securities it acquires with the investor's funds. It does not compete with those entities but merely provides an alternative means for investing in them with diversification of risk and professional investment management.

In recognition of these functions, the Internal Revenue Code for many years has provided in Subchapter M "conduit" income tax treatment for those corporations, under which no corporate income tax is levied on the companies as long as they distribute currently their net income and net capital gains to their shareholders. The shareholders pay tax currently on the receipt of those distributions. The distribution made out of net-long-term capital gains, called "capital gain dividends," retain their character as long-term capital gain in the hands of the shareholders.

If the regulated investment company incurs a net capital loss for any year, the loss is not deductible by the company against other income nor is it deductible by the shareholders. The net capital loss may be carried forward by the company for 5 years and used as an offset against capital gains of the company for that subsequent 5 year period.

Prior to the Revenue Act of 1964, in the case of all taxpayers, both corporations and individuals, net capital losses could be carried forward for 5 years but not carried back to earier years. In the 1964

Act the 5-year limit on capital loss carry-forwards was dropped for individuals, but retained for corporations. In the Tax Reform Act of 1969 corporations were allowed to carry back net capital losses for 3 years in addition to the right of a 5 year carry-forward, but the right of carry-back was not extended to regulated investment companies (Section 1212(a)(4)(B)). Thus at present corporations in general can carry over net capital losses of any year to 8 other years (3 prior and 5 subsequent years), and individuals have an unlimited carry forward, but regulated investment companies can carry over net capital losses only for 5 other years—the 5 subsequent years.

The Investment Company Institute submits that this 5-year limitation on regulated investment companies is unfair and inconsistent and believes that it should be changed. Since our surveys indicate that only about one-half of 1 percent of mutual fund shareholders are corporations (exclusive of incorporated tax-exempt organizations, such as charities), and since mutual funds distribute currently their net capital gains to shareholders (in whose hands they are taxed), there is considerable justification for making the unlimited capital loss carry-forward rule for individuals applicable to mutual funds.

At the least an 8-year carry-over, as provided in Section 1403 of H.R. 10612, should be permitted to mutual funds, since this is the number of years to which corporations may carry net capital losses. A carry-back to earlier years would be unavailing to regulated investment companies and their shareholders, since the companies would have distributed their net capital gains of prior years to shareholders, to whom they would have been taxed, and the capital loss carry-back could not be made available to the shareholders under subchapter M.[1] Hence a capital loss carry forward to 8 subsequent years should be permitted, at a minimum, to equ te these companies at least with other corporations.

Until recent years the limited 5 year carry-over period did not create a practical problem for regulated investment companies and their shareholders. However, the substantial decline of securities prices which began in the late 1960's has created a severe problem under this limitation. A number of Institute member mutual funds have incurred substantial net capital losses in years going back to 1970, and have not had sufficient capital gains in intervening years to absorb them.

Last year the Institute made a survey of 50 of its member mutual funds, representing approximately two-thirds of the assets of all mutual fund members of the Institute.

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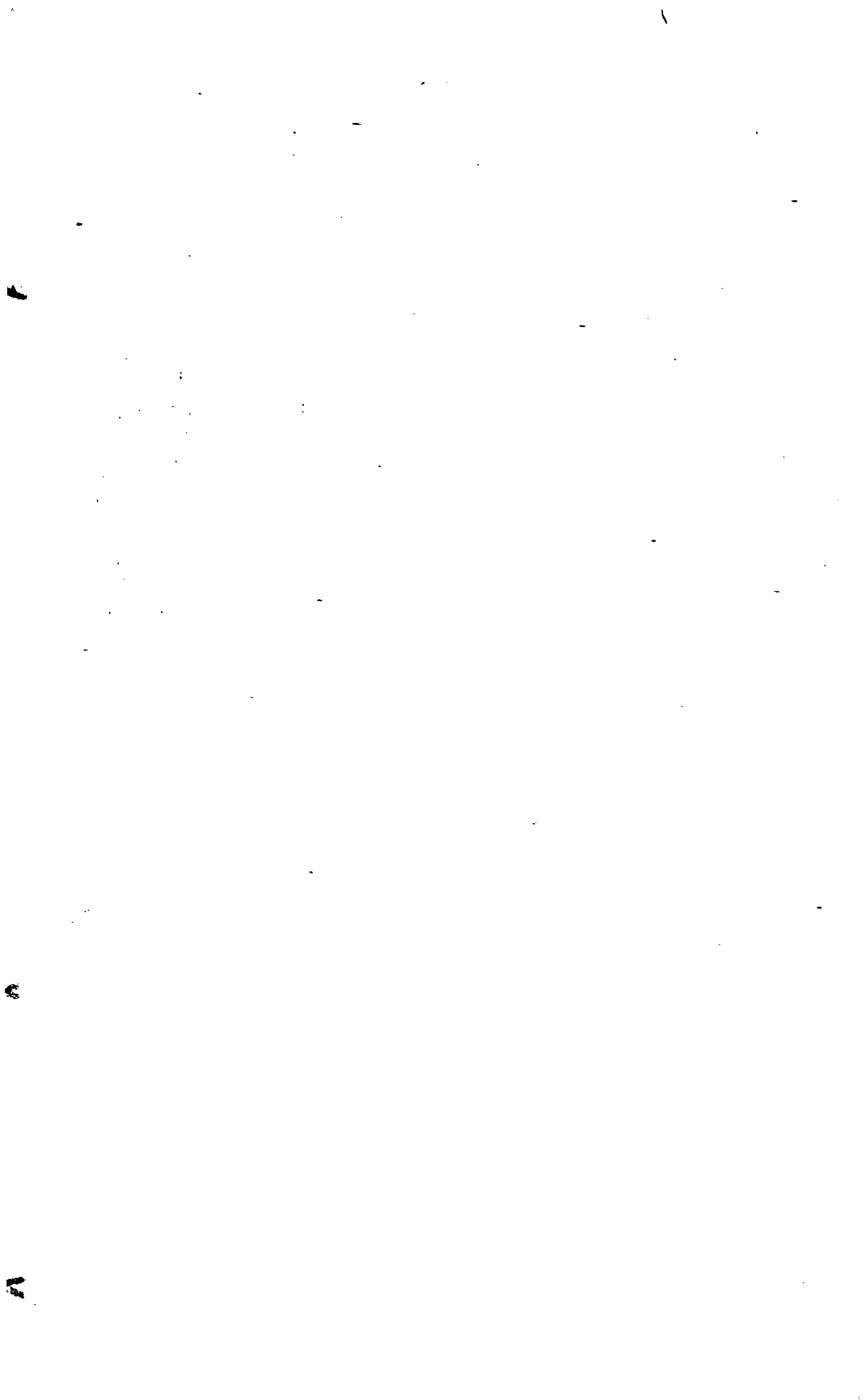
[1] Section 852(b)(3)(D) permits a regulated investment company to retain net capital gains but have the undistributed capital gains taxed to the shareholders as though they had been distributed. The shareholders including in their individual returns their pro rata share of the company's net capital gains are allowed a credit for the 30 percent capital gains tax paid by the company. This procedure is not frequently used, but even when it is used a capital loss carry-back would not be appropriate because the capital gains of the earlier year have been taxed at the shareholder level and allowance of refunds to the shareholders, stemming from the carry-back, would be impractical and inconsistent with the capital loss carry-over provisions for individual investors.

A summary of the results of the survey is as follows:

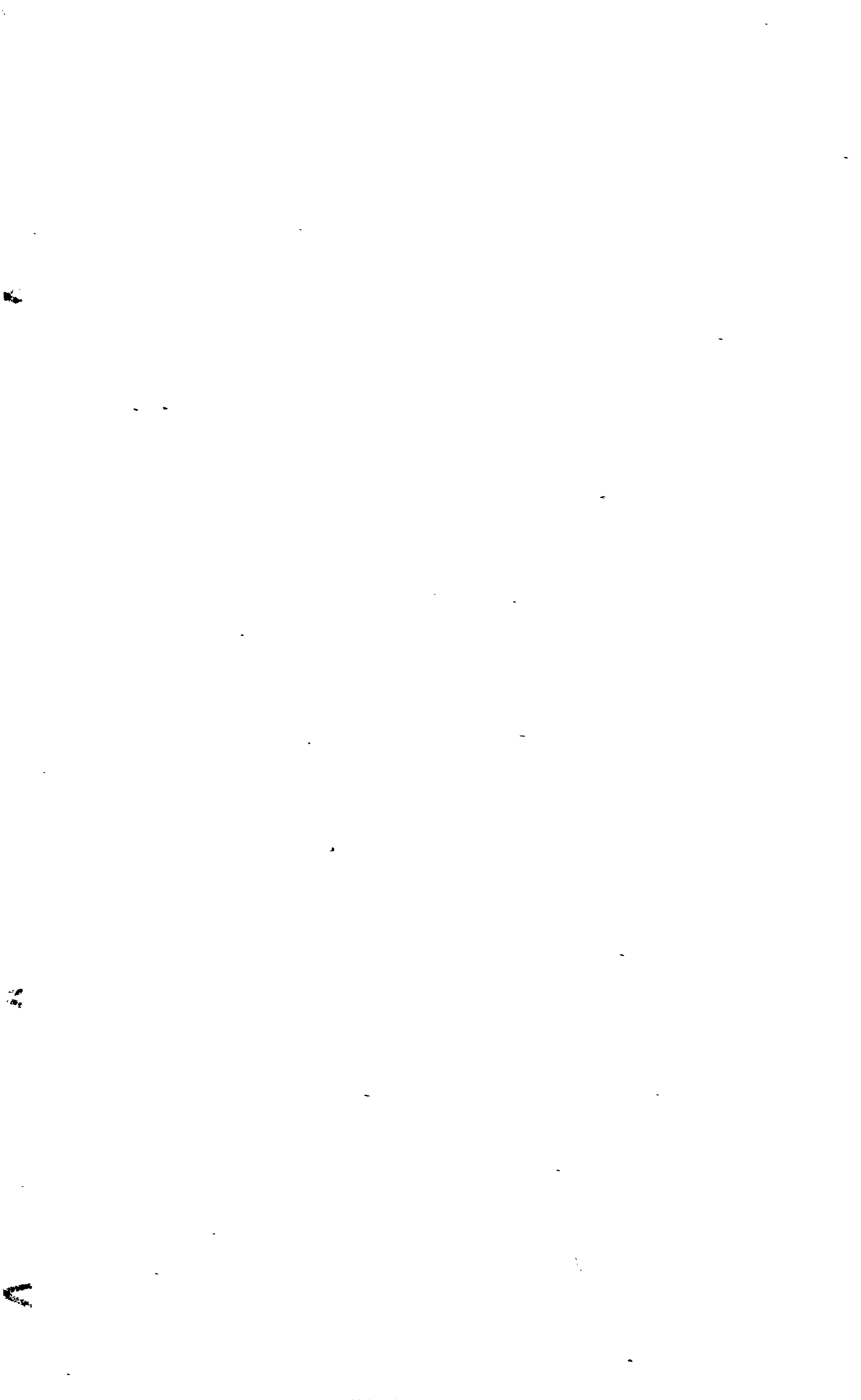
Fiscal year ending following calendar years	Future years[1] (millions)	Number of funds
1970	$458.2	13
1971	72.7	6
1972	22.5	3
1973	458.0	19
1974	920.9	36
Total loss carryover at the end of the most recent fiscal year	[2] 1,932.3	

[1] Dollar amount of capital loss carryover.
[2] These are figures for the mutual funds included in the Institute sampling. They do not include figures for: (a) Institute members not sampled, (b) "closed-end" regulated investment companies, and (c) non-Institute member mutual funds

The survey thus shows that nearly a half-billion dollars of capital loss-carryovers will very likely be lost to these regulated investment companies after 1975 because of the 5-year limitation rule. Unless the Code is amended to extend the carry-over period, capital gains realized in 1976 and subsequent years would have to be distributed to shareholders and taxed to them without regard to net capital losses realized more than 5 years earlier. The matter is thus of immediate importance to these companies and their shareholders. Accordingly we urge that the Committee approve Section 1403 of H.R. 10612 so that the present 5-year capital loss carryover period is extended to 8 years in the case of regulated investment companies.



Tax Treatment of Dividends



CHROMALLOY AMERICAN CORP.,
St. Louis, Mo., April 6, 1976.

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

DEAR MR. CHAIRMAN: I am privileged and grateful to you, the members of the Senate Finance Committee, for the opportunity of presenting to you my views as they relate to tax reform with particular emphasis on the problems of equity financing of the nation's industries.

I serve as Board Chairman and Chief Executive Officer of Chromalloy American Corporation. We are a diversified company with manufacturing and service companies located in a number of states represented by you who are serving on this committee. We currently employ 22,000 people, a number which has decreased from 26,000 on January 1, 1974. This lack of growth in the number of employees brings me to the subject under discussion today.

Basic to our economy is the production of food and fiber and our ability to provide products and services. All require three ingredients. First, a public need for the products or service; second, money to design products and to house and equip production facilities; and third, people to man the machines to produce the food, the product, or service. Any one of these ingredients, in short supply, cripples the ability of an industrial nation to prosper. The past few years have seen a growing inability of American business to raise the money or capital needed for its growth or survival. This ingredient in short supply is basic to our economic problems of this period.

Over the years, due to budget deficits including costs of wars, defense, foreign aid and social problems of an expanding population, our government has become annually a greater competitor for the use of the existing money supply. The result of government financing and refinancing of its obligation has been to dry up sources of equity capital for the industry and commerce of the nation.

Since business and industry cannot finance these needs through the sale of corporate securities, it became necessary to revert to credit sources, banks, life insurance companies and other lending institutions. They become competitors with the government in the money markets thus creating exorbitant interest rates. Increasing interest rates, in my opinion, represent the greatest single source of inflation represented by spiraling costs and resultant prices. Add to this capital needs to provide nonproductive, antipollution devices and equipment to meet ever increasing requirements of government regulations. This, I realize, is an over-simplification of a few causes of inflation that seem apparent to me.

In the event that the Federal Reserve System is to prevail at maintaining a money supply growth at an annual basis of 5 percent, we will be faced with an ever decreasing supply of money in proportion

to the demand. If American industry is to remain viable, it must be able to raise new funds through equity financing. Ability to do this would be enhanced if stockholders were placed on the same footing as individuals who acquired tax free government securities. Currently, corporate dividends have been reduced by corporate profits tax of approximately 50 percent and, when received by the stockholder, are again subject to individual income tax. In face of the risk of corporate investment with returns subject to double taxation, investors find corporate securities undesirable. Exemption of dividends paid on corporate securities from individual income taxes would place them on equal footing with tax exempt securities.

An exemption of the corporate dividends tax at first glance would seem to be prejudicial in favor of business and industry. However, upon closer examination, one finds that business and industry are largely owned by some thirty million shareholders in the United States most of whom are middle income married adults. They represent a huge percentage of the electorate which in this issue (double taxation) has been grossly abused and neglected. In our corporation alone, approximately ten percent of its shares are held by labor pension funds. While the pension funds are not taxed, it must be remembered that they have a deep interest in a recovery in the marketplace of the equity values. Certainly you are aware of how badly these values have deteriorated.

Investment tax credit is under constant attack. In fact, it is inadequate to enable industry to retain sufficient earnings after taxes to cope with the monetary demands placed on them for capital. This capital is necessary if industry is to expand, to provide job opportunity and to modernize to increase productivity, which the economists claim will help defeat inflation, and to clean up the air and water to satisfy the environmentalists.

At the risk of being repetitious, I would like at this time to attempt to again dispel an impression that seems to prevail in the Federal Government. This impression being that organized labor and its interests are diametrically opposed to the interests of business and industry. This is a totally erroneous impression. We know firsthand that both labor and business interests will work hand in hand in securing proper and prompt remedies to our current economic problems with a concerted effort in the capital providing areas that will create new jobs.

Common stock representing an equity interest in the nation's business and industry are not owned exclusively by the very rich but instead are owned by an estimated eighty million Americans. This extending to pension, insurance, and mutual funds as well as private ownership. Both labor and industry have a vital interest in maintaining the value of these assets in which they have substantial investments. It would appear that government as the representative of these same people should have a similar interest.

To return to the subject of capital formation, we must first recognize that industry depends for its existence and its growth upon an ability to get money permanently invested in the corporation itself. That means through the medium of the sale of shares of its stock. Now, with the decline in value of those shares, not actual value but at least in selling prices which has taken place through some five years now of

constant attrition, the employers—the thousands like myself—are denied the opportunity to issue additional shares because the shares are not selling, not being bought by the public for anything near their real value. There are several hundred fine corporate stocks on the New York Stock Exchange that sell today for as little as thirty percent of their book value, which is the real liquidation value of the company. Our own company closed today at around $14.00 per share. The actual value of each share in goods and properties and machinery is somewhere in the neighborhood of $22.00. If I want to expand my business and I want to get capital to do so, I could not be loyal to my shareholders and offer $22.00 worth of value at a price of $14.00 and then be forced, if I want to continue to expand, to go to what is known as the "borrowed money market".

We need a frontal attack on unemployment. We need programs, policies and the funds necessary to turn the economy around now, and a recommitment to the goal of full employment set thirty years ago. This is not an impossible dream. It can and must be done.

I can best illustrate the problems and a possible solution by using the facts contained in the attached charts which are based on the financial functioning of the corporation that I am responsible for. (See Exhibit A)

For these reasons we urge that you and your Committee give full consideration to incorporation of the described amendments in any tax legislation that is reported to the Senate for action.

Thank you very much for your consideration. We would like to request that this letter be made a part of the permanent record of hearings on this legislation.

Very truly yours,

JOSEPH FRIEDMAN.

CHART DESCRIPTION ON ELIMINATION OF DOUBLE TAX ON DIVIDENDS

Chart I—America's Hunger for Capital—Capital is the essential resource if America is to continue in the path of economic growth and prosperity. The demand for this resource is projected to reach the astronomical sum of $4.5 trillion dollars.

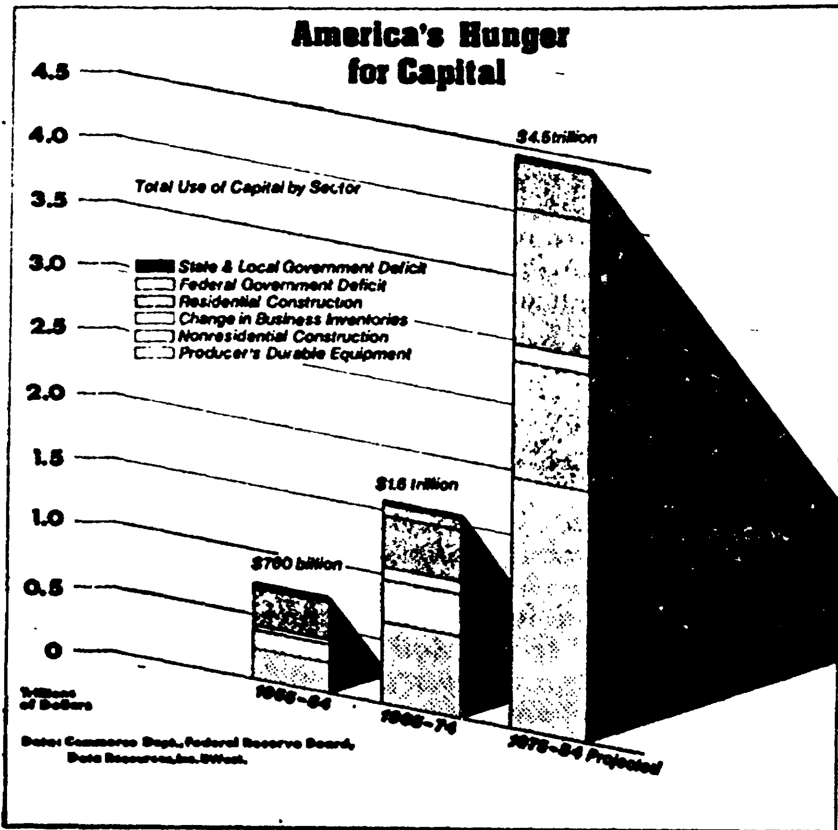
Chart II—One of the primary reasons that the demand for capital is increasing is that the capital invested per employee has been steadily increasing (partly due to inflation) in the past ten years. In fact, it has doubled.

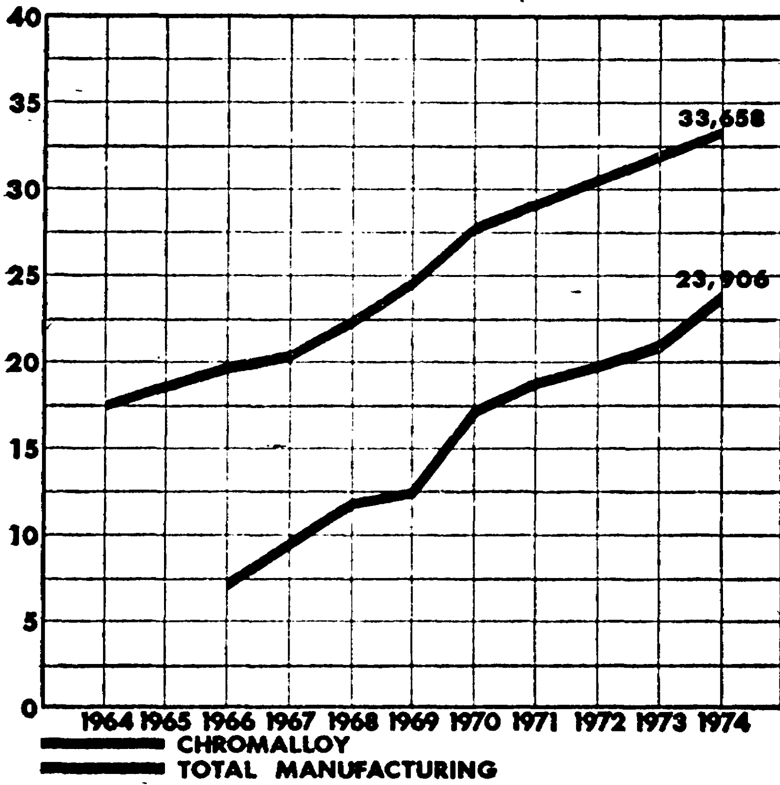
Chart III—Capital means jobs. Historically companies, when faced with a capital shortage, have reduced their capital appropriations which has had the effect of increasing the unemployment rate. Simply put, corporations without the money to expand or improve their facilities cannot create the jobs needed.

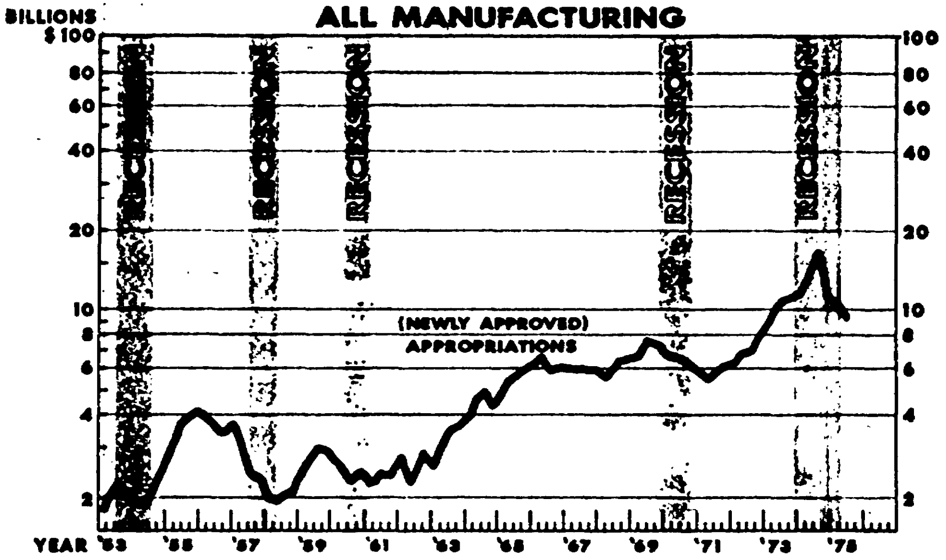
Chart IV—One solution to the capital formation problem is to eliminate the double tax on dividends. This action would place equity securities on a parity with tax free obligations and create an upward movement in corporate security paper, thus providing industry opportunities for equity financing to provide the funds for industries expansion, creating more jobs, more income tax revenues and a resumption of a growth in the gross national product.

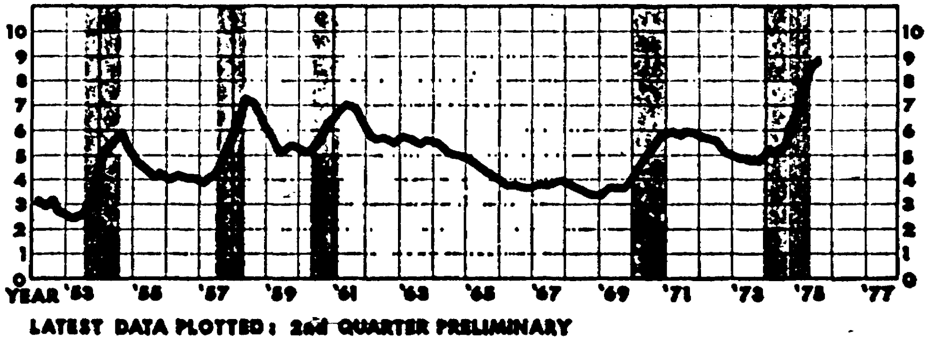
Chart V—An obvious question concerning the elimination of the double tax is the effect on federal revenues. Various Treasury and private studies indicate a possible revenue loss of $19 billion. However, these estimates *do not* take into account any changes in economic activity which would flow from the proposed change. In effect, it is assumed that the provision will be enacted in a vacuum and that no compensating changes would result. With respect to provisions affecting available capital and productive investment, this is an unrealistic procedure. Taking into account the increased economic activity which would result from having additional capital to invest, we estimate that instead of a large revenue loss, there would actually be a small revenue gain. More importantly, by the end of 1978—1,700,000 additional jobs would be created.

Chart IV—Elimination of Double Tax on Dividends—Effect on Chromalloy.



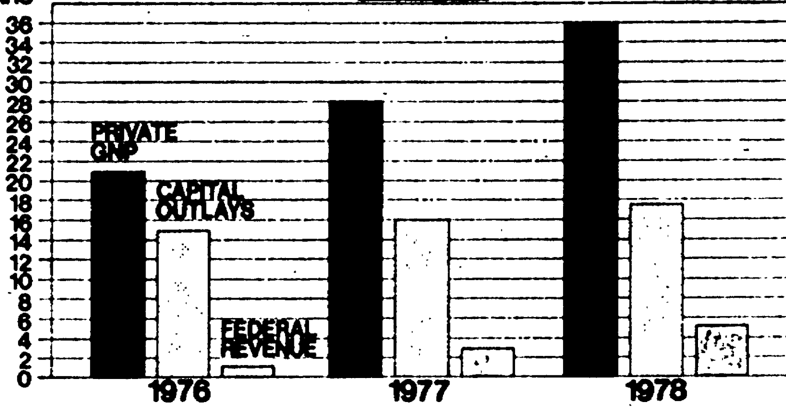

CAPITAL INVESTED PER EMPLOYEE
40
35
30
25
20
15
10
5
0
33,658
23,906
1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974
CHROMALLOY
TOTAL MANUFACTURING

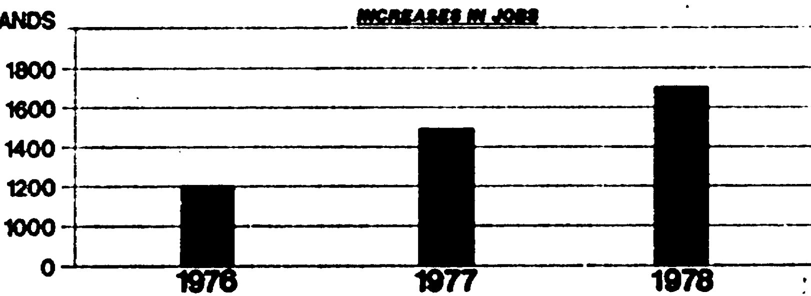




LATEST DATA PLOTTED: 2nd QUARTER PRELIMINARY

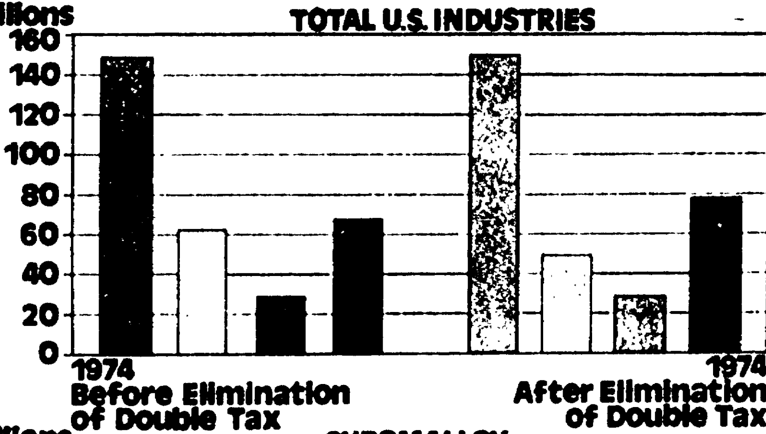
ECONOMIC EFFECTS-ELIMINATION OF DOUBLE TAX ON DIVIDENDS

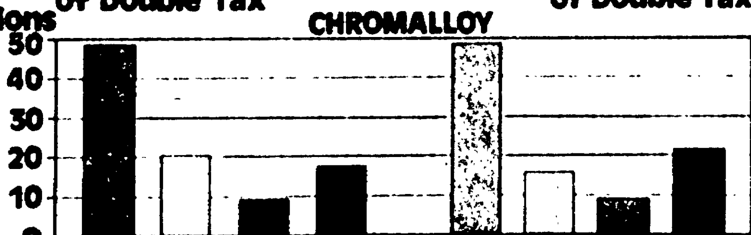




Note that employment effects are not cumulative.

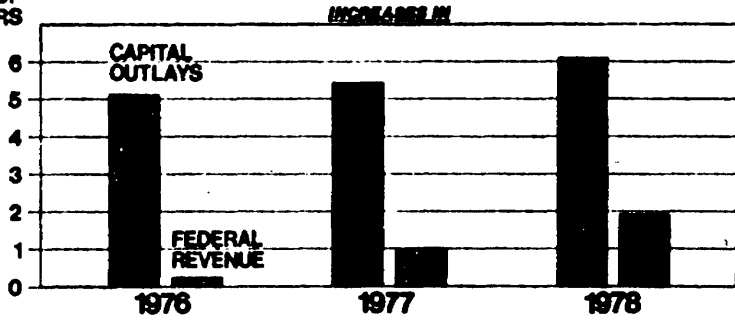
DISTRIBUTION OF CORPORATE PROFITS

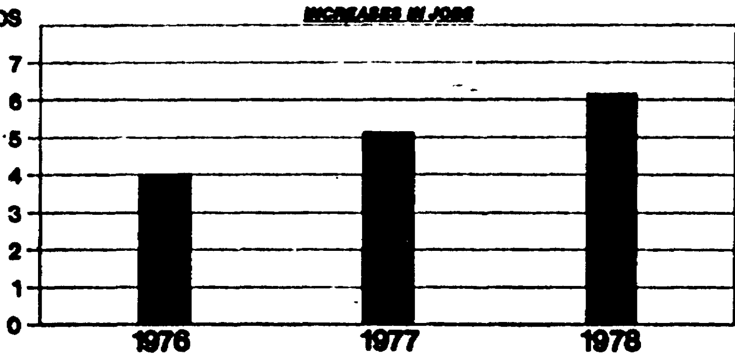




■ Corporate Profit Before Tax
□ Federal Tax
■ Dividends
■ Remaining Funds Available for Investment

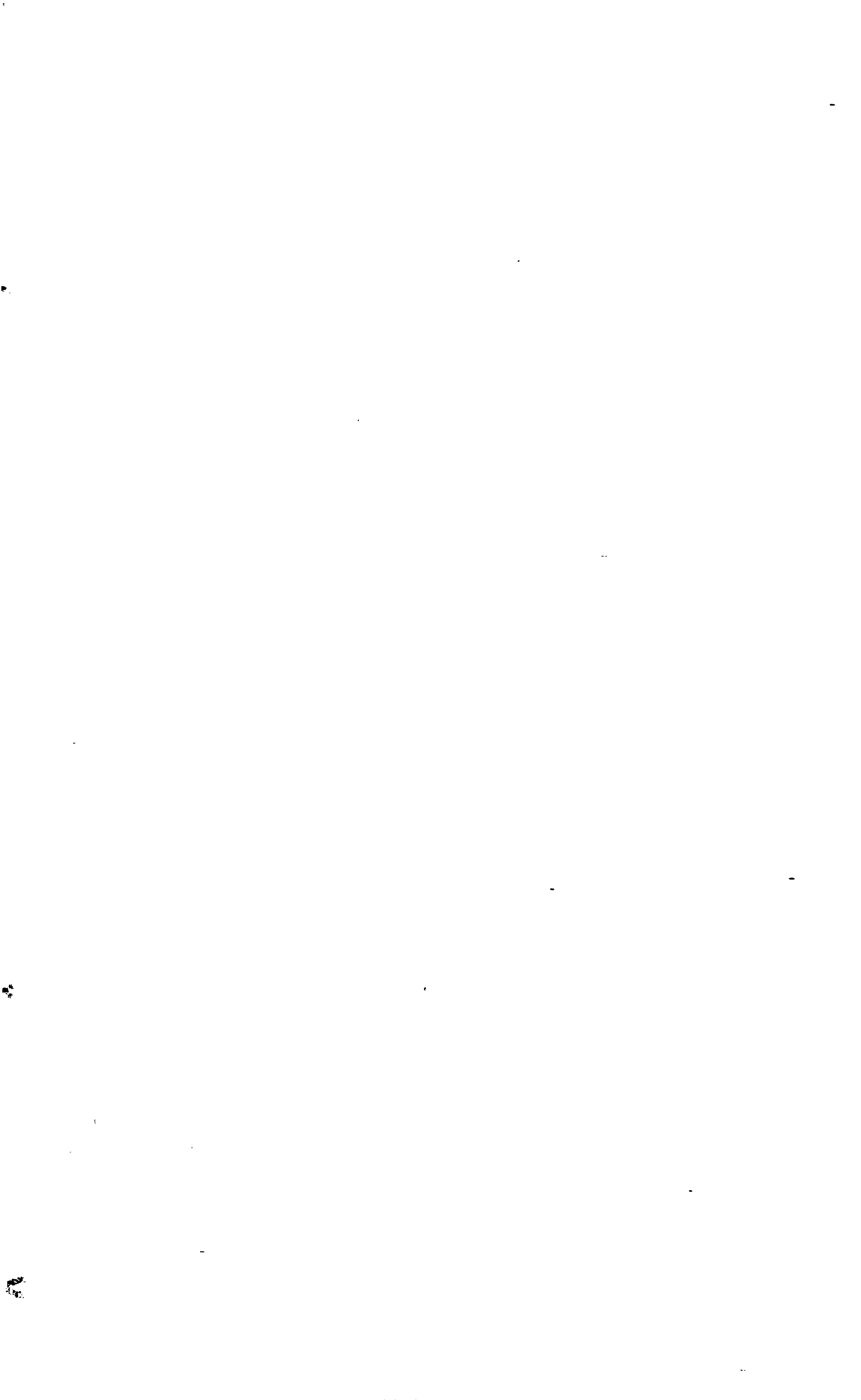
ECONOMIC EFFECTS ON CHROMALLOY-ELIMINATION OF DOUBLE TAX ON DIVIDENDS





Note that employment effects are not cumulative.

Highway Use Tax on Conservation Vehicles



STATEMENT OF MICHAEL E. STROTHER, REPRESENTING THE LAND IMPROVEMENT CONTRACTORS OF AMERICA

This statement addresses the problem of the Federal highway use tax on conservation vehicles. This tax and its state counterparts are particularly burdensome to the small land improvement contractor doing soil and water conservation work for farmers and under various government programs. The bills S. 17 and H.R. 2260, pending before the Finance Committee and Ways and Means Committee respectively, would exempt these vehicles from the highway use tax.

The bills, as written, would exempt those vehicles "not for hire" and used *exclusively* in soil and water conservation work. A conservation vehicle is a tractor-trailer or dump truck used to perform conservation work or for hauling conservation related equipment and materials to and from job sites. They now fall under the general Internal Revenue Service tax classifications as outlined on the attached diagram. Conservation vehicles are primarily A, B, D, H models shown, depending on axles, trailers, and weights. They are used to transport bulldozers, trenchers, crawler loaders, draglines, materials, and earth itself.

Conservation vehicles are employed in the construction of farm ponds and dams, waterways, terraces; and in construction of watersheds, floodwater retarding structures, and stream bank stabilization projects.

The local conservation operator is a small businessman with limited operating capital. Capital formation is a chronic problem in his business operations. He employs an average of only six full-time employees and grosses under $100,000 a year. He is primarily engaged in work for the Soil Conservation Service (USDA), the Agricultural Stabilization and Conservation Service (USDA), and local farmers. The conservation contractor plays an important part in keeping the cost of food production low and in maintaining our soil, water and food producing resources for future years.

The small business status of the conservation contractor is certified by the attached letter from Mr. William Pellington, Director of Size Standards, Small Business Administration, and in a corresponding letter from Senator Gaylord Nelson, Chairman of the Senate Small Business Committee.

There has been a chronic shortage of private contractors in recent years. Existing conditions have driven many qualified operators into other fields or to reduce operations. Thus, a significant incentive is needed to attract new contractors to this vital work. Mr. Mel Davis,

69-516—76—pt. 8——5

Administrator of the Soil Conservation Service, said of such an exemption in a letter to Senator Robert Dole:

> In recent years, there has been a shortage of contractors to perform soil and water conservation work approved by conservation districts with Soil Conservation Service technical help. Any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

The present federal highway use tax on conservation is grossly inequitable in our estimation. These limited-use vehicles average only 5,000 miles a year—with over 70 percent of this mileage on state and country roads. In comparison, a similar "for-hire" commercial rig often will travel as many miles in a single week on Interstate and other federal highways. Yet, both pay the same highway use tax.

The average *federal* tax paid on a conservation vehicle nationwide is $175 a year. *State* taxes range up to several thousand dollars a year. The federal highway use tax paid on all vehicles ranges from $81 to $240 a year. It is not unusual for an operator to pay $1,000 a year on a tractor-trailer that carries a bull-dozer from one conservation project to another while traveling under 1,000 miles in the year. The equivalent tax here is over $1 per mile. Yet, the vehicle is employed in the public interest and rarely uses federal roads.

An industry-wide survey conducted in May of 1975 showed there are approximately 40,000 vehicles in the country which could possibly qualify as "conservation vehicles." Not every one of these would ultimately qualify, however, under subsequent federal regulations. Each operator owns an average of two such vehicles.

According to the Joint Committee on Internal Revenue Taxation, tax revenue loss would not exceed $7 million a year from such an exemption. A copy of Dr. Laurence Woodworth's letter containing this estimate is attached.

Conservation vehicles serve the public interest in many ways. A majority of these vehicles are at one time or another employed in the U.S. Agriculture Department's Agricultural Conservation Program (ACP). ACP has helped farmers establish conservation practices on about 1 million farms a year. In a typical recent year, the program helped build 45,000 water storage reservoirs, to help control erosion, conserve water, and extend pollution abatement, and provide habitat for wildlife. During the same year 600,000 acres were serviced by terraces to stabilize land and reduce stream pollution; another 300,000 acres of contour and field strip cropping reduced air and water pollution.

In recent House hearings on conservation it was demonstrated that we started with about 500 milion tons of topsoil to grow our food. To date some 200 million tons have washed or blown away, and another 100 million tons are now being eroded. This eroded soil has caused the biggest single water pollution problem in our Nation's waterways.

Support for an exemption for conservation vehicles has come from several sources. The National Association of Conservation Districts endorsed both S. 17 and H.R. 2260 in December of 1975, in letters to Chairmen Russell Long and Al Ullman. A copy of their letter is attached. Mr. Mel Davis, Administrator of the Soil Conservation Service, said of the proposed exemption:

> Today, when full farm production is a major national thrust, resource protection is vital. Most acres now being brought into crop use to meet food and fiber needs will require careful conservation measures for sustained production and protection against air and water pollution. Thus, there is a need for more conservation contractors to place the practices on the land.

Six states have provided full or partial exemption from state use taxes for these vehicles. They are Illinois, Kansas, Minnesota, Nebraska, South Dakota, and Texas. We offer the following excerpt from Nebraska state law as a sample of wording now on the books:

> 60-331.03. Registration fee; trucks, truck-tractors, trailers, semitrailers; For the registration of trucks or combinations of trucks, truck-tractors or trailers or semitrailers which are not for hire and engaged in soil and water conservation work and used for the purpose of transporting pipe and equipment exclusively used by such contactors for soil and water conservation construction, the registration fee shall be one half of the rate for similar commercial vehicles registered under section 60-331; Provided, that no vehicle registered under this section shall be registered for a fee of less than eighteen dollars; and provided further, that such vehicles shall carry on their license plate in addition to the registration number the letter A.

State experiences with their own exemption programs have been universally good. Officials from several states have directly endorsed S. 17 and H.R. 2260.

Illinois.—"In my opinion it is definitely in the public interest and greatly to the advantage of rural America for (the passage of) either S. 17 or H.R. 2260." (Hon. Gale Schisler, Chairman, Agricultural Committee, Illinois House of Representatives.)

Nebraska.—"As Chairman of the Public Works Committee, may I encourage consideration for . . . the proposal to exempt (conservation operators) from paying the federal highway use tax on such trucks." (Hon. Maurice A. Kremer, Chairman, Public Works Committee, Nebraska State Legislature.)

South Dakota.—"We have not found that the exemptions granted are difficult to enforce. In fact, the members of the State Conservation Contractors Association do a commendable job of self-policing." (Col. Dennis Eisnach, Superintendent, South Dakota Highway Patrol.)

Copies of the letters containing the above quotations, and others concerning state experiences with the use tax exemption, are attached for the Committee's reference.

A federal use tax exemption for these vehicles, pending subsequent federal regulations, would be monitored by the IRS as the tax itself is

now. In addition, state motor vehicle departments would be involved where corresponding state exemptions are in place.

As a result of various court proceedings, certain other vehicles have been exempted from the federal highway use tax based on their limited or special use. Now exempt are derrick-drilling trucks, certain logging trucks, and certain over-sized vehicles. These exemptions were established as a result of the following respective court cases: Stafford Well Service vs. U.S.A. (Civil Action 5568—Wyoming, 1971); Carl Nelson Logging Co. vs. U.S.A. (281 F. Supp. 671, 1967); and Rossi vs. U.S.A. (220 F. Supp. 694, 1963) *In both the Stafford and Rossi cases the determining factor was that the highway use of the vehicle was merely incidental to its industrial use. The same is true of vehicles involved strictly in conservation work.*

A study of the several existing state exemptions and current circumstances in the industry suggest that the following features might be used as guidelines for federal regulations under a use tax exemption for conservation vehicles:

(1) To qualify, equipment should be that which is used on a "not-for-hire" basis, and exclusively for the purpose of transporting machinery used in soil and water conservation practices;

(2) The annual mileage for the vehicles over the public highways should not exceed 6,000 miles a year;

(3) The equipment should be operated within a radius of 500 miles from the owner's residence or place of business;

(4) The requirement of a sworn affidavit attesting to the above stipulations to accompany the annual registration;

(5) A requirement of the states that they issue special registration license plates to identify and control such vehicles.

We sincerely believe the exemption of conservation vehicles from the federal highway use tax is equitable and will stimulate more conservation. Such an incentive would encourage other states to follow suit on their own use taxes, and thus significantly increase the incentives to attract and hold new operators for vital soil and water conservation. Proper conservation in turn reduces the cost of producing our food and fiber needs. Such a move would also improve the health of one sector of the small business community and so contribute to our overall national economic growth. Thus, the Committee's action would have an aggregate effect beyond the seemingly small proportions of the exemption itself.

In closing, we urge the Committee to take the lead in exempting bona fide conservation vehicles from the highway use tax by so amending H.R. 10612, the Tax Reform Act of 1975.

We thank the Committee for the opportunity to submit this statement and related materials in their entirety. A summary fact sheet of background information on this provision is reproduced on the next page for the Committee's reference.

FACT SHEET ON H.R. 2260 AND S. 17

(1) H.R. 2260 and S. 17 are companion bills designed to exempt vehicles used *exclusively* in soil and water conservation from the federal highway use tax.

(2) S. 17 was introduced by Senator Robert Dole (R–Kan), and now has two other cosponsors—Senators Dick Clark (D–Iowa), and Paul Fannin (R–Ariz.), giving it bipartisan support. H.R. 2260 was introduced by Rep. Charles Thone (R–Nebr). Both bills have been endorsed by the National Association of Conservation Districts.

(3) Conservation vehicles are tractor-trailers and dump trucks used solely in conservation. There are approx. 40,000 eligible vehicles nationally. They are now subject to an *average* federal tax of $175 a year, and state taxes up to $1,000 a year.

(4) The annual lost revenue would not exceed $7 million, as projected by the Joint Committee on Internal Revenue Taxation.

(5) These are limited use vehicles. The average conservation vehicle, as determined by national survey, travels only 3,000 miles a year—with 80% of that over state and county roads.

(6) Other highway vehicles have been exempted from the federal use tax through legal proceedings. These include derrick-drilling trucks, certain logging trucks and oversized vehicles.

(7) Conservation vehicles are used in preventing soil erosion and water pollution. In a single recent year they were used to build 45,000 water containment structures, 600,000 acres of agricultural terraces, and to date, to build 400 watershed projects covering over 700 million acres of land.

(8) In virtually every case, these vehicles are operated by small businessmen as defined by the Small Business Administration in a recent evaluation transmitted to the Senate Small Business Committee. The average operator has only 6 employees and grosses under $100,000 a year.

(9) The present Administrator of the Soil Conservation Service (USDA) formally said of a use tax exemption for conservation vehicles:

> In recent years there has been a shortage of contractors to perform soil and water conservation work . . . any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

(10) Six states now make some provision for reduced taxes for conservation vehicles. These are: Illinois, Kansas, Minnesota, Nebraska, South Dakota, and Texas. State experiences with their own exemptions have been good. In many cases special license plates are issued to control vehicle use. Illinois Secretary of State Michael Howlett wrote to the two Congressional tax committees:

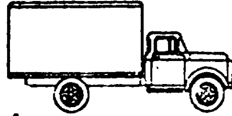
> This privilege has not been abused. . . . The plate has not resulted in a significant loss of revenue and has not caused administrative problems.

Federal Highway Use Tax

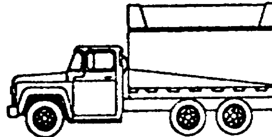
on trucks, truck-tractors and buses

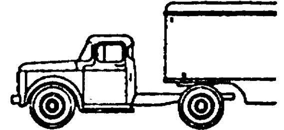
Publication 349
(Revised May 1973)

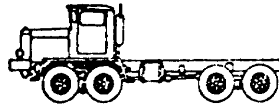
Department of the Treasury
Internal Revenue Service

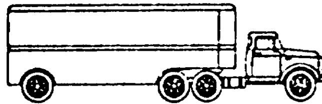


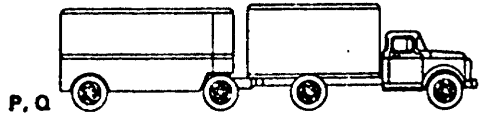
These pictures illustrate most of the types of vehicles subject to the use tax. Its taxable category is indicated by the letters. Consult the tables on pages 9, 10, and 11 for the amount of the tax on each taxable category.

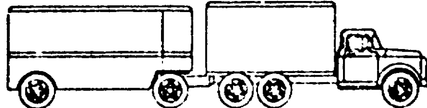












U.S. SMALL BUSINESS ADMINISTRATION,
Washington, D.C., December 10, 1975.

Mr. MICHAEL E. STROTHER,
Washington Representative, Land Improvement Contractors of America, Washington, D.C.

DEAR MR. STROTHER: We are pleased to reply to your letter dated December 3, 1975, concerning the size standard applicable to your membership.

All of the activities listed in your letter are classified in SIC Industry 1629, *Heavy Construction, Not Elsewhere Classified.* The applicable size standards for SIC 1629 are average annual receipts of $12 million or less for the preceding 3 fiscal years for the purpose of bidding on Government procurements, and $9.5 million or less for the purpose of obtaining a Small Business Administration loan.

If further information is required, please let us know.

Sincerely,

WILLIAM L. PELLINGTON,
Director, Size Standards Division.

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C., December 18, 1975.

Mr. MICHAEL E. STROTHER.
Washington Representative, Land Improvement Contractors of America, Washington, D.C.

DEAR MR. STROTHER: This will acknowledge your letter of December 11, transmitting background material on the percentage of land improvement contractors who might be classified as small business.

We note from the article in *Land and Water Development* magazine that the average payroll of a member company is about 11 persons, less than half of which are full-time. We also noted that almost two-thirds of your member companies have gross incomes of under $100,000 a year, with 96 percent grossing less than $400,000 a year, figures well below the SBA size standards of $9½ million for the applicable SIC No. 1629.

We appreciate having this information and will bear it in mind in considering any tax matters related to this branch of the construction industry. We also appreciate your efforts in obtaining this material and in informing the Committee of the situation with your small business member companies.

Sincerely,

GAYLORD NELSON, *Chairman.*

U.S. DEPARTMENT OF AGRICULTURE,
SOIL CONSERVATION SERVICE,
Washington, D.C., July 31, 1975.

Hon. ROBERT DOLE,
U.S. Senate.

DEAR SENATOR DOLE: This is in response to your letter of July 17, 1975, concerning the impact of the Highway Use Tax on vehicles used exclusively in soil and water conservation work.

Most contractors who install ponds, terraces, waterways, and other soil and water conservation measures are small, local operators. They usually own a few pieces of earthmoving equipment, and trucks to transport the equipment from one farm or ranch to another.

These contractors, in most states, seldom travel for long distances over paved highways. Many times travel is over unpaved roads that parallel or cross major highways.

Since these small operators use highways considerably less than other truckers, some feel they should not have to pay the same rate of highway tax (according to Title 26 of the Internal Revenue Code, Section 4481, now based on a taxable gross weight of more than 26,000 pounds at the rate of $3 per year for every thousand pounds of taxable gross weight or fraction thereof). We must recognize, however, that to exempt only these vehicles, when farmers and others use highways on a comparable basis but would continue to pay the tax would also be unfair.

In recent years, there has been a shortage of contractors to perform soil and water conservation work approved by conservation districts with Soil Conservation Service technical help. Any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

Today, when full farm production is a major national thrust, resource protection is vital. Most acres now being brought into crop use to meet food and fiber needs will require careful conservation measures for sustained production and protection against air and water pollution. Thus, there is a need for more conservation contractors to place the practices on the land.

Your concern for soil and water conservation work is greatly appreciated.

Sincerely,

R. M. DAVIS, *Administrator.*

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., September 8, 1975.

Hon. ROBERT DOLE,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOLE: This refers to your letter of August 5, 1975, in which you ask us to assess revenue impact of two bills in which you are interested.

1. S. 17 (94th Congress) would exempt highway motor vehicles used exclusively in soil and water conservation and in transportation of equipment used for soil and water conservation from the highway use tax. It is estimated that enactment of this proposal would reduce the excise tax liability for the first full year by about $7 million.

2. S. 1105 (93rd Congress) would permit an immediate deduction for expenditures to remove architectural and transportational barriers to handicapped and elderly. It is estimated that enactment of this proposal would reduce the income tax liabilities for the first full year by about $10 million.

Sincerely yours,

LAURENCE N. WOODWORTH.

NATIONAL ASSOCIATION OF CONSERVATION DISTRICTS,
Washington, D.C., December 5, 1975.

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

DEAR SENATOR LONG: We would like to make known to you and your committee the support of the National Association of Conservation Districts for S. 17, the bill that would exempt motor vehicles used exclusively for soil and water conservation work from highway use taxation.

We believe that enactment of this legislation would significantly aid the small land improvement contractor who now has to pay substantial taxes on vehicles that are principally used over short distances to carry heavy equipment from field to field for the construction of terraces, farm ponds, and other vital conservation practices. The services of these contractors are essential in accomplishing soil and water conservation work on farms and ranches, and this exemption would aid materially in helping them to remain solvent and available for service.

We hope that your Committee will approve this legislation.

Sincerely,

DAVID G. UNGER.

ILLINOIS HOUSE OF REPRESENTATIVES,
Springfield, Ill., September 16, 1975.

Re S. 17 and H.R. 2260.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN ULLMAN: It was a pleasure serving and working with you as a member of the House of Representatives in the 89th Congress.

I am writing you as Chairman of the Agriculture Committee of the Illinois House of Representatives.

In my opinion it is definitely in the public interest and greatly to the advantage of rural America for either S. 17 and H.R. 2260, which provide that any motor vehicle used exclusively in soil and water conservation work and in the transportation of equipment used for soil and water conservation is exempt from the Federal highway use tax.

In 1971, the Illinois General Assembly passed the following law:

"3–809.1 S 3–809.1 Vehicles of second division used for transporting soil and conservation machinery and equipment—Registration fee. Not for hire vehicles of the second division used, only in the territory within a 75-mile radius of a designated point, solely for transporting the owner's machinery and equipment used for soil and water conservation work on farms, other work on farms and in drainage districts organized for agriculture purposes, from the owner's headquarters to a farm, from farm to farm, and returning to the headquarters, shall be registered upon the filing of a proper application

and the payment of a registration fee of $325 shall be paid in full and shall not be reduced even though such registration is made during the second half of the registration year." (Ill. Rev. Stat. 1973, ch. 95-½, S 3.809.1)

We refer to the license as the "conservation plate." I regard this as one of the constructive laws enacted by the Illinois General Assembly in recent years.

A survey conducted by the Illinois Land Improvement Contractors Association in 1967 showed that vehicles used exclusively for soil and water conservation purposes used the highways very little when compared with other vehicles.

Because of the limited use of the highways and the need to encourage soil, water, and natural resource conservation, the law providing for the "conservation plate" was enacted.

The law is working very well and is accomplishing its objectives. I am informed by the Office of the Secretary of State that only 233 vehicles have the "conservation plate." The law has not resulted in any difficult administrative problems or a significant loss of revenue.

If S. 17 or H.R. 2260 become law, the Office of the Illinois Secretary of State could furnish you with the names and addresses of the persons who have the conservation plate.

I respectfully request that you use your considerable influence to obtain passage of this legislation that is very important to rural America.

Best regards,

GALE SCHISLER,
State Representative.

SEPTEMBER 29, 1975.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN ULLMAN: It is my understanding that the Land Improvement Contractors of America are engaged in a campaign to gain an exemption from paying the federal highway use tax on trucks used exclusively for the activities necessary for soil and water conservation construction projects.

Several years ago the Nebraska Legislature provided for a reduced rate for licensing such vehicles. We in the Legislature felt that was justifiable in that these vehicles travelled only short distances generally and made little use of our roads and highways.

Soil and water conservation is vitally important to the economy of our State, and construction of such projects needs to be encouraged. As Chairman of our Public Works Committee, may I encourage consideration for these people in the proposal to exempt them from paying the federal highway use tax on such trucks.

Sincerely yours,

MAURICE A. KREMER,
State Senator.

SEPTEMBER 12, 1975.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR MR. LLLMAN: This office has been contacted regarding pending legislation. This action involved certain exemption and fee reductions for vehicles utilized for soil and water conservation construction projects.

From an enforcement viewpoint, our Division has experienced only very minor problems with the special exemption granted to these vehicles by our State Legislature. We have not found that the exemptions granted are difficult to enforce. In fact, the members of the State Conservation Contractors Association do a commendable job of self-policing.

The only area that enforcement encounters any difficulty is an unclear or insufficient legal definition as to precisely what soil and water conservation practices entail. If legislative action could more clearly define this, it would help enforcement considerably.

If we can be of further service, please communicate with us.

Kindest personal regards,

DENNIS EISNACH,
Superintendent.

OFFICE OF THE SECRETARY OF STATE,
Springfield, Ill., September 12, 1975.

Re S. 17 and H.R. 2260.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN: I have been requested by the Illinois Land Improvement Contractors Association to write you about S. 17 and H.R. 2260, which provide that any motor vehicle used exclusively in soil and water conservation work and in the transportation of equipment used for soil and water conservation is exempt from the Federal highway use tax.

In 1968 the Illinois General Assembly passed the following law:

"3–809.1 § 3–809.1 Vehicles of second division used for transporting soil and conservation machinery and equipment—Registration fee. Not for hire vehicles of the second division used, only in the territory within a 75 mile radius of a designated point, solely for transporting the owner's machinery and equipment used for soil and water conservation work on farms, other work on farms and in drainage districts organized for agricultural purposes, from the owner's headquarters to a farm, from farm to farm, and returning to the headquarters, shall be registered upon the filing of a proper application and the payment of a registration fee of $325 shall be paid in full and shall not be reduced even though such registration is made during the second half of the registration year." (Ill. Rev. Stat. 1973, ch. 95–1/2, § 3.809.1)

We refer to the license as the "conservation plate."

The law was enacted following a survey which clearly indicated that vehicles used for soil and water conservation work travelled a rela-

tively small number of miles on the highway when compared with other vehicles. In addition, those using the conservation plate make a great contribution in the areas of soil, water and natural resource conservation. Further, there is a shortage of land improvement contractors in Illinois. It is hoped that the plate will encourage young people to enter the field.

This privilege has not been abused. Only 233 vehicles in Illinois have the conservation plate. The plate has not resulted in a significant loss of revenue and has not caused administrative problems.

The Illinois Land Improvement Contractors Association has carried on an effective educational program to ensure that the plate is used only on vehicles it was intended for.

If S. 17 or H.R. 2260 should become law, this office can provide representatives of the Federal Government the names and addresses of the persons in Illinois who have the conservation plate. It appears to me that if either one of these bills become law, the vehicles in Illinois entitled to the exemption would be those with the "conservation plate."

Sincerely,

MICHAEL J. HOWLETT,
Secretary of State.

STATE DEPARTMENT OF HIGHWAYS
AND PUBLIC TRANSPORTATION,
MOTOR VEHICLE DIVISION,
Austin, Tex., November 17, 1975.

Hon. BOB DOLE,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOLE: This is in reply to your letter of November 7, 1975, requesting an evaluation of the Texas provisions for soil conservation vehicles, for use in connection with legislation to exempt such vehicles from the Federal Highway Use Tax.

Article 6675a-2, Section (h) [1], Vernon's Texas Civil Statutes, provides for a 50-percent reduction in registration fees for vehicles used in soil conservation work. Each owner of such vehicles is entitled to register only one (1) truck or truck tractor and one (1) semitrailer or lowboy trailer at the reduced fee.

In order to qualify for the reduction in fees, each owner must submit with his application for registration (1) an affidavit that the vehicle is to be used exclusively to transport on the highways his own soil conservation machinery or equipment used in clearing land, terracing, building farm ponds, levees or ditches, and (2) a certification by the County Agricultural Stabilization and Conservation Committee that the applicant has been approved as a vendor of conservation services or materials. These qualifying requirements, of course, result in additional expense to the State for the maintenance of special files; however, this procedure does provide a degree of regularity and control to insure that those who receive the reductions in fees are actually entitled to them.

For the 1974 Registration Year, we registered 893 vehicles with Soil Conservation license plates. A portion of these were semitrailers or

lowboy trailers, which means that the number of trucks or truck tractors registered with such plates would range between 446 and 893. We do not have the Soil Conservation registrations broken out as to power units versus semitrailers.

There are, no doubt many others engaged in soil conservation work who do not avail themselves of the Soil Conservation license plates, due to their restrictive use. Instead, they purchase regular license plates at the full registration fee so they may use their vehicles in all types of hauling.

The special provisions for soil conservation vehicles have been on the Texas Statute Books for several years and, admittedly, there is some misuse of the special plates; however, we do not believe that such violations are flagrant. Enforcement against misuse of the Soil Conservation plates is rather difficult because the operator of the vehicle must be apprehended while actually operating in violation of the provisions of the law, and this is often times difficult to prove. Suffice it to say that we do not hear of too many violations for misuse of the Soil Conservation plates.

Self-policing by individuals or associations of persons engaged in conservation work might have some merit; however, it is doubtful that it would be very effective with regard to the issuance of license plates. If an applicant for Texas Soil Conservation license plates submitted the necessary affidavits required by law, we would be obliged to issue such plates irrespective of what some other individual or group of persons might say.

Senator Dole, if we can be of further assistance to you, please let us know.

Sincerely yours,

B. L. DeBerry,
Engineer-Director.
R. W. Townsley,
Director.

POSITION STATEMENT ON FEDERAL HIGHWAY USE TAX

This material has been summarized as a result of a survey conducted by LICA in 1974 among its members.

LICA, the Land Improvement Contractors of America, consists of 2,500 members in 33 states whose primary occupation is performing conservation work for the American farmer. LICA members are representative of conservation contractors in the United States and comprise approximately 15 percent of all conservation contractors in the United States.

Equipment owned.—Conservation contractors pay Federal use tax on lowboys and dump trucks which they use on a not-for-hire basis in performing their work on agricultural projects. Their lowboys are used to haul earth moving equipment to the job site while dump trucks are used in earth moving work on the job site.

Taxes paid.—About 80 percent of the contractors own equipment on which they are required to pay Federal use taxes. Taxes paid by the contractors ranged from a low of $90 to a high of $240 per unit

owned per year. The average contractor pays an average of $175 per year taxes on each piece of equipment they own.

Since the average contractor owns more than one piece of equipment (usually a lowboy and a dump truck) his Federal use tax bill amounts to $235 per year.

Mileage driven.—The survey revealed that conservation contractors drive their equipment an average of 5,000 miles per year. Most of this mileage is over county and state highways. About 30 percent of the contractors ever use the interstate highway system. 70 percent drive entirely on county and state roads and never use the interstate system. Those that do use the interstate systems average about 2,000 miles per year per contractor. 80 percent of conservation contractors drive less than 5,000 miles per year on vehicles on which they pay the Federal use tax. Most contractors engaged in conservation work perform their work within a radius of 50 miles or less and 95 percent of these contractors do their work within a radius of 100 miles or less.

SUMMARY OF NUMBER OF CONTRACTORS WITHIN CERTAIN ANNUAL DRIVING DISTANCES

	Percent	Cumulative percent
Drove less than 1,000 miles	14	
Drove between 1,001 to 2,000 miles	22	36
Drove between 2,001 to 5,000 miles	43	79
Drove between 5,001 to 10,000 miles	14	93
Drove between 10,001 to 20,000 miles	5	98
Drove between 20,001 to 40,000 miles	1	99
Drove over 40,000 miles	1	100

Projected U.S. lost revenue.—Assuming that there are between 20,000 and 30,000 land improvement contractors in the United States who use their equipment almost exclusively for work connected with soil and water conservation and each of these contractors, as is true of the LICA member, pays $235 per year, the total revenue lost from subject bills S. 17 and H.R. 2260 would be between $4,700,000 and $7,050,000 which is an insignificant sum as far as the U.S. budget is concerned but is a considerable sum to the small contractor business man.

Reinvested Stock Dividends

TESTIMONY OF EUGENE M. LERNER, CHAIRMAN, FINANCE DEPARTMENT, GRADUATE SCHOOL OF MANAGEMENT, NORTHWESTERN UNIVERSITY

My name is Eugene M. Lerner. I am a Professor of Finance at the Graduate School of Management of Northwestern University.

I am pleased to have the opportunity to submit a statement before the Senate Committee on Finance with respect to proposed changes in the tax law. Specifically I want to urge that dividends that are automatically reinvested by shareholders be treated as stock dividends. The effect of this change would be that shareholders could defer the payment of taxes on these dividends until such time as they actually sell the new shares that they purchase.

The reason why I urge that this legislation be passed is that it will improve the effectiveness of the nation's capital market. As a consequence, our economy will be stronger and investment will be stimulated. Employment will be raised and productivity will be increased.

Why will such a relatively modest change in the tax law have such a significant and desirable effect upon the economy as a whole? The answer lies in the fact that it will contribute to improving the capital structure and therefore the financial soundness of companies.

Firms can raise the money they need to pay for their new plant and equipment through either their own operations (profits and depreciation) or through the sale of securities (debt instruments or new stock). If they issue new debt instruments, they can sell either short or long-term securities. When firms sell new shares, (raise new equity) they raise permanent capital because these monies will typically never be retired.

One of the most important business decisions that a firm must make is to determine how it will finance its growth. Should it restrict its plant and equipment outlays to only the funds that it generates through operations or should it seek outside funds? Some firms only spend their internal funds because they simply do not have the business opportunities for continued growth. Most firms in as dynamic an economy as ours however do have the opportunity to invest more funds than they generate internally. These firms must then determine whether they will raise the additional funds they need through debt or through equity.

The method that a firm will use to finance its expansion depends critically upon its present level of risk. The cost of the new funds, and the return that it anticipates from the new investment.

Raising short term debt money is the most risky way to expand. The reason for this is that short term money constantly falls due and must be either repaid or rolled over. Since these funds may fall due at a time when the firm does not have the cash to repay the debt or credit markets are stringent, borrowing short term funds may lead to several financial problems.

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Raising long term debt money is an acceptable way to finance expansion if it is not carried on to excess. The payments that are required to service the long term debt, if they are modest, can be structured so that they coincide with cash inflows. If the payments are too large, i.e., if a company has an excessive amount of debt, it will have difficulty in meeting either the actual cash payments that are required or the covenants of the debt instrument itself. These covenants typically require that the companies' earnings be sufficiently high so that it covers the required payments by a specified margin.

Equity is the least risky way to finance expansion. Equity represents the investment by the owners of the firm in the enterprise. It is permanent capital and it provides a measure of safety to the bondholders.

While equity is the least risky way to finance expansion, it may also be the most expensive. The reason for this is that firms have earnings targets which stated in terms of "earnings per share" or "return on equity", i.e., the ratio of profits to equity, the larger a firm's equity, the more difficult it is to reach a stated target.

The financing decision that a firm faces therefore involves a tradeoff between expected return and risk. As it increases its reliance upon debt, it may improve its return and achieve its earnings targets. However this gain comes at the cost of increasing the riskiness of the firm. If it finances by equity, risk will fall but the earnings targets that it sets may not be achieved. Of course, if the riskiness of the firm is such that management does not want to see it increased, and equity is difficult to raise, the firm may simply cut back on its new plant and equipment outlays.

Each firm in a free and competitive society must decide for itself what is a prudent level of risk and what is a reasonable earnings target. The decision however is influenced by what other firms are doing. If competitive firms are earning high returns, new equity investors will be reluctant to invest their monies in firms that earn low returns. Similarly, if competitive firms offer creditors low risk, lenders will be reluctant to advance funds to high risk firms.

There are several measures that are used to indicate the amount of financial risk that a firm incurs. One of these measures is the ratio of total debt to total equity. The higher this ratio, the risker the firm. A second measure is the ratio of profits to interest payments. The lower this ratio (called "the interest coverage ratio") the riskier the firm.

Unfortunately, over the past decade, both of these ratios have deteriorated sharply. This is especially true in the case of utilities. For example the interest coverage ratio for all electric utilities declined from roughly 6 times in 1966 to less than 3 times in 1975. For independent telephone companies, the decline was from 4 times to 3 times over the same period. Similarly the ratio of debt to debt plus equity has increased from 52 to 55 percent for electric companies, from 33 to 49 percent for AT&T, and remained at roughly 57 percent for other telephone companies.

The deterioration in the capital structure of utilities is alarming. Changes should be made in the tax law to encourage the use of equity

so that these firms can be restored to some level of financial strength and health.

If the equity position of firms were improved they could finance the plant and equipment outlays that they must make without adding to their overall level of risk. Their willingness to take on new outlays would be enhanced and these expenditures would both raise the productivity of their own labor force and the level of employment throughout the economy. One way to raise the equity would be to defer the taxes on dividends that are reinvested.

At present if a firm elects not to pay dividends but rather to reinvest all of its earnings, the shareholder need pay no taxes on these earnings. However, if the same firm distributes all of its earnings and then seeks to sell new shares to its owners equal to the dividends it declared, the shareholder must pay taxes on the dividends. Simple equity demands that the tax law recognize that from the point of view of raising funds these two situations are basically identical, and that relief should be granted to shareholders that reinvests their dividends.

There is however an important distinction between the two cases. In the first case, the firm made the decision for the shareholder to reinvest his earnings. This denied the investor the option of choosing how to allocate his own funds. In the second case, the investor can elect to reinvest the funds he receives in the company that paid him the dividend, in another firm, or spend the money in another way. An efficient capital market would permit the shareholder to make his own decision as to how his funds should be allocated. If the shareholder wants to switch his commitment from one firm to another, he should be given the opportunity to do so. If he wishes to reinvest his dividends in the company he now owns because he has confidence in its management, he should be permitted to do so too.

Firms need more equity. Shareholders and others should be encouraged to make additional equity commitments. As the tax law now stands, however, the taxation of dividends discourages this reinvestment and encourages firms not to make any distributions at all.

I therefore urge that this committee move to correct this inequity and treat reinvested dividends on a par with retained earnings.

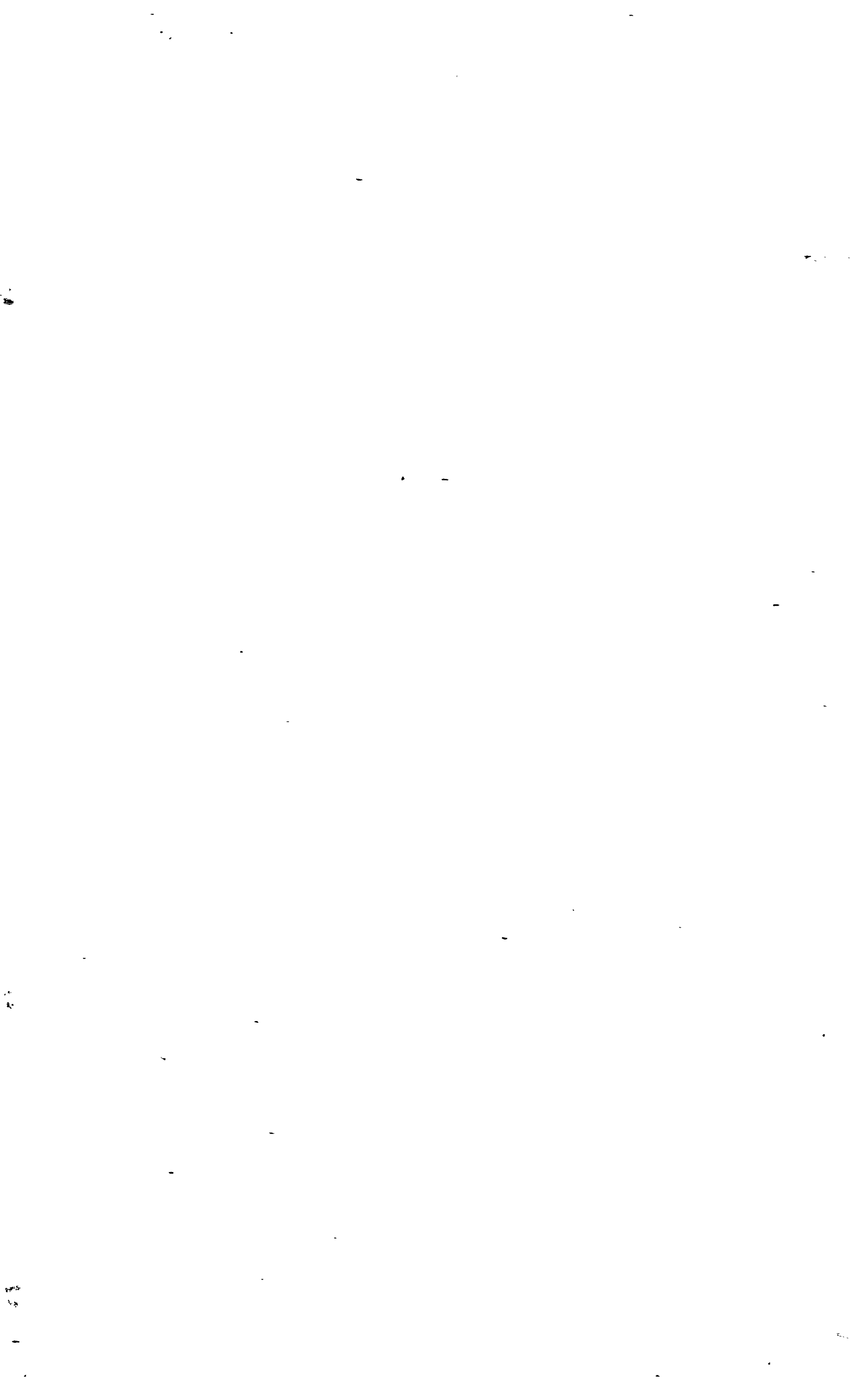
SUMMARY

There are many compelling reasons that the tax laws should be changed so that dividends which are automatically reinvested by shareholders will be treated as stock dividends. Among the major reasons are the following:

1. The distinction for tax purposes between stock dividends and cash dividends which are automatically reinvested is arbitrary, artificial and discriminatory.

2. Enactment would improve the effectiveness of the Nation's capital markets, help to provide needed equity capital and thus strengthen the financial structures of corporations.

3. Enactment would stimulate investment, improve productivity and provide additional job opportunities.



Motor Vehicle Excise Taxes

STATEMENT OF HON. GUY VANDER JAGT

Mr. Chairman, I am pleased to submit the following statement to your distinguished Committee. I believe you will find it constructive and that it represents an opportunity to correct an undesirable situation in our tax structure, a situation discouraging capital formation and the creation of jobs. I know both of these major economic issues have the strong interest of this Committee. I am referring to the Federal excise tax on trucks, buses, trailers, parts and accessories.

As this Committee well knows, the current Federal excise tax of 10 percent on the above products has been in effect since July 1, 1956 and was established to provide revenues for the Federal Highway Trust Fund. You will recall that passenger automobiles were likewise taxed, but the Congress, in its wisdom, repealed the excise tax on those vehicles under Public Law 82–178. I propose that this Committee include repeal of the excise tax on trucks, buses, trailers, parts and accessories as part of its 1976 tax reform proposals.

It will be recalled that your Committee incorporated this proposal as an amendment to the Tax Reduction legislation, H.R. 2166, in 1975. The Senate adopted the recommendation of your Committee, but unfortunately it was dropped in the Senate-House Conference.

The logic of repeal of this tax is substantial. While you are no doubt aware of many of the arguments favoring repeal, let me list those of which I have direct knowledge.

1. The excise tax is an inappropriate means of applying direct highway user charges to truck operators. Because the tax is imposed at the point of manufacture, it does not matter if the vehicle is driven 10 miles or 1 million miles, the tax remains the same.

2. The philosophy behind an excise tax is normally to restrict or discourage the use of the product on which the tax is imposed for some socially desirably purpose. However, this particular excise tax tends to discriminate against a specialized segment of our transportation system.

3. The tax is difficult to administer fairly. The tax may be higher or lower depending on the step in the distribution chain at which it is imposed. The tax on a truck part installed by the retailer will be higher than it would be had the part been installed by the original manufacturer, for example. The result is a competitive disadvantage for one manufacturer versus another.

4. The tax discriminates against the consumer who is dependent upon truck transportation. More and more of our population is located in suburban and rural areas not served by rail.

5. Congress over the years has substantially reduced excise taxes as a source of Federal revenues. As a consequence, and particularly in this instance, a very small segment of industry is now required to pay such taxes, a burden increasingly unfair as more excise taxes are eliminated.

6. The excise tax on heavy duty trucks now averages about $3,000. A reduction in price of this amount would provide a very substantial stimulus to scales resulting in increased production with concomitant increases in jobs. Because the trucking industry today employs in manufacture and distribution about 500,000 people, it is apparent that increased sales would effect a very substantial job base.

7. Trucks and truck equipment are capital goods. It is an unfortunate irony that we seek to increase investment in capital goods through the investment credit while continuing to impose a penalty on the trucking industry through the excise tax. Mr. Chairman, in the deliberation of the 92nd Congress, the Report of the Committee on Ways and Means accompanying the repeal of the passenger automobile excise tax contained language highly appropriate to the question of truck excise tax repeal. I quote:

> . . . the excise tax on passenger automobiles is repealed in this bill both to provide a stimulus for the purchase of cars and because of the jobs this is expected to create. In addition, Congress has previously concluded that excise taxes, such as the one on passenger automobiles, are undesirable because they interfere with the fredom on consumer choice . . .

Finally, the report indicated that this repeal:

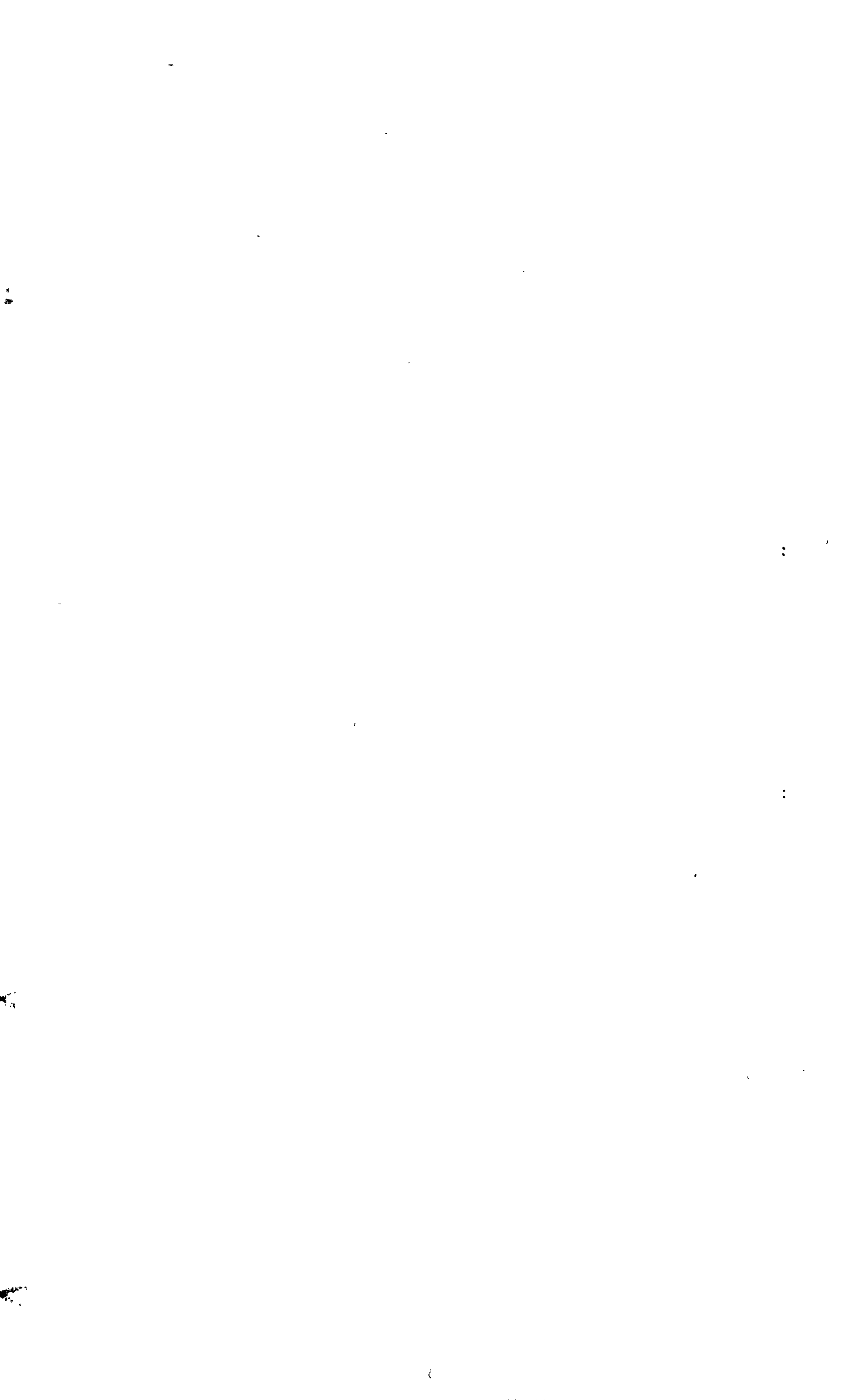
> . . . continues the trend begun in 1965 to repeal excise taxes which place discriminatory tax burdens on the consumers and producers of the taxed products.

Mr. Chairman, to remove the excise tax on trucks, buses, trailers, parts and accessories would contribute to the slowing of the inflation rate. Lowering the purchasing cost of these vehicles would be beneficial to small businessmen, farmers, and independent-owner operators of semi-trailer rigs, who have been hard hit by the recent bout with inflation. And, it is not fair to continue this tax—a tax that applies to no other form of transportation.

Mr. Chairman, I know your Committee recognizes the importance of the jobs and new investment in capital goods which would result from repeal of this Federal excise tax. Such repeal would provide relief to the consumer, stimulate truck manufacturing and its related industries, and end a burdensome tax.

Thank you for this opportunity to present this statement to this esteemed Committee.

Limitation on Artificial Losses



STATEMENT OF THE SOCIETY OF AMERICAN FLORISTS AND ORNAMENTAL HORTICULTURISTS, SUBMITTED BY PERRY A. RUSS, DIRECTOR OF NATIONAL AFFAIRS

SUMMARY

INTRODUCTION

The Society of American Florists and Ornamental Horticulturists is the national trade association which through affiliation represents over 50,000 American businesses engaged in all forms of commercial floriculture. Our members grow, distribute, and market fresh flowers, green plants, bedding plants, florist greens, ferns, etc. which add beauty to the environment and express the deepest of human emotion.

In all Federal regulation and all legislation heretofore enacted by Congress, commercial flower and plant growers have been classified as "farmers" and fall within the purview of those acts covering agricultural producers. It is on behalf of SAF grower members that we submit the following comments to the Senate Committee on Finance in regard to H.R. 10612, The Tax Reform Act of 1975.

ROLE OF EXISTING LAW AND PRESENT FARM TAX RULES

Generally, the rules of existing law provide workable and administrable solutions to the problems of farm tax accounting. These rules have survived for many years and have been sanctioned by the Treasury Department and the Courts, including the Supreme Court. Our members have for many years, both in legislation and as a matter of practice, been treated as farmers and have been permitted to apply these rules to report their income for tax purposes. Farmers, under the current tax rules, are permitted to use the cash receipts and disbursements method of accounting without the keeping of inventories. Farmers are permitted to deduct the costs associated with planting and raising their crops even though income associated with such crops may not be earned until a subsequent taxable year.

In the case of our members, these methods will, over a period of years, accurately reflect their income. Moreover, these rules permit our members to accurately reflect their income without requiring the keeping of complicated records or requiring arbitrary cost allocations. Further, although there are a number of complex rules already in the Code to prevent abuse of the farm tax rules, the present rules are, in general, comprehensible for the small agricultural businessman.

We believe that existing law provides substantial limitations to prevent abuse of the farm tax rules. For example, section 183 of the Code provides that certain deductions will be disallowed if a transaction is not entered into for profit. This rule, if applied in appropriate circumstances, is a strong weapon against those who would market tax

shelters based upon the farm tax rules. Moreover, existing law has been interpreted to restrict the use of non-recourse financing to generate tax losses. There are also judicial limitations applicable where tax consequences are the sole motivation for a course of action. We believe that if new provisions are to be adopted by the Congress to restrict the application of the farm tax rules, that such provisions should be narrowly drawn so as to apply only where necessary to prevent abuse which cannot be properly dealt with under existing law. These new rules should not be applicable to the ordinary farmer. The members of our association should not be required to comply with a new and complex set of rules which are unnecessary to cope with any abuse of the farm accounting rules.

PROVISIONS OF TAX REFORM BILL RELATING TO FARM TAX RULES

H.R. 10612, the House passed Tax Reform Act of 1975, contains several provisions which impact upon the farm tax rules. The most significant provisions are the so-called "limitation on artificial accounting losses" ("LAL") provision and the requirement that farming corporations and partnerships with corporate partners adopt the accrual method and capitalize "pre-productive period expenses." These new provisions are not limited to large corporate enterprises or tax shelter syndicates. They are applicable to small farmers and farmers whose income derives solely from farming.

H.R. 10612 RULES INCONSISTENT WITH SOUND TAX POLICY

We believe that many of the principal effects of H.R. 10612 are contrary to sound tax policy. First, we believe that the LAL provisions of House Bill discriminate against new investors in farming ventures, and those who, in expanding their farming operations realize start-up losses. Such persons frequently operate at an economic loss during these years, but would not be permitted to offset their economic loss against non-farm income under the LAL provisions. At the same time, the LAL provisions preserve the farm tax rules for those who have been in the farming business for several years and are operating at a profit sufficient to absorb their "accelerated deductions." Second, the LAL provisions are an enormously complicated and arbitrary set of rules which will impose difficult and burdensome requirements upon small farmers and upon large full-time farmers who in one year have substantial income unrelated to farming. These persons are not the proper or intended target of any "tax reform" effort. The complexity of these rules will, in many cases, render voluntary compliance with the law difficult or impossible. Third, the rules applicable to corporations engaged in the business of farming are overly broad and largely unnecessary. There are bona-fide business reasons for adopting the corporate form and the tax rules should not arbitrarily discriminate against this form of business organization.

RECOMMENDATIONS OF AMERICAN SOCIETY OF FLORICULTURISTS

Our basic recommendation to the Senate Committee on Finance is that the approach of the House Bill be abandoned. It is unworkable

and contrary to a sound tax policy. The provisions of the House Bill arbitrarily discriminate against new business ventures, small farmers who are unable to pay for costly accounting services, farmers growing various crops, and the corporate form of business organization.

Assuming that the Senate Committee on Finance determines that the approach of the House Bill should be followed, we have specific recommendations that would permit reform of the farm tax rules where necessary and, at the same time, not interject an unworkable set of rules into the average farmer's April 15th income tax filing requirements. Our specific recommendations are:

(1) The amount of unrelated income which can be offset by "accelerated deductions" before application of the LAL rules should be increased from $20,000 to $50,000. This revised test should apply to taxable rather than adjusted gross income. Only if the taxpayer has substantial nonfarm income otherwise taxed at the higher progressive rates will he be likely to embark upon a tax shelter program of any kind. In applying this floor to corporations, the nonfarm income of individuals owning more than 10 percent of the stock should be aggregated with the corporation's nonfarm income. These changes would focus the LAL provision upon the wealthy nonfarm investor and limit to a very few cases the likelihood that a full-time farmer will be caught in the web of LAL.

(2) The carryback of deductions which have been deferred by the LAL provision, should be permitted where nonfarm income drops below $50,000 in a subsequent year.

(3) The LAL farm rules should not apply to any person for whom gross income from farming is a substantial portion (perhaps 50 percent or more) of his gross income.

(4) The required use of the accrual method of accounting should be eliminated. If the other suggested changes are agreed to, this provision is not needed.

(5) There should be no requirement that expenses allowable under the accrual method be capitalized by a corporation engaged in the business of farming.

(6) Partnerships that happen to include a corporate partner should not be required to use the accural method, unless the corporation owns in excess of 50 percent of the capital interests in the partnership.

Statement

Introduction

The Society of American Florists and Ornamental Horticulturists is the national trade association which through affiliation represents over 50,000 American businesses engaged in all forms of commercial floriculture. Our members grow, distribute, and market fresh flowers, green plants, bedding plants, florist greens, ferns, etc. which add beauty to the environment and express the deepest of human emotion.

In all Federal regulation and all legislation heretofore enacted by Congress, commercial flower and plant growers have been classified as "farmers" and fall within the purview of those acts covering agricultural producers. It is on behalf of SAF grower members that we sub-

mit the following comments to the Senate Committee on Finance in regard to H.R. 10612, The Tax Reform Act of 1975.

The Tax Reform Act of 1975, H.R. 10612 ("the House Bill") was enacted by the House of Representatives for the purpose of preventing "investors" from taking ". . . advantage of the special farm tax rules to deduct farm expenses in a year or years prior to the years when revenue associated with such expenses is earned." [1] In an effort to accomplish this purpose, the House Bill provides a bewildering array mandatory accounting practices for farmers. Individual farmers may continue to use the cash method, but, depending upon the source and amount of their income, are required to adopt a highly complex system of deferred deduction accounts. The rules relating to "deferred deductions" are necessarily arbitrary since the entire concept falls wholly outside presently recognized accounting practices. Moreover, under the House Bill, certain farmers operating in corporate or partnership form are required to adopt the accrual method of accounting. In addition, such farmers are required to establish capital accounts for certain expenses which are allowable as deductions to other taxpayers on the accrual method of accounting.

Although there are special rules in the House Bill for "farming syndicates," the rules of the House Bill are not limited to "investors," or "farming syndicates," but are applicable to all who are engaged in farming, large and small, including many of our members.

The effect of the House Bill will be to require ordinary farmers to seek sophisticated professional and accounting assistance in order to comply with the law. We feel strongly that the Committee should weigh the cost of an increasingly arbitrary, complex, and unadministrable tax law against the benefits which the provision seeks. The Committee on Finance should consider specific provisions which deal with any problems directly, without penalizing the independent businessman engaged in agricultural production. In doing so, we will be happy to work with the Committee and its staff in addressing the few problems in the application of agricultural tax rules in a responsible way.

We would like to bring to the attention of the Committee certain features of the House Bill which are particularly distressing to The Society and its members.

PRESENT LAW PROVISIONS

The provisions of existing law which are under attack in the House Bill are the cash basis method of accounting and the deduction of certain expenditures during the development period of an agricultural commodity. The present farm tax accounting rules and administrative interpretations of those rules provide simple and administrable procedures for farmers. At the same time, they have been attacked as tax loopholes or tax subsidies to the farmer.

The farm tax rules have been promoted by marketers of tax shelters which promise investors, generally wealthy high tax-bracket individuals, that they will be able to deduct farm tax losses from their other

[1] H. Rep. No. 94-658, 94th Cong., 1st sess. 39 (1975).

income. In 1969 and 1971, provisions were added to the Code to deal with certain tax shelter arrangements. Three of the principal provisions of existing law that are relevant to the farm tax rules are: (1) recapture rules which treat as ordinary income gain derived from selling certain farm assets; (2) the "hobby loss" provision, which disallows deductions in the case of an activity not engaged in for profit; and (3) the provision requiring capitalization of certain developmental expenses in the case of citrus and almond groves.

The tax accounting rules for farmers, and the limitations of existing law on the use of these rules for tax shelters are described in more detail in subsequent sections of our statement.

USE OF CASH METHOD OF ACCOUNTING

A taxpayer engaged in the business of farming is permitted to adopt the cash receipts and disbursements method of accounting. Under this method, items are included in income in the year received (actually or constructively) and items of deduction are allowed in the year paid. Farmers are also permitted to deduct the cost of seeds and young plants purchased during a year for cultivation prior to sale. Farmers are not required to maintain inventories of their growing crops or supplies on hand at the end of the year.

The cash method of accounting has been accepted as a method for reporting income and expenses of agricultural operations for more than fifty years. It has withstood the test of time and been approved by the Treasury Department and by the courts for the reason that it is well adapted to the needs of the small agricultural businessman. The cash method of accounting is simple to apply and requires a minimum of complicated record keeping. It has been recognized, moreover, that the allocation of costs necessary to inventory growing crops is difficult and arbitrary in many ordinary situations. To illustrate this problem, consider the effect an inventory requirement would have on a grower of ornamental plants. Since the plants are sold at different prices for different sizes each of several thousand plants would have to be measured at year end and an allocable portion of the farmers cost assigned to each plant in order to properly value the year-end inventory and determine the farmer's cost of goods sold.

It has long been recognized that the cash method of accounting does not have as a primary goal the matching of income and related expenses. That is the primary goal of the accrual system. In particular situations, the effect of the failure to match income and expenses is to permit a deduction of losses from farming operations against income unrelated to farming and reporting of the related farm income in a subsequent year. Nevertheless, the cash receipts method of accounting is authorized for individuals and many businesses other than agricultural. This method gives considerable latitude in the timing of income and deductions. For example, payment of a medical expense, or a gift of property to a charity on the last day of the year will be allowed as a deduction even if the effect may distort the taxpayer's true income for the year.

CURRENT DEDUCTION OF DEVELOPMENT COSTS

Costs associated with cultivation of orchards and vineyards and similar products, and those associated with raising of farm animals may be deducted although they result in an asset having a productive life of several years. Income from the sale of fruit or the livestock is realized in subsequent years. In certain situations, the income realized is capital gain, and the capital gain is taxed at a preferential rate even though the deductions were used to offset ordinary income.

The deduction of development costs is justified on the same grounds as the cash method of accounting. That is, the farmer is not required to allocate his costs of cultivation or raising livestock to particular plants or animals in order to determine his income or loss.

LIMITATIONS OF EXISTING LAW

1. Recapture of certain farm losses

Section 1251 of the Code treats as ordinary income gain from the disposition of farm recapture property in certain limited situations. Thus, if a taxpayer has nonfarm income in excess of $50,000 in a year, uses the cash method of accounting, and has a farm net loss in excess of $25,000, the excess must be placed in an "excess deductions account." If, in a subsequent year, farm recapture property is sold, any gain recognized will be ordinary income, and not capital gain to the extent of the amount of the excess deductions account.

Section 1252 of the Code operates in a similar manner to recapture income derived from sale of farm land which has benefitted from the deduction of soil and water conservation expenditures.

2. Deductions in the case of business not engaged in for profit

Section 183 of the Code limits the current deduction of expenses in the case of an activity not engaged in for profit. Thus, if a farming venture is engaged in, the venture operates at a loss, and the taxpayer is unable to show a profit motive, only deductions such as interest and taxes, which are allowed whether or not a taxpayer is engaged in a trade or business will be allowed. Deductions for depreciation, purchase of plants and expenses of cultivation will not be allowed in excess of the income from the venture.

3. Capitalization of development costs of citrus and almond groves

Section 278 of the Code requires that taxpayers engaged in the business of planting, cultivating, and developing citrus and almond groves must capitalize their development expenses during the first four years after planting.

H.R. 10612 PROVISIONS RELATING TO AGRICULTURAL OPERATIONS

There are two provisions in H.R. 10612 which are directed toward the agricultural tax rules and affect our members. These are: (1) the limitation on artificial accounting losses ("LAL") provisions in section 101; and (2) the requirement that certain corporations engaged in agriculture adopt the accrual method of accounting (section 204). Other provisions in the Bill are intended to restrict the tax benefits

of certain tax shelter partnerships. These latter provisions include those relating to partnerships first-year depreciation (section 210(a)), special partnership syndication fees (section 210(b)), and retroactive partnership allocations (section 210(c)). Other provisions of the Bill restrict the deduction of non-business interest (section 206) and the deduction of pre-paid interest (section 205). Another provision (section 207) relates to the use of non-recourse financing for livestock ventures and for certain crops. These provisions, which are related to the syndication of partnership tax shelters and in several cases correct doubtful interpretations of existing law are not objectionable to the members of our association. Our concern is with the LAL proposal and the requirement that certain corporations adopt the accrual method of accounting and capitalize pro-productive period expenses.

THE LAL PROVISION

LAL ("Limitation on Artificial Accounting Losses") was first proposed by the Treasury Department in testimony before the House Committee on Ways and Means on April 30, 1973. The basic tenet of the proposal is that certain tax rules permit the deduction of expenses involved in a business prior to the time the income from the activity is realized. Assuming that it is the intention of good accounting rules to associate expenses and related income, the LAL proposal treats these deductions as "accelerated." If the accelerated deductions result in a loss for tax purposes, the LAL concept is to defer the loss until the property is disposed of or the income from the activity is realized. As the Treasury statement indicates, "We do not propose that any of these deductions be disallowed. Nor do we propose that they be capitalized. We propose only that if they create a loss from the activity to which they relate, that loss may not be used to offset or shelter other unrelated income of the taxpayer."

The LAL proposal, as applied to farming is as follows.[2] First, the general rule is that the farmer's accelerated deductions are not allowed to the extent they exceed the taxpayer's net income from related sources. These deductions which are disallowed are deferred until the property to which they relate is sold or there is an excess of net related income in a subsequent year. The LAL provision does not apply to disallow any portion of a farm loss unless the farmer has more than $20,000 of non-farm income in a taxable year. If the farmer has more than $20,000 of non-farm income, his allowable farm loss cannot exceed $40,000 minus his non-farm income. This threshold rule is intended to assure that full-time farmers are not subject to LAL. Thus, as it applies to farming, the LAL proposal is supposed to affect only non-farm wealthy individuals who are seeking to shelter their non-farm income. However, if the farmer has more than $20,000 of non-farm income, and his non-farm income plus his farm loss would exceed $40,000, the LAL provision is applicable and the farmer must apply the entire panoply of LAL rules in order to determine when he will be entitled to the deferred farm loss. Thus, if the phase-out rule is applicable, the taxpayer must compute his income and deductions under the LAL system until that farm loss is allowed.

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[2] There are special rules applicable in the case of farming syndicates and these special rules are not considered in this summary of the LAL provisions.

Accelerated deductions are defined as (1) pre-productive period expenses, (2) pre-paid feed, fertilizer, and supplies, and (3) accelerated depreciation of animals, trees or other property. The pre-productive period expenses include any amount attributable to crops, trees, or animals during the pre-productive period except (1) interest and taxes, (2) casualty losses, (3) expenses attributable to wheat, alfalfa, barley, oats, rye, sorghum, and cotton, and expenses attributable to livestock other than poultry. The pre-productive period includes the period before the disposition of the first marketable crop or yield (in the case of property having more than a single crop or yield) or the period prior to the disposition of property (in the case of all other crops).

The definition of net related income, for purposes of the LAL farming proposal, is any income from farming.

The LAL provisions apply to individuals (including estates and trusts) and corporations which are not subject to the rules regarding the accrual method of accounting (section 204 discussed *infra*). LAL may be avoided if the individual or corporation adopts the accrual method of accounting, and agrees to capitalize pre-production period expenses.

The special threshold rule discussed above is applicable only to individuals. Thus, a corporation that is not required to adopt the accrual method of accounting under section 204 of the Bill (generally family corporations electing to be taxed under Subchapter S of the Code) are required to refer any farm loss if the corporation has $100 or more of nonfarm income.

REQUIREMENT THAT CERTAIN CORPORATIONS AND PARTNERSHIPS ADOPT THE ACCRUAL METHOD AND CAPITALIZE PRE-PRODUCTIVE PERIOD EXPENSES (SECTION 204)

Section 204 of the Bill would amend the Code to require that corporations (other than "family" corporations and corporations electing to be taxed under Subchapter S of the Code) and certain partnerships with a corporate partner which are engaged in the business of farming, use the accrual method of accounting and capitalize pre-productive period expenses. The pre-productive period expenses which are required to be capitalized are those described above in the summary of the LAL provision. Unlike the LAL provision, this provision is applicable regardless of the crop or horticultural commodity which is grown. In the case of a partnership, this provision means that each partner is required to compute his farm income under the accrual method of accounting used by the partnership even though the corporate partner has only a one percent interest in the partnership.

The Bill provides a special ten year spread for income which is bunched as a result of a required change to the accrual method of accounting.

TAX POLICY CONSIDERATION OF CHANGES IN FARM TAX RULES

Our association believes that the approach of H.R. 10612 to the farm tax rules is defective on the grounds of tax policy. The LAL provisions are, we believe poorly conceived and misdirected. Analysis will demonstrate that the provisions will apply in many unintended situations,

will result in a greatly increased cost of compliance by many small farmers and growers of ornamental foliage, and will not be effective to prevent abuse of the farm tax rules. As our recommendations and discussion indicate, we believe that the limitations of existing law, combined with the special rules designed to prevent abuse of partnership tax provisions and interest deductions, are sufficient to prevent abuse of the farm tax rules. Moreover, even if it were demonstrated that these provisions would not be sufficient to prevent all abuse of the farm tax rules, the complexity and accounting problems which will result if H.R. 10612 is enacted are wholly unwarranted by the magnitude of the problem. The association believes that the Senate Finance Committee should review the provisions of existing law to determine whether any additional changes are needed. We believe that the Committee will reach the conclusion that existing law provides a sound basis for dealing with tax shelter speculators who are abusing the farm tax rules without the addition of a new and enormously complicated set of provisions.

LAL IS INCONSISTENT WITH A SOUND TAX POLICY

The LAL proposal, as applied to farming, has the effect of preserving the farm tax rules for those established operations which are operating at a profit, while suspending those rules for new ventures and farmers who are expanding their operations and suffer losses. The effect will be to discourage new ventures in agriculture and to penalize small farmers who wish to expand their farming operations. In the very situations where a farmer is most in need of funds, i.e., the start-up period or expansion period, the LAL proposal requires the farmer to suspend the rules permitted for his more established competitor.

The LAL rules will also discourage the introduction of new capital into agricultural operations. It is widely recognized that farming ventures require substantial capital investments and that there is frequently a considerable period during which the new farm venture will operate at an economic loss. If these economic losses cannot be offset against other income, the taxpayer is in effect required to make an interest free loan to the Government at a time when he can least afford to do so. The effect of this disincentive will be less capital investment in agricultural business and a decrease in the supply of farm commodities with correspondingly higher prices.

The LAL provision also adopts arbitrary rules which discriminate against different agricultural commodities and different forms of organizations. In making these distinctions, and in distinguishing between agricultural, real estate, oil and gas, and manufacturing operations, the LAL provision erects internal barriers to capital investment which cannot be evaluated or measured accurately. Thus, for example, wheat, alfalfa, barley, oats, sorghum, and cotton farmers are not subject to the LAL provision regarding pre-productive period expenses. There would not appear to be any tax policy considerations to support this distinction. Perhaps such exceptions are justified by economic considerations, however, the fact remains that one class of farmer is singled out for favored treatment while other classes, including our members, are not treated equally.

The provisions of the House Bill discriminate against different forms of business organizations. We have not directed our attention to the rules regarding farming syndicates and, we do not support the tax shelter operations entailed in farming syndications. Nevertheless, H.R. 10612 provides very burdensome rules in the case of corporations engaged in farming. That is, corporations which have $1.00 of nonfarm income are subject to LAL unless they are required to use the accrual method of accounting and capitalize pre-productive period expenses. There are very sound business reasons for incorporation of farming ventures. There appears to be no sound tax policy reason for the punitive effect of the LAL provisions of the Bill in corporate farming ventures. Presumably, the nonfarm income threshold is not applicable to corporations in order to prevent a wealthy investor from sheltering nonfarm income through a corporation.

However, we believe that a corporation should be permitted to deduct farm losses against nonfarm income if the individuals owning the corporation would have been able to do so had the farming venture not been incorporated. For example, if there were a corporation which had a farm loss of $20,000 and the nonfarm income of the corporation and its shareholders were $15,000, the full amount of the loss should be deductible against the corporation's non-farm income.

LAL IS TOO COMPLICATED

The LAL rules are not limited to wealthy nonfarmer investors seeking "tax shelter" through the use of rules developed for farmers and others who are engaged in producing agricultural commodities. Instead, they are applicable, by their terms to all agricultural producers, large or small. For this reason, the burdens of compliance are relevant to our industry as a whole. The provisions of LAL are eccentric and complex; therefore, many individuals may find compliance to be beyond their own abilities, and beyond the competence of the professional advisers who may be found in rural areas.

The integrity of our tax system is maintained through "self-assessment." This means that taxpayers each year must compute their own tax liability and pay the taxes so determined. Our tax system cannot operate when the rules are so complex that the average person simply cannot comply with the requirements. The present Internal Revenue Code has reached a point where many experts believe that further complexity will be self-defeating.[3] But the new proposals add several layers of complexity on top of our already over-burdened tax system.

A former Assistant Secretary of the Treasury called the Tax Reform Act of 1969. "The Lawyers' and Accountants' Private Relief Act" because that legislation's complexity necessarily required greater reliance by the average person on professional help in computing his taxes. The LAL provisions, if enacted, will make complexities of the 1969 Act provisions look rather simplistic. The producer under the proposed Bill must take time and money away from his productive activities to seek professional advice to attempt to comply with the new Act.

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[3] Hearings on Tax Reform before House Committee on Ways and Means, 94th Cong., 1st Sess., June 24, 1975, at pp. 125–394.

One of the most respected of modern judges, Learned Hand, wrote about the tax law as follows:

> In my own case the words of such an act as the income tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave, in my mind, only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." Hand, Learned, in Irving, "The spirit of Liberty" (New York: Alfred A. Knopf, 1960), p. 213.

This is what the House Bill LAL provisions present for farmers, *i.e.*, exceptions on top of exceptions, cross-reference on top of cross-reference, all of which successfully conceal the practical application of the law to the day-to-day activities of the producer.

One example, based upon provisions in the existing law relating to farming, may illustrate the problem of administration and compliance with such legislative confusion. Section 1251 of the Internal Revenue Code was enacted in 1969. Its objective was to prevent the offset of ordinary farm deductions against ordinary income, followed by a sale of farm property at capital gain. Although the provisions were enacted in 1969, today, more than six years later, there are no final regulations which interpret this provision. There are only proposed regulations which do not even deal with certain of the more difficult problems in the field. These proposed regulations appear on eighteen small type, single-spaced pages of the Federal Register for December 28, 1971. Is it any wonder that no one understands these and similar tax provisions when the Internal Revenue Service has taken more than six years to determine its own position? The problem of drafting regulations under section 101 of the House Bill will be many times greater than those under section 1251 of the Code.

The complexity of application of the LAL provisions can be shown in the case of a hypothetical small producer of floricultural products. As is true of many products produced by our industry, each fall he expends money in the cultivation of a crop which is harvested and sold in the following spring. His calendar year tax return reasonably reflects his income in each year, since it contains the income from the sale of one crop, reduced by the money expended in that year for planting and cultivating the next year's crop. In the first few years he has less than $20,000 of nonfarm income and does not operate in corporate form. Thus the new rules would have no impact in those years. In one year, however, he sells some property and has a $20,000 capital gain which together with other income not from agricultural operations, gives him nonfarm adjusted gross income of $25,000.

In this year our member must enter the web of LAL. It may help to illustrate the arbitrary nature of the House Bill to note that LAL would not be applicable if he happens to grow wheat, alfalfa, barley, oats, rye, sorghum, or cotton. Our members, however, grow floricultural crops, so they cannot escape.

Accordingly, our hypothetical grower must first determine whether he has any "accelerated deductions." The House Bill's definition of "accelerated deductions" is not limited to solving a specific area of concern, but would include any purchased seed, fertilizer, or other supplies purchased and paid for in the ordinary course of business,

and on hand at the end of the year. The statutory definition of "accelerated deductions" also includes the costs associated with raising products which are sold after the close of the taxable year. Although our grower has been in business for many years and continues to operate in the same manner, the costs of cultivation which are incurred during each year are now "accelerated deductions" and these may not be "deferred."

But our grower has not completed the LAL cycle yet. His accelerated deductions will still be allowed in full provided he has sufficient related income from his growing operation. In order to determine whether this test is met, he must compute his income from farming, taking into account only "non-accelerated deductions." Let us assume that the grower in our case did not make a profit on his farming operations in the year under consideration. In this situation, the grower must pay an income tax on a portion of his $25,000 of nonfarm income and cannot deduct the cost of raising his winter crop. This grower has taxable income, and must pay a tax, even though financially he operated at an economic loss. LAL distorts his income, which had been accurately reported over the long period of operations.

Our hypothetical grower could have a bumper year in the next year and be allowed to deduct his "deferred deduction." Since he could be in a higher tax bracket in the second year, he might actually save taxes by deferring the deduction. If there were no changes in tax bracket, the effect of LAL in such a case may be likened to an interest free loan by the grower to the Government.

These then are the consequences to our growers of the LAL provision—distortion of income, variation in the tax rate, administrative costs, discrimination against new ventures. We do not believe that these results are warranted in order to deal with abuses of the agricultural tax rules or consistent with a sound tax system.

MANDATORY USE OF ACCRUAL METHOD

The House Bill requires that all corporations engaged in farming, except certain family corporations or those electing to be taxed under Subchapter S of the Internal Revenue Code, adopt the accrual method of accounting and capitalize their pre-productive period expenses. There are sound nontax reasons for farm businesses to incorporate and many of our members conduct their business in corporate form. They do so in order to limit their liability, to increase their ability to attract additional capital, and for other substantial nontax reasons. The fact that the House Bill deals selectively with tax shelter syndications should, we believe, wholly eliminate the need for this provision in any other situation.

Section 204 is quite unique. *In no other industry is a specified method of accounting required by Congress.* Nor is the method of accounting made to depend upon the form of business organization. The Congress, in fact, has mandated that the accounting profession cannot dictate how certain types of tax credits are to be treated.[4] In the case of farmers and agricultural producers, however, the House Bill does exactly the opposite, it dictates the use of the accrual method of accounting.

[4] See section 101(c) of the Revenue Act of 1971.

Section 204 of the House Bill does not stop there. In addition to use of the accrual method, this provision requires that certain expenditures otherwise allowable as deductions under the accrual method must be capitalized. Unlike all other accrual taxpayers who may deduct expenses paid or incurred which are not properly included in inventory, the grower must capitalize these costs. This arbitrary rule is necessitated by the fact that in many situations, growing crops simply cannot be inventoried. Thus, the Bill arbitrarily disallows deductions which are allowable to taxpayers in other types of businesses.

Even if a farmer has been using the accrual method of accounting, the requirement that certain pre-production expenses be capitalized can lead to a "bunching of income." This problem is ameliorated by the House Bill through another complex mechanism. The "bunched income" can be spread over a ten-year period, subject to the provisions of section 481 relating to a change in a method of accounting. If, however, the taxpayer happens to have been in business for ten years, has used an accrual method throughout that period, and his products mature no sooner than the second year after planting, he is exempted from the requirement that he capitalize pre-production costs. Is this discriminatory? Of course. If such a taxpayer can continue to deduct his pre-productive costs, he has an enormous competitive advantage over newly formed competitors.

Certain provisions in the Internal Revenue Code specifically allow deductions for certain pre-productive period expenses which are not considered deductible under generally accepted accounting principles. See, for example, section 174 of the Code relating to research and development expenses. The ability to deduct research and development expenses, is not generally considered to involve a tax abuse. This proposal suggests that the average grower is being subjected to punitive legislation.

These punitive features of the Bill will have a wide effect in the floricultural industry, where many farming enterprises are carried on in the corporate form, or in the form of a partnership with a corporate partner. The inclusion of partnerships in the class selected for this drastic treatment is worthy of particular note. Generally, a partnership is viewed as a conduit, and the tax consequences of its operations are reported by each of its partners. If, therefore, three individual floricultural producers form a partnership to produce commodities for their business, they may be subject to the snares of LAL, but not forced to use the accrual method of accounting and to capitalize their pre-productive period expenses. If, however, they want to include a fourth partner which is a corporation, even as a one percent partner, the rules drastically change. All of the partners of a partnership with a corporate partner are subjected to the accrual method of accounting and the capitalization pre-productive period expenses. *This discrimination among forms of business enterprise is wholly unwarranted.*

SUMMARY AND RECOMMENDATION

Agriculture is capital intensive. The economics of farming make it a very risky operation. We believe the tax laws, at a minimum, should be neutral as between farmers and other types of economic endeavors. The House Bill violates neutrality. Agriculture is singled out and subjected to restrictive burdens not imposed on other forms of busi-

ness in the economy as a whole. Are the "abuses" of the farm provisions worthy of such measures? Again, relatively speaking, the cost to the Treasury of the farming provisions is minimal compared to those in other tax shelter areas. Yet the farming area is singled out for the "at risk" provision and the requirement of the accrual method of accounting and capitalizing pre-productive costs.

The basic recommendations of The Society of American Florists and Ornamental Horticulturists is that the House approach be totally rejected. If there are abuses in the tax system which must be eliminated, then legislation should be developed which is targeted specifically to the abuses—and does not punish our industry with a keen eye to the costs of compliance which must be borne by the small businesses when complex laws are enacted. We believe that provisions of existing law may be adequate to deal with abuses of the farm tax rules. They should be applied to "tax shelter" abuses in agriculture as well as other areas. Thus, for example, under present law deductions are only allowed if the organization is in business for profit. This rule is a reasonable and effective weapon against the abuses of the farm tax rules. Another illustration is the treatment of nonrecourse financing as equity investment (see, for example, Rev. Rul. 75-350, 1972-2 C.B. 394) and the disallowance of deductions based upon inflated nonrecourse financing. The rules of present law are in many cases adequate to protect against abuses of the farm tax rules if these provisions are applied as intended.

If, however, the approach of the House Bill is to be considered, we recommend the following specific changes:

(1) The amount of unrelated income which can be offset by "accelerated deductions" before application of the LAL rules should be increased from $20,000 to $50,000. This revised test should apply to taxable rather than adjusted gross income. Only if the taxpayer has substantial nonfarm income otherwise taxed at the higher progressive rates will be likely to embark upon a tax shelter program of any kind. In applying this floor to corporations, the nonfarm income of individuals owning more than 10 percent of the stock should be aggregated with the corporation's nonfarm income. These changes would focus the LAL provision upon the wealthy nonfarm investor and limit to a very few cases the likelihood that a full-time farmer will be caught in the web of LAL.

(2) The carryback of deductions which have been deferred by the LAL provision, should be permitted where nonfarm income drops below $50,000 in a subsequent year.

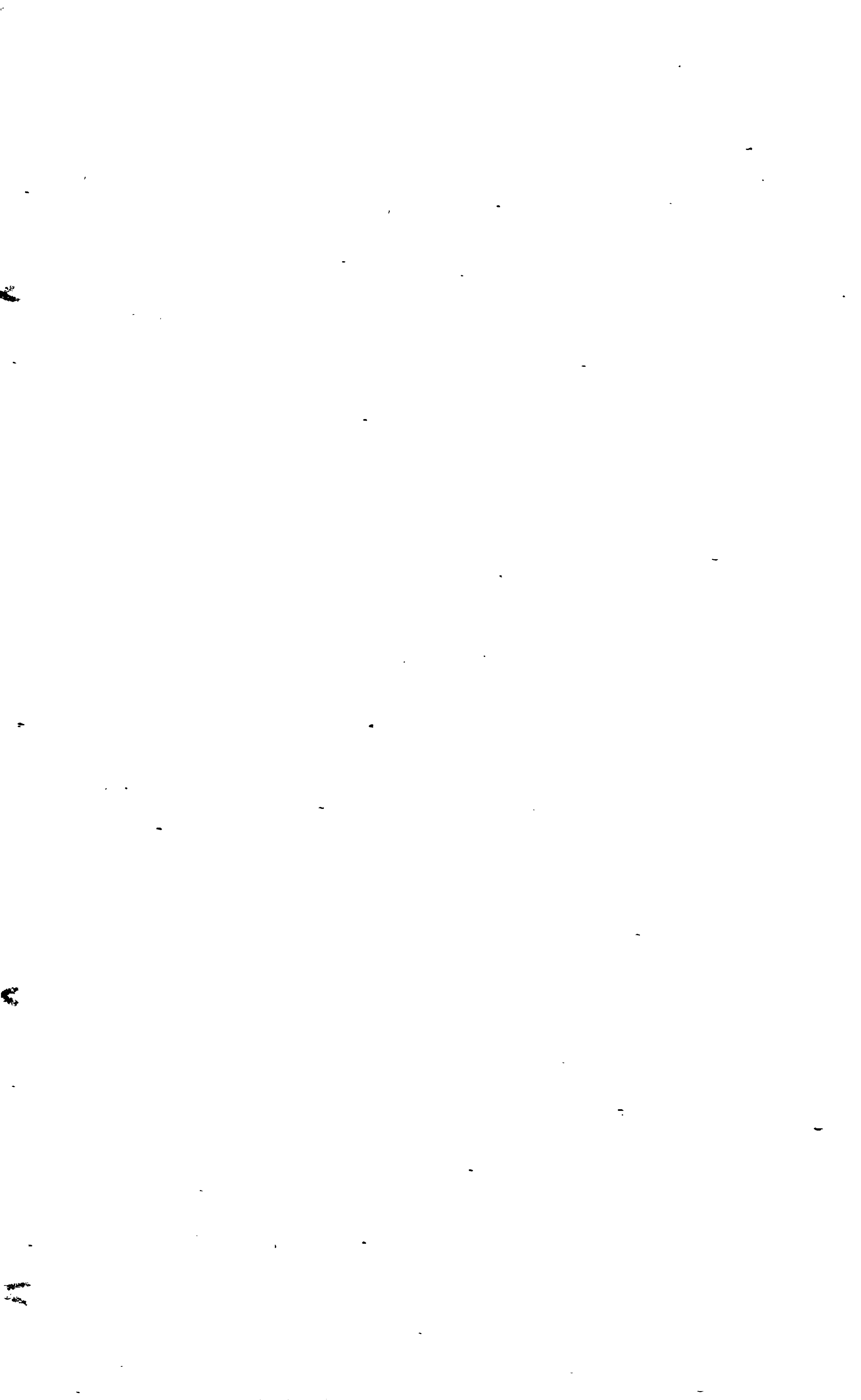
(3) The LAL farm rules should not apply to any person from whom gross income from farming is a substantial portion (perhaps 50 percent or more) of his gross income.

(4) The required use of the accrual method of accounting should be eliminated. If the other suggested changes are agreed to, this provision is not needed.

(5) There should be no requirement that expenses allowable under the accrual method be capitalized by a corporation engaged in the business of farming.

(6) Partnerships that happen to include a corporate partner should not be required to use the accrual method, unless the corporation owns in excess of 50 percent of the capital interests in the partnership.

Tax Deductions for Educational Expenses



Statement of Americans United for Separation of Church and State

Americans United for Separation of Church and State is an interdenominational organization founded in 1947 for the sole purpose of defending religious liberty and the constitutional principle of separation of church and state. Americans United has been a co-sponsor of a number of the lawsuits in recent years which have resulted in United States Supreme Court rulings banning as unconstitutional a variety of forms of tax aid for denominational private schools.

We believe that S. 2356, introduced by Senator Buckley, raises serious constitutional and public policy questions.

S. 2356 would provide income tax deductions up to $1,000 per year per student for tuition to public and private schools and colleges. Since public elementary and secondary schools do not charge tuition, and since public college tuition is generally under $1,000 per year, it is obvious that the primary purpose of S. 2356 is to aid private and church-related schools and colleges. The benefits of such legislation, therefore, would go disproportionately to the institutions enrolling the 9 percent of our students attending nonpublic elementary and secondary schools and the one quarter or so of our students attending nonpublic colleges and universities. We do not believe that providing tax benefits disproportionately to nonpublic educational institutions is fair or in the public interest.

Moreover, since tax deductions increase in relative value as family income rises and since the likelihood of enrollment in a private school rises with family income, S. 2356 would benefit the affluent far more than families of modest means. Further, schools and colleges charging higher tuition and serving more affluent families would benefit from S. 2356 to a greater extent than institutions charging little or no tuition and serving families of lower incomes. S. 2356, therefore, would aid the more well-to-do and slight the needy.

Nonpublic schools, and to a lesser degree nonpublic colleges, tend toward religious homogeneity of faculty and student body, and, especially on the lower levels, tend to inculcate particular denominational tenets. S. 2356 would therefore not only promote the division and separation of students and faculty along religious and other lines but also provide public aid for the teaching of religion. This would be divisive and of dubious constitutionality.

Donations for general purposes to private schools and colleges are presently deductible. Senator Buckley's bill would provide deductibility not to general donations but to tuition payments earmarked for specific students, students related to the payer of the tuition. Such a practice would, in our opinion, conflict with the Supreme Court's ruling in *Pearl* v. *Nyquist* (350 R. Supp. 655, 410 U.S. 907; 1973) striking down tuition reimbursement grants and tax credit/deduction reim-

bursements as unconstitutional for having "the impermissible effect of advancing religion."

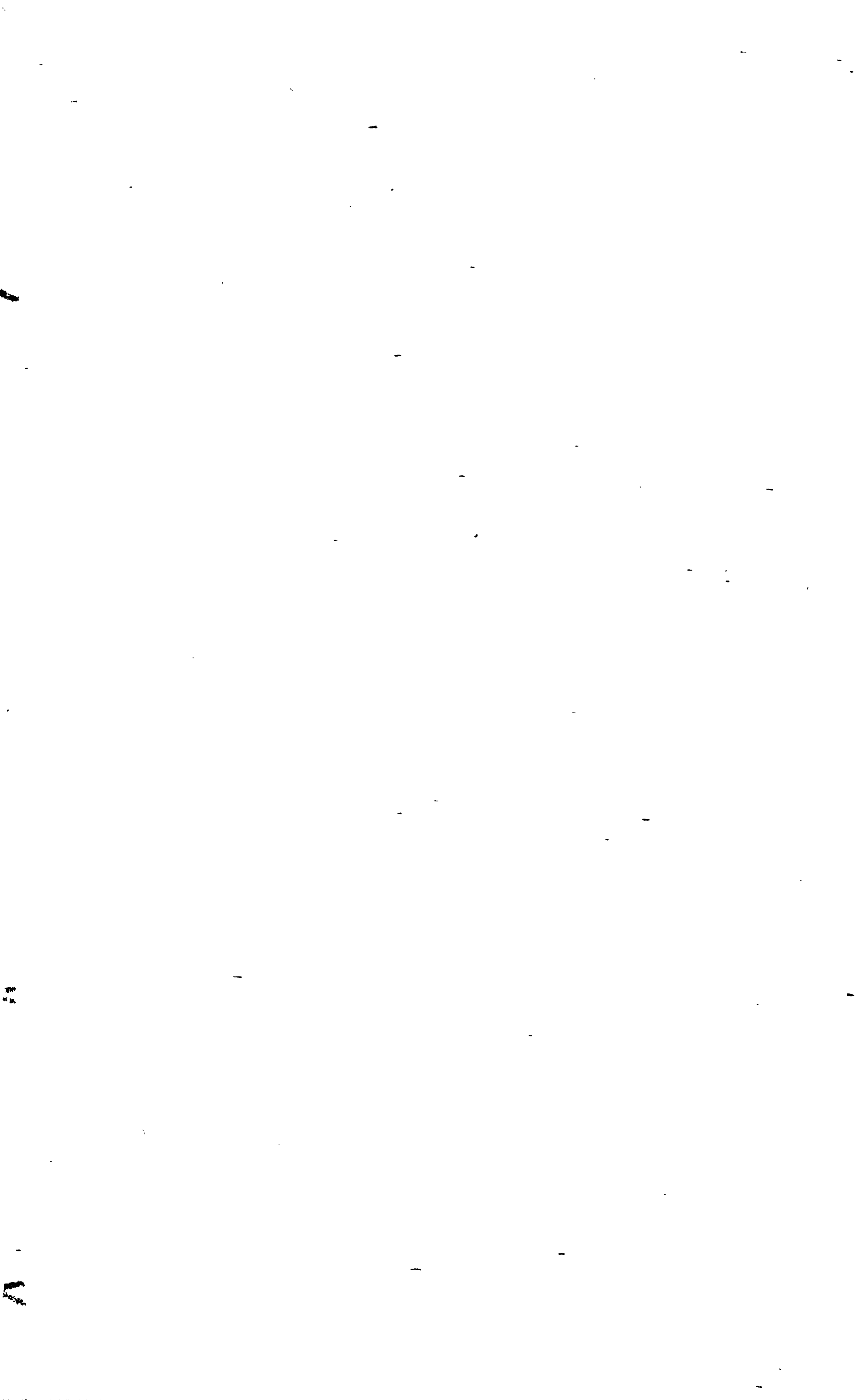
S. 2356 would also cost the U.S. Treasury a not inconsiderable sum. As there are 4.5 million students enrolled in elementary and secondary nonpublic schools and 1.1 million enrolled in nonpublic colleges, S. 2356 would cost the U.S. Treasury an estimated 1.1 billion dollars annually just for the nonpublic educational sector. With public schools and colleges suffering already from fund shortages, we do not believe that we can afford the luxury of further federal aid to nonpublic institutions and their more affluent than average patrons. We believe that any benefits which Congress wishes to extend to education should be confined to public institutions.

For these public policy and constitutional reasons, we urge the Senate Finance Committee to reject S. 2356 as socially and constitutionally unsound.

Respectfully submitted.

EDD DOERR,
Educational Relations Director

Tax Treatment of Certain Cooperative Housing Associations



Statement of Fred Thornthwaite, General Manager, Cooperative Services, Inc., Detroit, Mich., Treasurer, National Association of Housing Cooperatives

(Concerning Title XIII, Section 1301 of the "Tax Reform Act of 1975," H.R. 10612.)

As a person involved with cooperative housing since 1940, I appreciate the opportunity to talk with you about the impact of both tax policy and housing policy on the people who are housed and on the communities where the housing is built.

It is important to recognize that tax programs and benefits are as much a part of housing programs as the loan programs themselves. And our purpose here is to ask you to think about the impact of the tax policies on both people and the housing.

The management of multi-family projects is increasingly difficult for many reasons. But multi-family housing is a crucial part of America's housing supply.

Current statistics show that multi-family housing is in serious trouble. Tenants have obtained rent control legislation to protect against unaffordable rent increases. Rent controls have discouraged investors from entering the multi-family market. Older buildings go unrepaired because investors will not get a return on their money. Homeowners abandon houses which they cannot maintain and no longer meet their needs.

One approach to this dilemma is in arrangements that permit multi-family building occupants to take responsibility for their housing. Our experience is that the cooperative offers a way to achieve ownership concern and individual responsibility in a group setting and is especially useful for low or limited income persons. In fact, most housing Co-ops are owned by persons of moderate or low income.

In pioneer days when houses were far apart, there was no apparent need for people to be involved with their neighbors. The situation is different today since for multi-family projects people must live close together. The cooperative is a means whereby the group can undertake to maintain standards. An important feature is the fact that title is held by the corporation and that member-tenants own an undivided interest in the entire project.

A CO-OP IS GROUP OWNERSHIP—AND NOT A CONDOMINIUM

By supporting a reasonable tax policy, Congress can encourage the development of a sound cooperative housing program. But you must recognize that cooperative housing is different from individual home ownership and also from condominium ownership. Because the title to all the property is held by the corporation, there is no such thing as

"common property" or "privately owned property" as referred to in the House Committee report. The member-owners work as a group; participate in board meetings, committees, and group projects; and take responsibility for the entire project—not just their individual living unit.

A CO-OP IS NOT A CONDUIT

The cooperative corporation, therefore, is not "merely a conduit". The housing cooperative is a group creation which develops standards and policies and requires member education and support. The Co-op member is under certain constraints that are not imposed on an individual homeowner nor even upon the owner of a condominium unit. The cooperative is concerned with policies that preserve the quality of all the housing—both physically and as an emotionally supportive community.

A CO-OP ASSURES GOOD MAINTENANCE

The advantages of group ownership and responsibility are possible because the members' home ownership concern is combined with the ability of the cooperative to accumulate reserve needed for good maintenance. Cooperatives we are involved with are for people with limited incomes. The membership and occupancy agreement vary with the amount of financing available. The required equity investment stays the same for the entire life of the mortgage. If the equity payment were to increase, the housing Co-op would not be able to serve people of limited means.

WHAT ARE THE RESULTS?

In the Cooperative Services buildings for senior citizens, the membership investment is still $100. The monthly rents average $93.20 for a one-bedroom apartment and $79.60 for a studio apartment. Rents are subsidized—comparable projects with same subsidies have rents that are 50 percent higher than co-op projects. Because the members work together, there have been only two rent increases of between $2 to $6 a month in the past ten years. The buildings are well maintained and are a secure, happy environment.

In contrast, there is little chance that limited income people living as private homeowners or as condominium owners would ever set up needed reserves or take care of the property.

An individual, low income person faced with a sick child and a leaking roof goes to the doctor and lets the roof rot off. For this reason, the HUD program of getting mothers receiving Aid for Dependent Children into home ownership was a disaster. A cooperative with a low fixed membership investment could have been a success at one-tenth the cost. The reserve is paid in regardless of other bills and is used to fix the roof when it goes.

Another example of the importance of cooperative ownership is in the ability of the housing cooperatives to keep down their operating costs and to serve the income groups intended under government financing programs. In a suburb east of Detroit, part of a housing development sold as a condominium has not been fully occupied and is not

as well maintained as the cooperative across the street. The Williamsburg project discussed before has largely family occupancy with incomes averaging $9,017 a year. Monthly charges average $136, not including electricity.

TAX TREATMENT

Over the years, the tax treatment of cooperatives which combined group ownership with private ownership concerns raised a number of issues. These issues include whether tenant cooperators should be allowed to deduct the interest expenses and real estate taxes incurred by their housing on their personal income tax return and whether a co-op owned building can be depreciated and who is entitled to deduct that depreciation.

PERSONAL DEDUCTIONS

Internal Revenue Section 216 enacted by Congress in 1942 answered the first issue. The rationale apparently was that co-op owners should have a tax benefit similar to homeowners because they do take an ownership responsibility. Practically all interest and tax payments of any kind are deductible by individuals. Cooperators are individuals who have joined together to undertake the financial risks and obligations incurred in any multi-family project. It is their money which goes almost directly for the interest and tax expenses. Hence cooperators are allowed these deductions on their personal return, even though they are acting, through the legal vehicle of a corporation. Without this benefit there might be less incentive for individuals to use any capital on their own housing and to assume any of the responsibilities involved in cooperative ownership.

DEDUCTION FOR DEPRECIATION

The right of the cooperative housing corporation to take depreciation in the same way as any business corporation has always been assumed. Recent IRS rulings have denied this right. Part of the confusion seems to stem from the addition of Section 216c in 1962. The legislative history does not include the news reports which explained that Bobby Baker owned a number of apartments in a cooperative housing development. These apartments were rented. If he could take depreciation on these apartments, it would be to his advantage and so the law passed.

We believe this provision for depreciation in the law erodes the intent of Congress to support and encourage an individual who joins a cooperative housing endeavor. This depreciation deduction can be taken only when the member uses the property as a business. Renting out a co-op apartment is forbidden in most Section 213 cooperatives and in the Section 221D3 cooperatives. Such a practice would not be appropriate or desirable in cooperative housing developments operated for the benefit of the user-occupants.

The tax situation of housing cooperatives is further eroded by a 1972 decision in the tax court, *Park Place, Inc.*, which holds that cooperative corporations may not deduct depreciation. The rationale of the court is that, legally, the cooperative corporation involved in the

case was no more than a mere custodian of the building for its tenant-stockholders. The corporation had no investment as such in the building and hence, the corporation really owned nothing to depreciate.

The decision, we believe, offends good housing policy and is questionable legally.

Legally, co-ops are a hybrid of the typical multi-family rental project and of typical individual, single family homes. To pick out, as the tax court did, one element of a co-op's legal structure, namely the member-tenants' ownership of stock in the co-op corporation, and to peg the decision on that one element is unfortunate in view of the decision's impact on cooperative housing and housing policy. We might even ask about the fairness under the court's reasoning.

Good housing policy is offended because to deny depreciation deductions to co-op housing corporations means seriously undermining their financial viability. This is so because such deductions are one of the keys to the buildup of adequate cash reserves. Without reserves for major repairs or capital replacements, the cooperative is at the mercy of lenders or can make capital assessments against the members. Borrowing money is very expensive. This defeats common control and use of the reserve fund by the corporation. Capital contributions simply cannot be made by low income families.

Reserves are essential for a sound housing program. With the depreciation deduction, the cooperative corporation can set assessments at a break-even level and yet build up cash reserves for replacements. Without the depreciation deduction, these cash reserves would be drastically reduced by taxes and the long term stability of the housing jeopardized.

PROPOSED LEGISLATION

The "exemption" offered to cooperatives in HR 10612 is not favored by any of the housing cooperatives we are acquainted with. The pitfall for co-ops is in the fact that cooperatives—at least all through the House Committee report—are treated as if they are the same as condominiums or privately owned housing. The proposed legislation fits privately owned homes and condominiums; it will destroy cooperative housing operated by and for limited income people. Congress has expressed its intent to encourage cooperative ownership among low and moderate income families in Section 246 of the National Housing Act as amended by the Housing and Community Development Act of 1974. 12 U.S.C. 1715z-11.

The proposed legislation creates categories of acceptable expenses and acceptable income for co-ops, condominiums and housing associations. The assumption underlying these classifications is that the cooperative is the same as a condominium. For example, on page 328 of the House Committee report:

> Qualified income is to include fixed . . . assessments that vary depending upon the need of the association *to pay for maintenance*, improvements, . . . *on the common property.*

And on page 329,

> Your committee's bill provides an expenditures test . . . at least 90 percent . . . must be to manage, maintain, and care for, or improve, *association property* . . . expenditures on privately owned property—as opposed to common

property—are to qualify only in the limited situation of repair of exterior walls and roofs where the walls and roofs qualify as association property . . . transfers to a sinking fund account for the replacement of a roof would not qualify as an expenditure for the 90 percent test.

What will be the effect of all this on cooperative housing? Just plain catastrophe, that's all. There is no distinction in a cooperative between private property and common property or association property. Everything in a cooperative project is common property, including the facilities and individual units. The intrusion of a distinction between private and common property into a cooperative would be to defeat the essential concept of group control and group action that make a cooperative work for low and moderate income families. We know that Williamsburg Towne Houses, a Section 221D3 cooperative, spends money as needed to maintain good housing. This means that the Co-op replaces hot water heaters, bathroom floors, individual furnaces, garbage disposers, and repairs toilets, plumbing, and furnaces from monies collected as monthly carrying charges. Under the legislation, these expenses are not for "common property." What is supposed to happen now? Will maintenance responsibility be abandoned to the individual co-op member as it is in a condominium?

In a co-op there is *no* privately held property. Even now IRS court decisions are limiting depreciation to *common facilities*. Will the Internal Revenue Service next disallow expense incurred for maintenance work in the individual units?

Cooperative housing which can have a policy of setting aside adequate reserves will do more to assure sound housing stock than any other program—and at no added cost to the government. The person who first moves in to a dwelling is immediately using up—or wearing out—the unit. The carrying charge—or rent—should be high enough to allow money into reserves. These funds are used to replace the roof—or the furnace—or carpeting—all items whose cost should be spread over time to avoid disaster for the co-op housing project.

The ability to accumulate reserves from current charges and to maintain the property distinguishes a cooperative from condominiums and from individual home ownership. The housing cooperative is a corporation and, as such, should be allowed to take depreciation and to spend for all necessary maintenance.

When figured on a straight line basis over the life of the mortgage, the depreciation is enough to cover the payments to principal, reserves and incidental income such as interest on reserves. The members can then set the monthly carrying charges at a break even level and have a financial report that makes sense. No special tax exemption is needed for cooperative housing—just the same depreciation exemption as allowed for any corporation.

Because of tax court decisions, we urge that Congress act affirmatively for cooperative housing to be allowed a choice of taking depreciation—or being exempt. Because of court cases in which housing cooperatives have been held liable for income taxes on their reserve funds, we ure that current tax reform legislation include recognition of the right of cooperative housing corporations to deduct depreciation. We suggest that the Section 216c regarding tax depreciation for a cooperative landlord be repealed. We also believe that the tax exemp-

tion legislation with respect to co-ops is superfluous and should be dropped. The dissenting Judges in *Park Place, Inc.* stated the case simply: If all receipts by the cooperative are to be treated as income, then it should be entitled to all the offsetting business expenses, including depreciation.

Legislative recognition of the depreciation deduction for cooperatives could take the following form:

NEW SECTION 167(N)

Cooperative housing corporations as defined in Section 216(b)(1) shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property held by or for the benefit of such corporations. The depreciation deductions provided for in this subsection shall be computed in accordance with subsection (b) of this section.

HIGH POINT OF HARTSDALE I CONDOMINIUM,
BOARD OF MANAGERS, MANAGEMENT OFFICE,
Hartsdale, N.Y., June 30, 1976.

Re H.R. 10612 (The Tax Reform Act of 1976) section 1301 relating to the tax exempt status of Condominium housing associations.

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

DEAR SENATOR LONG: This letter is written in my capacity as President of the High Point of Hartsdale I Condominium, which consists of approximately 200 individual condominium apartment units located in Hartsdale, New York. In addition, I am engaged in the practice of tax law as a member of the New York City law firm of Miller & Summit.

Being President of this Condominium, I am interested in the peculiar problem dealt with in Section 1301 of H.R. 10612 as reported by you to the Senate on June 10, 1976. That Section contains amendments to the Internal Revenue Code of 1954 with respect to the tax exempt status of certain condominium management associations within the purview of the Bill. I am in favor of such an amendment.

It would seem that this Condominium would in all likelihood qualify for tax exempt status under the provision as drafted. However, I am concerned with the impact that the Bill might have upon the larger multiple condominium projects such as High Point; an impact which may not be the intended result of the Senate.

The larger condominium construction projects are often built in more than one phase for practical reasons and may, in fact, consist of more than one condominium entity joined together through another entity. For example, the High Point community consists of 500 condominium apartment units; these 500 units are divided into and operate pursuant to three separate plans of condominium ownership and are, as such, three distinct condominium entities: High Point I consists of approximately 200 units, High Point II consists of approximately 120 units and High Point III consists of the balance of the 500 units.

As is the usual case, each condominium has its own Board of Managers and each collects common charges and assessments and each maintains the common elements in accordance with its particular plan of condominium ownership. The three condominiums are, however, connected to each other through the use of a fourth entity, in this case called the High Point Community Association. It is the function of the Community Association to care for certain centralized facilities and numerous areas of concern to each of the three condominium entities. The expenses incurred by the Community Association are assessed *pro rata* to each of the three underlying condominiums; the amount of the Community Association's assessment would in turn be contained in each condominium's budget and eventually form, in part, the unit owner common charges.

It would appear that the conceptual underpinnings of the new law that condominium arrangements are essentially noncommercial and lack the profit motive on which to properly levy a tax, would clearly intend to exempt from taxation the Community Association entity in the same manner as it would exempt the individual condominium. There may be some question as to whether or not the actual words of the statute will accomplish that intent; in fact, an intention to tax, rather than exempt, such a central entity may arise. In order to qualify as a Housing Association under the statute as now prepared, a centralized association will need to qualify as a condominium management association. To do so, it would need to be organized and operated to provide for the acquisition, construction, management, maintenance and care of Association Property as defined in the statute (in the usual case, this would present no problem). However, in addition, 60% or more of its gross income must consist of amounts received as membership dues fees or assessments from "owners of residential units in the case of a condominium management association". I am concerned that the fees and assessments collected by the central associations might not fall within the statutory requirements with respect to the derivation of the payments. In many cases, such fees and assessments would not, in fact, be received directly from owners of residential units. At High Point, for example, the Community Association assessments would come from the three separate condominiums. This would leave the Community Association in the same position in which it now functions. By expanding the 60% rule to state that it refers to amounts received from owners of residential units in the case of a condominium management association "or, in the case of a central management association owned entirely by one or more condominium management associations, amounts received from such other condominium management associations", the problem might be eliminated.

That some clarification appears appropriate is demonstrated at page 396 of the Senate Finance Committee Report (No. 94-938); it is said that qualifying receipts "must be derived from members in the capacity of owner-member. . . .". It might be argued that the receipts by a central association would not be derived from members in the capacity of owner-members because the underlying condominium associations do not, in the usual case, own any residential units of their own; as such, an inference of taxability might arise.

Judging from the intent of the Senate Finance Committee and of the House Ways and Means Committee as set forth in the various reports accompanying this Bill, the intent of Congress would not be undermined by making the amendment described above. I would respectfully request that this suggestion be made part of the Senate record.

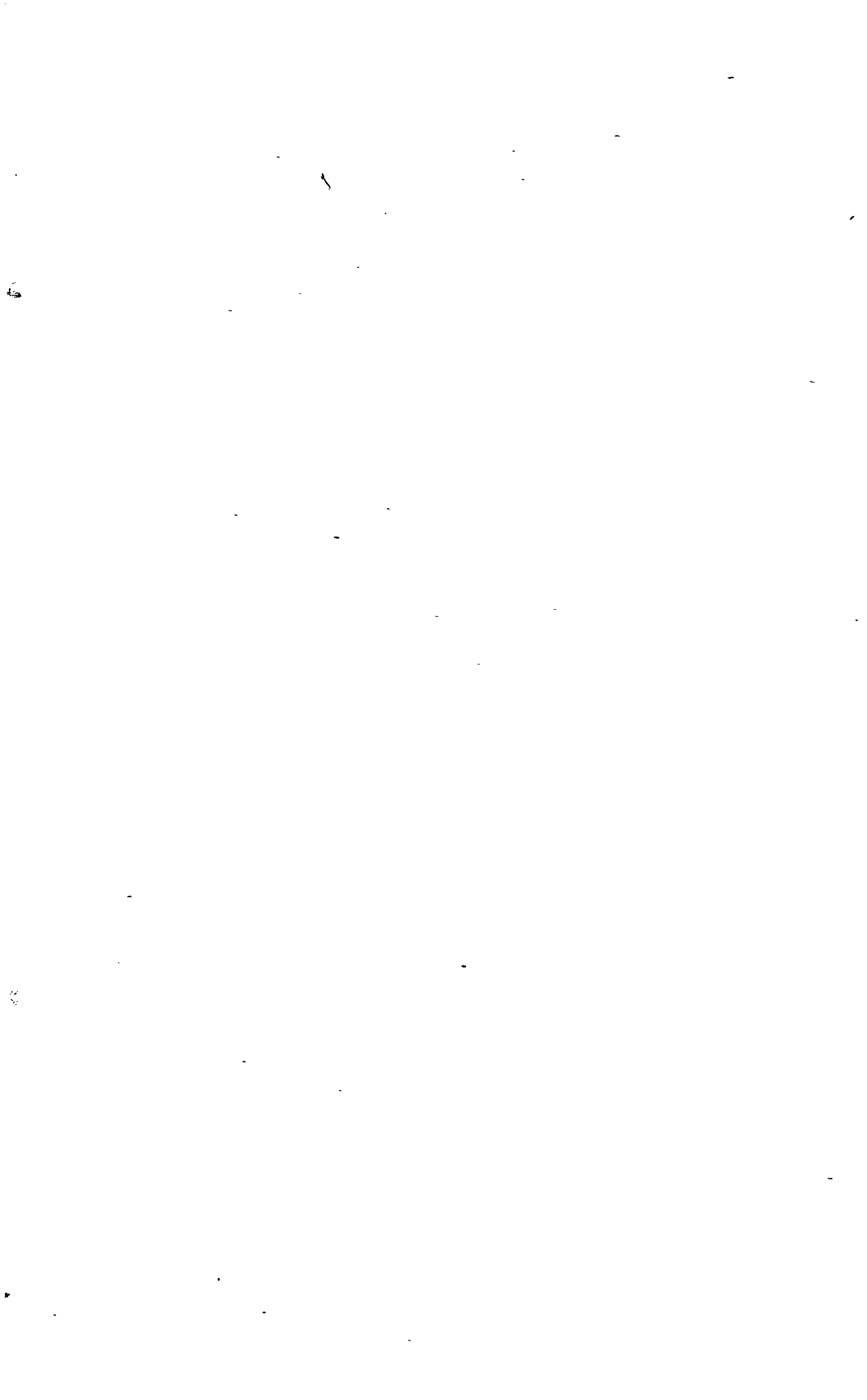
Should you wish to obtain further information with respect to the effect of this law on condominium arrangements. I stand ready to assist in any way in which you feel appropriate.

Thank you in advance for your consideration.

Very truly yours,

MICHAEL G. TANNENBAUM,
President.

Taxpayer Privacy



STATEMENTS OF SENATOR WARREN G. MAGNUSON, SENATOR HENRY M. JACKSON, AND SENATOR HUBERT H. HUMPHREY

Mr. CHAIRMAN: We appear today before the Senate Finance Committee to testify in support of fair treatment for the nation's taxpayers. Congress now knows of major, repeated abuses of taxpayers by the IRS. We call on the Finance Committee to act to correct these abuses so the tax system will be fair and equitable. Every citizen has a right to equal treatment at the hands of the tax collector. Congress has an obligation to ensure the IRS meets this standard.

The blueprint we suggest to the Committee for minimal procedural reform of the tax system is S. 2342, the Federal Taxpayers' Bill of Rights Act of 1975 and its proposed changes in the way the Internal Revenue Service does business.

S. 2342 was introduced by Senator Magnuson on September 16, 1975. The bill was widely acclaimed as a reasonable consensus for badly needed procedural reforms in the Internal Revenue Service. Twenty-two Senators are sponsoring the legislation. This includes five members of the Senate Finance Committee. Besides Senators Magnuson, Humphrey, and Jackson, Senators Case, Church, Goldwater, Philip Hart, Haskell, Hathaway, Hatfield, Inouye, Javits, Kennedy, Mansfield, McGovern, McIntyre, Mondale, Montoya, Proxmire, Ribicoff, Roth, and Tunney are cosponsors. This strong base of bi-partisan support is a clear reflection of the fear of the American people that the Internal Revenue Service cannot correct the flagrant abuses of taxpayers which have recently been revealed.

The United States collects personal and corporate income tax through a self-assessment mechanism. This assumes that individuals and businesses are familiar with the law, conscious of their rights, and willing to comply with the tax mechanism.

More importantly, the Internal Revenue Service is the one government agency which touches every employed citizen every year. It is the face of the Federal Government to most citizens. If it has no credibility or if it is arbitrary and capricious, or if it favors the rich over the poor, or if it is inefficient or bureaucratic, the entire U.S. Government stands indicted. Congress cannot tolerate any of these programs in any bureaucracy. But no agency is more important in this regard than the Internal Revenue Service. Also, if too many people question the basic integrity and fairness of their Government and the self-assessment mechanism, the fiscal integrity of the United States may be endangered. The Congress must take every reasonable action to insure fairness and equity in the tax mechanisms. Otherwise, self-assessment cannot work. The Senate has become fully aware of a whole range of abuses within the Internal Revenue Service. The Finance Committee has a unique opportunity in the context of these hearings and proposed legislation to deal significantly with these abuses.

This is April 13. Within two days, every single American wage-earner will file a tax return with the Internal Revenue Service. It is our belief that the reasonable expectations of most taxpayers that their returns will be handled fairly, equitably, without political considerations and held private are not fulfilled in the present tax system. How many taxpayers realize that their tax return information is widely accessible to all branches of the Federal Government and state and local governments without restraint on disclosure or use by those agencies? How many taxpayers will rely upon information provided them by the Internal Revenue Service that is incorrect and that an IRS error will not relieve the taxpayer of penalties and interest on any tax due? How many taxpayers know that the IRS audit procedure is an adversary proceeding and that the auditing agent will not inform them of legitimate uncertainties concerning their tax due? How many citizens will understand that they have the right of appeal from arbitrary IRS decisions? How many low and middle income taxpayers know that they will be held to a much stricter standard at audit than large-income taxpayers? For instance, how many taxpayers know that in 1974 the IRS settled cases valued under $1,000 for an average of 71 cents on the dollar, while it settled cases valued over $1 million for an average of 17 cents on the dollar.

The Taxpayer's Bill of Rights Act involves seven basic principles which we strongly urge this Committee to include in any tax legislation which it chooses to report to the full Senate:

First: The bill provides for significant new limitations on disclosure of tax return information. It permits taxpayers to recover civil damages for unauthorized disclosure of personal tax data.

Second: The bill establishes safeguards against the political misuse of the Internal Revenue Service. It limits nontax related surveillance activities of the IRS and provides criminal penalties for illegal surveillance.

Third: The bill protects taxpayers from arbitrary procedures. It places reasonable limits on the power of jeopardy assessment and termination of a tax year by IRS agents. It increases the amount of personal property exempt from tax levy for living expenses.

Fourth: It establishes a taxpayer Service and Complaint Assistance Office—a sort of ombudsman within the IRS. This new office will monitor improper behavior by IRS agents. It has the power to provide temporary relief in special cases of IRS abuse.

Fifth: It requires the IRS to fully inform the taxpayer of his rights during any audit or tax appeal procedure.

Sixth: It authorizes a pilot project of independent legal assistance to taxpayers in audits and appeals. The project would be limited to four cities over a 3-year period. The legal assistance would be available to both middle- and low-income taxpayers.

Seventh: The bill provides the General Accounting Office oversight authority over the IRS. GAO is required to report annually on the entire scope of IRS activities.

This is not a complete description of every possible administrative amendment to the Internal Revenue Code. However, it represents a reasonable, realistic goal for this session of Congress. If the Senate deals meaningfully with these particular reforms, it will take a long

step toward restoring the public's confidence in the federal tax assessment system.

TAXPAYER PRIVACY

S. 2342 provides an essential tightening of the taxpayer's right to privacy. It places realistic limitations on the disclosure of private federal tax return information. Commissioner Alexander testified before the House Treasury Appropriations Subcommittee:

> We have a gold mine of information in our tax system. We have more information about more people than any other agency in this country. We must have this. People file tax returns with us and tax returns contain a great deal of private information which we must safeguard.

Citizens reasonably expect that their tax return information will be held private by the Federal Government. In fact, tax returns are anything but private. Citizens' reasonable expectations of confidentiality must be insured. The present law does not do that.

On November 18, the Administrative Conference of the United States, an independent federal agency, released the results of a year-long study of the Internal Revenue Service. The Conference released a 1,000-page report prepared by expert tax consultants reviewing the procedures of the IRS. The Administrative Conference's privacy recommendations are very close to the provisions contained in the Taxpayers' Bill of Rights Act of 1975.

Mr. Meade Emory, who is currently an assistant to the Internal Revenue Service Commissioner, wrote the section of the Administrative Law Conference report on taxpayer privacy. As he pointed out, Congress does not require Americans to provide reports on their personal and financial affairs for general government use. Yet, we continue to tolerate a tax law which accomplishes this same potential purpose through the back door. Over the last fifty years, the IRS has provided steadily increasing numbers of tax returns to federal, state and local officials who may use them for statistical, investigative or other non-tax purposes. For instance, the Justice Department alone requested and received 19,000 tax returns from United States citizens in calendar year 1973.

How many taxpayers realize that the IRS has a procedure which requires its agency employees to report apparent non-tax law violations discovered through examination of tax returns? In the words of the Administrative Conference report, "Isn't this an all-purpose investigative body, sniffing out offenses of all kinds from compelled evidence"? The report continued, "On the Constitutional level, there is a far more insidious potential, if the information compelled against the taxpayer will be used against him."

Few of us who are Members of Congress fail to appreciate the potential for political abuse which we have observed through the Watergate years from release of tax return information to the Justice Department and the Executive Office of the President.

Our bill provides that returns will be open for inspection only by the taxpayer or by "an officer or employee of the Department of the Treasury, or the Department of Justice, or by the President personally, if such inspection is solely in connection with the administration or enforcement of this title."

Under this provision, the President would have to sign personally for the use of tax returns. There would be no more unrecorded flow of tax information to White House aides. In addition, the stronger anti-disclosure penalties in this bill will begin to adequately recognize people's reasonable expectations of privacy of tax return information.

In the past, the Justice Department has been able to obtain tax returns on individuals under investigation for criminal but non-tax related matters with no court review. Nowhere else are government investigators allowed unsupervised access to a person's home or private business information because the Constitution states that: The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures shall not be violated. . . .

We suggest that the Justice Department shall be required to obtain a search warrant issued by a competent judicial authority before the Department has access to an individual's tax return held by the Internal Revenue Service. By requiring court review, we hope that improper use of tax data by the Justice Department can be limited. And this makes the compelled disclosure of private information subject to the same procedural protections as a person's physical belongings or private business records.

We support the approach of the Administration Conference with respect to non-criminal IRS disclosure of tax return information. It should be limited by statute which designates who may see returns, the purposes for which disclosure may be made, the procedures governing such disclosure, and the limitations on the use or redisclosure of the return. For instance, the Conference staff recommended that IRS disclose tax returns only to executive departments or Federal Government agencies in connection with necessary enforcement of the tax laws, the Social Security laws, and the Employee Retirement Income Security Act. In particular, they recommended that the IRS should not disclose a tax return to any executive department or agency that is not related to tax law administration or for use in any way relating to an individual's service as a juror.

In much the same way, the recommendations of the Administrative Law Conference report with respect to discolsure of tax returns of individuals to the President or his staff parallel closely the provisions of our bill. The Conference report recommends that the President be required to personally sign a written request specifying the particular tax return, that the information be provided by the IRS only in written form, and that the President be required to return the tax material to the IRS.

The Administrative Conference report also endorses the underlying philosophy of the Taxpayers' Bill of Rights Act with respect to the availability of federal tax return information to state authorities. The Conference report recommended that states be required to enact statutes making it a crime for state personnel to disclose tax return information and that states be required to adopt legally enforceable regulations safeguarding the confidentiality of tax returns. We support this approach and note that the Taxpayers' Bill of Rights Act does not, in our view, prohibit states which passed appropriate statutes from continuing to share computer tape information and similar tax data with the Internal Revenue Service. However, the Taxpayers' Bill of Rights

Act would require that the governor request the information in writing initially, specify the purpose for shared information, why the information sought is available solely from federal tax return information and state why such use of the information is necessary to carry out a specified state legal duty. Admittedly, this is a much more stringent standard of disclosure than is currently in effect. But we submit that any lesser standard prevents effective protection of taxpayer privacy.

POLITICAL USE OF TAX RETURN INFORMATION

It is now evident that the IRS has been collecting and maintaining information on individuals and organizations over the last several years for purposes other than enforcement of the tax laws. Most of the files maintained by the IRS Special Services Staff had no relation at all to tax information needed by the IRS. Similar non-tax related data has been maintained in the IRS' intelligence-gathering and retrieval systems, a new computer system designed to help the IRS' Intelligence Division keep track of organized crime cases.

We suggest that it should be illegal to "investigate into, maintain surveillance over, and maintain records regarding the beliefs, associations, or activities of an individual or organization which are not directly related to the Revenue laws."

Our bill would give an individual or organization standing to bring suit for damages against any official who violates this provision.

ARBITRARY IRS PROCEDURES

Jeopardy assessment is a power given to the IRS to take suddenly the assets of a taxpayer if there is reason to believe the taxpayer is not going to meet his tax obligations. Historically, it has been used in cases where the taxpayer has been preparing to flee the country or otherwise hide or dissipate his assets. Termination of assessment provisions in the tax code have been used in recent years in the drive against narcotics dealers. Generally, when a person is discovered to be a drug dealer, his tax year is immediately terminated and he is assessed for the value of his assets—generally the value of the drugs or the proceeds from the drug sale as estimated by the IRS.

These are extremely powerful tools for law enforcement. At the same time, they have been misused on occasion. More importantly, there are currently no adequate restraints on how these powers could be used if persons in authority in the Internal Revenue Service or the Department of the Treasury should decide to use these mechanisms for narrow political or personal reasons.

Our bill attempts to give taxpayers certain limited recourses in cases of jeopardy or termination of assessment which are reasonable, do not conflict with lawful enforcement purposes or the Internal Revenue Service, and effectively restrain the arbitrariness of the mechanisms. Commissioner Alexander has expressed his own personal concerns about the use of these assessment powers and administratively has ordered tighter controls on the use of these tools. In fiscal year 1973, there were 3,090 jeopardy termination of assessments. In fiscal year 1975, the number of assessments declined to about 500. But we cannot

rely solely upon the discretion of administrators for restraint of the totally arbitrary powers currently residing in the Internal Revenue Service.

As former IRS Commissioner Sheldon Cohen testified on June 24, 1975 before the House Ways and Means Committee:

> The power of the jeopardy assessment or the power to close a taxable year is an awesome power. It is not often used by the Internal Revenue Service, but it is used. When it is used, the judicial remedy is down the road. There is no immediate action to report. A number of us involved in the Administrative Conference Study, I can't say unanimously, but I can say most people I believe, believe that there should be some access after the fact to a court. Perhaps within ten days after the jeopardy assessment or the close of a taxable year, the Commissioner should be bound at least to come into a court, if the taxpayer so chooses, to show prima facie that what he did had good reason.

Our bill allows for court review within 10 days of the jeopardy or termination assessment. The Secretary of the Treasury would have to appear and show reasonable cause for making the jeopardy assessment or termination of taxable period.

No one can argue that court review of IRS actions after the fact will unfairly inhibit legitimate IRS enforcement purposes. It is remarkable that Congress has not insisted before this date that citizens receive their minimum due process.

We note that the House Ways and Means Committee has proposed an amendment which is pending before your Committee on the matter of jeopardy assessments in termination cases. Again, it closely parallels our bill. The House's proposal would allow the federal court 20 days to decide whether the jeopardy assessment was reasonable and the amount appropriate. The House also would prevent the Internal Revenue Service from selling the taxpayer's property until after the court review.

A related issue that is also addressed in our bill is the matter of realistic property exemptions from IRS assessment and levy. For ten years, the American Bar Association has recommended that federal courts provide some relief to taxpayers who are so impoverished by jeopardy and termination actions that they cannot afford to pay themselves or to pay taxes on their property. The ABA has suggested that the court should be able to release some of the seized assets to the taxpayer. Our approach has been to suggest that the amount of property exempt from levy be increased to more realistic amounts: $1.500 for personal property, $1,000 for tools of trade, and a salary exemption of $100 per week plus support payments for minor children.

TAXPAYER'S SERVICE AND COMPLAINT ASSISTANCE WITHIN THE IRS

Another major mechanism of our bill to restore fairness and eliminate arbitrariness from the tax system is the creation of a new assistant commissioner for taxpayer assistance within the Internal Revenue Service.

The new Assistant Commissioner and his office will be responsible for providing responses to questions by taxpayers and assistance in filling out tax returns. In addition, he will serve as the ombudsman for taxpayers' complaints concerning the Service.

We would like to refer again to the testimony by IRS Commissioner Sheldon Cohen before the Ways and Means Committee on June 24, 1975. He stressed the need for a complaint office with the IRS:

We are, I think, of the opinion that the Service does not have an adequate handle on tracking taxpayer complaints.

It has to many different places where complaints can be handled and no organized system of maintaining records as to whether they have been services or not.

Now we are attempting to address a proposed solution to the service and centralize that office somewhat, whether it is called ombudsman or office of complaints, or whatever, that there would be people in every region or district, depending on its size, who would track complaints and report solutions to the taxpayer and report to the administrative people on the kinds of problems that people are having to attempt to point out methods of solution.

If the Internal Revenue Service knew the areas where it was getting the most complaints, it might be able to design techniques to be able to overcome them.

In addition to dealing with problems such as lost checks and computation questions, the Office of Taxpayer Services would be available to hear complaints of improper or abusive treatment by IRS employees. The Assistant Commissioner would have to provide an annual report to the Ways and Means Committee, the Finance Committee, and the Joint Committee on Internal Revenue Taxation on his activities. He would be given a special power to issue a "taxpayer order" if he determined "the taxpayer is suffering from an unusual, unnecessary, or irreparable loss as a result of the manner in which the Internal Revenue laws are being administered by the Secretary or his delegate."

DISCLOSURE OF INFORMATION TO TAXPAYERS IN AUDIT AND APPEAL PROCEDURES

Taxpayers who do not have legal representation face a number of problems when they are subjected to audits by the Internal Revenue Service. Few taxpayers really understand their rights. The IRS makes very little effort to inform them of their rights. Professor L. Hartwright, a University of Michigan law professor, has testified in Congressional hearings that most tax auditors do not know the law very well themselves. They are the lowest level and least well trained of the IRS's tax examiners. Yet the IRS is not required to make affirmative disclosures to taxpayers.

Our bill requires that the IRS develop a series of pamphlets describing, in clear and easily understandable language, the rights of taxpayers in audits, assessments, and the appeals process. These statements of taxpayer rights must be provided to the citizen at the time of the first communication from the IRS. The tax committees of the Congress would be given the opportunity to review and comment on the pamphlets.

The IRS already has a series of very helpful pamphlets describing the appeals process, et cetera. As a result of a series of hearings by Senator Montoya, the quality of these pamphlets has been improved dramatically in recent years. Our bill simply provides for a regular system by which a taxpayer is automatically advised of all his rights in all dealings with the IRS.

LEGAL ASSISTANCE PILOT PROJECT

Our bill would provide for a 3-year pilot project to be conducted in four cities by the Legal Services Corporation. Taxpayers would be provided with legal services in their audit and appeal dealings with the IRS. The service would be free for lower-income individuals with a sliding fee schedule for taxpayers in other income brackets.

Most taxpayers must deal with the IRS without the advantage of legal counsel. Only the wealthiest have been able to obtain adequate legal representation in tax proceedings. Therefore, there has been a record of inequitable enforcement settlements between income groups. A pilot project of legal representation will be extremely helpful in determining whether the general treatment of lower- and middle-income taxpayers can be improved through making tax legal assistance more readily available to all.

GAO OVERSIGHT OF THE IRS

The IRS has consistently refused to allow the General Accounting Office to examine its operations. Our bill provides, once and for all, that it is the law of the land that GAO may audit and investigate the IRS. It specifies that GAO is required to review a number of IRS activities and provide an annual report to the Congress. Language providing for GAO access is drawn largely from a letter of May 14, 1975, from the Comptroller General to the Chairman of the Ways and Means Committee.

CONCLUSION

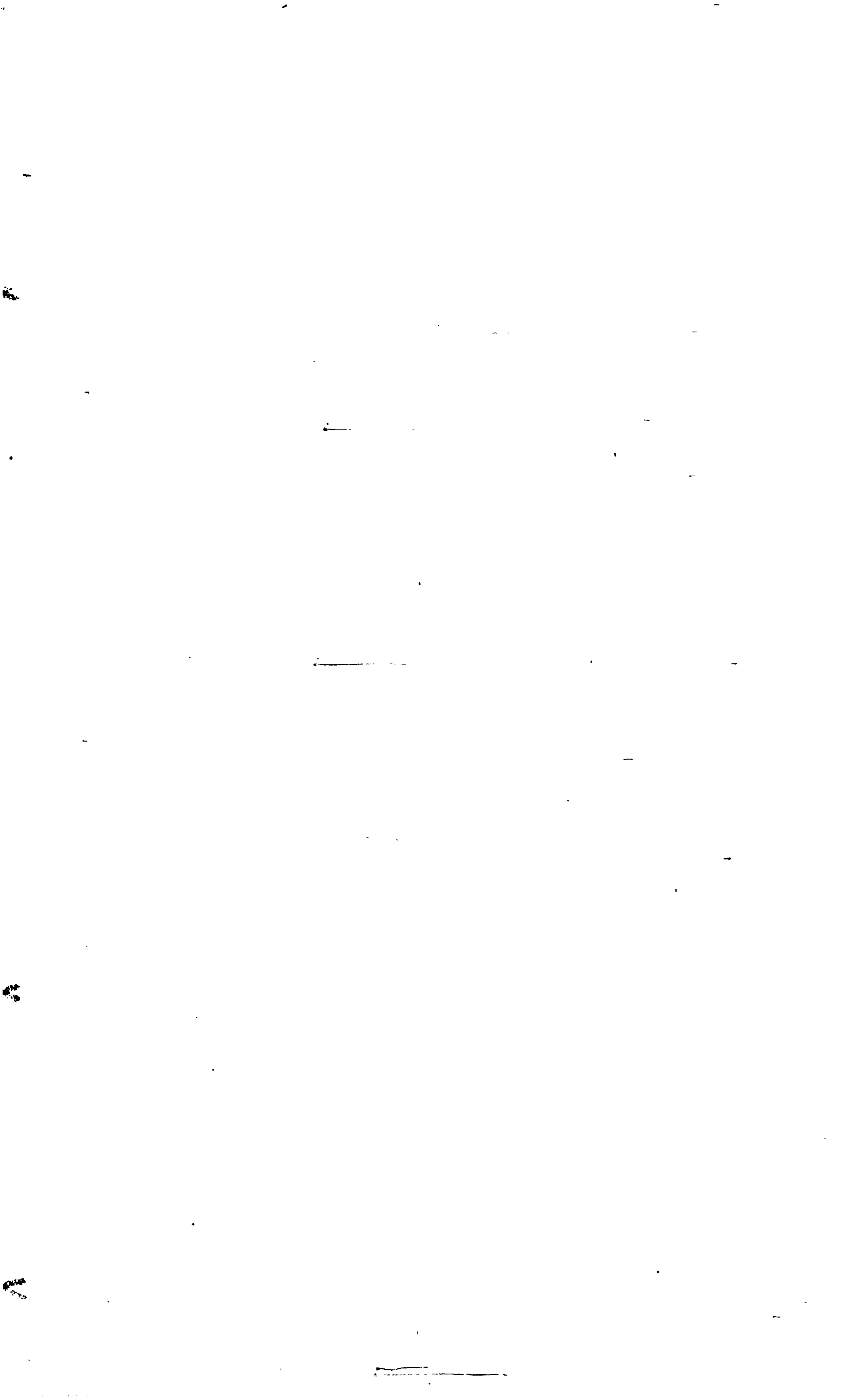
There are many areas of controversy in the procedural administration of the internal revenue laws of the United States. This bill is not a cure-all. But it is a critical first step. We must act on these proposals now. It is time that people's reasonable expectations of the tax mechanism more closely parallel the reality of the law.

Mr. Chairman, we request that a copy of a section-by-section analysis of S. 2342, the Taxpayers' Bill of Rights Act of 1975 be included in the hearing record. This explains in greater detail the specific provisions included in our proposal to deal with the problems that we have outlined.

Thank you.

Employee Stock Ownership Plans (ESOP's)

69-516—76—pt. 8——9



LAW OFFICES,
HEDRICK AND LANE,
Washington, D.C., April 13, 1796

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

DEAR SENATOR: During its consideration of legislation dealing with Employee Stock Ownership Plans, the Senate Committee on Finance should also give attention to the problem outlined below which results in particularly harsh treatment of lower- and middle-income taxpayers.

Section 402(a)(1) of the Code provides that amount distributed to a participant in a qualified plan shall be taxable to him in the year distributed under the provisions of section 72 of the Code. Under an exception to this rule, unrealized appreciation on securities of the employer purchased with employee contributions is not included in the amount of the distribution, but is taxed as a capital item upon disposition of the stock by the distributee. However, in the case of securities of the employer purchased with employer contributions, the unrealized appreciation (as well as the employer contribution) is taxable as ordinary income to the employee upon distribution. (There is an exception to this rule for lump sum distributions under section 402(e). However, experience has shown that, in the program described below, section 402(e) is applicable only infrequently.)

Some employee stock savings programs provide that employees can contribute a portion of their pay toward the purchase of the employer's stock, and that the employer will contribute a matching or some other amount which is also used to purchase employer securities for the account of the employees. Prior to becoming vested in the employer's contributions, the participants are given an election to receive their interests either (i) after "earning out" the stock acquired with employer contributions over a period of time (e.g., 36 months), or (ii) in a lump sum distribution upon separation from employment (by retirement, death or resignation). If the participant chooses to "earn out" the stock under option (i), then he is taxed at ordinary rates on the unrealized appreciation attributable to securities purchased with employer contributions.

In many instances, the employees who choose option (i) will retain their employer securities, the value of which is subject to fluctuations in the market. Eventually, these securities may be sold at a loss, especially by lower bracket taxpayers who cannot always choose to sell at the most favorable times. (The vast majority of participants in these programs are lower- and middle-income taxpayers.) If the securities are sold at a loss and the taxpayer sustains a long term capital loss,

only 50 percent of the loss is deductible against ordinary income, subject to the $1,000 limitation on capital losses. However, part of the loss is a capital loss of unrealized appreciation previously taxed as ordinary income.

It is inequitable to treat the entire loss on the sale of employer securities as a capital loss when the unrealized appreciation on such securities was taxed at ordinary tax rates when received. This inequity can be corrected by providing that when an employee is taxed at ordinary income rates on unrealized appreciation on employer securities and the employee subsequently sells the securities at a loss, the loss is to be treated as an ordinary deductible loss to the extent that the unrealized appreciation was previously recognized as ordinary taxable income.

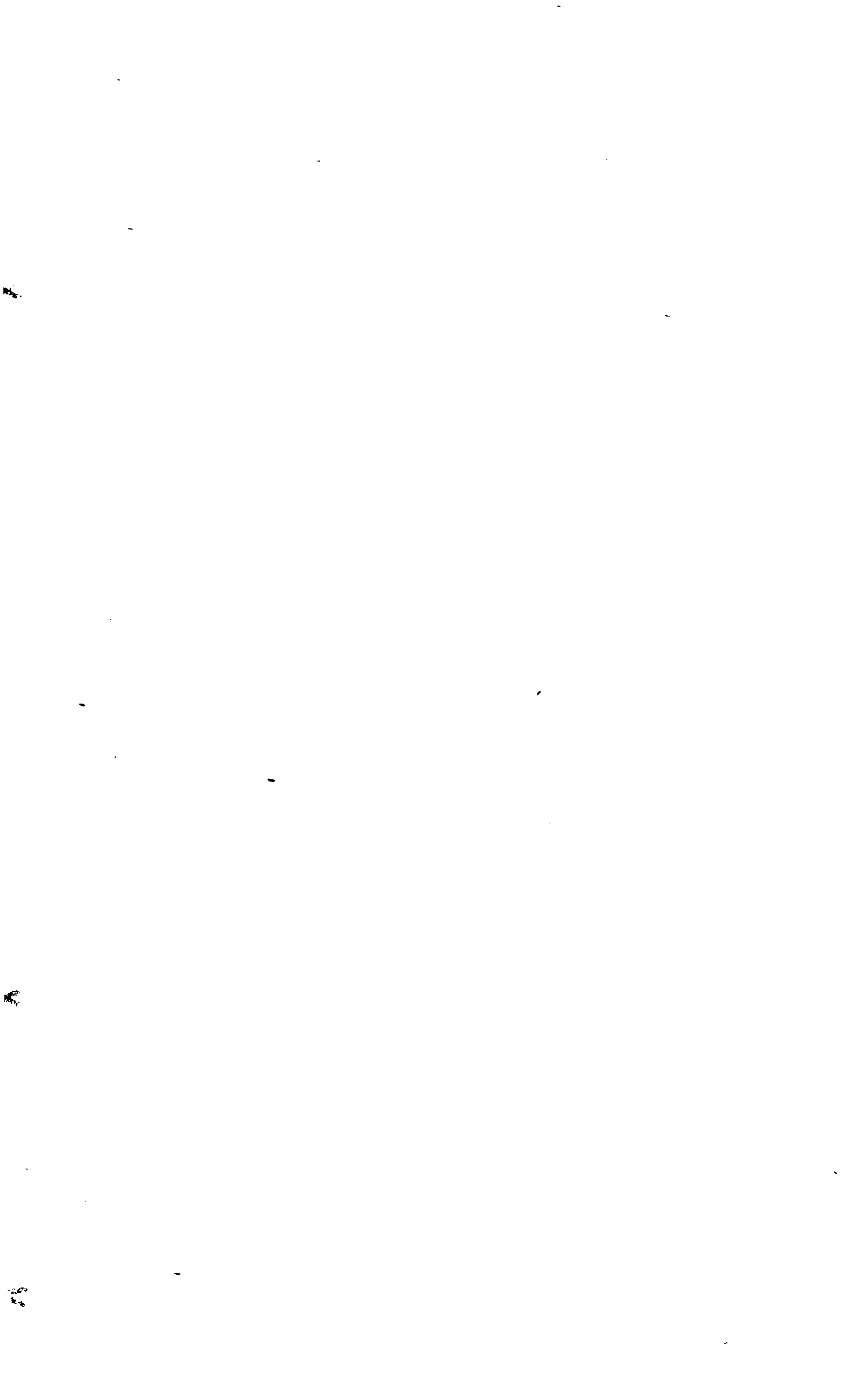
While this problem is under examination, your Committee may also wish to consider whether the entire loss should not be treated as an ordinary loss to the extent that the employee was previously taxed at ordinary rates. Providing for ordinary loss treatment on all of the losses attributable to the employer's contributions would remove a significant tax disincentive to participation in employee stock ownership programs.

Your consideration of this matter would be appreciated.

Sincerely,

F. CLEVELAND HEDRICK, Jr.

Tax-Exempt State and Local Bonds



SUPPLEMENTAL MEMORANDUM ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

REGARDING CHANGES IN THE FEDERAL INCOME TAX LAWS TO MAKE POSSIBLE THE CREATION OF REGULATED INVESTMENT COMPANIES TO INVEST IN TAX EXEMPT STATE AND LOCAL BONDS AND THUS BROADEN THE MARKET FOR SUCH BONDS

This supplemental memorandum is submitted by the Investment Company Institute* in favor of the proposal described below with respect to the taxation of interest on municipal (and state) bonds held by regulated investment companies.

If the Internal Revenue Code were amended to allow the municipal bond interest exemption to be passed through to shareholders of regulated investment companies, a *new and broader market* would be available for new issues of municipal bonds as they come out and for the many thousands of existing issues of municipal bonds. This would also benefit the investor of moderate means by making it feasible for him to invest conveniently in a diversified portfolio of such bonds. Two pending similar bills, H.R. 11955, introduced by Mr. Steiger and Mr. Frenzel, and H.R. 12217, introduced by Mr. Helstoski, provide for such amendment. The bills have been referred to the House Ways and Means Committee, which has not yet acted on them.

Such an amendment should be adopted whether or not the Internal Revenue Code is amended to permit State and local governments at their option to issue taxable bonds, since large amounts of existing tax-exempt bonds would remain outstanding and many issuers might well elect to offer new bonds on a tax-exempt basis.

Individual investors, primarily the wealthy ones, are already an important part of the market for the tax-free securities of State and local municipalities. At the end of 1974, households—including personal trusts and nonprofit organizations—owned 31.6 percent of all outstanding State and local securities, according to Federal Reserve Flow-of-Funds estimates:

Type of holder:	*Percent of outstanding State and local securities held, December 31, 1975*
Households	31.6
Commercial banks	46.1
Insurance companies	17.3
All other sectors	5.0
Total	100.0

*The Investment Company is the national association of the mutual fund industry. Its membership consists of 383 mutual funds, and their investment advisers and principal underwriters. Its mutual fund members have over $8 million shareholders and assets of approximately $48 billion, representing about 93 percent of the assets of all U.S. mutual funds.

It is probable that individual investors will have to continue to increase their participation in the State and local market in order to help offset the declining rate of commercial bank participation. According to Federal Reserve estimates, the commercial banks' share of the new-issue market has declined steadily during the seventies:

	1970	1971	1972	1973	1974	1975
Total net increase in outstanding State and local debt (billions)	$11.2	$17.6	$14.4	$13.7	$17.4	$15.4
Commercial banks share of net increase (percent)	95.5	71.6	50.0	41.6	31.6	8.4

In the years ahead, it seems doubtful that commercial banks will add to their holdings of outstanding state and local securities at the exceptionally high rates of years gone by. Insurance companies and other financial sectors are not likely to increase their holdings significantly and offset the declining demand of commercial banks for state and local securities.

There is, however, one large market for municipal bonds that has not yet been tapped because of a roadblock that exists in the federal income tax law. This market is the regulated investment companies—companies which offer to the investor of relatively modest means the advantages of continuous professional management and diversification of investment risk. The largest segment by far of the regulated investment company industry is the group of companies known as "mutual funds." As stated earlier, the Institute's mutual fund members today have approximately 8 million shareholders and assets of about $48 billion.

Regulated investment companies provide a medium for large numbers of persons to pool their investment resources in a diversified list of securities under professional management. The regulated investment company represents, in general, an intermediate layer between the investor and the entities whose securities it acquires with the investor's funds. It does not compete with those entities but merely provides an alternative means for investing in them with diversification of risk and professional investment management.

In recognition of these functions, for many years the federal income tax laws applicable to mutual funds and other regulated investment companies have been designed to subject an individual investing via a regulated investment company to substantially the same income tax burden he would have borne had he invested directly in his proportion of the underlying securities held by the company. In general, the investment company is treated by the tax law as a conduit through which its income passes currently to its shareholders. If the investment company complies with the rules of subchapter M of the U.S. Internal Revenue Code, there is no Federal corporate tax on its income at the company level—the income tax is paid by the shareholders based on the investment company income distributed to them, substantially as though they had invested directly in the securities in the investment company's portfolio.

Under the present federal tax laws, however, a dividend paid by a corporation is generally taxable to the shareholder who receives it, regardless of the type of corporate income out of which the dividend

is paid. There are specific provisions in the present tax law to preserve the character of long-term capital gains when distributed to shareholders by a regulated investment company, but there is no such provision with respect to tax-exempt bond interest. Hence, at present, if a regulated investment company receives tax-exempt bond interest and distributes it to shareholders, the amounts received by the shareholders are fully taxable as dividends. This is the roadblock to the creation of regulated investment companies specializing in municipal bonds.

In 1942 when the present income tax provisions covering regulated investment companies were enacted, the absence of a special rule allowing the exempt character of interest to be passed through to the shareholder was not a deliberate policy decision. It was simply not a matter of concern—probably because of the then low interest rates which made municipal bonds unattractive to individual investors unless they were in relatively high tax brackets. Today the situation is quite different. In recent years, as States, municipalities and other political subdivisions have increased the quantity of their borrowings, the interest rate on their obligation has increased to a marked extent so as to make such bonds attractive to the investor of modest means.[1]

For a number of reasons, persons of modest means find difficulties in investing in municipal bonds, but these difficulties would be removed if they could do so through a mutual fund:

(a) Municipal bonds are generally issued in denominations of $1,000, often with minimum purchase requirements of $5,000, a minimum price too high for many small investors. By contrast, shares of mutual funds are generally more modestly priced, and are suitable, therefore, to periodic savings programs for individuals.

(b) The "market" for municipal bonds is an extremely intricate one requiring professional expertise not possessed by most individual investors. There are many thousands of state and local government entities issuing municipal bonds and many have outstanding different securities issued at different times and at different interest rates. The average individual investor would usually be "lost" in trying to appraise quality, safety and market price.

A mutual fund, however, will provide the investor with diversification of investment risk and expert investment management. Moreover, with these advantages, it should be possible to include in an investment portfolio bonds of smaller and lesser known municipalities bearing higher interest rates, thus increasing the yield as compared with that which the average investor might be able to obtain by selecting individual bonds.

(c) Market quotations are not as readily available in the case of municipal bonds as in the case of other securities, and the large number of municipal bond issues outstanding makes the ascertainment of such information a burdensome task. On the other hand, the market value of mutual fund shares is readily ascertainable by the investor, since the net asset values of the funds are determined daily and the

[1] Between 1963 and March 1976, for example, the average yield on seasoned Aaa State and local bonds increased from 3.06 percent to 5.99 percent. This compares to a rise in Federal long-term bonds for the same period of 4.00 percent to 6.87 percent and for Aaa corporates of 4.26 percent to 8.52 percent. To a married person with taxable income of $16,000 a yield of 5.99 percent on State and local bonds is equivalent to a yield of 8.82 percent on taxable obligations; to an unmarried person it is equivalent to a yield of 9.07 percent.

prices of the shares are reported in many daily newspapers throughout the country.

(d) An individual seeking to liquidate a small investment in municipal bonds will very likely suffer a sacrifice in price if he is disposing of less than $10,000 or $20,000 principal amount. Shares of mutual funds, however, are redeemable by the fund at the election of the shareholder at a price based on the net asset value, and the investor may liquidate his interest promptly and without difficulty.

Moreover, the potential breadth of a mutual fund market is illustrated by the several billions of dollars of municipal bond trust units which have been offered in recent years by Merrill Lynch and other large broker-dealers and which permit the investor to receive tax-free income on his municipal bond trust units. But these fixed bond trusts have a number of disadvantages.

For example: their original portfolio holdings may not be changed if the investor is to receive the income tax-free; the trust units are generally priced at a level of $1,000 and there are frequently minimum purchase requirements, such as $5,000; and the market value of the trust units are not reported in daily newspapers and are not readily ascertainable. These trusts do not continuously offer new units and are therefore not suitable for periodic savings plans. Nevertheless, the relative success of these fixed bond trusts indicates the much larger market that would be created by municipal bond mutual funds which could pass through tax-free income to shareholders without the disadvantages of the fixed trust.

Therefore, it is proposed that the existing federal income tax law be promptly changed so that the public can purchase shares in mutual funds and other regulated investment companies which would be created to invest primarily in tax-free state and municipal securities. Small investors could thereby participate in a pool of tax-free securities, with interest income flowing through tax-free to the investor. Such a change would invite the service and promotional capabilities of the mutual fund industry, and might well increase by many billion dollars the market for municipal bonds. Moreover, it would be wholly consistent with the theory underlying mutual fund taxation—i.e., to place a mutual fund shareholder in the same position as if he owned directly the securities held by the mutual fund.

Attached is a copy of H.R. 11955 which would accomplish this result.

[H.R. 11955, 94th Cong., 2d sess.]

A BILL To amend the Internal Revenue Code to provide for distribution of certain tax-exempt income received by regulated investment companies to shareholders without change in tax-exempt status

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

Section 1. Short Title.

This Act may be cited as the "Municipal Bond Fund Act of 1976".

Sec. 2. Exempt-Interest Dividends of Regulated Investment Companies.

(a) General.—Section 852(a)(1) of the Internal Revenue Code of 1954 (relating to regulated investment companies) is amended to read as follows:

"(1) the deduction for dividends paid during the taxable year (as defined in section 561, but without regard to capital gain dividends) equals or exceeds the sum of,

"(A) 90 percent of its investment company taxable income for the taxable year determined without regard to subsection (b)(2)(D); and

"(B) 90 percent of the excess of (i) its interest income excludable from gross income under section 103(a)(1) over (ii) its deductions disallowed under section 265 and section 171(a)(2), and".

(b) DIVIDENDS PAID DEDUCTION.—Section 852(b)(2)(D) of such Code (relating to taxable income) is amended to read as follows:

"(D) the deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gain dividends and exempt-interest dividends."

(c) EXEMPT-INTEREST DIVIDENDS.—Section 852(b) of such Code (relating to method of taxation of regulated investment companies and shareholders) is amended by inserting after paragraph (4) the following new paragraph (5):

"(5) EXEMPT-INTEREST DIVIDENDS.—If at the close of each quarter of its taxable year at least 50 percent of the value (as defined in section 851(c)(4)) of the total assets of the regulated investment company consists of obligations described in section 103(a)(1), such company shall be qualified to pay exempt-interest dividends, as defined herein, to its shareholders.

"(A) DEFINITION.—An exempt-interest dividend means any dividend or part thereof (other than a capital gain dividend) paid by a regulated investment company and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including exempt-interest dividends paid after the close of the taxable year as described in section 855) is greater than the excess of—

"(i) the amount of interest excludable from gross income under section 103(a)(1), over

"(ii) the amounts disallowed as deductions under sections 265 and 171(a)(2),

the portion of such distribution which shall constitute an exempt-interest dividend shall be only that proportion of the amount so designated as the amount of such excess for such taxable years bears to the amount so designated.

"(B) TREATMENT OF EXEMPT-INTEREST DIVIDENDS BY SHAREHOLDERS.—An exempt-interest dividend shall be treated by the shareholders for all purposes of this subtitle as an item of interest excludable from gross income under section 103(a)(1). Such purposes include but are not limited to—

"(i) the determination of gross income and taxable income,

"(ii) the determination of distributable net income under subchapter J.

"(iii) the allowance of, or calculation of the amount of, any credit or deduction, and

"(iv) the determination of the basis in the hands of any shareholder of any share of stock of the company."

Sec. 3. Technical Amendment.

Section 103(e) of such Code (relating to exclusion from gross income of interest on certain governmental obligations) is amended by inserting after paragraph (23) the following new paragraph:

"(24) Exempt-interest dividends.—For treatment of exempt-interest dividends, see section 852(b) (5) (B)."

Sec. 4. Disallowance of Deductions.

Section 265 of such Code (relating to nonallowance of deductions for expenses and interest relating to tax-exempt income) is amended by adding at the end thereof the following new paragraphs:

"(3) Certain Regulated Investment Companies.—In the case of a regulated investment company which distributes during the taxable year an exempt-interest dividend (including exempt-interest dividends paid after the close of the taxable year as described in section 855) that portion of any amount otherwise allowable as a deduction which the amount of the income of such company wholly exempt from taxes under this subtitle bears to the total of such exempt income and its gross income (excluding from gross income, for this purpose, net capital gain as defined in section 1222(9)).

"(4) Interest Related to Exempt-Interest Dividends.—Interest on debtedness incurred or continued to purchase or carry shares of stock of a regulated investment company which during the taxable year of the holder thereof distributes exempt-interest dividends, but in an amount not in excess of the amount of the exempt-interest dividends received by such holder during such year."

Sec. 5. Effective Date.

The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1975.

Motor Fuel Excise Taxes

Statement on Behalf of the National LP-Gas Association, by Arthur C. Kreutzer, Vice President and General Counsel

SUMMARY OF PRINCIPAL POINTS

(1) The present method of taxation and handling of the motor fuel excise tax on use of propane in industrial lift trucks is inequitable and discriminatory, for the reason that equal or comparable tax is not imposed on competitive industrial lift trucks powered by electricity or diesel.

(2) The favored tax position provided for electric powered lift trucks represents stimulation of an inefficient use of energy resources.

(3) Conversion to use of propane in the desire to provide a cleaner working atmosphere should not be penalized.

(4) Revision in tax handling will eliminate substantial confusion for the lift truck user, the fuel supplier, and the tax collector.

(5) The amount of tax revenue involved is insignificant.

It is our recommendation that Sec. 4041 of the Internal Revenue Code be amended to limit the tax on liquefied petroleum gas (propane) to use in a highway motor vehicle. A suggested revision is attached to this statement.

INTERESTED PARTY AND PURPOSE

The National LP-Gas Association is a national trade association, having as members the producers of liquefied petroleum gas, the manufacturers of equipment and appliances using liquefied petroleum gas, and the distributors and dealers. LP-gas is the common name used for our product. The Association has over 5,500 members companies in 43 affiliated states. The membership represents over 90 percent of the industry's volume of business. Its membership is predominately at the distributor and dealer level. The Association's position as set out in this statement would also reflect the position of other industry companies. The more direct marketing impact of the tax discussed herein is felt by these distributors and dealers who sell LP-gas at retail. The employment and economic well-being of over 75,000 employees is involved in the LP-gas dealer's business and the problems presented. The manufacturers of, and dealers in equipment utilizing LP-gas are also adversely affected. Again, to the degree indicated in this statement, this problem is of serious concern to thousands of users of LP-gas equipment.

Our purpose in appearing is to inform this Committee of the existing discriminatory tax treatment accorded LP-gas, as compared with competing fuels in their use for the same purposes, the adverse impact on other national goals, and to apprise you of the confusing, burdensome, and impractical administrative application and handling of the present tax on LP-gas in non-highway motor fuel use incurred by both the government and the user. In solution of these problems we

recommend that the motor fuel tax on LP-gas be limited to use in a highway vehicle. This recommendation is also aimed at limiting the tax to those who receive the benefit.

PRODUCT AND TAX INVOLVED

LP-gas is composed of propane, butane, propylene, butylene, and their mixtures. It is an energy source, or fuel, and a small part[1] of total product usage is in motor fuel, principally off the highways. A portion of such motor fuel use is in industrial tractors, or industrial lift trucks. The tractor pulls or pushes a load and the lift truck carries it. It is herein that we encounter difficulties with federal excise tax administration and our statement is partially directed at that problem. In this usage LP-gas is a necessity in material handling and industrial processing, and its taxation becomes a business cost. To follow one step further, the tax burden on competitive products or business is not the same. It varies according to the means employed. Again, because of the diverse end product this tax impact cannot be evaluated.

The federal excise tax involved is the basic 2 cents a gallon tax on special motor fuel. (Sec. 4041). The additional gallonage taxes on highway vehicle use dedicated to the Highway Trust Fund are not involved. LP-gas is one of the special motor fuels subject to Sec. 4041. The others are benzol, benzine, naphtha, casinghead and natural gasoline, "or any other liquid". The other liquids that may be involved are unknown to us. The products, other than propane, have little, if any, motor fuel use.

Gasoline, or Sec. 4081 tax products, and kerosene, gas oil, and fuel oil are specifically excluded, and diesel fuel is separately handled as will be later covered. The special fuel tax is imposed on use in a motor vehicle. A motor vehicle is defined by the Treasury Department interpretation as a vehicle designed to carry or support a load. Consequently, this tax applies on LP-gas use in an LP-gas powered industrial lift truck and this is our area of concern.

DEFECTS IN PRESENT TAXATION

(1) *The Present Special Motor Fuel Tax Is Inequitable And Creates Discrimination, Placing LP-Gas At A Competitive Disadvantage.*

Competing electric battery powered or diesel fueled industrial lift trucks do not face similar fuel or power sources taxation. There is intense competition in this industrial tractor market and the LP-gas powered vehicle, and LP-gas use, is handicapped through unequal and discriminatory tax treatment that unfairly aids competition. Fuel cost is a substantial element in an industrial plant's decision on the type of lift truck to purchase and the 2 cents a gallon tax as reflected in total operating cost is many times the deciding factor.

Diesel fuel has a basic 2 cents a gallon federal excise tax *but only on use in a highway vehicle.* The tax is not imposed on use in an indus-

[1] Total internal combustion use in 1974, the latest year available was 1,309,750,000 gallons or under 10% of total product use (U.S. Bureau of Mines Report). The major portion of this 10% is on the farm, for tractors, irrigation pumping, etc.

trial plant nonhighway motor vehicle. A tax element of fuel cost is not faced when a diesel fueled industrial lift truck is purchased, or diesel fuel is used.

The electric or battery powered industrial lift truck does not face this tax, or any comparable tax, as an element of operating cost. Lower operating costs as a result of the tax favored position are a strong competitive sales argument used by electric lift truck suppliers in their advertising and promotional material. Competitive promotion of the electric lift truck emphasizes this tax advantage. Removal of the handicapping tax on LP-gas will not completely eliminate this cost differential, but it will place LP-gas on a more equitable and competitive plane. The effect of this promotion is demonstrated in the following statistical data compiled by NLPGA.

INDUSTRIAL TRUCKS IN USE

	1966	1971	1976
Total number	623,200	774,100	984,000
Electric walkers (number)	79,600	111,100	162,300
Percent of total	(12.8)	(14.4)	(16.5)
Electric riders (number)	76,200	121,100	182,100
Percent of total	(12.2)	(15.6)	(18.5)
LP-gas riders (number)	289,800	335,900	396,600
Percent of total	(46.5)	(43.4)	(40.3)
Gasoline and diesel riders (number)	177,600	205,900	243,000
Percent of total	(28.5)	(26.6)	(24.7)
	1965	1970	1975
SHIPMENTS			
Total number	59,900	69,800	66,400
Electric walkers (number)	8,200	13,800	14,400
Percent	(13.7)	(19.8)	(21.7)
Electric riders (number)	10,000	14,800	19,000
Percent	(16.7)	(21.2)	(28.6)
LP-gas riders (number)[1]	25,900	25,500	20,500
Percent	(43.2)	(36.5)	(30.9)
Gasoline and diesel (number)[1]	15,800	15,700	12,500
Percent	(26.4)	(22.5)	(18.8)

[1] Revised to reflect field conversions.

It will be seen that the market share, in the ten year period, of Electric Walkers increased by 3.7 percent, the Electric Riders by 6.3 percent while the LP-gas lift truck lost 6.2 percent of the market. While Gasoline and Diesel Riders also decreased by 3.8 percent the loss is believed to be primarily in gasoline units that were converted to propane. Contrasting 1965 and 1975 shipments reveal a much greater market takeover by electric fuel vehicles were in riders, the principal competitive unit, electric units showed a 11.9 percent gain, and LP-gas units dropped 12.3 percent. Not only did LP-gas market shares drop, but there was an actual decrease of 5,400 units.

To carry this element of discriminatory treatment between competing methods one step further, as a material handler the lift truck serves as a conveyor of materials. There is no comparable tax on the power that supplies conveyors of the many other types, such as a built-in belt conveying system. There are also material handlers or conveyors in electric powered pallets. The effect of this basic 2 cents a gallon federal excise tax on LP-gas as a special motor fuel is to create an inequitable and discriminatory tax that encourages tax free competition.

(2) *The Tax Favored Position Provided For Electrical Powered Lift Trucks Represents Stimulation Of An Inefficient Use Of Energy Resources And Impairs Energy Conservation.*

In a governmental report [3] it is estimated that the efficiencies in producing and delivering electricity range from 10 to 25 percent. In other words there is a loss of energy resource employed in the production of electricity of from 75 to 90 percent. The mentioned report further states that systems for providing fuels directly to the consumer are more efficient. "The greatest potential for energy conservation is often in the selection of the right energy system for a particular need". The direct use of propane in an industrial lift truck is both a more efficient use of a natural resource, and the selection of the right energy system for a particular need. We submit that instead of penalizing use of propane through inequitable taxation, its use should be encouraged. Or to express it otherwise, inefficient and wasteful use of energy resources should not be stimulated. These twin objectives can be met by removing the federal excise tax on use of propane in an industrial lift truck.

(3) *Conversion To Use of Propane In The Desire To Provide A Cleaner Working Atmosphere Should Not Be Penalized.*

Many industrial plants bought LP-gas fuel or converted existing lift trucks using other fuels to use of propane with the objective of providing a more desirable, or less polluted atmosphere through use of clean burning propane instead of fuels that place the worker in an atmosphere created by fuels with undesirable emissions, his upgrading of working environment should be encouraged by removal of any tax disincentive. National tax policy should encourage use of clean fuel. Propane is a clean burning gas, as contrasted with fuel used in other internal combustion engines. Some states with the objective of encouraging use of clean fuel have completely eliminated, or reduced, their highway motor fuel tax on propane. In this statement we are only requesting removal of the inequitable federal tax penalty.

(4) *Revision In Tax Handling Will Eliminate Substantial Confusion For The Lift Truck User, The Fuel Supplier, And The Tax Collector.*

The administration of the present law by IRS, and tax handling by the LP-gas fuel industrial lift truck user, is complex, confusing and costly. To appreciate the problems involved it should be first noted that the tax is applied to use in motor vehicles, defined by the Treasury Department as vehicle designed to carry or support a load. Use in a vehicle that pulls or pushes a load is not taxable. An industrial lift truck is in the first category. An industrial tractor is in the second category. Industrial operations commonly involve both types of vehicles. Consequently, we find in the same industrial plant, drawing from a common fuel source, the two types of vehicles. In addition the fuel may be used for other non-taxable purposes in the plant. The determination of how much fuel is used for taxable purpose and how much for non-taxable purpose presents problems of substantial difficulty both to the Government and to the taxpayers. Tax determination by the user and effective enforcement by the Government is costly.

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[3] Energy-Environment and the Electric Power Prepared by the Council on Environmental Quality, August 1973.

Substantial confusion exists among users as to the tax application that understandably resists clarification when the complexity is recognized. This confusion is not limited to users. In the past we have seen differing interpretations from differing IRS District Offices. A simplification of this tax will serve both Government and the taxpayer with little effect or tax income.

(5) *The Tax Revenue Involved Is Significant*

The tax dollars involved on a special motor fuels under Sec. 4041 are not consequential. While as earlier mentioned, this tax applies to specified other liquids, their taxable use is *de minimis* insofar as we can ascertain. This tax, in addition to being on use in motor vehicles, applies to use in motorboats and airplanes. LP-gas is not so used, and we understand that use of other special motor fuels, if any, is insignificant.

LP-gas taxable use in motor vehicles, other than in highway vehicles, would largely be confined to the industrial lift truck. Our calculations based on the number of LP-gas powered lift trucks in use at the end of 1976 and the average usage indicate that the tax involved would approximate $9.3 million a year.[3] Taxes would also fluctuate widely with industrial productivity.

SUMMARY AND RECOMMENDATION

Therefore, in the interest of competitive equity, efficient use of natural resources, encouragement of use of clean fuel, tax clarity, and administrative convenience we recommend that the existing special motor fuel tax law be modified to limit tax application to special motor fuel use in a highway vehicle, or if such proposal covers too broad a field of tax producing special fuels, which we consider unlikely, the motor fuel taxation of LP-gas be limited to use in a highway vehicle as is the present treatment provided for diesel.

SUGGESTED TAX REVISION

Sec. 4041. Imposition of Tax

(b) Special motor fuels. There is hereby imposed a tax of 4 cents a gallon upon benzol, benzene, naphtha, liquefied petroleum gas, casinghead and natural gasoline or any other liquid (other than kerosene, gas oil, or fuel oil, or any product taxable under section 4081 or subsection (a) of the section)—

(1) Sold by any person to an owner, lessee or other operator of a *highway* motor vehicle or motorboat for use as a fuel in such *highway* motor vehicle or motorboat; or

(2) Used by any person as a fuel in a *highway* motor vehicle or motorboat unless there was a taxable sale of such liquid under paragraph (1).

In the case of a liquid taxable under this subsection sold for use or used [otherwise than as a fuel is highway vehicle (A) which (at the time of such sale or use) is registered, or is required to be registered, for highway use under the laws of any State or foreign country, or

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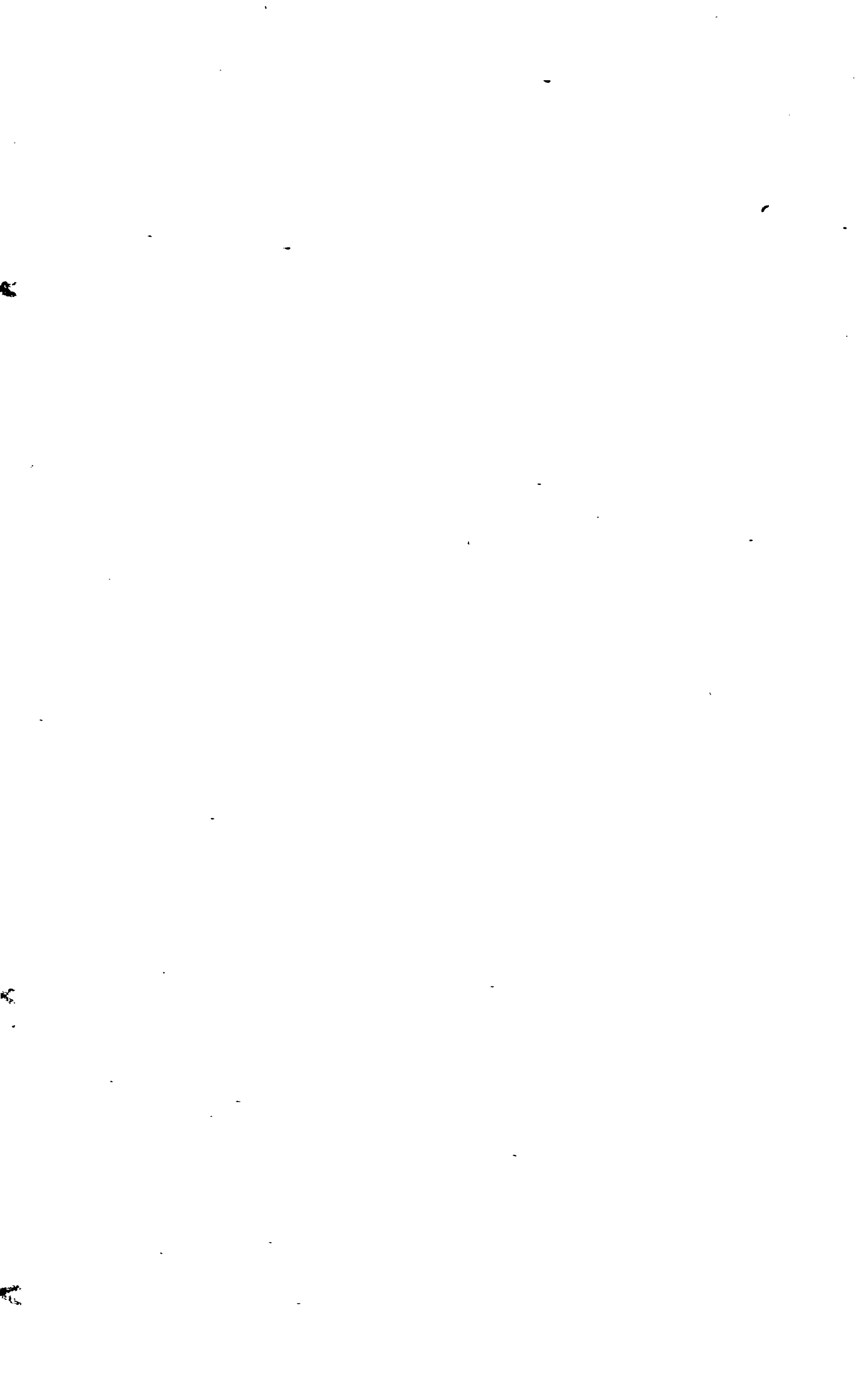
[3] 396,600 LP-Gas lift trucks in use with an average annual use of 1,200 gallons.

(B) which in the case of] in a highway vehicle owned, by the United States, [is used on the highway] the tax imposed by paragraph (1) or by paragraph (2) shall be 2 cents a gallon. [If a liquid on which tax were imposed by paragraph (1) at the rate of 2 cents a gallon by reason of the preceding sentence is used as a fuel in a highway vehicle (A) which (at the time of such use) is registered, or is required to be registered, for highway use under the laws of any State or foreign country, or (B) in the case of a highway vehicle owned by the United States, is used on the highway, a tax of 2 cents a gallon shall be imposed under paragraph (2).]

Taxation of Utilities



Written Testimony of A. Jones Yorke, President, Paine, Webber, Jackson & Curtis Inc.

SUMMARY

I am president of Paine, Webber, Jackson & Curtis Inc., one of the largest investment firms that deals directly with the general public. Paine Webber is a major investment banking firm with many years of experience in providing financial advice to corporations as well as marketing corporate securities. We think that Paine Webber is well qualified to speak on capital formation by utilities, having raised, as managing underwriters, over $2 billion annually in recent years for the telephone, electrical and natural gas utilities.

In recent years we have been raising increasing amounts of capital for utilities, in an environment of high interest rates, deteriorating quality of utility securities, and cutbacks in utility construction programs due to difficulties in raising capital. We recommend three basic steps in order to help utilities attract capital.

1. Permanently increase the investment tax credit to 12 percent for all utilities.
2. Defer taxation of automatically reinvested dividends (reinvested dividends would be treated for tax purposes as a stock dividend).
3. At the option of the issuer, dividends on new issues of preferred stock should be tax-deductible by the issuer.

We particularly urge that any tax legislation for electric utilities be extended equally to *all* ultilities. Any advantage given to one segment of the industry should be shared by all segments. This need results from the integrated nature of the market for the securities of public utilities. Securities of all utilities compete for the same investor dollars. Each segment is crucial to a healthy economy.

All utilities share the characteristic of being capital intensive. For the electrics and telephones, about $3.50 in capital is required to generate $1.00 in sales. (By comparison, manufacturing requires about 75 cents in capital per dollar of sales.) In addition, the capital structures of most utilities are highly leveraged with debt and share the problem of inadequate interest coverage. Moreover, in most states, the same regulatory agencies oversee the operations of all utilities and make no distinction between them. Finally, utilities are alike in that their rate of return on equity are inadequate at present levels to attract capital on favorable terms.

Apart from being capital intensive and highly leveraged, the utility industry is one of our Nation's largest employers. In this connection, it might be noted that the telephone industry employs almost one million people—approximately twice as many as the electric utility industry. Any tax legislation should be extended to all types of utilities in order to maximize job opportunities throughout the industry.

STATEMENT

Mr. Chairman and members of the Committee, my name is A. Jones Yorke. I am president of Paine, Webber, Jackson & Curtis Incorporated, one of the largest investment firms that deals directly with the general public. Paine Webber is a major investment banking firm with many years of experience in providing financial advice to corporations as well as marketing corporate securities. We think Paine Webber is well qualified to speak on capital formation by utilities, having raised, as managing underwriters, over $2 billion annually in recent years for the telephone, electric and natural gas utilities. We have recently been raising increasing amounts of capital for public utilities. At the same time, the cost of this capital has become unprecedentedly high for the issuing companies. Already, many utilities have significantly reduced their construction programs simply because of their inability to raise sufficient capital on reasonable terms.

I will address two questions: First, why should this Committee use tax policy to remedy a bad situation? Second, what can tax policy do to help meet the utilities' capital requirements?

WHY HELP THE UTILITIES?

At a time when we are struggling with recession and unemployment, the role of utilities should not be underestimated. Utilities' expansion must *precede and anticipate* growth in other sectors of the economy. Telephones and electricity must be available *before* other businesses can expand. Lead times of more than six years may be required to put these facilities in place.

The inability of the utilities to attract sufficient new capital, particularly equity capital, has contributed to slowing the pace of new construction. Unless we act quickly, we will suffer the consequences in the future. Growth of the economy could be unnecessarily retarded for lack of sufficient communications and energy facilities.

The best way to make utilities attractive to investors is to bring the rates they charge into line with the cost of the services they provide. To the extent that utilities receive sufficient rate relief, investors will be encouraged to buy their bonds and stock at more reasonable prices. Federal and state regulatory agencies have been somewhat responsive in recognizing this, and substantial rate increases, combined with large cutbacks in utility construction programs, have helped to improve the overall utility financing picture from where it was a year ago. But rate relief cannot do the entire job, because this would require rates to rise so far and so rapidly that a substantial portion of our population would no longer be able to afford these services.

I should emphasize that utilities share their staggering capital requirements with other corporate and governmental users. Tax measures that stimulate investment generally can benefit all those users, including the utilities. For instance, the introduction of measures such as Senator Bentsen's plan to lessen capital gains taxes in increments over a 15-year period would provide greater incentives to investment. Similarly, the mitigation of double taxation of dividends by increasing the

dividend exclusion from income taxes would spur investment by individual savers. Such measures could also have immediate impact on unemployment. We support the objectives of these and similar measures.

SPECIFIC RECOMMENDATIONS

Following are five recommendations for tax reform which we believe should be carefully considered for all public utilities—telephone, gas and water, as well as electric.

1. Permanently increase the investment tax credit to 12 percent

This committee's decision earlier this year to raise the limit on the investment tax credit to 10 percent was limited in impact by the two-year duration. Due to the time lag between passage of legislation and the time the legislation begins to have its desired effect, many utilities will be unable, because of their poor income positions, to take full advantage of the temporary increase in the tax credit.

It is important to make the investment tax credit permanent. Investors are aware that utilities are unable to plan capital expenditures on a cycle as short as two years and they realize that an investment tax credit of longer duration is necessary to make a significant impact on capital investment decisions. We endorse the President's Labor-Management Committee proposal of a permanent increase to a 12 percent rate.

2. Defer taxation of automatically reinvested dividends

As I mentioned earlier, we favor elimination of the double-taxation of corporate dividends. Short of complete elimination, we strongly support the proposal outlined by Secretary Simon to allow deferral of income tax on dividends that are automatically reinvested. This would encourage the accumulation from internal sources of capital which can be used to fund further growth. It would also equalize, to a certain extent, the tax treatment of an investor in a dividend-paying utility with an investor in a company which reinvests its capital rather than pay a dividend. This mechanism would thereby make utility stocks attractive to a new class of investors who seek capital appreciation rather than income. We believe that this is a key method of expanding the market for the securities of public utilities.

3. At the option of the issuer, dividends on preferred stock should be deductible

The option for a utility to issue preferred stock, the dividends on which would be tax deductible by the issuer, would have a tremendously beneficial effect on the capital position of utilities. This option would allow a utility to reach other classes of investors than the customary corporate purchasers of preferred stock. These corporate investors would continue to be attracted by the 85 percent exclusion available on the traditional form of preferred stock, which utilities could continue to offer, along with the new-type preferred. The new form of preferred would make higher dividends possible and would appeal to investors whose tax-exempt status or minimal tax liability make the 85 percent exclusion less attractive. We believe that the new option would substantially broaden the market for preferred stock, and that

the new preferred would be particularly attractive to individual investors.

Such an option would provide new capital to the utilities without diluting the position of common stockholders. Earnings per share would increase to the extent that the new preferred was substituted for old preferred or for common stock. To the extent it is used as a substitute for debt financing, the company's debt ratios would improve, thereby reducing the cost of debt financing.

4. Increase the term for loss carryback and carryforward

Many utilities are experiencing low earnings or actually operating at a loss for income tax purposes. We recommend, therefore, an increase from the present limits for loss carrybacks and carryforwards to more realistic limits such as ten and seven years, respectively.

5. Maintain competitive parity among utilities

Any advantage given to one segment of the utility industry should be shared by all segments. This need for competitive parity results from the integrated nature of the market for the securities of public utilities. Securities of all utilities compete for the same investor dollars. Each segment is crucial to a healthy economy.

All utilities share the characteristic of being capital intensive. For the electrics and the telephones, about $3.50 in capital is required to generate $1 in sales. (For comparison, manufacturing requires about 83 cents in capital per dollar of sales.) In addition, the capital structures of most utilities are highly leveraged with debt and share the problem of inadequate interest coverage. Moreover, in most states the same regulatory agencies oversee the operations of all utilities and make no distinction between them. Finally, utilities are alike in that their rates of return on equity are inadequate at present levels to attract capital on favorable terms.

CONCLUSION

We believe that the benefits of implementing these proposals are well worth the possible short-term losses to the Treasury. We urge the Committee's careful consideration of these proposals.

PAINE, LOWE, COFFIN, HERMAN & O'KELLY,
Spokane, Wash., April 2, 1976.

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

DEAR MR. STERN: We are counsel for The Washington Water Power Company of Spokane, Washington, a utility company primarily engaged in the production, transmission and distribution of electricity in Eastern Washington, Northern Idaho and Western Montana and in the distribution of natural gas in Eastern Washington and Northern Idaho. As such counsel, we were involved in litigation challenging taxes imposed by the State of Washington on electric energy sold for export and are presently involved in litigation in Montana and Idaho involving similar taxes.

It is understandable that States hard pressed for money will be tempted to raise money painlessly by imposing taxes paid solely by taxpayers of another State. It is also the function of the United States through constitutional or legislative processes to prevent the States from placing artificial economic barriers at State lines.

We, therefore, support the general intent of S. 1957. However, it appears to go too far as presently drafted. The title to Title II refers to "Discriminatory Taxes" but the substantive provisions appear to prohibit all taxes.

The New Mexico tax is one that appears to us to be patently discriminatory. We understand that New Mexico justifies its tax, in part, by reference to the Washington tax. The practical operation of the Washington and New Mexico statutes is quite different. In Washington there is a 3.6 percent tax at the retail level. The retail price includes manufacturing costs and transmission costs as well as distribution costs. Sales at wholesale involve only the manufacturing costs and transmission costs to the point of delivery which then incur a 3.6 percent tax on those functions only when the power is exported. In *PUD No. 2 of Grant County* v. *State*, 510 P. 2d 206, the Washington Supreme Court upheld a tax on the sale at wholesale of electricity to be exported from the State. However, the 3.6 percent tax was applied to export power that sold in the neighborhood of 5 mills while it was selling at retail at anywhere from two to three times that much and the same rate of tax is applied to retail sales. Applying 3.6 percent to 5 mills results in a tax of $.00018 per kwh. Applying 3.6 percent to 1.5¢ results in a tax of $.00054 or three times the tax applied to export power. Even this was considered unfair by the Washington Legislature because it resulted in a manufacturing tax much higher than other manufacturing taxes in 1965, while the court case was pending, the rate applied to manufacture of electricity which is paid only on export power was reduced by the Legislature to .44 percent. Applying this to 5 mills results in a tax of $.000022 per kwh, which makes the New Mexico tax over 18 times the tax now charged by Washington.

In summary, the principal point of difference is that Washington bases its tax on the value of the product at each stage and picks up the value on a proportionate basis at the manufacturing stage in its tax on retail sales in the State. As the Washington Court, in *PUD No. 2 of Grant County* v. *State* pointed out, "* * * the tax deduction that is made at the sale to a Washington utility is made up at the time the Washington utility buyer sells to its customers." The .4 mills per kwh levied by New Mexico, being completely arbitrary and with a direct credit to local utilities up to and including their entire liability under the Gross Receipts Tax, *in its practical operation* does "work a discrimination against interstate commerce." It lacks the automatic apportionment of the Washington statute and the tax is not apportioned to the business done in the State.

Since the United States is moving into a period of energy shortage and since the supply of energy is not evenly distributed, the Congress should address two aspects of the problem.

First is the prevention of discrimination against interstate commerce which may be prevented in the courts by enforcing the Constitution.

Second is the prevention of discrimination against energy sources. A state should be able to levy a manufacturing tax on electricity or other forms of energy but the amount of the tax should be reasonably related to the burden imposed on the state by the manufacturing or other process. The tax rate should be comparable to the rate of taxes levied on other comparable business as it is presently in the state of Washington.

The Congress should also consider expanding the studies proposed to include other forms of energy. Confiscatory taxes placed on coal, oil, natural gas, uranium, etc. will compound the nation's energy problems. It is particularly in the area of discrimination against energy as contrasted with discrimination against interstate commerce that the courts will not be able effectively to provide solutions and the Congress will be the only body having the authority to do so.

Thank you for this opportunity to express our views.

PAINE, LOWE, COFFIN, HERMAN & O'KELLY.
By ALAN P. O'KELLEY.

PUBLIC UTILITIES COMMISSION,
STATE OF CALIFORNIA,
San Francisco, Calif., May 6, 1976.

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

DEAR CHAIRMAN LONG: I am writing to call your attention to the undesirable economic consequences precipitated by a recent Internal Revenue Service Ruling. The nature of the dilemma created by the IRS as well as proposed legislative solution by an amendment to H.R. 10612 are outlined below.

All 400 of the water utilities under the California Public Utilities Commission's jurisdiction extend water service to individual customers, subdivisions, housing projects or industrial developments under an identical rule prescribed by this Commission after hearings and by formal decision. This rule, a copy of which is enclosed, specifically defines the terms and conditions under which Contributions In Aid Of Construction (hereafter called Contributions) are to be accepted.[1] As provided by paragraphs A-3c and A-6c, all construction for both subdivider advances as well as Contributions are adjusted to actual cost.

Utilities entering into specific agreements pursuant to this rule have on file, with this Commission, standardized contract forms. The amount of the Contribution and the specific facilities, associated with the Contribution, are set forth in these contracts. Any changes from these contract forms must be specifically approved by this Commission. Copies of the contract forms in which Contributions are required are enclosed for your review.

As indicated in Rule No. 15, contributions are, generally, paid by a developer, in cash, so that the utility may construct the necessary distribution mains, pumps or water tanks to provide service to the development. When the cost to construct becomes known, the amount

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[1] This was made a part of the official files of the Committee.

of the cash advance is adjusted to actual cost. The rule also allows the developer to construct the physical facilities himself. In this instance, the necessary record and vouchers to substantiate the actual cost is furnished the utility together with the cost of the utility's inspection and supervision.

The utility records the actual cost of the contribution in its plant accounts, and in its Balance Sheet Account No. 265, entitled Contributions In Aid Of Construction. In developing the rate base on which the utility is allowed to earn a fair rate of return, contributions are deducted. Depreciation expense on contributed plant is also not considered an allowable expense in developing appropriate rates. Thus, under regulation, contributions provide a direct benefit to the consumer, but not to the utility.

The principal beneficiary of this system is the existing ratepayer. If the water utility paid for the new plant construction the cost would be included in the utility's rate base and the utility would be entitled to a rate of return on that portion of its investment. However, since mains and services must be installed before roadways are completed and actual home construction begins, a considerable amount of time would pass before the utility realized a full rate of return on this new plant. The utility would, therefore, be entitled to increase the rates to existing ratepayers to insure a fair rate of return on this total investment. This is the situation which is avoided by developer contributions in aid of construction under Rule 15.

The IRS has, until recently, treated developer contributions in aid of construction as non-shareholder contributions to the capital of the Utility under Section 118 of the Internal Revenue Code.

In December, the IRS issued Revenue Ruling 75-557 holding that connection fees paid to water utilities constituted gross income rather than non-shareholder contributions to capital. While the ruling did not specifically consider contributions in aid of construction, it did revoke Revenue Ruling 58-555, which had held that contributions in aid of construction to regulated utilities were non-taxable contributions to capital. One must reasonably assume, as the water utilities are assuming, that the IRS intends to treat developer contributions in aid of construction as taxable income to the utility.

The legal basis for the Ruling is arguably non-existent and uncertain at best. This Commission, as well as the National Association of Regulatory Utility Commissioners (NARUC), has requested that the IRS clarify, reconsider or modify the Ruling. We were informed that such request could only come from a taxpayer who would be required to submit a specific set of facts to the IRS. This procedure is being pursued by one large utility within our jurisdiction. However, we do not expect a speedy resolution of the matter by the IRS.

Until this matter is resolved, the question remains: who will bear this tax burden? Should the utility bear it, it will simply be passed on to the ratepayer in the form of increased rates. An alternative is to require the developer to contribute an amount sufficient to cover both the cost of plant construction and the utility's tax liability. Under this plan the new home purchaser would bear the burden in the form of a higher purchase price. Neither result seems to us to be consistent with a national policy of economic vitality.

The NARUC has proposed a legislative solution to the problem described above. Their proposed amendment (copy attached) to the Tax Reform Act of 1975 would insure that developer contributions in aid of construction such as those administered by this Commission pursuant to Rule 15 would continue to be treated as non-shareholder contributions to capital under Section 118 rather than gross income under Section 61.

We strongly urge you to support this measure. It is truly in the best interest of utility consumers, the housing industry and the economy in general.

Very truly yours,

D. W. HOLMES, *President.*

Enclosure.

NARUC PROPOSED AMENDMENT TO H.R. 10612 TO PROVIDE THAT CONTRIBUTIONS IN AID OF CONSTRUCTION ARE NOT TAXABLE AS INCOME

SEC. —. CONTRIBUTIONS IN AID OF CONSTRUCTION.

(a) GENERAL RULE.—Section 118 (26 U.S.C., sec. 118) is amended by redesignating subsection (b) as subsection (c), and by inserting after subsection (a) the following new subsection.

"(b) CONTRIBUTIONS IN AID OF CONSTRUCTION.

"(1) GENERAL RULE.—For purposes of this subtitle, the term 'contribution to capital' includes any payment of money or transfer of other property made to or for the use of a regulated public utility [within the meaning of 26 U.S.C., section 7701(a)(33) (A), (B), (C), and (D)] as a contribution in aid of construction by a developer, an existing or potential customer, a governmental body, or any other person (whether or not a shareholder) if:

"(A) the money which is paid is used for (or is reimbursement for) the acquisition, construction, installation, extension, connection, or relocation of eligible property; or

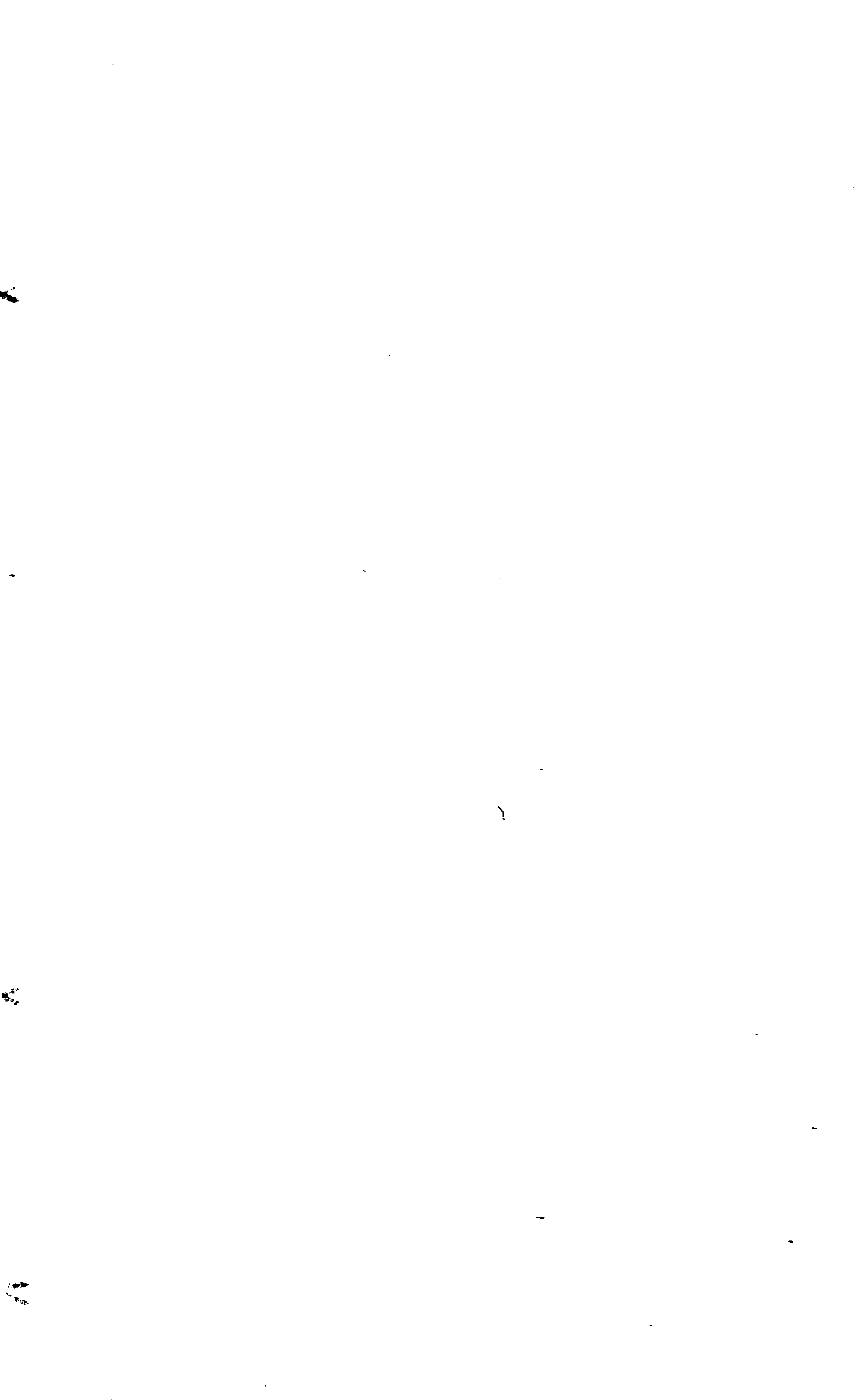
"(B) the property which is transferred will, in the hands of the transferee, constitute eligible property.

"(2) ELIGIBLE PROPERTY.—For purposes of paragraph (1), the term 'eligible property' means property used predominantly in the trade or business of the furnishing or sale of services described in section 26 U.S.C., section 7701(a)(33) (A), (B), (C), and (D).

"(3) DISALLOWANCE OF DEDUCTIONS AND INVESTMENT CREDIT.—Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, the expenditure by or on behalf of a regulated public utility of any funds constituting a contribution to capital by reason of paragraph (1)."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into on or after February 1, 1976.

Tax Treatment of Reusable Steel Drums



Statement of Morris Hershson, President, National Barrel and Drum Association

TAX TREATMENT OF REUSABLE STEEL DRUMS

My name is Morris Hershson. I am President of the National Barrel and Drum Association, having its offices in Washington, D.C. We represent the steel drum reconditioning industry, which reconditions and puts back into reuse approximately 40–50 million 55-gallon steel drums annually. Our Association represents about 75 percent of all reconditioners in this country and roughly 85 percent to 90 percent by volume of the total national production.

In the 55-gallon size, which is the main steel drum size in which we are interested, approximately 20–21 million drums are manufactured annually. Except for Rheem Manufacturing Company, the major drum manufacturers are subsidiaries of the steel industry: U.S. Steel, Jones and Laughlin, Republic Steel and Inland Steel, with many smaller volume, independent producers. The number of drums reconditioned annually is about 2 to 3 times the number manufactured. Although our members are all in the category of small business, our individual plant investments in this industry, essential to the environment, range from one half a million to seven million dollars in buildings and equipment. Nationally, our sales service volume is in excess of $300 million.

Reconditioners of steel drums have, for about 50 years, been conserving the nation's assets—conserving steel—conserving energy—conserving natural resources—and reducing solid waste pollution. Let us consider each of these salutary results of our industry's efforts.

With reference to energy: the study submitted with this statement, which was recently prepared by economists at the University of Illinois, calculates that manufacturing a steel drum—including the steel involved—consumes 10 times as much energy as reconditioning a drum. The conclusions are, and I quote:

"A shift from the current mix of reusable and single-use drums to an all-18-gauge drum system, with an average of 8 reconditionings per drum (9 fills), would create energy savings of 17,043 billion Btu per year, which is 23 percent of the total energy requirement of the present system, and enough energy to provide electric power for one month to a city the size of San Francisco."

"Clearly, efforts to increase the use of 18 gauge drums and the rate of return of such drums (by such means as deposits) would conserve energy. Conversely, a trend to increase the use of light gauge drums, or to reduce the return rate of drums would further burden American energy resources."

Translated into different terms, by reconditioning 40 million drums a year, our industry saves the equivalent in energy of 1 billion 800 million gallons of oil.

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As for the conservation of steel, by reconditioning 40 million drums annually, we save over 2 billion pounds, or 1 to 1¼ million tons of sheet steel. It is almost unnecessary to spell out the obvious resultant conservation of natural resources. The coal, iron ore, manganese, sulphur, phosphorus, carbon and other minerals and chemicals conserved by not manufacturing that 1 million tons of steel annually is a vital contribution to the preservation of our natural resources.

As for reducing solid waste pollution: if these drums were not picked up, reconditioned and put back into commercial reuse, they would constitute a serious blight and a contributing factor to pollution of the Earth, air and water. Most drums contain a residue of their previous contents—oils, chemicals, petrochemicals, pesticides, paints, etc. Our industry acts as an unpaid collection system, receiving all of these pollutants, treating them, cleaning the containers and returning them to commercial reuse, while at the same time disposing of the residual sludge.

Although our industry is not directly involved in the recycling business, we clean, recondition and refurbish steel drums so that they are again reusable by industrial fillers of the many products shipped in drums—both hazardous and nonhazardous. We feel that a reuse industry should be given as much, if not greater encouragement than a recycling industry.

This introduction to our industry leads me to the reason for our Submission to this Committee. For the past 10 to 15 years, the steel industry, through its subsidiaries, has been encouraging the purchase of "throwaway" (one-time use), or short-lived drums. These are thin-walled, lighter-weight drums, fabricated of 20, 22 or 24 gauge steel. The standard 55-gallon drum, for a quarter of a century, was made of 18-gauge steel, this thickness having proved itself to industry, in both peace and wartime, as bulwark of strength in transportation, storage, stacking, reconditioning and reuse, as the safest and most economical container. Furthermore, for safety reasons, according to Department of Transportation regulations, almost all hazardous materials shipped in drums must be shipped in drums made of 18-gauge or heavier steel.

The steel industry has introduced several lighter weight drums in order to compete with the reconditioned drum. They introduced a 24-gauge drum, fabricated of steel one-half the thickness of 18-gauge, which is sold in limited quantities; more importantly, they introduced the 20/18-gauge drum, made with an 18 gauge top and bottom and a 20 gauge body, 10 pounds lighter and with a short commercial life of 2 to 3 trips, compared with the 8 to 10 trips afforded by an all 18 gauge.

In recent months this trend has been accentuated. One drum manufacturer has obtained permission from the National Classification Board of the American Trucking Association to use, for the transportation of liquids, a 19/22/20 gauge drum; this drum has a light, 19 gauge bottom—a lighter 22 gauge body—and a 20 gauge top. It is marked "Nonreusable for Liquids" and therefore is, by design, a single trip, throwaway drum.

More dangerous is the all 20 gauge drum, proposed to the same Board by the Steel Shipping Container Institute, the association rep-

resenting steel drum manufacturers. This drum will be "reusable," and, in our opinion, will have an extremely short life, if any, beyond its initial use.

The steel drum manufacturers are not concerned with the wasteage of energy and natural resources. They are now asserting that they should be permitted even lighter gauge drums, in order to produce more drums per ton of steel. They disregard the fact that this increase in drum production would be illusory; actually, it would reduce the supply of used drums in the national inventory, a situation already affecting the Nation today. There is currently a severe shortage of drums because too many of the drums manufactured in recent years have been throwaway, or short-lived drums.

Because the 20/18 gauge drum uses 10 pounds less steel, there is a price differential of approximately $1.00 between it and the all 18 gauge drum. Due to this differential, many industries, such as chemicals, petrochemicals, varnishes, paints, et cetera, which sell drum and contents together, purchase the 20/18. The oil industry, in the main, is on a returnable drum system and therefore pays the additional $1.00 for the 18 gauge drum, since they consider it more economical because of its longer life.

For some years, we have endeavoured to persuade the chemical and other industries to revert to the all 18 gauge drum, for the reasons mentioned. Despite our efforts, light gauge tight head drums have increased in production from 2 percent in 1957 to 50 percent in 1974, to the detriment of the economy and the environment.

We believe that a tax incentive—or perhaps a tax disincentive—in this field would serve the national interest by reducing solid waste pollution, conserving energy and natural resources, and fighting inflation by reducing the packaging costs of essential industry products.

Let us assume that the 18-gauge drum cost $12.00, and that the lighter weight 20/18 gauge costs $11.00. If, for example, purchasers of 18-gauge, 55-gallon steel drums were permitted to deduct $13.50, or $1.50 over the cost of the drum, as a legitimate tax deduction, this would discourage the purchase of 20/18 and lighter drums.

Another avenue might be to restrict purchasers of 20/18 gauge or lighter drums from deducting the entire $11.00 cost of the package, allowing them a legitimate deduction of $9.00, or a reduction of $2.00. A simplified and more easily workable system would be to permit an increase in the tax deductible cost of 15 percent for 55 gallon drums of 18 gauge, and a decrease in the same percentage of 55 gallon drums lighter than 18 gauge. Such a tax incentive or disincentive should discourage the purchase of light-weight, nonreusable drums, and therefore would increase the production of all 18 gauge, reusable steel drums.

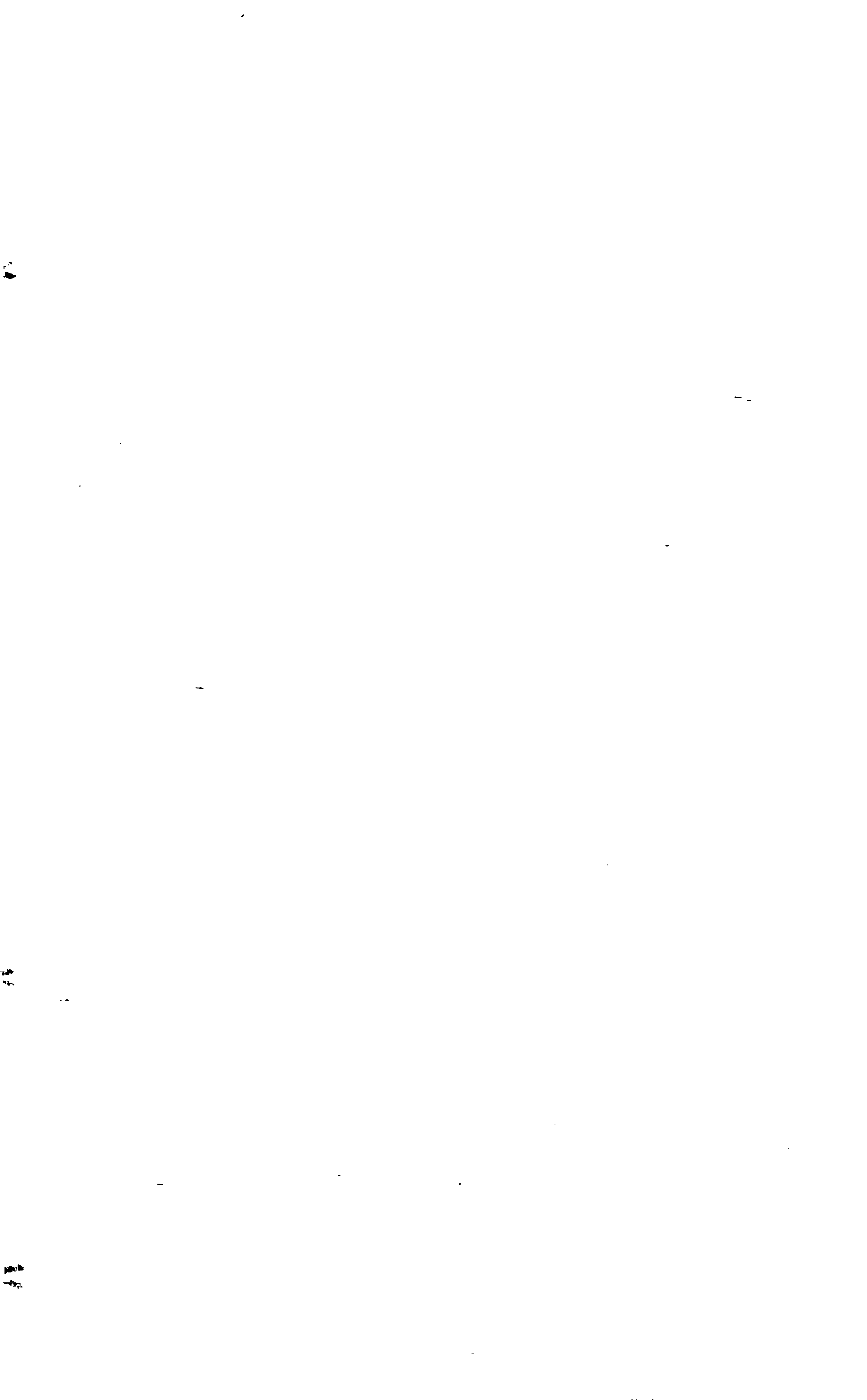
However, this recommended tax adjustment would not, by itself, completely achieve the desired objective. It would be in the national interest if sellers of drum and product (such as the chemicals industry) could be induced to use and reuse the 18 gauge drum. This reuse was recognized as a strategic necessity during World War II. At that time, the War Production Board prohibited the purchase of new drums unless the user had used and reused his supply of drums as

many times as possible, in order to save steel for the war effort. A similar requirement (by the tax route) should be imposed on industry today, subject of course, to Department of Transportation regulations. This would save steel needed for the economy, it would save energy and natural resources, and reduce the solid waste problem caused by throwaway drums.

Attached to this statement is a copy of the University of Illinois Energy Study referred to earlier, a copy of the remarks on the subject made by former Congressman Abner Mikva, which appeared in the Congressional Record of Nov. 1, 1971, and a copy of Senator Jennings Randolph's remarks, also, in the Congressional Record of Mar. 30, 1972. Since those remarks were made, bills have been introduced in the House to propose banning the manufacture of light-gauge, non-reusable steel drums, by former Congressman Brad Morse (H.R. 14707) in the 92nd Congress, and by Congressman Ancher Nelsen (H.R. 3471) and Congressman Edwin B. Forsythe (H.R. 11884).

We urge this Committee to recommend to the Congress the creation of a tax incentive or disincentive which, by discouraging the purchase of non-reusable, or short-lived steel drums, would provide significant environmental benefits.

Industrial Development Bonds



TESTIMONY OF MICHAEL D. BROMBERG, ESQ., DIRECTOR, NATIONAL OFFICES, FEDERATION OF AMERICAN HOSPITALS

The Federation of American Hospitals is the national trade association representing the nation's approximately 1,100 investor-owned hospitals. All of these facilities were built or acquired with private capital and a substantial number are located in medically underserved areas. These hospitals, providing quality care as efficiently as possible, are frequently the only institutions serving the communities in which they are located.

The testimony which we are submitting as part of these hearings on tax reform is meant to draw your attention to the urgent need to add hospitals to the list of categories exempt from the $5 million limitation on qualified, tax-exempt industrial developmental bonds. The need for such legislation has been recognized by Senator Lloyd Bentsen, who earlier this month introduced S. 3241, a bill designed to provide that exemption. As he noted in his introductory remarks, this bill "is needed to assure an adequate supply of health services in rural and inner-city sections of the United States. Historically, investor-owned hospitals have located in rural areas with inadequate health facilities." We would like to commend the Senator for his efforts and urge your favorable action on his bill.

Health care in the United States is desperately in need of capital financing for facility expansion and modernization. The usual sources are not always open to hospitals. Non-taxable hospitals are presently able to market their own bonds bearing tax exempt interest. At the present time, non-profit hospitals finance over forty percent of all new construction and/or modernization through the use of general revenue bonds. There is no limit on such issues, and last year they financed $4.3 billion in hospital projects.

In contrast, investor-owned hospitals must use industrial revenue bonds which are subject to a $5 million limit per issue. This limit applies to all capital expenditures related to the project which are made during the three years preceding and three years following the issuance of the bonds. The ability to finance construction and modernization projects in large part determines whether or not they will exist. Industrial development bonds figure prominently in underwriting the costs involved, and although the maximum $5 million issue adequately covered these costs in 1968, to build a similar 200 bed facility today would run over $11 million. Put another way, the $5 million limit will permit the construction of an 80 bed hospital at the present time, and generally speaking, such a small physical plant may be uneconomical unless it is a part of the integrated system.

Working from such a base, Congressional efforts to raise the maximum on small issues from $5 million to $10 million still fall short of what the investor-owned hospital industry deems to be necessary.

Since 1968, the Internal Revenue Code has permitted governmental units to issue industrial development bonds in six specified categories which bear tax exempt interest even though the proceeds from the sale of the bonds are turned over to private business. These six categories, which are exempt from the $5 million ceiling because of their public need and high construction cost, are as follows:

(1) Residential real property for family units;

(2) Sports facilities;

(3) Airports, docks, wharfs, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing;

(4) Convention or trade show facilities;

(5) Sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy, gas or water; and

(6) Air or water pollution control facilities.

We believe that hospitals should be added to the above exemptions because they too serve a fundamental public need and require a considerable capital investment. As Senator Bentsen noted, "There is no justification to give priority to convention halls and sports facilities as compared to health facilities."

One of the most important reasons for warranting the reclassification of hospitals into the fully exempt status is the development of effective areawide planning authorities, largely through the passage of P.L. 93-641, the Comprehensive Health Planning Law. This law, which requires state certificate of need programs as a condition for receiving federal planning funds, effectively limits future construction of projects to those which serve a real need in the community. As a matter of course, bond underwriters normally require an extensive feasibility study to document the community needs before considering marketing the proposed bonds. Thus, to the extent that there are excessive beds in a geographic area, the expansion of industrial revenue bond financing will not result in the creation of additional beds—unneeded facilities simply will not be constructed due to the planning authorities.

It is the common desire of both Congress and the health care industry to provide high quality care in the most efficient manner possible. An expansion of the tax exempt industrial revenue bond financing mechanisms would contribute directly and immediately to the lowering of hospital costs and charges.

If construction of private hospitals was financed through tax exempt industrial revenue bonds, the savings in annual interest cost would be approximately 30%. The annual savings that would result could be passed along to patients in terms of lower charges.

In brief, we urge the Committee to carefully consider and support Senator Bentsen's measure, S. 3241, because the inclusion of hospitals as an exempt category would:

(1) Attract investment of private capital in needed hospital construction;

(2) Ease the burden on strained federal, state and local budgets for construction of health facilities in underserved areas;

(3) Encourage necessary modernization of existing investor-owned hospitals;

(4) Provide relief for investor-owned hospitals which in 1974 alone paid $46.3 million in property taxes and $125.8 million in state income taxes;

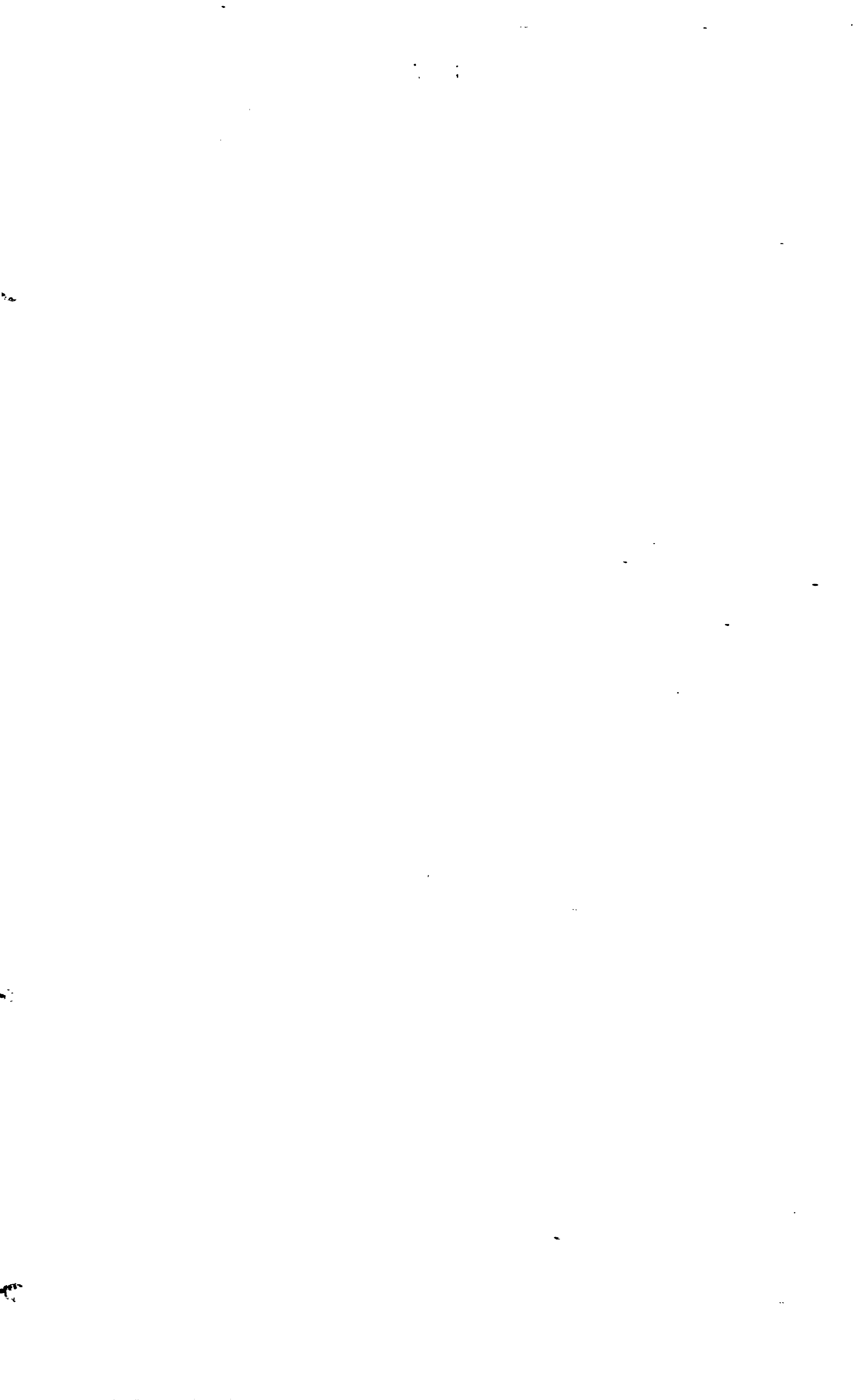
(5) Curb rising hospital costs and charges through general tax relief; and

(6) Provide greater capital resources to meet increasing demand for access to hospital care.

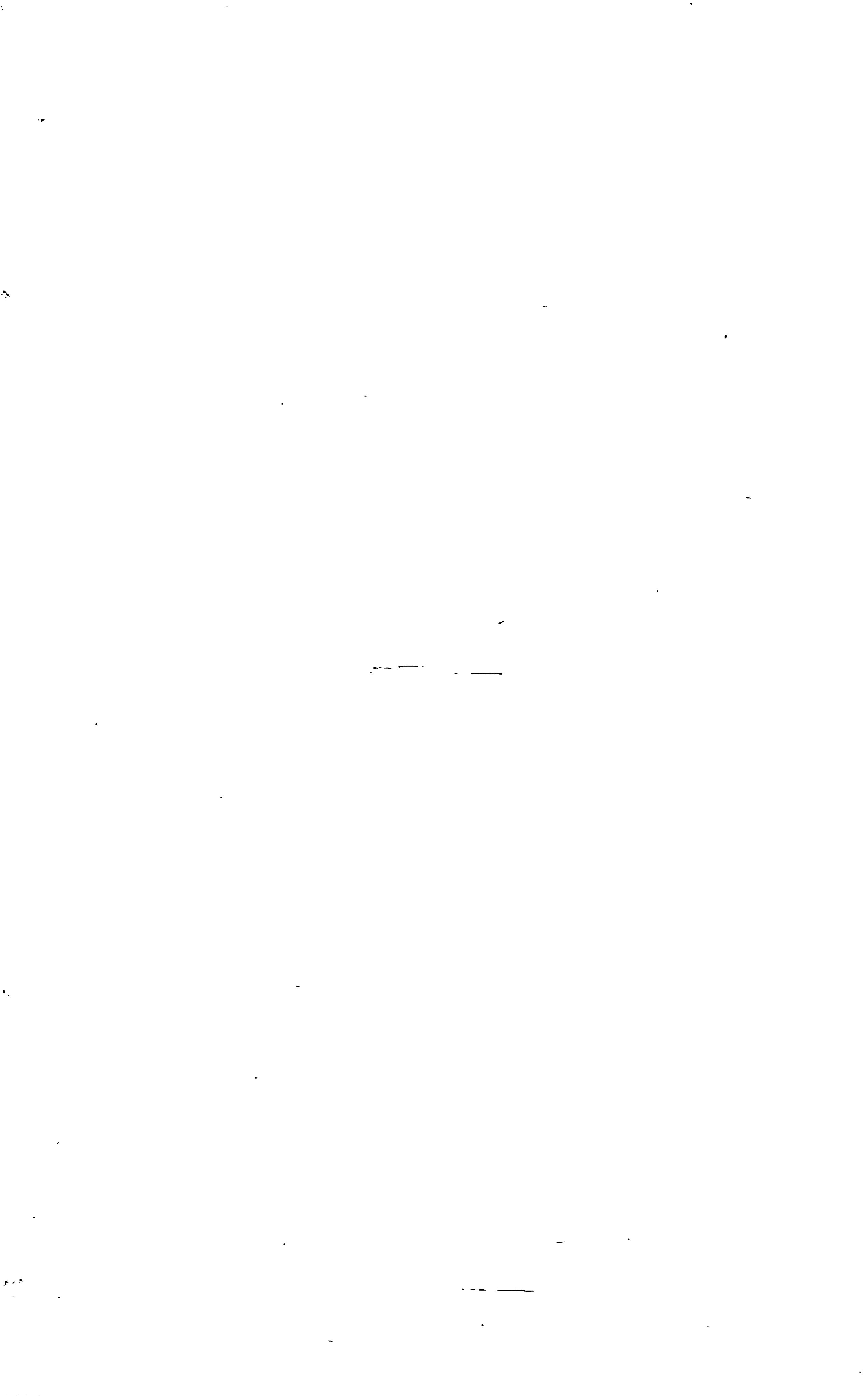
The Department of Health, Education, and Welfare has estimated that several billion dollars will be needed in the next decade to build needed new facilities and replace existing substandard facilities. These projections have not even been adjusted for the impact of national health insurance. In addition, the Senate is currently considering passage of a manpower bill to create the needed medical and paramedical resources which must be available to meet the anticipated increased demands which will be generated under a program of national health insurance. Manpower will be of little value, however, if there are not adequate physical plants.

The replacement of existing, outdated facilities or the construction of new ones in areas that never had a hospital, continues to be the cornerstone of our industry. There are still areas of the country—chiefly rural—where there is a tremendous need for the provision of quality health care. At the present time, there are over 300 communities where the only available hospital facility is investor-owned. There are other communities where as yet *no* hospitals exist. We are seeking to remedy that situation by building new facilities, all of which must meet specific certificate of need criteria. But financing is crucial. Reclassification of hospitals into the fully exempt industrial revenue bond category will go a long way towards meeting these capital needs through the private sector.

We thank you for the opportunity to make our views known, and ask that they be included as part of the official record of these proceedings.



Trade Associations' Income From Trade Shows



Statement of the American Society of Association Executives

IRS Regulations on Trade Associations Income from Trade Shows

This statement is submitted on behalf of the American Society of Association Executives by James P. Low, President and Chief Administrative Officer, ASAE, has submitted separate statements concerning the deductibility of attendance of foreign conventions and advertising in trade association publications. This statement is submitted to urge the Committee to overrule IRS interpretation of the unrelated business income provisions of § 512 of the IRC as it relates to trade show income. The Service position threatens the U.S. Commerce Department's Foreign Buyer Program which was launched in 1974 to encourage foreign buyers to attend trade shows in the United States. Further, the United States stands to lose millions of dollars in export sales and jobs as the result of the Service's position on trade show income.

In many cases, one of the most important functions of a professional society or trade association is the organization and operation of regular shows, where members of a particular industry may display their products and techniques, and where manufacturers and distributors of products used in the industry may display their products. Trade shows are operated in various ways, some of which give rise to income to the organizing association. The Internal Revenue Service considers such income under certain circumstances to be unrelated business taxable income to the sponsoring organization involved.

Recently the Internal Revenue Service issued rulings specifying when income from trade shows would constitute unrelated business taxable income. Those rulings held that if an association enforces "no selling" agreements at its trade show, no particular services would be performed for particular individuals, and no unrelated business taxable income would exist. In other words, where an association or society acts as a policeman and insures that exhibitors do not sell their wares at the trade show, no income will exist. Otherwise, income from the show would constitute unrelated business income of the association or society taxable under the Internal Revenue Code.

The contribution of trade shows (including selling ones) to the exempt functions of the association is undeniable. The purpose of trade shows is to provide members of a particular industry or profession, whether or not members of the sponsoring organization, with a method of displaying industry products and services to the public and to other industries. Often an industry is composed of a great many small to medium-sized producers which are not national in scope. The trade show provides such producers with an opportunity to display their products—new products, improved products, technologi-

cal advances, etc. Other firms in the industry are forced to review their own products with a view to upgrading in order to remain competitive.

Trade shows began in order to fill a void, displaying the products of smaller industry members and assisting them to maintain an awareness of changing industry and government standards. Trade association-sponsored shows do not compete with other organizations but merely foster competition within a particular industry or profession. It provides the little guy an opportunity to display his product side by side with the biggest member of the industry on a product basis without the intervention of national advertising or franchised dealerships. Further, it allows a person to expose his product to potential foreign buyers who, but for the show, would not even be aware of his existence.

In summary, the primary purpose of trade shows is not to make money for the sponsoring association. The purposes are to provide a giant display window to enable the public and potential purchasers to view that industry's products, and at the same time, permit smaller members of that industry to become conversant with the ever-changing government standards for such products. The rulings promulgated by the Service which expose incidental income to tax would make the operation of such shows much less attractive. One wonders what is achieved by such action—a small amount of revenue as compared with the potential overall damage to smaller members of some industries. This is not a situation in which a tax exempt organization is competing with a taxable organization and is using its tax-exempt status as a means to engage in unfair competition. Rather, this is the fostering of completion and the filling of a void. Foreign countries subsidize the organization and operation of trade shows. Why should we penalize U.S. associations and societies in their efforts to compete with foreign producers or professionals? To combat foreign competition, the U.S. Department of Commerce initiated a program of encouraging foreign nationals to attend U.S. trade shows and to buy products at U.S. shows. The "Foreign Buyers" program of the Department of Commerce appears to be in direct conflict with the Treasury Department's recent regulation.

As a result of the IRS action, many U.S. associations are reconsidering plans for future trade shows, especially those to attract foreign buyers who purchase millions of dollars of U.S. products and services which, in turn, result in jobs for many thousands of Americans. For example, the Society of the Plastics Industry, Inc., New York City, has recently cancelled plans with the U.S. Department of Commerce to invite 4,000 foreign buyers to attend its 1976 trade exposition. It seems incredible that one branch of our Federal government is restricting trade show selling while another is encouraging foreign buying at U.S. trade show.

The need to overrule the IRS on this matter is obvious. Section 512(b) of the Internal Revenue Code, which lists income not falling within the definition of unrelated business taxable income of Section 512(a), should be amended to include the income derived from trade shows. ASAE is ready and willing to work with the Committee and the IRS to resolve this important issue.

Advertising in Publications of Tax-Exempt Organizations

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, JAMES P. LOW, PRESIDENT

ADVERTISING IN PUBLICATIONS PROVIDED TO MEMBERS OF TAX-EXEMPT ORGANIZATIONS

This statement is submitted on behalf of the American Society of Association Executives (ASAE) to supplement two separate statements submitted by ASAE. Each of the three issues discussed is sufficiently important to merit individual treatment. Accordingly, ASAE has elected to submit separate statements on each issue.

Most associations, professional societies and other tax-exempt organizations prepare and circulate to their membership a journal, bulletin or magazine. In most instances these publications were created to fill a void resulting from the absence of any other publication. These publications contain articles, announcements, and other information related to the association's activities. In many cases, these association publications may also contain commercial advertising related to the association's functions and its membership's particular interests. Associations accept this advertising in their publication 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 costs of the publication. Associations and other non-profit organizations do not pay federal taxes on their dues. However, if in addition to their exempt activity the association 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 an association 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 non-profit associations, professional societies, and other tax-exempt organizations either: (i) paying taxes which divert money from their activities which the Congress has already determined to be worthy of tax exemption; or (ii) 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.

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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 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 our legislative proposal as a reasonable and equitable solution to tax treatment of advertising income. We would be happy to provide the Committee with any additional information which it may require on this matter or to explain our legislative proposal in more detail.

APPENDIX

PROPOSED AMENDMENT TO SECTION 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 an association entirely separately from the general activities of the association 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 an accuracy, this difficulty merely illustrates the problems of making such allocations at all—either with respect to receipts or expenses. The publication of an association 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 pri-

marily 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 four 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.

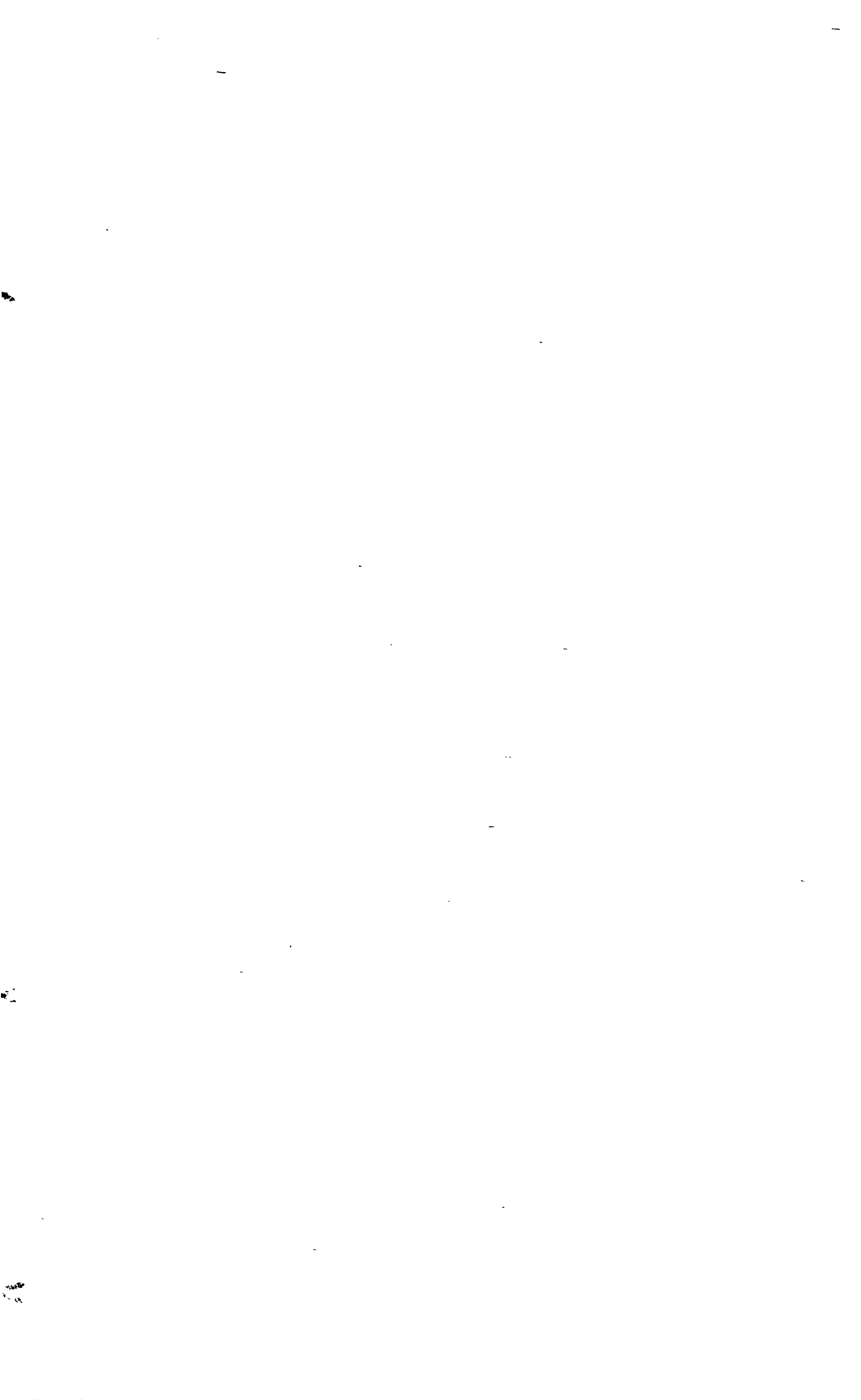
Thus, a legislative solution is necessary to eliminate any concern of the Treasury about its authority to provide some other and reasonable solution under present law and to deal with the few abuse cases which are the sole cause for concern.

The proposed statement to the Internal Revenue Code would provide as follows:

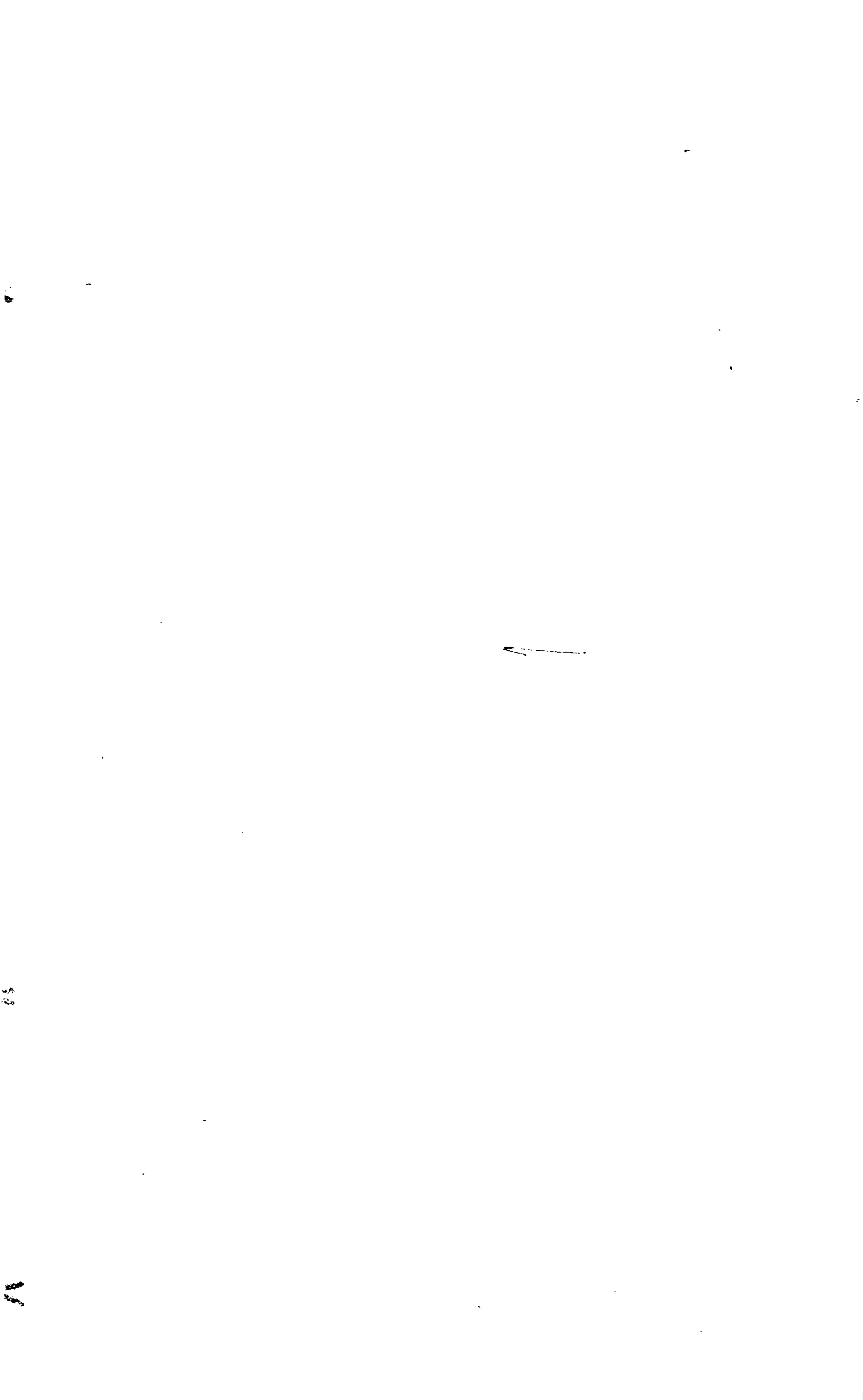
1. Associations and other tax-exempt organizations would be subject to unrelated business income tax only on *net* advertising income.
2. No amount of membership dues would be allocated to subscription price unless editorial and circulation costs of the magazine exceeded 50 percent of the organization's 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 circular cost as percentage of total expenditures:	*Maximum allocable membership dues (percent)*
50 or less	0
60	20
70	40
80	60
90	80
100	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.



Estate and Gift Taxes



April 23, 1976.

Statement on Estate Tax Submitted by Senator James B. Pearson

Mr. Chairman, I am pleased to have this opportunity to submit a statement on Federal estate tax revision to the Senate Committee on Finance. The present specific exemption of $60,000 has been in effect since 1942; the last major reform in this area was the 50-percent marital deduction which was added in 1948. During the intervening years, inflation has dramatically increased property values. A thorough reexamination of estate law is long overdue.

Family farms and business enterprises play an integral role in our economy. Today their future is endangered by our Federal estate tax law which forces some families to sell part of the family enterprise in order to pay estate taxes. Over several generations, these family enterprises can be reduced to a size that is no longer economically viable as a result of efforts to comply with Federal estate tax laws.

In 1963, Brown University studied a sample of small farms that had merged, or were sold, from 1955–59. This survey found that estate taxes were a contributing factor in three out of five cases studied. During the past 13 years, inflation has magnified this problem even more. For example, from 1962 to 1972, the average value of farm production assets rose from $47,500 to $102,100.

According to the Department of Agriculture, in 1970 real estate and machinery constituted 78 percent of all farm assets in the United States. This creates substantial liquidity problems as many farms already have outstanding debts even before estate tax burdens arise. These liquidity problems are further accentuated because of the low-profit margin of small farms and the difficulty of small businesses in obtaining bank loans. The relatively high risk nature of small businesses forces heavy reliance upon internal financial sources to provide capital for expansion thereby decreasing liquidity.

Although the Congress recognized a liquidity problem when it enacted section 6166 of the code, which permits the Secretary of the Treasury to extend the time for payment of estate tax where the estate consists largely of interest in closely held businesses, this relief does not go far enough. Even when the estate tax burden is spread over several years, liquidity problems can still cause insurmountable hardship. Moreover, section 6165 of the code mitigates against the use of the installment payment privilege by providing that the Secretary of the Treasury may require the taxpayer to furnish a bond in order to be granted an extension of time to pay a deficiency.

In an effort to preserve family enterprises, I have introduced a bill that would increase the specific exemption to $120,000, provide that a spouses services, as well as monetary contributions, shall be treated as consideration for purposes of determining the value of the decedent's

estate, allow a $130,000 deduction with respect to certain family farms and small business interests passed to a related individual, and authorized automatic increases in the estate tax exemption and family enterprise deduction to reflect rises in the cost of living.

The existing estate tax exemption has not changed since 1942. During this 33-year period, the efficacy of the specific exemption has been eroded by inflation to the point that it is now grossly inadequate. To remedy this problem, I propose to double the current exemption to $120,000. This increase would serve to restore the original intent of the law.

Increasing the estate tax exemption to $120,000 will help preserve small farms and businesses, but more is needed. Therefore, I propose that an additional exemption of $130,000 should also be provided. This provision, in addition to the specific exemption of $120,000, would further enable family farms and businesses to remain in the family if the estate passes to a related individual. By doubling the specific exemption to $120,000, all estates would be benefited. However, since estate taxes have the most adverse effect upon family farms, the additional $130,000 deduction is essential. Thus, family farms and businesses up to $250,000 could pass to a related individual without a crippling estate tax burden.

This additonal exemption is designed to insure that its benefits are directed only to those who are in need of special relief. Also, in order to prevent abuse, the decendent would be required to have owned the farm for at least 5 years and have exercised substantial management and control over the farm before he died. Those who inherit would also have to exercise substantial management and control over the enterprise for a period of 5 years in order to take advantage of the deduction.

I also propose that section 2040 of the code be amended in order to provide that services performed by a spouse shall be treated as consideration. Under present law, the entire value of property owned in joint tenancy or tenancy by the entirety is generally included in a decedent's gross estate for estate tax purposes except for the part of the value as is shown to be attributable to the amount of consideration in money or money's worth furnished by the surviving joint owner. This rule is known as the consideration-contributed test. Thus, if the decedent furnished the entire purchase price for property held in joint tenancy, the entire value of the property is included in his gross estate. If it can be shown that the decendent furnished only part of the purchase price, only a corresponding portion of the value of the property is included in his gross estate.

Controversies have arisen under present law with respect to the treatment of services performed by a surviving spouse as consideration for purposes of this provision. Typically, these controversies usually involve cases where a husband and wife have jointly operated and managed a farm, grocery store, or other small business. Some courts have recognized the performance of services by the surviving spouse as consideration for purposes of determining the portion of jointly owned property includable in the decedent's gross estate. For example, in *Estate of Otte*, 31 CCH Tax Ct. Mem. 301 (1972), the Tax Court held that services performed by a surviving wife in connection

with the operation of a farm constituted consideration in money or money's worth in determining that only a portion of the value of the farm was includable in the decendent's gross estate.

My bill would make it clear that services performed by a surviving spouse in connection with a trade or business are to be taken into account as consideration furnished for jointly owned property.

I also propose that the $120,000 exemption and the $130,000 deduction be automatically adjusted each year in order to provide permanent protection against future inflation. This would be done by adjusting the $120,000 exemption each year by reference to the Consumer Price Index and by annually adjusting the $130,000 deduction in relation to the gross national product deflator.

Although Federal gift taxes enable the transfer of many estates tax free prior to death, this alternative is not available to farm owners whose assets are primarily composed of land, building, and machinery, Federal gift tax rates are equal to three-fourths of the estate tax rates and are designed to encourage lifetime giving by providing an outright lifetime exemption of $30,000 in addition to annual exclusions of $3,000 per donee. While this enables small estates composed of liquid assets to be transferred to the next generation through gifts, farm owners and businesses are denied this relief.

A tax preference is needed in order to assure the survival of family farms and businesses. Estate tax revision should properly encompass this reform by providing for incentives to business. These incentives, however, must be targeted to meet a particular need in order to prevent unnecessary revenue loss. Increasing the specific exemption to $200,000 would extend far beyond those owning farms and small businesses. The Treasury estimates that this proposal would cost approximately $2 billion with much of this revenue loss going to large estates.

My proposal would cost $1.7 billion in total and would be targeted to meet the specific problem of passing family farms and businesses from generation to generation. The Treasury estimates that increasing the specific exemption to $120,000 would cost $1.3 billion, the $130,000 exemption would cost $300 million, and the spouses services provisions would cost approximately $100 million.

It has never been the intent of the estate tax law to force the sale of small farms and businesses. To the extent that it does, changes must be made. Congress must provide targeted relief. While some will argue that revenue loss cannot be afforded, it must be borne in mind that family farms and businesses that are sold to pay estate taxes are often purchased by corporations that, because of their perpetual life, will never pay estate taxes.

Some contend that by providing special relief we are interfering with competition and protecting inefficiency. However, the question is not one of efficiency or competition but a question of liquidity as family enterprises face the burden of heavy estate taxes twice each generation. For those who still insist that we cannot afford the fiscal impact, I counter that it is the social cost of losing the family enterprise stratum of our society that we cannot afford.

The thrust of my bill is to preserve family farms and businesses. It would provide for four changes in our Federal estate tax law. In doing this, it would put estate tax law on a more equitable basis, encourage

the perpetuation of an important social and economic goal, and provide necessary safeguards in order to prevent abuse of these provisions.

Mr. Chairman, I urge that the committee make every effort to report on estate tax reform as expediently as possible.

Statement of Robert D. Partridge, Executive Vice President, National Rural Electric Cooperative Association, on Federal Estate and Gift Taxes

Mr. Chairman and members of the committee, my name is Robert D. Partridge. I am the general manager and executive vice president of the National Rural Electric Cooperative Association (NRECA). NRECA is the national service organization of approximately 1,000 nonprofit rural electric cooperatives which provide central station electricity to nearly 25 million farm and rural people in approximately 2,600 of the Nation's 3,141 counties and county-type areas of 46 States.

We appreciate the opportunity to submit this statement on the proposals pending before this committee to update and reform the estate tax laws.

During the months of September and October of 1975, as in previous years, members of our rural electric systems met on a regional basis to discuss rural electric-related legislative matters, as well as other subjects of interests to rural people. At a number of these regional meetings last year, the membership endorsed by resolution changes in the present estate tax laws.

Then in February 1976 over 11,000 members of America's rural electrics gathered for our 1976 annual meeting, at which the voting delegates passed unanimously the following resolution:

Estate Tax Exemption

The preservation of agricultural land should be of vital concern to all people, both to insure an adequate supply of food and to maintain open space near heavily populated areas. The present Internal Revenue Service policy of appraising farm property at its highest sale value often forces its sale for a nonfarm use in order to provide funds for payment of estate taxes.

We therefore recommend that the exemption from the Federal estate tax should be increased from $60,000 to $300,000 or more in recognition of the economic changes which have occurred since the present exemptions were provided and that gift taxes should be comparably adjusted. It is further recommended that the period in which transfers of property are held to be in contemplation of death be reduced to 1 year.

Mr. Chairman, the reasons for changing the estate tax laws are numerous and of vital concern to rural Americans who produce the food and fiber for those living elsewhere. I don't think that anyone would suggest that the farmer's life has not been extremely difficult with the material rewards for his labor falling behind those who have chosen other areas of endeavor. The investment required in an operating farm today in staggering, especially in view of the limited liquid returns. There is no better testimony to this fact than the flight from the farms which has occurred over the last half century.

The cornerstone of the world's most successful agricultural operations has been the family farm of America. The term "family farm"

itself suggests that it is not an operation by the head of the household alone, but an operation involving the entire family who frequently work long hours to build what later becomes an estate. Increasing the estate tax exemption, the marital deduction, and the amount that may be given during one's lifetime would not be a special interest reward to the family farmer, but merely a long overdue recognition of those contributions made by the entire family to the estate.

As I indicated, there are numerous other reasons for changing these laws, many very ably pointed out by others testifying during these hearings. Among these reasons, inflation is certainly one of the most significant; that factor alone is sufficient reason for raising the $60,000 present exemption established in 1942 to something in excess of $200,000. Those who indicate that the present laws have many loopholes which encourage disposing of an estate or part of the estate prior to death are not recognizing the uniqueness of the farming operation, which generally should be enlarged in order to produce a living income and most certainly should not be fragmented. And of what use is the $3,000 annual gift to such an operation? Most equipment costs in excess of this figure and the legal fees and trouble involved in carving out $3,000 worth of property from an operation each year is most impractical.

Let me add that a great deal of the increased value of farmland is attributable to competition from other sources for that land, whether it be the comparatively wealthier urbanite who wants a hobby farm for weekends, or the commercial and vacation home developer. Accordingly, I would at least recommend that land used for farming, woodland or scenic open space be assessed for estate tax purposes on the basis of its current use rather than its higher potential uses.

Finally, I wish to state that while our testimony deals with the problems encountered by the family farmer only, I am in no way indicating that persons who leave other types of estates have not encountered similar problems. I have addressed myself to the problems of the family farmer because our constituency is primarily rural and our resolution deals only with their particular problems.

Mr. Chairman, of all the proposals that we have reviewed before your committee, we feel that those recommended by S. 1173 and several identical bills most nearly reflect the views of our members.

Statement of Charles M. Farmer, Associate Professor, Agricultural Economics, University of Tennessee

SOME COMMENTS RELATING TO ADJUSTMENT OF ESTATE TAX LEGISLATION

Contention.—The present estate tax exemption of $60,000 is unfair to farm families.

In Support of Stated Contention.—

1. *The recent trends in agriculture toward larger farms has amplified the inequities of the present exemption level.*—Due to the very competitive nature of American agriculture, farmers have been forced to increase the size of their farm operations. This trend, along with

rapidly increasing land values has made more and more estates subject to death taxes. For example, the number of Federal estate tax returns filed has increased from 17,000 in 1940 to 175,000 in 1973.

2. *If the $60,000 exemption was equitable in 1942, it is grossly unfair today.*—In 1942, the average acre of farmland in Tennessee had a value of $40. This meant that 1,500 acres of land, excluding livestock and machinery, et cetera, were needed to trigger the $60,000 exemption. In 1975, average land value in Tennessee was 13 or 14 times the 1942 level—some $516 per acre. This meant that 116 acres of land in 1975 had a value equal to the exemption level. Hardly anyone would consider this an excessive concentration of land. In fact, if livestock, machinery and equipment are included at average prices and inventory rates, a farm operation of about 80 acres would be large enough to reach the exemption level. Remember that the average farm size in Tennessee at 123 acres is 50 percent larger than the size of operation which would reach the exemption level. The average rate of return on farm investment capital is no more than 2 to 3 percent annually.

3. *Many farmers are essentially operating a small business which has a high market value.*—The average net return per acre of farmland in Tennessee for the 1972–74 period was about $20. This means that the average farm in Tennessee, 123 acres, produced a net farm income of about $2,460, barely $200 a month. Yet this farm operator had an investment of $80,000 to $85,000. A farm large enough to produce annual net farm income of $10,000 would have a value of $400,000 to $500,000. The death tax on an operation of this size would be quite substantial.

4. *The current exemption works a hardship on heirs.*—Technically, the estate tax is levied on the estate itself. In many actual situations, however, the heir or heirs must draw on other money sources, sell some of the farmland, or incur indebtedness to pay the estate tax.

FARMS IN TENNESSEE: NUMBER, AVERAGE SIZE, AND AVERAGE VALUE

Year	Number of farms (thousands)	Average size (acres)	Average value per acre	Year	Number of farms (thousands)	Average size (acres)	Average value per acre
1941		73	$37	1967	135	116	213
1942		73	40	1968	132	118	230
1960	169	99	132	1969	130	119	252
1961	163	102	137	1970	129	120	268
1962	157	104	146	1971	127	121	279
1963	152	107	157	1972	126	122	311
1964	147	110	167	1973	125	123	363
1965	142	112	179	1974	125	123	449
1966	138	114	197	1975	125	123	516

SOME QUESTIONS AND ANSWERS REGARDING ESTATE TAXES

Question. When did the estate tax become a part of the Federal revenue system and what are the present rates and exemptions?

Answer. The estate tax became a permanent part of the Federal system in 1916, although it had been used as an emergency measure prior to that year. The present exemption of $60,000 has been in effect since 1942, and the present rate scale of 3 percent graduating up to 77 percent was adopted in 1941.

Question. It is my understanding that both the Federal estate and gift tax amount to only about 2 percent of the total Federal tax receipt. How, then, do we justify the considerable current interest in what, from the standpoint of yield, seems to be a minor tax?

Answer. First, the number of estate tax returns filed has increased from 17,000 in 1940 to 175,000 in 1973. And thanks to inflation, estate taxes are taking a considerable bite out of those estates subject to the tax.

Second, although Federal tax on wealth transfers are only a small fraction of total tax receipts and occur by death only once in each generation, estate taxes do not present complex legal, economic and social problems. Present laws produce complexities in estate planning, encourage disposition of assets contrary to the best interest of the taxpayers, beneficiaries, and the economy and work inequities among taxpayers.

Furthermore, most farmers either are not aware of the laws or they simply are not in position to take advantage of them because they cannot jeopardize their current minimum earning capacity. These reasons are particularly applicable to recent trends in agriculture. In order to make a living, farmers have had to increase the size of their business and rapid appreciation in the value of farm assets has made many more estates subject to death taxes than ever before. Farmers ordinarily have little ready cash. Therefore, heirs frequently must borrow heavily in order to pay estate taxes to keep the farm operationally solvent.

Question. I understand that there are at least three main purposes for Federal estate taxes: (1) To produce revenue, (2) To prevent excessive concentration of wealth, and possibly (3) To direct the future course of society.

Is this basically true and if so how well does the Federal estate tax system serve these purposes?

Answer. No doubt estate taxes do these things. But, I question if the present structure serves the best interest of all concerned. I believe data will show there is excessive destruction of concentrated wealth. Many families remain in agriculture, realizing that the only way to leave any material goods to their heirs is through bequeathing to them a share of the farm. This is true because they ordinarily need income from the farm for family living. And because it is so difficult to accumulate other wealth. However, estate taxes are placing an ever-increasing burden on the family of the deceased. Many times a part of the farm must be sold to pay estate taxes.

Data show that the present $60,000 exemption is too severe, actually forcing excessive destruction of farm estates. This may retard progress toward aggregation of land into more productive, economical units—contrary to the interests of farm people and of our society.

Question. Today, inflation has reduced the purchasing power of the dollar by more than 65 percent of what it was when the present tax exemptions were established. With the inflationary spiral we have witnessed since 1940, would some system of adjusting the value of estate tax exemptions for inflation be appropriate for the future?

Answer. I believe it would. A periodic review would seem to be in order. Using a price deflator to adjust for inflation, the $60,000 personal estate tax exemption authorized in 1942 is worth only $18,000

in 1975, in terms of 1942 dollars. To establish the exemption at a level equal in real terms to $60,000 in 1942 would require that the exemption level be raised to approximately $200,000.

Such action would help promote the family farm; for $200,000 today will purchase only about 385 acres of land. It would still take another $100,000 for machinery and specialized equipment and approximately another $100,000 for operating capital. Thus, around $400,000 is needed to yield incomes barely up to the average for the nonfarm families.

Question. Give us an example of the direct impact of Federal estate taxes on the heir to the property of a deceased farm operator who had been making his livelihood entirely from farming.

Answer. In order to do that, let's assume we have a farm of about 300 acres with the land valued at $600 per acre including the home and buildings or $180,000. With $70,000 worth of equipment and machinery this would bring the estate to a value of $250,000. Assume further that the farmer has just enough cash to cover all outstanding debts and expenses.

Also assume that upon death only one heir—not his wife—is involved. In this case, the tax obligation would amount to $47,700 or almost one-fifth of the original estate. The heir would still be liable for additional estate and inheritance taxes to the State.

Obviously, the tax liability creates a financial burden for heirs although technically the estate tax is levied on the estate itself. The heir must draw on other money sources, sell some land or incur indebtedness to pay the tax.

And still, in our example, this is a small business in terms of the amount of annual income it generates.

Death taxes may have a large total potential impact upon farm than nonfarm estates because more of them are operated as proprietorships or partnerships. Furthermore, few farmers take advantage of legal estate management tools compared to other types of business.

STATEMENT OF DON WOODWARD, PRESIDENT, NATIONAL ASSOCIATION OF WHEAT GROWERS, ON BEHALF OF THE AD HOC AGRICULTURAL TAX COMMITTEE

Mr. Chairman and members of the committee. The following comments are presented not only on behalf of the National Association of Wheat Growers, but also on behalf of an Ad Hoc Agricultural Tax Committee. This committee includes the American Horse Council, Inc., American National Cattlemen's Association, American Seed Trade Association, American Sugar Cane League, Cotton Warehouse Association, Florida Sugar Cane League, National Association of Wheat Growers, National Cotton Council of America, National Milk Producers Federation, National Wool Growers Association, and the Rio Grande Valley Sugar Cane Growers Cooperative.

In this regard, I should mention that some of the members of the ad hoc committee are also presenting their views individually to emphasize the most important areas of concern to their particular segment of the farm community.

The committee is to be commended for calling these hearings to review the estate tax laws. Such a review, particularly as it relates to estates in which the principal assets are a family type farm and the personal property needed for its operation, is, in our opinion, long overdue. It is probably not an overstatement to say that estate tax reform for family farms is one of the most important of all farm issues now pending before Congress.

Two primary factors have contributed to the need for updating the estate tax laws for agricultural estates—inflation and increasing farm size. Along with increased farm size has come an improved technology in which specialized equipment is being substituted for farm labor.

The inflationary spiral, common to all of us, seems to have impacted more on agricultural than on the general economy. Since 1942, when the present $60,000 exemption was established for estates, farm real estate values have gone up some 1,000 percent. Values today are three times higher than they were in 1960.

Compound this increase in value by the fact that farm size on the average has more than doubled since 1942 and we find an entirely different situation today than we had in 1942 or even in 1960.

Based on U.S. Department of Agriculture figures the average farm in 1942 had 182 acres and its value, including buildings was $6,100. There are no records of the average value invested in farm equipment and other personal property at that time, but even when the value of personal property is added to the real estate value, the total was far below the $60,000 estate tax exemption. It is our conclusion that a farm had to be five or six times larger than the average farm in 1942 before it even began to pay an estate tax.

The 1975 situation is far different. The average farm now has 385 acres and, with buildings, is worth about $131,000.

Because of the great variety of farming in the United States, and within the group presenting this statement, it is difficult to place an average figure on farm equipment and other personal property. However, we do know that every type of agriculture today has costly highly specialized equipment, whether it be a tractor, a combine, a mechanical cotton harvester, self-propelled picker-sheller used in harvesting corn or a stainless steel pipeline milker and storage tank on the dairy farm. In the case of livestock farms, large sums are invested in breeding animals and other livestock. In view of this, we believe it reasonable to project that the investment in farm personal property is equal to that invested in real estate.

For the average farm cited above this means another $131,000 or a total farm investment of $262,000. Subtract the $60,000 estate tax exemption and there is a taxable estate, in round figures, of $200,000.

The estate tax on such an estate is $50,700 on a direct inheritance. In the case of a surviving spouse, who in most instances has been directly involved in operating the farm along with her husband there is a tax of about $9,000.

It is the impact of these levies which we find alarming. The income potential of farming operations does not have within it a tolerance which can pick up a $50,000 estate tax bill. And if the property is valued at other than agricultural values the tax burden becomes even greater.

Unless some changes are made in the method of dealing with the estate tax law as it now applies to family farms especially since technology requires increasingly large amounts of capital investment, we will continue to witness a trend which could ultimately bring about the demise of the family farm structure as we now know it.

There is an alternative to family farming, but it is one we do not like and we believe the Congress will like no better. It is total corporate farming financed solely by outside capital. We do not believe the Congress prefers this type of farm ownership to the present family farm structure. Yet unless action is taken this will most likely occur.

Fortunately, many members of Congress, as well as the President have come to recognize the problem. President Ford expressed concern about the situation in his state of the Union message and advanced one type of relief. We fully concur with this statement to the American Farm Bureau Federation Convention in St. Louis early this year when he said: "The continuity of our farm families is vital. I want this continuity preserved, so farms can be handed down generation to generation, without the forced liquidation of family enterprises."

The legislative branch of Government has shown an equal interest. Numerous bills have been introduced in the Senate to adjust the estate tax laws to maintain the family farm.

In the House the record is even more impressive. A check of the January 14, 1976, legislative calendar of your Ways and Means Committee shows three different categories under "Estate Taxes" which deal with "family farms", "rural property" or "real property which is farmland, woodland, et cetera." We are pleased to note that under those three headings there are 69 bills which have been introduced by 206 authors from 46 States. Since then more bills have been introduced on these subjects. These are bills directed specifically toward farming and the list does not include bills dealing with an increase in the basic exemption or the marital deduction—proposals which we also endorse but which we have not listed because they cover more than agriculture or rural areas.

Proposed Estate Tax Relief Measures

Most of the numerous estate tax proposals which I have mentioned call for one or more of the following changes to the estate tax law: (1) valuation of farmland and certain other lands on the basis of the "use" of the land rather than on the basis of "fair market value," (2) an increase in the $60,000 estate tax exemption to some higher amount, (3) an increase in the 50 percent marital deduction, and (4) a 5-year deferral of estate tax liability attributable to family farms and small businesses followed by a 20-year installment payment period at a 4 percent interest rate. This last proposal is the one offered by the President in his state of the Union address.

The various estate tax relief measures being proposed are not mutually exclusive and there is something to be said about the merits of each one. In view of this, we would hope that the committee will adopt a combination of these proposed changes. However, because our time is limited today, the emphasis of my remarks will be directed toward those proposals dealing directly with relief for family farms.

Valuation of Farmland on Use Rather Than Fair Market Value

If there is one measure which has almost universal support within the farm community it is the proposal to allow farmland to be valued on the basis of its use for farming purposes rather than valuation on the basis of fair market value. This is a type of relief proposed by Mr. Burleson's legislation, H.R. 1793 and other identical bills, which at last count has 63 cosponsors. Under the Burleson bill, land must continue to be held and used by the estate beneficiaries as farmland for at least 5 years following the death of the decedent in order to qualify.

The law now requires that property held at death, including farmland, must be included in the estate at fair market value. A large estate tax liability resulting from the valuation of farmland on the basis of its fair market value has caused in the past and continues to cause severe financial problems for the surviving members of a family. These people are forced to sell all or part of the land in order to meet the estate tax bill, or they are forced to abandon the use of the land for farming purposes and convert it to nonagricultural uses.

In determining fair market value under the present law, a variety of factors are required to be considered including the highest and best use of the property, sales of nearby or similar land, the location of the land, the size of the land, and other similar facts and circumstances. This means that farmland situated near urban areas may be valued on the basis of its use as a residential development or maybe on its use as an industrial park. This value can be many times greater than the value of the land when used for farming since the rate of return on farmland and other farm assets is generally much lower than in the case of other business uses.

By limiting the factors to be used in the valuation of farmland held by an estate to the use of the land for farming purposes, this clearly eliminates inflated values due to urban development or due to valuation on the basis of a more profitable use of the land.

It is noteworthy that 31 States already have laws allowing property tax valuations of farmland to be made on the basis of use of the land.

Mr. Chairman, for the reasons I have discussed, we strongly urge the committee to adopt a provision to allow alternative valuation of farmland based on its use for farming. In this regard, it is probably worth pointing out that the alternative valuation proposal involves a smaller drain on the Federal Treasury than the other estate tax proposals. According to Treasury Department estimates released by the Library of Congress, valuation of farmland based on use would only reduce estate tax collection by about $20 million based on 1974 levels.[1]

Increase the $60,000 Exemption

Next, let me turn to the proposal to increase the current $60,000 estate tax exemption to some higher amount. Most sponsors have suggested a rise to $200,000 in order to fully take into account the rate of inflation since the $60,000 exemption was enacted. Our organization has recommended a $300,000 exemption. The President on the other hand recently called for an increase to $150,000 to be phased-in over

[1] "Analysis of Estate and Gift Tax Proposals Introduced in the Senate in 1975," Congressional Record, Jan. 23, 1976, p. S435.

a 5-year period. Regardless of the figure, some substantial increase in the present exemption is clearly warranted. Because updating the exemption is long overdue, we favor adjusting it immediately rather than phasing it in over a period of years.

I say this from the farmer's point of view because, as mentioned earlier, the amount of capital invested by the average farm in such things as farm equipment, livestock, and other assets necessary for farming has risen dramatically over recent years. The proposal to value farmland on the basis of farm use does not provide any estate tax relief for the substantially higher value of farm property other than land. And, we believe this problem should also be dealt with. If farm equipment or other essential assets have to be sold to pay estate taxes, the effect is the same as having to sell or convert the farmland itself.

If the committee finds that from a budgetary standpoint it is not possible to increase the exemption across the board by an amount large enough to solve the problem caused by the higher values of farm equipment and other nonreal property, there is another way to treat the problem. This alternative would allow an additional exemption for the first $200,000 of the value of a family farm. This is an exemption in addition to the basic $60,000 exemption. If the committee raises the $60,000 exemption for all taxpayers, the additional $200,000 exemption for family farms could be lowered accordingly. As you are no doubt aware, the Senate in 1974 adopted an additional $200,000 exemption for family farms, but no action was taken on the measure in the House.

Before turning to the next proposal, let me make it clear that we are suggesting an increase in the exemption in addition to valuation of farmland based on use—not in lieu of this latter proposal.

Five-Year Deferral Followed by 20-Year Installment Payment of Estate Taxes

Next, I would like to briefly comment on the President's proposal to allow a 5-year moratorium on estate tax liability attributable to family farms or small businesses followed by a 20-year installment payment period at an interest rate of 4 percent rather than the current 7 percent rate. As with other proposals, this would be quite helpful to many farmers. However, we do not believe standing alone it provides sufficient relief. Consequently, it necessarily must be coupled with some or all of the other proposals. In addition, there are some technical problems with the proposal which we will be happy to discuss with the committee staff.

Increases the 50-Percent Marital Deduction

Others will no doubt discuss in great detail an increase in the 50-percent marital deduction. For that reason, I will limit my comments by stating that such an increase would obviously be helpful to everyone — farmers included — from at least two standpoints. It could eliminate estate taxes on the farm property left the surviving spouse and could also eliminate the complicated and often expensive estate planning now required to minimize taxes on the estate of the first spouse to die.

Capital Gains Tax on Property Held at Death

Finally, we want the committee record to clearly show that our group opposes a capital gains tax on appreciated property held at death. The effect of imposing such a tax would be to recreate most, if not all, of the estate tax problems which you are so diligently trying to solve through the various constructive provisions being considered. In the case of farmers, the farmland held at death has often appreciated greatly over the cost when originally purchased or when inherited. A large capital gains tax on this appreciation would again force the sale of the land in order to meet the tax liability.

In closing, I would like the committee to know that by commenting on the problems of farmers, we do not mean to imply there are not many other citizens who encounter serious problems because of the present estate tax law. We realize that you must deal with the problems of the farmer within the context of small business owners and other taxpayers, and also within budgetary restrictions. Nonetheless, within this context, we hope that the committee understands the plight of the farmer when considering estate tax changes. We urge you to adopt relief provisions along the lines suggested.

Thank you again for allowing me to present our views.

Statement of the Interreligious Taskforce on U.S. Food Policy

REFORM IN THE ESTATE AND GIFT TAX LAW

The Taskforce welcomes this opportunity to submit a statement for the consideration of the committee.

The Taskforce is a team of Washington-based staff of over 20 Protestant denominations and national Roman Catholic, Jewish, and ecumenical agencies. In each of our organizations, as well as in many other national religious bodies not related to our Taskforce, hunger at home and abroad has become a major concern and programmatic priority. New programs to deal with this problem have been developed and new funds contributed. There is widespread recognition in the religious community that public policy has played a key role in aggravating the problem of hunger and that it can play a key role in solving the problem. Thus it is commonly held that one of the primary religious duties of members of the community of faith is to address public policy issues.

The particular function of the Taskforce is to facilitate the witness of the American religious community for a responsible U.S. food policy. We are seeking to do this by clarifying moral issues in U.S. food policy by providing reliable information about policy and policy options, by identifying policies and policy objectives which in our judgment serve the cause of justice, and by recommending ways in which concerned members of the religious community can most effectively make their witness in the political arena.

The Taskforce speaks for itself only, and not for the almost two dozen national religious bodies cooperating in its work. The Taskforce speaks to those bodies, to the larger religious community, to the gen-

eral public, and, on occasion, to units of the U.S. Government such as this committee.

The grounds for our advocacy of revisions in the law

The Taskforce, whose primary concern is for justice in the production and distribution of food, is advocating revisions in the current law regarding estate and gift taxes for four reasons.

First, we are committed to the survival of the family farm. We believe that family farming as a means of producing food for the hungry at home and abroad is a precious way of life which should be continued. Some people boast of the way in which America's energy-intensive agriculture, especially in its technological forms introduced by agribusiness corporations, is making it possible for fewer and fewer people to grow more and more food. We believe that the transition of recent decades toward fewer family farms and more agribusiness operations is a mixed blessing which should not go unchallenged. Family farming is not only a rich part of our national heritage; it is also inherently more respectful of our fragile and precious farming land than is the care given by many of the large corporations.

Second, we believe that justice demands that our Nation give the family owned and operated farm a fair chance to survive as a viable social and economic unit of our society. The current structure of our estate and gift taxes, when combined with other economic factors such as the escalating cost of land and other farm inputs, unfairly stacks the deck against the individual farmer who wishes to keep his or her farm in the family.

Third, the current situation is contrary to the intent that Congress demonstrated in its most recent revision of the estate tax structure 34 years ago in 1942. Two goals of the 1942 revisions were to protect the family farmer and to break up excessive concentrations of wealth in agriculture by taxing those farmers with large landholdings. In 1942, $60,000 represented a fairly large farm estate. Hence, estates under that amount were exempt from estate taxes; only those at or over that amount were taxed. However, even though the asset value of the average American farm was only $50,000 as late as 1960, in recent years the cost of land and farm inputs has skyrocketed to the point that by 1974 the value of the average American farm was $170,000.

This combination of old law and new prices has worked considerable hardship on family farmers. An increasing number of family farmers, for example, have been required to file estate tax returns. In 1942 only 17,000 estate tax returns (farm and nonfarm) were filed, approximately 1 for every 60 deaths. In 1972 175,000 such returns were required, 1 for every 10 deaths. Many farmers have been forced either to sell a portion of their land in order to raise enough funds to pay the estate tax or, if they could get credit, to go further into debt by borrowing at the current high rates of interest. For a significant number of these, selling off a segment of their land has meant being left with an uneconomically small amount of land with which to earn a living.

Finally, the consequences of the current situation have been harmful for practically every sector of our society. For the structure of American agriculture itself, the current situation has meant that land sold of necessity by family farmers has been bought either by large agribusiness corporations or, in the case of marginally suburban land,

by developers who convert it to shopping centers or housing developments. Between 1950 and 1974, one-half—2.8 million—of the farms in the United States disappeared. Farmland lost to commercial development can never be regained.

By encouraging absentee ownership, the present tax law has contributed to dissolving the fabric of our rural communities. As family farmers move out and corporations move in, communities have less need for local businesses and services. For example, a recent study by a Wisconsin economist of the effect on small communities of the sale of small businesses in them to absentee, out-of-town owners found that employment dropped and the use of local lawyers, banking services, and other community services which kept the local economy healthy was reduced.

And then, for our national economy, present estate tax laws have meant greater concentration of agricultural land and wealth in the hands of fewer and fewer people, with the consequent loss of competition, accompanied by declining food quality and rising consumer prices.

For all these reasons—our commitment to the survival of the family farm; our conviction that justice demands that family farms be given a fair chance to survive; our sense that the current law violates the original intention of Congress; and our judgment that the consequences of the current law are harmful to practically every segment of society—the Taskforce recommends that certain changes be made in the present tax law.

Recommendations

One, we recommend that families today be provided the equivalent benefit of the 1942 exemption levels of $60,000 per estate and $30,000 per person via gifts during a lifetime. This benefit could be provided in several ways. The exemption levels could be increased. The $60,000 estate tax exemption could be updated for inflation to at least $200,000 and the gift tax exemption to $100,000.

A second option, which we would prefer, would be to substitute a reasonable tax credit for the present exemptions. This credit should be at least $50,000, which could perhaps be instituted on a gradual basis. The credit would have the positive effect of taxing the total asset value of the estate, thereby placing the greatest tax burden upon the wealthiest landholders while reducing the amounts contributed by smaller farmers and businessmen. It would also mean that approximately $1 billion less would be lost to the Federal Treasury than with a straight increase in exemption levels.

Another way of reducing the tax burden on the small farmer would be to adjust the current tax rate schedule by making it more progressive. A gross estate of $200,000, for example, is under current law taxed $20,700 plus 30 percent of the excess over $100,000.

It would be possible to adjust the current tax rates by adopting a revision such as the following one:

Taxable estate:	Tax rate percentage
0 to $50,000	5
$50,000 to $100,000	10
$100,000 to $150,000	15
$150,000 to $200,000	20
$200,000 to $400,000	25
$400,000 to $600,000	30
$600,000 to $1,000,000	35

Any one or a combination of the preceding alternatives would seem to us a substantial improvement over the present situation. Each should include an inflation escalator clause to prevent exemptions, credits, or tax rates from becoming outdated in the future.

Two, we recommend that some recognition be given to the unique partnership between husband and wife in operating a family farm. In the case of many families farming is a joint venture and involves a real partnership between the husband and wife. It is unfair to tax a surviving spouse on an estate that he or she has been heavily involved in building. We would favor the elimination or substantial reduction of estate taxes when an estate is being passed on to a surviving spouse who has been involved in building that estate. The estate will in any case be taxed when passing from the surviving spouse to his or her children. It seems unfair also to tax that estate when it initially passes to that surviving spouse.

Three, we recommend that the executor of a farm estate be given the option of valuing land used in farming at its value for agricultural purposes rather than at its fair market value. Under current Federal law all land, including farmland, is valued for estate tax purposes at its fair market value. Thus, land used in food production is taxed not on the basis of its agricultural use, but on its commercial potential. This inequity, combined with the antiquated $60,000 deduction for estate taxation, has contributed to the conversion of many family farms to nonagricultural uses.

Ine one sense the valuation is real, in that the land could be sold for that price to nonagricultural interests. But it is a false valuation from the viewpoint of the farmer paying the tax, because that value does not provide a commensurate profit to him or her. The farmer can only realize a profit by selling his or her land and going out of business.

This creates a peculiar and unfair burden upon the farmer. While the Government is encouraging full production of agricultural commodities which will help feed the world's hungry, the farmer is actually being penalized for producing food on the land rather than converting it to commercial use.

An attendant threat to future agricultural use of land exists if the farmer is forced to sell the farm. In a large majority of cases, it is a nearby well-established farmer with large landholdings or a nonagricultural commercial developer who can afford to purchase the land. The latter lends itself not only to nonagricultural use of the land, but to holding actions on land that is used for speculative purposes or tax shelters when it could and should be used in the production of food.

This revision providing for an optional method of valuing land would encourage continuity in the family operation of a farm and, according to the economic division of Congressional Research Service, would have a negligible effect on the total tax revenues received by the Federal Government. A safeguard is of course needed to insure that a farmer's heirs could not unfairly take advantage of a reduced land valuation for tax purposes and then at some future date sell that land to commercial interests at its higher market value.

Finally, we recommend that the current system of allowing estate tax payments to be spread out in installments over 10 years be continued but that the interest rate on the deferred balance be reduced to

4 percent from the current 9 percent. This revision in interest rate would be in line with the original intext of the law, which was to prevent undue hardship in paying estate taxes. This provision is not currently being used very widely. The interest rate should be reduced in order to encourage its use in hardship cases.

The Taskforce realizes, Mr. Chairman, that one result of the foregoing suggestions would be a reduction in the total amount of Federal tax revenue. It seems to us, however, that it is not worth the consequences of imposing such inordinate burdens upon our family farms for the small fraction of total Federal tax receipts currently represented by estate tax payments. It would also seem possible to increase taxes on larger estates and incomes in order to make up the amount lost through a reduction in taxes for small or moderate estates and incomes. This would place the heaviest burden of taxation where it legitimately belongs: upon the wealthiest segments of our economy.

The Taskforce believes that the recommendations offered in this testimony are reasonable and fair, and that they would contribute to the preservation of the family owned and operated farm and to the common good. We commend them for your serious consideration.

STATEMENT OF SENATOR DENNIS L. RASMUSSEN, SCOTIA, NEBR.

I am testifying as a farmer-rancher and concerned citizen who is interested in the preservation of the family farm.

I first became interested in the problems of our estate taxation system when I introduced a bill in our State legislature to give some relief from our State inheritance tax laws. I soon learned how difficult this is because of the credit the Federal estate tax law gives for State death taxes paid. This made it extremely difficult to give relief to the taxpayer. Rather, this original bill would have simply apportioned the total tax bill differently.

We have revised the bill considerably, and currently the bill has been advanced from committee and is waiting for action on the floor. The net effect of the revised bill is still to eliminate the estate tax on a $300,000 estate, and put that money back in the hand of the heirs.

As we worked on this bill, I gained considerable knowledge about the Federal estate tax laws, and began to realize that most of the problem results from the Federal law failing to keep pace with inflation, especially in land values. If we are really serious about maintaining the family farm, we must have help at the Federal level. There is not much a State can do, even if they are disposed to do so.

I represent one of the more rural legislative districts in an agricultural State. In Nebraska we have not had a serious problem in corporate interests buying out family farms, but we are seeing a dramatic change in the family farm. Let me illustrate what is happening to Nebraska farm families.

The current trend of family farm agriculture is to accumulate capital while sacrificing short-term income. In other words, farmers sacrifice most of their lives in order to have an estate of some value at death. Normally, a farmer will in order to increase his income, pur-

chase additional real property which will allow him to utilize the economics of size associated with agriculture.

A 1967 study of farms in eastern Nebraska showed that the average capital investment was $218,310. By 1972 the capital investment was $311,740. Capital inputs, including land, accounted for 45 percent of all agricultural inputes used in farm production in 1940, but climbed to 80 percent in 1972 and is projected to reach 90 percent by 1980.

The University of Nebraska made a study in 1972, which showed the amount of capital required for a farmer to produce approximately $14,000 per year income (range ± $1,024). The following are the results:

Type of farm	Acres	Capita
Swine, corn, eastern Nebraska	480	$250,000
Grade A dairy, corn, eastern Nebraska	400	275,000
Beef grading, corn, eastern Nebraska	480	425,000
Irrigated corn, beef cowhead, central Nebraska	640	570,000
Wheat Fallow, wheat farm, western Nebraska	6,000	76,000
Cow-calf ranch, northern Nebraska	22,000	2,765,000

At least in the case of ranch land, the value of the land has doubled since 1972, when this study was made. The study allowed $50 per acre; in 1976, several areas of sandhills pasture sold for $100 per acre or more.

The trend is clear; farms are getting larger and less numerous in Nebraska. One may also conclude that the total acreage or capital investment is not a good indicator of the potential net income to the farmer.

The cow-calf ranch, the fallow-wheat farm, and irrigated corn-beef herd are most likely to require sale to satisfy tax liability, yet they must have substantially larger capital to produce a moderate income.

In conclusion, the capital required to operate a farm is substantial. Any type of farm capable of producing a $14,000 income probably will have capital of more than $300,000, in some cases perhaps between $1 and $2 million more.

Clearly, a $300,000 estate is not substantial by Nebraska standards.

This is not simply an agricultural problem, however. Inflation has caused the same problem for a family business which carries an inventory or has capital assets. Examples of these include a grain elevator, grocery store, and lumber yard.

Inflation has made the current $60,000 exemption, which was established in 1943, very insignificant when compared with the assets of many self-employed people. Hopefully, this dollar figure can be raised to an amount helpful to those who have worked a lifetime to help their children carry on the family business.

As a member of the Nebraska Legislature, I can also report to you that the body, voting 40–0–9, passed a resolution urging the Congress to take action on the Federal estate tax laws so that the States may pass legislation to help save the family farm.

The measure received support from all elements of our legislature, both rural and urban; Liberal and Conservative; Democratic and Republican. Not one member voted in opposition; all of our diverse body can see the need, both for farmers and consumers, to preserve the family owned farm and small business.

The legislature realized that one of the major causes of destruction of the family farm system in the federal inheritance and estate tax laws. The resolution is strongly worded, an indication of the strong feelings the body had on the matter.

Statement of Jeff A. Schnepper

ESTATE TAX REVISION

The growth in the rate of inflation and its impact upon the true value of an individual's assets has made a revision of our current estate tax structure mandatory.

Under the current tax, the Internal Revenue Service computes the total value of the decedent's assets. Deductions are then allowed for administrative costs, attorney's fees, funeral expenses, and casualty losses in the settlement of the estate. Half of the remainder may go tax free to his spouse, followed by further deductions for charitable bequests. A final $60,000 exemption is subtracted and the rest is subject to a tax of 3 percent on the first $3,000 to 77 percent on the amount exceeding $10 million.

The tax is not on the property itself, but rather on the transfer of the property. Tax credits are available for State death taxes, foreign death taxes, estate taxes paid on bequests received within the preceding 10 years, and gift taxes paid on gifts made within 3 years of death.

Taxes on life-time transfers, gift taxes, are imposed at a rate three-quarters of that of the estate tax—from 2.25 percent on the first $5,000 to 57.75 percent on amounts over $10 million. The amounts subject to the tax is cumulative, that is the marginal rate is imposed on the last dollar at the rate specified for that dollar and the sum of all previous taxable gifts. There is a yearly exemption of $3,000 per gift per person and a $30,000 one-time cumulative lifetime exemption. Half of any gift given to your spouse escapes gift taxation as does all given to charity. An election may be made so that a gift may be deemed made one-half by each spouse, even though the money comes only from one. Therefore a married individual may give in effect $6,000 per person ($3,000×2) plus $60,000 ($30,000×2) in a given year tax free.

Inflation though, has distorted the above system. Whereas in 1945 only 1 percent of all estates had to pay any Federal tax, in 1975, 150,000 Americans, 7.7 percent of those who died, had taxes due. More importantly, liquidity problems have forced increasing number of small businesses and farms to be sold to pay the taxes. In a study of tax returns in 1973, on one return in four, taxes and administrative costs exceeded 25 percent of the estate's liquid assets after debts were paid.

What I propose is a revision of the present estate tax laws to the following effect:

Exemption

The present $60,000 exemption is grossly out of date. Rather than raise the exemption as has often been proposed, I suggest instead the creation of an estate tax credit. A higher dollar value of the exemp-

tion would favor those in the higher brackets. A $100 exemption saves a man with an estate of $10 million, $77, as opposed to a $3 saving to an estate of $5,000. A tax credit though of $35,700, would permit an estate of $150,000 to escape taxation, but would be more progressive and cost the Treasury far less when applied. It should be, by far, the preferred adjustment.

Marital deduction

The present marital deduction is 50 percent of the estate after the above discussed deductions. Here I agree with the proposal of President Ford. The deduction should be extended to 100 percent. This though, would not be avoidance. When the property passed to the next generation it would be taxed in full. The cost would be limited only to the deferral factor.

Tax deferral

The Ford proposal here is to exempt all tax for the first 5 years and then to allow 20 more years to pay off the balance at an interest rate of 4 percent. This amounts to a 45-percent reduction in estate taxes equal to the amount of interest that could be earned on the unpaid balance. I therefore cannot accept this revision.

Rather, I would increase the present 7 percent interest charge to 10 percent, allow 2 years in which no tax is due, and maintain the present 10-year period over which the balance must be paid. The 10-percent interest rate is closer to the real market cost of borrowing, and the 2-year grace period should be sufficient to restructure, if necessary, the ongoing business. This deferral should be phased out for estates valued between $250,000 and $500,000.

Trusts

Some of the money lost due to the suggested revisions to the exemption and marital deduction, may be picked up by eliminating generation skipping trusts. Under present laws, a decedent can leave his assets in trust to his grandchildren, with the income from the property going to his children. Under this arrangement, the transfer is taxed only once, rather than twice as it would have been, had the property passed from parent to child each time. Vice President Rockefeller reportedly received $38 million from these kinds of trusts over a 10-year period. This transfer tax loophole should be legislatively expunged.

Foundations

The deduction for contributions to private foundations which support charities and educational institutions must not be eliminated. With our present state and local financial problems, private support for our social needs should be encouraged rather than dissuaded.

The first estate tax in the United States was adopted in 1797. It was repealed in 1802. It is clear that our current estate tax provisions are out of date and need revision. It is time our present estate tax be amended to bring it closer to the realities of our prevailing economic society. I am hopeful that the above suggestions are in that direction.

VIEWS ON ESTATE AND GIFT TAX REFORM OF THE AMERICAN COLLEGE OF PROBATE COUNSEL

The American College of Probate Counsel, a group of more than 1,700 lawyers from all over the United States who specialize in estate planning and administration, recently authorized the creation of a Committee on Estate and Gift Tax Reform to offer its services and expertise to Congress.

William P. Cantwell, president of the college, submitted a letter dated March 12, 1976, to the Chief Counsel of the House Ways and Means Committee, expressing the views of the college on the broad objectives of estate and gift tax reform legislation. Mr. Cantwell also testified before that committee on March 17, 1976. Thereafter, a supplemental submission was prepared by the college's Estate and Gift Tax Reform Committee to set forth its specific legislative recommendations.

Copies of the Cantwell letter of March 12th, an edited transcript of his Ways and Means Committee testimony and the supplemental submission of the college's Estate and Gift Tax Reform Committee are enclosed for the printed record of the Senate Finance Committee hearings on tax revision.

FRANK S. BERALL,
Chairman, Committee on Estate and Gift Tax Reform, American College of Probate Counsel.

THE AMERICAN COLLEGE OF PROBATE COUNSEL,
Los Angeles, Calif., March 12, 1976.

JOHN M. MARTIN, Jr., Esq.,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. MARTIN: This letter follows up on the telegraphic request that a representative be permitted to appear before your committee on behalf of the American College of Probate Counsel in accordance with the press release February 20, 1976. This will supplement that request to be heard and supply the information requested by the press release.

1. CAPACITY IN WHICH I WILL APPEAR

William P. Cantwell, 2900 First of Denver Plaza, 633–17th Street, Denver, Colo. 80202, (303) 893-2900. I will appear as president of the American College of Probate Counsel, an organization described in the supplementary materials attached to this letter.

2. REPRESENTATION

I will represent the American College of Probate Counsel, whose address is 10964 West Pico Boulevard, Los Angeles, Calif. 90064 (213) 475-1200. Attached as exhibit A is a statement of the Object of the

American College of Probate Counsel, a Forward written by me, which is a part of the Roster of the College, a list of the members emeritus, who are past presidents of the organization, a list of the State chairmen for the 1975-76 business year of ACPC, and a list of the board of regents for the 1975-76 business year and a list of the American College of Probate Counsel honorary fellows. You will note that among the honorary fellows of the college are three Supreme Court Justices. The membership of the college exceeds 1,700 estate planning and estate administration specialists, organized on a nationwide basis, which will be described below.

3. CONFLICTS OF INTEREST

I will be making a statement on behalf of the American College of Probate Counsel. I am a member of the law firm of Dawson, Nagel, Sherman & Howard of Denver, Colo., but to my knowledge neither I nor my law firm has specific clients who have an interest in the subject other than the interest of all citizens seeking a sound tax system, and I am not representing any client having an interest in the subject which I will be discussing.

4. PROVISIONS OF THE ESTATE AND GIFT TAX LAWS ON WHICH I WILL TESTIFY

My testimony will be aimed at overall estate and gift tax reform in the sense that I do not at this time propose to discuss specific tax reform proposals that have been considered by past Congresses. My objective in discussing estate and gift tax reform is to bring to the committee a new perspective, one which will be directed toward what, in the opinion of Estate and Gift Tax Reform Committee of the American College of Probate Counsel, is much-needed reform. In this connection, however, on behalf of the American College of Probate Counsel, I request that the record may be held open so that if the hearings during the week of March 15 through March 19 disclose specific proposals which we of the American College of Probate Counsel believe require discussion, we wish an opportunity to submit for the record an analysis or reaction to some of the proposals. This presentation to you, however, is made in the light of the special nature of our organization. Attached as exhibit B to this analysis is a July 1973 analysis "State Inheritance or Estate Taxation of Non-Resident Estates" compiled by H. Bradley Jones, Los Angeles, Calif., a fellow of the American College of Probate Counsel, with the assistance of the 50 State representatives throughout the United States.

In connection with the question of estate and gift tax reform, one of the basic issues is the integration or relationship between State inheritance or estate taxation and Federal estate and gift taxation. Essentially, we are learning from throughout the country that the lawyers in the several States are finding that many consumers, many beneficiaries of estates, and many fiduciaries are complaining that the probate process and the delays of probate and the costs of probate arise not out of antiquated systems of probate about which much has been heard but rather from the administrative problems caused by the

Federal estate and gift tax, and the administrative problems caused by State inheritance or estate tax. There is much need for a closer intergovernmental relationship and for leadership from the Federal Government to persuade States to alter their systems of death taxation to procedures which will, by a simple administrative means, tie into the Federal estate tax so that estates do not have two separate, independent and often inconsistent tax returns, two separate tax audits, two separate tax determinations, and two separate crises with respect to the liquidity problems of estates.

Attached as exhibit C to this letter is a 1970 analysis by Fellow Richard H. Pershan of New York, "Applicability of United States Estate Tax and Gift Tax to Nonresident Aliens," again a subject which is the summary of studies that were made by the American College of Probate Counsel with respect to the practical types of problems that the probate practitioner is discovering throughout the country. In this case there was put together information for all of the 50 States so that those States would have a better idea of what were the situs rules in estate tax conventions with respect to foreign governments.

It is my opinion that the American College of Probate Counsel through its statewide resources and its expertise can be of assistance to the Congress in its deliberations in connection with estate and gift tax reform. As president of the American College of Probate Counsel, I am offering those resources.

In connection with current consideration of estate and gift tax reform, it is not my position at this time to comment upon the social objectives of whether or not there should be a different incidence of tax and an accompanying shifting of wealth or changing tax burdens.

However, we have numerous members of the college who are prepared to discuss such social objectives. Neither is it my objective in this particular presentation to discuss such things as the technical problems with a generation-skipping transfer tax or the technical problems with an additional estate tax on appreciation at death or the basis problem if in lieu of some taxation of appreciation at death there is a carryover basis. Again, I am not proposing in this paper to discuss such technical matters, although numerous members of the college have written extensively as lawyers representing committees studying estate and gift tax reform for the American Bar Association or for their State and local bar associations. In other words, our members on a nationwide basis are prepared to submit to the Congress in a very short period of time an analysis of the nationwide impact on a State-by-State basis of any significant tax reform proposal that Congress receives or is seriously considering.

My presentation today will be aimed at giving to Congress our perception of the thrust of the concerns of our clients who are the beneficiaries of estates and who are the fiduciaries who must cope with the tax administration process, both Federal and State. Thus, it will be my role to pose to the Congress some relatively basic questions which might best be wrapped up in the concept that it is the belief of our Estate and Gift Tax Reform Committee and of the president of the American College of Probate Counsel, based upon conversations with

members and clients, that we have reached a point where there is need for a taxpayers bill of rights in the field of estate and gift tax reform.

Putting it another way, the American College of Probate Counsel has been one of the leaders in the development of the uniform probate code which has sought to simplify probate procedures and to speed up probate settlement processes and to reduce the costs of the probate settlement process. Notwithstanding those efforts which are achieving respectable success, a persistent obstacle to even more effective probate reform has been the Federal estate and gift tax laws and the State inheritance and estate tax and gift tax laws. It is our hope that through the actions of Congress looking toward estate and gift tax reform that it will not only be possible to accomplish what may be the revenue objectives or other objectives of a sound Federal estate and gift tax system but that the system will also accomplish a number of the other desirable attributes of a sound fax system. We include among these a contribution toward simplification of probate procedures, a contribution toward speeding up the probate process, a reduction of the cost of the probate process, and a contribution to the simplification and understanding of the estate and gift tax laws as they apply to the citizens of the United States.

A resort to the Socratic technique may be helpful and in that spirit, to point up our concerns, I pose for the committee a series of questions:

1. We presently have a committee of representatives of the 50 States of the United States working on a state-by-state basis preparing an analysis of the economic effect of the State death tax credit. That report will be ready within 1 month and will be submitted to the House Ways and Means Committee for its consideration in connection with its deliberations. One question that the authors of this report have posed is whether the Congress is willing to reconsider the questions relating to intergovernmental relations. For example, is the Federal Government, having encouraged States to get into the State death tax field, now prepared to consider abandoning the death tax field to the States, as has been done recently in Canada, and abandoning the gift tax, as has been done recently in Canada, or is the Federal Government willing to consider as a matter of policy some procedure which may involve the Federal Government collecting the estate and gift taxes and then paying a subvention back to the States. If that alternative is not available then would a change in the Federal credit to the States for the State death tax credit in such a way as to reduce the number of State death tax returns which must be filed be possible? At a minimum, it would be extremely helpful to encourage the States which presently have an inheritance tax requiring separate complicated calculations to shift to an estate tax in the nature of a pickup tax as a percentage of the Federal estate tax which will then make for simplification of calculations of the tax and speed up the settlement of estates.

2. How can we simplify the valuation of assets in order to reduce the costs and delays inherent in valuation of assets and the disputes that traditionally arise in the asset valuation process?

3. How can we simplify the determination of the bases of assets if there is going to be an additional estate tax at death or a carryover basis?

4. How can we simplify the taxation of jointly held property or property held as a tenancy in the entireties in such a way as to eliminate the problems of tracing? Tracing can involve going back for many generations to determine whether the decedent or the survivor has contributed to the acquisition price of property held jointly at the time of death.

5. How can we avoid the serious problem of nonfiling in gift tax returns where people have made taxable gifts or reportable gifts over their lifetime and do not discover that they have gift tax obligations until they consult an attorney who advises them that what they have been doing over the years have constituted taxable gifts?

6. How can we solve the tracing problems in community property States to determine what is separate property and what is community property, or is there some way to reduce the problems of proof of title to property for purposes of calculation of death taxes?

7. How can enforcement of the estate and gift tax laws avoid uneven administration of matters subjective in nature or not susceptible of accurate ascertainment, such as contemplation of death motives, valuation of assets, contribution to jointly held property?

8. How can we conveniently deal with contemplation of death so that we don't have the administrative and litigative problems at the time of death? For example, could we at this time shift from the 3-year presumption in IRC section 2035 to a 2-year conclusive presumption in which if a transfer has occurred within 2 years of the date of death it will be included in the estate of the decedent, and as some offset to the possible adverse effect of that, how do we work out the exemption for small gifts, Christmas or otherwise, prior to death, and what other adjustments should be made to the concept of contemplation of death gifts to achieve administrative simplicity?

9. How can we be more objective on the tracing of the acquisition of jointly held properties so that the probate process and the settlement of the state need not be delayed because of the existence of jointly held properties which may not even be a part of the estate, even though the tracing and the dispute add to the cost of administration?

10. How can we avoid the whipsawing problem between State and federal death tax agencies in which each agency refuses to close its file or settle its case until the other has done so, and where each agency will take its best shot at the estate or taxpayer but hold open the statute of limitations for the purpose of determining whether there can be a higher tax imposed because the other agency imposes a higher valuation with respect to a particular asset?

11. How can we reexamine and further the objectives of the 1948 act adopting the marital deduction which was aimed at equalizing community property States with common law States?

12. How can normal, frequent, and persistent interspousal property transactions be effectively and permanently removed from the estate and gift tax area, particularly for the purpose of more perfectly accomplishing the purpose of the Revenue Act of 1948?

13. How can we reduce the number of tax returns which must be filed by estates of decedents? For example, what is the revenue effect and is it desirable to raise the minimum exemption to $150,000 for an

estate since the ravages of inflation have caused a $150,000 estate to be less than the $60,000 exemption in terms of true dollars?

14. How can we solve the problems of delinquent gift tax returns and the avoidance of the implications of tax fraud or penalties where there are innocent violations of the gift tax for filing requirements?

15. Why can't the reform of the estate and gift tax laws set up a law in which compliance is perfunctory, as income tax withholding statements are perfunctory, when someone gets a job and is paid a salary?

16. Why can't we turn the question of estate and gift tax reform into a question of probate reform aimed at benefiting the beneficiaries of estates who look to the system now as one which victimizes them because of the complexity and costs of determination?

17. If a unified tax is adopted, even more emphasis on proper reporting of inter vivos transfers will be required for even enforcement—what techniques for objective and reliable reporting requirements will be present?

18. How can an "actual use by the decedent at death" concept of valuation be effectuated to avoid very heavy liquidity demands in estates with land having potential for other higher uses, but no historical basis for valuation for such higher uses?

19. Could not a "historical use" by a decedent or his ancestors over a long period of time be useful in difficult land valuation matters?

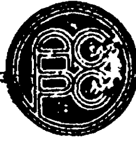
Beyond this series of questions, we believe there is one overriding consideration, central to the thought of a taxpayer's bill of rights I have suggested. We would hope that the estate and gift tax reform process would become an outstanding opportunity to give to the taxpayer as part of his bill of rights a freedom from continually increasing administrative burdens. We do not honestly believe that attempts at theoretically perfect solutions to abstract and infrequent problems or apparent abuses contribute to the objective we are discussing. In our view, the objective can best be attained if the Congress carefully defines its concepts and limits the proposed solutions to the minimum necessary to accomplish its goals. It should avoid the imposition of a national probate system (and corresponding national drafting standard) through the tax system.

Thus, in areas such as taxation of capital gains at death, generation-skipping, and the like, Congress could define its result and leave to the client and the practitioner maximum flexibility in planning the client's affairs (that is the tax differentials of various approaches should not be so severe as to force clients to adopt methods of disposition which are unnatural under the circumstances). The basic philosophy of such a taxpayer's bill of rights would be to keep the estate and gift tax laws essentially neutral in order to avoid forcing one disposition or another through tax impact or drafting requirements.

I have appreciated the opportunity to present these matters and I request the opportunity to present written replies or analyses to any questions which may be presented to me when I make my appearance Wednesday, March 17.

Yours very truly,

WILLIAM P. CANTWELL, *President.*



THE AMERICAN COLLEGE OF PROBATE COUNSEL

Object

The object of the College is to establish and maintain as an integrated group, lawyers skilled and experienced in the preparation of wills and trusts and the probate and administration of the estates of decedents, minors and incompetents; to improve and enhance the standards of probate practice, the administration of justice and the ethics of probate practice of the profession. To accomplish these aims, the purposes of this College shall be, among others: (a) To bring together members of the profession thus qualified and who, by reason of their character, personality and ability, will contribute to the accomplishments, achievements and good fellowship of the College; and (b) To cooperate and consult with the various bar associations of the several states and subdivisions and such other groups and organizations devoted to similar attainments, including governmental agencies.

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FOREWORD

The Roster of the College is a list of some seventeen hundred lawyers from every state and several foreign countries. Our charge to ourselves is to admit to fellowship outstanding probate practitioners who have demonstrated exceptional skill and ability.

It would seem, then, that being a Fellow is itself a form of recognition of accomplishment and so most of us view it. Yet, on the opposite page you may read that the association of ourselves into this grouping is only the threshold of our objective. Being associated, we have an obligation. We have adopted as our polar star the object of improving our field of law, across the board. We do so in an honorable tradition, long impressed upon me by these words of the great Elihu Root spoken in 1904:

> "He is a poor-spirited fellow who conceives that he has no duty but to his clients and sets before himself no object but personal success. To be a lawyer working for fees is not to be any the less a citizen whose unbought service is due to his community and his country with his best and constant effort. And the lawyer's profession demands of him something more than the ordinary public service of citizenship. He has a duty to the law. In the cause of peace and order and human rights against all injustice and wrong, he is the advocate of all men, present and to come."

As another year in College history opens, I hope each of our Fellows can respond to the demand for "something more." The opportunities are legion. If we are truthfully persons of exceptional skill and ability, we fit into a natural alliance to improve the law in our field by seizing such opportunities.

William P. Cantwell

William P. Cantwell
President

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(Revised July 1973)

THE AMERICAN COLLEGE OF PROBATE COUNSEL
10964 W. Pico Boulevard
Los Angeles, California 90064

STATE INHERITANCE OR ESTATE TAXATION OF NON-RESIDENT ESTATES

Real and Tangible Personal Property Owned Solely by a Non-resident Decedent

COMPILED BY

H. BRADLEY JONES

Los Angeles, California

FROM OPINIONS OF FELLOWS OF THE COLLEGE IN ALL FIFTY STATES

THE AMERICAN COLLEGE OF PROBATE COUNSEL
10964 West Pico Boulevard • Los Angeles, California 90064

STATE INHERITANCE OR ESTATE TAXATION OF NON-RESIDENT ESTATES

REAL AND TANGIBLE PERSONAL PROPERTY OWNED SOLELY BY A NON-RESIDENT DECEDENT

The full value of real and tangible personal property within its borders solely owned by a non-resident decedent is taxed by all the States and the District of Columbia except that New Hampshire does not tax real property passing to a surviving spouse, lineal descendent or parent; New York does not tax estates of non-residents consisting of real property situated and tangible personal property having an actual situs in the state, the gross aggregate value of which is less than $2,000.00, and Nevada has no state inheritance tax of any kind.

REAL and TANGIBLE PERSONAL PROPERTY OWNED BY A NON-RESIDENT DECEDENT AND ANOTHER AS TENANTS BY THE ENTIRETY OR AS JOINT TENANTS.

	No.		No.		No.		No.		No.
Alabama	2	Hawaii	13	Massachusetts	2	New Mexico	2	South Dakota	16
Alaska	26	Idaho	5	Michigan	10	New York	2	Tennessee	2
Arizona	2	Illinois	3	Minnesota	2 & 23	North Carolina	13	Texas	18
Arkansas	2	Indiana	6	Mississippi	1	North Dakota	15	Utah	2 & 17
California	2 & 5	Iowa	2	Missouri	10	Ohio	2 & 20	Vermont	2
Colorado	3	Kansas	7	Montana	3 & 11	Oklahoma	2	Virginia	2
Connecticut	11 & 22	Kentucky	25	Nebraska	2	Oregon	19	Washington	15
Delaware	2	Louisiana	8	Nevada	10	Pennsylvania	9	West Virginia	21
District of Columbia	3 & 4	Maine	22	New Hampshire	15	Rhode Island	2	Wisconsin	24
Florida	2	Maryland	9	New Jersey	12	South Carolina	15	Wyoming	14
Georgia	2								

1. Full value taxed.
2. Full value taxed except to the extent that the survivor can establish that he contributed to the consideration for the acquisition of the property. Nebraska makes an exception for that part, amount, or proportion of the property originally owned by the survivor and which the decedent did not pay full consideration.
3. Taxed proportionately according to the number of owners.
4. "Movables" such as automobiles and boats are not taxed; "Non-movables" such as cash, jewelry and furniture are taxed.
5. Tenancies by the entirety are not recognized; Community property passing to the surviving spouse is not taxable. Joint tenancies are taxed to their full value except such part as may be proved by the surviving joing owner or owners to have originally belonged to him or them and never to have belonged to the decedent.
6. Real property owned by the entireties is not taxed unless title was changed from the decedent to title by the entireties in contemplation of death or if one of the tenants by the entirety devised the real property by will to one other than the surviving tenant by the entirety and the surviving tenant does not elect to take by law; Joint tenancies are taxed in full against the surviving joint owners except to the extent that they can establish that the property originally belonged to him or them and had never belonged to the decedent.
7. Tenancies by the entirety are not recognized. Joing tenancies in full except to the extent proven to have been contributed by the survivor.
8. Tenancies by the entirety and joint tenancies are not recognized. Immovable property situated in Louisiana acquired in the name of either of the spouses or in the name of both none the less becomes "community property" and upon the death of either of the non-resident spouses the survivor would own one-half and the decedent's estate one-half.
9. Tenancies by the entirety are not taxed. Joint tenancies are taxed proportionately according to the number of owners.
10. Not taxed.
11. Where joint tenancy is created within three years prior to the death of a grantor without fair consideration, the entire value is taxed to the decedent.
12. Tenancies by the entirety are not taxed. Joint tenancies are not tax exempt, but property held in more than one name is taxed in full except to the extent that the survivor can establish he contributed to the consideration for the acquisition of the property.
13. Tenancies by the entirety are taxed as to one-half; Joint tenancies are taxed in full except to the extent that the survivor can establish that he contributed to the consideration for the acquisition of the property. In Hawaii, surviving spouse in either type of tenancy is granted an exemption of one-half, survivor also, regardless of relationship to decedent, receives exemption to the extent he can establish that he contributed to the cost of acquisition.
14. Property held by husband and wife is not taxed. In Wyoming, the rule applies to both types of tenancies of husband and wife.
15. Tenancies by the entirety are not recognized; Joint tenancies are taxed in full except to the extent that the survivor can establish he contributed to the consideration for the acquisition of the property. In New Hampshire, if survivor is spouse or lineal descendant of father or mother of decedent, property is exempt from tax. In North Dakota, as between spouses, there is a presumption that each spouse contributed equally to acquisition cost.
16. Tenancies by the entirety are not recognized. Joint tenancies are taxed proportionately according to the number of owners except that where property is held in joint tenancy by husband and wife, the accrual to one by the death of the other shall be deemed a transfer taxable at one-half of the value of the whole property and as to joint owners other than a spouse, the accrual of rights shall be deemed a transfer taxable proportionately, except that each beneficiary is not taxed on the part thereof he may prove originally belonged to him or never having belonged to the decedent.
17. When surviving tenant is either spouse or children of decedent, one-half of the property, but not to exceed $40,000.00 is tax exempt. This provision is in the alternative to the exclusion provided in footnote 2 above and may not be claimed when any exclusion has been made in favor of such surviving spouse or children under footnote 2. Property received by gift or inheritance by decedent and spouse as tenants by the entirety is taxed as to one-half. Property similarly received by decedent and others as joint tenants is taxed proportionately.
18. Decedent's interest in community property is taxable (even if to surviving spouse); tenancies by the entirety are not recognized; value of decedent's interest in joint tenancy is taxable.
19. Tenancies by the entirety are taxed as to one-half. Joint tenancies, as such, in real property have been abolished; other than holding real property as tenants by the entirety, holding of property in more than one name with rights of survivorship is recognized under some circumstances, in which event the property is taxed in full except to the extent that the survivor can establish he contributed to the consideration for the acquisition of the property.
20. In Ohio, when the surviving joint owner is the surviving spouse, one-half of the total value of the property is taxed.
21. Tenancies by the entirety and joint tenancies, as such, have been abolished, but holding of property in more than one name with right of survivorship is recognized when expressly provided for in the instrument, in which event the property is taxed in full except (a) for first $2,500.00 of bank accounts and shares or savings accounts in Federal Savings and Loan Associations with surviving spouse, descendant or parent (b) for 50% in case of surviving spouse and (c) to extent survivor (including spouse) can establish contribution of consideration for acquisition of the property.
22. Tenancies by the entirety are not recognized. Joint tenancies are taxed proportionately according to the number of owners.
23. Tenancies by the entirety are not recognized in Minnesota.
24. Full value taxed except to the extent that the survivor can establish that he contributed the property or consideration for its acquisition. If acquired by gift, bequest, devise or inheritance by decedent and any other person jointly, the property is taxed proportionately according to the number of owners unless the instrument creating such ownership creates interests in a different proportion. Tenancies by the entirety are not recognized in Wisconsin.
25. Kentucky taxes the full value of real and tangible personal property owned by a non-resident but does so in the case of tangible personal property only if it has acquired a situs in Kentucky and is not taxable elsewhere.
26. Alaska's tax is the proportion of the allowable credit from Federal tax that the gross value of the Alaska property bears to the entire gross estate wherever situate, and gross estate is defined by direct reference to Section 2031 (c) of the IRC, with the result that Federal contribution rules apply in determining how much, if any, of jointly held assets fall into the gross estate of the decedent.

INTANGIBLE PERSONAL PROPERTY

All States of the United States and the District of Columbia either have laws prohibiting taxation or provide for reciprocal exemption therefrom with respect to intangible personal property not having a business situs within their borders belonging to a person who died a resident of another state of the United States, except:

1. Kansas taxes such intangible personal property if it is not taxed or submitted for taxation in the state of domicile of the decedent.
2. Texas taxes intangible personal property except where (1) state of domicile of decedent does not tax intangibles of residents of Texas or (2) such state has a reciprocity statute.
3. The States of California, Florida, Massachusetts, South Dakota, Utah and Washington tax such intangible personal property when owned by a non-resident of the United States.
4. The District of Columbia taxes intangible personal property when owned by an alien, whether resident or not, of the United States.
5. Mississippi has repealed its reciprocity statute and now taxes intangible personal property of a non-resident (House Bill 365-Regular Session 1956).
6. Colorado's reciprocity statute extends to intangible personal property having an actual or business situs within the State owned by a resident of the United States.
7. Arkansas does not distinguish between tangible and intangible personal property and taxes all property of a non-resident of the state located in Arkansas except if another state exempts Arkansas, in which case the exemption is reciprocal as to the tax on all property.
8. Wisconsin does not tax a non-resident decedent's personal property not having an actual situs in the state if a like exemption in favor of Wisconsin residents is allowed at the time of decedent's death by the state of his residence.
9. Kentucky taxes intangible personal property owned by a non-resident decedent if it has acquired a business situs in the state.

WAIVERS

Waivers for the transfers of stock of a domestic corporation owned by non-resident decedents are required in the following states and application therefor should be addressed as indicated:

State	Address
Alabama	Commissioner of Revenue State Department of Revenue Estate Tax Division Montgomery, Alabama
Alaska	Department of Revenue Juneau, Alaska
Arizona	Arizona Estate Tax Commissioner State Capitol Building Phoenix, Arizona
California	Inheritance Tax Attorney State Controller's Office Sacramento, California
Dist. of Columbia	Finance Office Revenue Division Inheritance and Estate Tax Section Municipal Center Washington, D.C. 20001
Hawaii	Director of Taxation State of Hawaii Honolulu, Hawaii
Idaho	State Tax Commission Inheritance Tax Division Post Office Box 36 Boise, Idaho 83707
Illinois 2	Attorney General 160 North La Salle Street Chicago, Illinois 60601
Indiana	Inheritance Tax Administrator Department of State Revenue State Office Building Indianapolis, Indiana
Kansas	Director of Revenue State Commission of Revenue and Taxation Topeka, Kansas
Michigan	State Department of Revenue Inheritance Tax Division Lansing, Michigan
Mississippi	State Tax Commissioner Jackson, Mississippi
New York 4	Department of Taxation Miscellaneous Tax Bureau Transfer and Estate Tax Section Building 9, Campus Site Albany, New York 12226
New Mexico	Bureau of Revenue Succession Tax Division Santa Fe, New Mexico
North Carolina	Commissioner of Revenue Raleigh, North Carolina
Oklahoma	Estate Tax Division Capitol Building Oklahoma City, Oklahoma
Pennsylvania	Department of Revenue Inheritance Tax Division Harrisburg, Pennsylvania
South Carolina	Director of Estate Tax Division South Carolina Tax Commission Post Office Box 125 Columbia, South Carolina 29202
South Dakota	Commissioner of Revenue Inheritance Tax Division Pierre, South Dakota
Tennessee	Commissioner of Revenue 226 Capitol Blvd. Nashville, Tennessee 37219
Texas	State Comptroller of Public Accounts Austin, Texas
Utah	State Tax Commission Capitol Building Salt Lake City, Utah
Washington 5	Department of Revenue Inheritance Tax Division Olympia, Washington 98504
West Virginia	State Tax Commissioner Capitol Building Charleston, West Virginia
Wyoming	Inheritance Tax Commissioner Department of Revenue 2200 Carey Avenue Cheyenne, Wyoming 82001

Waivers ARE NOT required in the following States: Arkansas, Colorado (1), Connecticut, Delaware, Florida, Georgia, Iowa, Kentucky (7), Louisiana, Maine, Maryland, Massachusetts, Minnesota (3), Missouri (8), Montana, Nebraska, Nevada, New Hampshire, New Jersey, North Dakota, Ohio, Oregon, Rhode Island, Vermont, Virginia, Wisconsin (6)

1. Waivers are NOT required in Colorado UNLESS the stock has a business situs or actual situs in the state.
2. In Illinois, stock of domestic corporation is exempt unless it was "used or employed in carrying on a business in the State of Illinois", affidavit of non-residency, Form #43, can be obtained from the Illinois Attorney General's Chicago office. In 1965 Illinois repealed its general requirements for waivers for transfer of securities, bank accounts and intangible personal property belonging to non-residents.
3. Minnesota no longer requires a waiver for transfers of stock of a Minnesota corporation. However, an affidavit of non-residency on a form obtained from the Commissioner of Taxation, must be filed in duplicate as provided in Minn. Stats 291.19 subd. 5.
4. Waivers are NOT required in New York except where the interest in any one domestic corporation exceeds $2,000 in value under Section 249-p of the New York Tax Law.
5. Washington inheritance tax is imposed only on estates of persons who are not residents of any state or territory of the U.S.A. (this does not necessarily eliminate all administrative requirements of a waiver).
6. Wisconsin DOES require a waiver or "consent to transfer" from the Department of Revenue where the decedent is a resident of a state which does not impose a death tax.
7. Kentucky no longer requires a waiver but an affidavit must be filed with a transfer agent stating that the non-resident decedent had no property subject to Kentucky inheritance and estate tax. The affidavit is filed by the personal representative and a copy is furnished to the Department of Revenue.
8. Missouri requires that the corporation in which the decedent owned stock be provided an affidavit of decedent's non-residency on a form approved by the Attorney General of Missouri, which may be obtained from the Bureau of Inheritance Tax, Department of Revenue, P. O. Box 27, Jefferson City, Missouri 65101

Copyright, July, 1973

(Revised January, 1970)

THE AMERICAN COLLEGE OF PROBATE COUNSEL

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APPLICABILITY OF UNITED STATES ESTATE TAX AND GIFT TAX TO NONRESIDENT ALIENS

Compiled by
Richard H. Pershan, F.A.C.P.C.
New York, New York

ESTATE TAX

Property Subject to Tax

Subject to the death tax conventions summarized in Appendix A, the following property of a nonresident alien has a situs in the United States and therefore is subject to the United States estate tax:

1. Real property located in the United States.

2. Tangible personal property located in the United States except works of art on loan for exhibition in a public gallery.

3. Shares of stock issued by a domestic corporation, regardless of the location of the certificates.

4. Debt obligations, including bonds, issued by a United States person or corporation or by the United States (except currency and, if the decedent was not engaged in business in the United States at the time of his death, obligations issued before March 1, 1941) or a State or political subdivision thereof or the District of Columbia, regardless of the location of any evidence of indebtedness, except items 6, 7 and 8 described below under "Property Not Subject to Tax".

5. If the decedent dies after December 31, 1969, deposits with a United States branch of a foreign corporation if the branch is engaged in commercial banking.

6. Interests in estates or trusts to the extent that they consist of property having a situs in the United States.

Property Not Subject to Tax

The following property of a nonresident alien has a situs outside the United States and therefore is not subject to the United States estate tax:

1. Real property located outside the United States.

2. Tangible personal property located outside the United States.

Property Not Subject to Tax (Continued)

3. Works of art on loan for exhibition in a public gallery in the United States.

4. Shares of stock issued by a foreign corporation, regardless of the location of the certificates.

5. Amounts received as insurance on the decedent's life.

6. Deposits with a foreign branch of a United States corporation or partnership if the branch is engaged in commercial banking.

7. Debt obligations of a domestic corporation if any interest thereon which the decedent were to receive at the time of his death would be treated, for income tax purposes, as income from sources without the United States.

8. If the decedent dies after November 13, 1966 and before January 1, 1976, deposits with corporations or partnerships carrying on the banking business, deposits or withdrawable accounts with savings and loan associations, and amounts held by an insurance company under an agreement to pay interest thereon, if any interest thereon which the decedent were to receive at the time of his death is, for income tax purposes, not effectively connected with the conduct of a trade or business in which the decedent was engaged within the United States.

9. Debt obligations, including bonds, issued by a foreign corporation or government, regardless of the location of any evidence of indebtedness.

Miscellaneous Provisions

1. For estate tax purposes nonresident means nondomiciliary.

2. The gross estate of a nonresident alien is made up in the same way as the gross estate of a citizen or resident but is confined to property which is

Miscellaneous Provisions (Continued)

situated in the United States. Thus, it can include jointly-owned property, general powers of appointment, revocable trusts, etc.

3. Property of which a nonresident alien made a transfer taxable under Int. Rev. Code §§2035--2038 (transfers in contemplation of death, with retained life estates or taking effect at death, and revocable transfers) is subject to tax if situated in the United States either at the time of transfer or at the decedent's death.

4. The estate of a nonresident alien is allowed an exemption of $30,000 or, in the case of Switzerland and all the countries listed in Appendix A except Canada, Ireland, South Africa and the United Kingdom, the larger of $30,000 or that proportion of $60,000 which the value of the gross estate situated in the United States bears to the entire gross estate wherever situated.

5. Charitable deductions are allowed only for transfers to American beneficiaries.

6. Deductions for funeral and administration expenses, claims against the estate, unpaid mortgages, losses, and death taxes on charitable transfers are allowed only in the proportion which the value of the gross estate situated in the United States bears to the value of the entire gross estate wherever situated. It is immaterial whether the amounts to be deducted were expended or incurred within or without the United States. Where a nonresident alien owns property situated in this country which is security for a debt for which he is liable, the full value of the property, not merely his equity, is taxable, but the debt can be deducted only proportionately. City Bank Farmers' Trust Co. v. Bowers, 68 F. 2d 909 (2d Cir.), cert. denied, 292 U.S. 644 (1934). However, where he is not liable for the debt, only the equity is taxable. Estate of Harcourt Johnstone, 19 T.C. 44 (1952).

7. No marital deduction is allowed to the estate of a nonresident alien except that the convention with France provides for a proportionate deduction.

8. The option to have taxable property valued as of a date or dates subsequent to the decedent's death (alternate valuation) is available to the estate of a nonresident alien

9. The amount of tax on the taxable estate of a nonresident alien is

Taxable Estate	Tax
Not over $100,000	5% of the taxable estate
Over $100,000 but not over $500,000	$5,000, plus 10% of excess over $100,000
Over $500,000 but not over $1,000,000	$45,000, plus 15% of excess over $500,000
Over $1,000,000 but not over $2,000,000	$120,000, plus 20% of excess over $1,000,000
Over $2,000,000	$320,000, plus 25% of excess over $2,000,000

10. The credits against the estate tax for (a) state death taxes, (b) the gift tax and (c) the estate tax on prior transfers which are allowed to estates of citizens or residents are equally available to estates of nonresident aliens, except that the maximum credit for state death taxes cannot exceed an amount which bears the same ratio to the credit (computed without regard to this limitation) as the value of the property upon which the state death taxes were paid, and which is includable in the gross estate, bears to the total gross estate for federal estate tax purposes. No credit is allowed for foreign death taxes.

11. A preliminary notice and an estate tax return must be filed if the part of the gross estate situated in the United States exceeds $30,000 on the date of death.

GIFT TAX

Property Subject to Tax

A gift of the following property by a nonresident alien is subject to the United States gift tax

1. Real property located in the United States.

2. Tangible personal property located in the United States.

Property Not Subject to Tax

A gift of the following property by a nonresident alien is not subject to the United States gift tax

1. Real property located outside the United States

2. Tangible personal property located outside the United States.

3. Intangible personal property, wherever located

Miscellaneous Provisions

1. For gift tax purposes "nonresident" means "nondomiciliary".

2. The $3,000 annual exclusion is available to nonresident aliens, but the $30,000 lifetime exemption is not, except as provided in the conventions with Australia and Japan.

Miscellaneous Provisions (Continued)

3. Charitable deductions are allowed only for gifts to American beneficiaries.

4. Except as provided in the convention with Australia, no marital deduction is allowed to a nonresident alien donor.

5. Gifts to third persons may not be split between husband and wife if either is a nonresident alien.

6. The rate of tax is the same for nonresident aliens and for residents or citizens.

SITUS RULES IN ESTATE TAX CONVENTIONS **APPENDIX A**

COUNTRY	ACCOUNT RECEIVABLE	BANK ACCOUNT	BILL OF EXCHANGE AND PROMISSORY NOTE	BOND (CORPORATE)	GOVERNMENT SECURITY	JUDGMENT DEBT	SHIP AND AIRCRAFT
Australia (Gift and Estate Taxes)	Debtor's residence[1]	Location of bank	Debtor's residence	Debtor's residence[1]	Location of government	Where originally obtained[2]	Place of registration
Canada	Debtor's residence	Location of bank	Debtor's residence	Place of incorporation	Physical location of certificate if in bearer form, place of registration, if registered	Where recorded	Place of registration
Finland	Debtor's residence	Location of bank	Debtor's residence	Place of incorporation	Debtor's residence	Debtor's residence	Place of registration
France	Decedent's domicile	Decedent's domicile	Drawee's residence[3]	Decedent's domicile	Decedent's domicile	Decedent's domicile	Place of registration
Greece	Decedent's domicile	Decedent's domicile	Drawee's residence[3]	Decedent's domicile	Decedent's domicile	Decedent's domicile	Place of registration
Ireland	Decedent's domicile	Decedent's domicile	Location of document[4]	Decedent's domicile	Decedent's domicile	Where recorded	Place of registration
Italy	Debtor's residence	Debtor's residence	Debtor's residence	Debtor's residence	Debtor's residence	Debtor's residence	Place of registration
Japan (Gift and Estate Taxes)	Debtor's residence	Debtor's residence	Debtor's residence[5]	Debtor's residence[5]	Debtor's residence[5]	Debtor's residence	Place of registration
Norway	Debtor's residence	Location of bank	Location of document	Same as bill of exchange	Same as bill of exchange	Debtor's residence	Place of registration

SITUS RULES IN ESTATE TAX CONVENTIONS

(Continued)

South Africa	U.S. if domiciled in U.S.;[5] S.A. if ordinarily resident in S.A.	Same as account receivable	Location of document[4]	Same as account receivable	Same as account receivable	Where recorded	Place of registration
United Kingdom	Decedent's domicile	Decedent's domicile	Location of document[3,4]	Decedent's domicile	Decedent's domicile	Where recorded	Place of registration

1. Business debts situated in state where business is located if donor or decedent is domiciled there.
2. No provision in gift tax convention.
3. For negotiable promissory note, the residence of maker.
4. If nonnegotiable, at domicile of decedent.
5. Bonds and other negotiable instruments in bearer form excepted.

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January, 1970

Supplemental Submission of the American College of Probate Counsel in Connection With the Estate and Gift Tax Hearings of the Committee on Ways and Means of the U.S. House of Representatives

This statement supplements the March 12, 1976, written statement, submitted in letter form, together with the oral testimony given March 17, 1976, by William P. Cantwell, Esq., president of the American College of Probate Counsel. This statement has been prepared by a duly constituted committee [1] of the college and is being made under the direction of its president (Mr. Cantwell) and president-elect (J. Nicholas Shriver, Esq.). Following introductory points on the general philosophy of this committee with respect to estate and gift tax reform, the statement makes some suggestions for improving the operation of the estate and gift tax system.

A. PHILOSOPHICAL GUIDELINES

The history of the Federal estate and gift tax system and many of the observations which have been made during the course of the current hearings, show that there is little consensus as to whether the purpose of the system is to break up large accumulations of wealth or to raise revenue. As a practical matter, the foundation of the system probably rests upon a combination of these purposes. However, these purposes, and the efficiency of the system in achieving them, cannot be the only criteria to be applied in judging the system. Other significant criteria include the stability of the system under which estates can be planned in reliance that major changes in the law will not render the plan useless (or worse) by the time the propertyowner dies; the understandability of the system, at least to the average attorney, so that it can be dealt with competently in carrying out the clients' wishes (while an equitable system is desirable, it is not always possible to develop a simple and understandable tax structure that is equitable—striving for equity often results in complexity, creating problems of understandability to propertyowners and their attorneys); the neutrality of the system, so that actions need not be distorted to achieve tax objectives; and the certainty of the system (a corollary of both understandability and neutrality), a principle recognized by the Congress in keeping the Federal estate and gift laws basically unchanged since the marital deduction was brought in by the Revenue Act of 1948 and the present method of taxing powers of appointment was adopted in 1951.

Achieving certainty of application of the estate and gift tax laws sometimes runs counter to obtaining complete equity since, in striving for the latter, uncertainty is all too often created. (A key illustration of this is what happened to the provisions taxing accumulation trusts during the enactment of the Tax Reform Act of 1969.) This is more important from the standpoint of the propertyowner than from that of his lawyer, since uncertainty in the application of the tax laws creates additional costs for the propertyowner and increases his lawyer's fees. Another desirable principle is that the laws apply uniformly

[1] The committee members are listed on the last page of this statement.

to similarly situated taxpayers. However, it is not always possible to achieve these results without losing other objectives. For example, an unlimited marital deduction (or even the present 50-percent marital deduction) penalizes people who die unmarried and an argument could be made that one's marital status at death should not determine the amount of the Federal estate tax; on the other hand, the elimination of the marital deduction would bring back the inequities that existed between the eight community property States and the rest of the country prior to the Revenue Act of 1948, and run counter to the social policy of easing the impact on surviving spouses of the estate tax on the estate of the first to die.

The rights of the taxpayer must also be considered in any tax system. The taxpayer (in the case of the Federal estate tax, it is the decedent's estate), if insufficiently liquid, will find that the payment of the Federal estate tax imposes a great hardship, sometimes forcing the sale of family farms, ranches, or small businesses or the loss of the family residence. Easing the burden of the tax where an estate's assets are relatively illiquid is an extension of the ability to pay principle since, in an illiquid situation, there is inadequate ability to pay the tax without forced sales.

Last, but not least, taxpayers should have the right to expect an efficient system of tax collection. In most cases this should lead to the earlier closing of estates, while providing for extensions in those situations involving lack of liquidity or other hardships.

B. LIQUIDITY PROBLEMS

One of the most important problems in the Federal estate tax area involves the illiquid estate, whether it be illiquid because its principal asset is the family farm, a closely held business, or some other asset, the forced sale of which would cause considerable hardship. Many proposals have been made to deal with this problem of liquidity by giving special treatment to certain types of assets, such as farms, ranches, open space, or historical sites.

We reject this approach because it violates the criteria of neutrality, uniformity, and equity. It could readily lead to the creation of new estate tax shelters, while failing to cope with the problems of most illiquid estates, regardless of their assets. Instead of special treatment for certain types of assets, we recommend other changes. These are designed to relieve the hardship faced by all estates by establishing rules that set more liberal, objective standards for the grants of extensions for payment of Federal estate taxes.

1. Broaden definitions of closely held businesses eligible for deferred payment of estate tax

(*a*) Section 6166 permits 10-year installment payments of estate taxes attributable to a closely held business for up to 10 years, if the value of the business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, and, broadly speaking, defines a closely held business as one in which 20 percent of the value of the business is in the decedent's estate or in which there are 10 or fewer partners or shareholders. We propose that the definition of an interest in a closely held business be broadened to deal with situations

in which an estate may be unable to pay the tax because its assets consist substantially of an interest in an unliquid business which does not meet the present tests.

We propose broadening the section 6166 definition of a closely held business to include a business 20 percent or more of the value of which, or of the voting stock of which, was owned either actually or constructively by the decedent, or the stock of which was not traded on an exchange or in the over-the-counter market. This would expand the definition of closely held business to cover nearly all cases where the shares of a corporation may not be readily sold at their approximate fair-market value.

Constructive ownership rules attributing to the estate stock owned by siblings, descendants, and ancestors (and spouses) should be applied. These would extend the section 6166 treatment to those situations where the estate owns less than 20 percent of the business but, for practical purposes, the estate is no more liquid than if it owned more. This is because diffusion of ownership among family members is unlikely by itself to result in diminution of the liquidity problem, particularly because of the difficulty in selling a minority interest in a closely held business to an unrelated third party where other important shareholders are members of a single family.

The alternative definition of a closely held corporation—that it have 10 or less shareholders—should be replaced by a test as to whether or not the stock is traded on a securities exchange or in the over-the-counter market, since this really deals with whether the estate is in a position to liquidate its shares, regardless of the number of stockholders.

(*b*) Another serious problem for the illiquid estate for which a deferral has been obtained may arise because a withdrawal from or a disposition of the interest in the business can, under certain circumstances, cause acceleration of the remaining installments of the estate tax, without providing the estate with sufficient liquid assets with which to pay it.

Section 6166(h)(1)(A) provides in substance that, if withdrawals from the closely held business equal or exceed 50 percent of the value of such business, or 50 percent or more of the closely held business is sold or exchanged, the payment of the remaining Federal estate tax is accelerated.

There appears to be no justification for an acceleration of the Federal estate tax regardless of the percentage of the closely held business which is either withdrawn or sold, so long as the withdrawal or sales proceeds are applied substantially to pay the remaining estate tax due, and, in fact, the statute provides for exceptions in the case of a sale or exchange, where the proceeds are used entirely for the payment of Federal estate tax. But not all of the proceeds should have to be applied against the Federal estate tax to prevent an acceleration of estate tax payments. Some of these proceeds will be needed to pay State death taxes, or other debts, which fall due during the 10-year period of the section 6166 estate tax installments.

If section 6166 required all of the withdrawn funds or sales proceeds to be applied to the Federal estate tax, the executor who used such funds or such proceeds to pay State death taxes would then have

to borrow an equal amount of funds to apply on the Federal estate tax at the next installment due date. This hardly helps to alleviate the monetary problems of the illiquid estate. We would recommend that the exception to acceleration apply if at least half of the proceeds are applied against the Federal estate tax.

A similar problem arises under section 6166(h)(1)(B). This makes an exception from the general acceleration provision where there is a distribution in redemption of stock under section 303. The last paragraph of subparagraph (B) provides that this exception will only apply if an amount of the estate tax not less than the redemption distribution is applied on the next installment of the Federal estate tax. This requirement that the entire distribution be applied against the Federal estate tax causes the same liquidity problem noted above, namely, that where a distribution is necessary to pay the State death taxes or other pressing debts, it is then necessary for the executor to thereafter borrow the same amount of funds to apply against the Federal estate tax, thereby compounding his illiquidity problems. Again we recommend that only a portion of the redemption distribution, such as half of it, be required to be paid on the Federal estate tax at the time the next installment is due.

We also recommend defining a "disposition" under section 6166 (h)(1)(A)(ii) and a "distribution" under subparagraph (B) so that, when notes are received in exchange for the corporate stock, the "disposition" or "distribution" would be deemed to occur only when payments are made on the notes or the notes are pledged for a loan.

2. Set objective standards for reasonable cause for deferring payment of tax, and extend the period to 5 years

In addition to providing for more liberal relief through permitting installment payment of estate tax over a period of years to be available to a broader class of closely held businesses, we believe that the 12-month extension under section 6161(a)(1), permitted whenever a fiduciary can show reasonable cause for his inability to pay the estate tax when due, should be available on an objective basis, rather than giving the Internal Revenue Service discretion to grant this privilege only if an examination of all the facts and circumstances discloses that a request for an extension of up to a year is based upon reasonable cause. We also believe that this extension should be for up to 5 years.

The Senate Finance Committee Report to the Excise, Estate and Gift Tax Adjustment Act of 1970, gives six examples of cases in which there would be reasonable cause for an extension:

The first example involves situations where farms or closely held businesses comprise a significant portion of an estate, but not enough to satisfy the percentage requirements for obtaining a section 6166(a) extension. Although these interests could be sold to unrelated persons for their fair market value to obtain funds to pay the estate tax, the executor could raise the funds from other sources if he had more time.

The second example deals with an estate of sufficient liquid assets to pay the tax when otherwise due, where the assets were located in several jurisdictions and not immediately subject to control of the executor, so he cannot readily marshall them.

The third example is of an estate a substantial part of whose assets consist of rights to future payments—annuities, copyright royalties,

contingent fees, or accounts receivable—where there is insufficient cash with which to pay the estate tax when otherwise due and a loan cannot be obtained, except upon terms inflicting loss upon the estate.

In the fourth example, the estate includes a claim to substantial assets which cannot be collected without litigation, so that the size of the gross estate is unascertainable as of the time the tax is otherwise due.

The fifth example deals with assets which must be liquidated at a sacrifice price or in a depressed market to pay the estate tax when otherwise due.

In the sixth example, the estate has insufficient funds, without borrowing at a higher rate of interest than that generally available, to pay the entire estate tax when otherwise due, provide a reasonable allowance for the family during the remaining period of administration and satisfy claims against the estate. The executor has made a reasonable effort to convert assets in his possession to cash—other than an interest in a closely held busines to which section 6166 applies.

In all six of these cases, we recommend that an extension of time to pay the tax for up to 5 years be automatically granted upon representation of the existence of the problem in a sworn affidavit from the executor. This would still leave to the discretion of the Internal Revenue Service other cases where an examination of the facts and circumstances discloses that a request for an extension for up to 5 years—presently 12 months—is reasonable. However, in these other cases, the code should require the Commissioner to grant such an extension unless he determines that there is reasonable cause not to grant one. Should it later become apparent that the taxpayer submitted false or insufficient information, existing civil and criminal penalties are adequate.

The liberalization in 1970 did not extend to the discretion given the Internal Revenue Service to extend for up to 10 years the time for payment of any part of the estate tax in cases of undue hardship under section 6161 (a) (2). Such an extension may be granted only for a year at a time and requires more than a general statement of hardship or showing of reasonable cause to obtain it. Undue hardship means more than inconvenience. It means sale at a sacrifice price, or in a severely depressed market, or the disposition of an interest in a family business to unrelated persons, even though it could be sold at a price equal to its current fair market value to these people.

As pointed out above, we recommend that the time period for an extension of the estate tax payment for reasonable cause, under the criteria of section 6161(a) (1), be extended from 12 months to 5 years and that, thereafter, the undue hardship criteria of section 6161 (a) (2) be used for further extensions.

3. Lengthen the maximum extension to 20 years

The present maximum period for obtaining extensions of time to pay estate tax under sections 6161 and 6166 is 10 years, but an extension under section 6166 must be elected at the time the return is filed. We recommend that this election also be available if a deficiency is assessed and, furthermore, that installment payments of the tax under the conditions described in both sections 6161 and 6166 be permitted for up to 20 years.

4. Reduce interest rate on extensions to two-thirds of that on deficiencies

Finally, we propose that in all cases where the payment of the estate tax is to be deferred under sections 6161, 6163 (dealing with extensions for the payment of estate tax attributable to a future interest), 6166 and the new extension provisions advocated by us, the interest be reduced to two-thirds of the rate currently charged on deficiencies. For many years, until 1975, interest was imposed at only a 4-percent rate on extensions of time for undue hardship (section 6161(a)(2)), because of a future interest (section 6163), or where there was a closely held business in the estate (section 6166), although the regular 6-percent interest rate applied to 12-month extensions under section 6161 (a)(1).

Effective June 30, 1975, the preferential rate of interest was abolished at the same time that interest rates were raised to 9 percent (now 7 percent, at least until February 1, 1978). The Senate Finance Committee explanation of the change that eliminated the preferential interest rate overlooked that estates holding closely held businesses and other illiquid assets must not only earn profits to pay the interest charge, but also to pay the unpaid installments of estate tax. We merely seek to further the purposes of the extension provisions as originally enacted and the liberalizations as proposed by us, by reinstating a preferential interest rate which would rise and fall in proportion to the current rate of interest for income tax purposes.

We believe that the adoption of the above proposals would go a long way to solve most liquidity problems experienced by estates. From the standpoint of sound tax policy, the uniform application of these provisions, regardless of the nature of the illiquid assets, would further the objectives of neutrality, equity, and uniformity of application of the estate tax laws, as well as providing certainty that relief would be available in most cases.

5. Create a new alternative valuation concept for hard to value assets

Great difficulties are created for estates holding hard to value assets and for the Internal Revenue Service in dealing with these assets. Current rules require appraisals, which can be expensive, can result in expensive and time-consuming controversies with the Internal Revenue Service, and may result in unfairness to one side or the other when assets are sold within a reasonable period after death. Therefore, although we favor retention of the 6-month alternative valuation date, we recommend that where an estate holds assets described in section 6161(a)(1) or 6166, or real estate or tangible personal property (other than property which depreciates in value due to lapse of time or normal use—such as the family car) at the time of filing of the return, the executor should be permitted to elect a deferred alternate valuation date for such property (separate from the normal election as to valuation dates) that would permit the valuation of these assets to be postponed for a period of up to 3 years following the date of the filing of the return, with valuation to be fixed by actual sale or, if none, by appraisal at the end of the period. Needless to say, unless otherwise deferrable, the Federal estate tax attributable to these illiquid assets should be paid on an estimated basis and the statute of limitations as applied to questions affecting these assets tolled.

C. INTERSPOUSAL TRANSFERS

The problem of inter vivos and death-time interspousal transfers is one that has produced a number of proposals to make changes in the marital deduction. We are concerned that some of the more far-reaching ones which would provide for the unlimited marital deduction, making all interspousal transfers tax free, would create both an unacceptably high revenue loss (at least in the near term) and run counter to the objective of having a stable tax system. The two most serious problems in this area are the artificiality of the legal presumptions involving joint tenancy, particularly between spouses, and the tax pressures to distort a client's natural desire in making appropriate dispositions for a spouse and children. This is particularly serious where the client wants to be sure that his or her children, and not a second set of children the surviving spouse may have on remarriage (or even the surviving spouse's new marriage partner) share in the estate. Such pressures exist even more strongly in second marriages where there are children from a first marriage.

1. Inter vivos transfers of joint and community property

We propose retention of the 50 percent marital deduction in general, but advocate a major change involving inter vivos interspousal transfers. The gift tax marital deduction, unlike the estate tax deduction, does not permit a 100-percent deduction for up to 50 percent of the estate. The gift taxpayer gets a deduction for 50 percent of the actual amount given to his spouse. This requires the filing of returns for relatively small gifts, a requirement that is frequently ignored, leading to disrespect for the law on the part of many people and imposing onerous filing and payment requirements on the conscientious and well-advised taxpayers.

We believe that the same policies that led to adoption of the section 2515 exemption from the gift tax of the creation of a tenancy by the entirety or a joint tenancy with right of survivorship between husband and wife in real estate (in the absence of an election) should be expanded to many other interspousal transfers made inter vivos. Section 2515 should be extended so that all transfers into joint ownership, including community property transfers, by either spouse, regardless of the source of the funds, would be treated as exempt unless the spouses elected to have them treated as completed transfers. Thus, the umbrella of section 2515, now limited to real estate, should be extended to stocks, bonds, savings accounts, and all other types of property. Even tenancies in common should fall into this shelter, since the tendency of people in creating all of these joint interests is to give half of an aggregate amount, so that such a rule would really rather closely parallel the present policy on joint tenancy.

Under existing provisions of section 2515, termination of a real estate joint tenancy between spouses or a real estate tenancy by the entireties may or may not result in a gift, depending on the ratio of original contributions and the property interests acquired. This is frequently the occasion for an inadvertent gift. Extension of section 2515 to all types of property, without any attention to the inadvertent gift problem, would exacerbate the existing problems of noncompliance in this area. As an inducement to taxpayer awareness and compliance, a new type of taxpayer election in this area is suggested below.

Unawareness is the real reason that many transfers into interspousal co-ownership form are not coupled with elections to treat the transfer to the noncontributing spouse as a gift. Existing section 2515 requirements requiring the election to be made on a timely return operate as a trap, for when the couple finally becomes aware of the possibility that the transfer might have been a gift, it is almost always too late for a timely return. To constitute the noncontributing spouse as an owner then would require a gift of the entire one-half interest. Appreciation and inflation aggravate the problem since current fair market value would be involved in a transfer at termination of the joint interest. If that value is higher, and if the termination would involve a transfer of an asset acquired by gradual payments over a period of time, the gift tax consequences can be very severe.

As an example, consider a house bought with a purchase price of $50,000 and a $10,000 down payment. Mortgage payments in annual increments are made. Had elections been made on timely gift-tax returns to treat the down payment and annual mortgage payments as gifts, little if any gift tax would be paid. On the other hand, if the elections are not made and if a severance is effected on a sale with each spouse receiving one-half of the proceeds and the appreciated value is $150,000, the consequence is a $75,000 gift (subject to the gift tax marital deduction) by the contributing spouse to the noncontributing spouse. This can be very disadvantageous in many situations.

A relatively simple statutory change to permit the election to be made on a return, whether timely or not, would relieve the situation. It is particularly pertinent if the suggested section 2515 change is made, for nonrealty transfers are virtually handled in this fashion now. Acquisition of a security in joint form under existing law involves a gift. The tax now remains due, based on fair market value at acquisition, under today's law, and can and should be paid on a return, whether timely or not. The taxable event was acquisition, and not anything subsequent. What is being urged here for an expanded section 2515 is that acquisition remain the taxable event, with the election available to treat the transfer as a gift at anytime after acquisition. In essence, the question of gift or no gift would remain open until the spouses close the transaction, but, when it is closed, the closure would relate back to acquisition cost and would not require a fair-market value transfer at the date of closure.

2. Joint property at death

Section 2040 should be amended so that at death only half of the property held in any form of joint ownership would be taxed in the estate of each spouse, without tracing. But any property held in joint ownership for which no gift tax has been paid at creation should be removed from the adjusted gross estate in figuring the base on which the maximum marital deduction (50 percent of the adjusted gross estate) is computed at death. This is the present approach to community property.

3. Extension of the credit for prior transfers

If the donee-spouse dies first, half of the property will be included in her or his estate, and the entire property will subsequently be included in the donor-spouse's estate. This is a problem that generally exists where gifts are made to a spouse. It can be alleviated by an

extension of the existing credit for property previously taxed in the estate of one spouse, with the elimination of the present 10-year limit and the 20 percent credit decrease that occurs every 2 years. This specially extended credit rule for property previously taxed in interspousal transfers would permit a 100 percent undiminished credit, regardless of the number of years between the deaths of the spouses.

The unfortunate whipsaw consequences of the same property being included in the estates of two decedents (usually spouses) could be solved by extending the mitigation of the statute of limitations provisions in sections 1311 through 1315 into the estate tax area. These provisions deal with inconsistent income tax determinations that either give the Government or the taxpayer an unfair advantage which cannot be rectified because of the running of the statute of limitations. The provisions permit the reopening of the statute of limitations under certain conditions in the interest of fairness. However, they are quite complex and the extension of them to the Federal estate tax will add further complexity to them. We believe that the same objective can be accomplished through the use of the above-described 100 percent credit for tax on prior transfers between spouses.

4. Qualitative expansion of the marital deduction and elimination of the terminable interest rule

With respect to the qualitative aspects of the marital deduction, we favor qualifying for the marital deduction any full-income interest passing to the surviving spouse, regardless of whether there is a general power of appointment accompanying it. Thus, deductibility would be given in the first estate, provided that the interest is to be included in the second one. Furthermore, the surviving spouse should be allowed either to accept or reject the marital deduction tax result in the qualifying limited interest situation, such as where he or she receives only a life estate. Thus, in effect, the surviving spouse would have an option to prepay the death taxes when there is a straight life estate, but still receive the life estate.

In essence, the section 2056 terminable interest rule would be abolished in the interest of simplicity, to make it easier for the nonspecialist to avoid problems and to avoid the whipsaw effect of the inconsistency involved in requiring inclusion in the survivor's estate in situations where the marital deduction is not always available in the estate of the first spouse. This is illustrated by cases involving overly broad powers to allocate between principal and income or to retain unproductive assets, so that not all the income requirements for a marital deduction power of appointment trust are met and cases where the power of appointment does not qualify as a general power of appointment under section 2056 but nonetheless falls within the section 2041 definition of a general power of appointment. Another example of cases which would be ameliorated by this change are those where there is disallowance of the deduction in the first estate because of a requirement of survivorship running beyond the allowable 6-month period which actually is satisfied so that the property does in fact pass to the surviving spouse and is taxed in the second estate.

Perhaps the worst aspect of the present requirements is the compulsion they place upon a property owner. He must do something with his property that he might not otherwise wish to do. While he may

be perfectly willing to provide for his spouse, he may not want to do this in a way that allows that spouse to divert the property from his children after his death. These fears may involve a fear of the surviving spouse's remarriage or where a donor has a family by a predeceased first spouse and then remarries, fear that the second spouse will not make the adequate provision for the children of the first marriage. To mitigate this situation, we propose amendments to section 2056 that would permit a limited interest to qualify for the marital deduction.

If the decedent's spouse leaves the surviving spouse an interest which will cause the property to be includible in the survivor's estate upon death, that fact alone ought to be sufficient for a qualifying gift. If the survivor accepts broad benefits, such as a general power of appointment or outright ownership of the property, then of course the first estate is allowed a deduction, because the survivor has that quantum of ownership which requires estate taxation when he or she later dies. That rather parallels the present marital deduction, except that it substitutes for the technical terminable interest rules a basic rule which simply and directly states that the interest qualifies if the surviving spouse takes such an interest as would cause inclusion in the surviving spouse's estate if retained until death, which, of course, also means that, if the survivor disposes of it before death, it is subject to the gift tax.

A further recommendation is that the spouse dying first should be able to tender to the second spouse a terminable interest which qualifies, if the first spouse to die declares a desire to have that interest qualify. Thus, in the classic case of a life estate for the wife, with remainder over to whomever her husband directs, if the widow accepts this tender, it should be deductible in her husband's estate and her acceptance of it as a marital deduction gift will constitute a stipulation that it will be includible in her estate when she later dies. Unless her husband expressly conditions this bequest on her acceptance of it as a marital deduction bequest, however, she could take the property rights but decline the tax consequences through postmortem planning, and prepay the tax by declining to take it as a marital deduction gift. She could still have the right to the income—she need not forfeit her rights under the will—but she only declines to take it as a marital deduction gift.

Protection of the husband's other beneficiaries is important in such a situation. This could be accomplished by having the additional tax caused by this unanticipated enlargement of his taxable estate borne specifically by the assets which caused that enlargement, that is, the assets tendered but rejected for the marital deduction. Of course, the husband may include an apportionment clause to the contrary, but sections similar to the tax apportionment for life insurance under 2206 and powers of appointment under 2207 should be put in the code to deal with the unplanned situations.

These proposed changes should not cause a significant loss of revenue, but would give much more flexibility to estate planning, particularly at the postmortem stage; the election could actually result in particular cases in revenue advantages because of the prepayment of taxes that would otherwise not be due until the wife's death. This election, however, would most likely be used in cases where it would be advantageous from a rate viewpoint. In any event, where it does reduce the tax, it does so by removing an inequity rather than creating one.

D. RAISE THE EXEMPTION TO $100,000 AND CHANGE IT TO A CREDIT

Another problem that is receiving considerable attention lately is the debate over whether the Federal estate tax exemption should be increased, in view of inflation. We are concerned over the estimated $2 billion revenue loss that an increase in exemption to $150,000 would appear to create. We believe that many of the problems caused by inflation pushing far more people into the Federal estate tax brackets will be solved by adoption of the liquidity proposals we have previously made. We also recognize that some allowance must be made for inflation, that complete relief from the estate tax and the filing requirements is desirable in smaller estates. However, we believe the revenue impact of this relief must be held down by changing the exemption to a credit.

We also recognize that if there is a material increase in the estate tax exemption, questions of fundamental social reform, rather than narrow tax reform, are raised because, if a tremendous tax loss results from exempting so many modest-sized estates that are now subject to tax, it may be necessary to make up that difference by accelerating rates, if the estate tax is to continue to produce the same amount of revenue, and, inevitably, even without a conscious and independent policy decision, a rate structure might then be adopted which would tend to break up even moderate concentrations of wealth and deter needed capital formation. This is not the sort of result that should be reached as an incidental part of estate tax revision, but, to some extent, it would be a byproduct of raising the exemption unless the exemption can be raised in the context of other revenue increases.

It would be most desirable to exempt the many estates which involve only modest amounts of wealth being passed to a spouse or children where both planning and administration are now complicated and little revenue is produced. Accordingly, to the extent consistent with revenue considerations, we recommend that many estates be exempted from the Federal estate tax where neither the returns nor the administration and planning are worth the effort. We suggest that this be accomplished by means of a credit, rather than an exemption. This credit could be used, in effect, to increase the $60,000 exemption to $100,000 by taking the amounts from the bottom rather than the top—eliminating tax on the small estates, but giving the relief in the large estates at the bottom, rather than at the top rate.

We propose that in lieu of the present $60,000 exemption, $120,000 for transfers qualifying for the marital deduction, a credit against the tax due on the first $100,000 of taxable estate—$200,000 in the case of transfers qualifying for the marital deduction—be permitted. This credit should be designed so that gross estates of $100,000 or less need not file returns. This latter point is of the utmost urgency, since if it is not done, the change will cause further unnecessary complications and costs in the administration of small estates.

E. VALUATION

Turning to the question of valuation of assets, wherever there are closely held business interests or hard to value tangibles, estates are put to a considerable amount of additional expense and both the estate

and the Government spend quite a bit of time and money in valuation proceedings. We believe that the settlement of estates could be facilitated by improvement of the present valuation methods. For example, section 2031 presently requires that unlisted and untraded securities have their values determined by considering, along with all other factors, the value of securities of corporations engaged in similar lines of businesses which are listed on an exchange. The limitation of this comparison to corporations whose securities are listed on an exchange is a technical defect in the law. Accordingly, section 2031 should be amended to permit comparisons with the securities of other corporations engaged in the same or a similar line of business, regardless of whether their securities are listed on an exchange.

Under regulations promulgated pursuant to section 2031, tangible personal property is valued at the price at which an item or comparable item could be obtained in the retail market. Thus, replacement value is the criterion for valuation rather than the price obtainable in the market or markets available for the holder of the property being valued. This approach of the service was rejected by the U.S. Supreme Court in the *Cartwright* case, decided in 1973, which involved the valuation of shares of an open-end mutual fund. The price obtainable by the executor or donor in whatever markets are available to him is a fairer measure of value.

Accordingly, we recommend amendment of sections 2031 and 2512 (gift tax) to provide that tangible personal property be valued for estate and gift tax purposes at the price obtainable by the executor or donor in the market or markets available to him. If this proposal is coupled with the previously made one permitting an election of a delayed valuation date for hard to value assets, many of the valuation disputes that now occur would be avoided and the large expense incurred by estates possessing closely held businesses in obtaining appraisals of them for tax purposes could also be reduced, if not entirely eliminated in a large number of cases.

F. GIFT TAX FILING

There are two other areas of the estate and gift tax laws which are widespread in their effect where the present rules create both unnecessary complexity and inequities. The first of these deals with the gift tax filing requirements. The Excise, Estate and Gift Tax Adjustment Act of 1970 required for the first time that taxable gifts be reported quarterly, rather than annually as provided by prior law. This quarterly filing requirement has proven to be a major administrative inconvenience to the Internal Revenue Service and constitutes a costly nuisance to individuals who make relatively small taxable gifts in several quarters. The extra work required by the quarterly filing requirements may in many instances be far more costly than the relatively small value derived by the Treasury from a slight acceleration of gift tax revenue.

We recommended a prospective return to annual filing, at least for most donors. Only where an individual's gifts in one calendar quarter aggregates $100,000 should an individual still be required to file a quarterly preliminary gift tax return with respect to that calendar

quarter. This amount appears to be a reasonable figure which would eliminate most quarterly returns without deferring the payment of any substantial amount of gift tax. Eighty-five percent of the persons filing gift tax returns would not have to file quarterly preliminary gift tax returns, yet 75 percent of the total gift tax paid for the year would be reported and paid with the preliminary gift tax returns.

Where quarterly preliminary gift tax returns are in fact required, gifts between spouses should be permitted to be split on a preliminary basis, with a nonbinding election until the subsequent filing of a final return for the calendar year. At that time the spouses could elect to split their gifts or not split them, regardless of the election made in the preliminary quarterly returns. Similarly, the election to treat acquisition by spouses of a joint interest in any property as a gift would be made in the annual gift tax return rather than in the preliminary quarterly returns.

C. ESTATE TAX CREDIT FOR GIFT TAX PAID

We recommend that section 2012 be amended so that in computing the limitation on the estate tax credit allowed for gift taxes paid in respect of property included in the decedent's gross estate, the estate tax attributable to such property should equal the reduction in estate tax if such property were removed from the gross estate. At present, the estate tax credit for gift tax paid in respect of property included in a decedent's gross estate for estate tax purposes is limited to the lesser of the gift tax paid or the estate tax allocable to the gift. Those limitations are computed under present law by a complicated method involving the average gift tax rate and the average estate tax rate. Substitution of the highest applicable bracket rates for the average rates determined under present law would greatly simplify the computation of the credit and would reduce the number of cases in which the credit is partially lost by application of the limitations. Thus, we recommend that the computation used to determine the amount of gift and estate taxes allocable to property subject to both taxes for purposes of the limitations be changed to reflect the incremental amounts of gift tax and estate tax attributable to the doubly taxed property.

II. THE STATE DEATH TAX CREDIT

In the written statement submitted on behalf of the college by president Cantwell, he indicated that we were working on a State-by-State analysis of the economic effect of the State death credit and would submit a report, which we expected would be ready within a month, to your committee for its consideration in connection with your deliberations. It is now apparent that this report, which we had hoped to attach to or make a part of this supplementary statement, was not as far along as we had believed in March. Therefore, it will not be ready for several more months. When it does become available, we will submit its results, together with recommendations for a closer integration of the State and Federal death tax systems, based upon some form of incentives given the States to conform their death taxes to the Federal estate tax, to this committee.

I. EFFECTIVE DATES OF TAX CHANGES

Our final recommendation deals with effective dates of any and all changes that may be made to the estate and gift tax laws. We believe that all such changes should apply prospectively and not be applicable to any past transfers. The effective dates should be such as to allow a reasonable period for amendment of existing estate plans. If major structural changes, such as new taxes on generation-skipping transfers, an unlimited marital deduction, some form of taxation of appreciated property at death, a radical change in the entire death tax system by bringing in an accessions or an inheritance type of death tax or the unification of the estate and gift tax or substitution of a capital transfer tax for it, are made, we believe that an extensive period of time should be permitted for the transition to occur, in the interest of stability.

The general policy of amending tax laws only prospectively should be strictly observed in estate and gift tax revisions. Obviously, many gifts have been made and many trusts established on the basis of the present tax system and its rules, which have remained substantially unchanged since 1951. Fairness requires that significant changes not be applied to the detriment of those who relied on existing law. Specifically, if Congress decides to unify the estate and gift tax system or substitute for it a capital transfer tax, similar to that used in England, it is important, as the proposals to date have generally contemplated, that there should be a fresh start, with a single lifetime exemption available in full without regard to prior gifts, and without including prior gifts in computing the tax on future transfers. Similarly, if a switch to an accessions tax is made, there should be no attempt to compute and charge recipients of gifts and inheritances with any of these received prior to the effective date of the new law.

If a tax is to be imposed at death on appreciation, either a capital gains tax or an additional estate tax, or if there is to be a carryover basis, we believe that a new basis date should be provided, in order to avoid inequities caused by failure in the past to keep adequate records, which taxpayers could legitimately have considered unnecessary, similar in concept—if not in purpose—to the March 1, 1913, value used for income tax purposes, after adoption of the 16th amendment to the Federal Constitution.

If generation-skipping transfers are to be specifically taxed, the new tax rules should apply only to transfers made after the effective date. Irrevocable trusts created prior thereto, whether during the settlor's lifetime or as a result of his death, should have their dispositions exempt from these new rules.

Finally, there should be a reasonable grace period for amending wills, and revocable or otherwise amendable trusts, similar to that provided in connection with other estate and gift tax amendments that have caused major changes in the past, to allow a review of estate plans by all taxpayers and their advisers. This grace period should run for at least 5 years, since experience has shown that even relatively minor changes in the past have required extension of originally granted 2-year grace periods—witness what occurred to the changes

in the charitable remainder trust rules and the transitional rules designed to deal with problems caused by these changes under the 1969 Tax Reform Act.

The above proposals are those of a duly authorized committee of the American College of Probate Counsel, created by the college's Board of Regents and appointed by President William P. Cantwell, of Denver, Colo. The committee consists of the following lawyers:

Frank S. Berall, chairman, of Hartford, Conn.; Luther J. Avery, of San Francisco, Calif.; Joseph Kartiganer, of New York, N.Y.; Arthur Peter, Jr., of Washington, D.C.; Raymond A. Reister, of Minneapolis, Minn.; and E. Frederick Velikanje, of Yakima, Wash.

EDITED TESTIMONY OF WILLIAM P. CANTWELL BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS, MARCH 17, 1976.

My name is William Cantwell, and I am the president of the American College of Probate Counsel. The organization is a group of 1,700 probate specialists from every State in the United States, and while I perhaps have an ax that I am carrying, I do not believe that it is well honed, and I am not here for the purpose of applying it.

Our presence before you now is not to enter directly into the fray insofar as favoring or disfavoring any of the many proposals that have been placed before you, but to offer the services of our organization, with representation in each State, to advise your staff as to how any particular proposal would work within the probate system.

It seems an obvious truth to state that within a period from today into the early part of the next century, all American wealth that is capable of being transmitted will, in one way or another, pass through the probate system. Our consistent concern has been that the probate system be one in which the transmission of wealth could occur in an orderly, expeditious, and if you will have it, a reasonably priced, mechanism. We find, as representatives of the clientele subjected to that system, that the estate and inheritance tax transactions through which probate property must pass tend persistently to dominate the working of that system and, as well, to dominate the form of disposition of property.

We are here to suggest to you three basic things. Those three things are stability, neutrality, and the rights of the probate taxpayer.

By stability I would like to associate myself with all of those comments that Mr. Melvoin made regarding the existing structure for the disposition of wealth in this country. I don't believe there is anything like an accurate count of the number of plans for estates in this country, but I have already suggested that all American wealth, one way or another, must pass through some form of probate or estate-planning procedure. I would at least venture that there are outstanding some 20 million American estate plans. I believe they have been developed with a consistent respect for the state of the law since the Revenue Act of 1948, and that any radical change in the legal procedures by which those plans would dispose of wealth would place an impossible burden on the taxpayers and an absolutely unmanageable burden on the professionals expected to deal with amend-

ing those plans. I therefore would suggest, and urge, that as far as our group is concerned, dealing intimately and specializing on a day-to-day basis with the transactions through which these persons must dispose of their wealth, that the matter of the stability of the law is indeed an objective of a very high order, and that any sweeping substantive changes in the law without a very long lead time would place American taxpayers at a material disadvantage and could be totally counterproductive to whatever may be the objectives of estate and gift tax reform. It could end up as reform benefiting the professionals while exacting funds and frustration from the public and the treasury.

My second point is neutrality. I too live in an agricultural State, and I find it difficult to disassociate myself from the thought that there should be special legislation for special classes of taxpayers such as farmers and ranchers. I don't believe that there is any problem that I personally deal with that gives me more trouble than the problem of liquidity for agricultural enterprises, and yet I deal with that, and in the planning phase with my clients, I suggest in advance that they too deal with that. I think that all of the history of tax legislation which has attempted to single out particular classes of taxpayers for particular types of treatment has, in turn, ultimately become counterproductive tax legislation, for in attracting wealth into a particular form of activity because of potential tax advantages, I believe it tends to distort the economy. I believe some of the very problems we deal with here this morning with respect to agricultural enterprises have themselves perhaps been created by the attractiveness of agriculture as a form of investment for tax benefits. And therefore, while I personally would feel that the problems of the agricultural enterprise and any other small business enterprise ought properly to be dealt with, I would hope that they could be dealt with in a totally neutral form so that the tax laws neither force nor encourage any particular form of business enterprise or business activity simply because of the structure of those laws. And that is the meaning of my thought with respect to neutrality.

With respect to the matter of stability, why are we here concerned with estate and gift tax reform? Concededly there may be some inequities, and perhaps the agricultural problem is an inequity. However, I would suggest to you that through borrowing devices, through postponement devices, through expansion of 6161 and 6166, that that problem could probably be dealt with well. It could be aided by new valuation techniques which are different from those applied today. As to other inequities, I do not find in my practice that the administrative difficulties in administering a tax we have lived with for a long period of time are themselves unlivable. I am certainly disturbed, and I would hope that perhaps there is reform required in the matter of noncompliance in gift tax filing and meeting gift tax obligations. I am concerned that the original objectives of the 1948 act have not been satisfactorily achieved, and that perhaps reform is necessary to accomplish this. But these conceded yet minimal areas need to be placed on a scale of values opposite my position urging stability in the disposition of the affairs of American taxpayers representing the results of a thrifty lifetime.

To me the scale tips very, very heavily against any broad brush changes which would require revision of millions of estate plans, possibly accompanied by non-revenue-producing complexities of a sore which the legal profession is not equipped to meet. Our particular clients, our probate clients, are clients who are examples of the classic thrift and self-support concept of the American economy. We believe that they, certainly as much as any special class of taxpayers, have a series of rights. In my prepared paper I have suggested to you a series of areas in which we believe our probate clients do have rights and substantial concerns.

As a first in this series of questions, we are concerned that any reform your committee might propose to the Congress should address problems of the relationship between your tax and the State inheritance tax. This question extends to the necessity for filing two tax returns, often on an inconsistent basis, which can subject taxpayers to a whipsawing relationship between the two taxing entities involved.

We are next particularly concerned with the overall valuation problem. We would suggest to you that the valuation technique used on agricultural and other real estate, as well as closely held businesses, could stand great attention from this committee, and might in itself go a very long way to take care of the agricultural and other small business concerns with which you are dealing. Valuation is really the genesis of the problem, and liquidity required by valuations which are vastly inflated because of forces beyond the control of the taxpayers appear at the heart of the nature of the agricultural and small business problem.

Another of our concerns would arise if this committee should propose a unified tax. Where would taxpayers stand with respect to the basis problems and the horrendous administrative difficulties created by any form of carryover basis? We are equally concerned that if a unified tax should be enacted that the existing noncompliance with the gift tax statute would be accentuated. Picture, for example, the difficulties that would ensue in attempting to make a lifetime catalog of a giving program in order to do justice under a unified tax.

In another area we are hopeful that if there should be reform, that the extremely difficult problems of joint tenancy tracing might, in some manner or another, be erased from the law by simply allowing joint tenancy to be taxed on an objective basis.

We are very deeply concerned with noncompliance with the existing gift tax statutes overall, in the joint tenancy area, and in other areas as well. There simply exists no objective technique, such as the withholding tax, to deal with joint tenancy under the existing statute, and we think a bill of rights for taxpayers, for our type of taxpayers, should protect the filing taxpayer, the compliant taxpayer, from the reduction of revenue from the noncompliant taxpayer, particularly in the gift tax area where there doesn't seem to be any particularly good policing mechanism.

We would suggest that any legislation that might come forward would be legislation aimed at an ease of compliance rather than a complexity of compliance.

We would hope eventually that the Federal Government and the State governments might seek a method by which a single return rather than a two-return system could operate.

We would hope that the liquidity problems might be dealt with by a much more objective workout of section 6166 and section 6161 so that the administrative intervention of enforcement personnel does not prevent the intent of those statutes.

On an ultimate basis then, what our organization, concerned with the probate clients of this country, would seek would be a recognition that just as in 1948 there was a series of abuses by virtue of the difference between community and common law States, that now there is a series of problems that need to be dealt with.

The 1976 problems seem to center around the question of inflation, the interrelated question of liquidity based on inflation, and the objective of maintaining the potential for the small enterprise. We would think that the time has arrived for some form of taxpayers' bill of rights—a new version of the Revenue Act of 1948 to redress current inequities as that act was aimed at the 1948 problems. The 1976 statute would seek to deal with the inflation, liquidity, and small business enterprise objectives.

We would hope that any legislation might carry out the thoughts that I have tried to suggest to you. First, that there be neutrality—in other words, that the tax statutes not dictate any more than is absolutely essential the form of a family transaction. Second, that you seek stability. That would regard as significant the tremendous investment of time, energy, and personal anguish involved in those 20 million wills that are sitting waiting to be probated in lawyers' offices, and that you consider simplicity as an ultimate objective. More and more, complexity for taxpayers is becoming a factor in their attitude toward the working of their Government. We seek help in making the probate procedure an expeditious procedure and not a procedure in which delays and difficulties are based on the Federal tax system rather than on the local probate system, or on the delinquency of individual lawyers, which we are as opposed to as anyone.

Our offer to you is that we would like to help you determine how, in a probate sense, any proposals you ultimately adopt would work, and we offer our services for that purpose.

I have a written statement, and I would ask that it be entered into the record, and appreciate very much the opportunity to testify.

STATEMENT OF MRS. HARALD BRANDL, MANITOWOC COUNTY, WIS.

I am Mrs. Harald Brandl (Doris). My husband and I own and operate a 220-acre dairy farm in Manitowoc County, Wisconsin. I am testifying in favor of the Burleson Bill HR 1793. There hasn't been a change in the tax structure for these people for many years. Not since the 1940's. The present personal deduction hasn't been changed since 1942 when it was raised to $60,000. The cost of land has risen as much as 500 percent since that time. In some instances more than that. The cost of keeping the farm up to proper production has also risen tremendously. Like 500 percent also, when we purchase farm machinery and supplies.

The most important part of this Bill to us, will be to enable my husband and I to keep our farm in our own family if it is the desire of one or more of our children to own and operate it. We do not, and what farmer does, have a savings account to adequately cover the price of an estate. By this I mean to have enough money to pay out

their other children so one or two sons can own and operate the farm. To use my own family as an example, we have eight children, ages 4 to 25. Our family farm is valued at about $250,000. Until the debts are paid and the children given a equal share, I would have to sell our farm upon the death of my husband to settle the estate.

When we talked to our lawyer about a will and estate planning he said, "For tax purposes" even if a farm is in joint tenancy the husband is considered the proprietor. Now I would like to know what I have been working for along side of my husband for the last 27 years. I have worked in the fields, all day, did my housework at night when my children were small, took them along in the fields or rode them on the tractor. There has been very few times that I have missed milking. I have helped repair building and machinery when needed. I do bookkeeping and keep the records on cattle etc., etc.

Even if all farm women don't do all of these chores, they do know what is going on by helping with record keeping, doing errands such as getting parts for machines during harvest time and just by the general knowledge she has to have.

If the $200,000 personal exemption is passed as in HR 1793 it will also help a woman to continue to farm if she desires to do so.

It is estimated that less than 2% of revenues come from estate taxes. I suggest closing other tax loopholes to make up this difference, some of which are deliberately made.

I also endorse the proposed Definition of Real Property and the 60 months preceding the date of death as it pertains to the use of farm lands. I would hope this will help keep land in farming and if it is not there would be back taxes or a penalty to pay.

The production of food is one of our country's most important industries. Farming is a part of America, it is a way of life. Let's help to keep it that way.

NATIONAL COTTON COUNCIL OF AMERICA,
Memphis, Tenn.

Re estate and gift tax reform.

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

DEAR SENATOR LONG: It will be appreciated if you will insert this letter in the hearing record on tax reform legislation.

The National Cotton Council is the central organization of the U.S. raw cotton industry, representing growers, ginners, warehousemen, merchants, cooperatives, manufacturers, and cottonseed crushers.

At their annual meeting on February 2–3, 1976, Council delegates unanimously approved the following resolution, which directs that the Council:

"Work for adjustments in exemptions from federal estate and gift taxes commensurate with economic changes which have occurred since present exemptions were established.

Farms necessarily are much larger today than in 1942 when the estate and gift tax exemptions were established. The overhead required to operate a farm, in terms of machinery, chemicals, and buildings, has risen dramatically, and to continue farming under these conditions requires farmers to spread overhead costs over more units of production. This has led to a tremendous increase in their net assets in

relation to net income. USDA figures show that owner's equity per farm has increased about 19-fold in the period from 1942 to 1975, while net income per farm was up only a little more than 6-fold.

In terms of estate taxes, this means the tax liability of the average farmer's estate has far outrun his heir's ability to pay the tax out of the farm's continued operation. To make matters worse, financial assets such as bank deposits, savings, etc., now comprise only a little more than 5 percent of the average farmer's total assets, as compared to 11 pereent in 1942. Therefore, it has been increasingly neccessary for heirs of a farmer to sell the farm—or a very substantial part of it—to pay taxes on the estate. If the heirs want to continue farming, they must become tenants rather than landowners. We believe this trend is contrary to earlier developments in U.S. agriculture that made our country the world's most efficient producer of food and fiber.

Cotton farmers have been hit especially hard because real estate values per acre have risen faster in 12 of the 14 major cotton-producing states than in the nation as a whole, according to USDA data. For example, Georgia's farm real estate value per acre has increased 22 times since 1942, and South Carolina's 15-fold, compared with a 10-fold rise for the U.S. Nationally, real estate comprised 71 percent of total assets per farm in 1975.

One of the bills before your committee that has wide support would raise the estate tax exemption from $60,000 to $200,000. We realize of course, that the exemption applies to everyone, not just farmers. But, in light of the tremendous rise in average net farm assets we have cited, such an increase in the exemption is quite modest from the farmer's point of view.

We believe that estate and gift law adjustments to make it easier for heirs to continue farm and other small business operations will benefit the whole nation by: (1) encouraging more efficient and productive farming; and (2) keeping more investment capital available and working in the private sector. Shortage of investment capital is seen by most economists as a serious problem in the future of our nation.

If we are to encourage farminig operations to continue from one generation to another in a family, it seems essential that farm property in an estate be valued according to its use in agriculture, rather than its speculative value to a real estate developer or some other non-farm investor. To prevent abuse of such a provision, it may be necessary to make the valuation for estate tax purposes dependent on the use of the property in the years immediately following its passing into the hands of the heirs.

If your committee agrees that estate and gift tax liability should be adjusted so as to avoid forced sales to pay the tax, we urge that this move not be negated by applying a capital gains tax on the estate, as is being proposed in some quarters. Because of the tremendous increase in average net farm equities we mentioned earlier, such a tax would almost certainly force immediate sale.

We favor any approach to estate and gift tax reform that can help prevent sales of farms and small businesses to pay taxes. It appears that the increased exemption would be more helpful to most farmers. We urge early action on this important matter.

Thank you for the opportunity to present our views.

Sincerely,

W. D. LAWSON III, *President.*

STATEMENT OF RICHARD P. RECHTER, CHAIRMAN, NATIONAL LIMESTONE INSTITUTE, INC., AND EXECUTIVE VICE-PRESIDENT, RALPH ROGERS AND COMPANY, INC., BLOOMINGTON, IND.

We want to thank the Committee for this opportunity to present the National Limestone Institute's views on the revision of our Estate and Gift Taxes—a matter we feel is of extreme and urgent importance to the small businesses of this country who, for the most part, have a strong desire to preserve the family-owned business for future generations.

For the record, I am Richard P. Rechter, chairman of the board of the National Limestone Institute, and Executive Vice-President and Treasurer of the Ralph Rogers and Company, Inc. of Bloomington, Indiana.

The National Limestone Institute is a trade association representing some 600 members in 34 states. These 600 members operate some 2,000 quarries throughout the United States. Most of the companies in the limestone industry are family-owned enterprises who are well aware of the tremendous burdens of our current estate and gift tax laws.

Historically, the crushed stone industry was started around the turn-of-the-century by contractors looking for aggregate to build county roads and state highways. After the road was completed, the small pit or quarry was abandoned. As the market for aggregates grew, most of the small pits were reactivated by farmers and contractors or other businessmen to furnish the local needs. As of 1974, the Bureau of Mines has on record some 5,431 operations. I have no way of knowing how many of these are small family businesses, as the Bureau does not have that information broken out. But from my experience, during the past ten years of our industry, almost every sale of a quarry has been from a family corporation to a large conglomerate.

It is inconceivable to hear all the furor raised by the Congress over the information they receive of monopolies by large corporations, when it is the Congress' tax policies which force the sale of small businesses to pay estate taxes.

The average quarry sells approximately 400,000 tons of stone annually. With the average price of stone being around $2.00 a ton, this generates gross annual sales of $800,000. The amount of equipment it takes to produce and sell these volumes would cost anywhere from $750,000 to one and a half million dollars. The crushed stone business is not unlike other businesses; we operate on a 5–10 percent after tax profit on sales.

I have been informed by our legal counsel and accountants, that the method of valuation the Internal Revenue Service uses is a weighted book value and multiple of earnings. These multiples run between 10 and 16; and using a little high school arithmetic, I am sure you can see why our industry is forced to sell when the founder or majority stockholder dies.

I ask the committee's indulgence because unlike many of you, I am not an attorney and know very little about tax law. However, I have always wondered if the estate tax is a revenue producing or social tax. By social, I mean a means by which to break up large

concentrations of capital. I do not have the amount of money that this tax brings to the Federal coffers, but I seriously doubt that it has any appreciable effect on the Federal budget. The impact of the tax does have this effect on quarry operations: It destroys a tax paying entity; it can result in unemployment, as many times when a small operator is bought out for competitive reasons that operation is left dormant. And, of course, the only people in the market place with ready cash are the large conglomerates.

This committee currently has before it several proposals which, in various ways, would alter the current laws dealing with Estate and Gift Taxes. We have looked at many of them and find many proposals with which we are in sympathy. However, rather than discussing each of the proposals, we would like to touch briefly on those points which concern us most.

First among our concerns is the existing $60,000 exemption allowed for the estate of each U.S. citizen or resident. The great majority of legislation introduced to deal with estate and gift law recommends that the exemption be increased to $200,000. The $200,000 figure, as we understand it, represents the $60,000 exemption provided for in the 1942 Act plus an inflation factor. Or, put another way, $60,000 in 1942 is worth about $200,000 in 1976. There is, at least in our minds, no question that the exemption ought to be increased to at least $200,000. However, we would like to urge increasing the exemption to $400,000 and tie it to the Consumer Price Index so that another 34 years will not elapse before it is increased again.

My understanding is that Senator Dewey Bartlett of Oklahoma has introduced legislation to raise the exemption to $400,000. Also, we have been informed by the Senator's staff that the estate tax exemption under the 1939 law was $100,000 and that the $400,000 figure is equal in 1976 dollars to $100,000 in 1939. While I fully realize that very few have recommended an increase in the exemption to $400,000, I do hope that the Committee will give our recommendation its full consideration.

I think, Mr. Chairman, it all goes back to what I said earlier. We must ask ourselves the basic question: What are we trying to achieve through estate and gift taxation? Certainly one of the purposes is to raise revenue for the Treasury. But, at the same time, are we trying to make the big grow bigger at the expense of the small? For, if we are, then the current law is a complete success, at least with respect to our industry where, as pointed out earlier, this is definitely happening. I, for one, do not think that is the purpose of the law. Certainly we are not trying to abandon the small businessman for I think we can all agree that there is a sound economic advantage to the country in passing the small business from one generation to another. We have no bone to pick with the large companies, but we must preserve the small business which, from figures we have seen, do about 48 percent of the gross business production in this country. Indeed, 55 percent of the nonagriculture workers in the private sector are employed in the small business sector. In 1953, the Congress formally recognized the importance of small businesses when it declared it to be the policy of the Government to "aide, counsel, assist, and protect . . . the interest of small business concerns in order to preserve free competitive enterprise . . ." Certainly this is still the policy of our Government,

and, if we are to meet the objectives of that policy, we must enact many of the changes we and others are recommending.

Second, Mr. Chairman, we would like to see the Revenue Code broadened to allow the redemption of stock to include any stock held by the testator. In addition, there should be some method for capital retention to accomplish the redemption. As it is now, estate planning is not a legal reason for the building of liquid assets in a corporation.

Third, we must revise existing law to broaden the installment payback provisions so they do not work an unreasonable hardship on small businesses. Here, we are very much in sympathy with the proposal put forth by the Administration which would allow a five-year moratorium on the payment of estate taxes and provide an additional 20 years for full payment. However, we oppose the Administration's $300,000 ceiling. This is extremely important because the current regulations call for full payment, except where undue hardship can be shown, in nine months making outside financing impossible. This provision, if enacted, would go a long way toward easing the burden currently placed on small businesses. We would also like to see the interest rate charged during the payback period made more reasonable. Here again, the Administration's four percent figure is in line with our thinking.

Finally, we would like to see the tax rates lowered. In many cases, they are confiscatory in and of themselves and when combined with state taxes, they are ridiculously high. We are not prepared to quote figures but think that one way of handling this might be by raising the size of the estate to which a given rate is applicable. For example (and this is used only for illustrative purposes and is not a recommendation), an estate of less than $500,000 is taxed at a rate of 32 percent. The size of the estate covered by this bracket could be raised to $1,000,000 which is currently taxed at 37 percent. Also, we think it would be a good idea to tie the size of the estate in each bracket to the Consumer Price Index, thus insulating it against inflation. Another means would be to cut the existing rate for each bracket in half.

Mr. Chairman, that concludes my specific remarks on the revision of the laws dealing with estate and gift taxation. We urge the committee to give careful consideration to what we have said here today. We also urge the committee and the Congress to act expeditiously on this long overdue revision. We think there could be no more fitting recognition of the plight of the small businessman during this Bicentennial Year than the enactment of these revisions.

STATEMENT OF LORAN SCHMIT, CHAIRMAN, COMMITTEE ON AGRICULTURE AND ENVIRONMENT, STATE LEGISLATURE OF NEBRASKA, AND CHAIRMAN, TASK FORCE ON FOOD SUPPLY AND AGRICULTURE, NATIONAL CONFERENCE OF STATE LEGISLATURES

REVISION OF FEDERAL ESTATE TAX LAWS

Mr. Chairman, my name is Loran Schmit, and I serve as Chairman of the Agriculture and Environment Committee of the Nebraska Legislature. I am submitting this statement on behalf of the National Conference of State Legislatures, the official organization representing the Nation's 7,600 State Legislators and their staff.

NCSL has long supported revision of the Federal estate tax laws and has recommended that the present exemption level of $60,000 be increased substantially. However, after further study, we extended our position at a meeting last week to include that:

(1) The present $60,000 exemption be increased to $200,000 for all estates;

(2) The marital deduction for all estates be increased to 50 percent of the adjusted gross estate, plus $100,000; and

(3) Farm property be assessed at its value for current agricultural use, and not at its market value.

While raising the exemption level should have the highest priority when Congress revises the law, the other two provisions are essential for reinforcing the positive effect on small businesses and farms. Changes in this law will have major ramifications, both for the financial stability of those who inherit small estates, and, more importantly, for the fabric of American agriculture itself.

Statistics show that the small farm is disappearing at an alarming rate. Some estimates indicate that the United States will lose between 200,000 and 400,000 farms over the next 20 years. Even the U.S. Department of Agriculture projects that America will have a million fewer farm units by the turn of the century.

One study conducted by the Department of Agriculture indicates that the small farm, managed and operated by 1 to 3 people, is the most efficient unit for agricultural production. This 1968 study points out that efficiency reaches a plateau with the small unit and remains constant through the large-size range. Agriculture is just not subject to the same opportunities for economies of scale that industry is.

Losing these units, then, will have serious repercussions for the productive capacity of American Agriculture. At a time when the world is demanding more food from the American farmer and when agricultural exports are maintaining a healthy balance of trade for this country, loss of these units cannot be tolerated.

The pressures of urban development are also taking their toll on the availability of prime agricultural land. Such urban growth consumes about 2.2 million acres of farmland each year—and 20 percent of all farms in this country are already within metropolitan areas.

It is on the rural-urban fringe, though, where the small farm suffers its greatest demise. The pressures of development force up land values in this margin. Land then takes on a "speculator's value", an artificially high amount. To aggravate the problem, an heir to farm property in this fringe area discovers that the high property value causes his estate taxes to be exorbitant. Unfortunately, a farm's productive capacity does not increase when its market value increases. Therefore, to afford the payments, an heir must sell the land, even if he desires to keep it in agricultural use. The unfortunate result is that more acres of productive agricultural land are surrendered.

In rural areas, this problem is also arising as the pressures for development, particularly from second home and other recreational communities, are increasing. Farm property is especially attractive to a developer because it is nearly flat, is cleared of trees and shrubs, and generally has good drainage.

Another problem in rural areas is the growing influence of agribusiness and corporate landholders which further erode the land available to the smaller farmer. More and more of America's large corporations

are becoming agricultural land owners. Nationally, eight oil companies own almost 65 million acres—13 times the size of New Jersey. And corporations such as Coca-Cola, Standard Oil of California, and RCA are involved in agricultural production.

State legislatures across the country are alarmed about the disappearance of the family farm and the accompanying decrease in the availability of prime agricultural land. Many legislatures are now attempting to rectify these problems. For example, several States are currently proposing changes in their own State estate tax laws. Most are increasing their exemption levels, such as Wyoming. Which has raised its exemption to $60,000 from $10,000. Other States, such as Minnesota and South Dakota, are attempting to equalize deductions for widows and widowers. Wisconsin is also examining the possibility of deferring tax payments on inherited property. And the Minnesota legislature has provided for an alternative tax valuation method. If the estate passing to the surviving spouse is less than $500,000 and if the tax computed on 50% of the estate, without using exemptions, is less than the tax computed with normal exemptions on the entire estate, then the lesser tax can be paid.

Several other States, including Vermont and Massachusetts, have developed state food policies that recommend, among other changes estate tax benefits for farms which are willed to succeeding generation, and remain in active farm production for a certain time period. Vermont is also considering the feasibility of exempting the first $10,000 of net business income (including that of a farm) from taxation. The Massachusetts legislature is also considering a bill to value farm land at its current use for State estate tax purposes.

Other State legislative actions to preserve the family farm include regulations of corporate farming. Nine States (Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, and Wisconsin) have enacted laws in this area. Kansas was the first to do so in 1931, and North Dakota followed shortly thereafter. Kansas law specifies that if a corporation is allowed to farm a specific list of crops, it must have 10 or fewer stockholders, the incorporators must be State residents, stockholders cannot own stock in any other corporation, and that the corporation cannot own or supervise more than 5,000 acres. North Dakota prohibits virtually all corporations from farming.

In addition, the majority of States have laws attempting to preserve prime agricultural land. Most try to accomplish this by alleviating the property tax burden. Three general approaches have been used: preferential assessment, which allows land to be valued at its current use, not at its market value; deferred taxation, which also allows land to be assessed at its current use value, but which provides that if farmland is used for development, unpaid taxes on the value are recaptured; and restrictive agreements, which allow State and local governments to negotiate with a landowner to restrict development in exchange for a tax preference.

At least nine States have preferential assessment laws, although requirements for participation vary with each State. At least seventeen States have deferred taxation laws. And still other States are considering the use of development rights and easements. The California Legislature is also considering a bill to establish an agricultural resources council to have final authority over the State's prime agricultural lands.

Still other legislatures are experimenting with programs to assist the young farmer. In the Minnesota House of Representatives, for example, there is a bill to aid young farmers in obtaining credit to acquire farm real estate. The legislature has recognized the need to encourage the young farmer to remain in agriculture; however, Federal estate tax laws force him to leave.

State actions to preserve the family farm and its accompanying agricultural land will never never result in substantial success, however, while the Federal estate tax imposes such an exorbitant burden on the small farmer and heirs to farm property.

Therefore, NCSL recommends that, first of all, the exemption level be increased to $200,000 for all estates. Studies show that with the current rate of inflation, an exemption of at least $190,000 would be necessary to equal the 1942 purchasing power of the $60,000 exemption. Examples abound of how farmland purchased in 1942 at $50 per acre is now worth $1000 or more per acre. An antiquated exemption of $60,000 is not nearly substantial enough to ease the tax burden on an heir.

Second, the marital deduction for all estates should be increased from the present 50 percent of the adjusted gross income to $100,000 plus the 50 percent rate. Changes in this provision are necessary to recognize the partnership which exists between husband and wife and to alleviate the discrimination against women which currently exists in the estate tax laws.

And third, NCSL recommends that farmland should be assessed at its value for current agricultural use and not at its market value. By including this provision, an heir to farm property located in areas pressured by urban development will not be forced to sell land that he wishes to keep in production. NCSL also supports a provision stipulating that land assessed at its current use value be kept in that use for at least five years prior to and five years following the owner's death. Then, if the land is sold or converted to development, the market value assessment would be invoked. This current use provision could also be extended to include woodlands and scenic open space, as well as agricultural land.

All of the provisions which NCSL recommends are included in S. 1173, a bill sponsored by Senator Carl Curtis (R.-Nebraska), the ranking minority member of the Finance Committee. NCSL recommends your consideration of this bill and its swift passage. The changes which are proposed in this bill would have the following effect on the Federal budget for fiscal year 1977:

(1) Increasing the exemption level to $200,000 will incur a loss of $2.2 billion;

(2) Increasing the marital deduction will cause a loss of only $400 million; and

(3) Valuing farm property at its current use value will cause a loss of $20 million.

In summary, a combined State and Federal effort is needed to maintain the viability of the family farm and to insure that prime agricultural land is preserved for the food production so essential to the American consumer and our foreign customers. The States have realized their role in rectifying the problem, but without these recommended changes in the Federal estate tax laws, State actions will be greatly overwhelmed.

Thank you, Mr. Chairman, for this opportunity to recommend legislation to ease the burden of Federal estate taxes on those who inherit small businesses and farms.

STATEMENT OF WILLIAM PIETZ AND ROBERT BRANDON, PUBLIC CITIZENS TAX REFORM RESEARCH GROUP

ESTATE AND GIFT TAX REFORM

Historically, the initial purpose of the estate and gift tax was to raise Federal revenues. These taxes accounted for 7 percent of budget receipts in 1939, 4.4 percent in 1941 and 2 percent or less in the years since 1942. Estate and gift taxes are projected to bring in $4.6 billion or 1.5 percent in fiscal year 1975 and $7 billion or 1.3 percent of revenues in fiscal year 1981. While their revenue contribution continues to fall, estate and gift taxes do provide needed Federal revenues.

Assuming we are stuck with high taxes we have a choice of whether to shift even greater burdens on to people's work incentives through social security and income taxes * * * or taxing the amount which adults can inherit from their parents.

Given the choices, we should be looking for ways to increase estate and gift tax revenues. At a very minimum, any estate and gift tax reform package should be sufficiently well balanced as to not *reduce* tax revenues.

Advantages of Estate and Gift Taxes

Including social security tax and numerous income tax preferences, our Federal tax system is not very progressive. But according to the Treasury's 1969 studies roughly one-third of the progressivity that does exist is the result of the estate and gift taxes—taxes that are collected exclusively from families with annual incomes well over $20,000.

The estate tax is a relatively simple tax which can even handedly tax much of the property which escapes taxation under the income tax due to all the income tax preferences which have been enacted year after year.

Large inheritances may often dull the beneficiaries' productive incentive. Estate taxes also have the beneficial side effect of providing that people in each new generation are more equal at the start of the race to acquire possessions. Finally, as a source of tax revenues estate and gift taxes interfere least in the behavior patterns of individuals. And their impact on those receiving gifts and bequests seems to be most fair.

One person trying to beat the cost of living works hard to earn $60,000. He pays a substantial tax on that income and supports himself and perhaps a family on what's left. His neighbor is left a $60,000 bequest but pays no taxes at all on that income. Both individuals have to pay the same bills for food, clothing, a mortgage, health care and other expenses, but the person receiving the windfall gift or bequest pays with non-taxed dollars and his working neighbor makes due with what's left after taxes. In view of the foregoing, the estate and gift tax seems to be our "least bad" tax. Any attempt at reducing estate

taxes as a source of Federal revenues would seem unfortunate. And reducing their effect on estates generally is unneeded.

Who Pays the Estate Tax?

Contrary to generally held beliefs about death taxes, a very small number of very wealthy estates pay them, 60 percent of estate and gift tax revenues come from the wealthiest two-tenths of 1 percent of all decedents. (In the income tax, 60 percent of revenue comes from the top 20 percent of all taxpayers.)

Estate tax revenues in fact, equal only 5 percent of the total dollar value of all death transfers. Based on 1973 figures, less than 9 percent of decedents (173,000 people) were required to file returns. Of these, only 121,000 or a little over 7 percent paid any estate taxes at all. Today, when we talk of paying estate taxes we are still speaking of less than 10 percent of all the estates in the country. Any general liberalization of the present estate tax will therefore provide tax relief to the wealthiest 10 percent of all estates.

If this committee desires to further reduce Federal revenues, perhaps the 90 percent of our taxpayers who struggle during their lives to make ends meet and can leave no taxable savings at all are better targets for tax relief.

Distribution of Wealth

Even as a tax on the very wealthy, estate taxes have had little impact on wealth distribution.

In 1973, there were an estimated 200,000 U.S. millionaires. This may be more a tribute to the productiveness of our economic system than to the individuals themselves, for an extensive Federal Reserve System survey in 1966 reported that 59 percent of those with annual incomes of $100,000 or more inherited "a substantial portion of their wealth." The same survey found that the wealthiest 5 percent of consumer units owned 53 percent of all private wealth and 86 percent of all publicly traded stock. It was estimated in 1973 that there were more than 1,000 individuals with a net worth in excess of $50 million, including a number of "billionaire" families.

Low Effective Rates

In contrast to moves to lower estate taxes, the tax could be more progressive without hardship. Analysis of the Treasury's 1969 and 1973 *Estate Tax Returns* show millionaire estates paying federal estate taxes amounting to roughly 21 percent of their net estate (about 25 percent when state and foreign death taxes and others are included). The vast accumulations in the $10 million and above category, averaging $25.2 million, paid even less, 17 percent of net estate (nearly 21 percent including state, foreign, and other taxes). The Treasury's 1969 *Tax Reform Studies and Proposals* show effective tax rates on total transfers during both life and at death, for the $5 million and above category, to be 22.2 percent for married descendants and 39.7 for nonmarried.

The Present Rate Structure

Even though the tax is by its nature progressive, the rates need tightening. The person who happens to be the sole-beneficiary of a $1 million estate will pay a tax of $270,000 or 27 percent and, of course, for smaller estates the rates start out at only 3 percent. By contrast workers start out with an income tax rate of 14 percent plus payroll

taxes of about 6 percent and the rate reaches 50 percent when taxable income reaches $50,000.

The existing *marginal* estate tax rate climbs reasonably quickly from 3 percent on $5,000 taxable estates to 25 percent on $50,000 but it then climbs too slowly reaching only 38 percent on $1 million, not reaching 50 percent until $2,500,000 or 77 percent until $10 million. Even if you alleviate the effect of telescoping the bequest into a single year by applying the 5-year income averaging available on the income tax receiving a bequest is still a far easier way to meet the cost of living than is working (e.g., if a $1,000,000 estate—which now pays a marginal rate of 38 percent—were divided by 5, it would yield $200,000 which is taxed at 70 percent under the income tax).

The Estate Tax Exemption

The fact that the exemption has scarcely been looked at since 1942—or since 1916 when it was $50,000 (ignoring the 1948 marital deduction enactment which enlarges the exemption)—hardly justifies any increase now. From 1916–1970 the income tax at almost every level jumped at least tenfold and since 1938 the social security tax has gone from 1 percent to 5.8 percent. Since 1927 federal government expenditures have gone from about $25 per capita to far above $1,000 today. The simple truth is that our other taxes were upgraded during and after World War II to parallel the growth of government while estate taxes have been ignored.

A Credit in Lieu of the Exemption

Roughly 90 percent of all estates are already protected by the $60,-000 exemption. Any increase in it benefits relatively large estates. And given the progressive tax rates, any exemption increases gives the greatest relief to the wealthiest estates.

Today the estate tax raises less than $5 billion. According to Treasury estimates furnished to the Congressional research service proposed exemption increases will significantly cut down that revenue. Changing the exemption to a credit however, would keep the same number of estates off the tax rolls at a considerable savings in revenues. (See Table I)

Of the $4.1 billion 1973 estate tax revenues only about $75 million came from gross estates under $120,000 and $400 million came from gross estates under $200,000. This suggests that a vanishing exemption which phases out entirely in upper brackets (say $1 million) is a very inexpensive alternative to straight exemption increases.

ESTIMATED REVENUE COST OF INCREASED EXEMPTION LEVELS, AND OF SUBSTITUTING TAX CREDITS ACHIEVING SAME TAX-FREE NET ESTATE

Tax-free net estate achieved through direct exemption	Change in tax revenue from present law (billions)	Tax credit required to achieve same tax-free net estate	Change in tax revenue from present law (millions)
$60,000 (present law)	0	$9,500	+$740
$100,000 exemption	−$1.0	20,700	+90
$114,333 exemption	−1.2	25,000	−400
$131,000 exemption	−1.4	30,000	−700
$150,000 exemption	−1.7	35,700	NA
$163,333 exemption	−1.8	40,000	−940
$197,667 exemption	−2.2	50,000	−1,320
$200,000 exemption	−2.2	50,700	NA

Source: U.S. Treasury Department and Congressional Research Service.

Integration of Estate and Gift Taxes

Under present law estates and gifts are taxed under two separate but similar progressive tax rates. The gift tax rates are three-fourths of the estate tax rates. The two progressive rate structures allow those with great wealth to split their wealth by giving away half of it during their life and leaving half at death. Taxing each half at the lower ends of each tax rate provides significant tax savings. And the greater the wealth that is split, the greater the tax savings. For instance, total gift and estate taxes on taxable transfers of $1 million split evenly between a gift and a bequest would be $247,000 as contrasted to $325,700 were the entire transfer made by bequest—a savings of $78,645. Splitting $10 million produces a tax savings of $1,768,850.

The gift and estate taxes should be combined or integrated and the rate on gifts should be equalized with the rate on estates. Total transfers of wealth would be taxed at one tax rate whether given away during life or at death. There is no justification for setting a lower rate on gifts to stimulate lifetime transfers or for allowing decedents whose large gifts once placed them in a high gift tax bracket to start all over again in the very lowest brackets in computing estate taxes. As noted below, the present rate differential has not stimulated much gift-giving (especially when compared with what would perhaps occur anyway.) Gift tax revenues approximate only 10 percent of the estate tax revenues.

Lower rates only subsidize the knowledgeable few who can afford to part with property. This minority's effective tax rate tends to approximate 55 percent–60 percent of comparable persons who hang on until death. Gifts don't promote broader distribution of wealth since they rarely occur outside the family unit and claims that they place capital in younger and more vigorous (and less experienced) hands are baseless widowdressing—especially since gifts of trust interests and non-controlling business interests are common. Integration should make unnecessary the present litigation-spawning rules on gifts in contemplation of death.

By integrating the two taxes, the cash spent to pay the tax on lifetime transfers would be added back into the estate ("gross-up"). This will eliminate the existing abuse whereby a gift (even a death bed gift) of say, $5,000,000 by one in the 77 percent estate tax bracket will yield a tax saving of $1,300,000. Such a gift two months prior to death reportedly saved Mr. I. DuPont $16,000,000 in taxes on his $176,000,000 estate. The absence of "gross-up" confers progressively higher percentage benefits as the taxpayer's bracket increases.

Past gifts made prior to the effective date of integration should count in determining what bracket is available. This in effect simply amounts to a question of what rate will apply to transfers made tomorrow. Tax rates frequently change over the years and no one will have been harmed by justifiable reliance that rates will never change. Integration was first proposed by the Truman administration. Unless this is done, integration could cause revenue losses in the short run. In the long run it could raise gift and estate revenues by 5 percent to 10 percent.

Integration and the Exemptions

Given the present dual system, the exemption is actually too large. Thanks to the annual *gift* exclusion of $3,000 per donee ($6,000 for

couples) and lifetime *gift* exclusion of $30,000 ($60,000 for couples) a couple can transfer $540,000 free of *any* transfer tax to 3 children over a 30-year period.

But this exemption operates unfairly since it is used only by a few of the wealthiest and most knowledgeable taxpayers. Based on a 1957–59 sample 52 percent of decedents wth estates over $1,000,000 had made lifetime gifts but only 10 percent of those with estates under $300,000 had done so.

If there is to be any increase in the estate tax exemption it should be offset by repeal of the lifetime gift tax exemption. This would naturally result from unification of estate and gift taxes. Moreover, the $3,000 per donee yearly exemption was intended to cover casual Christmas and anniversary presents etc., and therefore should not be available for gifts of stock, trust interest or partnership interests which smack of estate planning, not casual generosity.

Generation Skipping Trusts

Vast amounts of wealth can escape taxation by transfers in generation skipping trusts. Wealthy individuals use the trust to skip the tax on all or part of the estate upon the deaths of the surviving spouse, the children, and, in extreme cases even the grandchildren. Through these trusts, the estate tax can miss two generations while the spouse and children enjoy most of the benefits of the estate while they're alive. Generation skipping trusts are utilized primarily by the very largest estates further reducing the progressivity of the estate tax.

Estate tax returns filed during the 1957–1959 period show that in estates of over $1,000,000, 25 percent of assets were transferred in generation-skipping form (19 percent in trust and 6 percent outright), but that only 9 percent of the assets in estates of less than $300,000 were transferred in that form. In the over $1,000,000 group, about 80 percent of all assets involved in trust arrangements were transferred on a generation-skipping basis. Of the decedents who had estates of over $2,000,000 and who used trusts, only 25 percent used trusts that were not in generation-skipping form; 77 percent of the decedents with estates of less than $500,000 did not use such trusts.

Generation-skipping transfers (whether or not in trust) should be taxed to produce enough tax equivalency to other transfers. In this regard, we support the 1969 Treasury proposals or any other mechanism achieving the same goal. The complexity of doing so is sizeable but not materially worse than the existing complexity of ingenious generation skipping transfers taking into account discretionary trusts, power of appointment, the rule against perpetuities, etc. Taxpayers don't complain about *this* complexity because it can frequently be availed of to avoid estate taxes for close to a century (usually the life span of the last surviving grandchild or great grandchild plus 21 years). By some estimates this might increase estate tax revenues by 10 percent or more in the long-run.

Capital Gains at Death

Presently, appreciation of capital assets are taxed at capital gains rates when sold. But if these same assets are transferred by gift or bequest that capital gain escapes taxation forever. If the heir or donee

sells that property, that appreciation still completely escapes income taxation and only appreciation after the transfer is taxed.

This is the most glaring weakness in our present tax structure today. It provides enormous tax advantage for the very wealthy who can afford to hold on to property holdings and stock portfolios until they die or give them away to their children before death. Enough has been written on the subject but it is time the Congress came to grips with this glaring tax inequity. It is perfectly possible to reform this area while addressing the specific problems surrounding certain family held assets such as primary residences, and small farms or businesses. Our concern for these assets should not deter solutions to the overall problem—a tax problem that dwarfs most others in magnitude.

The Treasury has estimated that in some recent years 40 percent to 50 percent of estate values has been untaxed capital gain. By this analysis, $15–20 billion of gain went untaxed annually. Failure to apply a capital gains tax at death cost about $1.5 billion in 1975, and will cost over $7 billion in fiscal year 1977. This largely accrues to the benefit of a very narrow group. Analysis of Treasury data for 1973 shows that 5.1 percent of taxpayers received 84 percent of all realized capital gains. Probably a smaller number pass on unrealized gains at death.

Long Overdue Reform

Not taxing gains at death obviously produces an undesirable "lock-in" effect since taxpayers hold their assets until death instead of releasing the funds for possibly more productive uses which might pay a higher pre-tax market return. Those who can afford to hold their assets are better off than less wealthy individuals who must periodically sell assets to raise cash or those who must build their estate through salary income.

While some capital gains are attributable to inflation, some capital assets such as real estate have appreciated faster than the consumer price index which means that the owners' purchasing power has increased. Also, owners forced to pay a deferred tax on capital gains would still be in a better position than people who pay taxes annually on interest on fixed income debt securities, and they pay at one half the ordinary rates. No adjustment is made in their tax bill for the inflation-induced loss of purchasing power represented in their interest returns. Moreover, the purchase of many capital assets is financed by debt. Paying off such debt later in cheaper dollars produces an inflation-induced profit, which, of course, goes untaxed. Ignoring inflation in all other areas of the code in order to avoid intolerable complexity, while overcompensating for it in this area produces an unjustifiable distortion.

Relief For Certain Family Assets

Proposals to tax capital gains at death such as the 1969 Treasury proposal, contain an unlimited marital deduction, an orphan child exemption, a specific exemption of $60,000, exclusions for life insurance and household effects, 10 year averaging provisions and extension of time for making payments. These seem reasonable. The $60,000 would protect any good sized family residence from the tax. Farmers and

small business owners could be protected from any hardships by utilizing the special valuation methods discussed below.

In our concern for small family estates we should not lose sight of the fact that these estates are not really small. They are only small compared to very large estates. But compared with the 90 percent of U.S. adults who leave no taxable estates at all, the recipients of these bequests are very well off.

Now, as a policy matter, Congress would not want to see families forced to sell the family home or business just to pay the tax owed. But concern over illiquidity is a separate issue and should not obscure the fact that by far the largest item of appreciation in U.S. estates is marketable securities.

Taxable estate tax returns filed during 1966 reported gross assets of $18.8 billion composed of the following:

Table II

	In billions of dollars
Real estate:	
Primary residence	$0.7
Other	2.7
Bonds	1.4
Corporate stock:	
Traded	6.7
Closed corporation	.9
Unspecified	1.0
Cash	2.1
Notes and mortgages	.6
Life insurance	.8
Annuities	.1
Trust and remainder interests	1.3
Noncorporate business assets	.5
Household goods and other	.3

At least $14 billion of the above involve no liquidity problem.

The Unlimited Charitable Deduction

The case of Mrs. Ailsa Mellon Bruce who died in 1969 and paid a tax of under 1 percent on her $570 million estate because she left her estate to the Mellon Foundation, is disturbing. So is the fact that in 1966 five large estates left a total of $200 million to charity while paying only $8 million in taxes. A case can be made for retaining the unlimited charitable deduction for gifts made to public charities. However, private foundations sometimes perpetuate private control of wealth while making legitimate charitable distributions only reluctantly. The Treasury will give up 77 cents on the dollar, but that money often will be paid out to charities at no more than the prescribed 6 percent rate.

In recognition of the undesirability of placing too many inflexible operating restrictions on foundations, our income tax laws simply place a lower ceiling on the charitable deduction for gifts to private foundations as distinct from public charities. By analogy, deductions for contributions to private foundations should be limited to at least 50 percent of the adjusted gross estate less the marital deduction.

The deduction creates other inequities. As it currently exists, the tax benefits from the charitable deduction are more a function of the decedent's wealth than of his generosity. If the $25 million estate donates $250,000 or 1 percent, the tax-savings can amount to as much

as $192,500 (77¢ on the dollar), while the decedent with $1 million who gives 25 percent—again $250,000—can reduce his taxes a minimum of $92,500 (about 37¢ on the dollar). And estates in the bottom tax bracket, no matter what their generosity, are reimbursed only three cents on the dollar.

Conceptually, substituting a credit for the deduction will make the tax more progressive and treat all gifts even-handedly without impairing gift-giving incentives.

The Marital Deduction

As part of an overall estate and gift tax reform package, we would support a full (100 percent) marital deduction in recognition of the joint and unseverable contributions made by spouses in building an estate. This would alleviate the special problem faced by farm wives and is a logical exception to the proposed income tax on capital gains at death. However, the cost of a full estate tax deduction might approximate 15 percent to 18 percent of the total estate tax revenues in the short run and half of this in the long run. (As surviving spouses eventually die with larger estates.) Even setting the ceiling at $100,000 plus 50 percent of the remainder might approximate $500 million in lost revenues. A ceiling would however, minimize the estate tax relief that would be accorded those with great accumulated wealth who marry very young spouses in their later years.

The present 50 percent marital deduction provides rate splitting benefits under the graduated tax structure. If the spouse who owns most of the family's property happens to die first, half of that property will be taxed immediately and the other half will be taxed when the surviving spouse later dies and passes it on. Each half will fall into lower brackets than the entire estate would if it were taxed all at once.

But if the impecunious spouse happens to die first then the entire estate *will* be taxed all at once when the property-owning spouse later dies. No rate splitting applies so the tax is accidentally higher. Community property couples have an advantage because they automatically own only half. If the wealthy spouse in a non-community property estate tries to give half his property to the other spouse before death he must pay a gift tax on half the property transferred (the gift tax marital deduction is limited to one half of the gift).

The complete estate and gift marital deduction recommended by ALI and by the Treasury in 1969 permits all couples to do exactly what community property couples are able to do. Before death, they can transfer half of their property into the husband's name and half into the wife's name. Thus, each spouse can leave his or her property directly to the children and thus be assured of rate splitting. Or a husband, for example, may wish to transfer all of his property tax-free to his wife at death. This would be advisable where the wife needs the property for support and may consume some of it. Otherwise the tax at death will be relatively large due to the absence of rate splitting.

Credit For State Death Taxes

We should repeal the credit for death taxes paid to the states. Even under present law there is no comparable credit for gift taxes. The death tax credit was enacted during the 1920's so that states would not

compete to attract wealthy residents but its effect is now limited because the amount is limited to 80 percent of the relatively low federal rates in effect in 1926.

The credit is zero for taxable estates under $40,000, only 1.6 percent ($400) for a taxable estate of $140,000 but a surprising 16 percent ($1,082,000) for a $10 million estate.

What About Family Farms and Businesses?

The exemption should not be increased for all taxpayers just to assist small businesses or farms. As a matter of perspective, for example, 1966 IRS data showed that total returns filed showed gross assets of $18.8 billion. Untraded closed corporation stock totalled not more than $1.9 billion, non-corporate business assets totalled $.5 billion and "all real estate other than primary residence" totalled $2.7 billion and by no means all of this was farm real estate.

Section 6166 Installment Payments

Section 6166 presently provides for 10 year installment payments of estate taxes in hardship cases. However, this provision is almost never used because the executor who is empowered to request relief under this section is made personally liable for the ten year installments. According to one IRS district officer in Omaha only about five percent of farm estates ever request relief under section 6166 and the IRS almost routinely grants the relief except for obvious cases of fraud. The liability for section 6166 installment payments should attach to the estate assets a lien. This one reform would do much to alleviate the estate tax burden of the small family estate.

Insurance

In addition, every commercial attorney knows that much of the estate tax burden of small businesses and farms can be alleviated by using life insurance proceeds to pay the tax. Insurance can easily be arranged so that the proceeds are not taxable as part of the decedent's estate. And as a matter of political realism this committee is unlikely to change this generous treatment.

Even with this help, many farmers and some small business owners are treated unfairly by the estate tax. But their problem is one of *valuation*. That problem should be dealt with narrowly rather than by an across the board exemption hike.

Small Business Estates

A small business owner often has good reason to fear the absence of any uniform standard in the code or regulations by which his business will be valued. Reviews of the hundreds of litigated cases show:

(1) The IRS almost always selects whatever valuation method produces the highest figure.

(2) Taxpayers often fare poorly due to poor preparation and inadequate appraisals.

(3) Courts frequently "split the difference" in very unscientific compromises.

The anguish occasioned by this will not be solved by increasing the exemption—especially since the huge cost (a $150,000 exemption would cost an additional $1.7 billion) makes it likely that a very large increase will not be affordable.

A small closely held business is usually valued at a multiple of less than 10 times its annual after tax cash flow by would-be buyers. Assume the tax is from 3 percent to 77 percent of this value. By definition permitting 10-year installment payments should enable the heir to pay off the tax from the business cash flow without selling the business.

We believe—as a few legal practitioners have testified before this committee in prior years—that businesses are seldom sold for any reason other than the unwillingness or inability of heirs to carry on. But the committee may be justified in considering a limit on the multiple at which the IRS can capitalize earnings for estate valuation and technical adjustments in sections 6166 and 303 to assure their availability to family businesses.

Family Farms and the Estate Tax

We believe the farm problem is a more severe one because farms are land intensive. U.S. farm real estate values have been soaring. They increased 25 percent in 1973 and 14 percent in 1974. Clearly, the fair market value of land if sold to a developer exceeds its farm use value. According to USDA surveys, the average value of all farmland in the U.S. reached $370 per acre by March 1975 but land transferred to industrial uses brought $1,872 per acre, subdivision land brought $1,574 and land converted to rural residential brought $974. (In 1975 average farmland value per acre varied greatly geographically, e.g., $2,500 in New Jersey, $600 in New York, $300 in Kansas, $240 in Texas). Taxing this inflated paper value can create a problem, especially since farm estates are illiquid. Almost 80 percent of farm estate assets are in land and machinery compared with an average of 20 percent for all U.S. estates.

The Problem in Perspective

But the problem should be kept in perspective. The transfer of land out of farming which exceeded a rate of 100,000 farms per year until the late 1960's has steadily declined and equalled only 26,000 farms in 1973 and a majority of these sales were probably made for reasons other than estate taxes. USDA economist Fred Woods concluded in 1974 that estate taxes are "not yet a serious problem for most types of farms." And the number of acres planted in the U.S. (1,060,000,000) was actually the same in 1970 as it was in 1940 which may suggest a transfer of land to more efficient larger farms. Moreover the USDA "Balance Sheet of the Farming Sector 1975" states: "Sale of land going into nonfarm use is not a major factor in setting the price of land except in isolated instances. Most land transferred in 1974 was purchased for farming purposes and was expected to be paid for with farm income."

The Illiquidity Problem

Nonetheless estate taxes can sometimes operate unfairly and prompt the sale of family farms. According to the USDA the nationwide average of production assets per farm was an estimated $160,000 on January 1, 1975, and the average farm contained 370 acres. The average return on the market value of equity in farm production assets was only 5.8 percent in 1974. From 1969 through 1971 it was below 3.5 percent although in 1973 it was 10 percent.

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The USDA publication Farm Costs and Returns (1968) lists "representative" figures for "viable" *one-man* farm units. The following is a random sample: A 40-cow New York dairy farm had 250 acres and total equity of $81,000 in 1968 and earned $12,100; a 60-cow Wisconsin dairy farm had 210 acres, $111,000 equity and earned $13,000; a New Jersey egg farm had 10 acres and $52,000 equity and earned $4,600; a Georgian broiler farm had 65 acres and $26,000 equity and earned $1,700; a corn belt hog and beef farm had 292 acres and $175,000 equity and earned $12,000; a corn belt grain farm had 324 acres and $227,000 equity and earned $11,000; a Mississippi cotton farm had 1,000 acres and $440,000 equity and earned $38 000; a southwest cattle farm had 11,690 acres and $220,000 equity and earned $7,300.

The above earnings were before income taxes and mortgage debt payments, if any, and, of course, the equity values would be much higher by 1975.

Substantial technical advances in machinery (principally an increase in the number of rows which one tractor can plant) has recently increased the desirable size of one-man farms. Technically optimum one-man farms can vary from 1,900 acres for a Montana wheat-barley farm (land value $245,000 in 1973) to 200 acres for a California vegetable farm (1973 land value $400,000). The actual average size for most types of farms is still below the optimum. According to the USDA expansion has led to "a substantial increase in debt to asset ratios." The debt has been collateralized by increased land values.

These and numerous other USDA statistics suggest that some farmers especially those with existing mortgages, or those in areas close to urban development are reaping small cash flows even though they are land-rich.

The chart on the following page is a 1973 statistical profile of farms and potential estate tax liability.

TABLE III

Gross sales [1]	1973 number of farms in United States	Percent of total farms in United States	1973 average net equity	Maximum possible estate tax	Average estate tax paid
Under $2,500	707,000	25	$44,000		
$2,500 to $5,000	494,000	17	61,000		
$5,000 to $10,000	246,000	9	79,000	$1,600	$480
$10,000 to $20,000	325,000	12	117,000	8,750	4,500
$20,000 to $40,000	588,000	21	177,000	25,000	11,050
$40,000 to $100,000	355,000	12	281,000	57,000	23,930
Over $100,000	115,000	4	685,000	189,450	116,180
Total	2,830,000	100			

[1] Net income before income taxes and debt payments frequently is from 20 to 40 percent of gross sales.

Pinpointing the Solution

The key to any solution to the farm problem is to tie estate valuation to the potential earnings which the heir will have available to pay the tax. An estate tax based on the value of the farm as a farm would be the answer.

But as the USDA has warned, many such proposed solutions are very dangerous. They are likely to prompt the wealthy to invest their

estates in farm real estate to avoid estate taxes. This will further inflate land costs creating entry barriers for the legitimate farmer and exacerbating the existing valuation problem. This is the principal defect of the several bills which would value farms at their farm-use value instead of fair market value provided the heir keep the land in farming for, say, 5 years. Even if the land had to remain in cultivation for 50 years, farm land would still be an irresistible tax haven for the wealthy who wish to transfer enormous appreciaton to their grandchildren free of tax. It would be just as attractive as a generation-skipping trust. Any such opportunity for estate tax shelters would be just as damaging to legitimate farmers as present income tax shelters.

Relief for Farms Is a Land Use Decision

By allowing a lower valuation Congress would be departing from the traditional view of both economist and business planners that land should be dedicated to its highest and best use. This would be a conscious decision to adopt a form of land-use planning designed to preserve farms. Many states and localities have already begun moving in this direction. Some allow farm use valuation to be used for property tax purposes. However, this had led to speculative land purchases by wealthy outsiders which hurt the farmer. To avoid this problem some localities have been allowing farmers to sell their development rights to the local government or to transfer their development rights to the local government in exchange for lower property tax valuations. Speculators unwilling to part with their development rights don't get the favorable treatment.

The federal government could adopt the same concept in the estate tax. The family desiring to continue farming could pay an estate tax based on land use value (to be determined by rental value as in S. 6166) and could transfer its development rights to the Treasury in satisfaction of the portion of the tax which would otherwise be due on the value of the development rights. Estates would only qualify if as under S. 6166 the farm was a major portion of the estate. A lien for the amount of the tax forgiven would run with the land. If the heir ever decided to abandon farming they or the purchaser would have to pay the lien by paying the amount of the estate tax forgiven plus fair market interest. The interest would run for, say, at least 10 years but stop in the future to avoid compounded interest problems. Despite the conveyance of the development rights the family could retain the right to sell off small parcels from time to time. This would mean heirs that chose to be "farm poor" would pay much lower estate taxes, if any, but if they choose to become more well off by selling their farms for development they can afford the additional tax.

Relief for Families Who Keep Their Farms

This would mean that farm heirs would not have to pay a steep estate tax at all so long as they remained in farming. This is more generous than proposals such as President Ford's to make them pay the tax but only over an extended period. Yet it shouldn't entice too many non-farmers into land speculation—as a complete forgiveness of the tax or increased farm exemption would.

Under present law a farmer could, in fact, deed his land development rights to a charitable or conservation organization. Since this would yield a charitable deduction equal to the development rights the estate tax would in effect be based on the farm use value of his land. But, of course, his heir couldn't ever get the development rights back. The foregoing proposal would remove this drawback.

Conclusion

Estate and gift taxes are our most neglected taxes. Since World War II we have significantly broadened the base of the income tax and the payroll tax. While federal revenues continue to fall below anticipated outlays, this committee should be looking for ways of broadening the federal tax base. Estate and gift taxes—our most progressive and least distorting taxes—are prime candidates for additional revenues. The structural changes we have outlined will move in that direction. Special hardship problems in the estate tax area should be dealt with specially and not used as a peg for wholesale reductions of the estate taxes of the nation's wealthiest 10 percent.

In estate tax relief, as elsewhere, there is no free lunch. To avoid larger deficiets, any revenues lost by granting relief to those who inherit wealth will have to be made up by increased taxes on working individuals or going business concerns. Given the choice, this committee should opt for taxing inherited income over added taxes on earned income.

Statement of Alric C. T. Pottberg on Estate and Gift Taxation

SUMMARY

Alric Pottberg, a Florida rancher in a fast-growing area, has seen the effect of the present estate tax on family farmers and ranchers, the loss of open areas, the loss of flora and fauna, and the reduction of Florida's most important natural resource—water. A continuation of the present estate tax endangers these natural resources, and removes an asset important in maintaining the present quality of air at a time when industrial progress is causing the dumping of great amounts of pollution into the air. The present law results in injury to society by forcing out of existance agricultural open-space units that produce food abundantly at low prices. The Public generally will gain from a change in the estate tax law so that agricultural land will be assessed at its value for agricultural use. The farm-ranch family will then be able to keep the land in open-space agriculture.

INTRODUCTION

I am Alric C. T. Pottberg, president of Pottberg Ranches, an agricultural family corporation, owning land in Florida in a fast-growth area. As a cattleman, I am dedicated to preservation of agricultural units. I am known as one who is in favor of preservation of natural resources and the natural environment. I am a member of the Florida Agricultural Tax Council, Florida Agricultural Water Council, Ecology and Environment Committee of the Florida Cattlemen's

Association, and Sierra Club (Florida Chapter). These groups have encouraged me to speak in favor of changing the estate tax law to enable farmers and ranchers to maintain agricultural units, to the benefit of the public. I have resolutions and endorsements from the following Florida organizations: Florida Agricultural Water Council, Florida Chapter Sierra Club, Florida Citrus Mutual, Florida Agricultural Tax Council, and Florida Cattlemen's Association. Copies of these resolutions and endorsements are attached hereto as Exhibits 1, 2, and 3.

I

FARMERS, RANCHERS AND OWNERS OF OPEN SPACES GENERALLY ARE INJURED BY REASON OF THE PRESENT ESTATE TAX LAW AND THE REGULATIONS AND POLICIES OF THE INTERNAL REVENUE SERVICE BASED UPON THOSE LAWS

The problem is that many of today's farmers and ranchers cannot pay estate taxes based upon values determined on the so-called highest and best use. Farmers and ranchers make a limited amount of money from farming or ranching and because of that these farmers and ranchers do not have the opportunity from their income to amass large sums of money with which they would have cash on hand to pay huge estate taxes. If they had been using the land intensively, their income would be greater by large proportions. They would then have accumulated sums sufficient to pay estate taxes based upon valuations of land at intensified uses from profits. They could do that and still keep the land, but only if they had made an intensified use of it.

A man who had contacted the Internal Revenue Service in my area, was told that they considered all land in our County to have residential potential although there are presently no large towns in the County. The policy of the Internal Revenue Service is that without regard to the fact that the property has been used for agricultural purposes for decades, the land will be appraised, under the present law, at such a high nonagricultural, development or speculative rate that the farmer will need to sell the property simply to pay taxes upon it.

I have a friend, Joe Barthle, who had to sell about a third of his ranch in order to pay estate taxes. The land was not really ready for higher use or intensified development; but because of the valuation of it by the Internal Revenue Service, there was no way that he could have paid the estate taxes other than by selling the land to a speculator. The only person who is in a position to pay the higher price for the land is a speculator who either will instantly develop the property into communities such as we have in Florida in many places, or will hold the property for some period of time and then develop it. Bedroom communities spring up fast in Florida.

I have another friend: Jim Williams. He lives on the land. For as long as I can remember, Jim has farmed at least a forty-acre patch. He wants to continue to do that. He typifies the feeling farmers and ranchers have about the land. He is 78 years of age now and a little bent; but when the weather permits and the land needs it, he works that 40 acres. His wife suggested recently that he stop, retire. Jim answered, she told me: "If I didn't have the land to farm, what would I do? Lie down and die?" Farmers and ranchers never *want* to give up their land. His feelings typify the feelings of most ranchers

and farmers who are tied closely to the land, and want to keep it intact for farming or ranching purposes and have it available for their families' children and grandchildren in the future.

The estate taxes are injuring farmers' and ranchers' families, by requiring them to give up the land to pay the taxes. For a Jim Williams, if he is forced to give up the land, there is nothing else for him because that is the central point in his life and that is what kept him going day after day even at the age of 78.

The State of Florida is an example of what can happen in a fast-growing area. It is an indication of what is ahead for other parts of our Nation. As indicated by a recent publication, a copy of which is attached as Exhibit 4, Florida's population increased from 4,951,560 to 8,517,100 between the years 1960 and 1975, and 75 percent of the State's population is located on 27.6 percent of the land. Land used for agricultural purposes in Florida, if purchased for agricultural use may not receive favorable Green Belt local tax treatment where the purchase price exceeds three times the agricultural assessment on the property, as shown by a copy of the newspaper article attached and made a part hereof as Exhibit 5. This fact has precluded one county in Florida from allowing future agricultural owners the ability to obtain favorable local tax treatment. The present estate tax causes many agricultural families not to be able to continue with their agricultural unit because of the high estate taxes. The State of Florida has recognized the importance of preserving agricultural lands and the need for future estate tax reform, as disclosed by a copy of the State Comprehensive Plan attached hereto as Exhibit 6.

II

WATER IS FLORIDA'S MOST VALUABLE NATURAL RESOURCE, IT IS BEING DEPLETED BY URBANIZATION

Florida's most valuable resource is water. Without water Florida could not continue to exist and grow. It is one of the nation's fastest growing states. I live in an area commonly referred to as Tampa Bay Area of Florida, encompassing Pinellas, Pasco, Hillsborough, Manatee and Sarasota Counties. These areas are having water problems due to growth at a rate so great that existing facilities have difficulty keeping up with day to day needs. Water shortages exist. The underground salt water, however, steadily marches inland. Actions have had to be taken by local communities to limit the use of water.

Water is important to everyone; to agriculture, to industry, to the public. In order to assure communities of continued water resources, large areas of land must be maintained in open spaces. Most of these large areas of open space lands are owned by farmers, ranchers, and others dedicated to their preservation as undeveloped open space.

When cities need water supplies, near the Gulf Coast of Florida initially they put down wells which pump fresh water. As time goes by and as needs increase, more and more water is pumped up and it is done, the level of the fresh water, or "head" is decreased and salt water from the ocean intrudes. Salt water intrusion is one of the biggest problems that Florida coastal properties face today. Communities are

having to reach out with long pipelines to areas where water can be obtained. Salt water intrusion increases in intensity in Florida each year. Salt in the water in Florida and other places is a risk of health to the communities, particularly for citizens suffering from heart trouble. Our own family agricultural unit has been contacted concerning the supply of water to communities where their own water supplies have been the subject of salt water intrusion. This is a growing problem in Florida which most probably will hit other coastal areas in other states, in the future.

The maintaining of large areas of land as open space, for agricultural use, can help the situation. It is hoped that water taken from these large land areas and used in the cities eventually will be subject to processing which will allow it to be sent back to the open areas for recharge purposes. But if these open areas are not maintained, and are used for intensive purposes, or developed, then there is no source for water for these communities. The processing of salt water into fresh water is too expensive to be practical, unless we want to lower our living standards to achieve it.

Communities have temporarily solved their problem by constructing well fields. In Hillsborough County the Eldridge Wilde Well Fields "cone of depression" extended outward more than eight miles, as shown in the attached copy of an article, marked Exhibit 7, from the Tampa Tribune dated August 5, 1973.

Six areas in the Tampa Bay area have salt water intrusion problems, as shown by the copy of an article from the Pasco Press attached hereto as Exhibit 8 in which it is noted that the City of New Port Richey closed several wells when five of nine wells contained chloride in excess of public health standards. Rivers such as the Pithlachascotee which runs for several miles through our ranches suffer by reason of salt water movement upstream and sinking into the diminished ground water table. Virtually all of the peninsular and downtown Tampa area have been engulfed in a zone of encroachment slowly inching northward and inland.

The problems in Florida forecast the problems that will come in some other areas as there is continued draw-down of fresh water. Florida is a showcase of what is happening all over the country. The harm done by condemning open space to development, in order to pay estate taxes based on its consequently exaggerated value, is particularly remarkable in the case of water; obviously the one resource beside land and air critical to life. When the open space needed to supply ground water is inhabited, paved over and roofed over, it becomes only a water consuming instead of a water producing area; the effect of its conversion on the water supply is, in effect doubled.

Excessive use of water adversely effects the land and those dependent upon it. Improverished and dying pastures, trees, shruberry, and inadequate inexpensive surface water supply for cattle and wildlife are a part of the costs. The availability of large land areas for water recharge sources can prevent the excessive use of, and the excessive taking of, water, from one particular area. It is now beginning to be recognized, that what governmental units should do is to spread out the taking of water, to take a little water from many different land areas. But if these different land areas have been taken up in

development or industrial use, the communities do not have that choice available. It is important for large agricultural and open spaces to be ready and available to permit the rain recharge of this water. Development, or intensified use of the land, reduces the availability of water resources. The present tax policy encourages the development and intensified uses of property that otherwise could be available for future water resources. Salt water intrusion can harm and injure communities. If agricultural open-space units are allowed to continue to exist, without having to be sold to pay estate taxes, this problem can be diminished and eventually solved. It was, of course, the temptation or tendency of those who dealt only with finance to consider everything in the form of dollars. The estate tax was designed to destroy large aggregations of dollars passing from generation to generation. If land is considered only as aggregations of dollars, then, of course, the open land is destroyed to the detriment of all our society.

III

THE ESTABLISHMENT AND CONTINUANCE OF AGRICULTURAL, FARMING AND OPEN SPACES IS NECESSARY TO CONTINUE TO PROVIDE FOR CLEAN AIR AND THE EXISTENCE OF WILDLIFE AND OTHER NATURAL RESOURCES

We have all heard about the condition and quality of our air. Florida is not unlike many other states. Some areas of the State have pollution problems. Clean air can be improved by the presence of open areas where farming and other agricultural operations are being conducted. Air is "cleaned" as a result of the photosynthetic process in trees and shrubs and wild plants as well as cultivated crops. However, with an intensified use of land, as distiguished from an agricultural use, trees and crops will disappear at a time when they are needed not only because of our food problems but because of our air problems. These open spaces act, in fact, as clean air generators. The absence of large open spaces can affect the quality of the air. Poor air quality can result in respiratory diseases and unhappy lives for those who have them.

Air pollution problems would be even greater now than they are, were it not for the fact that we still have a substantial number of large open spaces and agricultural units in operation, relatively close to heavily populated areas of air pollution.

As population steadily increases, the need to assure our supply of natural wildlife increases. Wildlife can exist on agricultural and open areas; but intensified use will cause them to disappear. On our land we have deer, quail, turkeys, sandhill cranes, and the only American stork, Mycteria Americana. I hope never to see the time when they will be gone. But if the present estate tax is not changed and land must be sold to pay taxes, the certain purchaser of land will have to be a speculator-developer who would have to make an intensified use of the property either at the present time or in the near future to justify the payment of the price which IRS sets on the land. Wildlife should be preserved for the future as a National asset. The natural beauty of the land, forests and streams is emphasized by the natural presence of wildlife. The tax-forced encroachment upon these areas by

development is causing not only a reduction in the wildlife but a complete removal of some species, or at least a substantial reduction of them; such as the aforementioned Grus Canadanses.

As a member of the Sierra Club, and the Ecology and Environment Committee of the Florida Cattlemen's Association, I am concerned about the preservation of the environment, for ourselves and future generations. Estate tax reform can lead the way in assuring future generations the beauty of the outdoors and the natural presence of wildlife. Economists can more easily put a price tag to air and water-recharge areas than they can to their companion relatively natural environment. Almost a thousand years ago, a poet-philosopher wrote:

> "With me along the strip of herbage strown
> That just divides the desert from the sown,
> Where name of Slaves and Sultan is forgot—
> And Peace to Mahmud on his golden Throne!" [1]

Man's nature has not changed. But what psychologists call his "crowd-stress" has become greater. Environmental groups constantly draw our attention to dramatically beautiful wilderness areas, the beauty of which is threatened by some development. These areas may be visited annually by a fortunate few. But who can fairly evaluate their importance in comparison with local unspoiled areas perhaps only one-tenth as beautiful, but which are accessible to thousands?

IV

THE PRESENT TAX LAW CAUSES RANCHERS AND FARMERS TO SELL LAND TO WHICH THEY HAVE EMOTIONAL ATTACHMENT. THIS REDUCES THE AMOUNT OF ACREAGE INVOLVED IN FOOD PRODUCTION, AND LEADS TO INCREASED FOOD PRICES.

We face a grave problem in the future if our food resources are inadequate. At the present time about 4 percent of our people produce our food. About half this number are small marginal farmers, producing little more than enough to feed their own families. Yet, at this very time, the most productive private farmer is being driven out of farming, and food prices are being forced upward, by a "kill the golden goose" tax. By the private farmer I mean the individual, or the family corporation, or partnership, engaged in farming or ranching. These families are emotionally attached to the land. They try to retain it in open spaces for agricultural use and are not as likely to easily use the land for development as the public corporation, or speculator, which or who must regard the land only as a form of dollars. They represent the only strong opposition to further development of open areas. Love for the land causes the farming family to decline offers to buy the land, which would be adequate to cause others to sell. By forcing private farmer-ranchers to sell their land to pay estate taxes we are destroying open areas that cannot be regenerated in the future.

Estate taxes based on potential, rather than actual use, are so great, surviving children or grandchildren haven't cash with which to pay

[1] Omar Khayyam, *Rubaiyat of Omar Khayyam*, rendered into English verse by Edward Fitzgerald: N.Y.: Grosset and Dunlap, 1946.

the tax IRS demands that the land be sold, at their "highest and best use" appraised figure, in order that as high as 77 percent of it can be turned over to them, within nine months of death.

While the land may have an intensified use value, it seldom means that using it for agricultural purposes would generate an income consistent with that value. Agricultural use of property produces less income than an intensified use. The farmer and rancher finds this to be an intolerable position throughout the country. This is particularly true in Florida, and other "resort" areas, or areas proximal to towns, where open space is most desirable.

The effect of a continued policy such as this will mean that the people of our country will be deprived of farms and ranches and food production will be substantially reduced. The recent effect upon our country of less oil brings home the realization that if there are fewer agricultural producing units, food prices will increase. We will not continue to have the abundant supply of food at reasonable prices. Less food, with which we have been, in effect, "buying" oil from abroad, means less oil, less energy, a lower industrial standard of production and jobs, a lower living standard for us all, a lower defense posture. Tax reform is necessary to have continued reasonable prices not only for the food we eat, but to preserve our American standards of living, and our America.

SUMMARY

It is probable that the subject here being discussed is one whose time has come. The question is perhaps no longer "Whether," but "How." Recognition of this fact has already stimulated more than half a hundred recent, proposed formulae for reformation of existing estate tax convention. Many of these direct themselves mainly to recognition of, and solution for, the problems created by existing law; but fail to recognize the opportunity presented to achieve some lasting and flairful social benefits of far greater social significance.

Something needs to be said to put the matter in the broadest perspective. This is that, on balance, the real, central, lasting potential for benefit to society is to be found in the opportunity to control the presently explosive rate at which suburban land is being forced into development; to control it by providing an alternative to immediate sale to pay estate taxes; so there can be a choice, not only by the owners, but also by government, which then has time to make considered evaluations and to later purchase desirable areas. To the extent that suburban land, especially, is withheld from development the environmental and economic advantages to the concentrated population nearby are manifest and lasting. The cost to society of deferring or even excusing that part of the estate tax attributable to, and predicated on, uses to which the land is *not* being put is insignificant,[2] but payable today; the cost of failure to do so, is incalculably high; but payable tomorrow. Which road Congress elects will determine the calibre of this Congress, and, to a large extent, the future of the United States of America.

All agricultural units should be included; whether small, medium or large farm or ranch operations. If there is an immediate and pre-

[2] Congressional Committee on Ways and Means, U.S. House of Representatives, *Background Materials on Estate and Gift Taxation* 62, (Mar. 8, 1976).

dictable obstacle to achievement of these maximum goals it may lie in concern on the part of some about extending such tax reform to owners of large land units. Such concern should not be allowed to preclude the necessary changes. If it did so, the present debate on this subject would turn out to be simply another political exercise and prospects of substantive, long-term social benefit would be lost, in deference to immediate political expediency. This danger lies in fear of political rebuke for extending the effect of such legislation to include the larger farm and ranch operations. *Larger tracts of land constitute a major part of the opportunity to help preserve our natural resources.* They are much sought by the developer. The large operations are most jeopardized by present tax convention (because their theoretical value places them in higher estate tax brackets). They constitute the main prospect for aesthetic and environmental stability, and they are *the* areas large enough to support meaningful agricultural businesses at the edges of the cities. If this fear prevails the present debate will have been, simply, another political exercise, in which prospects for far-reaching, long-term social benefits are buried in deference to immediate political considerations.

The assets of an agricultural unit should be treated the same without regard to whether the ownership is in a person, firm, family-corporation, or trust, and without respect to whether it is small, medium or large in its operations. There should be no restrictions placed upon the nature of the income; the sole question should be whether the land or the unit is a trade or business engaged in agriculture. If it is a trade or business it should not be affected by some arbitrary requirement that a percent of its income be specifically from agriculture. Agricultural-use rental income should qualify the land as personal management agricultural income. Internal family gifts or other transfers should be encouraged as a division of ownership without affecting a change in ownership. The public need for a change is certainly present.

Congress can save farmers and ranchers from losing their land, preserve natural resources and the environment, keep reasonable food prices, aid our National balance of payments, living standards, and our Nation's defense by reforming the Estate Tax Law. The present tax hurts ranchers and farmers, the public and the Nation. The tax is destructive. It must be changed.

EXHIBIT 1

ALRIC POTTBERG,
Hotel Washington, Washington, D.C.

You are hereby authorized to represent the Florida Agricultural Water Council with respect to the hearing on Federal estate and PPT Packs Law. The Councils position is: 1. Land used for bona fide agricultural uses should be appraised for its agricultural value and not at the highest and best use. 2. The estate tax exemption should be increased to amounts reflecting present day values.

This action will encourage maintaining present agricultural property in agricultural use and will not necessitate forced selling of family farms to pay estate taxes.

ELTON CLEMMONS,
Chairman Florida Agricultural Water Council Co.

EXHIBIT 2

ALRIC POTTBERG
Washington Hotel,
Washington, D.C.

This will authorize you to present to Congress our view that Federal gift and estate tax law should encourage rather than discourage the preservation of open space.

CASEY GLUCKMAN,
Florida Chapter Sierra Club.

EXHIBIT 3

FLORIDA CITRUS MUTUAL,
Lakeland, Fla., March 11, 1976.

Mr. RICK POTTBERG,
Hudson, Fla.

DEAR MR. POTTBERG: Attached is a copy of a resolution passed by our Board of Directors on March 10th.

We would very much appreciate it if you would present this directly to the Ways and Means Committee when you are in Washington next week. Express our appreciation for the consideration of this problem and our wholehearted support in making the modifications which are suggested here.

You are specifically authorized to relate the support of Florida Citrus Mutual's more than 15,500 citrus grower members.

Thank you for your cooperation in this matter.

Sincerely,

TOM OSBORNE,
Executive Vice President.

RESOLUTION

Whereas, the United States Congress is currently considering modification in estate and gift tax proposals, and

Whereas, the estate tax exemption has not been increased during the past twenty-five years, and

Whereas, agricultural land, for estate purpose, is valued at highest and best use rather than as agricultural land, and

Whereas, in practice the application of current law and regulations make it extremely difficult for family farms to remain in the hands of the family following the death of each generation: Be it hereby

Resolved by the Board of Directors of Florida Citrus Mutual at its regular meeting on March 10, 1976, in Lakeland, Florida, that:

1. The modification of current estate tax law and regulation is the only way to assure the maintenance of family farms, and therefore
2. The Congress be requested to increase the exemption on estate taxes, and
3. The Congress be requested to require that agricultural lands be valued on the basis of their use as agricultural lands and not on a highest and best use basis, and
4. Copies of this resolution be forwarded to the Honorable Al Ullman, Chairman of the Committee on Ways and Means, United States

House of Representatives, to all members of that Committee and to the entire Florida Congressional Delegation.

Attest:

FRANK BOUIS,
President.
CHARLES C. PARTIN,
Secretary.

EXHIBIT 4

DRAFT STATE LAND DEVELOPMENT PLAN ISSUED

We recently received a draft copy of the "State of Florida, Land Development Plan." The introduction says in part: Development in the state has occurred and continues to occur without benefit of an overall management strategy. Failure to recognize opportunities for and constraints to development provided by land and related resources has resulted in unwise expenditures of fiscal and natural resources by government and the private sector.

Between 1960 and 1975, population in the state increased from 4,951,560 to 8,517,100. During the early 1970's the state's population increased at a rate of approximately 24,000 per month. Florida's population is estimated to be 9,945,700 by 1980 and 14,558,300 by the year 2000.

Presently, 75 percent of the state's population is located on only 27.6 percent of the land area of the state, the coastal zone (see Fig. 2). As well as being the most attractive area to new residents, the coastal zone is the most sensitive to development. Within the last 20 years, the coastal resources have suffered abuse to the extent that much of the beauty of the state has diminished. But more importantly, the capability of the coastal zone to support continued, unmanaged growth no longer exists.

There are approximately 7,059 square miles of upland areas in the state which are generally well drained and contain sufficient natural resources to support growth and development.

Copies of the plan are available from Helge Swanson, Chief, Bureau of Comprehensive Planning, 660 Apalachee Pkwy., Tallahassee 32304.

EXHIBIT 5

"GREENBELT" EXEMPTION TIGHTENED

(By Mary Anne Corpin)

More than half the people who applied for greenbelt exemptions on newly purchased property in Hillsborough County this year didn't get the special tax exemption.

"Greenbelt" means the difference between paying taxes based on, say $125 an acre appraisal on improved pasture, and the taxes on an appraisal of $1,554 an acre, such as one young couple faces because they couldn't get greenbelt on their new, 40-acre farm.

"Without greenbelt," said Farm Bureau Executive Director Betty Jo Tompkins, "agriculture couldn't survive in this state. If farms were taxed at 'fair market value,' it would put the farmers out of business.

"But we don't want the greenbelt abused."

The abuse comes in, property appraiser Bob Walden said, when someone wants to live in the country, buys five acres, builds a house, brings in two or three cows, and says, "I'm a farmer."

"They just don't meet the requirements of the law," Walden said. "We get quite a few of these—I wouldn't even guess at the number."

Some contend that the abuse also exists when city dwellers own untouched palmetto land for speculation, but who nonetheless have greenbelt exemptions.

In trying to avoid the abuse, the county "has to draw a fine line" in determining whether some cases qualify for greenbelt, Walden admitted, tracing an imaginary line on a map for emphasis.

The county received 626 new applications for greenbelt exemption this year, Walden said.

Appraisers from his office denied greenbelt to 357 of these applications, or 57 percent of the total, and approved the other 269.

About 7,000 greenbelt exemptions from previous years were renewed, but 196 of the old exemptions were denied.

More than 60 people who were denied greenbelt are appealing to the county's Tax Adjustment Board. Some are getting the exemption. Some aren't. Some of the board's members think it's "a waste of time."

"When we have overruled the tax assessor's (property appraiser's) judgment on it (the greenbelt law), the Department of Revenue (the state's tax department) has overruled us," said Mrs. Pat Frank, one of the five county school board members who rotate on the tax board.

County Commissioner Betty Castor told the county's legislative delegation a few days ago that it's almost impossible to buy farm land at a price which will allow for a greenbelt exemption.

"The law presumes that if you purchase land for more than three times the amount of the appraised value, that's cause for losing "greenbelt." Commissioner Castor said. "Many people who want to have a bona fide agricultural operation in this county today can't.

"There's hardly a place in Hillsborough County where you could purchase property that wouldn't be more than three times the current assessed value."

The agricultural assessment varies, according to the type of farm, Walden said.

For instance, he explained, row crops have a $250 per acre assessment (which means a buyer could pay $750 an acre and not be suspect). Orange grove land is appraised at $400 an acre, hay fields at $250, native pasture at $40 to $60, and a hog farm at $450 an acre.

"If anyone pays more than three times the agricultural assessment allowed, then we're to question if it's a bona fide agricultural use." Walden said.

Is there any land that sells for these low prices in Hillsborough County? "Not any more," Walden said. He later revised this to say some land "sells for $600 to $700 an acre, out in the pastures." Compared to prices in most of the county, he said, "you can find property a lot more reasonable at the south end (in the Ruskin area)."

The appraisal prices "don't give much latitude," Mrs. Frank said.

"It precludes a small person from being able to go into any agricultural enterprise," the school board member told the county's legislators.

She said a large cooperative can get a better per-acre price on 100 acres than can the small persons buying 10 acres.

"It's a bad situation," Farm Bureau Director Tompkins said. "The cost of going into agriculture continues to rise. It has reached the point at which you must inherit a farm, or marry into it, or you've just got to luck out somehow.

"Most of the people who lend to agriculture will tell you that to get into farming today, you have to have a lot of capital behind you, some good strong backing," Mrs. Tompkins said. "Most young farmers are working in a family operation, with other relatives as partners. Otherwise, it's very hard to get into it, and it gets harder all the time."

EXHIBIT 6

DEPARTMENT OF ADMINISTRATION
DIVISON OF STATE PLANNING
COMMISSIONER OF AGRICULTURE
DEPARTMENT OF AGRICULTURE & CONSUMER SERVICES

AGRICULTURE ELEMENT of the STATE COMPREHENSIVE PLAN

FILING DATA

DATE: DRAFT 4

	Strongly Agree	Moderately Agree	Agree	Moderately Disagree	Strongly Disagree	No Opinion
POLICY J-7: Child Care: The physical standards for child care centers should be reassessed on a more practical basis, for the purpose of increasing the availability of day-care centers operated by non-profit agencies for rural low-income, farm workers' families.						
POLICY J-8: Child Labor: There should be a rigorous enforcement of federal and state child labor laws.						
POLICY J-9: State Housing Authority: A state housing authority should be created to facilitate the construction of decent housing for farmworkers and other low-income groups.						
OBJECTIVE L-I: Preservation of Agricultural Lands: To prevent further despoliation and harm to Florida's renewable resource lands through unregulated development, the state shall embark upon a program to identify and preserve agricultural lands with special emphasis upon those agricultural lands most seriously threatened by urban development, government, or other forces.						
POLICY L-1: Definition of Agricultural Lands: The State of Florida should adopt the following definition of agricultural lands.						
POLICY L-2: Mapping of Agricultural Lands: In order to properly consider the soil in both agricultural planning and development, Florida's 10-year statewide soil survey mission should be continued with increased priority given to rapidly urbanizing counties with agricultural, environmental and other renewable resource lands.						
POLICY L-3: Soils Consideration: All planning and developmental activities affecting Florida's lands must explicitly consider the protection of the natural qualities of the land and water and the capabilities and needs of the soils so as to discourage and discontinue soil wastage and soil erosion.						
POLICY L-4: Agricultural Impact Statements: Agricultural lands are essential, renewable resources of our environment which shall be dealt with in environmental and socio-economic impact statements.						
OBJECTIVE L-II: Tax Laws and Policies: Existing tax laws and policies at all levels of government should encourage the preservation of agricultural land.						
POLICY L-5: Federal Estate Taxes: Changes in federal estate tax laws should be made so that agricultural land may be valued at its value as farm land as long as it remains in agriculture, and the estate tax exemption should be raised to a more realistic present-day level	✓					

EXHIBIT 7

PINELLAS PUMPING AFFECTS AQUIFER UP TO 8 MILES

(By James Walker)

Southwest Florida Water Management officials yesterday disclosed maps and pumping figures that show the three big wellfields in Northwest Hillsborough have overlapping impact that reaches as far as eight miles from the wellhead.

Most, in fact, of the northwest county, can measure some water drawdown in the Floridian aquifer because of the cones of depression from the fields.

The SWFWMD figures apply to the aquifer, which in instances is hundreds of feet below ground surface, and don't directly measure the "surficial" aquifer, the ground water that lies close to surface.

But Derill McAteer, chairman of the SWFWMD governing board, said, "We consider it (water) as a unit. When the aquifer is pumped down, the surficial sands drain water to it faster."

A clay layer lies between the surface water table in the sands and the deeper Floridian floodway which flows through porous limerock, but leaks and gaps in the clay provide troughs to drain the upper water as the aquifer drops.

"We think that as far as 2.5 miles out from each wellfield, there is a definite influence" on the water table, McAteer said. "I think that in the case of the Section 21 wellfield, it has caused definite damage to surrounding lakes."

McAteer asked the SWFWMD to prepare the data in hopes the northwest county residents can be more helpful in giving witness to the need for pumping regulations.

Too often, he indicated, a property owner will complain of dropped water capacity on his property, then either blame the wrong wellfield or misidentify its owner.

The major fields in northwest Hillsborough are St. Petersburg's Section 21 and Cosme fields. Just across the Pasco line, the City of St. Petersburg has opened its Pasco field. The County of Pinellas operates the Eldridge-Wilde field on the Hillsborough, Pinellas, Pasco county lines.

SWFWMD also supplied pumping figures for the fields for June, the month of historic record, on which the impact to the acquifer was estimated.

Section 21 pumped 23.1 million gallons per day; Cosme some 101 million gallons; and the Eldridge-Wilde some 44.7 million gallons per day.

Based on these pumpages, Section 21 caused a drawdown in the aquifer of 10 feet at a distance one mile from wellhead, a five feet drawdown 12,500 feet from the well and zero impact only beyond 40,000 feet (nearly eight miles) from the wellhead.

The Cosme field, which SWFWMD moved to curtail pumping on first because of its critical harm to nearby lakes, showed the least impact in June. At one mile from the wellhead, it caused a drawdown in the aquifer of 4.5 feet, and at eight miles from the wellhead, the aquifer drawdown was less than half a foot. Eldridge-Wilde shows the colossal figures.

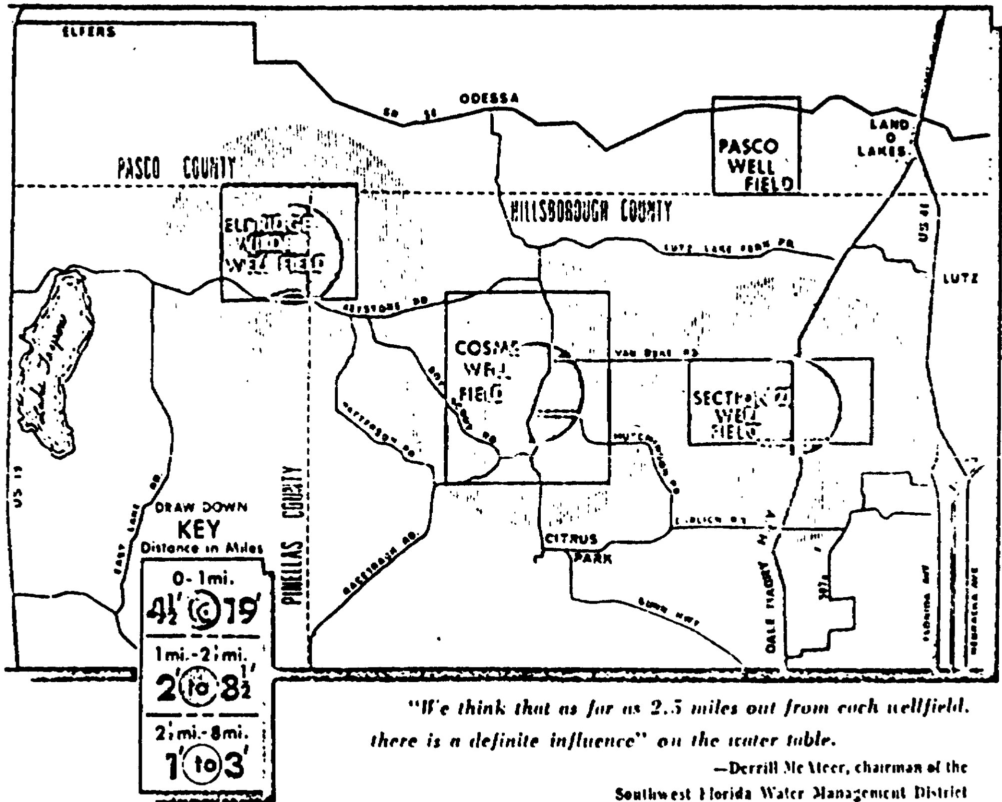
Pumping at the June rate of 44.7 million gallons per day, the aquifer drawdown was some 19 feet a mile distant from the wellheads; at two and half miles from the wells, the drawdown was 3.5 feet; and at 40,000 feet from the wells, the drawdown was registering about a foot and a half.

This corresponds, SWFWMD officials indicate, with data which shows Pinellas County is actually pumping below sea level in some wells in the field, creating a big cone of depression. The normal potentiometric surface at the Eldridge field is some 20 feet above sea level.

SWFWMD is proposing to curb Pinellas from pumping more than 28 million gallons per day from Eldridge-Wilde, but with provisos it might take more during heavy rains.

McAteer currently is negotiating with Merritt Stierheim, Pinellas County manager, for stipulations on operation of the field to avoid court battle.

St. Petersburg city officials have agreed to pumping regulations which SWFWMD staff believe will restore the fields and lessen the drawdown impact.



"We think that as far as 2.5 miles out from each wellfield, there is a definite influence" on the water table.

—Derrill McAteer, chairman of the Southwest Florida Water Management District

EXHIBIT 8

* * * * * * *

Monitoring of water table levels would provide a proposed means of regulating the well field operations. District hydrologists, however, have concluded that the water table cannot be used effectively as a regulatory index, because of natural variations.

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The almost instantaneous effect of rainfall on the water table and the time lag between pumpage from the deep Floridian aquifer and its effect on the water table makes the method discussed at the last public hearing far too cumbersome according to the district hydrologists.

District hydrologists have expressed concern over the salt water intrusion zone which affects the Tampa Bay and Pasco County areas.

Senior scientist and chief hydrologist Gerald G. Parker says that with recognition of the serious salt intrusion problems, corrective action can be taken. Improvements that can be done include: Salt water barriers in channels and rivers, water conservation projects, well field regulations and rules designed to prevent further lowering of the aquifer.

Florida's aquifer, a volume of underground fresh water, is only one source of water supply for the state, the district publication "Hydroscope" points out this month.

There is also the source of Florida's springs that have a combined flow six times greater than all the public water systems in the state, according to a just-released report from the U.S. Geological Survey.

The combined flow of Florida's springs is five billion gallons per day (8,000 cubic feet per second), according to the report, "An Index to Springs of Florida."

It identifies the magnitude of 165 springs and seven pseudosprings and specific data on water quality, discharge and temperature is given for 22 first-magnitude springs (those discharging more than 100 cubic feet per second).

Authors of the report, Jack Rosenau and Glen Faulkner, say that the water of most Florida springs is of excellent quality, low in salinity and of moderate hardness.

The December 1974 issue of "Hydroscope" cites the federal report as offering Pasco County's Pithlachascotee River as a potential supplementary source of water supply for the fast growing west side, or as a source for recharging the Florida aquifer.

In times of low flow, the river is subject to 11 miles of upstream salt water movement, but upstream from the tidal action, fresh water in the river "usually" meets the water quality standards for public water supply.

The report suggests that salt water barriers in the river channels would increase the fresh water zone and could be either low dams with movable gates or rubber or plastic inflatable dams.

Also suggested in the report on the Pithlachascotee is diversion of a portion of the river run-off during high flow periods into temporary detention areas to induce seepage into the aquifer or into some large lakes for storage.

The hydrologists content that there are two major reasons for salt water movement into inland areas. One canalization by dredging from the Gulf or from a bay or river that is subject to tidal action salt water invasion. Two factors are involved, the drainage of fresh water the soil and the flow the canal of salt water for contact with the soil that is being drained.

The second reason for the movement of the salt water into inland areas has been a lowering of pressure in the aquifer brought about

by increased pumpage. An increasing population means increased demand for potable water and long-term rainfall deficiency hastens the pressure in the aquifier, increasing the movement of salt water inland.

The district hydrologists have noted six areas in the Tampa Bay megapolis where zones of salt water intrusion have been cited. The city of New Port Richey has already closed some wells because of this encroachment, and five of nine wells contained chlorides in excess of public health standards.

All of coastal Pasco County and northern Pinellas have zones of encroachment encompassing nearly everything west of U.S. 19 and in some places east of the traffic route.

St. Petersburg's Cosme-Odessa faces a potential threat from the west and south. Virtually all of peninsular and downtown Tampa has been engulfed in the zone of encroachment, and the zone is believed gradually inching northward.

Because salt water is heavier, fresh water "floats" on sea or brackish water, and, in Florida, the sheer volume and weight of fresh water holds salt water. The water level in the Floridian aquifer stands well above mean sea level because of the constant recharge of the aquifer from rainfall and the constant outflow and impediments that create a time lag in the flow toward sea level.

Statement of
Tax Policy

4

Estate and Gift Tax Reform

Issued by the Federal Taxation Division of the
American Institute of Certified Public Accountants

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Foreword

Statements of Tax Policy represent a conscientious effort by the federal tax division of the American Institute of Certified Public Accountants to explore, comment, and, where appropriate, develop positions on, matters of tax policy covering major areas of taxation in which members of the accounting profession have special competence.

Reform of the present system of estate and gift taxation has been under serious consideration for a number of years, with proposals for change coming from many sources, including Congress, the Treasury Department, and a number of professional organizations. The federal tax division has also been actively advocating changes in this area, and its ideas and proposals are summarized in this statement. It is intended that the formal presentation of this study will assist members of the congressional tax writing committees, members of the executive branch of government, and the public in their consideration of this subject.

Statements of Tax Policy are approved by the executive committee of the federal tax division after they are developed by the division's tax policy subcommittee. Other division subcommittees may develop a policy statement if requested to do so. This statement was developed by the 1972-73 financial and estate planning subcommittee and approved by the 1973-74 executive committee.

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1

Synopsis of AICPA Position

The American Institute of Certified Public Accountants supports estate and gift tax reform legislation in the following key areas.

Generation-Skipping Transfers

Under current law, an individual can make a transfer of property to a descendant two generations removed and, so long as intervening generations are limited to a mere economic interest (that is, an income interest), no estate or gift tax is imposed on the intervening generation. We recommend the following:

- No imposition of tax on outright transfers benefitting a "skipped" generation.
- Imposition of a tax on creation of inter vivos and testamentary trusts which benefit a skipped generation.
- Basing such tax on actuarially determined values.
- Imposing such tax on the estate of the skipped generation and making it payable from trust corpus.
- A liberal disclaimer provision and extension of the previously taxed property tax credit for a period of up to twenty-five years.

The Marital Deduction

Under present law a decedent may transfer up to one half of his estate to his spouse free of tax so long as the interest trans-

ferred does not lapse because of the passage of time or occurrence of certain events ("terminable interest rule"). We recommend the following:

- Retention of the 50 percent marital deduction limitation.
- Retention of the terminable interest rule.
- As stated below, an exemption level of $150,000, which would permit a $300,000 estate to pass free of tax.

Appreciated Assets Transferred at Death

At present, when a decedent owning appreciated assets dies, the appreciation is not subject to the income tax, and the beneficiaries take a basis in the property received equal to its fair market value. We recommend retention of our present system in this area.

Unified Transfer Tax

There currently exists an exemption from the estate tax of $60,000, and a lifetime gift tax exemption of $30,000 per donor. In addition, there is an annual exclusion of $3,000 for each donee for gifts of present interests. We recommend the following:

- Unification of these two systems of transfer taxes.
- Retention of the present estate and gift tax rates.
- That upon death, there be included in the estate tax computation 75 percent of the fair market value of inter vivos gifts made.
- Allowance of a credit for gift taxes paid on inter vivos gifts.
- Retention of the $3,000 annual gift tax exclusion.
- Increasing to $150,000 the current combined $90,000 exemption for estate and gift taxes.

Liberalization of Deferred Payment of Federal Estate Tax

Under present law, an extension of time to pay the federal estate tax may be granted in two situations: (1) where payment of the tax would result in "undue hardship" to the estate (Section 6161) and (2) where the estate consists largely of an interest in a closely held business (Section 6166). In addition, Section

303 permits certain redemption distributions to be made to help in paying the estate tax, without certain adverse income tax consequences. We recommend the following:

- Treatment as a single corporation, for both Sections 303 and 6166 purposes, a decedent's interest in two or more corporations if the estate owns more than 50 percent of each.
- No change in the amount of redemption proceeds qualifying under Section 303.
- Liberalization of ownership requirements in connection with the payment of estate taxes where an estate consists largely of an interest in a closely-held business.
- Liberalization of Section 6161 with regard to extensions of time for payment of the tax.

2

Generation-Skipping Transfers

Background

Under current law, a person may transfer property by gift or bequest to a lineal descendent more than one generation removed from himself (for example, a grandchild), and, as a result, the transfer tax is not paid by the intervening generation. In addition to outright transfers, a settlor may make a taxable transfer of property and not have the property subject to transfer tax again for several generations with the use of trust instruments which satisfy the rule against perpetuities. This is true although some elements of beneficial enjoyment of the property accrue to the intervening (or "skipped") generations.

Discussion

The U.S. Treasury Department *Tax Reform Studies and Proposals* dated February 5, 1969,[1] pertaining to estate tax, recommended a tax upon generation-skipping transfers. It was proposed to levy a "substitute" tax, in addition to the present transfer taxes, if property is transferred to a grandchild or more re-

[1] U.S. Treasury Department, *"Tax Reform Studies and Proposals,"* A Treasury Tax Study (Washington, D.C., Feb. 5, 1969), hereinafter referred to as 1969 Treasury Proposals. All subsequent direct citations of this report will be indicated by page number within the body of the text.

mote generation. This tax upon generation-skipping (GST) would apply to outright transfers as well as transfers in trust. The tax would be 60 percent of the basic transfer tax, unless the member of the skipped generation elected to treat the transfer as a gift or bequest to him and a simultaneous gift to the next generation.

Position of Other Professional Groups

On April 30, 1968, the American Law Institute (ALI) issued a report entitled *Federal Estate and Gift Tax Project.*[2] It was therein reported that the Council to the Members of the ALI approved a resolution to recommend a GST only upon a very limited class of transfers. Basically, the ALI proposal was to have a GST only upon transfers in trust that would vest in a younger generation at a time subsequent to the time of death of the immediately succeeding generation. In other words, if the trust provided for income for benefit of a child and the remainder to a grandchild upon the death of the child, there would be no additional tax. If, however, the trust continued after the death of the child with the remainder to a great-grandchild upon the grandchild's death, there would be an additional tax.

The American Bankers Association (ABA) would also limit the GST solely to transfers in trust. The ABA, in general, would impose a GST only if the transfer skips more than one generation.

AICPA Proposals

The AICPA's position is that there should be a tax upon transfers in trust that skip a generation; the Institute favors a limited inclusion in the estate of the member of the skipped generation, provided such person had a beneficial interest in the trust. The AICPA, therefore, makes the following proposals.

No Separate Generation-Skipping Tax on Testator or Settlor. To the extent that there would be a tax on the property passing to a grandchild or later generation, such tax would be computed

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[2] Published as *Federal Estate and Gift Taxation: Recommendations Adopted by the American Law Institute at Washington, D.C., May 23-4, 1968.*

by including a value in the gross estate of the skipped person. The tax would be due at the time that person's estate tax is due. Thus, no additional tax would be due from the settlor of an inter vivos gift in trust nor from the estate of the creator of a testamentary trust. The tax would be payable from the corpus of the trust. If a generation obtains its interest in the trust or the property in a manner other than by death of the skipped generation (such as after a certain term), the tax would be payable at the time of transfer of interest as though the generation whose interest had terminated had made a gift.

No Additional Tax on Outright Gifts or Bequests. Only gifts in trust would be included in the gross estate of the skipped person. Also, only to the extent that the skipped person had a beneficial interest would there be an inclusion.

Inclusion in Gross Estate Based Upon Actuarial Values. If a person's beneficial interest in a trust expires and if a more remote generation from the grantor than such person will obtain an interest (for example, if the son of a grantor dies and the corpus goes to the grantor's grandchild), then a computation would be made of an amount to be included in the estate (or taxable gifts) of such a person. The fair market value of the corpus at the date of such termination would be calculated. A pro rata portion of this fair market value would be included in the calculation of his gift tax. The portion included would be based upon an actuarial computation of the interest so terminated. This computation would be made as of the date the trust is created (or at the date it became irrevocable if this is later). If the decedent was solely an income beneficiary, the actuarial value would be based upon present value tables of a life-income interest using the age of the beneficiary as of the date of the commencement of his income interest in the trust. If his interest was only for a term of years, then the calculation would be based upon that period. The AICPA believes, however, that the present 6 percent table is too high for this purpose. A table based upon a 4.5 percent or 5 percent return would appear to be more equitable.

Example—Assume that a father dies at a time when his son is age forty-five. Father leaves $1 million in trust with income to his son, and upon the son's death, the remainder to his grandchil-

dren. When the son dies, the corpus has a fair market value of $2 million. The present value at 5 percent of the right to use $1 for the life of a forty-five-year-old person is about 62 percent. Thus, 62 percent of the $2 million date-of-death value would be subject to estate tax upon the death of the life beneficiary. The amount subject to tax would be limited to the interest passing to the next generation. The estate tax would be paid out of the trust corpus unless the life beneficiary provided by will or otherwise that the tax should come from his estate.

The tax charged to the corpus would be from the top brackets. Thus, the personal estate of the life beneficiary would not be affected by the inclusion of the life interest in the tax computation.

With Sprinkling Trust, Taxation of Corpus Upon Death of Last Beneficiary to Die. The question arises as to the best method of taxing the corpus when the income may be paid to any member of a class that includes more than one member of the skipped generation through the use of a sprinkling trust. The AICPA recognizes that arguments could be made for taxing a portion of the corpus as each beneficiary dies or when the last member dies, basing the tax in either case upon the rates applicable as if the pro rata part had been included in each beneficiary's estate at the time he died. Yet again, arguments could be made for granting various elections to the trustee. Each of these various approaches has certain advantages. They all, however, lack the characteristics of simplicity and ease of administration. Because it would work without putting an unreasonable burden upon the IRS or the trustees, the AICPA has determined that the best approach would be to tax the corpus upon the death of the last beneficiary to die, based upon the facts applicable to such last member of the generation. Thus, if the last to die had an actuarial interest of 60 percent, that percentage of the fair market value of the corpus on the date of his death would be included and taxed in his estate.

In this regard, it is important to note the need for the enactment of a very liberal disclaimer provision. The AICPA recommends that the Internal Revenue Code provide that a beneficiary may be permitted to waive his income rights at any time within a two-year period commencing with the date of death of the testator or with the date that an inter vivos trust is created. Such

a disclaimer would result in *no* tax. There would be tax neither at the date of disclaimer nor at the date of the beneficiary's subsequent death. Thus, the possibility is reduced that the corpus would be taxed at rates applicable to the wealthiest members of the generation.

With Power to Invade the Corpus, Taxation of Corpus Based on Value at Time of Beneficiary's Death. The trustee may have the power to invade the corpus for the benefit of a member of the skipped generation, or the beneficiary may have the power to demand the corpus. If the beneficiary does not disclaim his right to receive the corpus pursuant to such power, the AICPA would have the tax on the corpus based upon values at the time of his death. There would not be any reduction based upon actuarial computations unless the invasion power is less than complete. Thus, assuming that a person has a limited power to request corpus (for example, a right to $5,000 or 5 percent of the corpus per year), the value of such right would be included in his estate tax computation. If, therefore, a forty-five-year-old person received a life interest and a "5-and-5" power, the AICPA would actuarially compute the value of the power plus the value of an income interest upon the remaining corpus. The tax on this amount would be based upon fair market values at the time of his death. If he actually draws down corpus each year, the AICPA would not have the remaining corpus subjected to a tax based upon this power. If the power is partially used, the computed amount would be reduced by the amount previously withdrawn.

Even in a case where there is more than one member of the generation for whom there can be an invasion, the AICPA would not recommend a tax until the last member dies. At such time, the full fair market value would be included and taxed in such last person's estate. In other words, the facts and circumstances applicable to the last surviving member would be used for the tax computation. An obvious exception would be those cases where a portion of the trust's corpus terminates as each skipped person dies. In such a case, there would be a tax on such a portion at the time of termination.

More Liberal Credits for Tax Paid on Prior Transfers. An injustice can occur if the skipped person dies shortly after the trust

is created. The severity of this problem can be greatly reduced, however, by the AICPA proposal for more liberal credits for tax paid on prior transfers. For this purpose, a liberal credit would be allowed not only for estate tax on prior transfers, but also for gift tax paid in the case of an inter vivos trust. (This logically follows as a result of the proposed integration of the gift and estate taxes.)

With Two Skipped Generations, Taxation Based Upon Actuarial Computations. There would be a tax upon the death of each skipped generation based upon actuarial computations. The actuarial interest of a child who had an income interest would be taxed upon his death. The actuarial interest of a member of the next, skipped, generation would be taxed upon that member's death. Assuming, for example, a life income to a son and then to a grandson with remainder to great grandchildren, the tax upon the death of the son would be as described above. The tax upon death of the grandchild would be based upon his age at the time his income interest vested (that is, at the death of the son). If the grandchild should predecease the son, there would be no tax upon the grandchild's death. If the grandchild dies shortly after the son, there would be a liberal credit for the tax paid upon the son's death.

Extension of Availability of Previously Taxed Property Credit. Under present law, if a gross estate includes property recently inherited from a prior decedent and the prior decedent's estate paid a tax with respect to the property, a credit is available to the second estate. A full credit is available if less than two years has elapsed between the two deaths. The credit is reduced by 20 percent every two years, until no credit is available if the second death occurs more than ten years after the first.

Estate and gift tax reforms have been proposed that will generate additional tax revenue. The generation-skipping proposals, in particular, can result in a tax for each generation rather than for every second or third generation, as is presently the case with large accumulations of wealth. Because of the greater and more frequent incidence of tax, the AICPA has concluded that the previously taxed property credit should be available for a longer period of time than the present ten years.

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The AICPA favors extending the availability of the previously taxed property credit. For the first five years after death a 100 percent credit for prior estate taxes would be granted. The percentage of the credit available would be reduced by 5 percent per year thereafter. When a period of twenty-five years has elapsed, no credit would be available.

Example—Assume that *A* dies in 1974 leaving his entire estate to *B*, and *B* dies in 1978. *B*'s estate will have an available credit equal to the entire estate tax paid by the estate of *A*.

If *B* dies in 1984, ten years after *A* dies, the credit would be reduced to 75 percent of the taxes paid by *A*'s estate, that is, 100 percent less 25 percent (five years at 5 percent). If *B* dies after 1999, no credit from *A's* estate would be available.

The period of twenty-five years was selected as representative of a customary period between generations. The gradual reduction in credit between five and twenty-five years was considered to be logical inasmuch as the second decedent would have enjoyed the inherited assets for some period of time. The transfer at his death should, therefore, be at least partially taxed.

This liberalization becomes logical if generation skipping is adopted. If a member of a skipped generation dies prior to his actuarial expectancy, his estate, under the AICPA proposals, must nevertheless include an actuarially computed amount. The liberalized credit results in fairer treatment in such cases of premature death.

Summary

The AICPA is opposed to a tax upon outright generation-skipping transfers because the member of the skipped generation has no economic interest in the property. Further, the AICPA finds nothing socially or economically wrong with gifts or bequests that totally skip a generation. If a person has an economic interest, that interest should be subject to a tax at the time the interest terminates. The tax should be measured by the value of the person's estate as well as the value of the interest. An additional tax on the original settlor or on his estate is unfavorable, since this would cause an incorrect timing of the tax. Nor should taxpayers be required to make an election as to when the tax is payable or as to when the trust property should be valued. The AICPA is

opposed to the IRS proposals because it does not believe that a new tax should be enacted. Rather, it is thought that the situation can be corrected by redefining the criteria that will result in inclusions in a gross estate or in taxable gifts. The IRS proposals may result in excessive complexity, lack of relationship of the tax to the economic interest subject to tax, and incorrect timing of the tax.

There are many situations not covered in this presentation. Only a basic concept necessary to solve a basic problem has been set forth. This basic problem is that, at present, a generation may have the benefit of corpus which is not subject to transfer tax when it is passed on to the next generation. To subject such corpus fully to tax when the generation has only a limited interest is, in the opinion of the AICPA, inappropriate. The foregoing proposals attempt to find a fair and equitable solution to a very real problem.

3

The Marital Deduction

Background

Current law allows a deduction to a donor or decedent for part of the value of property transferred to a spouse. Such a deduction, referred to as the "marital deduction," is limited in the case of a gift to one-half of the value of the gift and in the case of an estate to one-half of the "adjusted gross estate." As a result of the marital deduction, an individual may transfer one-half of his separate property to his spouse, tax free.

To qualify for the marital deduction, outright ownership of the property transferred generally must pass to the spouse so that, unless it is consumed or again given away, it will eventually be included in the estate of the surviving spouse. Such provision is referred to as the "terminable interest rule."

Discussion

Many practitioners and professional groups believe that the present structure of the marital deduction works a hardship on small to moderate-sized estates, especially those estates where all the assets are bequeathed to a widow who must provide for herself and her children. Treasury Department studies indicate that, on the average, a widow survives her husband by ten years, and it is felt that when property passes to a widow, a tax imposes a difficult burden at a time when other significant income sources often disappear.

While it is generally agreed that adequate protection for widows and a reduction in estate tax on moderate estates is a necessary part of estate tax reform, there does not appear to be any reason for the deferral of estate taxes when property transferred to a surviving spouse is more than sufficient to satisfy her needs. An unlimited marital deduction, advocated by some groups, goes far beyond the objective of providing relief to a surviving spouse and would be of greater benefit to larger estates than smaller estates.

Studies indicate that the adoption of an unlimited marital deduction would result in a permanent reduction of 7 percent of the revenue from federal estate and gift taxes and an immediate revenue loss of as high as 17 percent since there would be a tax deferral until such time as the surviving spouse dies. Most of the other estate and gift tax reform proposals would result in an increase in revenue. Accordingly, a retention of the existing 50 percent marital deduction (with a modification for modest estates) would allow for an adjustment in the rate structure and exemption level which would not be dependent on the enactment of a provision for taxing appreciation at death.

An unlimited marital deduction would tend to distort proper estate planning. In order to minimize the tax on the first to die, there would be a tendency to transfer all of the property to the surviving spouse. In estates of any substance, the transfer of all property to a surviving spouse, particularly when there are children, should not be encouraged. Under an unlimited marital deduction, deferral possibilities resulting from remarriages can be carried to ludicrous extremes.

Adoption of an unlimited marital deduction appears to make the adoption of a beneficial enjoyment theory essential. Under an unlimited marital deduction, the beneficial enjoyment test would be the only means available for a decedent to have control over the ultimate disposition of property and yet for such property to qualify for the marital deduction. Such a provision would be a necessity where there are children involved or in situations of second marriages where the tax deferral opportunity under an unlimited marital deduction would encourage outright transfers of all property to surviving spouses.

While the adoption of a beneficial enjoyment rule would allow a decedent to qualify property for the marital deduction and still

retain control over its ultimate disposition, it would appear that an unlimited marital deduction would still tend to encourage the transfer of all property to a surviving spouse.

Position of Other Professional Groups

In their studies for estate and gift tax reform, the U.S. Treasury Department, the American Law Institute, and the American Bankers Association all propose liberalization of the current marital deduction with respect to both the amount of the deduction and the type of interest which will qualify.

Recommendations of the Treasury and of the ALI propose that the present 50 percent marital deduction be removed entirely and replaced by an unlimited 100 percent marital deduction. The ABA favors a retention of the existing 50 percent marital deduction, coupled with a deduction for the first $250,000 of property transferred to the surviving spouse regardless of the 50 percent limitation.

With respect to the type of interest which will qualify for the marital deduction, the Treasury, the ALI, and the ABA, in general agree that the present terminable interest rule should be eliminated and replaced by a concept referred to as the "current beneficial enjoyment rule," whereby a mere income interest to the surviving spouse may qualify for the marital deduction. Under the current beneficial enjoyment rule, an interest will qualify for the marital deduction whether or not the surviving spouse controls the underlying property, as long as it is agreed that the property will be taxed at the death of the spouse.

AICPA Proposals

Retention of the 50 Percent Marital Deduction. The AICPA believes that the current incidence of gift and estate taxation imposes a disproportionate burden on small and medium-sized estates. The AICPA's unified transfer tax proposal recommends an exemption level of $150,000. Assuming an exemption level of $150,000, it is felt that a 50 percent marital deduction will provide adequate relief for a surviving spouse in moderate-sized estates. Accordingly, the AICPA recommends a retention of the 50 percent marital deduction as currently provided in IRC Sec. 2056.

Retention of the Existing Terminable Interest Rules. The AICPA also recommends a retention of the existing terminable interest rules. Advocates of change in the existing terminable interest rule point to the complex and technical requirements necessary for an interest other than outright ownership to qualify for the marital deduction. The existing terminable interest rule has resulted in an inequity for those unaware of its restrictive provisions. To replace such rule with a beneficial enjoyment theory would likewise cause inequity to the unwary. While a beneficial enjoyment rule would allow for greater flexibility in estate planning, introduction into the Internal Revenue Code of an entirely new concept permitting a mere income interest to qualify for the marital deduction would add additional complexity to the law probably causing considerable new litigation.

Summary

The AICPA is opposed to a change in the federal estate and gift tax laws that would permit an unlimited marital deduction and the addition of a beneficial enjoyment rule. While estate tax reform should provide adequate protection to a surviving spouse in moderate estates, the AICPA feels that the increase in the existing exemption level to $150,000 from $60,000, along with retention of the existing marital deduction and terminable interest rules, will accomplish such a result. A change to an unlimited marital deduction and a beneficial enjoyment concept would be of greater benefit to larger estates, resulting in substantial revenue loss and adding further complexity to the existing tax laws.

4

Appreciated Assets Transferred at Death

Background

Under current law, the federal estate tax is imposed upon the fair market value of assets includable in the decedent's gross estate determined at the date of death or alternate valuation date (after taking into account allowable deductions and credits). The basis of the property in the hands of the recipient beneficiaries then generally becomes its value for estate tax purposes. If, however, the property represents the right to "income in respect of a decedent"—such as wages receivable after death, or obligations derived from a sale reported by the decedent under the installment method—the beneficiary must carry over the decedent's basis, if any.

Asset appreciation is not subject to income tax, although it is included in the post-death basis of the asset, under the general rule stated above. Appreciated property transferred by inter vivos gift normally retains the same basis in the hands of the donee as it had in the hands of the donor, plus gift tax paid on the full value of the transfer.

The 1969 Treasury Proposals contended that the current law permits vast portions of capital gains to escape income taxation. It charged that the law fails to recognize the separate characters

of estate and income taxation. It further claimed that accumulations derived from appreciation are favored over accumulations from annually assessed dividends, interest, and wages. In addition, the Treasury Department also stated that "unnatural holding patterns" develop because older investors become locked into appreciated assets to avoid paying income taxes on recognized gains. The Treasury Department drew up statistical tables based upon data gleaned from returns of the 1960's and concluded that $15 billion a year of capital gains fall outside the income tax system.

Under the 1969 Treasury Proposals' capital gain tax concept, the appreciation on capital assets held at death would be taxed in the final income tax return of the decedent as if the assets had been held for more than six months and sold just prior to death. "Income in respect of a decedent" would no longer be taxed as the income is received. It too would be "bunched" into the decedent's final return and taxed as capital gain or ordinary income, depending upon its nature. Only appreciation that accumulates after enactment of the proposals would be subject to the tax. Thus, the provisions would not have retroactive effect, but establishing valuations on the enactment date would be necessary.

The income tax attributable to such capital gains and "income in respect of a decedent" would be deductible from the gross estate of the decedent and would reduce the taxable estate and, accordingly, reduce the estate tax (if any) otherwise payable. The taxed property would acquire a stepped-up basis in the hands of the beneficiaries as under current law.

Property transferred to a surviving spouse and to charity would be exempted from the tax. The decedent's basis for the property would carry over to the spouse. Every decedent would have a minimum basis entitlement of $60,000 to preclude taxation below that level. All losses on capital assets held at death would be considered long-term and applied against capital gains in the year of death; then, under special rules, applied in the following order: against capital gains in the three prior years; against ordinary income for the year of death; and, lastly, against ordinary income of the three prior years. When losses are carried back, they would be applied first to the most recent preceding year. Only 50 percent of the capital loss would be deductible when

applied against ordinary income. Any losses not applied during the four-year period would expire unused.

Under the 1969 Treasury Proposals, since appreciation on property passing to widows and charity—and to a limited extent, to orphans—would not be taxed, the basis would be allocated arithmetically among the assets other than cash, in proportion to their respective fair market values. The objective of this rule would be to discourage transfers to particular beneficiaries principally to accomplish tax objectives.

Income taxes generated by the foregoing proposals would be payable, along with the estate tax, under broadened tax deferral provisions. The 1969 Treasury Proposals also held out the prospect of lowering transfer taxes to the extent that revenues are expected to be produced by this new capital gains tax.

Discussion

Some insight into the rationale underlying the 1969 Treasury Proposals can be gained by reflecting upon certain statements contained therein, and upon a lecture given by their chief advocate, Professor Stanley S. Surrey. The proposals assert: "*For administrative reasons* the tax system does not every year make the taxpayer [whose assets have appreciated] calculate how much his holdings have appreciated in value." (P. 332; emphasis and bracketed matter supplied.) Professor Surrey elaborated upon this theme during his portion of the Third Hess Memorial Lecture delivered to the Association of the Bar of the City of New York on November 18, 1971. Among other things, he stated:

> We could, and probably in equity we should, tax gains as they accrue currently year by year. But, we don't and the income tax system stays its hand as the asset increases in value, partly for administrative reasons and partly for policy reasons, such as, for example, that money may not be at hand to pay the tax.[1]

[1] Richard B. Covey, Stanley S. Surrey, David B. Westfall, "Perspectives on Suggested Revisions in Federal Estate and Gift Taxation," in *The Record of the Association of the Bar of the City of New York*, Vol. 28, no. 1 (1973), p. 49. All subsequent citations of this article will be made by page number within the body of the text.

This argument could lead to the conclusion that if the administrative procedures could be made somewhat easier, then nothing would stand in the way of a periodic, perhaps year-by-year, tax on unrealized appreciation. Another factor is the philosophical view of the economist Gardiner Ackley, which was quoted with apparent approval by Professor Surrey during the Hess Lecture and introduced by his comment that these words do not come from a radical economist:

> In my judgment the time has now come to move steadily and rapidly toward the virtual abolition of the unequal start in economic life that accrues to one who is born rich. . . .
> The vehicle is at hand to do this in the radical revision of our estate and gift tax laws. I should hope that within a decade or two we could place a virtual ceiling on the transmission of more than the most minimal property income from members of one generation to members of the next. (pp. 45-6)

If one starts with a predilection for the income taxation of unrealized gains and is inclined to seek the eradication of disparities of wealth, these factors would tend to support a tax system containing the technical complexities and burdens inherent in the capital gain tax proposals. While this report does not take a position with respect to such goals, the AICPA feels however, that Congress ought to be fully aware that they may be the springboard of the 1969 Treasury Proposals.

The 1969 Treasury Proposals place great weight on statistics to stimulate Congress to action. It should also be noted, however, that the Treasury Department drafted the proposals in the context of an active stock market and used examples of investors who experienced 50 percent appreciation in one year. Shortly after the proposals were issued, the stock market began a precipitous plunge. More recent statistics indicate the probability that severe inequities could result from the arbitrary taxation of appreciation at a date prior to the realization of capital gains.

While those in favor of a tax on appreciation at death often argue that it eliminates the lock-in problem, changing economic conditions are a far stronger force to that end. We have recently

witnessed significant changes in investment philosophies, and traditional practices of indefinitely holding on to "blue chip" investments are now being challenged. Untouched investments in many basic industries—rails, automobiles, chemicals, basic metals, electronics, and so forth—over extended periods of time would have produced little gain and some notable financial disasters. Tomorrow's "blue chip" investments will be different from today's, and the elemental urge to preserve capital will dictate changes in security portfolios.

There is one type of investment, however, where a tax on appreciation is certain to forcibly unlock long-standing ownerships —small businesses. The problem here is that the unlocking process may be ruinous. The prospect of the conjunction of income and estate taxes on the value of the business would probably accelerate the trend to merge or sell out to avert forced sales when the owners of closely-held companies die. This consequence should not be overlooked by Congress when it considers the advisability of imposing a capital gain tax on appreciation.

The 1969 Treasury Proposals repeatedly refer to the advantages held by a taxpayer who accumulates wealth through untaxed appreciation of his capital assets over one who earns ordinary income. While there is no doubt that one who is subject annually to a tax upon his ordinary income is at a comparative disadvantage, that disadvantage exists whether or not the investor is taxed on his capital gains, because the capital gain tax applies only when the investor chooses to realize the gain, and the tax is at lower effective rates. Probity dictates that the effects of current law be evaluated by comparing persons who are similarly situated to measure fairly the advantages that one may have over the other.

The two exhibits that follow contradict the implications of the 1969 Treasury Proposals that the current law permits high-bracket taxpayers to elude paying their fair share of taxes forever. They disclose that the estate tax, assuming other proposals in this report for a unitary tax structure and for the prevention of generation skipping are enacted, effectively balances the tax impact in the two situations.

Exhibit 1, page 22, compares two taxpayers, *A-1* and *B-1*. At the

beginning of a 20-year period ended by their deaths, both held $2 million worth of capital assets. During the 20 years, the assets appreciate 30 percent (compounded) every five years. *A-1* sells his property at five-year intervals and pays the capital gain taxes. When he died, the last five years of appreciation remained untaxed. *B-1* does not sell any appreciated assets, so that the appreciation arrives unreduced by income taxes into his estate. The Treasury Department's commentary indicates that, under current law, *B-1* has enormous advantages over *A-1*, but it disregards the effects of the estate tax in this situation. For example, the Treasury Department states: "The estate tax will fall on both [*A-1*

EXHIBIT 1

Taxpayer A-1		*Assets*	*Taxes Paid*
		(000 Omitted)	
Cost basis		$2,000	
Appreciation—first 5 years—30%	$600		
Tax—35%	210	390	$ 210
		$2,390	
Appreciation—second 5 years—30%	$717		
Tax—35%	251	466	251
		$2,856	
Appreciation—third 5 years—30%	$857		
Tax—35%	300	557	300
		$3,413	
Appreciation—fourth 5 years—30% Not taxed, taxpayer dies		1,024	
		$4,437	
Federal gross estate tax		2,076	2,076
		$2,361	$2,837
Ratios of assets and taxes paid to combined amount		45%	55%

EXHIBIT 1 continued

Taxpayer B-1	*Assets*	*Taxes Paid*
	(000 Omitted)	
Cost basis	$2,000	
Appreciation—first 5 years—30%	600	
	$2,600	
Appreciation—second 5 years—30%	780	
	$3,380	
Appreciation—third 5 years—30%	1,014	
	$4,394	
Appreciation—fourth 5 years—30%	1,318	
	$5,712	
Federal gross estate tax	2,905	
	$2,807	$2,905
Ratios of assets and taxes paid to combined amount	49%	51%

and *B-1*] *so it is not relevant* to say that [B-1] ought not to pay any income tax on his accumulation of wealth 'because he pays an estate tax.'" (P. 332; emphasis and bracketed matter added.) In Exhibit 1, A-1, the repeatedly taxed investor would have paid or had paid by his estate cumulative taxes of $2,837,000. *B-1,* who avoided the capital gain tax would have paid federal estate taxes aggregating $2,905,000—$68,000 more than *A-1.*

Exhibit 2 employs the same assumptions with respect to sales and growth rates, except that taxpayers *A-2* and *B-2* each held $4 million worth of capital assets at the beginning of a 20-year period ending with their deaths. *B-2,* who deferred payment of tax until his death and thereby obtained a stepped-up basis free of income taxes, would have paid taxes aggregating

$7,138,000, or $429,000 more than the cumulative taxes paid by *A-2*. The taxable estates of *A-1* and *A-2* would have been reduced, of course, by both the taxes paid and the appreciation on the tax money no longer available for investment. The higher estate tax brackets reached by *B-1* and *B-2* brings the percentage of assets of the four estates paid into the federal treasury into comparable alignment. The computations for these two exhibits are as follows.

Exhibits 1 and 2 assume that the taxpayer is not married at date of death and is therefore unable to utilize the marital deduction. In the following two supplementary illustrations, the facts are identical except that the taxpayer takes advantage,

EXHIBIT 2

Taxpayer A-2		*Assets*	*Taxes Paid*
		(000 Omitted)	
Cost basis		$ 4,000	
Appreciation—first 5 years—30%	$1,200		
Tax—35%	420	780	$ 420
		$ 4,780	
Appreciation—second 5 years—30%	$1,434		
Tax—35%	502	932	502
		$ 5,712	
Appreciation—third 5 years—30%	$1,714		
Tax—35%	600	1,114	600
		$ 6,826	
Appreciation—fourth 5 years—30% Not taxed, taxpayer dies		2,048	
		$ 8,874	
Federal gross estate tax		5,187	5,187
		$ 3,687	$6,709
Ratios of assets and taxes paid to combined amount		35%	65%

EXHIBIT 2 continued

Taxpayer B-2	Assets	Taxes Paid
	(000 Omitted)	
Cost basis	$ 4,000	
Appreciation—first 5 years—30%	1,200	
	$ 5,200	
Appreciation—second 5 years—30%	1,560	
	$ 6,760	
Appreciation—third 5 years—30%	2,028	
	$ 8,788	
Appreciation—fourth 5 years—30%	2,636	
	$11,424	
Federal gross estate tax	7,138	
	$ 4,286	$7,138
Ratios of assets and taxes paid to combined amount	38%	62%

EXHIBIT 3

Taxpayer A-1 and Spouse	Assets		Taxes Paid
	(000 Omitted)		
At time of death	$4,437		$ 761
Marital	(2,218)	$2,218	
	2,219	2,218	
Federal gross estate tax	831	830	1,661
	1,388	$1,388	$2,422
	1,388		
Assets transferred	$2,776		
Assets transferred versus taxes paid	53%		47%

EXHIBIT 3 continued

Taxpayer B-1 and Spouse	*Assets* (000 Omitted)		*Taxes Paid*
At time of death	$5,712		
Marital	(2,856)	$2,856	None
	2,856	2,856	
Federal gross estate tax	1,155	1,155	$2,310
	1,701	$1,701	$2,310
	1,701		
Assets transferred	$3,402		
Assets transferred versus taxes paid	60%		40%

through transferring one-half of his property to his spouse, of the maximum marital deduction.

In Exhibit 3, the total taxes paid by A-1 and spouse (the taxpayers who recognized gains and paid the capital gains tax) now

EXHIBIT 4

Taxpayer A-2 and Spouse	*Assets* (000 Omitted)		*Taxes Paid*
At time of death	$ 8,874		$1,522
Marital	(4,437)	$4,437	
	4,437	4,437	
Federal gross estate tax	2,076	2,076	4,152
	2,361	$2,361	$5,674
	2,361		
Assets transferred	$ 4,722		
Assets transferred versus taxes paid	45%		55%

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EXHIBIT 4 continued

Taxpayer B-2 and Spouse	*Assets* (000 Omitted)		*Taxes Paid*
At time of death	$11,424		None
Marital	(5,712)	$5,712	
	5,712	5,712	
Federal gross estate tax	2,905	2,905	$5,810
	2,807	$2,807	$5,810
	2,807		
Assets transferred	$ 5,614		
Assets transferred versus taxes paid	49%		51%

exceeds by a minor amount ($2,422,000 versus $2,310,000) the estate taxes paid by B-1 and spouse. However, in Exhibit 4, the estate taxes paid by B-2 and spouse continue to exceed ($5,810,000 versus $5,674,000) the combination of capital gains and estate taxes paid by A-2 and spouse.

The AICPA believes that Professor Surrey was erroneous in these remarks concerning the present system during the Hess Lecture:

> This *complete forgiveness* is totally unfair to people who have built up their estate from after-tax income, whether it derives from dividends, salary or capital gains upon which tax has already been paid. It is a *complete windfall* to those who are building up their estates out of before-tax income, the *untaxed appreciation* in value. (p. 49; emphasis added)

Certainly the terms "complete forgiveness," "complete windfall," and "untaxed appreciation" are grossly deceptive and do not properly describe the tax situations of the hypothetical taxpayers *B-1* and *B-2* in the above illustrations.

Position of Another Professional Group—American Bankers Association

In its commentary on the 1969 Treasury Proposals, the ABA contends that the capital gain tax on appreciation at death is regressive and unfair. Large estates would have the lowest net rate of capital gain tax since the tax would be allowed as a deduction at the highest transfer tax bracket. At present rates, 77 percent of the capital gain tax could be recouped from the estate tax. Whatever progressive rate scale is adopted, the capital gain tax must bite more deeply into estates in the lower brackets.

Undue complexity is another charge levelled against the Treasury Proposals by the ABA. Complications stem from the exclusion from the capital gain tax of property qualifying for the marital, charitable, and orphans deductions. Such exclusions would make the basis of any particular asset unknown until all assets are finally allocated among the beneficiaries, and sales of assets and funding of bequests of pecuniary amounts would have long uncertain tax consequences.

The ABA further points out that the 1969 Treasury Proposals contain a specter of interdependent tax computations with multiple variables. The amount of the marital and charitable deductions depends on the capital gain tax; that tax is dependent on the amount of property qualifying for the deductions; and the estate tax depends on, and often is interwoven with, the equation in fractional share deduction computations.

The brusque discarding by the 1969 Treasury Proposals of the present deferred tax treatment of "income in respect of a decedent" in IRC Sec. 691 is challenged by the ABA. The Treasury Department proposed to bunch all "income in respect of a decedent," whenever it is to be received, in the final return of the decedent, leaving the amelioration of the tax consequences to the income-averaging provisions. The ABA points out that the proposal complicates rather than simplifies the taxation of such income. Generally, "income in respect of a decedent" is not readily marketable and not readily subject to accurate valuation. Therefore, it will necessarily be reported at values below the full amounts to be collected. The discount would be reported over the same period, in the same fashion, and by the same taxpayers

as under current law. Moreover, anticipatory taxation would create serious liquidity problems for the estate.

The ABA further points out that taxpayers with identical amounts of losses would be treated differently, depending upon the existence of gains and losses in the year of death and in the three prior years. Furthermore, while losses would be allowed on lifetime gifts, they would be disallowed on transfers to related parties. The ABA rhetorically asks, "To whom does one ordinarily make lifetime gifts, if not to related parties?"

In other areas of criticism, the ABA takes issue with the Treasury Department's proposed allowance of basis at the higher of actual basis or enactment date value, with the minimum basis, with the absence of an exemption for life insurance, and with the triggering of added taxes where the decedent's state of residence conforms its income taxes to those of the federal government. The ABA shies away from the obligation to prove cost basis, asserting that many taxpayers maintain inadequate records, in reliance upon the stepped-up bases rules under the current estate tax law.

The ABA originally advocated carryover of basis as its alternative to the present system. It reconsidered, and now is in favor of the Additional Estate Tax (AET). Under the carryover of basis concept, the transferor's tax basis for all properties included in the decedent's estate would carry over to the transferee, as is the case at present when property is transferred by inter vivos gift. The federal estate tax before state death tax credit would be added to the bases of assets transferred, but limited to the extent that the fair market value of the estate's assets exceed their bases. Tangible property held for personal use by the decedent would be allowed a step-up of basis within the limits of $5,000 per item and $25,000 in total.

The carryover-of-basis proposal was attractive for the following reasons:

- It has proved to be operative under present gift tax rules;
- The tax burden would fall on the parties who realize income on a voluntary sale of the property, and at a time when funds become available to pay the tax;
- Death is not the moment of realization of income;
- Carryover of basis meets the objection to the escape from in-

come tax of appreciation on a decedent's assets;

- The inequity of imposition of tax before realization of income cannot be eliminated by averaging devices; and
- Relief measures for deferring the tax will not be necessary under the carryover-of-basis concept.

Yet in its commentary on the carryover-of-basis proposal, the ABA presented its reconsideration of the matter.

The ABA is deeply concerned with proposals that would require the establishment of historical cost basis for federal income tax purposes after property passes through an estate. It contends in its commentary, that many people have not maintained adequate records in reliance on current law which makes cost basis irrelevant when the property owner dies.

The carryover-of-basis proposal also allows the addition of federal estate taxes to the bases of items of property. The ABA is concerned that sales of property by the executor of an estate prior to the final determination of the estate tax liability will involve guesswork as to the income tax consequences of such sales and will necessitate the filing of amended fiduciary and beneficiary income tax returns as a matter of burdensome routine. Further, with carryover of basis the period over which taxpayers tend to refrain from the sale of property to postpone the incidence of taxation would be indefinitely extended, thus creating a lock-in problem.

The ABA also considers it manifestly unfair for estate taxes to be allocated under the carryover-of-basis proposal to property qualifying for the marital or charitable deductions. Yet, if certain property is to receive a basis adjustment, and other property is not, the entire process of administration would be beset by the indefiniteness of the bases of specific items.

Sales soon after the date of death are often obligatory to pay death taxes, debts, expenses, and bequests. Under the carryover-of-basis proposal, the ABA concluded, these sales may result in substantial capital gains, and the need to pay taxes thereon may require further sales which in turn may add to additional capital gain taxes—a compound "mushroom" effect. In light of this interaction, the ABA contends that the carryover-of-basis proposal

bears a close resemblance to the capital gains tax-at-death proposal—without the advantages of the latter (that is, the capital gains tax liability would reduce the estate tax).

The ABA believes that a carryover-of-basis rule would bring with it the practical elimination of the utilitarian pecuniary marital bequest. Draftsmen would be wary because the funding of such bequests might involve recognition of prohibitive amounts of capital gain.

Finally, if a carryover-of-basis rule is enacted, the ABA envisions firm resistance by Congress to meaningful transfer tax reductions. The ABA believes that the tax revenues eventually to be derived from adoption of a carryover-of-basis rule cannot be accurately measured.

While the ABA favors retention of the current taxing system, it urges only as the least problem-filled alternative the adoption of the "Additional Estate Tax" (AET). The ABA devised the AET as an alternative to the capital gains tax after deciding to reject support for the carryover-of-basis concept which it had previously favored.

The AET would be imposed at the fixed rate of 14 percent on net appreciation of assets upon death and upon transfers made within the two years preceding death. Property transferred earlier would take a carryover basis as under current law. The 14 percent rate was arrived at by multiplying the complement of a postulated highest transfer tax bracket (60 percent) by the highest capital gains tax rate (35 percent). The tax would apply even upon property qualifying for the marital and charitable deductions.

Losses at death would not be rebated to any extent by the AET. The ABA considers their proposed reduced rate structure a sufficient compensation for estates holding depreciated assets. Only appreciation after the enactment of the AET would be subject to the tax. Accordingly, the proposed rate reductions of the transfer tax to a ceiling of 60 percent would be phased in over a five-year period as the revenues generated by the AET would presumably increase.

The AET is advocated by the ABA in lieu of the Treasury Proposals on three broad grounds: (1) it would be progressive, and therefore fair; (2) it would be simple because it would avoid

complex refinements, and would be collected along with the basic transfer tax; and (3) it would be constitutional because it would be an excise tax, a classification which might not apply to the capital gains tax. Each of these claimed attributes of the AET is evaluated below.

AICPA Proposals

Retention of Current Law. After carefully studying each of the proposals for taxing, directly or indirectly, the unrealized appreciation of assets at death, the AICPA concluded that the objectionable features of each proposal were compelling and beyond recasting. It has further concluded that the AICPA should not temper its strong belief that the current law should not be abandoned, or by expressing a qualified preference for one proposed change over the others. The following discussion serves to support the AICPA's conclusions.

The ABA's proposed tax is called an "Additional Estate Tax," but it is not that; it is an income tax. It is measured by gains—unrealized gains—and that is its fundamental defect. The AICPA, as a general observation, takes the position that the claimed advantages of the AET are not valid. It does not agree that the tax is fair, progressive, simple, and constitutional beyond debate.

The Correlation of Death and Gain. The focal point of the problem with both the AET and the 1969 Treasury Proposals is their turn from the heretofore well-established principle that taxes on appreciation should be imposed only when gains are realized and when cash to pay the taxes is generated. The AICPA believes that the view of death as a moment of realization of gain is philosophically unsound. Paper profits at any point in time are so ephemeral that, if they are to be taxed, only an immensely complex system involving alternate valuation dates, liberal tax deferrals, credits, averaging, and quick-refund procedures could possibly provide for fairness.

Double Tax. The AET would be in effect a double tax. This is acknowledged by the ABA. No deduction would be allowed for the basic estate tax for AET purposes. The resultant double tax is embraced by the ABA so that the AET would be progressive, when viewed in combination with the basic estate tax.

Rate of Tax. The AET would not be on a graduated scale, yet it is labeled "progressive" by the ABA. It is not convincing to contend that the AET is progressive when (but only when) it is combined with the basic estate tax rate schedule. It is obvious that a taxpayer who has accumulated a modest amount of taxable appreciation over many years would be taxed at the same rate as one who has accumulated substantial appreciation over a short-term period. By contrast, the income tax rules do ease the burden upon lower-bracket taxpayers. In addition, the inclusion of only one-half of net long-term gain in taxable income, the exemption from the minimum tax, and the income averaging provisions operate in favor of the individual who recognizes relatively small amounts of gain on an annual basis.

The AET rate would be tied directly to the highest capital gain tax rates. There have been many proposals to increase or otherwise modify the capital gains tax. If the tax is increased, as it has been in recent years, it has been assumed that an increase in the rate of the AET would follow. Such a change would magnify the problems associated with the AET, not the least of which would be the liquidity crisis in prospect for estates.

Basis Problems. The ABA is concerned with the requirement, especially under the carryover-of-basis proposal, to prove actual cost basis. The AICPA does not share that concern—at least not to an extent that would justify so complicating the estate tax structure. The current recordkeeping requirements should be observed by all taxpayers; and no taxpayer should be entitled to ignore these requirements based on the highly speculative assumption that he will hold his property until his death.

The ABA's concern with proof of basis, however, does not extend to several areas in which carryover of basis is adopted under the AET. For example, there is apparently no concern with the present gift tax basis rules. Nevertheless, to avoid proof of basis it proposes to adopt a start-up date rule. The AICPA sees a serious problem in the choice of fair market value on the enactment date as the basis of property for AET purposes.

The enactment date rule would create a nationwide appraisal obligation which would be a substantial administrative burden. Estates are not necessarily made up primarily of listed securities, and the valuation problems at the time of death could be enor-

mous. Disputes between examining agents and taxpayers' representatives often involve the valuation of real estate, partnership interests, closely held corporations, loans receivable, copyrights and patents, valuable art work, large blocks of securities, and present and future interests in trusts. These disputes often reach the courts. A start-up date would bring another set of subjective valuations into the transfer tax picture, and the AICPA believes that the accompanying distortions and inaccuracies would be an unfortunate consequence of this approach. Moreover, the development of self-serving records to support valuations for the types of assets listed above could become a widespread practice. The prospects of an informed and fair review of the accuracy of these records would likely be inversely proportional to the interval between their preparation and review.

If a start-up date is adopted, enormous numbers of persons will be obliged to price an inconceivably large number of assets. Relatively few estates now must file federal estate tax returns because of the exemption under current law. Consequently, the assets of relatively few estates undergo professional appraisal. But it is difficult—if not impossible—for a taxpayer to know that he will not have a taxable estate in the uncertain future. He, therefore, cannot safely assume that he need not determine his start-up date values. Under these conditions, the appraisal of property as of the start-up date would be an immediate major burden, and valuation controversies in the settlement of estate tax liabilities would be many times more frequent than is presently the case.

Marital and Charitable Deductions. The AET makes no allowance for transfers that qualify for the marital and charitable deductions. In connection with the 100 percent marital deduction proposal, the 1969 Treasury Proposals appropriately state:

> It does not appear, then, that transfer of property between husband and wife are appropriate occasions for imposing tax. An especially difficult burden may be imposed by the tax when property passes to a widow, particularly if there are minor children. The present system of taxing transfers between spouses does not accord with common understanding of most husbands and wives that the property they have accumulated is 'ours.' (p. 358)

This view should be compared with the ABA's view that "as a matter of theory, imposition of a tax on appreciation should not turn upon the destination or use of the appreciation." As a matter of practice and public policy, the marital deduction has been allowed in valid recognition of the nature of the marital relationship and to equate the tax consequences of taxpayers living in jurisdictions having different property law concepts. Moreover, deductions for income tax purposes generally have been allowed for the value of assets transferred to charity, and no gain need be reported if the transferred assets have appreciated.

The ABA's overriding consideration in suggesting these tax provisions is revealed in the following statement.

> Further, if exemptions from the AET based upon the recipients of the property subjected to the tax or adjustments to it are introduced, *simplicity is lost*, and administration becomes complex. *It is time that simplicity and ease of administration, whether it works 'for' or 'against' the taxpayer, be considered as priority objectives in the enactment of tax laws.* (pp. 2-43, 44, emphasis supplied)

If we substitute for the words "for" and "against" in the foregoing quotation the words "equitably" and "inequitably"—or "fairly" and "unfairly"—the consequence of the selection of simplicity as the overriding priority may be more clearly apparent.

Simplicity and Unfairness—The Correlatives. Although the AET conceivably could be modified to achieve greater equity, the ABA apparently prefers not to do this on the grounds of an overriding need for simplicity. The following observations seem appropriate in this connection.

• Appreciation would be taxed, but there would be no tax rebate for a net loss at death. The investor may have paid capital gains taxes throughout his life, but no carryback of a net loss position would be available, and no transfer tax reduction is suggested. The ABA suggests that the investor would have some relief with its proposed lower tax rate schedule. The AICPA believes that in an effort to simplify this proposal, the fundamental income tax

character of the AET is ignored, and thus the normal income tax equitable safeguards are omitted.

- The AET is at a flat rate. A graduated rate, providing lower rates for insubstantial amounts of appreciation, is rejected—in the interest of simplicity.
- Properties qualifying for the marital and charitable deductions are subjected to the AET—in the interest of simplicity.
- The AET proposal incorporates a mandatory start-up date basis rule, although the ABA recognizes that inequities would occur between and among individuals, that there would be advantages for taxpayers holding highly appreciated property at the enactment date, and that there would be hardship for taxpayers who have a provable basis for property greater than its value on that date—in the interest of simplicity.
- Tangible personal property generally is exempted from the AET; neither gain nor loss would be considered; and no dollar ceiling would be imposed upon the exemption, even though inequities could result—in the interest of simplicity.

Constitutionality. The ABA states that the capital gain tax on net unrealized appreciation at death has been attacked as unconstitutional. It further asserts: "Any problem in this regard is avoided by the AET, which is an excise tax as contrasted to an income tax." Regarding the nature of its proposed tax, the ABA admits, "Some people will say that the AET is nothing more than a capital gains tax at death. They are obviously correct in the sense that *the result is the same*—the taxation of net unrealized appreciation at death." In view of the foregoing, a layman might wonder why an AET at death should be considered any more or less constitutional than a capital gain tax at death. Would not the courts, in evaluating the constitutionality of the AET, look hard at the acknowledged similarity of the *result*, and not be unduly swayed by the label "excise tax"?

Summary

The proposals that would purportedly prevent any tax reduction opportunities under the current system are melanges of complexities and inequities bound to cause extreme difficulties for taxpayers and government alike. If there is merit to the positions

of both the 1969 Treasury Proposals and the ABA that proof of actual basis over the years would be a hardship, then carryover of basis is impractical and, as a matter of equity, we should then resort to a new start-up basis under any new taxing proposal. If, however, there is—as the AICPA contends—a host of inherent inequities in the new start-up basis, then it should be rejected. It is believed also that the notion that the occasion of death is an appropriate time for the recognition of unrealized gain is unsound and that it should not be acceptable to Congress.

The asserted imperatives for a change of current law are not absolutely compelling. It is at least debatable that a shift of problems from one tax system (for example, the income tax system) to another (for example, the estate tax system) is progress. Estates which pay as much tax as did our illustrative taxpayers *B-1* and *B-2* on pages 23–27 do not escape the taxing system. Furthermore, there should be no extensive opportunities for transfer tax avoidance if the AICPA's other recommendations—a unified transfer tax; restrictions on generation skipping; and rejection of an increased marital deduction—are adopted. The present rules do not confuse the separate roles of the income and estate taxes. The estate tax complements the income tax. The estate tax is equitably progressive; at least, it has such high rates that Congress should continue to permit the beneficiaries to take bases equal to the full values subject to such heavy tax assessments.

The AICPA knows and experienced practitioners will attest that the present system is workable. The ease of reference to finally determined estate tax values to prove the bases of assets subsequently sold is manifest. If simplicity of administration of the tax law has merit, as is so often asserted by members of Congress and professional groups, the AICPA believes that where the law has this attribute with respect to taxation at death, it should not be discarded.

A practical and equitable exchange of a tax on appreciation cannot be made for an appreciable rate reduction. A new start-up date necessitates a phase-in of any rate reduction, as is apparent in the AET proposal. The new start-up date also requires speculation as to the amount of tax which would be derived from appreciation over the years ahead as shown by the previous discussion of the ups and downs of the securities markets. Congress would have to gamble that appreciation during that period would

be enough to permit a considerably lower top tax bracket. Moreover, whatever the rate concessions might be, these intended benefits might be more than counterbalanced by the new proposed tax system to which estates would be subject. Reasonable opportunities for rate reduction exist in the AICPA's several other recommendations.

5

Unified Transfer Tax

Background

Current law imposes an estate tax on certain transfers at death and a gift tax on certain transfers during life. Each tax has a separate rate schedule with the gift tax rates representing three-quarters of the estate tax rates at comparable levels. The estate tax exemption is $60,000 while the gift tax has a lifetime exemption of $30,000 for each donor and an annual exclusion of $3,000 for gifts of present interests to each of any number of donees. The gift tax is imposed on the value of the gift but the gift tax itself is not treated as an additional transfer subject to tax. Under the estate tax law, the tax itself is subjected to tax because the estate tax is imposed on the gross estate reduced only by deductions and not by the estate tax.

Statistics repeatedly issued by the Treasury indicate that despite the substantial tax incentives for lifetime giving, only a small percentage of individuals for whom estate tax returns are filed make such gifts in amounts exceeding the lifetime gift exemption and the annual gift tax exclusions.

Discussion

The primary policy question involved in determining whether there should be a single rate structure applicable to lifetime transfers and to transfers at death is the extent to which lifetime giving should be encouraged. The general consensus appears to be that such giving should be encouraged because it is socially desirable to have property transferred to or for the benefit of

younger generations where there is usually a greater need and a greater willingness to make the property productive. Thus, the issue becomes whether the present dual rate structure strikes a proper balance between creating incentives for lifetime giving and being fair to different taxpayers.

The 1969 Treasury Proposals take the position that current law grants an undue preference to lifetime gifts because it benefits the relatively wealthy individual who can afford to make significant lifetime gifts compared to the less well-to-do individual who cannot afford to do so.

Position of Other Professional Groups

The ABA favors a single rate structure for all transfers, whether made during life or at death. The ABA's acceptance of a single rate structure is subject to the qualification that the rates will be lowered to offset the additional transfer taxes that will be payable at death by persons who make taxable transfers during life.

"Grossing up" the amount of lifetime gifts to be included in a single rate structure for all transfers has also been proposed. This concept has been explained to require that the single-rate-schedule transfer tax would be imposed upon the fair market value of the property transferred, including, in the case of lifetime transfers, the amount of the federal transfer tax incurred on the transfer, which is an integral part of the making of the gift. Under present law, the tax on lifetime gifts is based on the fair market value of the property transferred exclusive of any gift tax. In the case of testamentary transfers, however, the present estate tax is imposed on the full value of the property in the estate, including that portion used to pay the estate tax imposed. Under the unified transfer tax, this difference in treatment between lifetime gifts and testamentary transfers would be eliminated by grossing up the fair market value of lifetime gifts, thus causing the transfer tax in effect, to be paid out of the property taxed, as is the case with testamentary transfers. A table would be provided showing the amount of the grossed-up transfer so that taxpayers would not be burdened with complex calculations.

The ABA opposes the use of grossing up for all lifetime transfers on two grounds. First, it discourages lifetime gifts because the payment of the additional transfer tax imposed on the

tax results in the loss of subsequent earnings on that amount during the remaining life of the transferor. Second, it is complicated and would not be understood by transferors, particularly when, as is possible, the tax is greater than the amount of the gift itself.

A majority of the members comprising various bodies within the ALI appear to prefer a unified transfer tax. In October 1967, however, the Council of the ALI voted 12 to 11 in favor of the retention of the dual tax system.

At the present time, there appears to be no official ALI recommendation on the choice between a dual tax system and a unified tax system. The ALI does appear to favor grossing up all lifetime transfers and the retention of the present $3,000 annual gift tax exclusions.

AICPA Proposals

Since lifetime transfers should continue to be encouraged and further, since the current incidence of taxation on testamentary dispositions is imposed disproportionately and unfairly on low and medium-sized estates, the AICPA proposes a modified unified transfer tax as follows.

Retention of Current Estate Tax Rates. The modified unified transfer tax would utilize the federal estate tax rates as currently established by IRC Sec. 2001. Along with this, the AICPA advocates continuation of the current incentive to make inter vivos gifts by subjecting such gifts to a tax at the rate of 75 percent of that rate.

Inclusion of Lifetime Gifts. Lifetime gifts would be included in the unified rate without grossing up lifetime dispositions except for gifts in contemplation of death. The 75 percent rate would be preserved at death by the inclusion of only 75 percent of the taxable value of property transferred during lifetime and by the granting of credit against the unified transfer tax liability for gift taxes paid on such taxable gifts. Gifts in contemplation of death, as that term is currently defined by Sec. 2035, would be grossed up so that both the value of the property at the date

of death and the amount of gift tax paid would be subject to the unified transfer tax at death. Credit would be granted against the unified transfer tax liability for gift taxes paid on gifts made in contemplation of death.

Annual Exclusion for Gifts. The AICPA advocates the continuation of the $3,000 annual exclusion for gifts of present interests in property as currently provided by Sec. 2503(b).

Unified Transfer Tax Deduction. For the current estate tax exemption in the amount of $60,000, provided by Sec. 2052, and the current specific gift tax exemption in the amount of $30,000, provided by Sec. 2521, the AICPA would substitute a unified transfer tax deduction in the amount of $150,000, available, at the option of the taxpayer, either against inter vivos gift tax liabilities or against the unified transfer tax imposed at death.

Retention of Marital Deduction. The AICPA proposes the retention of the allowance of a marital deduction as currently provided by Sec. 2056.

Summary

The AICPA believes that the recommendations outlined above will continue to encourage lifetime gifts. The continuation of the 75 percent gift tax rates, the availability of annual gift tax exclusions, the continuing possibility of removing asset appreciation from an estate by eliminating from the death transfer tax appreciation from the date of the gift to the date of death, and the income tax considerations often associated with inter vivos transfers can all be cited as continuing reasons to support inter vivos gift transfers.

The current estate exemption of $60,000 and the current specific gift tax exemption of $30,000 are inadequate when considered in light of many years' inflation. Accordingly, the AICPA recommends that the current tax exemptions be replaced by a unified transfer tax deduction of $150,000, available to a taxpayer to reduce either the amounts of inter vivos taxable gifts or to reduce the taxable estate. Also recommended is the continuation of the

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two present transfer tax schedules since the availability of two schedules does not create undue administrative problems.

The "gross-up" concept for inter vivos transfers is opposed primarily because such a provision would discourage lifetime gifts. The gross-up concept also appears to be extremely complex in administration.

Exhibits 5, 6 and 7 (p. 44-47) respectively illustrate the AICPA recommendations to retain the current rates, to retain the current concept of a marital deduction, and to substitute a unified transfer tax deduction in the amount of $150,000 for the current $60,000 and $30,000 estate and gift tax exemptions. (Each schedule illustrates four hypothetical estate valuations.) The AICPA believes that these recommendations, when combined with its other recommendations, including our recommendation for severe restrictions on generation skipping, will not adversely affect the total federal revenues derived from these sources. Instead, these recommendations should alleviate substantial inequities currently imposed on low and medium-sized estates. It is noteworthy in the following schedules that total transfer taxes from an estate with net disposable assets aggregating $200,000 would be decreased from $36,100 to $7,000, while for larger estates, total transfer taxes would not be significantly affected. Equally important should be the fact that in the typical situation where the male predeceases the female, no death transfer taxes would be payable at the death of the first decedent until net disposable assets exceed $300,000 where the surviving spouse inherits all of the family's assets. Since the necessities of life often dictate that in low and medium-sized estates the surviving spouse requires all of the family's assets, the AICPA proposed tax structure should permit and strongly encourage such testamentary dispositions by imposing the major portion of death transfer tax liability only at the time of death of the second spouse.

Exhibit 7 (p. 46—47) illustrates the effect of inter vivos gifts (other than gifts in contemplation of death) by the first decedent. Note that substantial savings in total federal unified transfer taxes can be realized by the continued use of inter vivos gifts; such savings are increased where the unified transfer tax deduction of $150,000 is not claimed against earlier gifts taxed at low gift tax rates.

EXHIBIT 5

Current Federal Estate Taxes—No Inter Vivos Gifts

First Death				
Net disposable assets (after reduction by liabilities and expenses)	$200,000	$1,000,000	$5,000,000	$10,000,000
Less:				
Marital deduction	100,000	500,000	2,500,000	5,000,000
Exemption	60,000	60,000	60,000	60,000
Total reductions	160,000	560,000	2,560,000	5,060,000
Taxable estate	$ 40,000	$ 440,000	$2,440,000	$ 4,940,000
Federal estate tax	$ 4,800	$ 126,500	$ 968,800	$ 2,430,400
Second Death				
Net disposable assets	$195,200	$ 500,000	$2,500,000	$ 5,000,000
Less exemption	60,000	60,000	60,000	60,000
Taxable estate	$135,200	$ 440,000	$2,440,000	$ 4,940,000
Federal estate tax	$ 31,300	$ 126,500	$ 968,800	$ 2,430,400
Summary				
Total federal estate taxes	$ 36,100	$ 253,000	$1,937,600	$ 4,860,800
Tax as % of total net disposal assets	18.1%	25.3%	38.8%	48.6%

Proposed Federal Unified Transfer Tax—No Inter Vivos Gifts

First Death				
Net disposable assets (after reduction by liabilities and expenses)	$200,000	$1,000,000	$5,000,000	$10,000,000
Less:				
Marital deduction	100,000	500,000	2,500,000	5,000,000
Unified transfer tax deduction	150,000	150,000	150,000	150,000
Total reductions	250,000	650,000	2,650,000	5,150,000
Taxable estate	None	$ 350,000	$2,350,000	$ 4,850,000
Federal estate tax	None	$ 97,700	$ 924,700	$ 2,373,700
Second Death				
Net disposable assets	$200,000	$ 500,000	$2,500,000	$ 5,000,000
Less unified transfer tax deduction	150,000	150,000	150,000	150,000
Taxable estate	$ 50,000	$ 350,000	$2,350,000	$ 4,850,000
Federal estate tax	$ 7,000	$ 97,700	$ 924,700	$ 2,373,700
Summary				
Total federal estate taxes	$ 7,000	$ 195,400	$1,849,400	$ 4,747,400
Tax as % of total net disposal assets	3.5%	19.5%	37.0%	47.5%

EXHIBIT 7

Proposed Federal Unified Transfer Tax—With Inter Vivos Gifts

Net disposable assets	$200,000	$1,000,000	$5,000,000	$10,000,000
Inter vivos gifts by first decedent of 20% of net disposable assets (not in contemplation of death)—except in case of $200,000 estate	None	$ 200,000	$1,000,000	$ 2,000,000
Less unified transfer tax deduction	None	(None claimed)	(None claimed)	(None claimed)
Taxable gifts	None	$ 200,000	$1,000,000	$ 2,000,000
Federal gift tax		$ 38,000	$ 244,300	$ 564,900
First Death				
Net disposable assets (reduced by amounts of gifts and gift taxes)	$200,000	$ 762,000	$3,755,700	$ 7,435,100
Plus:				
75% of inter vivos gifts	None	150,000	750,000	1,500,000
Asset balance	200,000	912,000	4,505,700	8,935,100

Less:				
50% marital deduction	100,000	456,000	2,252,850	4,467,550
Unified transfer tax deduction not previously claimed	150,000	150,000	150,000	150,000
Total deductions	250,000	606,000	2,402,850	4,617,550
Taxable estate	None	$ 306,000	$2,102,850	$ 4,317,550
Federal estate tax	None	$ 83,600	$ 803,600	$ 2,038,300
Less credit for gift tax paid	None	38,000	244,300	564,900
Net federal estate tax	None	$ 45,600	$ 559,300	$ 1,473,400
Second Death				
Net disposable assets	$200,000	$ 456,000	$2,252,850	$ 4,467,550
Less unified transfer tax deduction	150,000	150,000	150,000	150,000
Taxable estate	$ 50,000	$ 306,000	$2,102,850	$ 4,317,550
Federal estate tax	$ 7,000	$ 83,600	$ 803,600	$ 2,038,300
Summary				
Total federal unified transfer taxes	$ 7,000	$ 167,200	$1,607,200	$ 4,076,600
Tax as % of total net disposable assets	3.5%	16.7%	32.1%	40.8%

EXHIBIT 8

Summary

Net disposable assets (after reduction by liabilities and expenses)	$200,000	$1,000,000	$5,000,000	$10,000,000
Total current federal estate taxes (no inter vivos gifts)—Exhibit 5	$ 36,100	$ 253,000	$1,937,600	$ 4,860,800
Total tax as % of net disposable assets	18.1%	25.3%	38.8%	48.6%
Total proposed federal unified transfer taxes (no inter vivos gifts)—Exhibit 6	$ 7,000	$ 195,400	$1,849,400	$ 4,747,400
Total tax as % of net disposable assets	3.5%	19.5%	37.0%	47.5%
Total proposed federal unified transfer taxes after inter vivos gifts of 20% of net disposable assets—Exhibit 7	(Not applicable)	$ 167,200	$1,607,200	$ 4,076,600
Total tax as % of total net disposable assets	(Not applicable)	16.7%	32.1%	40.8%

Exhibit 8 (opposite) summarizes the computations in Exhibits 5, 6, and 7.

Assume the following for these schedules:

1. Decedents with net disposal assets of $200,000 or less transfer their total estate to a surviving spouse. Such second estates are reduced only by federal estate taxes imposed at the first death.
2. Decedents with net disposable assets of $1,000,000 or more utilize a full marital deduction and limit testamentary dispositions to a spouse to such amount.
3. Assets transferred at the death of the first decedent neither appreciate nor depreciate in value between the date of transfer and the date of death of the second spouse.
4. Credit for state death taxes are disregarded for the purposes of these computations since they effectively represent a substitution for such death taxes.
5. Annual exclusions are disregarded in determining inter vivos gifts in Exhibit 7.

6

Liberalization of Deferred Payment of Federal Estate Tax

Background

Section 6166 was enacted by Congress in 1958. The House committee report accompanying HR 8381, which added Sec. 6166 to the 1954 code, provided that where the value of an interest in a closely held business represents a significant portion of the base on which the federal estate tax is computed, the federal death tax can be paid in ten annual installments instead of a lump-sum payment fifteen months after the death of the decedent.

For purposes of IRC Sec. 6166 a closely held business includes a proprietorship, or stock or ownership interest in a partnership or corporation of 20 percent or more, or a partnership or corporation in which there are ten or fewer partners or shareholders.

The House committee report explained the purpose was to make it possible to keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax. Under existing law, when a decedent has a substantial portion of his estate invested in the business enterprise, the heirs might be confronted with the necessity of either breaking up the business or selling it to a larger enterprise in order to obtain funds to pay the federal estate tax. This is especially unfortunate in the case of small businesses, which traditionally are also closely held businesses. By spreading out the period over which the estate tax may be paid, it would be

possible for the estate tax to be paid out of the earnings of the business, or at least it would provide the heirs with time to obtain funds with which to pay the tax without upsetting the operation of the business. This provision was believed to be particularly important in preventing corporate mergers and in maintaining the free enterprise system.

Section 6166 was deemed necessary because the general provision of Sec. 6161(a)(1) permitting a six-month extension of time for payment of federal taxes, including federal estate taxes by the IRS for reasonable cause, is not an adequate remedy for an executor holding an interest in a closely held business. Section 6161(a)(2), which permits the IRS to grant an extension of time for up to ten years for payment of estate taxes upon a showing that payment of the entire estate tax would result in "undue hardship" to the estate, is also an inadequate relief procedure for an executor holding an interest in a closely held business. For decedents dying after December 31, 1970, an extension of time under Sec. 6161(a)(1) can be granted for up to a year (for reasonable cause). Section 6165 permits the IRS to require that a bond (for up to twice the amount of tax involved) be furnished where an extension of time for payment is granted. The regulations permit the IRS to require such a bond when an extension is granted under Sec. 6161. The bond requirement has not been applied in connection with Sec. 6166 extensions.

Where applicable, Sec. 303 presently permits redemption of stock of closely held corporations, to the extent of the entire amount of estate taxes, administration expenses, and funeral expenses. If there is a profit on the redemption (that is, if the sales price exceeds the estate tax value), the profit is taxed as a capital gain.

Discussion

Reference to the amount of the estate taxes, federal and state, payable at death, indicates that the executor of the estate of a deceased owner of a closely held business interest is faced with a substantial liability for estate taxes. The growth of the value of such an interest during the lifetime of the owner, increases the potential estate tax burden. The greater the growth, the greater the likelihood that the executors will have to sell the

closely held business interest. Inflation serves further to aggravate this problem.

The following chart indicates the estate tax liability of a decedent resident of New York State.

Estate before exemption	*Federal tax*	*New York tax*	*Total*	*Percent on excess Federal*	*New York*
$ 300,000	$ 59,100	$ 10,000	$ 69,100	26.8	5.0
500,000	116,500	20,000	136,500	28.0	6.0
700,000	176,700	32,000	208,700	30.2	7.0
1,060,000	289,140	58,800	347,940	33.4	8.0
2,060,000	649,280	153,000	802,280	41.8	10.0
3,060,000	1,075,920	267,200	1,343,120	47.2	12.0
4,060,000	1,551,560	401,400	1,952,960	52.6	14.0
5,060,000	2,069,880	551,000	2,620,880	55.8	15.0
6,060,000	2,620,200	710,600	3,330,800	58.0	16.0

The owner of a substantial equity in a closely held business needs statutory help, which would permit deferred payment of these substantial tax liabilities. The very size of the tax in relation to the estate should be enough "hardship" to permit relief without the necessity of proving "undue hardship" as presently required by Sec. 6161(a)(2).

The approach of Sec. 6166 in permitting an absolute right for installment payments over a ten-year period of federal estate tax attributable to taxation of a closely held business interest should be extended to provide relief in more instances.

Where there are several closely held business equities in an estate, the yardsticks of Sec. 303 and Sec. 6166 to treat them as one interest should be alike.

Position of Other Professional Groups

Section VIII of the 1969 Treasury Proposals, "Estate and Gift Tax Proposals," contained recommendations for liberalization of the Sec. 6166 payment rules. The proposals indicate that the "voting stock" requirement should be eliminated and that the shareholder limit should be raised from ten to fifteen. Further proposed liberalization would include permitting the installment-payment election (Sec. 6166) where the interest in the closely

held business exceeds 25 percent of the taxable estate. The Treasury Proposals would then limit the application of Sec. 303 to the portion of the estate tax which could qualify under Sec. 6166.

The ABA, in its "Summary of Transfer Act Draft Statute of the American Bankers Association" would permit deferral under Sec. 6166 where the decedent's interest in a closely held business exceeds 20 percent of his transfers at death. The definition of closely held stock would include any stock not traded on a national securities exchange or in an over-the-counter market, or if so traded, if the estate includes 20 percent or more of the voting stock. In the case of partnerships, the required percentage of partnership interest would be reduced from twenty to ten, and the limitation on partners would be increased from ten to twenty.

AICPA Proposals

Section 303 Rules Regarding Treatment of Several Closely Held Business Equities as One Should Take on the Standards of Sec. 6166. Section 303 presently permits two or more corporations to be treated as a single corporation where an estate owns more than 75 percent in value of the outstanding stock in each of the corporations. Section 6166 has a similar provision, except that the ownership requirement is more than 50 percent of the stock. The AICPA recommends that this percentage test be the same for purposes of Secs. 303 and 6166, and that the 50 percent or more test of Sec. 6166 apply for purposes of Secs. 303 and 6166.

Period for Sec. 303 Redemption Should Recognize Litigation in Any Court. The period during which Sec. 303 may be utilized is the period of limitations for assessment of federal estate tax plus ninety days, or, if a petition for redetermination of an estate tax deficiency has been filed with the Tax Court, at any time before the expiration of sixty days after the decision of the Tax Court becomes final. The AICPA feels that there is no reason that taxpayers who litigate in the District Court or Court of Claims should be prejudiced, and the AICPA recommends that the period during which Sec. 303 may be applied be extended to the expiration of ninety days after the conclusion of litigation with regard to the estate tax liability.

Elimination of Voting Stock Requirement of Sec. 6166 and the Raising of the Shareholder Limit. These AICPA proposals are in agreement with those set forth by the Treasury Department.

Reductions in Percentage Ownership of Stock Requirements in Secs. 303 and 6166. This is in agreement with the ABA's proposal. The AICPA favors these reductions in percentage ownership of stock requirements to 20 percent (of transfers at death). It is also felt that Sec. 6166 should be as available to partners as it is to stockholders.

The purpose of Sec. 6166 is to provide additional time to pay estate taxes where the deceased's assets are not readily convertible to cash because such assets consist of an interest in a closely held business. In these instances, an estate which includes a minority interest in a business may be less able to cause a redemption by the business of that interest than a holder of a large interest. Therefore, some holders are in great need of the benefit of Sec. 6166.

The problem with respect to liquidity of partnership interest is similar to that of the liquidity of a stockholder interest and should be subject to the same rules.

Retention of Sec. 303(a). In opposition to the 1969 Treasury Proposals, the AICPA does not feel that Sec. 303 should be restricted to the estate taxes attributable to the inclusion of a closely held business in the gross estate. Section 303 is presently broader in that it permits redemption of amounts representing all estate taxes as well as administrative expenses. The narrowing of Sec. 303 would impose a serious liquidity hardship on estates which have to incur a substantial income tax liability in order to pay the estate taxes.

Eliminate "Undue" Requirement of Hardship Situations. Section 6161(a)(2) should be revised to eliminate the word "undue" from the phrase "undue hardship." The use of the word "undue" has in effect nullified the value of the provision because of the administrative problems of determining what hardship is "undue" hardship.

Section 6166 Should Apply to Partners in a Manner Similar to Stockholders. Section 6166 relief should be as available to partners as to stockholders.

Eliminate Sec. 303's Extension Restriction to Tax Court Cases. A Sec. 303 redemption should be permitted after the conclusion of litigation in any court.

Summary

The AICPA believes that the tax laws should be made as consistent as possible in similar provisions of related sections and in addition that they should not contain provisions which are administratively impractical.

Differences among similar provisions, such as Secs. 6166 and 303, presently cause confusion and inequities among taxpayers, and we feel our recommendations would result in greater fairness.

We believe that the recommendations contained in this section will bring about better results administratively and will be more acceptable to taxpayers in various situations.

Conclusion

The AICPA believes that the recommendations in this report provide a sound basis for federal estate and gift tax reform as far as the five areas reviewed are concerned. The AICPA feels that it has conformed the principles of fairness and simplicity to the extent that these two principles can be combined in this connection.

Possessions' Corporations in Puerto Rico

TAXATION WITH REPRESENTATION: TESTIMONY BY RALPH J. SIERRA, JR., SAN JUAN, PUERTO RICO

POSSESSIONS' CORPORATIONS IN PUERTO RICO

BIOGRAPHICAL NOTE

Ralph J. Sierra, Jr., CPA is a partner in the San Juan office of Peat, Marwick, Mitchell and Company. He is a member of the AICPA, and the Puerto Rico Institute of CPAs.

SUMMARY OF STATEMENT

To help the economy of Puerto Rico, Section 931 of the Internal Revenue Code offers special tax benefits to corporations operating there.

A proposed amendment to Section 931 would allow corporations receiving dividends from a related possessions corporation (i.e. a company operating in Puerto Rico) to take a dividends-received deduction of 85 percent or 100 percent. This proposal would encourage corporations to take out profits earned in Puerto Rico, rather than reinvest them within Puerto Rico.

A more equitable approach would be to tax these dividends in the normal manner, but to allow a dollar-for-dollar tax credit for investment by the possessions corporation or its corporate Stockholder in qualified Puerto Rican investments.

DISCLAIMER

The views expressed in this statement are solely the responsibility of the author. They should not be construed as representing the views of any of the organizations or firms with which he is or has been associated.

ADDRESS

Further information regarding the views expressed in this statement can be obtained by writing Mr. Ralph J. Sierra at G.P.O. Box 4089, San Juan, Puerto Rico 00936.

This statement deals with the Tax Reform Bill (H.R. 10612) approved by the House of Representatives on December 4, 1975 and currently pending hearings before the Senate Finance Committee. I offer my comments as an individual citizen relying on my expertise developed in the field of international taxation by the United States, and in no way should my comments be understood to be an expression of the accounting firm of which I am a partner.

I limit my comments to the one provision of the U.S. Internal Revenue Code of 1954, as amended, with which I have had extensive experience; that is, Section 931 which deals with, among other things, the federal income taxation of corporations doing a major part of their

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business in the Commonwealth of Puerto Rico. I need not at this time discuss the details of that provision. (See my article published in May 1973 issue of the Journal of Taxation which outlines the tax benefits to be derived from operating in Puerto Rico under that provision of the Code and its complementary provisions.)

The significance of Code Section 931 to the economic and social stability in Puerto Rico was well expressed by the Honorable Jaime Benitez, Resident Commissioner of Puerto Rico in the United States House of Representatives, the Honorable Salvador Casellas, Secretary of the Treasury of the Commonwealth of Puerto Rico, and the Honorable Teodoro Moscoso, Administrator of the Economic Development Administration of the Commonwealth of Puerto Rico before the House Ways and Means Committee during hearings of that Committee on tax reform. The success of Puerto Rico as demonstrated in their statement, as well as the underlying studies, could never have been accomplished without the presence of Code Section 931.

Changes, the net effect of which would be to make even more attractive the establishing of businesses in Puerto Rico, were recommended as part of the Energy Tax and Individual Relief Act of 1974 (H.R. 17488). I understand that these changes will be incorporated in the tax reform legislation contemplated to be generated this year.

Among the changes is the requirement that not only must a corporation meet certain operational criteria, but must also make a virtually irrevocable election binding itself to possessions' corporations status for a period of 10 years. In addition, in lieu of the exclusion from gross income currently afforded a qualifying corporation, a tax credit would be made available equal to the Federal income tax attributable to the corporations' income from a possession trade or business and from qualified possession investments. As a result of this latter change, other income which would hitherto have excaped federal income tax would henceforth be subject to the federal income tax.

Finally, and it is to this proposed change that I will be directing my comments, it is proposed that corporations receiving dividends from possessions' corporations be entitled to the special 85 percent or 100 percent, as the case may be, dividends received deduction. My personal experience has been that as corporations become successful over the years in maximixing the benefits of doing business in Puerto Rico under Code Section 931, the problem of what to do with their accumulated cash becomes a major one. Because of close scrutiny of related intercompany transactions by the U.S. Internal Revenue Service, they are hesitant to apply these funds to what otherwise would be valid commercial use within the corporate family in fear of having a constructive dividend alleged. Under present law, the dividends would be subject to full federal income tax and would negate the tax and other economic benefits offered by Puerto Rico under our industrial incentive program. The proposed amendment would allow these companies to immediately repatriate their earnings under our industrial incentive program back to the United States without any diminution of the overall tax benefits of doing business here.

For the benefit of Puerto Rico I wholeheartedly support approval of the change in the U.S. Internal Revenue Code which, in effect, would allow corporations doing business in Puerto Rico under our

industrial incentives program to repatriate on a current basis their Puerto Rico source earnings. However, I must question the practical or political wisdom of this proposed change. The Congressional Budget Act of 1974 would appear to indicate that over the long run the U.S. Congress will not allow corporations to completely escape federal income tax by establishing their plants in the Commonwealth of Puerto Rico, especially when the bulk of the goods produced here will be withdrawn from the Puerto Rico market for final disposition. In addition, encouraging the fleeing of these earnings from Puerto Rico rather than a reinvesting of them here would allow these companies to remain aloof from the Puerto Rican business, social and environmental community.

It would appear that a more equitable approach would be a provision that would encourage the possessions' corporations to more identify themselves with Puerto Rico. Along these lines, I would propose that rather than allowing dividends from possessions' corporations to be eligible for the dividends received deductions, these dividends should be subject to federal income tax in the normal manner but a dollar-for-dollar credit against the federal income tax attributable to this dividend be allowed to the extent that either the possessions' corporation or its corporate stockholder invest in qualified Puerto Rican investments. What constitutes a qualified Puerto Rican investment could be left to the discretion of the Secretary of the Treasury as promulgated under regulations, in consultation with the Commonwealth of Puerto Rico. Our own Industrial Incentives Act in effect in order to encourage corporations operating here under the industrial incentives program to reinvest their earnings here, accords income tax exemption on interest and rental income from certain investments. The proposed federal tax credit against the income tax liability attributable to dividends received from possessions' corporations could be correlated to similar investments. A sample listing of qualifying investments under our industrial incentives program is as follows:

Obligations of the Commonwealth of Puerto Rico, or any of its instrumentalities or political subdivisions;

Mortgage loans made by the Housing Bank of Puerto Rico or in mortgages insured by that Bank;

Loans secured by mortgages constituted for the financing of the construction and/or acquisition of housing in Puerto Rico;

Loans for a term of not less than five (5) years and in an amount of not less than $25,000 for the construction, expansion or acquisition of industrial buildings and/or land and for the acquisition of machinery and equipment and/or operating capital used in exempt manufacturing projects for exempt hotel operations;

Loans for a term of not less than five (5) years, used in the financing of maritime operations, related directly to the commerce and industry of Puerto Rico, including, but not limited to, money used in the construction, acquisition and operation of any type of maritime vessel;

Loans granted by the Government Development Bank for Puerto Rico and/or the Industrial Development Company of Puerto Rico, and the Agricultural Credit Corporation, as well as the participation in such loans;

Buildings leased or rented to the Government of Puerto Rico for public hospitals, health or nursing homes and facilities complementary to these institutions;

Buildings leased or rented to the Government of the Commonwealth of Puerto Rico for public schools and physical facilities complementary to education; and

Certain deposits in financial institutions.

Although the above benefits have been part of our tax statutes for a couple of years, the desired results have not been obtained. Furthermore, I doubt if these incentives would become attractive without the impetus of a federal tax benefit. The allowing of Puerto Rican earnings to flow back into continental United States free of federal income tax would further detract from getting the corporations in question from aiding the Puerto Rican economy through the making of the aforementioned investments.

I do not as a general philosophy endorse the concept that the U.S. tax laws should be used as a vehicle for obtaining nonfiscal goals of the U.S. economy. When the tax laws are so used, due regard for all considerations which would normally enter into the development of the non-fiscal goals must be kept in mind. Yet, the tax credit for qualified Puerto Rican investments is not too far removed from U.S. fiscal goals, especially as they concern the economic interrelationship between Puerto Rico and the United States. Accordingly, this tax credit approach might be looked upon as a form of revenue sharing (Puerto Rico does not participate in the general federal revenue sharing program) in lieu of the tax expenditure currently contemplated.

[A reprint from the Journal of Taxation]

Tax Advantages Available to U.S. Companies Doing Business in Puerto Rico

(By Ralph J. Sierra, Jr.*)

The many tax advantages available to U.S. controlled companies that do business in Puerto Rico are due to the interplay of the Industrial Incentives Act and the Code. Mr. Sierra focuses on U.S. taxation of Puerto Rico resident individuals and corporations, Puerto Rico domicile corporations, the Puerto Rico income tax and how to obtain maximum benefits by coordinating the Industrial Incentives Act with the Puerto Rico Income Tax Act. He also discusses planning and problem areas.

The industrial incentives program continues to be the force behind the economic and social development of Puerto Rico. The success of the program is primarily attributable to two laws, the Industrial Incentives Act of Puerto Rico and the U.S. Internal Revenue Code.[1]

Taxation of Puerto Rico Residents

Together with Guam and the Philippines, Puerto Rico was ceded to the United States by Spain at the termination of the Spanish-

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[1] Although the industrial incentives program has received strong emphasis since 1948, reference to these laws will be limited to the Puerto Rico Industrial Incentives Act of 1963, as amended, and the U.S. Internal Revenue Code of 1954, unless otherwise indicated.

American War in 1898. However, it was not until 1917, under the collective naturalization provisions of the Organic Act of Puerto Rico,[2] that U.S. citizenship was granted to Puerto Ricans residing on the island on April 11, 1899, and their children born subsequently thereto. The Nationality Act of 1940 later extended the status of U.S. citizen to all persons born in Puerto Rico.

Nevertheless, starting with the U.S. Revenue Act of 1918 through the Revenue Act of 1950, Puerto Ricans were uniformly treated, for Federal income tax purposes, as non-resident aliens. For these purposes, a Puerto Rican included (and continues to include) not only persons born in Puerto Rico, but also any U.S. citizen residing in Puerto Rico.[3] Consequently, during those years only income derived from sources within the 48 states, the incorporated territories (at that time, Alaska and Hawaii), and the District of Columbia, was subject to Federal income tax.[4]

Beginning with tax years starting after 1950, the scope of Federal income taxes applicable to Puerto Ricans was expanded to the outlying waters of Puerto Rico, but did not penetrate into the island. That is, effective with tax years beginning on or after January 1, 1951, the only Federal income tax exemption peculiar to Puerto Ricans has been with respect to all income (of whatever nature) derived from sources within Puerto Rico.[5]

U.S. DOMICILE CORPORATIONS

Probably the most popular vehicle for a U.S. domiciled corporation to do business in Puerto Rico is under the provisions of Section 931. Basically, this Section provides that an otherwise U.S. domestic corporation is subject to Federal income tax only on U.S. source income if the following two criteria are met:

1. At least 80% of its gross income is derived from sources within a possession of the U.S.; and,
2. at least 50% of its gross income is derived from the active conduct of a trade or business within the possessions of the U.S.

Pursuant to the Reg. 1.931-1(a), the following are considered to be a possession for the foregoing purpose: the Panama Canal Zone, Guam, American Samoa, Wake and the Midway Islands, as well as the Commonwealth of Puerto Rico.[6] The requisite gross income need not all be earned in a particular possession.[7] The gross income criteria are required to be met for the 36-month period immediately preceding the close of the tax year in question or since inception if this latter period is shorter.[8] For manufacturing operations, Reg. 1.61-3(a) states that gross income is generally considered to be comprised of sales, less cost of sales, plus investment income and all other income

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[2] 39 Stat. 951 (1917).

[3] The Puerto Rican Federal Relations Act presently includes in the definition of a Puerto Rico citizen "... all citizens of the United States who have resided or who shall hereafter reside in the island for one year. ..."

[4] I.T. 3788, 1946-1 CB 153; I.T. 4047, 1951-1 CB 59. For additional background, also see *Rexach*, 185 F.Supp. 465 (DC P.R., 1960), and subsequent related cases. A similar situation existed in the Federal estate and gift tax responsibility. The tax haven that Puerto Rico afforded U.S. born citizens for estate planning was closed by the Revenue Act of 1958 (establishing Section 2208) as a result of *Estate of Smallwood*, 11 TC 740 (1948).

The corresponding loophole for Puerto Rico born estate planners was closed by the Revenue Act of 1960, which added Section 2209, as a result of *Rivera's Estate*, 214 F.2d 60 (CA-2, 1954).

[5] Section 933, introduced as Section 116(l) into the 1939 Code by the Revenue Act of 1950.

[6] See Section 7701(c).

[7] *Rev. Rul.* 71-13, 1971-1 CB 217.

[8] *Rev. Rul.* 65-260, 1965-2 CB 243.

from incidental operations or other sources. However, Section 931(b) also provides that amounts received within the U.S. will constitute U.S. source gross income, irrespective of actual source.

As can be seen from above, there is ample room for generating additional income from sources outside the U.S., and either from within or without a possession by use of margins allowed for Section 931 compliance. That is, up to 20% of the gross income can be earned outside both the U.S. and the possession. In addition, passive income can reach the 50% of gross income mark (including the 30% which must be from possession sources) without being subject to either Federal or Puerto Rico income tax.[9] Practical experience has indicated that proper placement of these funds can augment accumulated exempt earnings by at least 40% over the life of an incentives grant.

Furthermore, if at least 80% of the capital stock (as defined by Section 332(b)(1)) of the "931" corporation is held by a U.S. corporation, all of the accumulated earnings can be repatriated back into the United States, free of Federal income tax, by means of a liquidation under Section 332. Section 4 of the Industrial Incentives Act (IIA) of Puerto Rico similarly allows these earnings, in analogous circumstances, to be transferred back to the U.S. free of Puerto Rico tax. More will be mentioned of this in discussion below.

PUERTO RICO DOMICILE CORPORATIONS

For Federal income tax purposes, a Puerto Rico corporation is a foreign corporation, but under Section 957(c) is not treated as a controlled foreign corporation if certain conditions are met. Basically, these conditions are the same as the source of gross income requirements imposed on "931" companies. However, there is an essential difference in that the qualifying activities of trade or business are specifically defined in Section 957(c)(2). The restricted activities are virtually the same as those ac-corporation does not have the 20% which would normally qualify for an incentives grant in Puerto Rico (IIA, Sections 2(d) and (e)).

Although a prior Section 367 ruling from the Internal Revenue Service is required to effect the liquidation of a Puerto Rico corporation, approval is obtainable without Federal income tax consequences.[10] This formality, combined with the fact that a Puerto Rico margin that is available to "931" corporations for generating income outside of Puerto Rico and the U.S. free of any income tax, usually dictates against the use of a Puerto Rico corporation unless warranted by special circumstances.

PUERTO RICO INCOME TAXES

The Puerto Rico income tax structure is quite similar to the Federal income tax structure. This is because the Puerto Rico Income Tax Act (ITA) of 1954 was adapted from the Internal Revenue Code of 1939. Two major differences are that the ITA does not provide for either stock option plans or consolidated returns.

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[9] Available passive investment markets for accumulated tax-exempt earnings is discussed in O'Connor and Sierra "Tax Planning for the Most Effective Use of Puerto Rico Tax-Exempt Profits," *Taxes*, May 1972, p. 310.

[10] *Rev. Proc.* 68-23, Section 4.02(3), 1968-1 CB 821, 830.

As such, Puerto Rico corporations are taxed on their worldwide income, whereas U.S. corporations are taxed in Puerto Rico solely on Puerto Rico source income (ITA, Section 231). Either corporation qualifies for an incentives grant. That is, under the industrial incentives program, the place of incorporation has never been a condition for obtaining a grant.

U.S. citizens not residing in Puerto Rico are subject to tax only on Puerto Rico source income (ITA, Section 119; ITA, Reg. 143-10). This income is ordinarily subject to a withholding of Puerto Rico income tax at source of 20% (ITA, Section 143(a)). The withholding does not relieve the U.S. citizen recipient of the requirement to file a Puerto Rico income tax return (ITA, Section 143(c)); however, he is entitled to the same deductions and credits as a resident, and is subject to the same tax rates.[11]

Although a Civil Code jurisdiction, Puerto Rico follows the domicile concept in determining personal rights and obligations.[12] Accordingly, it has been determined that a U.S. citizen, a resident of Puerto Rico, but not domiciled on the island, is taxed as a non-resident.[13]

All U.S. citizens domiciled in Puerto Rico are taxed by Puerto Rico on their worldwide income. As indicated in the discussion above, these persons are also subject to Federal income tax, except with respect to Puerto Rico source income (Section 933). Irrespective of actual source, Puerto Rico treats as U.S. source income all income subject to Federal income tax from sources outside both the U.S. and Puerto Rico.[14]

IIA TAX EXEMPTION

The IIA exempts the beneficiaries of a grant from three major taxes: income tax, property tax, and municipal license tax. The related income tax burdens are as follows:

The Puerto Rico income tax at the individual level is progressive with rates ranging from 7% to 82.95%. In comparison with the U.S., it can reasonably be estimated that a married couple with two children and $15,000 of taxable income will be subject to a higher tax cost than in a similar situation in the United States. In addition to the fact of the more rapid acceleration of rates,[15] the higher cost is also attributable to the fact that the ITA does not provide for the filing of separate returns by married persons. A married couple, unless not living together, is required to file a single return, and pay the income tax on the combined income, without special rates being applicable (ITA, Section 51(b)).

The Puerto Rico corporation income tax is also progressive as follows:

1. 22% of all net income (ITA, Section 13(b)).
2. 9% of the first $75,000 of surtax income (ITA, Section 15(b)(1)).

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[11] "What You Should Know About Taxes In Puerto Rico," Commonwealth of Puerto Rico, Department of the Treasury, 1972 edition, p. 15. Confirmed by private rulings which clarify that no apportionment of personal items is necessary. This procedure relies on *Shaffer* v. *Carter*, 252 U.S. 37 (1920) and Section 2 of the Puerto Rican Federal Relations Act which guarantees equal rights, privileges, and immunities for all U.S. citizens.

[12] *Martinez* v. *Widow of Martinez*, 88 P.R.R. 429 (1963), and cases cited therein.

[13] *Fiddler* v. *Secretary of the Treasury*, 85 P.R.R. 302 (1962); *Sheffer O. Buckert* v. *Secretary of the Treasury*, Superior Court of Puerto Rico, San Juan Part, February 28, 1969, Puerto Rico Tax Reporter, CCH p. 10.105 (June 1972).

[14] ITA, Section 131(b)(2), accordingly, allows the related tax credit.

[15] Compare ITA, Section 11, 12 and 406 to I.R.C., Section 1.

3. 18% of surtax income in excess of $75,000 (ITA, Section 15(b)(2)).

A single surtax exemption of $25,000 is allowed to be apportioned by a family of affiliated companies (ITA, Section 27), in a manner similar to that of Section 1561.

By amendment made in 1971, the general scope of the IIA outlined herein is applicable until June 30, 1983 (IIA, Section 13).

When a manufacturer receives an industrial incentives grant, the benefits are not applicable to his operations as a whole, nor to a particular plant that he may occupy. The grant covers the income generated by, and the assets used by, the economic phenomenon referred to as an "industrial unit." This concept can be briefly defined as any productive entity capable of producing a manufactured product on a commercial scale (IIA, Section 2(h)). The manufactured product may be one that was not produced in Puerto Rico on a commercial scale as of January 2, 1947 (or, if in the production at that time, was not produced in Puerto Rico during calendar year 1969 and 1970) (IIA, Sections 2(d)(1) and (e)(35)), or any of 35 other designated items (IIA, Sections 2(d)(2), (3) and 2(e)). (See list of such items in the accompanying box.)

Naturally, manufacturing is not the only business venture eligible for an incentives grant. The two most significant, in addition to manufacturing, are the leasing of property used by the lessee in operations covered by an incentives grant (IIA, Section 1(g)), and the operation or owning of a tourist or commercial hotel (IIA, Sections 2(d)(5), (6)). The operating of a guest house was recently added to the eligible businesses.

As alluded to earlier, in addition to the Puerto Rico income tax, the grant exempts the grantee from property tax and municipal license tax (IIA, Sections 1(a)(1), 1(b) and 1(c)). For companies operating under the incentives program, the assets most susceptible to property tax (were it not for the grant) are their inventory, plant and equipment, and investments in non-Puerto Rico entities. That is, the nature of the operations normally requires these assets to be present. Assets not subject to property tax include cash in banks and accounts receivable (13 Laws of P. R. Annotated (LPRA) 443). The tax rates fluctuate according to the municipality where the property is located. For the government fiscal year ending June 30, 1973, the rates ranged from 1.58% to 3.23%.[16] The tax is imposed on the market value of the property, which administratively is considered the net book value with respect to personal property; whereas, periodic appraisals are made for real property assessment.

The Municipal license tax rate is progressive and uniform throughout the island. The tax is imposed on the gross volume of business transacted in a particular municipality, and is paid to that municipality. Were it not for the grant, the tax applicable to a manufacturing enterprise would reach a maximum of 0.2% on all business transacted in excess of $1,000,000 (21 LPRA 641a, 641b Group "B"). As can be seen in most cases, this is a relatively insignificant tax.

In addition to the foregoing taxes, the grant exempts from income tax, under specified circumstances discussed further below, dividends paid out of accumulated exempt earnings (IIA, Section 3(a)).

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[16] See Puerto Rico Tax Reporter, CCH p. 7051 (June 1972).

For purposes of administering the industrial incentives program, the island is divided into five industrial regions. The region classification depends primarily upon the unemployment situation in the region and the ease with which production may be transported from the plant to the customer. These two factors determine the period for which the grant is effective. Depending on the region where the operation is located, the effective tax exemption benefits can be for 10, 12, 15 or 17 years, and in the case of two nearby island municipalities, the period is 25 years (IIA, Sections 1(a), (b), (c), (j), (p), (r)).

In exchange for subjecting otherwise qualifying exempt income to income tax, an additional period of exemption is available; that is, if the grantee will accept, in lieu of full exemption, benefits of 50%, 60%, 70% or 80% during the initial base period (10, 12, 15, 17 or 25 years), an additional period of equivalent years will be given with exemption benefits of 50%, 80%, 60% or 40%, respectively.[17]

COORDINATING IIA WITH ITA

The focal date for the beginning of the tax exemption benefits is the commencement of operations date. This date, when the grantee submits his request for a grant prior to starting the operations covered by the grant, is basically the date of the first factory payroll, or any other date within 180 days from the first payroll date, at the choice of the grantee (IIA, Reg. 5-2, 5-3). Also, the commencement of operations date can be further postponed for an additional period of up to two years, by the grantee's timely election (IIA, Section 1(l). Consequently, the grantee can elect to have an initial tax exposure on his operation for up to 2½ years.

The initial intention of this deferral is believed to have been to allow the grantee to avoid start-up losses applying against accumulated exempt earnings. However, a favorite use of this deferral has been to recover capital investments through accelerated depreciation. When practicable, start-up losses are better retained by the U.S. parent, where the deduction gives rise to immediate tax benefit, by starting in Puerto Rico as a branch. When it is anticipated that the initial operating expenses will be recovered, then the formation of a "931" subsidiary can be availed of. Recapture problems as discussed in *Rev. Rul.* 71-569, IRB 1971-50, 24 are usually minimal.

Before discussing the Puerto Rico tax aspects, another alternative that might be considered for Federal purposes with respect to the treatment of start-up losses is to include the losing "931" corporation on a Federal consolidated return. This position was explicitly prohibited by *Rev. Rul.* 65-293, 1965-2 CB 323, but the Ruling has been subsequently considered invalid in *Burke Concrete Accessories, Inc.*, 56 TC No. 48 (1971). A bill was under study by the last U.S. Congress that would have subjected "931" benefits to a ten-year election and not allow consolidation during the period the election was in effect.[18] It would appear that the consolidation of start-up losses would still be possible by deferring the "931" election.

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[17] IIA Sections 1(k) and (q). The option available and the benefits thereunder are discussed by Clark and Galarza, in "An Interesting Amendment To The Industrial Incentives Act," *Official Journal of the Puerto Rico Institute of CPA's*, August 1972, p. 5.

[18] H.R. 11158, reported Aug. 3, 1972. House Report 92-1300.

The major benefit under the ITA is the peculiar method of accelerated depreciation available to certain taxpayers. Manufacturers and hotels are included in the group of taxpayers who are allowed to take as a depreciation deduction an amount equivalent to the net income determined before this special deduction. The deduction is limited to the basis, and cannot be used to generate an operating loss (ITA, Section 114A). Consequently, by deferring the commencement date of effectiveness of the grant, additional tax exempt income equivalent to the investment made in depreciable property can be earned. The anticipated income tax savings must be weighed against the property and municipal license tax exposure. In addition, since prior notice is required to be given if the commencement date to be elected will not fully use up the two-year add-on period (IIA, Section 1(1)), failure to do so will expose the grantee to income tax on the income earned in excess of available deductions up to the commencement date selected in conformity with the law. In view of this latter exposure, unless the additional savings available are material, and an adequate forecast of turn around point can be made, some companies forego this opportunity.

The second major additional benefit available by harmonizing the IIA and the ITA is the additional basis allowed to be assigned to depreciable assets received by the transferee in the tax free liquidation of its grantee subsidiary. IIA Section 4 provides that ". . . the base of the property to the transferee on subsequent disposition . . . and . . . for allowance for depreciation or depletion . . . shall be the adjusted base of the property, pursuant to the provisions of the ITA in force, *plus* an amount equal to the earned surplus of the transferor at the beginning of the liquidation. . . ." (Emphasis added.) This "plus" amount is commonly referred to as "set-up" basis. Naturally, if the transferee is a U.S. corporation not qualifying for Section 931 treatment, the major benefit, if any, is the ability to control the Puerto Rico income tax liability and, thus, minimize excess foreign tax credit exposure. If the transferee is not an internat onal organization, or has no excess foreign tax credit problems, the set-up basis is of no benefit.

The use of an intermediate corporation which can be substantiated to have valid existence affords a better opportunity to maximize on the "step-up" benefits. This intermediate company would continue to operate the assets received, availing itself of the higher depreciation basis. The tax reduction would generate additional actual savings in lieu of the aforementioned excess foreign tax credit modification, but the timing differential would have to be considered.

PLANNING AND PROBLEM AREAS

One of the initial tax planning problems that must be confronted when deciding to do business in Puerto Rico is the intercompany price structure. It is not uncommon that the Puerto Rico based operation either obtains its new materials, or sells its finished product (or, at times, even both) to an affiliated company not located in Puerto Rico. With respect thereto the Internal Revenue Service has issued specific guidelines in *Rev. Proc.* 63-10, 1963-1 CB 490, concerning the examining of U.S. income tax returns and disposing of cases involving the allocation of income and deductions between U.S. corporations and their manufacturing affiliates in Puerto Rico.

Furthermore, recognizing that Puerto Rico based affiliate allocation problems arise in the unique context of the economic relationship between Puerto Rico and the United States, the IRS has indicated in *Rev. Proc.* 68-22, 1968-1 CB 819, that in the exercising of its general power to allocate, distribute or apportion income, deductions, credits and allowances among affiliated entities under Section 482, cases wherein Puerto Rico based affiliates are involved will be settled under the general or specific guidelines depending upon which is more favorable to the taxpayer.

WHERE TO PLACE THE GRANT

Another tax planning problem is, "Where do you place the grant?" Disregarding at this t me the future cash flow aspect, the question can be reduced to whether or not a separate corporation should exist for exempt operations. In two major cases where a corporation coterminously conducted exempt and taxable operations, it was found that the net operating loss of the taxable operation had, in essence, to be offset by the profits generated by the exempt operations before carryback and carryforward benefits could be determined.[19] The fact that the Regulations issued under the ITA specifically provide that income which is by statutory provision exempt from income tax is not considered gross income (ITA, Reg. 21-1(a)(2)) for income tax purpose is not discussed in either case.

If this were subsequently to be verified, then the offset would not be necessary since the required adjustments to determine a net operating loss deduction do not include this type of income (ITA, Reg. 122(1)(a)). In view of this nebulous situation, where practicable, unless willing to litigate the issue, it would be advisable normally not to combine distinct taxable and exempt operations.

THE EQUITY HOLDER

The next two problems to be discussed concern themselves with the equity holder; that is, the receipt of dividend income, and the taxation of gain realized on the disposition of exempt company stock. Basically, IIA, Section 3(a)(1) provides that residents of Puerto Rico can receive dividends out of exempt accumulated earnings free of Puerto Rico income tax. In view of Section 933, these dividends are thus received free of any U.S. or Puerto Rico income tax.

Non-residents are required to pay Puerto Rico income tax to the extent that these dividends are subject to income tax by the jurisdiction in which they reside (IIA, Sections 2(a)(2), (3), (4)).[20]

The constitutionality of this provision, as far as non-resident U.S. citizens are concerned, is questionable, once again in view of Section 2 of the Puerto Rican Federal Relations Act.[21] Were the pertinent IIA provisions, as applied to U.S. citizens, declared void, the effect on U.S. tax treaties would be highlighted. This is because the Puerto

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[19] *Elgee, Inc.* v. *Secretary of the Treasury*, 88 P.R.R. 403 (1963), and *Caribbean Container Co.* v. *Secretary of the Treasury*, Superior Court of Puerto Rico, San Juan Part, July 31, 1969, Puerto Rico Tax Reporter, CCH, p. 10.180 (June 1972).

[20] Also see, ITA Section 144(b).

[21] See *supra* note 11. In 1954, the Puerto Rico Supreme Court in *Posley* v. *Secretary of the Treasury*, 75 P.R.R. 822, struck down, based upon this Section of the Federal Relations Act, an income tax provision which taxed non-resident U.S. citizens at a rate higher than that imposed on residents. In *Sartorious & Co.* v. *Descartes*, 79 P.R.R. 119 (1956) it was decided that Section 2 of the Puerto Rican Federal Relations Act is not applicable to corporations.

Rico Supreme Court has also upheld[22] the right of an alien residing in continental U.S. to be taxed at rates applicable to a U.S. citizen where the treaty entered into by the United States and the foreign country reciprocally required nondiscrimination in such circumstances.

This decision did not take into consideration the provisions in the treaty which allow (and to which Puerto Rico has never complied) territories of the contracting parties to become an additional party thereto. The court basically reasoned that, since persons born in Puerto Rico are U.S. citizens and consequently could avail themselves of benefits under the treaty were they to reside in the foreign country, it is only fair that subjects of the foreign country correspondingly be able to exercise their treaty rights against Puerto Rico.

With respect to gains realized on the sale of stock of an exemption grantee, the IIA provides that the gain or loss realized on the disposition of the stock is tax exempt. Administratively, this has been interpreted to mean, in essence, the gain or loss commensurate with the ratio that exempt earnings bears to earnings during the period that the shares were held.[23]

REPATRIATED TAX-FREE EARNINGS

A third major problem area with respect to corporate equity in accumulated exempt earnings deals with the amount of accumulated exempt earnings that can be repatriated tax free back into the United States by means of a liquidation (IIA, Section 4; IRC, Section 332). IIA, Section 4 states that no Puerto Rico income tax is to be assessed on the liquidation that takes place prior to the expiration of the exemption grant.

It is held by some tax practitioners that this is the sole distinguishing factor in the timing of a liquidation which takes place prior to, rather than subsequent to, the expiration of the exemption grant. Accordingly, all earnings, irrespective of whether or not covered by the grant, could pass tax free to the parent company were the liquidation to take place before the grant expired.[24] However, administratively the Puerto Rico Bureau of Income Tax in private rulings has held that only earnings accumulated under the scope of the incentives grant may be repatriated tax free. The propriety of these holdings is questionable, but has not been tested before the courts.

The final problem area is procedural in nature. We have alluded to the possibility of first establishing in Puerto Rico as a branch, and subsequently transferring exempt operations to a new corporate entity. This transfer requires that a notification thereof be sent to the Governor of Puerto Rico within 30 days of effecting the transfer if grant benefits are to be retained (IIA, Section 6(c)). If the transfer will result in a change of control of the exempted business, approval of the grant transfer is required to be obtained prior to effecting the transfer (IIA, Section 6(a)).

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[22] *Orcig v. Secretary of the Treasury*, 86 P.R.R. 327 (1962).

[23] Ruling of February 23, 1967 issued by the Puerto Rico Department of the Treasury to the Commonwealth Oil Refining Company, Inc., and communicated by the latter to its shareholders.

[24] Goldberg, "Tax Effects Upon Getting Out Of Puerto Rico: Timing; Techniques; Sale or Liquidation of Business," NYU *Twenty-Eighth Annual Institute On Federal Taxation* (1970), Matthew Bender & Company, New York, p. 413 (see, in particular, p. 416).

The term "designated articles" includes any of the following articles or businesses:

1. Articles of straw, reed and other fibers,
2. Artificial flowers,
3. Balls for baseball and other sports,
4. Bedsprings and mattresses,
5. Articles made from leather or imitation leather,
6. Bodies for motor vehicles and trailers,
7. Candles,
8. Candy,
9. Canned, concentrated, preserved or otherwise substantially processed food products, and extracts thereof so long as each particular industrial unit engaged in such production meets quality standards prescribed by the Commonwealth of Puerto Rico Department of Agriculture. In the event that such standards are not otherwise promulgated by law or regulations, adequate provision therefor shall be made in the decree of tax exemption. The production of crystallized or liquid sugar, molasses and the processing of roasted and ground coffee is excluded from this classification as a designated article,
10. Ceramic products, including among others, bricks, roof tiles, sanitary ware, tiles and clay products,
11. Cigars,
12. Cigarettes,
13. Perfumes, cosmetics and other toilet preparations,
14. Hosiery of all types and of all materials,
15. Biscuits, crackers and pretzels,
16. Edible oils and fats,
17. Fishing tackle, including, but not limited to nets, seines, lines and harnesses,
18. Furniture, but not the mere assembly thereof,
19. Polishing or other processing of diamonds and other precious and semi-precious stones,
20. Glassware and glass products,
21. Gloves,
22. Paperboards and paper pulp,
23. Rugs, hand woven and machine made,
24. Shoes and slippers,
25. Soaps of all kinds and for all uses,
26. Food pastes (spaghetti, macaroni and the like),
27. Leather tannings and finishing,
28. Tin containers—other tinware,
29. Water and oil paints,
30. Animal feed in general,
31. Men's, women's and children's wearing apparel, including, but not limited to dresses, coats, pants, suits, overcoats, topcoats, sport coats, slacks, shirts of all kinds, skirts, blouses, pajamas, underwear of all kinds, provided the cutting of material therefor is done in Puerto Rico,
32. Products of slaughtering operation, including, among others, the products of the slaughtering of fowl and rabbits, and the products of packing houses that use the products of slaughtering operations as

raw material as long as each unit engaged in one or more of such operations meets the quality standards prescribed by the Department of Agriculture of the Commonwealth of Puerto Rico. In case such standards have not been prescribed by law or the regulations, adequate provisions therefore shall be included in the tax exemption decree,

33. Any kind of plantings and cultivation through the process known as hydroponics, provided such operations are carried out under standards and in accordance with the practice established or approved by the Department or approved by the Department of Agriculture of the Commonwealth of Puerto Rico,

34. The publishing of books so long as the printing is performed in Puerto Rico; provided, that when the facilities are also used to produce other types of printing, such as, among others, pamphlets, reviews, newspapers, forms and cards, the industrial unit shall be eligible for exemption only with respect to such part of the taxes set forth in sections 1 and 3 of this Act which correspond to the proportion existing between the gross income of the business derived from the printing and binding of books and its total gross income,

35. Every product which was manufactured in Puerto Rico on a commercial scale on or before January 2, 1947 and/or for which there existed at that date production facilities in Puerto Rico capable of producing said manufactured product on a commercial scale, but that for the calendar years 1969 and 1970 was not manufactured in Puerto Rico on a commercial scale; provided the Governor determines, upon consultation with the Secretary of the Treasury and the Economic Development Administrator, that the grant of exemption for said product will be in the best interest of the Commonwealth of Puerto Rico in view of the nature of the facilities, the investment, the number of employees and the amount of the payroll involved in ahe manufacture of said product, and

36. All kinds of cardboard boxes, wrappers and containers, except those made of corrugated paperboard.

Charitable Contributions

THE ACADEMY OF THE NEW CHURCH,
Bryn Athyn, Pa., March 1, 1976.

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

DEAR MR. STERN: On behalf of the Academy of the New Church, its several schools and affiliated nonprofit uses, I would urge you to:

(1) Preserve current tax incentives to charitable giving.

(2) Remove "overcorrections" of the 1969 Tax Reform Act.

(3) Authorize a new type of deferred gift—The Charitable Remainder Variable Annuity Trust.

This year the Academy Schools celebrate their 100th Anniversary, in concert with the nation's Bicentennial. In one hundred years of operation the Academy has accepted not a single penny of Government or State subsidy to assist in carrying out its vital, religious-motivated education. It has been a cherished privilege to be able to pay taxes for the support of public education, while at the same time making sacrificial contributions to maintain our distinctive private education. We believe that the very special input into the character and quality of our nation which private institutions like the Academy have made possible, would be sorely missed if these institutions were to be forced out of existence by unfair and discriminatory legislation against charitable giving.

Not only would the end result be more costly for the government, if our private institutions were to become extinct, but a certain freedom and incentive which private schools stimulate in our country would surely die.

Your consideration of our thoughts and feelings in this matter will be most appreciated.

Sincerely yours,

LOUIS B. KING, *President.*

STATEMENT OF THE HAVENS RELIEF FUND SOCIETY

SECTION 6056 OF THE INTERNAL REVENUE CODE 1954

Under the present provisions of section 6056(b)(7) of the Internal Revenue Code of 1954, every private foundation with at least $5000 of assets must file with the Internal Revenue Service an annual report which discloses, among other things, the name and address of each recipient of a grant from the foundation, together with the amount of such grant. Under section 6056(d)(3) and Treas. Reg § 1.6056-1(b)(3), a copy of this report must also be sent to the Attorney General of each state having jurisdiction over the foundation and upon request to the Attorney General of any state. Moreover, section 6104(d)

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requires the foundation to publish notice of the availability of the report in a newspaper of general circulation in the country of its principal office and to make the report available for inspection by any citizen upon request within 180 days of such public notice. Treas. Reg. § 1.6056-1(b)(2) requires copies of the report to be sent to such libraries and depositories as the Commissioner of Internal Revenue may designate.

The Havens Relief Fund Society was organized in New York in 1878 under the will of a gentleman named Havens. The Society does not raise funds but for nearly a century has performed the most traditional of charitable functions—direct relief of the poor—by distributing the income of the testamentary grant to indigent and needy persons, generally only those who can be rehabilitated by a relatively small grant. The Society is a private foundation and is exempt from income tax under section 501(c)(3).

The Havens Relief Fund Society has encountered problems in complying both with its charitable objectives and with the reporting requirements of section 6056. The persons most deserving of temporary financial assistance are often unwilling to be identified in a list of persons receiving charity, especially when the list is made available to the general public. Grants frequently involve very personal and sensitive needs, such as expenses related to medical treatment, and recipients particularly do not want it to be a matter of public record that they are under medical care.

The Society is also concerned that many recipients of its gifts might not be providing accurate information because they wish to avoid public identification and embarrassment. Any attempt to increase efforts to verify the information would further aggravate the reluctance of the potential recipients to accept the grants. On the other hand, the Society is concerned that its failure to initiate more aggressive verification efforts might render it liable for reporting penalties. Furthermore, the administrative burden of verifying—indeed, even of reporting—individual grants that in many cases amount to no more than a few dollars frustrates the Society's purpose of efficiently serving the indigent and needy.

Disclosure and publicity of grants of a personal nature, especially of small grants to indigent and needy persons, do not appear to have been contemplated by Congress when the reporting requirements of section 6056 were added to the Internal Revenue Code by the Tax Reform Act of 1969. When reporting the provision, both tax committees of Congress explained: "The primary purpose of these requirements is to provide the Internal Revenue Service with information needed to enforce the tax laws." H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 36 (1969); S. Rep. No. 91-452, 91st Cong., 1st Sess. 52 (1969). The context reveals that the "tax laws" sought to be enforced were specifically the sanctions of section 4945, which were also added by the Tax Reform Act of 1969. House Report at 31-37; Senate Report at 46-53. The Ways and Means Committee reported:

> In recent years, private foundations have moved increasingly into political and legislative activities. In several instances called to your committee's attention, it was made clear that funds were spent in ways clearly designed to favor certain candidates * * *.
>
> * * * * * * *
>
> It was also called to your committee's attention that existing law does not effectively limit the extent to which foundations can use their money for "edu

cational" grants to enable people to take vacations abroad, to have paid interludes between jobs, and to subsidize the preparation of materials furthering specific political viewpoints.

Your committee has concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations must involve more effective sanctions. . . .

* * * The bill [now section 4945] provides that private foundations are to be forbidden to spend money for lobbying, electioneering (including voter registration drives), grants to individuals (unless there are assurances that the grants are made on an objective basis), grants to other organizations (unless the foundation accepts certain responsibilities as to the use of the funds by the donee organization), and for any purpose not exempt under section 501(c)(3). [House Report at 32-33. Compare Senate Report at 47-48].

Nothing in this discussion, nor in the text of section 4945, suggests any intention to restrain the traditional relief of the poor undertaken by charities such as The Havens Relief Fund Society. In the effective administration of the private foundation laws, it is not necessary to require disclosure of the names and addresses of the recipients of relatively small gifts. To do so could infringe the privacy of those recipients and interfere with this type of charitable activity.

Accordingly, The Havens Relief Fund Society strongly urges the enactment of an amendment to section 6056 in the form attached hereto as Exhibit A to eliminate the requirement to report the recipients of grants to indigent and needy persons that do not exceed $1000 per year. Grants in excess of that amount, grants to persons disqualified within the meaning of section 4946, and grants for other purposes such as education, travel, or study would still require an itemized report, thus guarding against possible abuse. A bill to the same effect (H.R. 15474, 93d Cong., 2d Sess.) was introduced in the last Congress and was the subject of a favorable report by the Treasury Department to the Chairman of the Ways and Means Committee, dated December 12, 1974.

MARCH 4, 1976.

JOHN S. NOLAN,
Havens Relief Fund Society.

EXHIBIT A

A BILL To amend section 6056 of the Internal Revenue Code of 1954

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

SECTION 1. (a) Section 6056(b)(7) (relating to information which must be set forth in the annual report of a private foundation) is amended by striking out "contribution." at the end thereof and inserting in lieu thereof the following: "contribution, except that the name and address of any recipient of one or more charitable gifts or grants made to such recipient as an indigent or needy person which do not exceed $1,000 during the year (other than a grant to a disqualified person within the meaning of section 4946) may be treated as confidential and need not be listed.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to annual reports filed for taxable years beginning after December 31, 1973, except that for the purpose of public inspection of annual reports under sections 6104 (b) and (d)

the amendment made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1969.

STATEMENT OF THE HILLCREST MEDICAL CENTER

TOPICAL OUTLINE OF COMMENTS AND SUMMARY OF RECOMMENDATIONS

1. Hillcrest Medical Center's Role in Society.
2. Hillcrest Medical Center's Need for Continued Philanthropic Support and Adverse Effects of Reduced or Lost Support.
3. Preserve the Current Tax Incentives To Charitable Giving.
4. Remove "Over-Corrections" of the 1969 Tax Reform Act.
5. Authorize the Charitable Remainder Variable Annuity Trust.
6. Recommendations:

A. We *strongly oppose* the following proposals and *urge* that they not be enacted:

1. Reducing the charitable deduction for gifts of long-term appreciated property (securities, real estate and tangible personal property for a "related" use) or taxing the appreciation.
2. Placing a ceiling on the estate and gift tax charitable deductions.
3. Placing a percent of adjusted gross income floor on the income tax charitable deduction.
4. Substituting a low credit for the income tax charitable deduction. Instead, urge the Congress to adopt the Filer Commission's recommendations to continue the present deduction system and allow a deduction equal to twice the amount of the charitable contribution for families having incomes under $15,000 and a deduction of one and one-half times the contribution for families having incomes between $15,000 and $30,000. Also, allow charitable deductions for those who take the standard deduction.
5. Penalizing donors who make substantial gifts by adopting any of these rules: allocation of deductions, limit on tax preferences, minimum taxable income (MTI).

B. We suggest consideration be given to removing some of the over-corrections, relative to charitable giving, the 1969 Tax Reform Act made.

C. We suggest consideration be given to authorizing the Charitable Remainder Variable Annuity Trust as a technique for accepting donations in order to allow charities to respond to competition from non-charitable tax incentive proposals authorized.

7. Conclusion: The charitable deduction is unique among deductions and it is society that benefits most by having that deduction, not the individual donor. Tax incentives should be increased, not decreased.

STATEMENT

HILLCREST MEDICAL CENTER'S ROLE IN SOCIETY

Hillcrest Medical Center is a non-profit, short-term acute care hospital dedicated to the community and held in trust by a board of trustees who serve without remuneration (a current listing of the officers

and members of the board including their business and professional affiliations is attached). We pride ourselves as being a true community service-oriented facility responding to the needs of Tulsa and Oklahoma instituting, for example, Oklahoma's first and only Burn Center and Comprehensive Rehabilitation Center; Oklahoma's first Full-time emergency Room Physicians; Tulsa's first and only Poison Control Center, Retinal Surgery program, Hospital-based Extended Care Facility, and Kidney Transplant Program; and Tulsa's first Renal Dialysis Center, Heart Catherization Laboratory, Outpatient Clinics, Heart Surgery Program, Day Care Center, School of Nursing and Chaplaincy Internship Program.

Further, true to our policy of providing the best possible treatment to the sick and injured—regardless of ability to pay, we provide approximately sixty-five percent of the inpatient charity care in the city. We average 16.26 charity days per staffed bed and 24.22 charity days per occupied bed—highest in the state (a copy of the report from the Oklahoma Health Planning Advisory Council Committee on Indigent Care from which these figures were taken is attached).

We write off approximately twenty percent of our gross revenue each year in support of such charitable care and non-collectible portions of Medicare and Medicaid patients' bills. In 1975 the total was $6,158,000.00 with $3,584,000.00 from the Medicare-Medicaid portion and $2,574,000.00 from direct indigent care. Our 1976 budget projects a total write-off of $6,928,515.00.

HILLCREST MEDICAL CENTER'S NEED FOR CONTINUED PHILANTHROPIC SUPPORT AND ADVERSE EFFECTS OF REDUCED OR LOST SUPPORT

In order to have provided the innovative services noted above and offered quality medical care to those not able to pay, we have relied heavily on private philanthropic support. In order to maintain our existing level of excellence and, as we indeed must, to do more and to continue to provide medical care to the indigent, we must continue to receive this support from the private sector. We receive no federal, state, county, or city funds (other than those we earn via Medicare, etc.) to offset the cost of these programs. The point being that, in the absence or even with reduced amounts of philanthropic support, our institution will have little alternative to raising prices (an action we all dislike), discontinuing services to the poor (equally distasteful), or allowing our level of service to deteriorate (a fate the American public should not and we think will not accept).

We have received the following amounts from individuals, trusts, and foundations over the past four years:

Year	Amount
1971	$875, 301
1972	932, 378
1973	1, 232, 089
1974	1, 708, 915
1975	1, 698, 017

In most cases, tax consequences had a significant impact in terms of the gift being made as well as, and more importantly, in terms of the amount we eventually received and were able to utilize in better serving the community.

PRESERVE THE CURRENT TAX INCENTIVES TO CHARITABLE GIVING

The current provisions in the tax laws have a two fold impact on charitable giving. First, the tax incentives provide a way to encourage private support of worthwhile causes such as Hillcrest Medical Center. Second, and equally as important, tax incentives often allow support at a much increased level.

Although there is, perhaps appropriately so, much concern over tax reform and equalizing the tax burden, to direct such reform as the charitable giving tax incentives is, we believe, misguided. Those that donate to the cause of their choice are recognizing the types of causes the public sees as important and necessary and are *giving away* their valuable assets to support those activities. The point is that they *are* giving away their valuables and the tax incentives currently available allow them to do this in the most efficient and effective manner. Those donating are not benefiting from the tax considerations because they are giving away their property, *we* are benefiting from those tax incentives. To modify the present tax incentives is purely a tax that, albeit indirectly, is imposed on us and reduces our capability to serve the people in our area. The tax provisions relative to charitable giving cannot be likened to other provisions which, perhaps, provide a benefit to the taxpayer.

Concerning gifts of long-term appreciated securities, real estate and tangible personal property, we are opposed to proposals which would limit the charitable deduction to the property's cost basis or to the property's fair market value minus one-half of the appreciation. Further, proposals which would allow a charitable deduction for the property's fair market value, but tax the appreciation just as if the donor had sold the property and contributed the proceeds or which would require a longer holding period in order for a donor to take a charitable deduction for the fair market value of the property contributed or which would subject the property's appreciation to the 10 percent or other minimum tax or which would tax the appreciation element of gifts of appreciated property given to charitable organizations at death are opposed. Changes such as these would have a drastic effect on the support we receive; in fact, many of the donations we are currently working on would not be made if such proposals were enacted.

Proposals which would place a ceiling on the estate or gift tax charitable deduction are opposed. Such a proposal would simply amount to an indirect tax on a charitable institution and would have reduced the $60,000 we received in bequests this past year.

Proposals which would place a percent of adjusted gross income floor on the income tax charitable deduction are opposed. Such a proposal would serve to effectively eliminate the income tax incentives from the majority of our donors and we, no doubt, effectively serve to reduce the contributions we receive.

Proposals which would substitute a credit for the income tax charitable deduction are opposed. Such a proposal would have an adverse effect on those donors who make our largest gifts and would effectively serve to reduce the contributions they make to us.

REMOVE "OVER-CORRECTIONS" OF THE 1969 TAX REFORM ACT

The 1969 Tax Reform Act while making adjustments that were necessary and desirable also made some overcorrections relative to the area of charitable giving. We request consideration be given to restore some of these overcorrections.

As examples of tax incentives that might be restored, perhaps some of the following could be considered:

An income tax charitable deduction should be allowed for the fair market value less one-half of the amount would be taxed as ordinary income on a sale when the gift is of inventory, crops, donor-created art works, short-term appreciated securities and short-term appreciated real estate.

An income tax charitable deduction should be allowed for the fair market value of a gift of appreciated long-term tangible personal property, such as art works, whether the gift is related or unrelated to the donee's exempt function.

The income tax charitable deduction should not be discounted by straight line depreciation when a gift of a personal residence or farm with retention of a life interest is made. This is an unrealistic correction made by the 1969 Act and by reducing the charitable deduction removes an important tax incentive.

Support organizations, described in Internal Revenue Code Section 509(a)(3) should be allowed to maintain and be remainderman of pooled income fund trusts.

Charitable deductions should be allowed for transfers to charitable remainder unitrusts and charitable remainder annuity trusts even though the trustee has the power to invade principal for the beneficiary if there is an ascertainable standard of invasion and based on that standard the possibility is so remote as to be negligible. This would remove a lingering concern that some donors have about the outside chance of needing the principal in the future and would further encourage their gift.

Charitable gift annuities should be allowed for more than two lives without the charity being taxed under Internal Revenue Code Section 514 so long as the other requirements of Section 514(c)(5) are met.

A donor who makes a lifetime gift of the right to use property rent free or who lends money interest free should not be subject to gift and estate taxes on the rental value of the property or the value of the free use of the money.

Regarding gifts of mortgaged property, (1) An outright charitable gift of mortgaged property should not be a bargain sale; (2) The prohibition on transferring a mortgaged asset—when the mortgage was placed on the property within the last 10 years—should not apply to charitable remainder unitrusts, charitable remainder annuity trusts, pooled income fund trusts and short term charitable income (lead) trusts; (3) There should be no imposition of capital gains tax when a donor transfers mortgaged property to fund a charitable remainder unitrust, a charitable remainder annuity trust, a pooled income fund trust or short term charitable income (lead) trust. This rule should also apply to a gift of a mortgaged personal residence or farm with a retained life estate; (4) Charitable remainder unitrusts and charitable remainder annuity trusts should not be deemed to have any

unrelated business taxable income merely because the trust holds mortgaged property or borrows to meet trust obligations; and (5) A charitable organization accepting mortgaged property in exchange for its promise to pay an annuity should not be subject to tax on unrelated business taxable income. This provision has caused delay in consumating a gift to us of land valued at $500,000–$1,000,000 since we have been forced to try to find other solutions to how the property taxes on this land would be paid—in case the land does not sell prior to them coming due, a virtual certainty in today's real estate market.

AUTHORIZE THE CHARITABLE REMAINDER VARIABLE ANNUITY TRUST

The new and recently proposed charitable remainder variable annuity trust would offer the donor a hedge against deflation and inflation making possible remainder gifts that are not made now because the donor must choose to hedge against one but not both of the factors. We recommend it be adopted. To some degree, because of the sophistication of donors and their desire to maximize their gift, the issue is raised as to why we can't offer a variable annuity as do commerical companies. Donors are aware of such techniques and, in a sense, we are competing for the way they see to best use their assets and when such things as the variable annuity or limited partnership exchange funds are authorized for the commerical sector an impact is made on us.

The reasons most often given for having taxes are to raise funds for the government and to avoid excessive accumulations of wealth.

Tax laws which reduce giving to charitable institutions such as Hillcrest Medical Center leave little alternative to reducing services or obtaining increased governmental support. The American public wants the best in medical care and we have recently begun to realize that the government simply cannot provide everything for everyone. Tax incentives encourage private support which allows us to provide the desired and necessary services at no extra burden on the government and encourages a do it yourself attitude that we perhaps need to return to.

Giving serves to break accumulation of wealth as much as does taxation since the wealth is distributed to charity who spends it to support needed activities.

We respectfully urge that the charitable giving incentives so long recognized as important in this country be continued.

OKLAHOMA HEALTH PLANNING ADVISORY COUNCIL, COMMITTEE ON INDIGENT CARE

(By Featherson/Boyd, Commission Staff)

I Effort Index No. 1
  Charity Care by Individual Hospitals
    Computed Charity Care Days
    Per Hospital Bed
      Staffed Beds
      Occupied Beds

II Effort Index No. 2
Charity Care by Hospitals Aggregated by Standard Planning Areas
Index Computed
Use Rate
Computed Charity Care Days to Expected Days
Computed Charity Care and Bad Debt Days to Expected Days

OKLAHOMA HEALTH PLANNING COMMISSION

(A staff paper by Featherson/Boyd)

Subject: Charity Care, measures of comparative efforts by Oklahoma hospitals on two bases.

This paper attempts to further assess the charity care efforts of Oklahoma hospitals in cognitive mathematical terms which begin to address the criteria of Equity, Fairness, and Ability.

Although these definitions may be found on page 3 of the main report, they are repeated here for clarity.

Charity care.—Medical services provided individuals who have neither personal resources to pay for the medical services they need, nor a third party mechanism to make payment in their behalf.

Equity.—Charity care costs shared fairly among acute care hospitals.

Fair.—The proportion of number of total patients served to number of charity care patients is approximately equal among hospitals according to ability.

Ability.—The dollar amount of charity care and treatment a hospital can provide without:

(1) Impairing its ability to meet current operational expenses for inpatient departments, and

(2) Losing its capacity to provide community and patient services at current volume levels.

Effort index No. 1 (Charity Days Per Bed) is an attempt to provide some measure of the *fairness* of the distribution of charity care among Oklahoma's short-term acute care hospitals. It was derived by calculating a total cost per patient day and dividing that into the dollar amount of charity care reported by the hospital. That gives an approximation of the number of patient days that the hospital gave to charity patients. This figure was then divided by the number of beds in that hospital, to give "charity days per bed". Effort index No. 1 allows comparisons in terms of units of service provided (hospital day equivalents). This permits the 25 bed hospital to be compared with the 500 bed hospital within the framework of the services capability of each.

FORMULAE

C=Cost per patient day

$$C=\frac{\text{Total operating expenses}}{\text{Census}\times 365}$$

CD=Charity dollars
B=Beds
O=Occupancy rate

$$\frac{CD/C}{B}=\text{Days of charity care per bed}$$

$$\frac{CD/C}{B\times O}=\text{Days of charity care per occupied bed}$$

C, B, and O were taken from AHA Guide Issue for fiscal year 1973, for all hospitals except University. University's figures were taken from data furnished by the OHA and University Hospital. The charity dollars data was furnished by the OHA.

Hospital	State area	Staffed beds	Charity days per staffed bed	Charity days per occupied bed
Hillcrest-Tulsa	6	511	16.26	24.22
Mercy-OKC	8	183	15.14	20.15
Bradshaw-Miami	1	26	12.88	14.57
University-OKC	8	255	12.64	15.78
St. John's-Tulsa	6	567	11.40	14.34
Bartlett-Sapulpa	6	143	10.81	13.68
Baptist-OKC	8	376	10.71	12.13
Stroud	5	25	9.76	12.20
Jay	1	28	8.14	10.36
Durant	4	80	7.85	10.30
Henryetta	3	44	7.64	8.40
Buffalo	11	25	7.60	10.56
Moore	8	51	7.57	13.79
Cimarron-Boise City	11	20	6.40	10.67
Newman-Shattuck	11	66	6.04	7.61
St. Mary's-Enid	7	287	5.87	9.80
Blackwell	7	65	5.85	7.60
Oklahoma Osteopathic-Tulsa	6	308	5.76	6.91

Effort Index No. 2 attempts to relate actual effort to estimated need for services. A use rate was computed for each Area by dividing the total patient days of hospitals in the Area by the population. This gives patient days per person. This ratio shows some indication of hospital ability per Area. For instance, areas with low patient days per person usually have hospitals which do not offer many sophisticated services.

The use rate for the total population is then multiplied by a segment of that population (the potential medically needy) to arrive at an estimation of a potential use rate for this set. This number assumes that the use rate for this part of the population will be similar to the population of that Area.

One must remember that this figure (pt. days/pop.×Indigents) includes people who have health insurance or in some other way manage to pay their bills. It does not include institutionalized people in the Area. Although not a true reflection of actual need, it does provide

a basis by which to compare the relative adequacy of the actual care being rendered in that Area.

One may then compute a ratio of actual/need by dividing the total charity patient days (or charity and bad debt days) by the estimated patient days for the medically needy population. This ratio allows, to some extent, a comparison between areas of how well the hospitals in that Area are meeting the charity care need of that community. It does not show that, for example in Area I, that only three percent of the medically needy are receiving care. But it does allow one to say that Area X seems to be meeting less of the need than Area XI.

CHARITY DAYS PER BED

	Per bed	Per bed times occupancy
Hillcrest	16.26	24.22
St. John's	11.40	14.34
Sapulpa	10.81	13.68
Oklahoma Osteopathic	5.76	6.91
St. Francis	2.91	3.48
Pawhuska	1.70	2.80
Doctor's	1.35	1.80
Collinsville	.64	.80
Fairfax	.21	.36
Drumright	.18	.28
Hominy	.12	.33
Bristow	0	0
Broken Arrow	(1)	(1)
Mercy	15.14	20.15
University	12.67	15.78
Baptist	10.71	12.13
Moore	7.57	13.79
Bone and Joint	6.57	6.76
South Community	4.16	4.61
Deaconess	3.62	4.01
St. Anthony's	2.83	3.59
Hillcrest Osteopathic	2.64	3.26
Presbyterian	2.63	3.61
Parkview	1.41	2.38
Midwest City	.99	1.20
Edmond	.32	.88
Norman	.12	.17
Bethany	0	0
Logan	(1)	(1)
Grandway	(1)	(1)
Oklahoma Medical Research	(1)	(1)

[1] No data.

Area	Use rate for area (pt. days over pop.)	Expected use rate for segment of population (pt. days over pop. times indigents)	Charity pt. days	C + BD pt. days	Percent	
					[illegible]	[illegible]
I	1.09	64,893	2,204	7,560	3	12
II	.70	62,329	571	6,288	1	10
III	.75	44,168	176	6,434	2	15
IV	1.16	86,579	1,500	10,406	2	12
V	.71	47,062	856	5,564	2	12
VI	1.43	156,269	20,138	46,198	13	30
VII	1.33	62,052	3,180	6,911	5	11
VIII	1.16	159,813	15,001	35,229	9	22
IX	.88	50,566	632	5,213	1	10
X	.87	30,343	483	2,978	1	8
XI	1.04	19,380	1,089	2,808	6	14

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Statement Submitted by Rev. Ernest Bartell, C.S.C., President, Stonehill College, Inc.

CONTRIBUTIONS TO NONPROFIT INSTITUTIONS

The rationale behind the desire on the part of Congress to close "tax loopholes" is understood and appreciated. It is hoped, however, that the Congress will equally understand that tax structures which offer strong incentives for private philanthropy are not "tax loopholes," but a positive contribution to the maintenance of important institutions of our society, including colleges and universities.

It is well-known that tuition, even at today's increasing rates, offsets only a portion of the operating costs of institutions of higher education. Private colleges and universities, in particular, are heavily dependent upon the philanthropic dollar to bridge this gap and, equally importantly, for institutional advancement programs. In many younger and smaller institutions without larger endowments, the ability to attract outside support is often a matter of the survival of the institution.

To meet such challenges, private colleges assiduously appeal to alumni, private individuals, corporations and private foundations for support to meet both ongoing needs and for the capital increments necessary to improve physical facilities and to enrich academic programs.

Any contemplated tax structure which would lessen incentives to private giving to private institutions would have immediate, serious and long-range effects.

At Stonehill College, a typical small college, for example, $12 million in essential capital improvements alone have been added to the campus in the last decade. This growth would not have been possible without individual, corporate and foundation gifts to the college.

An average of approximately 70% of the student body at Stonehill depends on some sort of financial assistance. There is a limit to which Stonehill can meet its needs through tuition increases without immediately and deeply affecting enrollments. The college is located in southeastern Massachusetts which has been a distressed economic area even before the current recession. The majority of Stonehill students come from this region (with a total of 75% from New England) and the college has been able to meet the educational needs of increasing numbers of students in direct proportion to its ability to attract financial assistance from outside sources. In addition to seeking support for pressing immediate needs, much effort has been spent in developing future bequests from individuals and charitable trusts which will accrue to the college through wills or future trust distributions.

The elimination or modification of tax incentives for giving would considerably lessen our ability to attract such support.

A most important feature of private philanthropy is its flexibility to respond to special and unusual needs. A college with an experimental or innovative program is frequently able to attract a grant from a private source to try an imaginative new approch in education when no other source of funds for such a venture might be available.

This adds an important element of vitality to education. In any such venture there is always a certain risk involved. A private source is frequently willing to share such a risk with the institution because of the tax incentive entailed.

Education and the society in which education functions have reaped many substantial benefits from such cooperative undertakings. It would be a serious loss to American higher education if such possibilities were eliminated or weakened at a time when an increasingly larger proportion of our youth are seeking higher education, and when the uncertain future of all of our processes and social institutions demands the best possible response from the educational sector.

THE ASSOCIATION OF ART MUSEUM DIRECTORS,
New York, N.Y., April 7, 1976.

COMMITTEE ON FINANCE,
U.S. Senate,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is in response to your February 5, 1976 announcement of public hearings on the subject of tax reform. I am writing as President of the Association of Art Museum Directors, which consists of representatives of the leading art museums of the country. We are encouraged by the enlightened position taken by the Secretary of the Treasury William T. Simon, in his testimony before the Committee on March 17 to leave the charitable contributions deduction unaffected by the Treasury's Minimum Taxable Income proposal. As the Secretary recognizes in his written statement, continuing inflation is causing dire financial difficulties for our nation's art museums, which rely heavily on charitable contributions for support of their operations in serving the public. Under these pressing circumstances, it is heartening to learn of Treasury's concurrence in the importance of continuing the present tax treatment of charitable contributions for our nation's privately supported art museums.

Respectfully submitted.

EVAN H. TURNER, *President.*

STATEMENT OF THE CHILD & FAMILY SERVICES OF CONNECTICUT, INC.

My name is Roger Sullivan and I am Director of Development and Public Affairs for Child and Family Services of Connecticut, Inc., an independent, non-profit social service agency headquartered in Hartford, Connecticut. I am grateful for this opportunity to testify before the Committee and to represent the views of my colleagues regarding potential changes in the laws governing charitable gifts and bequests.

The Committee will, I know, entertain extensive testimony on this important subject, much of it presented by persons with far greater technical expertise than myself. I shall not attempt therefore to reiterate or duplicate such legal or technical points as have been or will be made here this morning. Rather, I believe that I can contribute most to your deliberations by placing these considerations into the

context of my own organization, Child and Family Services of Connecticut. Since laws are intended to serve societal objectives, no legislative decision should be removed from the reality of its impact.

Originally established in 1809 as a home for young wanderlings, Child and Family Services offers some fourteen different services including adoption placement for handicapped or disadvantaged children, specialized foster care, clinical, residential and out-patient treatment for emotionally disturbed children, and counseling to families under stress, and unwed parents.

My Agency serves a four county area with total population of nearly 1,200,000 and during 1975, Child and Family Services conducted over 22,000 treatment and counseling sessions.

Our operating budget for the year was $2,152,656, however, we received from client fees, the State Department of Children and Youth Services (for wards of the state), the State Welfare Department (for AFDC children) and other municipal, state and federal agencies a total of only $892,011. An operating deficit of over $1,260,000 was averted however, because our Agency has over the years benefited from numerous gifts and bequests. An endowment of nearly $20,000,000 comprised exclusively of estate legacies generated income for 1975 of $951,900 which, coupled with current gifts of $55,000 and a grant from the United Way of Greater Hartford, subsidized our operating income. Child and Family Services is *not* unique in so far as such private support is concerned. We are able to serve a large number of poor and disadvantaged families for whom public funds do not provide *only* because of individual gifts and bequests.

Connecticut, like many states, is now undergoing a severe financial crisis. As a result, many social service programs, even those affecting children, are threatened by retrenchment. Under those circumstances, the gap between operating revenues and expenses at our Agency will undoubtedly *increase* over the next several years. The only way that gap can be filled is through increased charitable giving.

My point is this: Private giving has filled the gap between public need and what our public fiscal systems can provide. Anything done to reduce the favorable regard in which charitable giving is held or to impose restrictions upon personal generosity will be *extremely* counterproductive; in no way will increased tax revenues from such measures compensate for the loss of human services. Moreover, it should be pointed out that numerous recent studies show these services provided through the private non-profit sector at a *lower* cost to taxpayers than through comparable public agencies.

Estate Charitable Deductions

The Committee has before it, as I understand, a proposal which would impose a 50-percent ceiling on the estate tax charitable deduction.

Such a measure would do irrepairable harm without accomplishing any real good; it would close off a vital avenue of support for the nonprofit sector while generating only a marginal amount of new tax revenue.

Our Agency has received numerous bequests from individuals whose entire estates were bequeathed to charity. By my own estimate, the

existence of a 50 percent ceiling on the estate charitable deduction would have reduced the total of legacies to Child and Family Services by at least $1.8 million while increasing public tax revenue by a mere fraction of that amount. I say "at least" because any policy which qualifies the government's attitude toward charitable support would also serve to discourage and make apprehensive any conscientious citizen.

I would point out that every deductible dollar given to bona fide charities is devoted to public purposes and as such substitutes for federal revenues that would otherwise be needed. For the Congress to withdraw its blessing from private giving at a time when the nonprofit sector is being asked again and again to fill the void left by retrenchment in publicly funded human services programs seems unconscionable.

Unified Transfer Tax

Yet another proposal before the Committee would substitute a unified transfer tax for the present estate and gift taxes and would result in a 50 percent ceiling on life time gifts to charitable organizations. Although less easily measured in terms of a particular organization, like mine, the general impact of such a measure would clearly be to reduce overall charitable giving. Here again, such a measure would imply a lack of faith by the Congress in the whole charitable system; Citizens would suspect further regressive measures and become reluctant to avail themselves of *any* tax related incentives to private giving.

Gifts of Appreciated Property

The Committee will, I assume, also consider the matter of appreciated property as it relates to charitable giving. In the case of my own institution, gifts and bequests of appreciated property account for nearly one-half of the principal of our endowment. Any restriction or tax on such gifts could therefore be projected to diminish future support accordingly.

The tax treatment of such gifts was thoroughly considered by the Congress prior to the Tax Reform Act of 1969, and obviously reflects a belief that incentives for these kinds of gifts should be retained. What's more, President Ford is now urging citizens to invest in the stock market as a means of stimulating the national economy. It seems ludicrous to add such a stigma to the concept of capital appreciation, and imposing what would in effect be a tax on charitable organizations.

I strongly urge the Committee to maintain current provisions regarding gifts of appreciated property.

Conclusion

On these and all other matters pertaining to estate and gift tax provisions I urge the Committee to consider the inherent good of charitable giving. It should be perfectly clear that solutions to the problems of American society cannot simply be legislated. The efforts of individuals and organizations to find answers and solutions must continue, and we must have the unequivocal support of the Congress.

If the Congress questions the purposes to which charitable support is being put, then it should examine the process by which organizations are granted 501(c)(3) status and the policies which govern their use of charitable support; my institution would welcome such scrutiny

as a means of purging some of the illegitimate "charity rip-offs" that exist, and dispelling doubts as to the merits of our work.

If, on the other hand, the members of your Committee support the work which is done by charitable organizations in this country, then please also endorse that work by making clear to all citizens your encouragement of charitable giving. It seems to me that there is very little to gain by reducing estate and gift tax charitable deductions, and a great deal to lose.

ROGER J. SULLIVAN.

Charitable Requests and the Federal Estate Tax: Proposed Restrictions on Deductibility *

STATEMENT OF BORIS I. BITTKER **

I want this evening to discuss with you an important proposed amendment to the federal estate tax law, under which the deduction allowed for charitable bequests—now unlimited in amount—would be limited to a specified percentage of the testator's estate—the most frequently mentioned figure is 50 per cent. Similar proposals to emulate the income tax by imposing a percentage limit on the deduction of charitable contributions have been floated from time to time for at least 35 years,[1] but recently these trial balloons have attracted more attention on Capitol Hill than ever before.[2] By itself, the issue is a narrow one, affecting only a small fraction of estates; but I propose to show that it raises fundamental issues about the nature and objec-

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*The author is indebted to Harley J. Williams, J. D. Yale Law School, 1975, for editorial assistance in preparing this address for publication.

**Sterling Professor of Law, Yale University.

[1] Hearings on Revenue Revision of 1942 before the House Committee on Ways and Means, 77d Cong., 2d Sess., 91 (1942) (Statement of Randolph Paul):

Limitation upon deductions for contributiins to charity.—Amounts bequeathed or transferred for specified charitable purposes are deductible in computing the estate subject to tax. The statute contains no limitation upon the amount of the deduction for such gifts to charity and thereby affords to wealthy individuals an opportunity virtually to escape all liability under the tax. The provision also enables decedents to perpetuate, through charitable trusts and corporations, family control over their wealth without paying the estate tax. The policy underlying the deduction for gifts to charity does not justify such results, and it is suggested that the deduction be limited to a specified percentage of the decedent's estate.

See also Hearings on Revenue Revision of 1951 before the House Committee on Ways and Means, 82d Cong., 1st Sess., pt. 1, at 72 (1951) (discussion within Treasury of imposing 15 percent limit on deduction for charitable bequests, but without reaching a conclusion)).

[2] See H.R. 1040, 93d Cong., 1st Sess., 1973 ("Tax Equity Act of 1973"), summarized by Representative Corman, 119 Cong. Rec. 386 (1973).

See generally Locke, The Estate Tax and Charitable Donations, 20 Wayne L. Rev. 1227 (1974); Boskin, Estate Taxation and Charitable Bequests, Stanford University Center for Research in Economic Growth, Memorandum No. 180 (1974), — J. Pub. Econ. — (1976); Schaefer, Charitable Transfers at Death Under the Federal Estate Tax (1966) (Ph. D. dissertation Columbia University); Myers, Estate Tax Deduction for Charitable Benefits: Proposed Limitations (1975) (memorandum submitted to Commission on Private Philanthropy and Public Needs (the "Filer Commission")); Wagner, Death, Taxes and Charitable Bequests: A Survey of Issues and Options (1975) (memorandum submitted to the Filer Commission); McDaniel, Study of Federal Matching Grants for Charitable Contributions (1975) (memorandum submitted to the Filer Commission); Westfall, Proposed Limitations on the Estate Tax Deduction for Charitable Transfers (1975) (memorandum submitted to the Filer Commission); Westfall, Revitalizing the Federal Estate and Gift Taxes, 83 Harv. L. Rev. 986 (1970); McNees, Deductibility of Charitable Bequests, 26 Nat'l Tax J. 79 (1973).

In its final report, Giving in America: Toward a Stronger Voluntary Sector 151 (1975), the Filer Commission, one member dissenting, recommended that the deduction for charitable bequests be retained in its present form. A coalition of public interest, social action and volunteer groups that acted as advisors to the Filer Commission recommended the institution of a minimum estate tax, comparable to the minimum income tax, but did not suggest a rate or any details See Donee Group, Private Philanthropy: Vital & Innovative? or Passive & Irrelevant? 29 (1975).

tives of death taxation and that, on analysis, the proposal for a percentage limitation turns out to rest on a faulty foundation. This analysis also exposes parallel shortcomings in the rationale underlying several other proposed changes, such as converting the deduction into a tax credit or substituting a system of matching federal grants to charitable institutions.[3]

I. THE ORIGIN AND HISTORY OF THE DEDUCTION

First, a brief historical narrative.

When Congress turned to death taxes as a source of federal revenue in 1916 (as it had in 1797 when war with France seemed possible and again in 1862 and 1898[4]), it granted no exemption for bequests to charity. The legislative history of the 1916 law is meager, and we are left to speculate about the reason for the failure to grant charities an exemption that was almost universal at the time in state inheritance laws.[5] Perhaps the explanation may be found in the difference in theory between the typical state inheritance tax and the much less common estate tax that Congress chose to enact in 1916.[6] The legal structure of an inheritance tax focuses on the decedent's beneficiaries, who are customarily grouped into several categories, depending on the closeness of their relationship to the decedent. Bequests to the most favored group (the widow or widower and children) ordinarily qualify for generous exemptions and relatively modest rates, while bequests to more distant relatives and "strangers" get less generous exemptions and are subjected to higher rates. Since it directly reduces the amount received by the heir or legatee, an inheritance tax on charitable bequests is readily perceived as a burden on the charitable institution and its beneficiaries; and this perception, in turn, virtually invites a legislative exemption of such bequests lest the institution's charitable functions be curtailed.

By contrast with typical state inheritance taxes, the 1916 death tax imposed by Congress looked to the aggregate estate left by the decedent, rather than to the separate amounts passing to the heirs and legatees. This legislative decision to enact an estate tax contributed to simplicity, by avoiding the necessity of classifying recipients into a number of categories; and this in turn sidestepped the valuation problems created by testamentary trusts whose ultimate recipients are not known at the date of death and may eventually fall into any of

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[3] C. Shoup, Federal Estate and Gift Taxes (Brookings Institution, 1966), regards the existing system of deducting the bequest "off the top" as wasteful, on the ground that decedents with large estate need little or no tax incentive to make small bequests to charity. This leads him to propose reversing the rates in computing the tax allowance for charitable bequests (e.g., a credit if 3 percent of the first $5,000 left to charity, 7 percent of the next $5,000, and so on up to 77 percent of any amount over $10 million).

See also McNees, supra note 2 (credit); McDaniel, supra note 2, and compare with Bittker, Charitable Contributions: Tax Deductions of Matching Grants? 28 Tax L. Rev. 37 (1972).

[4] For history, see 1 R. Paul, Federal Estate and Gift Taxation, ¶ 1.02 (1942); Eisenstein, The Rise and Decline of the Estate Tax, 11 Tax L. Rev. 222, 224 (1956).

[5] See compilation of the state laws in Hearings on the Revenue Act of 1918 before the House Committee on Ways and Means, 65th Cong., 2d Sess., pt. 1, at 907 (1918).

[6] The terminology was not as precise at that time. See S. Rep. No. 103, 65th Cong., 1st Sess (1917) (1939–1 C. B. (Part 2) 65) (referring to the 1916 tax as "the inheritance tax levied by the National Government"). See also S. Rep. No. 793, 64th Cong., 1st Sess. (1916) (1939–1 C. B. (Part 2) 30) (referring to the 1916 tax as the "estate or inheritance tax").

several categories, depending on the way the trustee subsequently exercises discretionary powers or other postmortem events.[7]

But the very fact that the federal estate tax would be the same whether the estate went to the decedent's children, collateral relatives, or friends, as well as the fact that the identity of the recipients might not be known for many years, tended to divert attention away from these persons, as though the burden of the tax fell not on them, but on the decedent. The status of charitable bequests, therefore, may have been overlooked by the draftsmen of the 1916 law in their preoccupation with the size of the estate as such; or they may have viewed an exemption for bequests to charitable legatees as inconsistent with the basic concept of a tax on the estate as a whole.

Whatever the reason for failing to exempt charitable bequests in 1916, this omission was quickly remedied. In 1918 Congress enacted a deduction for charitable bequests[8] that has remained substantially intact to this day. According to Dean Griswold, this change in the law occurred "almost by accident."[9] (Dean Griswold's characterization was probably not intended as praise, though no doubt some disenchanted observers of Capital Hill might argue that legislation by accident is sometimes better than legislation by plan.) In point of fact, however, the deduction may owe its origin to something more rational than accident.

As passed by the House of Representatives, the Revenue Act of 1918 reenacted the 1916 estate tax with substantial amendments, including a more steeply graduated rate schedule, but the Senate, following the recommendation of the Senate Finance Committee, substituted an inheritance tax.[10] As the Senate committee pointed out, under the 1916 federal estate tax, a person receiving a bequest of a given amount from a large estate bore a heavier burden than a person receiving a bequest of the same amount from a smaller estate; by shifting to an inheritance tax based on the size of the individual share, Congress could equalize their burdens and thus achieve, in the committee's opinion, a "fairer and more equitable" result.[11] The Senate substitute included an exemption for charitable bequests, seemingly patterned on the exemption in typical state inheritance tax laws. When the bill went to conference to resolve this head-on collision between the House's estate tax and the Senate's inheritance tax, the conferees recommended retention of the 1916 estate tax structure but with higher rates, an exemption for charitable bequests, and a few other changes.[12]

This bit of legislative history suggests that when the congressional committees focussed on the status of the beneficiary, who after all must bear the burden of any death tax—the decedent being henceforth concerned with less mundane matters—they may have concluded that equity was better served by exempting, rather than

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[7] See H.R. Rep. No. 922, 64th Cong., 1st Sess. (1916) (1939-1 C. B. (Part 2) 25):

Your committee deemed it advisable to recommend a Federal estate tax upon the transfer of the net estate rather than upon the shares passing to heirs and distributees or devisees and legatees. The Federal estate tax recommended [by the committee] . . . can be readily administered with less conflict than a tax upon the shares.

[8] Revenue Act of 1918, ch. 18, tit. IV, § 403(a)(3), 40 Stat. 1057, 1098.

[9] E. Griswold, Cases and Materials on Federal Taxation 1074 (6th ed. 1966).

[10] See S. Rep. No. 617, 65th Cong., 3d Sess., 15 (1918) (1939-1 C. B. (Part 2) 127).

[11] Id.

[12] See H.R. Rep. No. 1037, 65th Cong., 3rd Sess., 70–71 (1919) (1939-1 C. B. (Part 2) 151).

taxing, amounts destined for charitable uses. If the beneficiaries of a charitable bequest are persons on the lower rungs of the income ladder, their meager ability to pay strongly suggests that an exemption is preferable to a tax on their share of the estate.[13] Even if the beneficiaries of the bequest are not indigents, but members of the general public, as would be true if the bequest is to a college, museum, or similar institution, their average economic status is almost certainly lower than that of typical recipients of federally-taxed bequests. For this reason, an exemption of charitable bequests that inure to the benefit of run-of-the-mine citizens is, in my view, completely harmonious with the spirit of the federal estate tax.

We cannot know for sure whether these considerations were present in the minds of the legislators when they added the deduction for charitable bequests to the Revenue Act of 1918. The record does establish that the Senate Finance Committee recognized the "ability to pay" issue indirectly, when it noted the unfairness of taxing two bequests of the same amount at different rates simply because one came from a larger estate than the other. (The point of this criticism was that in judging the fairness of death taxation, we should look at the living person who gets the bequest, not at the dead person who left the property.) It seems entirely possible that the conferees were unwilling to correct this undesirable aspect of the 1916 estate law by shifting to an inheritance tax for any of a number of reasons—the simplicity of an estate tax, a potential loss of revenue during wartime, the fact that wills may have been drafted and estates planned on the assumption that the 1916 law would remain on the books, etc.—but that they accepted the inheritance tax approach in the limited area of charitable bequests because the injustice of taxing these transfers was especially apparent.

Whatever the reason, the deduction was enacted as part of the Revenue Act of 1918 [14] and has been retained by Congress throughout the ensuing years with remarkably few changes. Indeed, if a member of the Congress that enacted the Revenue Act of 1918 were to peruse today's Internal Revenue Code—a harsh interruption, to be sure, of his eternal rest—he would find few provisions that preserved his work as faithfully as § 2055. There have been, in fact, only two changes of consequence, both designed to limit or deny the deduction if the bequest may be diverted from the purported charitable beneficiary.[15]

II. THE PERCENTAGE LIMIT ON THE INCOME TAX DEDUCTION FOR CHARITABLE CONTRIBUTIONS

From the outset, the deduction has been unlimited, in the sense that a charitable bequest, no matter how large, qualifies for deduction, so

[13] It may be argued that the beneficiaries of charitable institutions would not suffer, on balance, if chariable bequests were taxed, since the resulting reduction in charitable activities would be offset by an increase in government revenues and hence in public spending. But this argument requires heroic assumptions about the destination of the funds raised by taxing charitable contributions, disregards the likelihood that charitable bequests will diminish by more than the revenue raised, and overlooks the desirability in a pluralistic society of strong non-governmental social welfare and cultural activities.

[14] Revenue Act of 1918, ch. 18, tit. IV § 403(a)(3), 40 Stat. 1057, 1098.

[15] (1) The Revenue Act of 1932, § 807, 47 Stat. 169, 282 (now § 2055(c) of 1954 Code), overruling the decision in *Edwards v. Slocum*, 264 U.S. 61 1924); and (2) the Tax Reform Act of 1969, 83 Stat. 487, introduced to eliminate abuses arising from the use of charitable remainder trusts. See Cannon, Charitable Remainder Trusts: A Study of Current Problems, 1975 Brigham Young U.L. Rev. 49.

that no federal estate tax is payable if the entire estate is left to charity. Section 2055's income tax counterpart, however, was restricted to 15 percent of the taxpayer's income when it was enacted in 1916; this ceiling has been repeatedly raised and now stands at 50 per cent of adjusted gross income.[16] Although Congress eliminated the ceiling in 1924 for taxpayers donating substantially all of their after-tax income to charitable purposes (a tiny group), in 1969 this exception was repealed, subject to a transitional period of gradual phase-out.[17] Thus, the percentage limit has been a basic feature of the income tax since the inception of the deduction in 1916.

The contrast between the limited income tax deduction and the unlimited deduction allowed for federal estate tax purposes has not gone unnoticed. As long ago as 1940, in his casebook on federal taxation, Dean Griswold asked:

Would a maximum limit on the amount of charitable gifts allowed as deductions [for federal estate tax purposes] be desirable? Cf. section 23(o) of the income tax.[18]

I find that in the 6th edition of his casebook, published in 1966, Dean Griswold asked exactly the same question, and continued to refrain from supplying an answer.[19] I mean no criticism; as a teacher, I can testify that when a question succeeds in stimulating class discussion, it should be preserved with care, and protected against erosion by those who want to see their answers in print. Nothing casts a pall on a classroom like a student who has read the teacher's law journal article on a subject of discussion and then proceeds to regurgitate it.

One of Dean Griswold's colleagues, however, has addressed himself to the question (though not, to be sure, until after the Dean's departure from academic life). In his 1971 Hess lecture before this Association, Professor Westfall suggested "that we may no longer be able to afford the luxury of an unlimited charitable deduction for estate tax purposes," and he recently fleshed out this comment by recommending that the deduction be limited to 50 percent of the estate.[20] As I have already suggested, I disagree with this proposal.

The best point of entry into the issue before us is the income tax's percentage limit on the deductibility of charitable gifts, since this is sometimes held up as a model, the absence of such a limit from the federal estate tax being viewed as an anomaly that calls for legislative correction. Why does the income tax contain a percentage limit on the deduction of charitable gifts and are these reasons equally applicable to the federal estate tax? Unfortunately, the Congressional committees did not announce their reasons for recommending enactment of the percentage restriction in 1916, nor has this lacuna been filled in the subsequent years, despite the repeated amendments that have expanded § 170 from two brief sentences in the Revenue Act of 1916 to

[16] Int. Rev. Code of 1954, § 170(b)(1) (individual donors): the limit is lower if the donees are outside the circle of "public" charities specified by Int. Rev. Code of 1954, § 170(b)(1)(A). For corporations, the deduction is limited to 5 percent of taxable income. Int. Rev. Code of 1954, § 170(b)(2).

[17] Int. Rev. Code of 1954, § 170(b)(1)(C).

[18] E. Griswold, Cases and Materials on Taxation 264 (1st ed. 1940).

[19] E. Griswold, supra note 9, at 1076.

[20] Covey, Surrey and Westfall, Perspective on Suggested Revisions in Federal Estate and Gift Taxation, 28 Record of the Association of the Bar of the City of New York 42, 47 (1973): Westfall, Revitalizing the Federal Estate and Gift Taxes, supra note 2, at 1002-06.

14 pages of turgid prose in its 1975 counterpart. Moreover, the percentage limitation has not evoked any significant body of speculation or discussion from tax theorists and commentators.

The simplest explanation for the restriction, that it was enacted to prevent a loss of revenue, is not persuasive. The number of persons who give as much as the deductible limit, or who even exceed the biblical tithe, is small; if Congress was ever seriously concerned about a potential drain on the Treasury from an unlimited deduction, that fear should have been allayed long ago by the statistics.[21]

Perhaps the restriction stems, at least in part, from a feeling that taxpayers get satisfactions from their charitable contributions that resemble the pleasures derived from hobbies, vacations, cultural activities, and other personal uses to which they may put their income. In exercising his command over income by making a charitable gift, the taxpayer is sometimes said to get a kind of "psychic income" in the form of personal pleasure and public fame that should not be disregarded in determining his tax liability, even though it cannot be given a precise dollar value. Critics of existing law, indeed, sometimes argue that charitable gifts are simply a form of personal consumption that is no more entitled to a deduction than ordinary expenditures for the cost of hobbies and other personal activities.[22] Other tax theorists are not prepared to go this far, however, because they perceive a "selfless" element in charitable gifts distinguishing them from expenditures for hobbies and other personal activities. But if they also perceive an element of psychic income in charitable gifts, they may wish the tax law to reflect both of these perceptions.

As a device to take simultaneous account of the selfless element and the psychic income in charitable gifts, however, the percentage limit is a crude instrument. Up to the amount of the limit, the selfless element gets full sway, since the deduction is not reduced by any psychic income; on the other hand, amounts above the limit generate no deduction for the donor's generous impulses, implying that they are totally eclipsed by his psychic income. A remedy that would be more suited to the foregoing analysis of the psychological foundations of charitable gifts would be a deduction limited to a specified percentage of each donated dollar.

Another argument that is sometimes offered in support of the income tax's percentage limitation is that in its absence, taxpayers would be able to avoid paying any income tax, no matter how great their income, if they were prepared to donate the entire amount to charity. Since these taxpayers would continue as citizens to enjoy the benefits of the federal government's programs—and not neces-

[21] Approximately 5 percent of the individual tax returns filed in 1972 contained charitable deductions in excess of 10 percent of adjusted gross income, and only 0.5 percent contained charitable deductions in excess of 30 percent. Int. Rev. Services, Statistics of Income, 1972, Individual Income Tax Returns 111–12 (1974).

[22] The existence of the charitable deduction, however, undermines the assumption that donating a dollar to charity generates as much satisfaction for the donor as spending the same dollar on himself. To use the terminology of the economist, the deduction has a "price effect," so that it "costs less" to donate a dollar to charity than to spend a dollar on a hobby or vacation. For this reason, if a taxpayer makes a charitable contribution of $1,000, and thereby saves $500 of taxes, it is far from clear that he gets a full $1,000's worth of pleasure or satisfaction; that inference would be justified only if he would have made the contribution even if it had not been deductible. If repeal of the statutory deduction would have led him to spend part or all of the $1,000 on himself, the theory that charitable contributions are indistinguishable from personal consumption would have to be scaled down or abandoned.

sarily as ascetics, since they might maintain an expensive standard of living by dipping into capital or using tax-sheltered receipts[23]—this freedom from tax liability, it may be argued, is objectionable.

In 1969, this was the rationale offered by the Senate Finance Committee when it recommended repeal of the unlimited charitable deduction that had entered the income tax law in 1924: The committee does not believe that high-income taxpayers should be allowed to significantly minimize or completely avoid tax liability by means of the charitable contribution deduction. Accordingly, the committee agrees with the House that the unlimited charitable contribution with the increase should be repealed. The effect of this. . . . is that charity can remain an equal partner with respect to an individual's income, but the charitable contributions deduction no longer will be allowed to reduce an individual's adjusted gross income by more than one-half.[24]

These reasons for limiting the deduction for charitable contributions in computing income tax liability—the "psychic income" derived by the donor from such contributions and his continued enjoyment of the benefits of government—are not entirely persuasive. "Psychic income" comes from many sources, but for sound reasons, Congress has never sought to tax it; if emotional satisfaction from one's activities generated taxable income, people like Ralph Nader, William Buckley, Kenneth Galbraith, and Ronald Reagan might have to pay more than John Paul Getty, who seldom looks—at least to this observer—as though he enjoyed his wealth.

Finally, the principal other rationale for the percentage limit (viz., the duty-to-support-the-government argument) presupposes that the benefit of the tax deduction inures to the donor rather than to the donee. But this premise, in turn, rests on still another assumption, viz., that charitable bequests are unaffected by the deduction. If this assumption is invalid, and charitable bequests would be reduced if they were taxed, the unlimited deduction of existing law inures *pro tanto* to the benefit of the charitable donees rather than the donor. Seen in this light, the deduction appears to relieve charitable institutions and their beneficiaries of the cost of supporting the federal government. The wisdom of this policy may be debated, but its impact is certainly altogether different from relieving the *donor* of the burden of supporting governmental services.

III. SHOULD THE PERCENTAGE LIMIT BE EXTENDED TO THE ESTATE TAX DEDUCTION?

Notwithstanding these misgivings about the percentage limitation on the income tax deduction for charitable contributions, I am prepared to accept it arguendo as an embodiment of wise policy. Even on this assumption, I see no case for extending it to the federal estate tax.

[23] The income tax's unlimited deduction for charitable contributions (the "Philadelphia nun" provision), supra note 17, was evidently designed for a taxpayer who took an oath of poverty on joining a religious order, to which she thereafter paid over all income from a trust of which she was the life beneficiary, but which could not be effectively assigned within the rule of *Blair v. Commissioner*, 300 U.S. 5 (1937), because of a spendthrift clause. See T. Hunter, The Tax Climate for Philanthropy 12 (1968). No doubt other taxpayers using this deduction lived well by dipping into their capital; those owning appreciated securities could, of course, donate the securities to charity without recognizing the capital gain, while living on their dividends and interest.

[24] S. Rep. No. 91–552, 91st Cong., 1st Sess., 70 (1969) (1969–3 C. B. 474).

So far as psychic income from charitable bequests is concerned, the decedent has left us, and this being a secular society by virtue of the First Amendment, we should not base our legislation on the assumption that he will enjoy the psychic income of a happier hereafter because of his charitable bequests. It is occasionally suggested that death taxes should be viewed as the final installment on a debt to society that was not fully discharged by the payment of taxes during life, but this rationale collides with the fact that nothing will be due if the taxpayer spends all he has before death. What kind of a final reckoning is it that can be so easily evaded and that falls only on those who refrain from such extravagance?

Sense can be made of the federal estate tax, in my opinion, only if we disabuse ourselves of the primitive notion that the decendent "pays" the tax. The decedent, I make bold to suggest, leaves this world with nothing, whether the tax is high or low; it is the living persons whom he leaves behind who will enjoy the benefits of his assets and bear the burden of the death tax. The tax, therefore, should take account of *their* circumstances.

To be sure, the legislative decision to impose an estate tax sets limits to the achievement of this objective. To avoid valuing every potential beneficiary's interest in the estate, the federal tax is imposed on the entire estate; the inevitable cost of this simplicity in administration is that the rate of tax cannot be geared to the separate financial situations of the individual legatees. In effect, they are all taxed at an average rate that ought to bear a reasonable, even though rough, relationship to their ability to pay.[25]

Many tax theorists favor changes in the death tax area that would refine this relationship, by tailoring the tax closely to each legatee's personal circumstances. Thus, some favor taxing gifts and bequests as income; others propose an accessions tax; and there are still other ways to "individualize" the death tax.[26] But this can be done to some extent even within the constraints of a conventional estate tax. The marital deduction is one such element in the federal estate tax, based on the theory that amounts inherited by a surviving spouse should not be taxed as heavily as transfers to other persons. A similar theory underlies recent proposals to exempt bequests to the decedent's minor children or other dependents up to a specified amount (e.g., an exemption for each child of $5,000 times the number of years remaining before attaining adulthood).[27]

The deduction for charitable bequests has a similar function. Far from being an anomaly in the federal estate tax structure, it is, I

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[25] For my own effort to trace through the policy implications of this theory, see Bittker, Federal Estate Tax Reform: Exemptions and Rates, 57 A.B.A.J. 236 (1971).

[26] On taxing bequests as income to the recipient, see H. Simons, Personal Income Taxation 125–47 (1938); 3 Canada—Report of the Royal Commission on Taxation, ch. 17, 465–519 (1966); J. Pechman, Federal Tax Policy 186–87 (rev. ed. 1971) (gifts and bequests should "in theory" be taxed as income). On the taxation of gifts and bequests as "accessions" to the recipient's wealth, see Rudick, A Proposal for an Accessions Tax, 1 Tax L. Rev. 25 (1945); Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974). See also W. Vickrey, Agenda for Progressive Taxation 224 (1947). While the proponents of these alternatives to the federal tax are not always explicit on the point, their proposals ordinarily contemplate exempting charitable recipients.

This focus on the recipient rather than on the donor can also be seen in the frequent use of the term "windfall" to characterize gifts and bequests, and in proposals to tax the generation-skipping trust, which rest ultimately on the theory that a bequest of income to one generation with remainder to the next is enjoyed by both generations.

[27] Tax Reform Studies and Proposals, U.S. Treas. Dept., Joint Pub. House Comm. on Ways and Means and Sen. Comm. on Finance, 91st Cong., 1st Sess., pt. 3, at 381 (1969) (orphan children); Covey, Surrey and Westfall, supra note 20, at 44 (minor children and "actual dependents" of the decedent); Bittker, supra note 25, at 239.

submit, an appropriate—indeed admirable—device to tailor the tax to the beneficiary's ability to pay. In recent years, only about 9 per cent of decedents left estates large enough to require filing a federal estate tax return,[28] and almost a third of these were nontaxable.[29] A rate structure designed for the children and other legatees of this tiny upper crust of American society would be grossly disproportionate if imposed on bequests to social welfare organizations, educational institutions, and other charitable groups, whose beneficiaries are drawn almost entirely from much lower income levels. If the decedent leaves his country estate to a charitable organization to be used as a summer camp for children of the ghetto, should the transfer bear the same tax as a bequest of the same property to the decedent's children for their personal use? Judged by their taxpaying capacities, these two groups are as different as night and day. By permitting charitable bequests to be deducted, existing law tacitly, but unmistakably, acknowledges that there is a difference between the beneficiaries of charitable bequests on the one hand, and the members of the decedent's family who receive the bulk of noncharitable bequests on the other. Only by disregarding the obvious can one conclude that the deduction for charitable bequests is a tax loophole, rather than a sensible way of adjusting the rate structure to the realities of life.

When the death tax is viewed as a tax on the recipients of bequests rather than on their deceased benefactor, it becomes evident that the proposed percentage limitation on the charitable contribution deduction would be similar to an income tax on charitable institutions, based on the bequests they receive. The income tax treatment of charitable organizations has been subject to much criticism in recent years, leading to numerous legislative changes and even more proposals; but to the best of my knowledge, no responsible commentator has ever recommended that contributions should be taxed to the charitable recipient. Yet this is exactly what would happen, albeit somewhat indirectly, if the federal estate tax were amended to restrict the deduction for charitable bequests.

In saying this, I am, of course, assuming that imposition of a percentage limitation would in fact reduce the amount received by charity. If the entire estate is left to charity, this assumption is obviously valid, since only ½ would be deductible, and there is no other source from which the tax on the balance could be paid.[30] If there are other bequests, the effect of a percentage limit is slightly more problematical, but the result is, in my opinion, likely to be similar. Assume, for example, that under existing law a testator plans to leave 20 per cent of his estate to friends or relatives, and the balance, after taxes, to a charity. Assume also that under existing law this plan would result in transmitting 20 per cent to the noncharitable legatees, 5 per cent to the government as taxes, and 75 per cent to the charity. What changes would the testator be likely to make if the law were changed so that the charitable bequest could be de-

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[28] See Int. Rev. Service, Statistics of Income, 1972, Estate Tax Returns 1 (1974) (up from about 3 percent 15 years ago).

[29] Id. at 2 (54,000 of 171,000 estate tax returns filed in 1972 were nontaxable).

[30] I discard, as wholly unpersuasive for charitable bequests of the magnitude we are discussing here, the possibility that the testator would have scaled down his lifetime consumption in order to enlarge the estate so that the same net amount would go to the charity after payment of the hypothetical tax.

ducted only in part—up to 50 per cent of the estate? Assume that the hypothetical change in the law would increase the federal estate tax from 5 per cent to 20 per cent of the estate—an increase of 15 per cent. Would the testator be likely to cut back the noncharitable bequests by this amount, giving the donees only 5 per cent of the estate rather than the 20 per cent they were to get under the original plan? Or would he be more likely to throw most or all of the entire burden on the charity? The latter seems by far the more likely outcome.

Indeed, he might decide to cut back the charitable bequest by *more* than the amount of the added tax. Under existing law, the unlimited deduction is an inducement to make such bequests: the charity gets more than the testator's other heirs lose. Under the proposed change, however, there is no tax incentive to give more to a charity than can be deducted; the tax result will be the same whether the additional dollars are given to the charity or to the testator's friends and relatives. For this reason, the testator may well be impelled to cut the charity back to the deductible 50 per cent, leaving the balance after taxes to the non-charitable heirs. If this is his reaction, an increase in the tax of 15 percentage points would cause a reduction in the charitable bequest of 25 percentage points. The noncharitable heirs would then get 30 per cent of the estate, rather than the 20 per cent that they would have received under the original estate plan.

If these views about the probable impact of the proposed percentage limit are correct, it is objectionable in two fundamental respects: First, it would impose a burden that cannot be justified on "ability to pay" principles. The federal estate tax, by virtue of its $60,000 exemption, exclusion of most life insurance, and exemption of survivor's benefits under the federal social security system and qualified private pension plans, is a distinctly upper class tax. We do not have any exact knowledge of the economic status of the heirs of decedents leaving estates large enough to be subject to the federal estate tax, but it has been estimated that this tax is paid almost exclusively by families with annual incomes of over $20,000.[31] The proposed percentage limitation would be felt almost entirely by the largest estates, where it is a virtual certainty that the typical heirs are very high on the income ladder. Taxing charitable bequests (by imposing a limit on the deduction) will, therefore, apply an estate tax rate schedule designed for these wealthy taxpayers to charitable institutions and their ultimate beneficiaries whose economic status is utterly different. No matter how vague the "ability to pay" principle may be, we surely know that there is a world of difference between the average heir to a multi-million dollar family fortune and the run-of-the-mine middle and low income citizen who benefits from bequests to universities, museums, community funds, and other charitable institutions.

Second, if we take into account the role of the federal estate tax as a device to moderate the concentration of family wealth—its primary function in the eyes of some theorists; an important secondary func-

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[31] Hearings on the subject of Tax Reform before the House Committee on Ways and Means, 91st Cong., 1st Sess., pt. 11, at 3978 (1969) (Statement of Jerome Kurtz). But see, Wicks and McDonald, Income Distribution of Death Bequest Recipients, 22 Nat'l Tax J. 408, 409 (1969), whose implications to the contrary must, in my view, be taken with caution. For one thing, the low income recipients of large bequests may well be minor children of wealthy tax parents, who are "poor" only in a technical sense.

tion for an even larger group[32]—an unlimited exemption for charitable bequests is not only consistent with this role, but actually makes an affirmative contribution to its achievement.[33] By encouraging testators to make charitable bequests, the deduction helps to disperse wealth among a larger group. Indeed, it may outperform the tax itself in this respect, since some testators—as argued above—may reduce their transfers to family members in order to make deductible bequests to charitable institutions. Conversely, if part of the charitable bequest became nondeductible, testators might well prefer, as suggested, to leave more of their property to members of their families, thus increasing, rather than diminishing, the concentration of wealth.

IV. TECHNICAL PROBLEMS

I should like to turn from the fundamental policy issues to some technical problems that would be introduced into the areas of tax law and estate planning by the enactment of a percentage limitation on the deduction of charitable bequests. For simplicity, I will assume that the prescribed limit is 50 per cent—the same as the income tax limitation.

1. Charitable bequest formula clauses?—Faced by a permentage limit on the deductibility of charitable bequests, some testators will wish to insure that the federal estate tax attributable to the nondeductible portion does not diminish their other bequests. This can be done, of course, by including a tax-apportionment clause in the will or by allowing an applicable state tax-apportionment law to take effect.[34]

Other testators, however, will want to avoid nondeductibility entirely, preferring to transmit the otherwise nondeductible amount to members of the family. If they want to take full advantage of the deduction without exceeding it, the obvious solution will be a charitable bequest formula clause, comparable to the marital deduction formula clauses now used to achieve a similar result.

It is surely unnecessary to stress, before this group, the estate planning complications that would arise from adding another type of formula clause to the lawyer's tool kit. Quite aside from these complexities, it would be deplorable to increase the number of wills that the testator must accept on faith because he cannot be expected to understand what his lawyer has drafted. Moreover, while testators may be willing to accept marital deduction formula clauses on being told that the plan is "good for the family," a testator who confronts a similarly complex formula when a charity is the beneficiary may feel that the complexity smacks of tax avoidance or worse, or presages a field day for the lawyers after his death, and he may then react by cutting back sharply on the bequest itself.

2. Charitable gifts in contemplation of death.—In applying the proposed percentage limitation on the deduction of charitable bequests, the Code would presumably take into account charitable gifts made

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[32] See 1 R. Paul, *supra* note 4, ¶ 1.07 at 81: Certainly it is a substantial, if not primary, motive of the American Federal estate tax to discourage excessive concentration of wealth. (Footnotes omitted).

[33] Wagner, supra note 2, at 18.

[34] For these methods of requiring each beneficiary of an estate to pay his own share of the death taxes, see 4 J. Mertens, The Law of Federal Gift and Estate Taxation §§ 30.12–30.19 (1959).

in contemplation of death during the last three years of the decedent's life. Although existing law does not exclude charitable gifts from the contemplation of death provision, the issue does not ordinarily arise because inclusion of a charitable gift would simply increase the estate's deduction by the same amount, so the net result would be a wash.[35] Under the proposed change, however, an unusually large charitable gift could become part of the gross estate because made in contemplation of death but, because of the percentage limit, not be offset by an equally large deduction. This risk would increase the use of charitable bequest formula clauses by foresighted draftsmen as a way to keep the aggregate charitable transfers, during life and at death, at or below the percentage qualifying for deduction.[36]

3. Carryover of "excess" charitable bequests.—The income tax provision limiting the deduction of charitable contributions, which, as I have said, has inspired the proposed estate tax limit, permits an "excess" contribution to be carried forward for use as a deduction in later years if the taxpayer's gifts fall below the deductible limit.[37] A similar carryforward of a disallowed charitable bequest for federal estate tax purposes might be feasible in the case of married couples. If the first spouse to die exceeded the limit and also left a bequest to the survivor, the survivor's estate could be allowed to deduct the excess amount, up to its percentage limit. On the other hand, if the first decedent did not fully use the allowance, the estate of the surviving spouse might be allowed to use the balance at least against property inherited from the first decedent. Such a carryforward of either an excess deduction or an unused percentage allowance could rest on the theory that each spouse should be treated as owning one-half of the family fortune and as making one-half of their joint charitable bequests, regardless of the actual division of the funds and bequests between them. I cannot envision, however, any other situation in which a carryforward would be warranted or feasible.

4. Percentage limit in federal gift tax?—A final question, which I list as a technical issue though it has important policy ramifications, is whether the proposed percentage limitation on the estate tax deduction for charitable bequests is to be accompanied by a parallel limit on the deduction of lifetime gifts in computing the federal gift tax. In general, of course, the gift tax was enacted and has been treated as a buttress to the federal estate tax, rather than as an independent tax with significant objectives of its own. Though Congress has not yet been willing to integrate them, the intimate relationship between the two taxes is evidenced by the adoption of the gift tax's split-gift provision and marital deduction in 1948, when the estate tax's marital deduction was enacted, as well as by their parallel treatment of com-

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[35] Situations sometimes arise, however, where executors claim that transfers to charities made during the decedent's lifetime are includible in the decedent's gross estate as gifts made in contemplation of death. The resultant increase in the gross estate permits a larger maximum deduction for bequests to spouses, but does not increase the estate tax payable because the charitable deduction is increased by the same amount. See the summarization of the "Tax Equity Act of 1973" by Representative Corman, supra note 2, at 392.

[36] In response to this the proposed "Tax Equity Act of 1973," supra note 2, § 604(b), explicitly provides that contributions made during a decedent's lifetime (which would be deductible under § 2055 of the 1954 Code if made at death) cannot be added back into the gross estate.

[37] Int. Rev. Coe of 1954, § 170(d).

munity property from 1942 to 1948. If a limit on the deduction of charitable bequests is enacted, can a limit on the deduction of charitable gifts be far behind?

Without a gift tax limit as a buttress, the percentage limit on charitable bequests could be avoided by lifetime gifts, unless the donor died within three years and the gifts were thrown into the estate because made in contemplation of death. But a gift tax limit would in turn place great stress on the timing of all lifetime transfers, since a large charitable contribution could be sheltered by large gifts to members of the family in the same year, though it would be taxable if it was made in one year and the family gifts in another.[38]

To mitigate the rigors of annual (indeed, quarterly) accounting for gifts, a carryforward might be allowed with a donor who exceeded the limit in one year being allowed a deduction for any later year (or a refund of the prior year's tax) in which his charitable gifts were less than half of his aggregate gifts. Conversely, much could be said for permitting unused allowances to be carried forward from year to year to be used whenever charitable gifts exceeded the allowance that would be permissible for a particular year, rather than to apply the limit year-by-year as though each year were unconnected with the prior period.

Finally, if the long-overdue integration of the federal transfer tax system were achieved, it would imply a correlative integration of the percentage limitation, under which it would be immaterial whether charitable contributions were made during the taxpayer's lifetime or at death. This would require a cumulative computation of all transfers (save for de minimis amounts and exemptions, if any, granted to encourage early gifts), which the percentage limitation becoming effective if—but only if—the aggregate charitable gifts during life and at death exceeded the applicable percent of all transfers. If there had been a temporary excess resulting in a transfer tax during the taxpayer's life (e.g., a charitable gift in the first relevant year exceeding that year's percentage limit), the resulting tax would be treated as a down payment on the amounts due for later years and eventually at death (and refunded if necessary) if the charitable gifts were below the limit when cumulated over the taxpayer's lifetime.

CONCLUSION

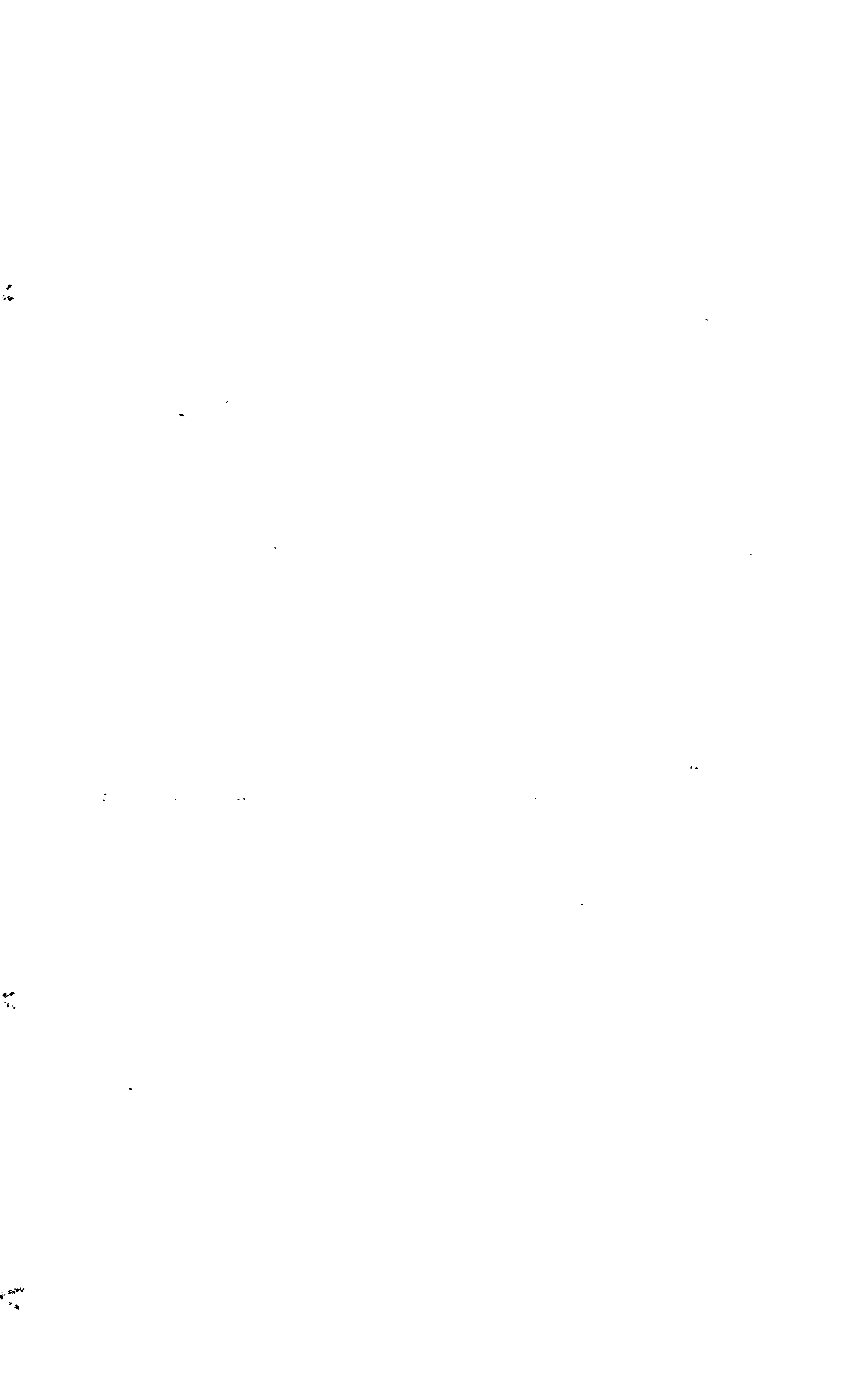
In conclusion: The last few years have been a difficult period for charitable institutions; social needs have increased; contributions have suffered from the recession; and the legislative climate, especially as respects taxes, has been chilly. Unquestionably there were abuses that cried out for Congressional remedies,[39] but just as certainly there have been remedies that went too far. I have discussed only a small corner of this troubled area, but my principal point—that the burden of death taxes falls not on the decedent, but on the persons and institutions who survive the decedent—has much wider ramifications and,

[38] Westfall does not propose a gift tax limit. See Westfall, Revitalizing the Federal and Estate and Gift Taxes, supra note 2, at 1005.

[39] See Bittker, Should Foundations Be Third-Class Charities? in The Future of Foundations 132 (F. Heimann ed. 1973).

though simple, is often overlooked. Any proposed change in the tax treatment of charities should, in my opinion, be preceded by an analysis of the ultimate burden of the change. It may then become apparent that the added tax will fall on persons least able to bear it—the beneficiaries of charitable institutions. The limit on the deductibility of charitable bequests is only one of a number of legislative proposals that take on a different complexion when this point is recognized.

Tax Shelters



ADDISON L. GARDNER III,
Greenwich, Conn., December 8, 1975.

Hon. EDWARD W. BROOKE,
U.S. Senate, Senate Office Bulding,
Washington, D.C.

DEAR SENATOR BROOKE: I am writing to call your attention to the fact that the so-called Tax Revision Bill, which recently passed in the House, and which contains the politically popular tax rebate extension, also contains a little understood provision which, if it becomes law, will literally drive the small, independent oil operator out of business.

As you are perhaps aware, the small and medium independent oil operator is responsible for approximately 70% of the new oil and gas discoveries found in the United States in the past fifty years.

As small businessmen, we independents depend entirely for our source of exploration capital upon the participation of investors in high tax brackets, who are disposed to take these very high risks because they are permitted to write off exploration and development expenses directly against income from other sources. This provision in the existing law is known as the intangible writeoff, and is specifically intended to encourage exploration in high risk, energy-related industries.

The so-called Tax Revision Bill which you are about to consider so restricts and limits the intangible provision as to render it useless altogether. If this provision becomes law, it will put the small independent out of business by cutting off his source of exploration capital, and it will take away from domestic drilling activity between $1 billion and $2 billion at a time when the need for such activity was never greater.

Therefore, Senator, I urge you to give careful consideration to this counter-productive section of the Bill, and to give your support to what I hope will be a major effort to delete entirely the provision relating to intangible drilling costs.

Sincerely yours,

ADDISON L. GARDNER III.

STATEMENT OF LARRY GORDON

THE IMPORTANCE OF RETAINING THE PRESENT TAX STRUCTURE CONTROLLING THE MOTION PICTURE INDUSTRY

In order to create a stimulus to the growth of various aspects of the economy, the U.S. government has permitted certain tax deferral incentives to various industries.

69-516—76—pt. 8——25

It has worked well, creating considerable additional taxable income.

Now the House of Representatives has singled out a major American industry: Motion Pictures, from which to remove those incentives.

But why do we need tax reform in this industry?

Has there been widespread abuse of the tax laws?

In the hundreds of film projects undertaken here and abroad under the current tax "law", the amount of so-called tax abuses have been minimal, and they are inevitably detected in the course of the fine job the IRS does of eliminating abuses in all industries.

The present tax incentives as applied to the motion picture industry have developed as a result of the need that exists and has been deemed a most viable method for infusing money into the industry. The end result has been to create additional taxable income, and develop considerable foreign exchange.

The U.S. is the only major government in the western world which provides no subsidy for the arts, and to many in the industry it has appeared that the tax incentive under the present law is tantamount to a tacit acknowledgement of that fact.

The few abuses that have come about do not necessarily mean that the idea was not worthwhile.

Rather than eliminate it, I would suggest that modifications be added to the current system to work as a safeguard.

For to cut our tax incentives in the investment of motion pictures would make it virtually impossible for the independent motion picture producer—and that includes the vast majority of those producing films—to raise sufficient money for them by any other means—unless he has a fortune in negotiable securities or an unmortgaged mansion as collateral.

It is a known fact that there is great risk in the field, with only 1 in 30 movies becoming great box office successes and only 1 in 5 recouping its cost of production.

Because of this high risk, it is not unreasonable to expect the situation to be cushioned. An incentive must be present, and to give that incentive, a tax deferral is necessary.

The deferral is obviously well worthwhile, considering the beneficial effect on the economy that it will have in terms of considerably increased employment in the myriad segments of, and serving, the movie industry.

Revisions and safeguards rather than the elimination of the original rules would allow funds to continue to be funneled into productions as the government originally intended.

TWO MAJOR TYPES OF MOTION PICTURE INVESTMENTS FOR LIMITED PARTNERSHIPS

In a "production service deal", the production service company enters into a contract with the owner of the rights, under the terms of which it agrees to perform production services and render financial services to the owner of the film. For that it receives a fee, partly fixed and partly based upon the gross receipts of the film. The partnership provides approximately 25 percent of the budget and will borrow approximately 75 percent from a financial institution for a period of approximately 26 months. The partnership is entitled as a cash basis

taxpayer to deduct its cost of doing business in the calendar year in which it is expended.

As income is received the money is divided between the partnership and the bank until all monies are repaid. Each dollar of film revenues received are taxable 100 percent to the partnership since it had, initially, deducted the expenses. That is $1000 is received, $750 is applied to the bank loan, $250 is returned to the partnership. Its taxable income is the full $1000.

In a case in which the full amount of the bank loan has not been paid by the time the loan becomes due, the partnership must, nevertheless, pay tax on the entire balance.

What has actually happened is: When an individual invests ordinary income which is subject to a maximum of 50 percent tax, he recaptures the tax benefits he had previously received, with a recapture rate of 70 percent.

The government has gained an extra 20 percent in the deal.

The other usual type of motion picture transaction is the purchase of a completed film and the amortization of the total purchase price of the film. Very often the purchase price will include a non-recourse promissory note for a portion of the purchase price.

The non-recourse promissory note is usually an interest-bearing note for a period of 10 years and requires repayment out of the partnership's receipts from exploitation of the motion picture.

Under the current tax "law", at the end of the 10 year period, there would be a recapture.

Why should the note be for the 10 year period?

Because it's realistic. The period of a promissory note must be measured against the life of the picture.

All financing, whether it be real estate, leasing, financing or machinery, etc. by loans and/or mortgages, is based on the useful life of the property or product.

In the motion picture industry, the period of 10 years has been used in most transactions as the period of a non-recourse note because it approximates the most useful part of the life of a film.

If I were to draw a financial graph of the income of a motion picture, it would usually adhere to the following:

A great deal of money would be received in the first three years from theatre exhibition and first-run pay-TV.

The TV sale would be made in the third or fourth year.

The film put out for TV syndication in the fifth or sixth year.

Re-release in the seventh year.

Home box office exhibition in the tenth year.

The fact of the matter is that a film's useful life is much longer, as evidenced by TV showings of pictures that are 25 years and even older.

Therefore, ten years is reasonable, for if a producer has to foreclose, he still has a product with considerable life left to it.

FOREIGN-MADE FILMS

The ramifications of withdrawing the tax deferral incentives for motion picture investments would be akin to dropping a pebble in a lake and watching ever-widening ripples result.

Not only would it have a disastrous effect on the industry in the U.S., and all the services and suppliers that exist to aid it, but it would curtail the ability to import productions made abroad, for American exhibition.

Major pictures today, no matter where they are made, are basically designed for the international market, for that justifies the multi-million dollar expenditures for internationally-known stars.

Films produced abroad are made with the understanding that the U.S. is half the world market.

The current proposed legislation would cut down the availability of American partnerships to buy films made in Europe—most with American talent paying high American taxes. And if it is not possible to find ready buyers for a film made abroad, why should European banks loan money to producers in their own countries to make that film—with the knowledge that America is no longer available as half the world market to buy it?

This presents an ironic situation.

At the same time that our government hands aid in many forms to Western European countries like France, Italy and Spain, with supportive moves such as payments to the World Bank and import benefits to maintain a stable economy, we would be doing much, with the other hand, to wipe out a major industry there.

This is something the U.S. motion picture industry can hardly afford, for there is a very important case to be made for the importation of foreign films.

A major point is the healthy boost in the U.S. balance of payments which results, in turn, in stimulating reciprocal overseas importation of our domestic films.

WHY ARE FILMS NEEDED IN LARGE QUANTITIES?

U.S. movie houses need a constantly changing schedule to draw repeat crowds through its doors, and they cannot show the same films as other theatres in the area.

One N.Y. exhibitor asserts that the more films being made, the more likely it is that there will be good ones to sustain a strong box office for the exhibitors, who are presently suffering from a "sellers" market.

The fewer the films to choose from, the higher will be their cost, according to the old law of supply and demand.

The exhibitor feels that prices will have to rise, films kept for longer runs and more old films revived, all resulting in fewer customers and, therefore, even higher prices to make up for it.

A rising spiral.

GROWTH PATTERNS

The U.S. Motion Picture industry has enjoyed considerable growth in the past few years—years in which tax incentives increased the flow of outside investors. This has enabled the industry to absorb the constantly escalating costs of filmmaking and still increase its pace.

During 1973, 192 films were produced domestically.

In 1974, 144 went into production here, as well as 86 produced abroad under the aegis of American companies and 12 were shot both in the U.S. and abroad, for a total of 242.

1975 was even better. 150 were filmed here, 94 abroad and 17 shot both here and overseas, for a total of 261.

(These are Motion Picture Association of America figures)

THE SIZE AND SCOPE OF THE INDUSTRY

Motion pictures comprise one of the biggest and most vital industries in the U.S.

There are 350 motion picture corporations.

There are 257 Theatre Circuits in the U.S. which own 3 or more theatres. Many own dozens.

There are over 15,000 theatres.

There are over 4,000 Drive-In theatres.

To fill them all, more film product is needed, not less.

When this product is shown in theatres, the largest part of the box office income stays in its communities, providing employment, paying local taxes, supporting the local newspapers, and often radio and TV with its advertising. Everyone wins; no one loses.

According to the National Association of Theatre Owners, there were 180,000 full time employees in theatres with an average salary of $7,911 in 1973. There were also 23,000 part-time employees. The payroll for those working steadily, full time, was therefore $1,423,-980,000.

Box office receipts, which totaled $80 million a week in 1946, before the advent of TV, and which had gone steadily downward as a result of the inroads of that medium, were $19,400,000 in 1974 and rose to $19,900,000 in 1975.

In the three major branches of the industry, $1,549,000,000 was spent during 1974.

This breaks down to Production: $663,200,000. Distribution: $135,800,000. Theatres and Services: $750,000,000.

Committed investment in production starts, and purchase of rights to films totaled $718,800,000 in 1974, according to a raw general estimate of the MPAA.

In a broader view, total capital investment commitments in inventories for films, film rights, stories, etc., were $1,100,000,000.

The grand total of fixed assets in 1974 was $215,000,000, with property, land and buildings worth $1,315,000,000.

The total payroll estimated for production and distribution in the U.S. motion picture industry in 1974 was estimated at $799,000,000.

In spite of this, unemployment figures are startling.

The Screen Actors Guild, with 30,000 members across the country reports that, in 1974: Less than 1% earned in excess of $100,000; 3% earned $25,000 or more; and 90% earned less than $1,000.

Unemployment figures in the U.S. which have been averaging 9 to 10 percent, are exceeded in the motion picture industry, to a startling degree. The drying up of investors' funds will result in fewer films and a vastly accelerated unemployment level.

Union/guild unemployment figures spring 1975

Union/Guild:	Percent unemployed
Art Directors, Local 876	42.0
Cameramen, Local 659	42.0
Costumers, Local 705	43.4
Crafts Service, Local 727	30.0
Editors, Local 776	24.0
Grips, Local 80	50.0
I.B.E.W., Local 40	10.5
Illustrators and Artists, Local 790	30.0
Makeup, Local 706	51.0
Motion Picture Electricians, Local 728	63.0
Plasterers, Local 755	75.0
Projectionists, Local 165	15.0
Property Craftsmen, Local 44	29.0
Publicity, Local 818	16.0
Set Designers, Local 847	18.0
Screen Actors Guild	85.0
Screen Extras Guild	90.0
Script Supervisors, Local 871	56.0
Sound Technicians, Local 695	10.0
Transportation, Local 399	40.0
Writers	45.0

SERVING THE INDUSTRY

The finished product—a movie—is merely the tip of the iceberg. It is the visible result of concerted activity in numerous fields. When a film is made, it is the result of products and services beyond the obvious efforts of actors, producers, directors and studios.

Others involved, all employing large staffs, include: Film processing; raw stock; storage; color processes; photo reproduction labs; film storage vaults; stock shot film libraries; raw stock manufacturers; producers of short subjects, newsreels, cartoons; record companies; rental studios and production facilities; sound and recording services; tape recording facilities; videotape to film transfer; camera sales, rentals, repairs; lighting equipment; cutting rooms; film effects; music, music libraries and music cutting; costumes and uniforms; animation; properties and scenery; consultants; commercial jingles; ad agencies; merchandisers; market research; photo studios; slides-telops; stop watches; studio equipment; talent and literary agencies; and public relations.

There are 55 buying and booking services.

The purpose of this presentation is to reemphasize to those responsible for making our laws the facets involved in motion picture legislation and the adverse effects upon the economy as a whole that the proposed legislation would cause.

In view of the foregoing, I feel it would be inappropriate for the Legislature to make any changes regarding the tax laws regulating motion picture industry.

STATEMENT OF JOHN E. KASCH, VICE PRESIDENT, STANDARD OIL CO. (INDIANA)

TAX TREATMENT OF PROTOTYPE OIL SHALE DEVELOPMENTS

My name is John E. Kasch and I am a Vice President of Standard Oil Company (Indiana). I have been associated with the company since

1942. Today, I would like to share with you some of my company's views on the role of constructive tax policies in the development of prototype oil shale projects. I recognize that this Committee faces a very busy schedule, and sincerely appreciate the opportunity you have given me to talk with you briefly about this valuable source of domestic energy.

Our company, along with the Gulf Oil Corporation, is a co-holder of one of the four oil shale leases issued in early 1974 under the Department of Interior Prototype Federal Oil Shale Leasing Program pursuant to competitive bidding. One of my overall responsibilities at Standard of Indiana is the development of this new source of domestic petroleum—shale oil. It is a tremendous challenge and one fraught with economic, environmental and technical problems. From the technical viewpoint, the technology for the recovery and upgrading of raw oil shale into high-quality crude petroleum, while quite similar to conventional petroleum refining technology, has never been demonstrated on the scale necessary for commercial production. The equipment is certain to be complex and very costly, particularly in the pioneer stages of development. Environmental groups, rightfully, are concerned about the impact of an oil shale industry on the Western United States. To accommodate that concern, and under the terms of the lease, we are carrying out intensive base-line environmental studies and we believe that this development can be accomplished in an environmentally acceptable manner.

The Federal, State and Local governments are interested and con-concerned in many aspects of oil shale development. In fact, over 200 agencies of these government bodies have an expressed interest of some type. Satisfying such a large group will be difficult and it is not possible to predict the governmental regulations which may be imposed on our operation nor the costs and delays that may be incurred in satisfying such regulations. Finally, from an economic viewpoint, oil shale development is highly capital intensive, and developing even a small commercial plant involves risking several hundred million dollars of investment before any production comes on stream.

Our interest in oil shale stems from the belief that the addition of this vast petroleum resource to our domestic reserves can materially assist in solving the nation's energy problems. Oil Shale in the United States is a huge untapped natural resource. Its primary value is that an oil virtually equivalent to crude petroleum can be obtained by a complex process of mining, retorting and upgrading. Domestic crude oil production is declining. Events have shown that imported oil is not always readily available and very costly, both in terms of price and lost U.S. tax revenues. Thus, there are both economic and national security incentives to expedite development of a U.S. oil shale industry, which currently offers the best new opportunity we have to displace oil imports over the next two decades.

The largest known deposit of oil shale in the world is the Green River Basin of Colorado, Utah and Wyoming. The Department of Interior estimates that about 600 billion barrels of oil are potentially recoverable by processing techniques under development. By contrast, this is approximately twice the proven reserves of the Middle East and more than a 100-year supply of oil for the U.S., at present rates of consumption. Crude oil reserves in the U.S., totaling less than

35 billion barrels last December 31, as estimated by the American Petroleum Institute, are equivalent to only about nine years supply.

These oil shale lands are largely owned by the U.S. Government. To foster development, the Department of the Interior offered six new leases of approximately eight square miles each in early 1974. Four leases were awarded in open competition, with Standard of Indiana and Gulf Oil Corporation successfully bidding just over $210 million for the first lease in Colorado known as Tract C-a. This outlay is, of course, just the beginning. Our present development plans for this Prototype project are targeted on a 50,000 barrel per day plant coming on stream in 1985 at an investment cost in excess of $1 billion, with subsequent operating outlays estimated at $100 million per year. As a plant of this size is about the smallest that anyone can envision yielding a break-even profit, I would imagine that the other participants in the Prototype Leasing Program are looking at capital outlays of similar magnitude.

We are confident that oil shale can become a viable competitor in the energy marketplace, although it will not start to play its role for close to another decade for several reasons. Pioneer engineering projects employing massive scale-ups of research technology cannot be obtained "off-the-shelf" but involve protracted design and construction phases.

Environmentally, we sincerely want our project to be a good neighbor at both the community and national level, but I'm sure we all realize that meeting the requirements of the various government agencies and citizen groups involved will necessarily slow the progress of prototype shale developments. Finally, the huge investment required for a minimum commercial project would place a substantial drain on the capital resources of even the largest participant in the program. Any prudent businessman would proceed with deliberate caution when risking an investment of that magnitude on something that quite literally has not been tried before.

Today I would like to focus on this problem of the economic risks and financial obstacles to oil shale development, and suggest for your consideration some ideas on tax treatment on pioneering shale projects that would expedite these risky ventures.

The economics of an oil shale project can be analyzed in the same fashion as most any business decision, large or small. Ultimately, you are asking three questions: how much will I get in the marketplace for what I am selling, how much will it cost me to bring this product to market, and how much time will elapse before I recover the funds I have invested? These are obvious risks and uncertainties surrounding each of these questions, especially so in the case of oil shale. The world price of oil moved up sharply following the 1973 embargo, and made synthetic fuels such as shale oil begin to look commercially attractive. However, I think we all recognize that future world oil prices are becoming increasingly uncertain and unpredictable. Meanwhile, the rapid inflation of 1974–75 hit particularly hard at the costs of large engineering and construction projects; estimates of the costs of constructing shale oil and other synthetic fuels facilities have doubled over the last three years. Regrettably, our nation still faces these

uncertainties and inflationary pressures, and their potential impact on oil shale is magnified by the third factor I mentioned above, the time lag between committing outlays and realizing revenue.

Although we hope to have one small unit of our plant operational by 1979 or 1980, our most ambitious estimate is that the full scale 50,000 barrel per day prototype will not come on stream until 1985, or eleven full years after we committed our funds to the lease. Throughout this period, we will be investing more and more funds in the project. These funds, I might add, could well be invested elsewhere in commercial ventures of known technical feasibility that promise faster and more certain payouts. Federal tax policy can assist in reducing the economic risk of pioneering oil shale efforts by taking a portion of this huge, front-end cash commitment and effectively postponing it until the project generates revenues.

I would ask this Committee to give serious consideration to allowing immediate deductions from taxable income for oil shale lease acquisition outlays plus current and future investments in depreciable assets directly associated with development of the oil shale resources found on such leases. I would also suggest that those investments in the above category which would normally be eligible for the Investment Tax Credit retain such eligibility.

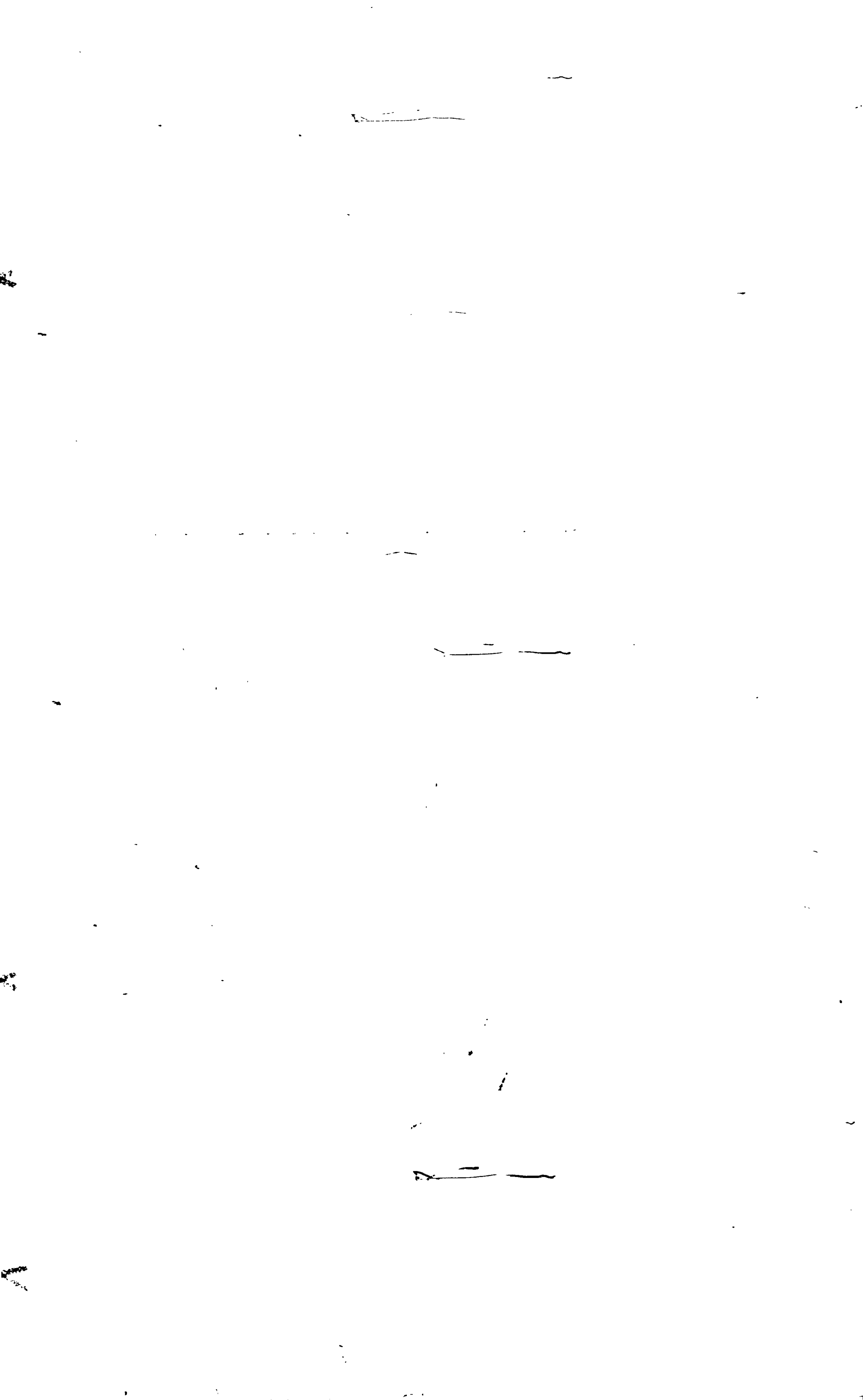
A tax incentive plan of this type is not a "loophole," allowing permanent forgiveness or avoidance of taxes. It is in essence, a program allowing taxpayers participating in the pioneering program to develop a vital national resource the option of accelerating the deduction of certain costs in the period before the project yeilds operating revenues. Parenthetically, I should note that under current tax laws, oil shale projects are inherently disadvantaged relative to other capital intensive industries. Because of its unresolved technical and commercial risk, a shale venture has none of the implicit borrowing power of a project in an established industry like electric power or petrochemicals. Consequently, the oil shale development must resort almost entirely to costly equity financing.

By easing the heavy front-end cash outlays associated with the project, immediate expensing partially corrects this tax bias and also improves the economics of the project in a discounted cash flow sense. Being able to write off a dollar today instead of ten years from today will raise an 8 per cent discounted rate of return to 12.4 per cent, assuming a 48 per cent tax rate. To alleviate any possible concerns about the program leading to abuses, I would suggest it be limited to investments made or committed by the end of 1986. Hopefully, such a plan would attract additional new ventures into the oil shale industry over and above those connected with the Department of the Interior's Prototype Oil Shale Leasing Program.

I realize that several other government programs for reducing the financial burdens and risks of initial oil shale investments have been proposed, but they do not appear to be making much forward progress. Last year, the proposed Energy Independence Authority made the headlines for a few days but now suffers from a neglect that is scarcely benign. In this session of Congress, Section 103 of the ERDA funding

bill was dropped and although legislation has been introduced to reinstate some of the provisions contained in Section 103, its fate is undetermined. I sincerely hope that this Committee will be able to act favorably on the tax policies I have outlined and help to provide a stable investment climate geared to aggressive development of our nation's oil shale resources.

Deduction of Expenses Attributable to Business Use of Homes, Rental of Vacation Homes, etc.



S. RICHARD FINE,
Chicago, Ill., March 8, 1976.

Re: H.R. 10612

STAFF DIRECTOR,
Senate Finance Committee,
Senate Office Building,
Washington, D.C.

DEAR SIR: Although I am a practicing attorney I write this letter on my own behalf and not on behalf of any client. I am the owner of a condominium unit in a golf and tennis resort known as "Innisbrook" located in Tarpon Springs, Florida. My comments are directed exclusively to section 601 of H.R. 10612 (The Tax Reform Bill of 1975) which would add § 280 to the Internal Revenue Code.

I

Under three separate paragraphs of § 280 a determination is required as to the number of days during the year for which the dwelling unit was "rented" at a fair rental. [Subsection (d)(1)(B); Subsection (d)(2)(C); Subsection (e)(1)]. The meaning of the term "rented" is unclear in the light of the "rental pool" concept by which a number of resort operations (including Innisbrook) function. The rental pool concept permits Owner A, whose unit is available for rental but is not actually rented, to share in the rents received by other owners whose units are in fact rented and occupied. The proposed legislation should make it clear that an unoccupied unit participating in a rental pool is deemed to be rented (at a fair rental) on any day in which it is so participating.

II

The two alternative tests established in subsection (d)(1) for determining whether a taxpayer uses a dwelling unit as a residence seem unnecessary since they merely succeed in establishing a minimum test of 14 days and a maximum of 18. It is highly unlikely that a significant amount of revenue would be lost if an 18 day test were used exclusively.

III

Moreover, it is submitted that a final determination of residential use based on 18 days of personal occupancy is unduly restrictive. Many persons who are owners of condominium units in Innisbrook own two or more units. Their sole motivation in purchasing more than one unit could only be based upon the prospect of economic profit. The same profit prospect motivated many owners who purchased only one unit. To penalize these persons who may personally occupy their units for 19 days (or whose family or friends may do so) when their unit is actually earning income for them (through the rental pool) on the other 346 days appears unnecessarily harsh.

In this connection it should be noted that the profit expectation of many of these purchasers has not been disappointed. The type of unit which I currently own was originally offered for sale in 1970 and 1971 at a price of less than $30,000.00. In 1974 I paid in excess of $50,000.00 for the same unit. The asking price for this unit today is still higher. This increase in price has occurred despite the fact that during most of the years since 1970 each unit at Innisbrook has been operated at a loss even if it participated in the rental pool during the entire year.

Moreover, the suggested test under § 280(d)(1) should be contrasted with the current Regulations under § 274 dealing with the question of when a summer home is deemed to be an "entertainment facility." Reg. § 274-2(e)(iii) provides that a taxpayer is deemed to have established that his summer home is used primarily for the furtherance of his trade or business if he establishes that more than 50% of the total calendar days of use were days of business use.

Thus, if § 280 is enacted in its present form we could have the anomalous stituation of two condominium units located side-by-side at a resort. One is owned by a corporation and is legitimately used by that corporation for business meetings on 183 days of the year and is used by the president of the company for personal purposes on the other 182 days. The second unit is owned by an individual and is occupied by him for 21 days. The balance of the time it is producing rental income or is at least actively held out as available for rental purposes. The corporation is permitted under § 274 to deduct 50% of its expenses attributable to the unit while the individual under § 280 would be limited to that amount of expenses that does not exceed his rental income.

Alternatively, assume that the corporation referred to in the prior paragraph is an electing small business corporation. Under § 274 it would be entitled to deduct 50% of the expenses; under § 280 it would be entitled to no deduction whatsoever [since none of the exceptions under subsection (c) would be applicable]. Is it intended that § 280 override § 274?

Very truly yours,

S. Richard Fine.

Taxation With Representation: Statement of Martin A. Gage, Professor of Accounting, Widener College

BUSINESS USE OF HOMES

BIOGRAPHICAL NOTE

Martin A. Gage, Professor of Accounting at Widener College, Chester, Pennsylvania, has taught Federal income taxation and accounting at Widener and New York University for over twenty years. He is a Certified Public Accountant of New York and Pennsylvania and conducted an accounting and tax practice in New York for many years.

He holds an MBA degree from New York University and is a member of the American Institute of Certified Public Accountants, the American Accounting Association, the New York State Society of

Certified Public Accountants and the American Taxation Association. He is a former President of the Tax Society of New York University.

His tax articles have appeared in various publications including the Journal of Taxation, Tax Notes and the Widener College Economic Education Newsletter.

ADDRESS AND TELEPHONE INFORMATION

Further information regarding the views expressed in this statement can be obtained by writing to Dr. Martin A. Gage, Widener College, Chester, Pa. 19013. He may also be reached by telephone at (215) 876-5551 (office) or (215) 565-4348 (home).

Business use of homes

I am in agreement with the general objectives of the proposed legislation on the business use of homes. I am concerned, however, with the contemplated rules concerning employees who perform some of their work at home.

The Bill provides that the deductions is limited to the excess of the gross income derived from the use of the home office over the deductions attributable to such use. I have no quarrel with this provision as it applies to self-employed individuals. With respect to employees, however, the question arises as to whether *any* of an employee's gross income can be considered to be related to his home office. Assume, for example, that a teacher, accountant, lawyer or salesman is not provided with an office by his employer at certain times of the day or night. To properly perform his job responsibilities, he has to work at home. His salary is fixed and he receives no additional income because of his work at home. Is any of his salary considered to be applicable to the home office? My guess is that the intention of the House of Representatives, in passing the Bill, was to say "no" to this question and to deny the deduction. Hopefully, I am wrong. Assuming that the House had no such intention, the determination as to what portion of an employee's salary is due to work performed at home would be difficult to determine and would, I believe, cause much conflict between taxpayers and the IRS.

The Bill also requires that the portion of the home office that is used for work, be used exclusively for that purpose; and that such use be for the convenience of the employer. I believe that an employee who has met these requirements has clearly established the business purpose of his office at home, and should not further be subjected to the gross income test. I recommend, therefore, that the gross income requirement with respect to employees be eliminated from the Bill.

Rental of vacation homes

Proposed Section 280 deals with (1) the business use of homes and (2) the rental of vacation homes. Although some relationship between the two items is evident, the differences between them seem to be greater than the similarities. The result of interweaving in one section the rules regarding both categories makes for a very complicated and rather confusing exposition. Section 183 and related regulations presently cover the rules on vacation home rentals. In the interest of clarity and simplicity, I therefore suggest that those portions of

proposed Section 280 related to vacation homes be removed from that Section, and be treated as amendments to Section 183. Section 280 would then include only the rules on the business use of a dwelling.

MARRIOTT CORP.,
Washington, D.C., January 28, 1976.

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

DEAR SENATOR LONG: This letter is in reference to the proposed income tax legislation (H.R. 10612) affecting the personal use of vacation properties.

We will summarize our proposal to modify the language (Title VI, Section 601 B) limiting tax deductions if a taxpayer uses a vacation home for the greater of two weeks or 5 percent of the actual business use; but, we would like to suggest a meeting to supply you with an in-depth presentation and any additional information you may require.

Marriott's Camelback Inn (a Mobil 5-Star resort hotel) is located in Scottsdale, Arizona, and has a record of outstanding year-round occupancy of 83 percent which is one of the highest in the country. All the rooms and suites are sold as condominiums and the owners' usage is limited to 28 days per year. When the owner elects to stay at the Inn, he or she pays a daily service charge which covers the direct costs of using the unit. Obviously, the owner pays for any incidentals such as food, beverages, etc., just like all other guests. The condominium owners become members of a limited partnership, of which Marriott Corporation is the general partner, and participate jointly in the profits of a rental pool. We are enclosing the Camelback Inn S.E.C. prospectus for your further reference.

We have analyzed the lost income the Hotel has had as a result of owners using their units—that is, the amount of room revenue which would have been generated had there been an available room to rent to the public when condominium owners were staying at the Inn—and find the amount diminutive:

Year ending July	Lost revenue	Actual room sales	Percent
1974	$6,800	$3,867,400	0.18 of 1 percent.
1975	9,100	4,355,900	0.21 of 1 percent.

Based on our original research, we designed our program to limit owners' usage to 28 days because we did not want the profits of the Hotel to decline. Now, after two years of good experience, we can demonstrate that owners' usage has had a very negligible effect on gross sales. Therefore, tax revenue from the Inn has not diminished as a result of partners taking vacation days.

As a matter of fact, for the owners who use their units, we have found their vacation time is so varied over the year that the owners' usage is a benefit to the Hotel because they generate income which

otherwise would not be present. The condominium owners are bringing more business into the Hotel. (Conventions, meetings, etc.)

The Camelback condonimium sales started in December, 1972, and to date we have sold 373 of the 407 project total. Of the total, half were constructed during the program. It is the Camelback Inn partners who have provided the funds necessary to expand operation of the Inn for the construction of the 207 new units which have been built since the inception of the condominium plan. This type of sales program ($22,000,000 sales and $2,000,000 in tax dollars paid by the developer) is an example of what is badly needed for the economy and has been created by the partners purchasing units.

In view of the above, we conclude that a hotel-type condominimu rental pool like Camelback should be permitted to operate under the 28-day rule.

We believe that the abuse which may exist in certain condominium projects does not exist in a hotel rental pool condomimiun such as we have designed and implemented at Camelback Inn.

We sincerely believe that the legislation as now proposed should not be designed so as to reduce the condominium owners' usage from the limitation that we have set of 28 days to that in the proposed legislation of 14 days.

We also realize that this particular item is a small item in a major tax reform package. As a result, it may be difficult to have the proper focus placed upon it. It is, however, not only important to individual condominium owners, but also to the Marriott Corporation. We are in the process of planning the development of a number of other resorts which would utilize this unique concept and these projects could easily exceed $100 million within the next few years. Unfortunately, the present language may shelve these projects and others which the industry might develop.

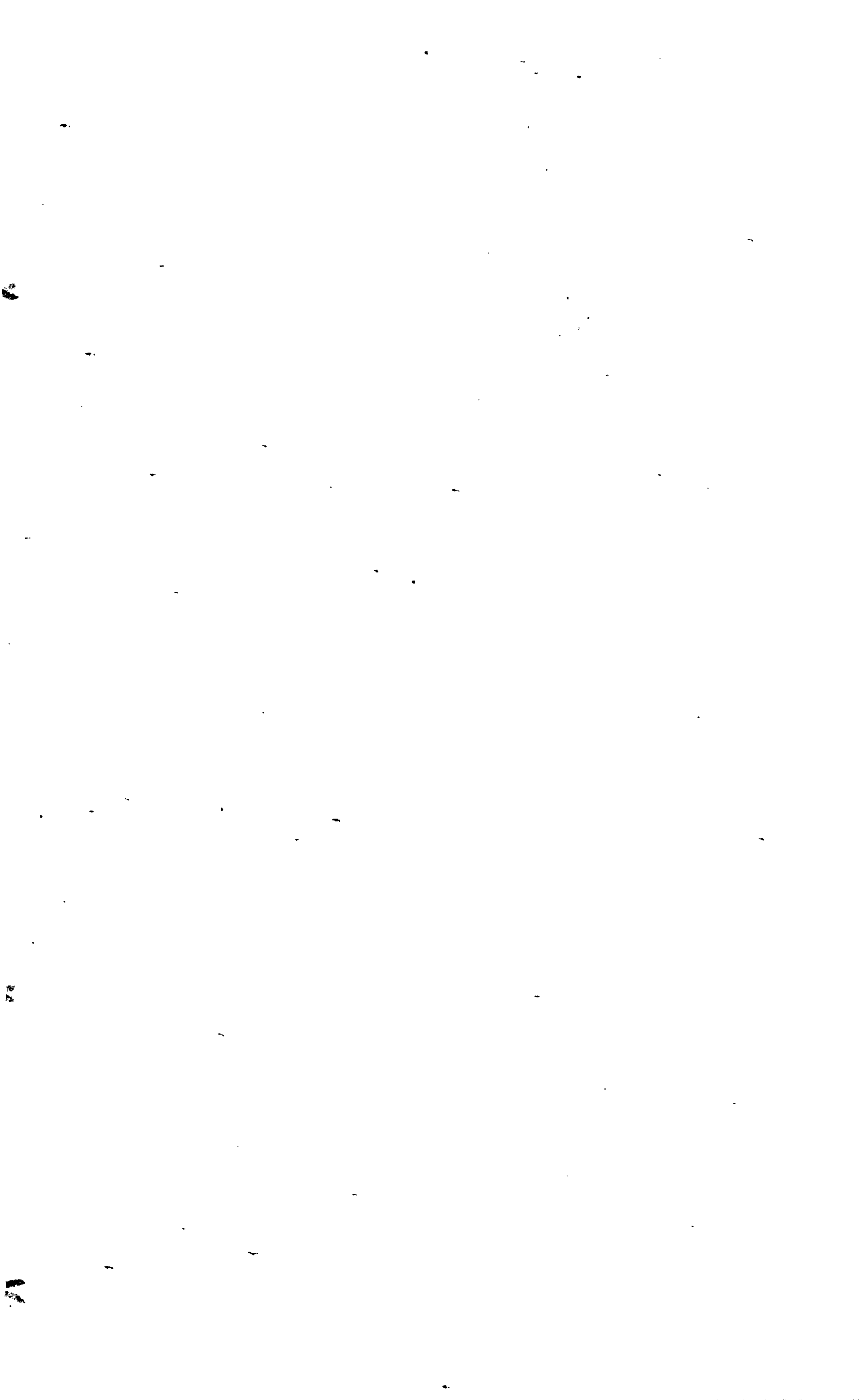
We would appreciate your consideration in this matter and we would suggest two alternative wordings which would improve the proposed legislation:

1. Change the 5 percent or 14-day limitation to 10 percent or 28 days.
2. Exempt mandatory hotel rental pool condominiums where a maximum of 28-day personal use limitation applies.

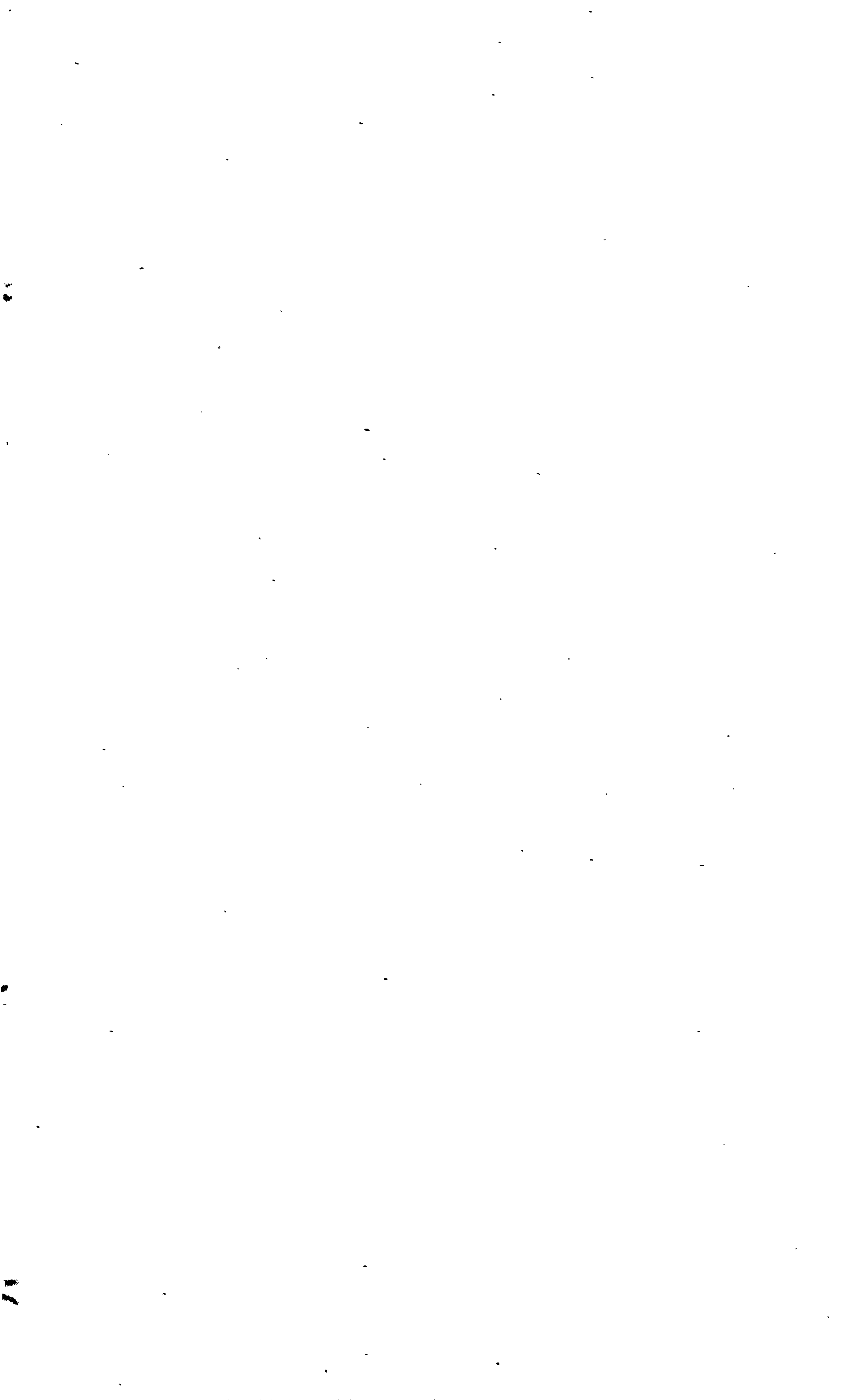
We will look forward to the opportunity of meeting with you and your staff.

Very truly yours,

FRED BOULINEAU.



Domestic International Sales Corporation (DISC)



NATIONAL FISHERIES INSTITUTE, INC.,
Washington, D.C., April 23, 1976.

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

DEAR SENATOR LONG: The National Fisheries Institute would like to submit comments for the record on H.R.10216, the Tax Reform Act of 1975. Specifically, the institute would like to express its concern with regard to a provision contained in title XI of the bill, which would exclude agricultural products and commodities, including fish, which are not surplus commodities or products from coverage under the DISC provisions of the Internal Revenue Code.

The eventual enactment of this language into law would have a damaging impact upon the domestic fishing industry. At this time, it is not likely that any domestic fish species would be surplus products as defined in the House bill. As a result, the companies in the industry which have been developing a valuable export trade would be severely restricted.

This legislation is being considered at a time when the enactment of the Fishery Conservation and Management Act of 1976 will provide the American fishing industry with expanded opportunities for the export of excess fish stocks. It would appear to be contradictory to enact other legislation which would restrict the development of this export trade. In addition to being an effective vehicle for capital formation, it will also permit the industry to increase employment opportunities within the United States through the expansion of its export potential.

Examples of the effective utilization of the DISC provisions by the fishing industry has been received by the institute. One of our member companies has increased its total export sales by 12 percent since the initial enactment of the DISC provision. Other companies have provided the institute with similar information regarding their utilization of DISC to obtain necessary capital and to increase their export sales.

In light of this development, it would seem appropriate for the Congress to retain the present DISC provisions.

Sincerely,

GUSTAVE FRISTSCHIE,
Director, Government Relations.

STATEMENT OF JOHN MOHAY, EXECUTIVE VICE PRESIDENT, NATIONAL INDEPENDENT MEAT PACKERS ASSOCIATION

DISC

The National Independent Meat Packers Association (NIMPA) is particularly concerned with title XI, containing amendments affecting the present DISC program of the so-called tax reform bill (H.R. 10612) which discriminates against the beef-growing and beef-packing industry of the United States.

NIMPA originated in 1942 as a trade association and presently represents over 300 meatpackers and processors in the United States. Our membership consists entirely of plants engaged primarily in the meat business; that is, the slaughtering and processing of meat and meat products. In this regard, NIMPA represents approximately 65 percent of the beef-packing industry. Consequently, the proposed retroactive, discriminatory termination of DISC benefits to agricultural products is of concern to our members.

DISC PROVISIONS OF H.R. 10612

The House bill affects DISC benefits in two ways:

1. The bill eliminates DISC benefits for certain industries, or portions thereof, from any further benefit after October 2, 1975. Generally, it disqualifies agricultural products including beef exports and military equipment from further DISC treatment after that date. However, certain agricultural products held to be in excess supply under the marketing quota program of the Agricultural Adjustment Act continue to qualify.

2. The House bill restricts benefits for companies of taxable income in excess of $100,000 to income on gross sales during a moving base period—the previously recommended House position of 1971, the so-called "Incremental Method" approach.

Without burdening the record unduly since the House position on DISC has been totally analyzed by the testimony before your committee and generally been rejected, NIMPA feels that the discriminatory treatment of agricultural products and the inequitable retroactive treatment to sales after the arbitrary date of October 2, 1975, is obviously not acceptable and cannot be defended. Further, the suggested incremental approach brings with it a highly complicated and almost unworkable method to the DISC program necessary for qualification as well as provides an unfair advantage to companies who have not previously established DISC companies. The incremental approach imposes a so-called base period upon which a company's eligible exports qualify for DISC benefits. Thus, if a company establishes a DISC in 1976 it does not have a base period until 1981 and all its exports qualify for DISC; thereby achieving an unfair advantage over companies with existing DISC's who are limited to an excess over average sales. This factor alone should be sufficient for the Finance Committee to once again reject the House incremental approach proposal.

REASONS WHY DISC PROGRAM SHOULD BE CONTINUED

Further reasons exist to continue DISC over and beyond the fact that the proposed House DISC revisions are impractical. First is the fact that the DISC program is working and that the committee from its hearing record has ample support to reach this conclusion. The recent testimony of Secretary Simon, of the Treasury Department, should eliminate any of the doubts and the continuing arguments that the DISC program is a mere "giveaway," that it somehow provides something for nothing. In submitting the 1974 annual report of the Treasury Department on the operation and effect of DISC, he pointed out that U.S. exports had been increased by $4.6 billion last year as a direct result of DISC thereby creating an estimated 230,000 jobs in the export sector. While these estimates are obviously dependent upon a number of assumptions, they are indicative of the real impact that DISC has in providing incentive to our export program and jobs here on the domestic scene. Further, the testimony of Congressman Karth of Minnesota before the committee on March 29, 1976, supports Secretary Simon's comments and report. Congressman Karth who offered the House provision has now taken a somewhat different view of his creation. After a timely and important visit to the GATT negotiations in Geneva, he advised the committee that DISC was working and that only "as a very minimum" should the committee adopt the House-passed modification.

Beef products should continue to be afforded the same treatment as other products especially manufactured goods under the DISC program. There is no conceivable justification for the discriminatory treatment proposed by the House in eliminating on a retroactive basis DISC benefits for beef and beef products while retaining these benefits for manufactured goods and certain agricultural exports. Applying the reasoning of the Ways and Means Committee results in the same conclusion. The presumed reason for retaining benefits for certain agricultural products such as tobacco, rice, and peanuts was that these products were obviously in excess supply and would, therefore, not have an adverse effect on domestic prices by their export.

Applying then this "touch stone" to beef products, many of which are in excess supply in the United States, it would be reasonable to conclude that they would be equally afforded continued DISC benefits. However, this is not the case and obviously should be corrected.

Another important aspect is increased commercial sales of domestic agricultural commodities, including beef products, has produced a surplus rather than a deficit in our balance of trade. For example, in 1975 the United States exported approximately $22 billion of agricultural commodities and imported approximately $12 billion resulting in a net surplus of agriculture trade of about $10 billion.

NIMPA hopes the committee will keep in mind the trade negotiations presently underway and suggests that any change should only be made which results in our obtaining effective international agreements with compensating actions by foreign trading partners; especially since these trading partners have attacked DISC as a violation by the United States of agreements under the GATT treaty. It is imperative to remember that our DISC program provides much less

benefit to U.S. exports than the practices other countries engage in to afford their exporters an advantageous position.

Finally, we suggest that the committee seriously consider continuing a program that works. It is difficult to understand the House action and its temerity toward a program initiated to have an impact on exports and provide incentives to U.S. firms. Then when this objective is achieved with exports increased and U.S. firms taking advantage of the incentive offered resulting, of course, in a reduction in their tax liability—but on a deferred basis only—the committee acts to stymie and take away the very benefit they provided. The same type of start and stop attitude was applied to another tax incentive, the investment tax credit, with disastrous results. Beef exporters, as well as other U.S. firms are entitled to rely upon DISC and other tax incentives as permanent parts of the tax law, and, thus, be able to base their corporate planning and sales in a highly competitive area on a continuation of such benefits. An on-again-off-again atmosphere creates much uncertainty and will have obvious adverse effects on exporting firms.

RECOMMENDATIONS

In view of the foregoing NIMPA respectfully recommends to the members of the Committee on Finance that they completely reject the House provisions affecting the present DISC program and eliminate entirely from the bill title XI. In adopting this recommendation, the committee will continue a highly important program as well as reassert the correctness of its prior position when it considered a similar House suggestion in 1971 when the original DISC legislation was developed.

The Finance Committee made the right decision then, which the Congress adopted, and hopefully the committee will make the right decision once more.

We hope our comments will assist the committee in its markup deliberations on H.R. 10612 and would appreciate your making this statement a part of your hearing record.

STATEMENT BY THE AMERICAN MEAT INSTITUTE

DISC

The American Meat Institute is the national trade and educational association of the meat packing and meat processing industry. The institute appreciates and thanks the committee for the opportunity to present a statement in opposition to section 1101, H.R. 10612, the Tax Reform Act of 1975, amending Internal Revenue Code provisions relating to taxation of Domestic International Sales Corporations.

The Revenue Act of 1971 created a program of tax deferral on income derived from exports through the operation of Domestic International Sales Corporations. The DISC system was adopted to (1) stimulate reversal in the declining trend of U.S. share of the world's export markets, (2) help achieve long-term trade balance in light of

growing U.S. imports of foreign-produced commodities, and (3) provide an alternative to those U.S. firms which found it necessary to invest in foreign-based plants and equipment in order to effectively compete in many world markets. A Treasury Department report concludes that $2.56 billion of export increases in 1972, the first year of effective operation of DISC, were directly attributable to the DISC export incentive. Based on these figures, Treasury estimates that about $5.2 billion in additional exports resulted from DISC in 1975, adding between $10 and $15 billion to the gross national product and generating as many as 900,000 jobs.

Section 993(c)(1)(A) of the Internal Revenue Code, in defining "export property" qualifying for DISC treatment, specifically includes property manufactured, produced, grown or extracted in the United States. Three separate provisions of present law detail situations in which agricultural products would not qualify: Section 993 (a)(2)(B) provides that exports "accomplished by a subsidy granted by the United States or any instrumentality thereof" do not qualify for DISC benefits; section 993(c)(2)(D) excludes from export property "products the export of which is prohibited or curtailed under section 4(b) of the Export Administration Act of 1969 to effectuate the policy set forth in paragraph (2)(A) of section 3 of such act—relating to the protection of the domestic economy"; and, section 993 (c)(3) provides the President with the authority to exclude property in short supply from the DISC program. This final provision, while it has never been applied, remains available to deal with shortage situations.

Section 1101 of H.R. 10612, the Tax Reform Act of 1975, passed by the House of Representatives on December 4, 1975, eliminates Domestic International Sales Corporation benefits generally for agricultural and horticultural commodities and products. Because of the high level of foreign demand for American agricultural products, the House Ways and Means Committee report on the bill (H. Rept. 94-658) states, export incentives are not needed. Agricultural and horticultural commodities and products within the meaning of the bill include all products or commodities which are grown or raised, the bill specifically placing in these categories livestock, timber, poultry, fish and fur-bearing animals. The only exception to the elimination of DISC benefits for agricultural products applies to those commodities considered to be in surplus supply. Absent repeal of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1281, et seq.), only those products with respect to which a marketing quota has been instituted will be considered in surplus supply. In recent years just four commodities have been subject to marketing quotas—rice, tobacco, peanuts, and extra-long-staple cotton. Therefore, if enacted, section 1101 would limit DISC benefits to these four crops.

Agricultural commodities account for a significant portion of U.S. export trade. In 1975, agricultural exports were valued at $21,894 million, or about 20 percent of total U.S. foreign trade; in 1974, the figure was $21,999 million, about 22 percent of the total. Sizable exports of agricultural commodities play an important role in offsetting rising U.S. imports of foreign-source raw materials and holding down or avoiding a deficit in the balance of trade.

As one of the largest sources of U.S. exports and a major contributor to the U.S. balance of payments, agriculture should be encouraged to maintain and expand its share of world markets. DISC incentives have played an important role in building these markets by making American products more competitive with those of government-subsidized producers in other countries and by providing a partial hedge against the risks inherent in export trade. To say that incentives are no longer needed because of the high level of foreign demand is to ignore the fact that American agriculture is tremendously diverse and in need of outlets for a wide variety of products.

Animals and animal products rank fourth—behind wheat, feed grains, and soybeans—among agricultural commodity groupings in value of exports. Exports of animals and animal products have almost doubled in dollar value since 1971. The meat export market principally absorbs animal byproducts in low domestic demand. As shown in the attached table, hides, greases, and tallow, and so-called variety meats or offals—livers, kidneys, hearts, tripe, tongues, lips, and so forth, account for up to 85 percent of exports of meat and animal products. The meat industry depends heavily on foreign markets for these commodities. For example, the U.S. exports over 50 percent of its domestic production of hides, amounting to almost 30 million skins in 1975, and nearly 40 percent of inedible tallow and grease production, over 2 billion pounds in 1975. These exportable items, including hides and tallow, represent about one-third of the live weight of the animal. By providing outlets for otherwise unusable or unwanted byproducts of the meat processing industry and promoting more efficient use of the whole animal, export markets reflect favorably back through the meat producing chain, permitting a better overall return to cattle producers and effectively lowering the price of meat to consumers.

Simplistic notions concerning the effects of higher demand levels for particular commodities on domestic food prices should not be permitted to serve as justification for elimination of a tax incentive program that has contributed to increased marketing efficiency in a major sector of the agricultural economy. The present statute, in section 993 (c)(3), already provides effective means for removing items in short supply from the DISC program. If it is felt that these statutory restrictions are insufficient to guard against creating unnecessary domestic shortages, section 993(c)(2)—relating to property excluded from export property—might be extended to exclude "agricultural and horticultural commodities except for products which are in surplus supply as determined by the Secretary of Agriculture." In this way, domestic shortages could be avoided while at the same time insuring DISC benefits to certain commodities—such as hides, variety meats, and other byproducts of the meat processing industry—which, because of low domestic requirements, are dependent upon foreign markets.

The American Meat Institute opposes the general curtailment of the DISC program envisioned by section 1101 of H.R. 10612. The institute urges the Senate Finance Committee to place no further restrictions on a tax incentive system that, by promoting export of surplus agricultural commodities, has provided economic benefits and jobs to the

domestic economy, while alleviating world food shortages, reducing the cost of U.S. Government subsidies, and lowering the price of agricultural products to American consumers.

LIVESTOCK, MEAT, AND MEAT PRODUCTS VALUE OF U.S. EXPORTS AVERAGE 1967-71, ANNUAL 1970-75

[In millions of dollars]

Commodity	Average 1967-71	Annual 1970	1971	1972	1973	1974	1975
Live animals	32.6	40.5	46.1	66.8	167.1	154.1	[1] 112.9
Meat	67.3	61.3	71.9	110.3	225.3	152.6	268.8
By-products:							
Tallow, greases and lard	199.9	244.1	266.0	207.3	330.1	580.4	355.4
Variety meats	64.3	69.5	78.2	88.6	123.9	113.1	109.9
Casings	9.1	13.1	11.7	11.3	17.5	17.9	21.2
Hides and skins	185.6	187.0	198.7	354.1	473.5	461.7	408.0
Wool and mohair	8.5	7.9	7.3	13.0	13.6	10.2	16.2
Other miscellaneous	21.1	23.8	26.1	31.9	73.8	86.5	99.8
Total by-products [2]	489.3	545.4	587.9	706.2	1,032.4	1,269.8	1,010.5
Grand total [2]	589.1	647.2	706.1	883.2	1,424.7	1,576.5	1,382.2

[1] Preliminary.
[2] May not add due to rounding.

Source: USDA, Foreign Agricultural Service, FLM MT March 1976.

STATEMENT OF HARVEY W. MAUTH, PRESIDENT, AMERICAN SEED TRADE ASSOCIATION

My name is Harvey W. Mauth. I am the president of the Rogers Brothers Seed Co., of Idaho Falls, Idaho. I am submitting this statement as president of the American Seed Trade Association—ASTA.

SUMMARY OF ASTA POSITION

The position of ASTA with respect to changes in the Internal Revenue Code as it relates to domestic international sales corporations—DISC's—proposed by the House of Representatives in its bill, H.R. 10612, is as follows:

1. Agriculture, and the seed industry in particular, needs the tax deferral now provided by the DISC provisions of the Internal Revenue Code if seed exported from the United States is to compete effectively in foreign markets.
2. The incremental approach to limiting DISC benefits is not workable for exporters of seed and many other agricultural products and it is the opinion of ASTA that DISC benefits should be expanded instead of being reduced.
3. Producer loans will not be a successful means by which exporters of agricultural products will be able to continue to defer previously earned DISC profits.

ASTA AND THE SEED INDUSTRY

ASTA is a trade association of more than 500 firms engaged in the processing and distribution of all kinds of seeds for planting. During 1975 approximately $113 million of seed was exported from the United

States. Many of ASTA's member firms involved in exporting seed do so through DISC corporations.

Although some firms in the seed trade produce their own seed, most companies enter into contracts for seed production with independent farmers throughout the United States. The total seed production contracted by each such company is based on its estimate of its share of the domestic and foreign market for seed one or more years in the future. Seed, being a special purpose cash crop, allows farmers to diversify their production and to produce a special purpose crop destined for domestic and foreign markets.

Once the seed is produced by the farmer, it is cleaned, tested, treated, graded, bagged, and sold by companies in the seed trade. In order to perform these functions, seed companies invest a significant amount of capital into specialized equipment and processing facilities. Such plants are usually located in the rural areas where the seed is being produced. The construction and staffing of these plants means additional employment opportunities for those living in rural areas near such facilities. The vast distribution network necessary to move a substantial volume of seed to many markets in time for planting creates numerous additional jobs in the transportation and storage industries.

As the world population increases, so does the need for food. Foreign countries are attempting to meet this need by placing more land into agricultural production. They are also attempting to improve the yields from land now in production through the use of modern technology and improved seed varieties. This developing market presents the seed industry with exciting growth potential. Because the climate in the United States is so diverse, seed adaptable to virtually every foreign market can be produced here. If the economic climate of the United States allows the seed industry to remain competitive with foreign seed producers, the U.S. seed trade will make significant contributions to the future U.S. balance of trade and will create many export related jobs.

Even though the industry anticipates an expanding foreign demand for seed, it is not as certain that seed produced in the United States will retain its competitive position in the market. This scepticism is due to the increased competition the U.S. seed trade is experiencing from foreign produced seed. Seed produced in or near the market for which it is intended enjoys the obvious competitive advantages of (1) reduced freight cost and delivery time, (2) possible elimination of import and export permits, tariffs and phytosanitary restrictions (3) and lower cost of production due to lower wage levels.

Significant amounts of government aid and protection to seed producers in foreign countries pose a substantial additional threat to the ability of seed produced in the United States to remain competitive with foreign produced seed. For instance, the European Economic Community (EEC) fosters and protects by:

1. Direct subsidies to seed producers—A recent study indicated that subsidies paid to grass seed producers within the EEC countries were in the range of 50 percent of the price paid to growers of similar seed in the State of Oregon. This means the seed producer in an EEC country can sell his seed for one-half the price of the Oregon farmer and enjoy the same gross revenue. This artificially low priced seed is

then allowed to compete advantageously in non-EEC foreign markets against seed produced in the United States.

2. EEC reference prices—The EEC establishes a minimum price at which certain seed may be sold in EEC countries. This protects its seed producers from competition from imported seed.

3. EEC compulsory certification—The EEC requires most varieties of seed be produced under certification programs before they are eligible to be imported into EEC countries. When the variety is not normally produced under such certification programs in the United States, this additional requirement increases the cost of producing the seed and results in it being less competitive with seeds produced in the foreign countries.

4. Restrictive variety lists—The EEC has official variety lists and only seed varieties on the list are approved for marketing within the EEC. Becoming an approved variety is a long, complex and expensive procedure definitely favoring EEC bred varieties.

The presence of such extensive Government assistance and competitive advantages provide significant incentives to companies to transfer the production of seed destined to foreign markets from the United States to foreign countries. Some members of ASTA have already been forced, by competition from foreign produced seed, to commence producing and processing seed in foreign countries. As a result, capital investment, employment opportunities, and export profits which otherwise would have benefited the economy of the United States were not realized.

DISC AND THE SEED INDUSTRY

Although there exists many competitive advantages to foreign seed production, ASTA believes most of its members would prefer to produce the seed needed for foreign markets within the United States if it remains economically feasible to do so. The DISC provisions of the Internal Revenue Code are regarded by many members of ASTA as an important consideration in evaluating their relative competitive position in the foreign marketplace. The source of financing provided by DISC during periods of high interest rates and tight money is an important benefit to companies and is not regarded lightly by those involved in the seed trade who must, due to the highly seasonal nature of our business, finance large volumes of inventory for extended periods during the year.

DISCUSSION

1. DISC's have increased U.S. exports, including seed exports

U.S. Treasury figures make it clear that DISC has provided a substantial stimulus to U.S. exports. Secretary Simon has estimated that the increase in 1975 exports on account of DISC would be in the range of $4 to $6 billion.

We understand that you will hear from other witnesses as to the effect of DISC on agricultural exports in general. My statement is addressed only to seed exports. It is clear that there has been a significant stimulus to seed exports since the effectuation of the DISC

legislation in 1972. Thus, the quantity and value of total U.S. seed exports since 1971 has been as follows:

Year (June 30)	Quantity (1,000 lb)	Value (thousands)
1971-72	233,145	$60,211
1972-73	294,175	75,983
1973-74	303,830	105,808
1974-75	*219,930	*113,116
6 mo to Dec. 31, 1975 (annualized)	*225,258	*105,072

* The figures given for 1974-75 and 1975-76 exclude certain exports to Mexico and Canada, figures for which were not available at the time of preparation.

We know that a substantial number of the companies substantially engaged in seed exporting have formed DISC's, and we understand that others are actively considering forming DISC's if agricultural exports remain eligible for DISC status.

2. Seed and other agricultural exports should remain eligible for DISC incentives

It has been suggested that DISC is not necessary to provide an incentive to agricultural exports because farmers plant and grow all the crops they can, and the channels of agricultural marketing and distribution take care of the export of whatever is left after meeting domestic demand.

As a general matter, this seems to us a greatly oversimplified approach. It does not make sense to assume that DISC incentives will work only for manufactured goods. Moreover, agricultural exports are one of the United States' largest export categories, and make a major contribution to the U.S. balance of payments. Some have suggested that in the future, we will rely even more heavily on agricultural exports as a source of national income and influence. The Congress should consider carefully whether it makes sense to pull the economic props out from under this key flow of products and export earnings at a time when we are so heavily dependent on them, and may become more dependent.

In any case, whatever the validity of this argument for other types of agricultural products, it clearly is not valid for seed exports. Seed companies are under no compulsion to plant any particular amount of seed. Since export distribution is in the same hands as decisions on planting, companies are not likely to plant more seeds than they expect to need.

Specifically, a seed company is free to grow in multiple locations and, in particular, is free to arrange for the local growing in foreign countries of seed to be sold in such countries. Thus, if it is American public policy to encourage the export of seed grown in America, rather than local production in the country of destination, it is necessary to provide economic incentives to do so, to overcome the relatively higher U.S. cost of production and higher shipping costs.

American companies are, in fact, already substantially engaged in the foreign growing of seed for export.

In terms of seed exports, we have no doubt that the loss of DISC eligibility would result directly in an increase in the foreign growing

of seed by American companies, instead of growing it in this country. This is not a result of any lack of concern by U.S. companies for the American balance of payments and local employment of U.S. workers, but simply the result of economic forces. Foreign labor costs tend to be less, and the cost of transportation and storage is less.

3. DISC's increase long-term tax revenues

It is generally accepted that after the initial revenue loss—which is now a matter of history—the DISC system has increased U.S. tax revenues. Thus, we are at a loss to understand why Congress is seriously considering the curtailment of the DISC system. While this might produce a temporary short-term revenue increase, it is clear that the long-term effect would be a substantial tax loss.

4. DISC incentives should be increased to 100 percent deferral

We believe that an increase from 50 percent to 100 percent in the percentage of export earnings on which the tax is deferred would provide a subtantial further increased incentive for U.S. production and exports. It would provide a net long-term increase in U.S. tax revenues, just as has resulted from the existing DISC incentives, through further increases in U.S. jobs and capital investment.

5. The base-period concept is unworkable for agricultural exports

Finally, the base-period concept, in addition to being a step in the wrong direction, simply is unworkable as an incentive to agricultural exports, and particularly seed exports. In contrast to the export prices of manufactured goods, the prices of seed exports fluctuate so greatly from year to year that a company could easily achieve a substantial increase in the physical volume of exports in a given year and yet enjoy no tax deferral under DISC, because through no fault of the company, the current selling price resulted in lower dollar sales than during the base period.

Thus, even on an industrywide basis, considering all varieties of exported seeds, there are large annual price fluctuations. For the years since 1971, the percentage changes in average price per pound of seed over the preceding year were as follows:

	Percent change
1972–73	−13
1973–74	+34
1974–75	+41
1975–76 (6 mo.)	+ 1

These overall figures, however, conceal some much sharper price fluctuations for individual varieties. Since seed companies ordinarily specialize by type of seed handled, these fluctuations would distort any base period sytem for seed export DISC's. For forage—(grass)—seeds, corn and sorghum, for example, the annual price fluctuations for the same years were as follows—overall export price/weight ratio compared with preceding year:

	Percent change		
	Forage	Corn	Sorghum
1972-73	+8	−46	+10
1973-74	+53	+35	+7
1974-75	+9	+26	+35
1975-76 (6 mo.)	−23	+44	−24

In the absence of an assured incentive offering tax deferral regardless of price fluctuations, there is no special reason to make an effort to achieve a sales increase. Obviously, if there is no such effort, and sales remain at the same physical volume, there will be a net dollar drop in export values. Thus, DISC incentives are essential to maintain export levels even though in a given year there may be no dollar increase in export values.

Moreover, these price fluctations tend to have the same distorting effect on the base period, although in lesser degree because a 3-year average is used.

We would suggest that the temporary revenue benefit of the introduction of the base period system will be much more than offset in the long run by the loss of revenue resulting indirectly from export increases that would otherwise take place. This will be an inevitable result, due to the substantially reduced level of DISC incentives, even in those industries in which price fluctuations are less significant. For agricultural exports, and particularly seed exports, the base-period concept would not only lessen export incentives, but would substantially eliminate them.

Moreover, with respect to all industries, the base-period concept represents a substantial increase in tax law complexity at a time when every policy consideration demands reduced complexity in the tax laws.

6. The DISC "recapture" provisions are inequitable

As we understand the bill, if agricultural exports are excluded from DISC eligibility, this will not only preclude the deferral of any tax on income from future agricultural exports. It will also trigger a tax on all past deferrals. Even though spread over a period of years, we are advised that this "recapture" will require the total tax to be set up on a taxpayer's balance sheet as a deferred tax liability, with resulting adverse consequences to the company's credit standing.

While such recapture may be fair when a company voluntarily ceases to export, it seems highly unfair when a company continues to export as in the past. It amounts to a penalty based on an activity that was previously the subject of official encouragement.

At a minimum, we believe, if Congress in its wisdom determines to remove DISC incentive for future agricultural exports, it should not go so far as to tax previously deferred earnings on past agricultural exports. Rather, it should permit continued tax deferral on these past exports for so long as the taxpayer continues to have export sales of a kind and volume which would not cause such recapture had the law not been amended.

RECOMMENDATIONS OF ASTA

It is the position of ASTA that H.R. 10612 should not be allowed to become law and that its provisions excluding agricultural products, in particular seeds, from the benefits of DISC are not justified and will result in significant losses in United States exports, related capital investment and employment opportunities. ASTA strongly urges that the present DISC provisions be retained for agriculture and/or the U.S. seed industry and if possible be expanded to provide for tax deferral on a greater percentage of the profits derived from export sales.

STATEMENT OF ROBERT C. WAHLERT, PRESIDENT, DUBUQUE PACKING CO.

Mr. Chairman and members of the committee, I am Robert C. Wahlert, president and chairman of the board of directors of Dubuque Packing Co. of Dubuque, Iowa.

This statement is made to emphasize to the committee and Congress the importance of DISC provisions to agriculture in the United States. I hope to illustrate the importance of DISC to the farmers, ranchers, and feeders who produce livestock and to meatpackers such as our company which slaughters, processes, and sells meats and numerous meat byproducts.

Our company has been in business over 40 years, we have 9 plants in the United States and slaughter in excess of 3 million head of livestock a year consisting of pork, beef, veal, and lamb.

The price that we are able to pay the farmer, feeder, or rancher for his livestock is directly determined by our ability to sell not only that portion of the animal that appears in the stores as meat but also such tongues, surplus livers, casing, gelatin, and certain glands which are items as kidneys, sweetbreads, hides, lard tallow and inedible grease, utilized in pharmaceutical production.

The enumerated items have limited market appeal in the United States or are surplus to domestic needs or the U.S. palate and must compete in the world market if they are to be utilized to meet both maximum human nutrition needs and for maximum economic return.

We don't have to point out the importance of exports to a favorable balance of trade. These items are perfect sources for generating this surplus.

Our company began using the DISC program in December of 1974. As a direct result, we have been able to expand our sales into new foreign markets. The DISC has helped us overcome foreign tariff barriers.

Our most recent available figures show our foreign sales for the first 2 months of 1976 were 27 percent higher than the corresponding period in 1975—the first 2 months in which we had the DISC incentive and our startup period for expanding exports.

DISC has helped us compete in the world market, has benefited our expanding 4,500 employee labor force, and has clearly helped us cushion the blow to U.S. livestock producers who are suffering economic losses due to surplus livestock production.

STATEMENT OF THE LEAF TOBACCO EXPORTERS ASSOCIATION, PRESENTED BY HUGH C. KIGER, EXECUTIVE VICE PRESIDENT, DOMESTIC INTERNATIONAL SALES CORPORATION

I. INTRODUCTION

I am Hugh C. Kiger, Executive Vice President of the Leaf Tobacco Exporters Association. The Association is a voluntary organization of forty-seven (47) leaf tobacco exporters with headquarters in Raleigh, North Carolina. Attached to our written statement as Appendix A is

a list of the members. Appendix B is a copy of a letter to this Association from Mr. Joseph R. Williams, President of Tobacco Associates, Inc. Appendix C is a copy of a letter from Mr. Frank B. Snodgrass, Vice President and Managing Director of the Burley and Dark Leaf Tobacco Export Association.

II. SUMMARY OF TESTIMONY

The Leaf Tobacco Exporters Association advocates retention of the DISC provisions in the Internal Revenue Code (sections 991–997). We feel that the present House provisions (H.R. 10612) relative to DISC unnecessarily limits benefits. The DISC provisions are a real incentive to the exportation of leaf tobacco. The United States produces substantially more leaf tobacco than it consumes. The competition for the foreign markets is keen, with foreign governments providing significant incentives to their exporters. The DISC today is the primary U.S. government incentive for exportation of leaf tobacco. It is very important that this incentive not be removed at a time when it is most meaningful and when it is imperative that all Americans do all they properly can to increase U.S. employment and improve the U.S. balance of payments.

III. LEAF TOBACCO EXPORTERS

It may be helpful at this point to describe very briefly the business of leaf tobacco exporters. The members of the Leaf Tobacco Exporters Association buy tobacco on the auction markets in all cigarette tobacco producting areas of the United States and ship it to their plant facilities located strategically throughout the producing areas. In its farm state, tobacco is semi-perishable. There is a relatively short period in which to process and package it in a form acceptable to customers. In the plants, most of the tobacco is tipped and threshed, the stems are removed, and then it is redried and packaged for trans-oceanic shipment. That work requires considerable investment in equipment and plant and requires many assemblyline type employees. The average plant in the industry costs several million dollars to build and equip and employs close to or in excess of 1,000 people on a seasonal basis. Thus, the Leaf Tobacco Exporters are more than brokers or wholesalers of a farm product. Their processing of U.S.-grown leaf tobacco adds considerable value to the product.

The tobacco in which members deal is primarily sold to foreign cigarette manufacturers. The selling of this tobacco is accomplished by direct contact between members' salesmen and the foreign customers.

There is stiff competition among tobacco dealers—both U.S. and foreign—for export trade in the world market. The success of the U.S. exporters affects the U.S. tobacco farmer both directly and beneficially. The U.S. consumes only about 60–70 percent of the domestic production; therefore, it is critically important that the U.S. exporters market the other 30–40 percent in foreign countries. Using flue-cured tobacco as an example, flue-cured being the primary kind of tobacco grown in the Eastern seaboard states from Florida to Virginia, each year approximately 1.2 billion pounds of this crop are

harvested and sold at auction. A full 45 percent, or 560 million pounds per year on the average, is bought, redried and exported. As indicated, this 45 percent of production is not tobacco taken away from the domestic manufacturers; at current capacity they can use only about 700 million pounds per year. The tobacco which is exported provides an economic benefit to U.S. farmers and others in the tobacco business of hundreds of millions of dollars annually. Naturally, it also impacts positively on the U.S. balance of payments.

The leaf tobacco exporters do not seek governmental protection or special treatment; they would like to see a free international market. Until that is achieved, the leaf tobacco exporters do seek U.S. government assistance aimed at developing a free market or at least equalization of trading advantages/disadvantages.

IV. DISC IMPACT—FOREIGN COMPETITION

The legislative history of the DISC provisions indicates that there were three primary reasons for their enactment:

(1) To encourage exports;

(2) To lessen the discrimination in the tax structure then faced by domestically based exporters; and

(3) To foster investment and jobs in domestic export industries.

In view of the members of the Leaf Tobacco Exporters Association, the DISC provisions have fulfilled their legislative objectives. First, the level of exports indicate this. The average volume of exports of tobacco for the years 1965 to 1969 was 553.4 million pounds, valued at $485.3 million. In 1972 and 1973, the first years for DISC, exports climbed to 606.1 and 612.5 million pounds valued at $639 million and $681 million, respectively. By 1974, when DISC was generally available to leaf tobacco exporters, total leaf tobacco exports were 651.4 million pounds. The 1974 exports represented $832.1 million, up over 70 percent from 1972 and 1973. In 1975, the value of U.S. tobacco exports totalled $852 million.

All of the growth in tobacco exports cannot be attributed solely to the availability of the DISC provisions. During the same period, there were changes in the exchange rates; sharp increases in prices of oil, agricultural products, and other raw materials; and an increase in the worldwide demand for leaf tobacco. Yet, the DISC provisions clearly had significant impact, Most U.S. leaf tobacco exporters also deal in foreign leaf tobacco. Other things being equal, the DISC provisions encourage them to sell U.S.-grown tobacco. Thus, the DISC provisions have a direct effect of increasing the exports of U.S.-grown tobacco.

Moreover, they will have an even greater impact in the future. This will result from the fact that prior to 1974 most experts of tobacco were under certain export incentive programs which, under proposed Treasury regulations, did not qualify for DISC treatment. With the expiration of most of those programs, only the DISC provisions remain as the primary public incentive for exportation of domestically grown leaf tobacco.

The DISC provisions have taken a long step in reducing discrimination against the American exporter. In addressing a message to

U.S. businessmen in DISC, a Handbook for Exporters, on January 24, 1972, the Secretary of the Treasury wrote:

"The DISC legislation provides a straightforward method of treating exports for tax purposes in a manner more equivalent to that available to many foreign competitors."

Foreign exports receive a number of competitive advantages over American exports. For example, most countries that rely heavily upon direct taxes, such as the value added tax, rebate or exempt such taxes on export sales. Other countries provide lower rates of tax on export income or exempt profits by foreign sales affiliates.

The U.S. leaf tobacco exporter primarily competes with exporters from Argentina, Brazil, Canada, Greece, India, Italy, Korea, Mexico, Philippines, Rhodesia, and Thailand. Those countries offer significant tax incentives to their exporters, thereby providing them a competitive advantage over U.S. exporters. Foreign exporters generally are permitted greater capital cost allowances, particularly in Canada and Italy. In addition, most competing countries enjoy a duty free status or trade preference in many key world markets; the impact of which can be mitigated by DISC benefits. Retention of the DISC provisions, therefore, is desperately needed so long as competing countries provide significant incentives to their exports.

The DISC provisions have had a significant impact on the financial stability and the growth of U.S. leaf exporters. The DISC provisions have the effect of providing funds, in a manner similar to depreciation, for increased plant capacity and modernization of equipment. With DISC-deferred funds, our members have increased investment and created many jobs. This economic impact does not affect only the members; its "ripple effect" touches the tobacco farmer as well as the manufacturer-seller of tobacco products.

We are attaching as Appendix B a letter to this Association from Mr. Joseph R. Williams, President of Tobacco Associates, Inc., and as Appendix C a copy of a letter from Mr. Frank B. Snodgrass, Vice President and Managing Director of the Burley and Dark Leaf Tobacco Export Association. It may be noted that these two Associations of 600,000 farm families favor continuation of DISC provisions for tobacco.

V. SUMMARY AND RECOMMENDATIONS

To summarize, the DISC provisions already have had a significant impact on the tobacco exporters of this Nation. The real impact has been the mitigating effect on the price of processed U.S.-grown leaf tobacco relative to the prices of foreign-grown tobacco and the resulting incentive for expansion of U.S. facilities and jobs at a time when tobacco manufacturers have been seeking foreign sources of supply. The DISC provisions have fulfilled the purposes for which they were enacted. Those same purposes are valid today. Moreover, there is every expectation that retention of the DISC provisions will have an even more significant impact in the future. Due to loss of markets in Southeast Asia and to increased excise taxes in England and Germany, as well as the worldwide recession, the volume of tobacco exports is expected by the Department of Agriculture to drop in fiscal year 1976 as compared to fiscal year 1975. To repeal the DISC provisions at this time would impair severely the ability of the

U.S. leaf exporters to compete in world markets. This, in turn, would have an adverse effect on the value of the U.S. dollar which is just recently beginning to strengthen. It hardly seems an appropriate time to discourage exports by repealing any incentive. For these reasons, we strenuously urge this Committee to retain the DISC provisions as presently embodied in the Tax Code.

Mr. Chairman, the Leaf Tobacco Exporters Association appreciates and thanks the Committee for the opportunity of submitting testimony for the Committee's significant considerations by presenting our views and recommendations.

Appendix A

Membership List of Leaf Tobacco Exporters Association, Inc.

W. A. Adams Co., Inc., Oxford, N.C. 27565.
The Austin Co., Inc. P.O. Box 360, Greeneville, Tenn. 37743.
Austin Carolina Co., Box 809, Kinston, N.C. 28501.
J. E. Bohannon Co., Bowling Green, Ky. 42101 (and), Box 3009, Kinston, N.C. 28501.
Carolina Leaf Tobacco Co., P.O. Box 796, Greenville, N.C. 27834.
Carrington & Michaux, Inc., Box 4087, Richmond, Va. 23224.
China American Tobacco Co., Inc., Rocky Mount, N.C. 27801.
Commonwealth Tobacco Co., Kenbridge, Va. 23944.
Dibrell Brothers, Inc., Danville, Va. 24541.
Dibrell Carolina Farm Eastern Corp., P.O. Box 137, Greenville, N.C. 27834.
Dickinson Tobacco Co., Inc., Box 587, Richmond, Va. 23219.
Dunnington-Beach Tobacco Co., Box 468, Farmville, Va. 23901.
Eastern Tobacco Co., Box 338, Farmville, N.C. 27828.
K. R. Edwards Co., Inc., Box 1337, Smithfield, N.C. 27577.
Falls City Tobacco Co., Box 480, Louisville, Ky. 40201.
E. B. Ficklen Tobacco Co., Greenville, N.C. 27834.
G. R. Garrett Co., Inc., P.O. Box 796, Greenville, N.C. 27834.
Greenville Tobacco Co., Inc., P.O. Box 2007, Greenville, N.C. 27834.
Hail & Cotton International, Suite 300, 100 N. Sixth Street, Louisville, Ky. 40202 (and), P.O. Box 2465, Rocky Mount, N.C. 27801.
International Tobacco Co., Inc., P.O. Box 1824, Greenville, N.C. 27834.
W. B. Lea Tobacco Co., Inc., Rocky Mount, N.C. 27801.
Maury Leaf Tobacco Co., P.O. Box 693, Richmond, Va. 23206.
J. I. Miller Tobacco Co., Wilson, N.C. 27893.
A. C. Monk & Co., Inc., Farmville, N.C. 27828.
Monk-Henderson Tobacco Co., 151 E. 3rd St., Wendell, N.C. 27591.
Mullins Leaf Tobacco Co., Box 32, Mullins, S.C. 29574.
Edward J. O'Brien Co., 100 N. Sixth St., Louisville, Ky. 40202.
Piedmont Leaf Tobacco Co., P.O. Box 756, Winston-Salem, N.C. 27102.
T. S. Ragsdale Co., Inc., P.O. Drawer 937, Lake City, S.C. 29560.
E. S. Robey & Co., Franklin, Ky. 42134.
W. L. Robinson Co., Inc., Durham, N.C. 27702.
W. I. Skinner Co., Inc., Williamston, N.C. 27892.
Southeastern Tobacco Co., Robersonville, N.C. 27871.

Southwestern Tobacco Co., P.O. Box 519, Lexington, Ky. 40501.
Standard Commercial Tobacco Co., 6620 W. Broad Street Road, Richmond, Virginia 23230, Attn: Mr. Eugene S. DesPortes.
E. R. Sykes & Co., P.O. Box 1387, Rocky Mount, N.C. 27801.
J. P. Taylor Co., Box 1377, Goldsboro, N.C. 27530.
J. P. Taylor Co., Box 380, Henderson, N.C. 27536.
Thorpe & Ricks, Inc., P.O. Drawer 271, Rocky Mount, N.C. 27801.
Tobacco Trading Corp., Box 1127, Durham, N.C. 27702 (and), 2110 Bardstown Road, Louisville, Ky. 40205.
Universal Leaf Tobacco Co., P.O. Box 25099, Richmond, Va. 23260.
G. F. Vaughan Tobacco Co., P.O. Box 160, Lexington, Ky. 40501.
Virginia Tobacco Co., Danville, Va. 24541.
R. P. Watson Co., Inc., P.O. Box 30, Wilson, N.C. 27893.
Wendell Tobacco Co., 151 Third Street, Wendell, N.C. 27591.
Whitehead & Anderson, Inc., Lumberton, N.C. 28358.
Winston Leaf Tobacco Co., P.O. Box 2499, Winston-Salem, N.C. 27102.

APPENDIX "B"

TOBACCO ASSOCIATES, INC.,
Washington, D.C., February 23, 1976.

Dr. HUGH KIGER,
Executive Vice President,
Leaf Tobacco Exporters Associates,
Raleigh, N.C.

DEAR HUGH: You are hereby authorized to incorporate in your testimony on the DISC legislation the following statement.

"Tobacco Associates is an organization representing primarily approximately 400,000 flue-cured tobacco producers in the States of Virginia, North Carolina, South Carolina, Georgia and Florida. Flue-cured tobacco producers are dependent upon 40 percent of production to go into export trade in order to maintain current economic levels. We urge that DISC be retained in the tax structure for the following reasons:

"1. U.S. flue-cured tobacco, due to superior flavor and aroma is the highest priced in the world. We feel that any tax savings by virtue of DISC will be passed on to importers by our exporters in order to be more competitive with cheaper grown tobacco.

"2. We firmly believe that agricultural exports should be afforded the same treatment under the DISC program as other products.

"3. We do not think that the DISC tax deferral program should be turned on and off. If DISC is a part of the tax structure, agricultural and industrial exporters alike should be able to rely upon it, to base their forward sales planning on its continuation, and not be faced with its discontinuation on short notice.

"4. We feel the U.S. should not unilaterally abandon the DISC program. Such change should only be made in the context of effective international agreements which result in compensating actions by our foreign trading partners. In reality, the DISC is generally of much less aid to U.S. exports than the practices of other countries are to the exports of those countries.

The Committee's consideration of these points concerning the provision affecting DISC treatment for U.S. agricultural exports will be greatly appreciated."

Sincerely,

JOE R. WILLIAMS, *President.*

BURLEY AND DARK LEAF
TOBACCO EXPORT ASSOCIATION, INC.,
Washington, D.C., March 16, 1976.

Dr. HUGH C. KIGER,
Executive Vice President,
Leaf Tobacco Exporters Association,
Raleigh, N.C.

DEAR HUGH: I was pleased to learn that you have requested to appear at hearings before the Senate Committee on Finance on the subject of Domestic International Sales Corporations (DISC). In the conservation of time of the Committee and in order to avoid repetition of testimony, we are pleased to join with you in endorsing the position taken in your statement.

The DISC program was adopted with the purpose of providing tax incentives for U.S. firms to increase their exports and provide tax treatment for their export sales income in line with that accorded by many foreign countries to their exporting firms. We feel that this program as originally conceived offers additional opportunity to expand U.S. tobacco export markets. International trade in leaf tobacco is highly competitive and it is becoming increasingly difficult to maintain and expand our markets due to the presence of tariff and non-tariff barriers, as well as significant incentives provided by foreign governments to their exporters of competing leaf tobacco.

Many of our U.S. tobacco exporting firms have gone to considerable expense in legal fees and employment of appropriate staff to conduct their sales under DISC. This was done in good faith in full belief that it was the intent of Congress that agricultural exports should be afforded the same treatment under DISC as other products and therefore considered as qualified export receipts under the DISC program.

We join with you in urging the Committee to retain the DISC program as a part of the tax structure for exporters of U.S. tobacco.

Sincerely,

FRANK B. SNODGRASS,
Vice President and Managing Director.

STATEMENT BY THE NATIONAL COTTON COUNCIL OF AMERICA

The National Cotton Council is the central organization of the U.S. cotton industry representing cotton growers, ginners, warehousemen, merchants, cooperatives, manufacturers, and cottonseed crushers in the 19 cotton-producing states from the Carolinas to California.

This statement is limited to a discussion of the DISC program's benefits, through expanded exports, to the economy of our nation and to the cotton industry.

Much of the efficiency of today's cotton industry is predicated upon having a very sizable export market. Exports normally require from a third to a half of U.S. cotton production. Therefore, a substantial part of the overhead investment cost in production, ginning, compression, warehousing, and merchandising can be spread over that export volume. Inability to compete successfully in the export market would

mean that a heavier burden of overhead costs would fall on the portion of the crop that goes for domestic use. This same principle applies, of course, to every sector of our economy that produces substantial quantities for export.

Since many of U.S. cotton's leading competitors for international markets sell through government or quasi-government organizations, those exporters pay no taxes at all. Examples are Russia, Egypt, and Turkey—the second, third, and fourth-ranking cotton exporters—and Pakistan, Colombia, El Salvador, Greece, Syria, and Sudan. The DISC deferral of taxes on 50 percent of the income of qualifying export corporations helps us compete with these countries. Some 85 percent of our cotton exports were shipped by DISC corporations in 1974–75, according to USDA estimates. As strictly prescribed by law, the tax is deferred only so long as the untaxed portion is invested in ways that will enhance exports—either in financing them or modernizing export operations.

Strong exports aided by DISC provisions, give domestic mills a much larger selection of qualities needed for specific uses at the lowest possible cost. This results in better consumer products at lower cost.

The seed from cotton produced for export is crushed in this country and the cottonseed meal produced adds to the high-protein feed supply for U.S. livestock production. Very little of it—less than 5 percent—is exported.

Depressed cotton exports could mean depressed cotton prices until growers were able to adjust to smaller markets. This, in turn, could well result in large government costs under the cotton program, which in recent years has been operated at very little cost.

The DISC program—by enhancing exports—benefits not just cotton and agriculture, but the whole economy. Using the Treasury Department's formula, it is estimated that in 1975 the DISC program added $4 to $5 billion to U.S. exports, $10 to $15 billion to the Gross National Product, and 280,000 to 350,000 new jobs throughout the country. This increased economic activity produced a probable increase of $2 to $3 billion in tax revenue.

The benefits of growing export trade from DISC programs are widespread. It is estimated that 70,000 jobs are added for each billion-dollar increase in exports. Growing imports of all kinds of goods from all over the world, seeking our strong markets, have to be paid for with exports. Imports dropped in 1975 for the first time in 14 years due to the recession, and the result was a surplus in merchandise trade. It is already apparent that this surplus is likely to be short-lived. In January we returned to a deficit position, just as we have been in for three of the past four years. Increasing imports of high-priced oil will make it difficult for exports to keep up with imports. This situation makes it imperative that we do everything possible to stimulate exports of all kinds.

H.R. 10612, which is the subject of your hearing, eliminated most agricultural exports from DISC eligibility, presumably on the theory that such exports should not be encouraged because of tight supplies. The only commodities remaining eligible are crops in "surplus," which are defined as those subject to marketing quotas and acreage allotments. As you know, farm program changes made by the Congress several years ago eliminated quotas and allotments for most of the extensively grown commodities for reasons unrelated to supply.

It seems strange, therefore, that the House felt it necessary to amend the DISC program, regardless of the supply situation of individual commodities in particular years, since the present law provides that the President may exclude from DISC eligibility any product he deems to be in short supply. We feel that the House bill discriminates against most of agriculture at a time when farmers need encouragement to grow as much as they possibly can to meet the world's critical needs for food and fiber.

We respectfully urge that DISC provisions of the present law be continued unchanged in the interest of a stronger nation that is better able to meet the needs of its own people and of people around the world.

XCEL CORP.,
March 23, 1976.

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

DEAR MR. STERN: Pursuant to your telegram of March 18, 1976 the following statement is presented to the Senate Committee hearings in regard to Senate Bill S. 651, Section 104, TERMINATION OF SPECIAL TAX TREATMENT FOR DOMESTIC INTERNATIONAL SALES CORPORATIONS.

It is our understanding that passage of this bill will effectively eliminate the tax benefits accorded to DISC Corporations. It is my belief that the DISC concept is one of the most effective pieces of foreign trade legislation ever produced by the Congress and as a direct result of the DISC program, our company has become a significant competitor in world markets for our cellulosic plastic films.

We are a medium sized company, organized in February of 1973, to purchase the cellulosic film and sheet business previously operated by the Celanese Corp. from two factories in Newark and Belvidere, N.J. At the inception, we inherited a small export business from the predecessor company which operated a major export subsidiary handling all corporate product lines. Candidly, in the absence of the DISC program, we would have abandoned this small and relatively unprofitable export business. However, the DISC corporation tax benefits enabled us to justify continuation of exports which have subsequently grown considerably and made a significant contribution to the success of our company.

I feel that the export experience for small corporations similar to XCEL Corporation amply justifies continuation of the DISC program. It seems to me that XCEL Corporation exemplifies the situation that the drafters of the original legislation had in mind, to provide incentive for small companies with modest export sales potential to undertake the expensive and time consuming job of becoming a direct exporter. Discontinuation of the DISC Corporation program will very substantially erode our ability to compete with foreign producers. I might add that the two major competitive firms in the world market for our product are both European based divisions of large multinational corporations.

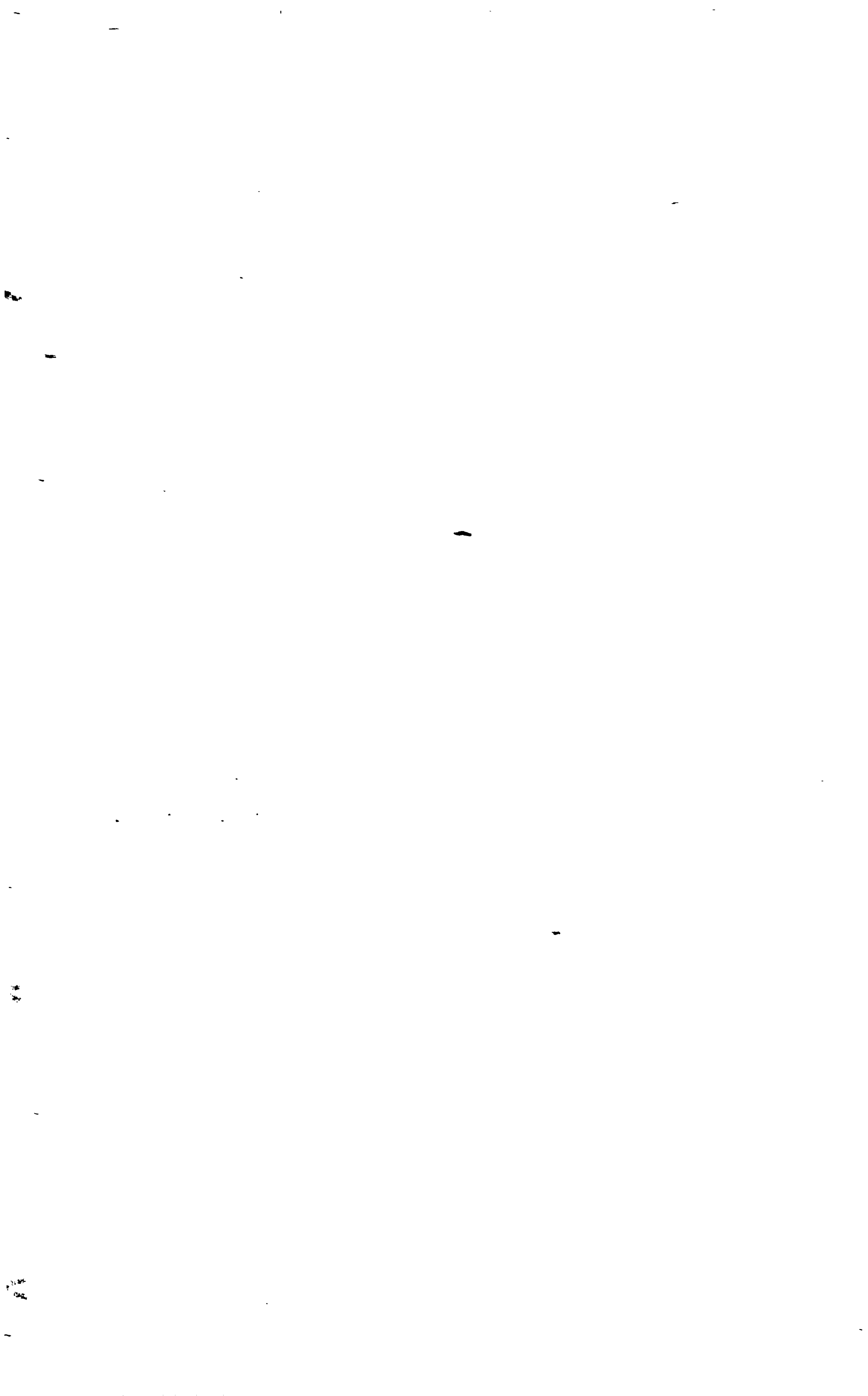
It may be possible that the provisions of the law establishing the DISC concept generated excessive tax benefits for large companies already committed to an export program. However, if this is the case the tax benefits generated for companies such as XCEL Corporation do not fall into this excessive category, but rather these tax benefits form the economic basis on which companies such as we have built our direct export trade. I trust the Committee will find thru other testimony on this proposal and certainly thru its knowledge of the many medium size corporations which operate in New Jersey and elsewhere that the DISC regulations have stimulated manufacturing for export and have contributed substantially to employment in the United States.

In summary, revocation of the tax benefits would do irreparable harm to the export programs of small and medium size companies and would contribute substantially to the unemployment situation which has grown to near depression levels, particularly in New Jersey. This DISC program has aided companies' capital growth, and should be maintained, certainly, for companies such as ours which fall directly within the original intent of the law.

Very truly yours,

XCEL CORPORATION,
THOMAS E. BRYDON,
President.

Advertising and Publications of Tax-Exempt Organizations



STATEMENT OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

(By Jeffrey M. Yates, assistant general counsel)

The Independent Insurance Agents of America, Inc. ("IIAA", formerly the National Association of Insurance Agents, Inc.) is a trade association representing approximately 33,500 independent insurance agency firms, having over 100,000 licensed insurance agents throughout the country. IIAA has qualified as a nonprofit tax exempt business league under section 501(c) of the Internal Revenue Code.

IIAA publishes a monthly magazine known as the Independent Agent in order to keep its members abreast of association activities and developments in the insurance industry. Recent regulations finalized by the Internal Revenue Service in December 1975 would subject our magazine to substantial unrelated business income tax under section 512 of the Internal Revenue Code even though our advertising income does not nearly cover our expenses to produce the magazine. For example, during our 1974–75 fiscal year, our expenditures on the magazine were $609,454, but our advertising income was only $416,000. The magazine made an additional $5,000 on approximately 1,000 nonmember subscriptions, leaving $198,454 to come from member dues.

IIAA publishes a monthly magazine known as the Independent reasonable result and that legislative action should be taken to formulate an appropriate rule for such periodicals. For this reason, IIAA supports and recommends adoption of the attached legislative proposal of the American Society of Association Executives as one means of correcting this unfair result.

The Independent Agent is the official publication of our association, and we believe it is an absolutely essential instrument of communication to our members, if our association is to remain an effective organization. Out of a circulation of 35,160, all but 1,660 issues go to members of our association at no additional cost to them. We see no reason for taxing a publication such as ours which is not self-sustaining, and which uses its advertising revenue to reduce the need for subsidization by the sponsoring association. The situation would be different if producing the magazine were the central endeavor of the association, or the magazine had net advertising income after deducting all of the expenses that went into producing it. But in our case, as a result of the recent IRS regulations, the association is forced to subsidize the magazine even more and to divert this money from other association activities which we were given our tax exemption to carry out.

The rationale behind taxation of not-for-profit association periodicals is based on alleged unfair competition with comparable commercial publications. We understand how this result could occur if the magazine were the central endeavor of the association or if it had net advertising income after all expenses. But we do not see how it applies to magazines such as ours which are not profitable standing

on their own and which have the parent association's membership as their primary audience.

The fact is that the new IRS regulations give for-profit commercial publications competitive advantages over not-for-profit publications. This is because under the regulations, the not-for-profit publication must apply an arbitrary and unreasonable formula to allocate dues income to circulation income if the magazine is automatically sent to all dues-paying members. If this circulation income figure equals or is larger than the costs specifically allocable to readership costs, then none of the readership costs can be used to offset taxable advertising income. The formula we would have to apply calculates circulation income to equal total dues receipts multiplied by a fraction, the numerator of which is total periodical costs and the denominator of which is total periodical costs plus all other association costs.

In essence, what we are required to do under this formula for circulation income is to arrive at a subscription price that pays for the entire magazine. But note that almost every, if not every commercial periodical partially subsidizes the subscription side of the magazine with advertising revenue. Because of this artificially high value placed on subscription income, we are not permitted to deduct our readership costs to reduce our ultimate tax liability while for-profit commercial publications are so permitted.

Under this formula prescribed by the Internal Revenue Service, we arrive at a per member subscription price of about $12.50. Once again, we have a circulation of 35,160, and a per page advertising rate of $860. Take a look at the subscription price charged by similar for-profit commercial publications appealing to the same market as our Independent Agent with a similar circulation and advertising cost per page. The American Agent and Broker has a total agent circulation of 38,809, charges $830 per page advertising, but charges no subscription price. Rough Notes has a total agent circulation of 28,230, charges $883 per page advertising, and charges a subscription price of $3. Best's Review (property/casualty edition) lists a subscription price of $10, but most of its subscribers get the magazine at no cost when they subscribe to other services offered by Best's. Best's agent circulation is 17,390 and its charge is $1,045 per page advertising. Insurance is a semimonthly publication which charges no subscription price, has an agent circulation of 12,845 and charges $550 per page advertising.

As you can see from this comparison with similar for-profit commercial publications, the IRS formula for circulation income gives a completely arbitrary and unreasonable result which effectively prevents periodicals of not-for-profit associations from being able to deduct readership and editorial costs as commercial publications are able to. For this reason, IIAA supports the attached ASAE proposal which will both remedy this inequitable result and cover those instances where not-for-profit periodicals are unfairly competing with for-profit periodicals.

IIAA would be happy to supply the committee with any additional information that it requests and hopes that it will give these comments and the attached ASAE proposal serious consideration.

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

(By James P. Low, President and Chief Administrative Officer)

This statement is submitted on behalf of the American Society of Association Executives (ASAE) to supplement two separate statements submitted by ASAE. Each of the three issues discussed is sufficiently important to merit individual treatment. Accordingly, ASAE has elected to submit separate statements on each issue.

Most associations, professional societies and other tax-exempt organizations prepare and circulate to their membership a journal, bulletin, or magazine. In most instances these publications were created to fill a void resulting from the absence of any other publication. These publications contain articles, announcements, and other information related to the association's activities. In many cases, these association publications may also contain commercial advertising related to the association's functions and its membership's particular interests. Associations 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 costs of the publication. Associations and other nonprofit organizations do not pay Federal income taxes on their dues. However, if in addition to their exempt activity the association 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 an association 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 relations will result in non-profit associations, professional societies, and other tax-exempt organizations either: (i) paying taxes which divert money from their activities which the Congress has already determined to be worthy of tax exemption; or (ii) 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 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 our legislative proposal as a reasonable and equitable solution to tax treatment of advertising income. We would be happy to provide the committee with any additional information which it may require on this matter or to explain our legislative proposal in more detail.

Appendix

PROPOSED AMENDMENT TO SECTION 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 an association entirely separately from the general activities of the association 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 an association 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	20
70 percent	40
80 percent	60
90 percent	80
100 percent	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.

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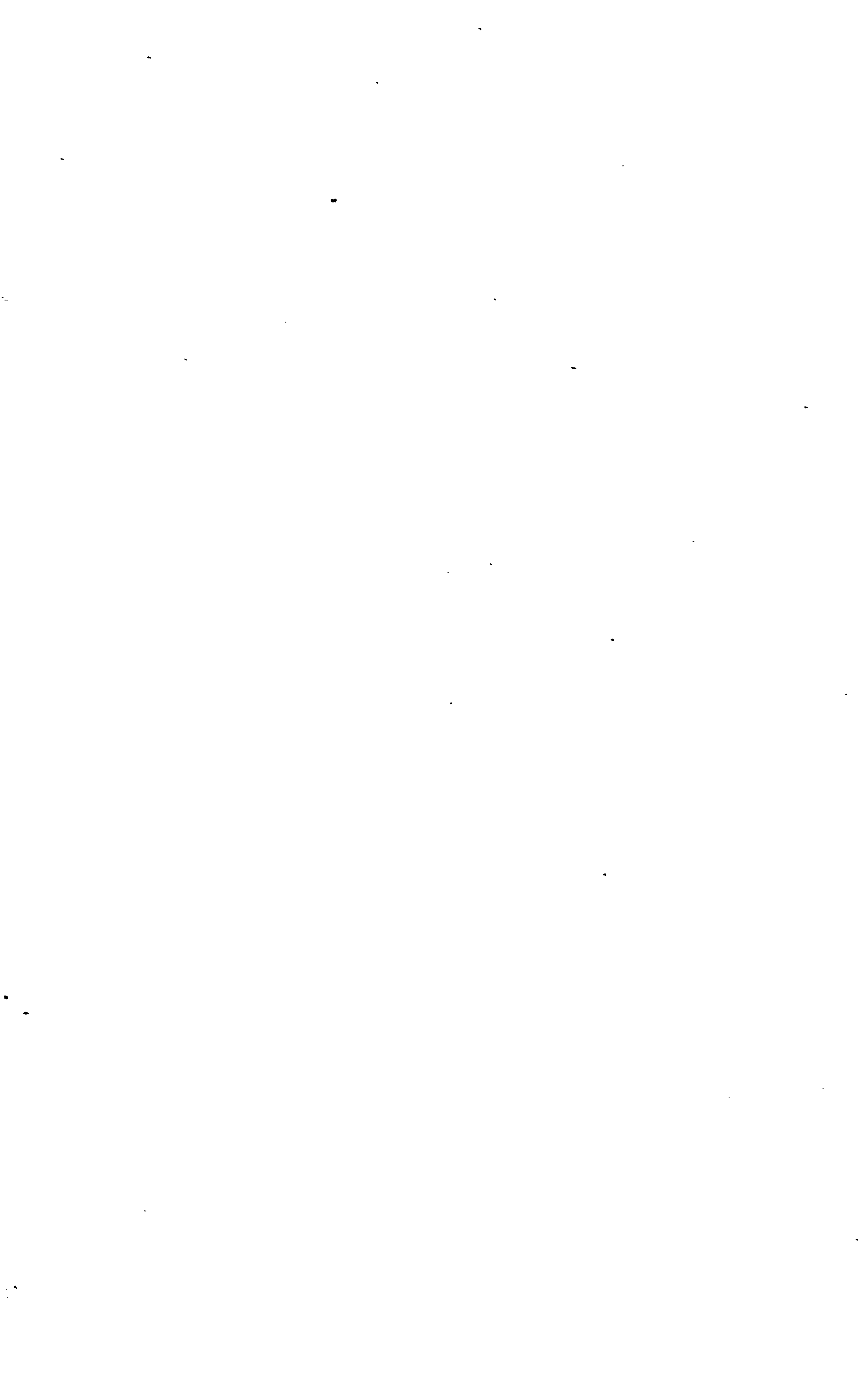
Private Foundations



LOS ANGELES INTER-FOUNDATION CENTER,
Los Angeles, Calif., April 16, 1976.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Dirksen Senate Office Building, Washington, D.C.
(Attention Michael Stern, Staff Director)

DEAR CHAIRMAN LONG: My name is Joseph G. Dempsey. I am the executive director of an association of grantmaking foundations which give their attention to the philanthropic needs of southern California. I appreciate the invitation to present testimony on some tax revisions the Finance Committee is considering which affect private foundations.

In preparation for this testimony, the Los Angeles Inter-Foundation Center convened a "Consultation of Southern California Foundations" to establish positions on five major legislative issues that influence the status of foundations. Rather than recite the rationale behind all five of these positions, I would like to focus my attention on only two issues presently in the forefront of debate about private foundations, the 4 percent excise tax and the minimum payout rate.

It is difficult to add anything new to the record on this controversial tax. The Finance Committee is well aware of the legislative history that has attempted to justify this tax. Apparently, some legislators questioned the propriety of giving private foundations an unqualified tax exemption; that is, since foundations also benefit from government and are obviously financially capable, private foundations should help bear the burdens of supporting government (see H. Rept. 91-413, pt. I, 91st Cong., 1st sess., 19, 1969). Other legislators, anticipating an extraordinary high cost for enforcing compliance with the Tax Reform Act of 1969, reasoned that private foundations should justifiably underwrite these high costs as they were the culprits who caused this new expense (see H. Rept. 91-552, pt. I, 91st Cong., 1st sess., 17, 1969).

Private foundations associated with the Los Angeles Inter-Foundation Center wish to register their profound objections to this excise tax on the basis of: (1) Equity, (2) principle, (3) accuracy, and (4) effect. Let me briefly expand on each of these objections.

Principle.—By law and by definition, private foundations are formed and dedicated to accomplish the "public good." Traditionally, and by the logic of our tax law, a tax-exempt status has been granted to those organizations which collaborate with the efforts of Government to seek the "public good." The 4 percent excise tax clearly violates this principle.

Equity.—Discrimination is practiced against private foundations by the imposition of this 4 percent excise tax. While private foundations are called upon to pay this tax, other tax-exempt organizations such as employment pension plans, country clubs, cemetery associations, and the like are not also asked to share the costs of government or asked to underwrite the expense of auditing their activities.

Accuracy.—If principle and equity are insufficient to abolish this unfortunate regulation, then for the sake of accuracy, both the name and the amount of revenue raised should be changed. The revenue should be redesignated an "audit fee" in place of the present term, "excise tax." The revenue should be reduced to an amount which accurately reflects the costs of administering the audit. Costs of the past 7 years and future costs estimated by the Commissioner indicate a rate that is considerably less than 2 percent of foundation net investment income.

Effect.—Finally, it is not difficult to understand that the cost of the 4 percent excise tax is not being borne by private foundations. The cost is measured by those charitable institutions, agencies, and programs that do not receive the amount of the 4 percent excise tax in contributions which otherwise would be theirs.

We recommend section 4940 of the Internal Revenue Code be abolished. It is a regulation without merit. However, if it must be maintained in spite of violations of principle, equity, and effect, then at least the revenue should be reidentified as an "audit fee," and the rate should be lowered to an amount that is closer to the actual costs of administering the audit.

Minimum payout rate

In principle, the minimum payout requirement is acceptable. However, we find objectionable the means by which the rate is determined. We find that the present regulation (4942)—

1. Is vague, complex, and tends to distort the payout rate on the high side;
2. Encourages imprudent investment practices;
3. Provides effective disincentives to the formation of new foundations; and
4. Eventually will decrease the contribution that foundations make to charity.

Under the present regulation, the Secretary of the Treasury must announce a payout rate that bears "relationship to 6 percent [which is determined] to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields of the calendar year 1969."

The fact that the Secretary of the Treasury must use the base percentage of 6 percent and compare rates and yields in their relationship to the untypical investment year of 1969 produces unrealistically high payout rates. This becomes most evident from recent information coming out of the Department of the Treasury that the payout rate for 1976 will be 6¾ percent.

Requiring such an unrealistic payout rate will inevitably cause foundations to suffer a prolonged and involuntary divestiture. Foundation officials confronted with the compliance to the minimum payout requirement are caught in an unfortunate dilemma: on the one hand, to seek appreciation and dividend yields that are sufficient to meet the payout requirement while keeping pace with inflation, high-risk equity securities must be the principal focus of such investment objectives; on the other hand, to avoid the possibilities of loss through risk, investments in "debt obligations" need to be the basis of an investment portfolio by which the required income can be secured but without a

hedge against inflation through appreciation. In either case, the choice of such investment objectives probably will lead to effective and eventual divestiture.

Senate bill 2475.—For these reasons, we support the legislation proposed by Senator Carl Curtis, S. 2475, that sets a flat 5-percent minimum payout rate to be reviewed every 5 years. We believe this is a rate that will not jeopardize foundation assets while providing an optimum amount of money for charity. This bill also will do much to encourage the formation of new foundations. This is an especially important factor in this period of rising needs in philanthropy. We recommend the approval of S. 2475 to you.

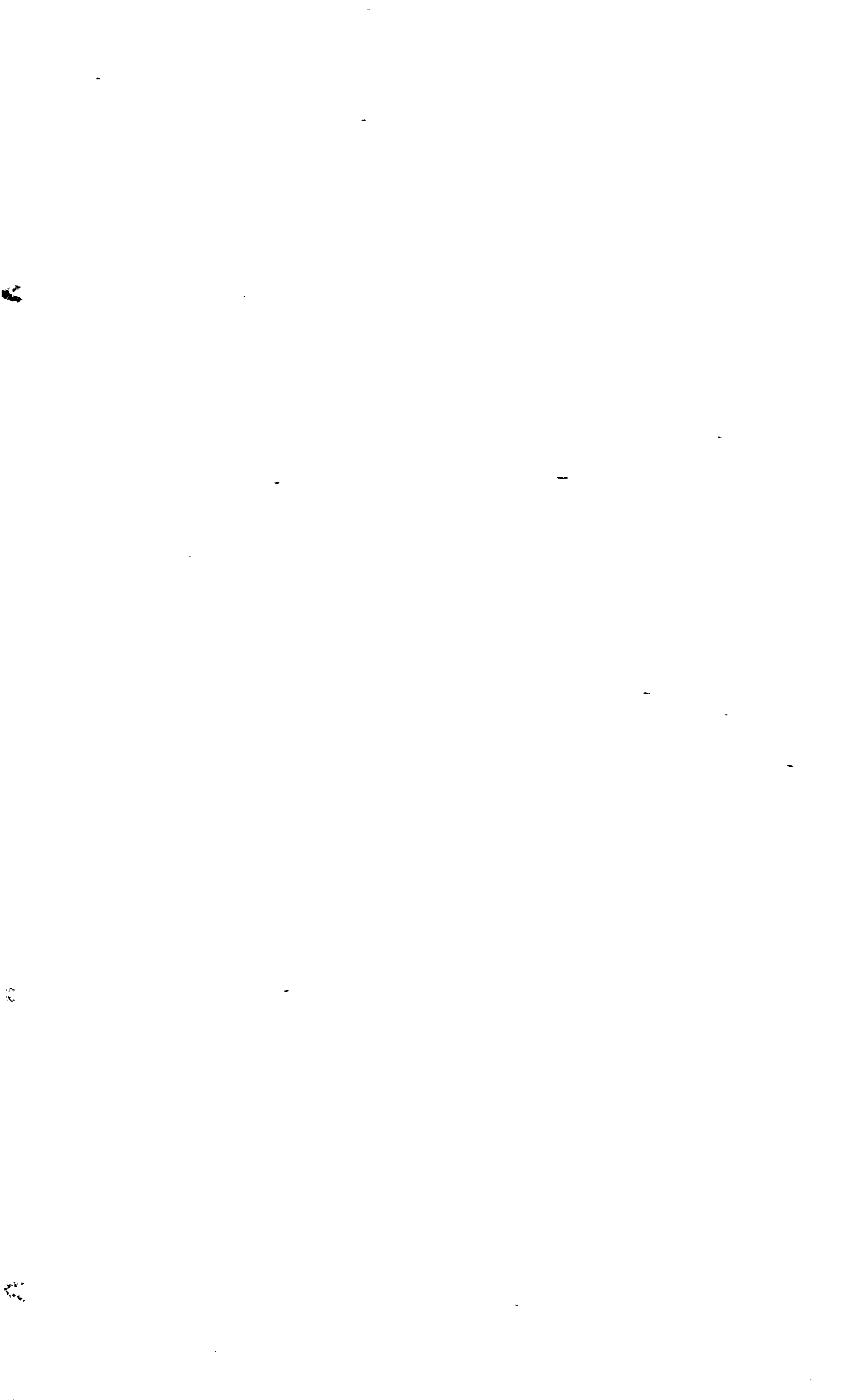
CONCLUSIONS

The Senate Finance Committee is well aware of the negative comment being expressed across the country concerning "big Government." It is our belief that private philanthropy, as it is served by private foundations in particular, is one of the important alternatives to "big Government." Not to be compared with the size and force of Government, foundations nevertheless have the ever-present potential to point in the right direction, to uncover the correct information or to encourage the right people. Private foundations will not always complement governmental efforts, but rather foundations represent one of the few opportunities to accomplish that which Government cannot or will not do.

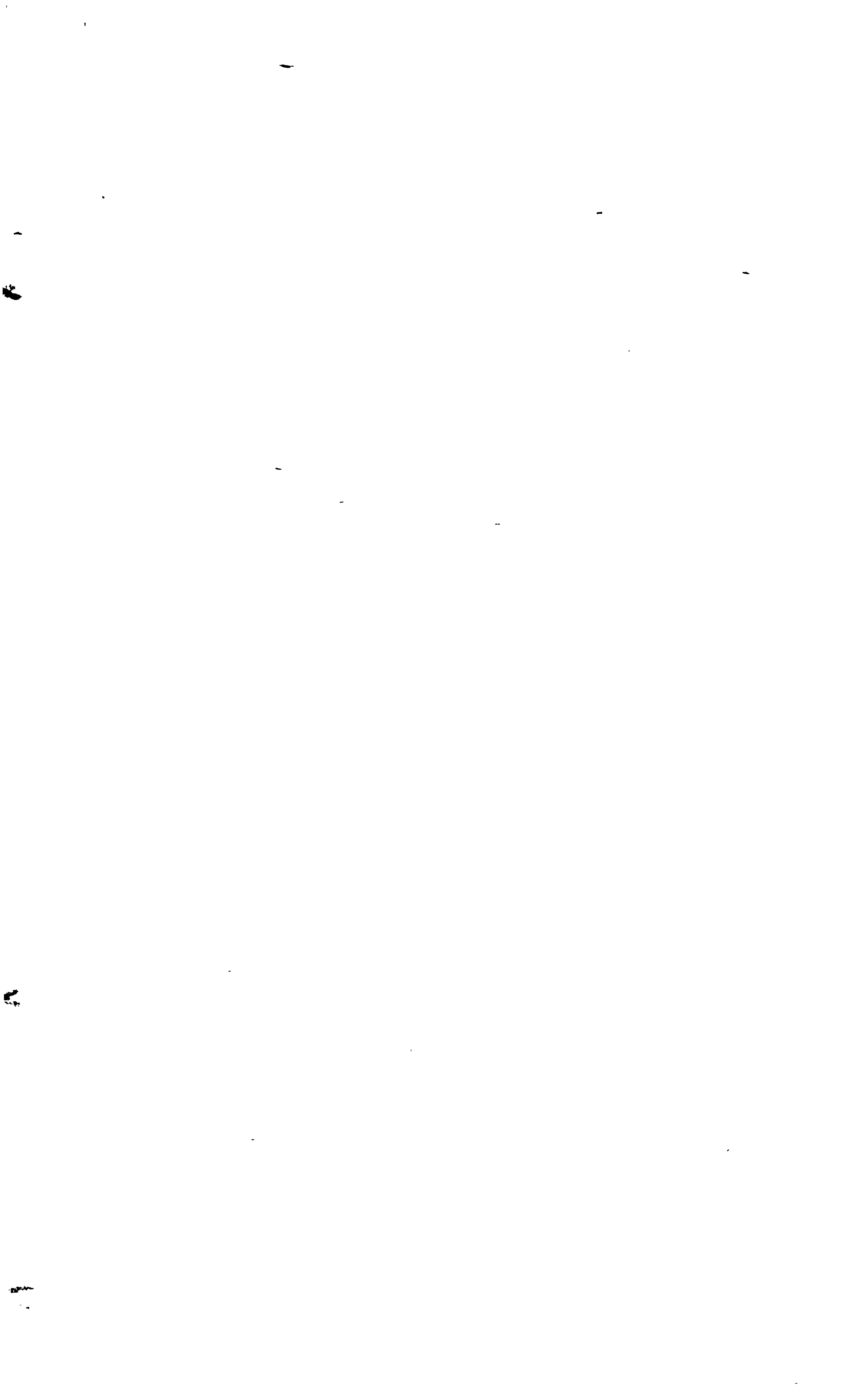
We suggest that the recommendations contained in this testimony will go far to maintain a healthy and vigorous private philanthropy which can serve the "public good" in ways unattainable by Government.

Respectfully,

JOE G. DEMPSEY,
Executive Director.



Cooperatives and Condominiums



Statement of F. McDonald Ervin

My name is F. McDonald Ervin. I represent the South Side Cooperative-Condominium Owners Association in Chicago, which consists of over 100 housing cooperatives and condominium housing associations.

I am testifying on behalf of this organization on legislation affecting the taxation of cooperatives and condominiums. I appreciate the opportunity to testify.

Our concerns are the following:

1. That legislation recognize that preservation of livable housing units is a principal goal of cooperatives and condominiums. Residents in such housing are not simply homeowners. They have many purposes similar to homeowners, but their principal purpose, as they associate together or incorporate, is to preserve the structures in which they live.

2. That legislation establishing tax-exempt category for housing cooperatives and condominiums recognize the preservation of housing is the principal "exempt purpose" of such organizations.

3. That income to funds set aside in reserves for preservation of housing structures be recognized as income related to this "exempt purpose."

4. That legislation establish proper accounting for depreciation of the assets of housing cooperatives, allowing the charge to accrue to the true owner. If the owner is a corporation, then to the corporation. Depreciation to a housing cooperative is the cost of owning and providing housing, yet nowhere in the Internal Revenue Code is this recognized as a cost chargeable to the income of the cooperative. It is a cost to a cooperative housing corporation as it is to any other corporation owning property for the production of income, considering income in the broad sense as the Internal Revenue Code does.

Our concerns about exempt status stem from our desire to see a tax policy favorable to the preservation of the housing stock. Our experience has been with older apartment buildings, and we know that repairs and replacements must be made timely. Otherwise the expense of doing so may become unbearable. Tax-exempt status will encourage the accumulation of reserves as the expense of deferred maintenance. Income on invested reserves augments these reserves and helps to maintain their purchasing power in these times of inflation. A tax-exempt status recognizing this fact and avoiding the taxation of such income will further encourage reserves for maintenance and replacement.

Our concern regarding depreciation charges stems from recent cases in which the Internal Revenue Service has dissallowed depreciation as an expense of cooperative housing corporations. We consider this treatment inequitable. These decisions have apparently resulted from a lack of any Internal Revenue Code sections dealing with depreciation of property held by cooperative housing corporations. The fact that a

cooperative provides housing for use does not invalidate depreciation as a legitimate and reasonable expense. It is a measure of the degree to which housing structures are being used and used up, by cooperative members. Depreciation is thus a valid charge to be covered by income from them.[1]

NATIONAL ASSOCIATION OF HOUSING COOPERATIVES,
Washington, D.C., April 22, 1976.

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

DEAR MR. STERN: We hereby acknowledge your telegram advising that it is not possible to schedule our association for oral presentation at the hearings on the Tax Reform Act of 1976, but that you will print a written statement in the record. This letter is our statement.

Since we understand that several organizations affiliated with our association have separately submitted statements, including the California Association of Housing Cooperatives and Cooperative Services, Inc. of Detroit, this statement merely summarizes the key issues from the standpoint of the National Association of Housing Cooperatives.

1. *General tax position of housing cooperatives.*—Our Association of Housing Cooperatives, which represents more than 100,000 families living in its dues-paying member cooperatives, opposes special tax legislation for housing cooperatives. However our association is vitally interested in seeing that not-for-profit housing cooperative corporations are treated fairly under the tax laws in comparison with profit-motivated rental owners and individual homeowners.

2. *Availability of the depreciation allowance for housing cooperatives.*—In line with the general principle outlined in paragraph 1 above, many housing cooperative corporations are utilizing the depreciation deductions which are customarily and regularly available to all types of business corporations including private rentals. However the application of these usual depreciation allowances by housing cooperative corporations has been under challenge by IRS for reasons which we believe are without merit. Clarification of this issue would be appreciated.

3. *Availability of tax deductions for required reserves.*—Other housing cooperatives find they do not need to use the depreciation deduction because of the not-for-profit nature of their operations. The only concern these housing cooperatives have is regarding their right to deduct payments into those reserves which are required by the Department of Housing and Urban Development or comparable State regulatory agencies. This is another matter on which clarification would be helpful.

4. *The "Bobby Baker" amendment, section 216(c).*—This provision of the existing Internal Revenue Code permits individual member stockholders to take depreciation on their stock in the cooperative corporation. It is not in the interest of housing cooperatives generally and is a special privilege for a very limited number of people who use

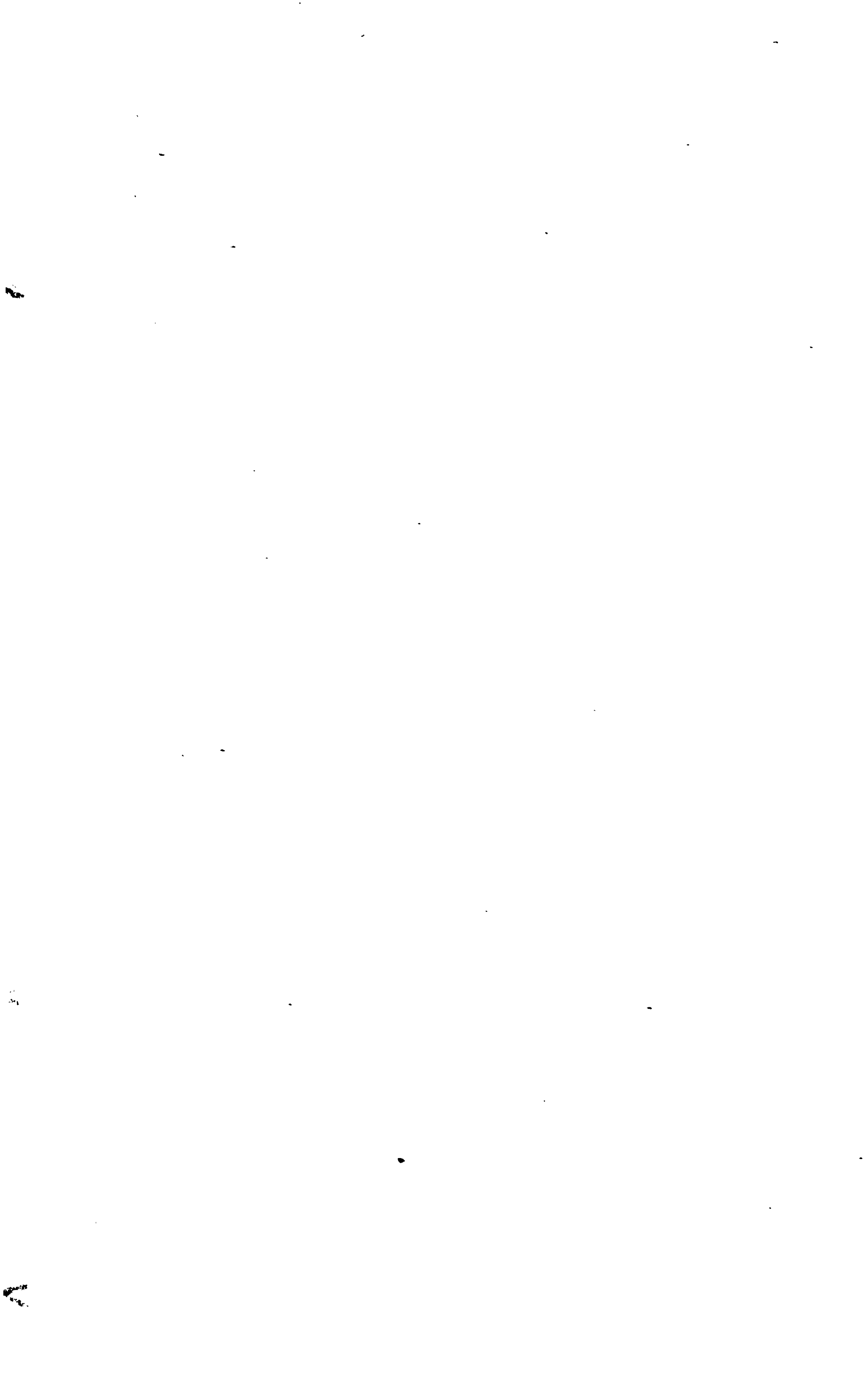
[1] We make this point strongly, since some cooperative housing corporations may not qualify for tax exemption under the new legislation.

their dwelling units for business purposes—a use which is generally prohibited in all housing cooperatives with Federal or State assistance. The National Association of Housing Cooperatives concurs in the position taken by Cooperative Services, Inc. in opposition to this special legislation because it is not consistent with the general principle outlined in paragraph 1 above.

In summary, we urge that as a minimum, there be clarification that depreciation can be a deductible item for cooperative housing corporations, just as it is for all business corporations under the Internal Revenue Code.

Very truly yours,

ROGER WILLCOX, *President.*



Premiums on Guaranteed Renewable Health and Accident Insurance Policies

STATEMENT OF NATIONAL ASSOCIATION OF LIFE COMPANIES IN SUPPORT OF S. 2759

The National Association of Life Companies ("NALC") is headquartered at 550 Pharr Road NW., Atlanta, Ga. 30305. Our association was organized in 1955 to provide progressive life insurance companies with a forum, both for internal communication of ideas and for joint commentary on items of mutual interest. NALC began with a membership of 43 companies: today its membership is nationwide, with over 225 companies represented. NALC companies have more than 143,000 home office and field employees, over 340,000 stockholders, and more than 40 million policyholders. Most of our members are small and medium sized life insurance companies.

NALC supports the enactment of S. 2759, introduced on December 9, 1975, by Senator Fannin, and cosponsored by Senator Curtis. As precisely described by Senator Fannin when introducing the bill (see 121 Congressional Record S21417 (daily edition Dec. 9, 1975)), S. 2759 would amend section 809(d)(5) of the Internal Revenue Code to clarify the original congressional intent that qualify for the 3 percent of premiums deduction provided for therein. This committee and the Senate previously approved legislation producing a result identical to S. 2759, but, unfortunately, the conferees for the House objected on the stated grounds that they did not have sufficient time to explore its technical aspects—not because of any fundamental disagreement with its provisions.

A substantial portion of the business of NALC's member companies is health and accident insurance. Life insurance companies which write a significant amount of health and accident insurance often issue three basic types of policies. These policies may be described as follows:

1. Noncancelable policies are policies under which the insurance company is obligated to continue or renew the insurance coverage at a guaranteed premium.

2. Guaranteed renewable policies are policies under which the insurance company is obligated to continue or renew the insurance coverage and may not cancel the policy or change the nature of the risk covered, but may, after complying with relevant State law, adjust premium rates by classes (not by reference to an individual policy) in accordance with its experience with the entire class.

3. Cancelable policies are policies which the insurance company may cancel for any reason at the renewal date.

As is evident from the above descriptions, noncancelable and guaranteed renewable health and accident insurance policies are very similar in that they both involve the insurance of long-term risks i.e., they may not be unilaterally canceled by the insurance company). Indeed, this fact has been recognized by the Internal Revenue Service. Revised Ruling 71-367, 1971-2 C.B. 258. The only difference between noncancelable and guaranteed renewable policies is the fact that under

a guaranteed renewable policy the insurance company has a limited right to adjust premiums by class in accordance with its experience with the class. Cancelable policies, on the other hand, differ from the other two types of policies in that they involve the insurance of relatively short-term risks, since they may be individually canceled by the insurance company for any reason at the renewal date.

Section 809(d)(5) provides a deduction in an amount equal to 10 percent of the annual increase in reserves for nonparticipating policies, or in an amount equal to 3 percent of the premiums received on nonparticipating policies which are issued or renewed for periods of 5 years or more, whichever is greater. When, as with many of NALC's member companies, a life insurance company's business includes a substantial amount of noncancelable and/or guaranteed renewable health and accident insurance, as compared to nonparticipating life insurance, the 3 percent of premiums deduction is often significantly larger than the 10 percent of reserve increase deduction. Consequently, many of NALC's member companies have consistently claimed the 3 percent of premiums deduction with respect to their guaranteed renewable health and accident insurance policies.

In so claiming the 3 percent of premiums deduction, these companies have acted consistently with the original purpose of section 809(d)(5), which was to permit life insurance companies issuing nonparticipating policies insuring long-term risks to compete on an equal basis with life insurance companies which issue participating policies insuring long-term risks.[1] Companies issuing participating policies are able to charge a premium on these policies which exceeds the actual cost of providing insurance coverage, and they may retain a portion of the excess premium as a cushion against the long-term risks insured. Section 809(d)(5) was intended to provide companies issuing nonparticipating policies with a similar cushion against the long-term risks insured.

Nevertheless, and in the face of the legislative purpose of section 809(d)(5) (and the express provision of section 801(e)), the Internal Revenue Service has consistently refused to allow the 3 percent of premiums deduction on guaranteed renewable health and accident insurance policies. The service agrees that nonparticipating noncancelable accident and health policies are eligible for the 3 percent of premiums deduction under section 809(d)(5), and that cancelable accident and health insurance policies are eligible for the 2 percent of premiums deduction under section 809(d)(6). However, the service has taken the position that nonparticipating guaranteed renewable policies are not eligible for either the 3 percent of premiums deduction or the 2 percent of premiums deduction. The service maintains that, on nonparticipating guaranteed renewable policies, life insurance companies are limited to the 10 percent reserve increase deduction under section 809(d)(5)—which often is significantly less than even the 2 percent of premiums deduction under section 809(d)(6) available for

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[1] The action of these companies in claiming the 3 percent of premiums deduction on their guaranteed renewable health and accident insurance policies has also been entirely consistent with sec. 801(e) which was enacted contemporaneously with section 809(d)(5) and expressly provides that, for purposes of the taxation of life insurance companies, guaranteed renewable health and accident insurance shall be treated in the same manner as noncancelable health and accident insurance.

short-term cancelable policies, and, of course, is also often less than the 3 percent of premiums deduction under section 809(d)(5). Revised Ruling 65-237, 1965-2 C. B. 231; Revised Ruling 71-368, 1971-2 C. B. 259.

The life insurance industry generally has successfully sustained its entitlement to the 3 percent of premiums deduction for guaranteed renewable policies under section 809(d)(5) in the Court of Claims. See, *United American Insurance Co.* v. *United States*, 475 F. 2d 612 (Ct. Cl. 1973); *The Lincoln National Life Insurance Co.* v. *United States*, No. 521-69 (Ct. Cl. January 4, 1974); and *Central States Health & Life Co. of Omaha* v. *United States*, No. 276-74 (Ct. Cl. October 30, 1975). The Tax Court reached the same conclusion (48 T.C. 118 (1967)), but was reversed by the Ninth Circuit. *Pacific Mutual Life Insurance Co.* v. *United States*, 413 F. 2d 55 (9th Cir. 1969). Obviously, life insurance companies will continue to resort to the courts, if necessary, to sustain their entitlement to this deduction.

However, resort to the courts should not be necessary to establish a taxpayer's entitlement to a deduction which Congress so clearly intended to provide. This committee already has concluded "that it was the intent of Congress in the Life Insurance Company Income Tax Act of 1959 to treat guaranteed renewable contracts in the same manner as noncancelable contracts," and that guaranteed renewable contracts should be eligible for the 3 percent of premiums deduction under section 809(d)(5). (See, Senate Report No. 92-1290, 92d Cong., 2d Sess. 6-7 (1972)). NALC urges the committee to reach the same conclusion again, and to report S. 2759 favorably so that its member companies' entitlement to the 3 percent of premiums deduction under section 809(d)(5) for guaranteed renewable health and accident policies will be clarified once and for all, and so that no further resort to litigation will be necessary.

AMERICAN LIFE INSURANCE ASSOCIATION,
HEALTH INSURANCE ASSOCIATION OF AMERICA,
Washington, D.C., April 15, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The purpose of this letter is to express our support for S. 2759, relating to the tax treatment of guaranteed renewable health and accident insurance policies. The American Life Insurance Association and the Health Insurance Association of America have approximately 520 member companies which, in the aggregate, write more than 90 percent of the life and health insurance written in the United States.

S. 2759 would amend section 809(d)(5) of the Internal Revenue Code to make clear that guaranteed renewable life, health, and accident insurance contracts are eligible for the 3-percent-of-premiums deduction available under that section to nonparticipating contracts issued for 5 years or more. We believe such an amendment would be in accord with the intent of Congress when it enacted section 809(d)(5) as part of the Life Insurance Company Income Tax Act of 1959.

In this regard, while we believe that the terms of present law support the deduction, a specific amendment to the code to clarify this matter is desirable in view of an outstanding ruling by the Internal Revenue Service to the contrary. Although the IRS position has been rejected in several recent cases, it has been upheld by one court and a statutory amendment would avoid the necessity of further litigation.

It is important to note that your committee, and the full Senate, approved an identical amendment in 1972. This amendment, which was added to H.R. 1467, was not accepted by the conference committee. The chairman of the House Ways and Means Committee indicated, in this regard, that the House conferees had rejected the amendment, not because of any fundamental disagreement with it, but, rather, because there was not sufficient time for the House conferees to fully explore the technicalities involved in the amendment.

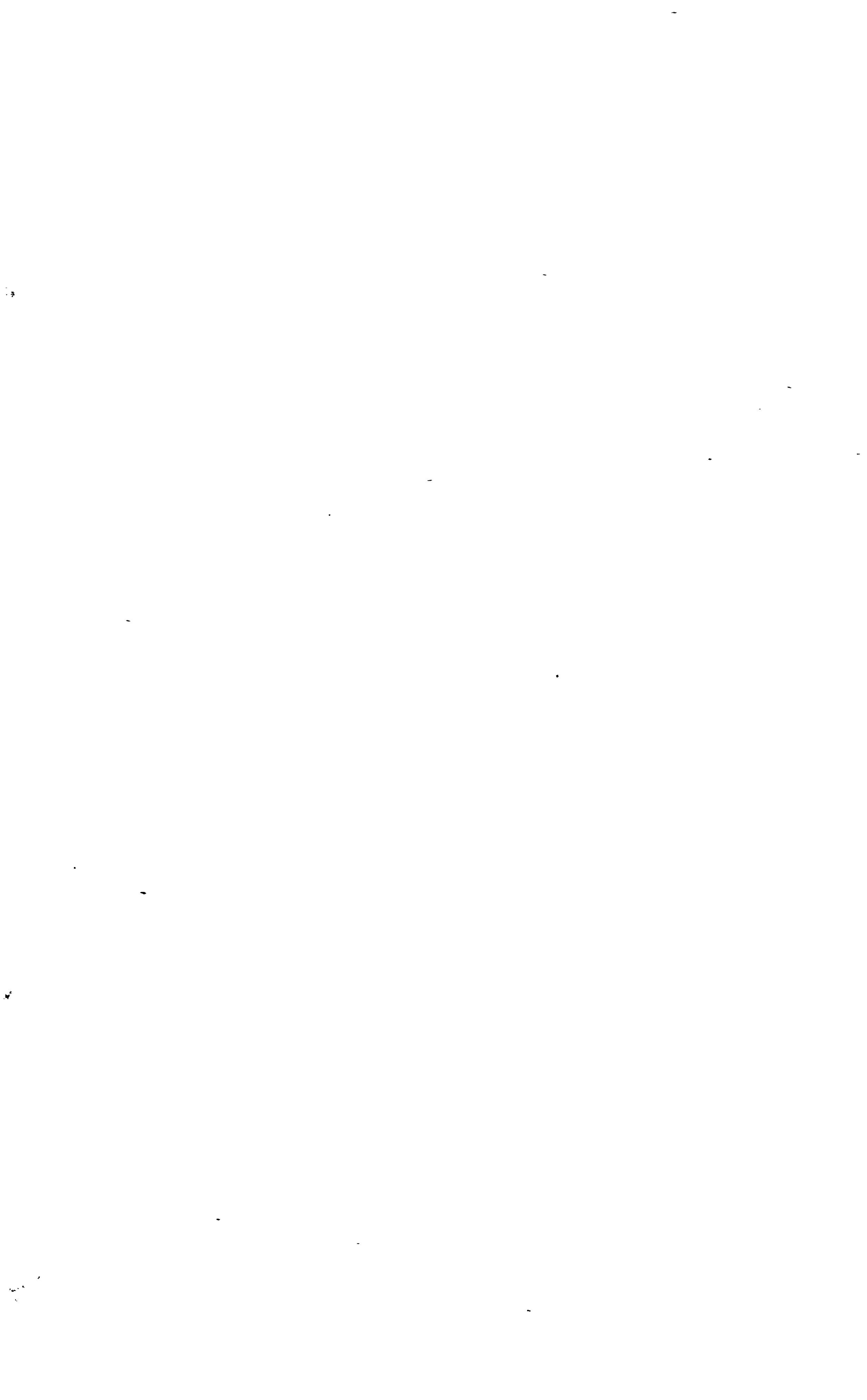
Thus, for the reasons set forth in this letter, we urge that the Senate Finance Committee approve the amendment embodied in S. 2759.

Sincerely,

WILLIAM T. GIBB,
Chief Counsel, Federal Taxes and Pensions,
American Life Insurance Association.

PAUL M. HAWKINS,
Vice President and Washington Counsel,
Health Insurance Association of America.

Employment Taxes



Statement on Behalf of the National Association of Independent Insurers, Submitted by Charles W. Davis

INEQUITIES IN EMPLOYMENT TAXES AS APPLIED TO CASUALTY INSURANCE COMPANIES

Mr. Chairman and members of the committee, my name is Charles W. Davis. I am an attorney in private practice in Chicago, Ill., and submit this statement on behalf of my client, the National Association of Independent Insurers (NAII).

NAII is a voluntary insurance company trade association with more than 400 members. Companies, both members and subscribers, now affiliated with the organization, total 605. Companies within the membership range from the small, one-State type of company to the largest multi-State writer; from the highly specialized writer of farmers or other consumer groups to the so-called full multiple-line insurer; and from those merchandising their insurance product through the mails to those using the American agency system. Virtually every State is represented in the membership. Thus, policy is developed on the basis of a very broad consensus of the insurance business.

I recognize that the bill upon which the committee's attention is focused (H.R. 10612) does not in its present form deal with the Internal Revenue Service's administration of the employment tax area. However, I do wish to echo Secretary Simon's expressed hope that the committee will give this important area serious consideration.

In this hope, this statement is submitted to urge that you take this occasion to resolve two recurring and increasingly important problems which have arisen with respect to the application of employment tax provisions to insurance companies and to other businesses as well. The first of these problems deals with the retroactive determination that commission insurance agents, who heretofore have generally been deemed by the insurance industry and by the Internal Revenue Service to be independent contractors, are instead to be treated as employees for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the collection of income tax at source on wages (withholding). The second, and equally significant, problem deals with the inequitable multiple exaction of FICA and FUTA taxes in certain circumstances from related employers of the same employee. While these problems are not significant in terms of overall revenues of the social security, unemployment, and withholding tax systems, they impose large and unfair burdens on insurers, individuals performing services as insurance agents, and indeed, upon any business where employees perform services for more than one related corporate entity.

STATUS OF AGENTS FOR EMPLOYMENT TAX PURPOSES

The FICA and FUTA provisions of the Internal Revenue Code define the term "employee" for employment tax purposes in terms of common law rules (IRC secs. 3121(d) and 3306(i)). A similar definition is applicable for withholding purposes by virtue of Treasury Regulations sec. 34.3401(c)-1(b).

Applying these common law rules, commission insurance agents have for many years been found to fall within the category of independent contractors rather than employees. Between 1937 and 1969, seven published rulings issued by the Internal Revenue Service have considered whether commission agents representing only one company (or one group of affiliated companies) are "employees" for employment tax purposes. Each of these rulings concluded that such agents must be classified as independent contractors and not as employees. (G.C.M. 18705, 1937-2 C.B. 379; S.S.T. 249, 1938-1 C.B. 393; Rev. Rul. 54-309, 1954-2 C.B. 261; Rev. Rul. 54-312, 1954-2 C.B. 327; Rev. Rul. 59-103, 1959-1 C.B. 259; Rev. Rul. 69-287, 1969-1 C.B. 257; Rev. Rul. 69-288, 1969-1 C.B. 258.) Moreover, courts have agreed that commission insurance agents are properly classified as independent contractors rather than employees. *Reserve National Insurance Co.* v. *United States*, 74-1 U.S.T.C. par. 9486 (W.D. Okla. 1974); *Standard Life & Accident Insurance Co.* v. *United States*, 1975-1 U.S.T.C. par. 9352 (W.D. Okla. 1975), and *Kelbern M. Simpson*, 64 T.C. No. 974 (1975). In short, in a series of published rulings and under pertinent case law, it has consistently and uniformly been held that commission insurance agents are properly includable in the category of independent contractors rather than employees. There are no contrary published rulings.

However, in a number of recently issued private, unpublished technical advice memorandums, the Service, in evident disregard of its long-established position and of the case law, has held that such commission agents are employees. These unpublished memorandums, which have been issued without the support of any unpublished authority and without any announced change in the Service's position, have resulted in assessments being proposed or levied against insurance companies, including NAII's members, on a retroactive basis, on the ground that commission agents should have been treated as employees for all open years. Notably, these assessments represent in the main duplication of Federal income and self-employment taxes already paid by agents.

This retroactive shift in position by the Service has led, and must inevitably lead, to administrative and economic chaos both for the companies involved and for their commission agents. The following list of problems which result from the reclassification of commission insurance agents as employees are illustrative:

1. Huge retroactive assessments.—In several cases involving members of NAII, the Service has assessed or proposed assessing employment tax liabilities retroactively for past periods extending as much as 8 years backward. The assessments, ranging in amounts as high as $10 million to $25 million for each individual company, have been asserted without regard to the provisions of sections 3402(d) and 6521 of the Internal Revenue Code, which require offsets to withholding tax and FICA liability if employees have paid income taxes and self-

employment taxes. The result is that the assessments are grossly overstated and unfair. In large part, they represent an effort to collect taxes twice on the same compensation.

2. Inadequate and defective procedures for obtaining credits.—Because the assessments are retroactive, reaching well back into the 1960's, thousands of such agents have terminated and their present locations are unknown to the companies; also, numerous agents have died. Thus, the companies are faced with the extremely difficult burden of tracking down thousands of agents who represented them over a period of many years in order to establish the companies' admitted rights to credits under the Code.

3. The status of employees of agents.—A great many of the agents in question have their own employees. The retroactive shift of IRS position raises troublesome questions about the status of such employees of agents. The insurance companies have no control over the hiring, firing, or supervision of agents' employees, who may now be treated as employees of the companies.

4. H.R. 10 plans.—A large number of agents have adopted self-employed persons' pension or profit-sharing plans (H.R. 10 plans). These numerous plans will almost necessarily be retroactively disqualified also, inasmuch as they were adopted by persons whom the Service considers to be "employees," and who therefore are not entitled to maintain H.R. 10 plans. This means the review and correction of numerous income tax returns of agents in order to disallow deductions taken for contributions to H.R. 10 plans, as well as to disqualify the plans involved.

5. Company pension and profit-sharing plans.—In some cases, the qualified pension and profit-sharing plans maintained by the insurance companies have not provided for the coverage of agents—in accordance with published pension trust section rulings which flatly state that commission insurance salesmen cannot be covered under a qualified plan.

The retroactive change in IRS position may have the effect of disqualifying such qualified plans for failure to cover the agents in question, in the face of and notwithstanding the published position of the IRS. In one case, a District Director has already determined that a pension plan is retroactively disqualified because of failure to cover insurance agents. This results in the disallowance of deductions for contributions, taxing the income of the plan, and direct injury to thousands of employees who are beneficiaries of the plan. Retroactive disqualification of a plan necessarily means that the tax status of pension benefits and distributions is adversely affected; furthermore, employees with vested rights may become taxable immediately with respect to contributions made by the company.

6. Effect on income tax reporting.—The Service's retroactive change of position means that thousands of insurance agents in virtually every part of the United States have filed the wrong kind of income tax return schedules, reporting their earnings derived from their agencies on schedule C, form 1040 (Profit or Loss From Business or Profession). If these agents should retroactively be determined to be "employees," their tax reporting will have been erroneous, and they will be subject to different rules for the treatment of business expenses which are applicable to employees, as opposed to self-employed persons.

7. *Bonding.*—In the case of the retroactive assessments in question, the possibility of litigating before payment is not available. For this reason, the substantial deficiencies in crediting procedures (as to withholding taxes and self-employment taxes) become even more serious when companies prepare to challenge in court the duplicated and pyramided amounts discussed above. Some IRS officials have insisted that 200 percent of the entire amount of the inflated assessments for all years must be escrowed or bonded. This position not only imposes a direct financial burden on the companies' legal surplus required by State insurance laws; in some cases, the companies may be compelled to curtail operations as a result.

8. *Unequal treatment for companies and agents in the same position.*—The shift in position by the IRS has been applied ad hoc and unevenly to different companies. As late as 1971 the National Office was still issuing favorable rulings to some companies. These private rulings followed the published rulings. However, as noted above, in the last 2 years, the IRS has issued technical advice memorandums which ignore the published rulings and reach a contrary conclusion. As a result, similarly situated companies, carrying on business in the same manner with closely similar agent relationships are being treated altogether differently. Companies which obtained private rulings prior to the change in IRS position are presumably protected against application of the IRS's new rulings. On the other hand, numerous other companies, conducting their business in the same way, which had properly relied on the published rulings, are faced with huge retroactive assessments.

I respectfully submit that the serious inequities which will necessarily flow from the shift in position recently taken by the Internal Revenue Service with respect to the status of insurance agents for employment tax purposes requires that legislative action be taken to insure that commission insurance agents continue to be accorded the status of independent contractors for employment tax purposes, or alternatively, that any change in their employment tax status be prospective only.

THE MULTIEMPLOYER EMPLOYMENT TAX PROBLEM

The second employment tax problem to which I urge the committee to direct its attention relates to the current inequitable practice of subjecting related employers of the same employee to multiple liability for the same employment taxes under certain circumstances. This problem of multiple taxation is especially acute for insurance companies due to the industry operating structure that has evolved in response to State regulatory requirements. But many other kinds of companies are also affected. Every business, small or large, conducted in corporate form through subsidiaries rather than divisions, is potentially subject to the burden of multiple taxation.

The Federal Insurance Contributions Act and the Federal Unemployment Tax Act impose a tax on employers which is a percentage of wages paid to employees. The FICA tax is limited to the first $15,300 of wages paid by the employing corporation, and the FUTA tax is limited to the first $4,200 of such wages. Duplication of tax occurs whenever an employee earns more than those amounts by performing

services concurrently for more than one employer—even when the employers are part of a single enterprise under common ownership or management. Under present law, each employer is considered to have paid as wages the amount attributable to the services performed by the employee for that employer. When two or more employers employ an individual concurrently, each must pay the applicable payroll tax with respect to the first $15,300 ($4,200 in the case of FUTA) of services rendered to it by the employee. This means, for example, that if an individual is concurrently employed by two related corporations which each pay that individual $15,300, both must pay the maximum amount of payroll taxes that may be imposed on an employer with respect to any one employee. Thus, the tax is imposed, not on the first $15,300 of wages, but on the first $30,600 of wages—double the amount paid in ordinary situations. If the employee performs services concurrently for three or four corporate employers—which is often the case in the insurance industry—the tax can be tripled or quadrupled.

The problem described is particularly serious for the insurance industry because it is so structured that a great many employees work for more than one corporate entity. Insurance is extensively regulated at the State level. As a result of the different requirements in the 50 different States (including the historical fact that in some States certain lines of insurance had to be written in separate entities), an insurance enterprise often consists, legally, of a group of separate corporations operating within different States and dealing in different lines of business. Typically, a single management and a single sales force run the entire operation, picking and choosing, as the circumstances dictate, the corporate entities whose policies will technically be issued. Payroll and operating arrangements vary from company to company, but the threat common to all is that employees who are in fact working for a single integrated enterprise are, as a technical matter, performing services which ultimately benefit a number of corporate entities.

Other companies in other industries have similar problems whereever a business is operated through several subsidiaries. In contrast, if different phases of a business are operated through separate divisions within a single corporate entity, the duplicate tax penalty disappears. Thus, a wholly arbitrary and major tax penalty can attach to operating through subsidiaries, even where enterprises are operating in that manner for historic and legitimate business reasons wholly unrelated to tax considerations.

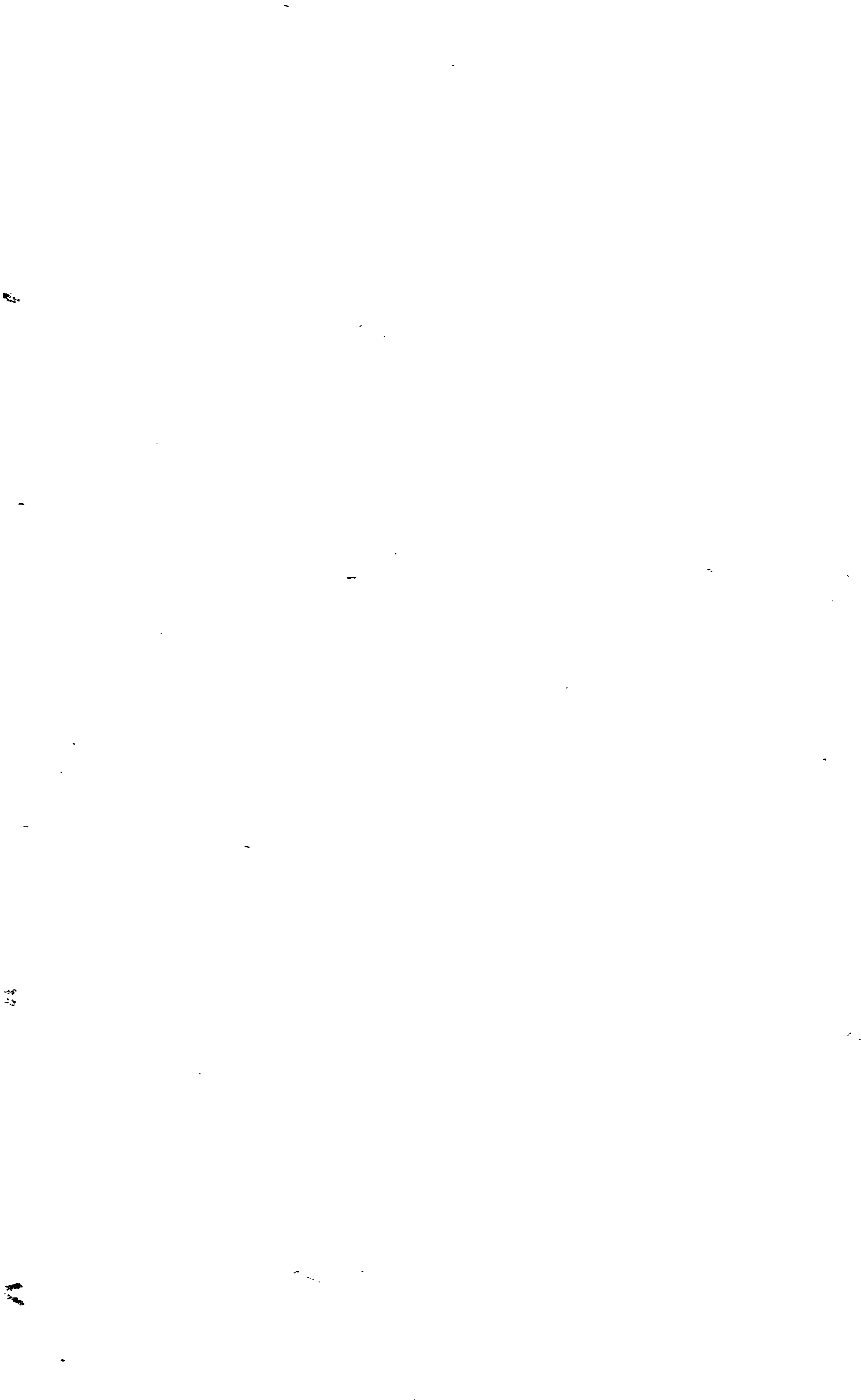
Further, this burden of excess tax is becoming increasingly heavy. The maximum FICA tax has, for example, increased approximately thirtyfold since 1949. For the first 13 years, 1937–49, the FICA tax rate was only 1 percent, applied to the first $3,000 of earnings—a maximum of $30. By 1960 the rate had climbed to 3 percent, and the wage base was $4,800. By 1970 the rate was 4.8 percent and the wage base was $7,800. In the past 4 years, accelerations in the rate and wage base have been even more rapid, so that today, in 1976, the rate is a sizable 5.85 percent, and the wage base is $15,300, having almost doubled in 5 years. Moreover, further increases are scheduled in the future. When the tax was small, duplication of tax could perhaps be overlooked as a minor imperfection in the system. But at present levels

it creates major inequities and can no longer quietly be condoned. I therefore urge the committee to alleviate this unfair multiple employment tax burden currently placed upon related employers of the same employee.

The National Association of Independent Insurers has drafted proposals for coordination among its membership which I believe would resolve the two problems which I have discussed. Should the committee decide to give consideration to this important area, we should welcome the opportunity to provide you with our proposals and to assist you in any other manner you might desire.

On behalf of the National Association of Independent Insurers, allow me to express appreciation for the opportunity to submit our views on these matters.

Personal Holding Companies



Statement by Senator James B. Allen, on S. 3288 Proposing an Amendment to the Internal Revenue Code

Senator Sparkman and I have introduced a bill (S. 3288) proposing an amendment to the Internal Revenue Code to relieve the unintended hardship of section 543(a)(6) on taxpayers who have unwittingly become trapped into a personal holding company.

Under present law a corporation can rent its properties to its shareholders without the rental income being considered to be personal holding company income unless these payments are used to shelter passive income in excess of 10 percent of the corporations' gross ordinary income. The theory behind these provisions is that rent received from stockholders for the use of corporate property in legitimate business enterprises are not intended to be classified as personal holding company income unless these rents are used to shelter other passive investment income.

However, the Internal Revenue Service has taken the technical position that where the rental property consists of both tangible and intangible property any payments which are made for intangible properties are royalties under section 543(c)(1) rather than compensation for the use of corporate property under section 543(c)(6). This position of the Internal Revenue Service prevents a taxpayer from using the present beneficial sections of the law even though the company has not been used to shelter passive investment income.

The particular case which I have in mind involves a bottling company in my State which rented all of its physical assets along with the exclusive right to bottle and sell a beverage within a specified area. The Internal Revenue Service has taken the position that any payment for the exclusive right to sell the product is a royalty and since this payment constitutes more than 10 percent of the company's gross income, it consequently is a personal holding company. Therefore, this company has been unwittingly trapped into personal holding company status because, although all of the income which it receives is for the use of the assets comprising a single business, some of this income is treated unfairly as royalty income rather than as a compensation for the use of property under section 543(a)(6).

Certainly the concern shown by Congress in enacting the present law should cover situations like this where the assets of the corporation consist of tangible as well as intangible property. Such a corporation is no more an incorporated pocketbook at which the personal holding company provisions are aimed than a corporation whose assets happen to include only tangible assets necessary for legitimate business operations. It is important to note that our amendment will apply only where the intangible assets are part of an integral group of business assets consisting of tangible and intangible assets and will not apply where the corporation merely licenses an intangible asset. Also, the amendment leaves undisturbed and preserves the existing prohibition

against using payments from shareholders for the use of business assets to shelter substantial amounts of outside investment income. The amendment also insures that rents and royalties which are described under section 543(a)(6) and are excluded from personal holding company income under that section will be excluded from sections 543(a)(1) and 543(a)(2).

Since the purpose of this amendment is to relieve the unintended hardship of section 543(a)(6) on a taxpayer who unwittingly became trapped into personal holding company status, this amendment should be made retroactive and, since the legislation is so proper, no terminal date should be adopted.

Bank Holding Company Amendments

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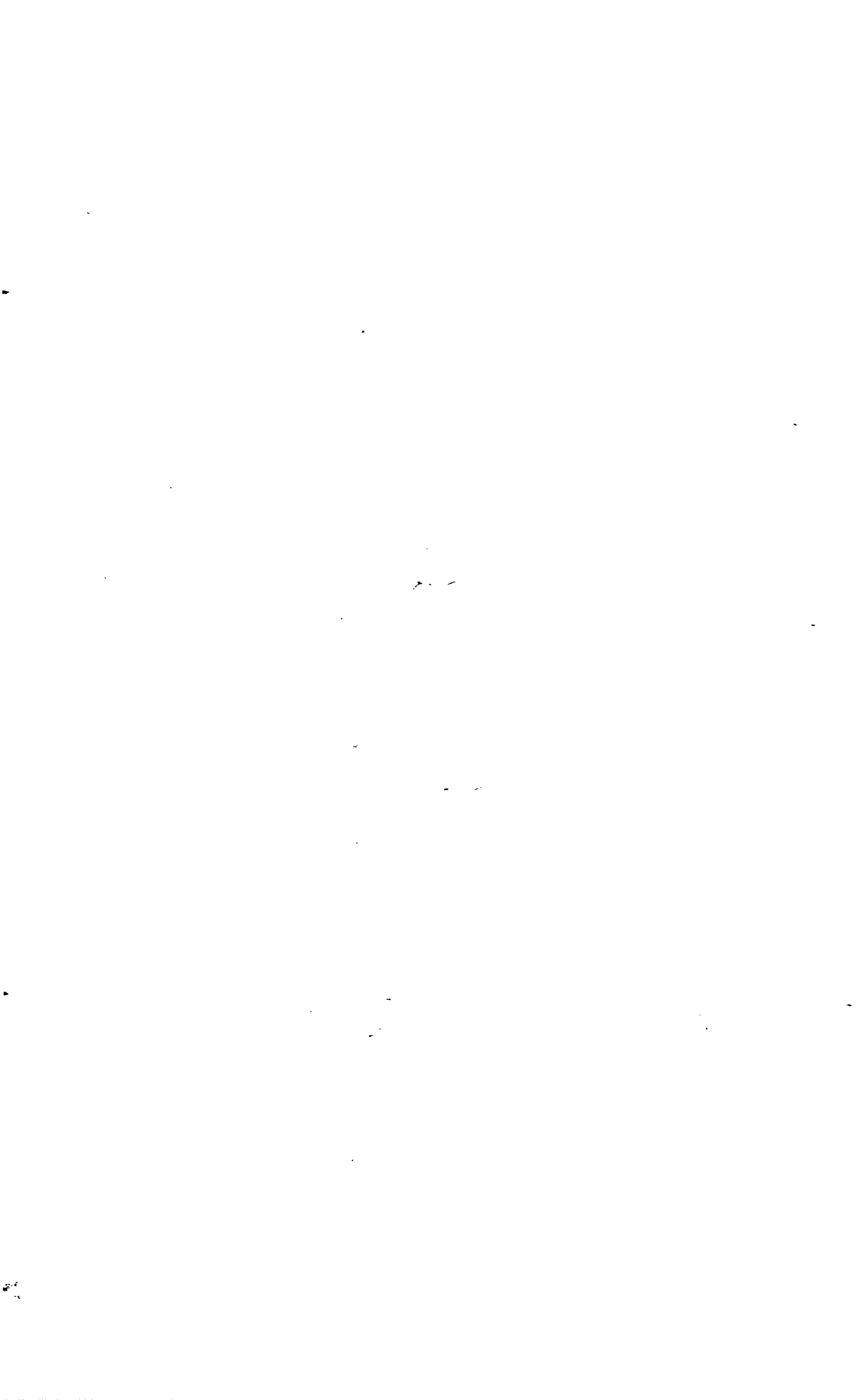


STATEMENT BY MAC ASBILL, JR. ON BEHALF OF WORLD AIRWAYS, INC.

TAX RELIEF FOR DIVESTITURE PURSUANT TO THE BANK HOLDING COMPANY ACT AMENDMENTS OF 1970

Summary

Congress should promptly enact legislation along the lines of H.R. 11997, passed by the House of Representatives on March 15, 1976, which would grant appropriate tax relief to divestitures certified by the Federal Reserve Board as "necessary or appropriate" to effectuate the purposes of the Bank Holding Company Act Amendments of 1970.

Statement

This statement is submitted by Mac Asbill, Jr., a lawyer practicing in Washington with the Washington and Atlanta firm of Sutherland, Asbill & Brennan, on behalf of World Airways, Inc., a Delaware corporation headquartered in Oakland, Calif. It advocates the prompt enactment of H.R. 11997, or its equivalent in purpose and effect. That bill would grant appropriate tax relief to divestitures certified by the Federal Reserve Board as "necessary or appropriate" to effectuate the purposes of the Bank Holding Company Act Amendments of 1970.

The adoption by the Congress of the Bank Holding Company Act Amendments of 1970 subjected so-called one-bank holding companies to the Bank Holding Company Act for the first time. Generally speaking these amendments required such holding companies to divest themselves of either their banking or their nonbanking assets before December 31, 1980. It was contemplated in 1970 that appropriate tax relief would be provided with respect to such divestitures, as had been done in the case of earlier bank holding company legislation. Thus, the report of the Senate Committee on Banking and Currency, S. Rept. No. 91-1084, provided:

> It is anticipated that the Congress will follow precedent and will pass a bill providing companies required to make divestitures under this legislation with relief from an undue tax burden as a result of such divestiture. It would be inequitable to require these divesting companies to commit themselves to a divestiture plan without knowing precisely what their tax situation will be in regard to such divestiture. Accordingly, it was deemed necessary to provide a divestiture period of sufficient length that these companies will have adequate time to make their divestiture plans after the appropriate tax relief measure is passed by Congress.

Pursuant to this commitment, the Treasury began the formulation of such relief legislation and first submitted a proposal, S. 3111, to the Congress in 1972. In 1973 an identical draft bill was introduced as S. 407. That bill provided for the tax-free spinoff (i.e., distribution to stockholders) of stock divested pursuant to the 1970 amendments and also provided for the deferral of gain realized upon the sale of divested property if the proceeds were reinvested in certain other property (the so-called rollover provision).

World Airways, which is an international and domestic supplemental air carrier, had in May 1968, through its wholly owned subsidiary, Worldamerica Investors Corp., purchased over 99 percent of the stock of First Western Bank & Trust Co., a California corporation. By virtue of this purchase, World Airways was a one-bank holding company of the type subjected to the divestiture requirements of the Bank Holding Company Act amendments of 1970. Although it might have been permitted, under the "grandfather" provision in the 1970 amendments, to retain its bank if it were willing to forego forever expansion of its nonbanking activities, World was forced, as a practical matter, to choose between retention of its bank or its nonbanking businesses. Being primarily in the air carrier business, it decided to divest itself of the bank, in that way carrying out the congressional mandate to separate its banking from its nonbanking businesses.

It was concluded for several reasons that a spinoff of the bank's stock to the shareholders of World Airways was not feasible. Worldamerica had borrowed a substantial part of the purchase price of the bank stock, and had pledged all of that stock to secure the loan. It needed the earnings produced by the bank, or the proceeds of sale, in order to pay off that loan. The pledgee, Bank of America, would not permit a spinoff of the bank stock so long as the loan was outstanding. Moreover, another loan agreement covering loans to acquire aircraft prohibited distribution of any substantial part of World's assets, including the stock of Worldamerica or the bank stock owned by that subsidiary. Thus, the only way that divestiture could be accomplished was by a sale.

It soon became obvious that because of antitrust considerations, and provisions of the Bank Holding Company Act which prevented bank acquisitions across State lines, it would be difficult to find a suitable purchaser. Indeed, the Department of Justice in 1972 challenged on antitrust grounds the sale of the bank to Wells Fargo Bank which appeared to be the only qualified California buyer with the means to acquire the bank. World concluded that as a practical matter it would probably be necessary to sell the bank to a foreign purchaser. Following termination of the Wells Fargo transaction, World began negotiations with Lloyds Bank Limited of London which resulted in the sale of the bank in January 1974, to Lloyds First Western Corp. (a wholly owned subsidiary of Lloyds Bank Limited). This sale was approved by the Federal Reserve Board. Of the approximately $7,650,000 tax attributable to the sale, about $6,800,000 had been paid by September 15, 1975; the remaining $850,000 was deferred in anticipation of being eliminated by a loss carryback from 1975.

At the time of the decision to dispose of its bank, World Airways was, of course, aware that in 1970 Congress had committed itself ultimately to providing appropriate tax relief from the hardships caused by divestitures prompted by the Bank Holding Company Act amendments of 1970. However, because of the limited number of financially competent and qualified buyers to whom the bank could be sold without violating the antitrust laws and other applicable Government restrictions, World Airways was unable, as a matter of practical economics, to await final passage of such relief legislation. Rather, faced with a narrow class of potential buyers who could be expected to avoid challenge on antitrust or other grounds, World Airways was compelled

as a matter of business prudence, once a suitable buyer could be found, to make the sale in reliance upon the promise of subsequent tax relief.

After full hearings and almost 3 years of deliberation, the Ways and Means Committee on March 4 reported out, and the House of Representatives on March 15 passed, H.R. 11997, a bill designed to grant relief from the tax consequences of divestitures required by the Bank Holding Company Act amendments of 1970. That relief takes two forms.

The first is a provision permitting a holding company to "spin off" (that is, to distribute to its stockholders) tax-free either its nonbanking assets (including stock) if the corporation elects to continue to be a bank holding company, or its banking assets (including stock) in the event the corporation elects to cease to be a bank holding company.

In recognition of the fact that such a spinoff would often be inappropriate, and in some instances impossible, for reasons such as those applicable in World's situation, the bill provides an alternative type of relief, the "installment payment method" pursuant to which a bank holding company which sells banking or nonbanking property pursuant to the Bank Holding Company Act amendments of 1970, may pay in equal annual installments the tax attributable to that sale. The installment period ends in 1985, or, if later, 10 years after the due date of the return for the year of sale. In order to encourage early dispositions in compliance with the 1970 amendments, the bill provides that interest will not be imposed upon the annual installments due in 1985 or earlier years, but that it will be imposed on any installments due thereafter. In those situations where—as in World's own case—the sale has been made and the tax paid before the effective date of H.R. 11997, the bill provides for a refund of that portion of such tax representing installment payments which would not become due until after that effective date.

The Ways and Means Committee and the House of Representatives rejected the "rollover" type of relief that is, treating the sale as an involuntary conversion, the gain on which would not be recognized provided the proceeds were reinvested in specified types of property and provided that the basis of such replacement property was appropriately reduced), because of the complexities inherent in that type of relief, especially where the sale's proceeds were invested in stock of a corporation rather than directly in replacement assets.

Because a procedural provision in the Congressional Budget and Impoundment Control Act of 1974 (that is, that, except in the event of a waiver in the Senate, neither House shall consider a bill which produces a decrease in revenues effective during the next fiscal year until the first concurrent resolution on the budget for such year has been agreed to), H.R. 11997 provides that its effective date will be October 1, 1977, the beginning of fiscal year 1978, and that no refunds will be paid pursuant to the bill prior to that date.

We believe that H.R. 11997 reasonably fulfills Congress' commitment to provide appropriate tax relief for divestitures pursuant to the 1970 amendments. We would recommend only one change, namely that the effective date provision be modified if possible so that the act will become effective upon enactment. We know of no substantive reason why the effective date should be postponed beyond that time.

More than half of the 10-year period for divestiture prescribed by the 1970 amendments has already elapsed. Consequently, it seems reasonable to expect that both those one-bank holding companies which have already accomplished that divestiture and those which have not yet done so, be apprised soon of the ground rules which will govern the tax consequences of such divestitures. Consequently, we applaud the decision of the House to deal with this issue in H.R. 11997, and we urge this committee and the Senate to take prompt action along the lines of that bill.

REPUBLIC OF TEXAS CORP.,
Dallas, Tex., May 10, 1976.

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

DEAR CHAIRMAN LONG: In response to the invitation contained in your press release dated February 5, 1976, the Republic of Texas Corp. (hereinafter "Republic") submitted a statement concerning the Bank Holding Company Tax Act of 1976 (H.R. 11997) for consideration by the Committee on Finance and for inclusion in the printed hearing record. Republic wishes to supplement such statement as set forth below.

In our previous statement, we emphasized our belief that H.R. 11997 should be modified to include rollover provisions as a third alternative method of tax relief for those taxpayers who must divest themselves of property because of the 1970 amendments to the Bank Holding Company Act. We stated our belief that rollover provisions could be designed which would not be unduly complex and which would be fair to all concerned. We believe that those goals could be accomplished by adding the attached exhibit to H.R. 11997, to be a new section 1104 of the Internal Revenue Code of 1954. The "reinvestment period" in the exhibit is the same as that contained in the 1974 draft legislation and differs from that proposed in our earlier statement. The reinvestment period proposed in the exhibit appears to be fair and to be consistent with other provisions of the code.

The operation of proposed section 1104 may be illustrated by the following examples, in which it is assumed that all property sold is prohibited property, that all property purchased is qualifying replacement property, that all purchases, except as noted, are made within the relevant reinvestment period and that the appropriate elections are made:

Example (1).—Assume that the taxpayer sells all of the stock in A for $10 million. The taxpayer's basis in the A stock is $1 million, and A's basis in its assets is $3 million. The taxpayer buys all of the stock of X for $10 million. X's basis in its assets is $5 million. The taxpayer would recognize a gain of $2 million under section 1104(e) (1) X's asset basis − A's asset basis). Its basis in the X stock would be $3 million under section 1104(d).

Example (2).—Assume the same facts as in example (1) except that the taxpayer buys all of the stock of X for $7 million and all of the stock of Y for $3 million. X's assets have a basis of $5 million

and Y's basis in its assets is $1 million. The taxpayer would recognize a gain of $3 million under section 1104(e)(1). (X's asset basis − A's asset basis) + (Y's asset basis − A's asset basis [reduced pursuant to sec. 1104(e)(3)]). The taxpayer's basis in the X stock would be $2,700,000 ($700,000 under section 1104(d)(1) and $2 million under sec. 1104(d)(2)); its basis in the Y stock would be $1,300,000 ($300,000 under sec. 1104(d)(1) and $1 million under section 1104(d)(2)).

Example (3).—Assume the taxpayer sells all of the stock of A for $10 million and all of the stock of B for $8 million. The taxpayer's basis in the A stock is $2 million and $3 million in the B stock. A's basis in its assets is $6 million, and B's basis in its assets is $2 million. The taxpayer buys all of the stock of X for $9 million and all of the stock of Y for $9 million. X's basis in its assets is $4 million, and Y's basis in its assets is $5 million. The taxpayer would recognize a gain of $1 million under section 1104(e)(1), computed in the one of the following methods:

(*a*) (X's asset basis − A's asset basis) = 0 gain. (Y's asset basis − (B's asset basis + A's asset basis [reduced for this purpose only by $4 million pursuant to sec. 1104(e)(3)]) = $1 million gain.

Under this method, he taxpayer's basis in the X stock would be $2,500,000 under section 1104(d)(1), and its basis in the Y stock would be $3,500,000 ($2,500,000 under sec. 1104(d)(1) and $1 million under sec. 1104(d)(2)).

(*b*) (Y's asset basis − B's asset basis + A's asset basis) = 0 gain (X's asset basis − (B's asset basis + A's asset basis, reduced by $2 million and $3 million, respectively, pursuant to section 1104(e)(3)) = $1 million gain.

Under this method, the taxpayer's basis in the X stock would be $3,500,000 ($2,500,000 under sec. 1104(d)(1) and $1 million under sec. 1104(d)(2)), and its basis in the B stock would be $2,500,000.

In this example, it would appear appropriate to allow the taxpayer to elect between method (a) and method (b).

Example (4).—Assume the same facts as in example (3) except that the acquisition of the stock of X is within the reinvestment period for the sale of both A and B, but the acquisition of the stock of Y is within the reinvestment period for the sale of B only. With respect to the sale of A, the taxpayer has a gain of $1 million under section 1104(a) and a basis in the X stock of $2 million under section 1104(d)(1). With respect to the sale of B, the taxpayer has a gain of $3 million under section 1104(e)(1) (Y's asset basis − B's asset basis) and a basis of $7 million in the Y stock ($4 million under sec. 1104(d)(1) and $3 million under sec. 1104(d)(2)).

The foregoing examples illustrate the relative simplicity of applying the rollover method proposed herein. Additionally, we believe that section 1104(e) answers the concern which was behind the complex, unfair "double basis reduction" in the 1974 draft of H.R. 11997. Under the proposel herein, a taxpayer could not obtain the benefit of purchasing the stock of a corporation whose asset basis is higher than the basis of the assets sold by the taxpayer without paying a capital gains tax.

We wish to emphasize that we urge the "rollover" concept as a third available method of relief—not to replace either the spinoff or the

installment method, both of which are useful and should be retained; and that the installment method would be available against any gain partially recognized because of the "rollover" reinvestment of a part, but not all, of the proceeds of sale of prohibited property. The Republic of Texas Corp. strongly supports the passage of H.R. 11997 with the modification discussed herein and in our previous statement.

Sincerely,

JAMES D. BERRY, *President.*

SEC. 1104. CERTAIN SALES PURSUANT TO BANK HOLDING COMPANY ACT AMENDMENTS OF 1970

(*a*) *Nonrecognition of gain.*—If, after July 7, 1970, a bank holding corporation sells bank property or prohibited property, the divestiture of either of which the Board certifies, before such sale, is necessary or appropriate to effectuate section 4 or the policies of the Bank Holding Company Act, at the election of the taxpayer gain realized from such sale (except as provided in subsec. (c)) shall be recognized only to the extent that the amount realized on such sale exceeds the cost of qualifying replacement property purchased during the reinvestment period. Such election shall be made at such time and in such manner as the Secretary may by regulation prescribe. This section shall not apply to any sale of prohibited property if the taxpayer (or a corporation having control of the taxpayer or a subsidiary of the taxpayer) has made an election under this section with respect to bank property or has made any distribution pursuant to section 1101(b). This section shall not apply to bank property if the taxpayer (or a corporation having control of the taxpayer or a subsidiary of the taxpayer) has made an election under this section with respect to prohibited property or has made any distribution pursuant to section 1101(a).

(b) *Reinvestment period.*—The reinvestment period referred to in subsection (a) shall be the period beginning 2 years before the date of disposition of the prohibited property or bank property, as the case may be (but not before July 8, 1970), and ending 2 years after the date of disposition of such property, or ending at the close of such later date as the Secretary may designate for reasonable cause shown.

(c) *Qualifying replacement property.*—

(1) For purposes of subsection (a), qualifying replacement property means property which is permitted to be held without any requirement of divestiture under the Bank Holding Company Act of 1956, as amended by the Bank Holding Act Amendments of 1970, and which is—

(A) Stock of another corporation if, immediately after the purchase of such stock, the acquiring corporation has control (as defined in section 368(c)) of such other corporation (whether or not such acquiring corporation had such control immediately before the purchase); or

(B) Substantially all the assets of another corporation used in the trade or business of such corporation.

An acquisition described in subparagraph (A) shall not be treated as a purchase for purposes of section 334(b)(2).

(2) For purposes of this subsection—

(A) Property acquired before a disposition of prohibited property or bank property shall be considered to have been acquired for the purpose of replacing such property only if held by the taxpayer on the date of such disposition;

(B) The taxpayer shall be considered to have purchased property only if, but for the provisions of subsection (d) of this section, the unadjusted basis of such property would be its cost within the meaning of section 1012; and

(C) The taxpayer shall be considered to have purchased stock only if the taxpayer's purchase of such stock was not a transaction to which section 1032 applied.

(*d*) *Basis of qualifying replacement property.*—

(1) If an acquisition of property results in the nonrecognition of gain pursuant to this section, the basis of such property shall be the cost thereof decreased in the amount of gain not so recognized; if the property acquired consists of more than one piece of property, the basis determined under this subparagraph shall be allocated to the acquired properties in proportion to their respective costs. For purposes of this subparagraph, gain recognized under subsection (e) shall be deemed not to have been recognized.

(2) If an acquisition of stock results in the recognition of gain under subsection (e), the basis of such stock determined under subparagraph (1) of this subsection shall be increased by the amount of such gain.

(*e*) *Recognition of gain in certain cases.*—

(1) In the case of an acquisition described in paragraph (1)(A) of subsection (c), if the basis of the assets of the acquired corporation in the hands of such corporation exceeds—

(A) the basis in the hands of the taxpayer of the property described in subsection (a) the gain from the sale of which is not recognized in whole or in part under this section by reason of such acquisition, or,

(B) if such property described in subsection (a) is stock of a corporation, the basis of the assets of such corporation in the hands of such corporation,

then the gain from the sale of such property shall nevertheless be recognized to the extent of such excess.

(2) In the case of a sale of stock of a corporation with respect to which an election is made under subsection (a) which was not a sale of all of such stock with respect to the sale of which the taxpayer could have made an election under this section or which was not a sale of all of the outstanding stock of such corporation, the basis of the assets of the corporation the stock of which was sold shall, for purposes of paragraph (1) of this subsection, be considered to be that part of the total basis of such assets in the hands of such corporation that bears the same relationship to such total basis as the fair market value of the stock sold bears to the fair market value of the total outstanding stock of such corporation.

(2) Solely for purposes of applying paragraph (1) of this subsection to an acquisition, the basis in the hands of the taxpayer of property described in subsection (a) or the basis of the assets in the hands

of the corporation the stock of which is described in subsection (a), as the case may be, shall be reduced by the amount of such basis that prevents the recognition of gain when such paragraph is applied to any other acquisition.

(f) *Assessment of deficiencies.*—If the taxpayer has made an election under subsection (a) with respect to a sale, then notwithstanding any other provision of law or rule of law the statutory period for the assessment of any deficiency (including interest and additions to the tax) shall not expire until 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of the purchase of qualified replacement property or the failure to timely purchase such property. Such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(g) *Installment method.*—The tax under chapter 1 attributable to recognized gain from a sale with respect to which an election is made under subsection (a) shall, at the election of the taxpayer, be payable in the manner specified in section 6158. An election under this subsection shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. This number and due dates of installments of such tax shall be determined in the manner specified in section 6158 as if the taxpayer had made a timely election under such section and had not made an election under subsection (a) with respect to such sale; for purposes of section 6158(c)(1), no such installment shall be considered not paid on or before the date fixed therefor if such installment is paid on or before the due date (determined without extension) for the taxpayer's return of tax under chapter 1 for the taxable year in which gain from such sale is recognized under this section. The last sentence of section 6601(b)(2) shall not apply to any installment that, but for the preceding sentence, would have been considered not paid on or before the date fixed therefor.

"(h) *Definitions.—For purposes of this section—*

(1) *Terms have meanings given to them by section 1103.*—The terms "qualified bank holding corporation" "Bank Holding Company Act," "Board"; "control" (except for purposes of subsection (c)), and "subsidiary" have the respective meanings given to such terms by section 1103.

(2) *Prohibited property.*—The term "prohibited property" means property held by a qualified bank holding corporation which could be distributed without recognition of gain under section 1101(a)(1).

(3) *Bank property.*—The term "bank property" means property held by a qualified bank holding corporation which could be distributed without recognition of gain under section 1101(b)(1).

REPUBLIC OF TEXAS CORP.,
Dallas, Tex.

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

DEAR CHAIRMAN LONG: In response to the invitation contained in your press release dated February 5, 1976, the Republic of Texas

Corp. hereby submits its statement concerning the Bank Holding Company Tax Act of 1976 (H.R. 11997) for consideration by the Committee on Finance and for inclusion in the printed hearing record. The Republic of Texas Corp. (hereinafter "Republic"), a registered bank holding company located in Dallas, Tex., urges the Finance Committee to approve H.R. 11997, with the modifications discussed below. The enactment of this bill into law would represent the fulfillment of the express commitment of Congress to provide tax relief to those bank holding companies which were forced to divest property as a result of the 1970 Amendments to the Bank Holding Company Act.

HISTORY OF H.R. 11997

In 1956, Congress passed the original Bank Holding Company Act in order to compel bank holding companies to separate their banking from their nonbanking activities. Under section 4 of that act, a covered bank holding company was required within specific time limits either to divest its nonbanking assets or to divest its banking assets and to cease being a bank holding company. Corporations which were classified as bank holding companies in 1956 (because they controlled two or more banks) were permitted by that act to make tax-free distributions, or "spinoffs," of those banking or nonbanking assets which they were required to divest. Congress had enacted the spinoff provision because it had recognized that it would be unfair to require bank holding companies to restructure their businesses by divesting property (which, in the absence of legislation, they would have continued to hold) without providing equitable tax treatment for the proceeds which would be received upon the disposition of the prohibited assets.

In 1970, Congress amended the Bank Holding Company Act and thereby expanded the definition of "bank holding company" to include any company which directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities of just one bank. By expanding the definition, Congress intended to subject each "one bank holding company" to the divestiture requirements of section 4 of the act.

When Congress included one-bank holding companies within the scope of the Bank Holding Company Act in 1970, it recognized that unless it passed tax relief legislation similar to that provided in 1956, forced divestiture would create harsh tax consequences.[1] For example, under current Internal Revenue Code provisions, a bank holding company which is required by the act to sell either the stock in, or the assets of, a nonbanking subsidiary to a third party is also compelled to recognize immediately the full amount of capital gain realized from the sale, unless the strict requirements of the installment sale provisions of section 453 are satisfied. If the bank holding company decides, instead, to distribute the stock it holds in a nonbanking subsidiary to its own shareholders, then unless the stringent requirements of section 355 of the Code are satisfied, the distribution will be treated as a taxable dividend the share holders will be required to realize ordinary income on the fair market value of the stock they receive.

[1] Congress also amended the Bank Holding Company Act in 1966, and tax relief was provided to those bank holding companies brought within the divestiture provisions of the act at that time.

Congress clearly intended to alleviate the impact of these consequences through the contemporaneous passage of tax relief legislation. For example, the Senate Banking and Currency Committee stated that

> It is anticipated that the Congress will follow precedent and will pass a bill providing companies required to make divestitures under this legislation with relief from an undue tax burden as a result of such divestiture. It would be inequitable to require these divesting companies to commit themselves to a divestiture plan without knowing precisely what their tax situation will be in regard to such divestiture. Accordingly, it was deemed necessary to provide a divesture period of sufficient length that these companies will have adequate time to make their divestiture plans after the appropriate tax relief measure is passed by Congress. [S. Rept. No. 91-1084, 91st Cong., 2d Sess. (1970)].

Later in the same report, the committee stated that it wished ". . . to insure that required divestitures are made as quickly as possible, as efficiently as possible, and with as little economic loss to the divesting company as possible."

In order to carry out the express intent of Congress, the House Ways and Means Committee tentatively approved legislation in November 1974, which provided three alternative methods of tax relief for bank holding companies which makes divestitures that the Federal Reserve Board certifies are necessary or appropriate to carry out the purposes of the act. The first method was a "spinoff" provision similar to that provided in 1956. The second method, which was termed "rollover" treatment, allowed the tax on the gain from a sale of nonbanking or banking property to be deferred, if the proceeds of that sale were reinvested in "qualified replacement property" and appropriate reductions in the basis of the qualifying replacement property were made. The third method permitted the installment payment over a specified period of time of taxes on capital gain realized from a sale of nonbanking or banking property.

This draft legislation was not reported out of the Ways and Means Committee in 1974, and consequently, the committee began its deliberations anew in 1976. Hearings were held on January 27, 1976, and the Republic of Texas Corp. and other interested parties testified. The product of those hearings and subsequent markup sessions was H.R. 11997, the "Bank Holding Company Tax Act of 1976." H.R. 11997 was overwhelmingly approved by both the Ways and Means Committee and the full House of Representatives and was referred to the Senate Finance Committee on March 16, 1976.

EXPLANATION OF MAJOR PROVISIONS OF H.R. 11997

In general, a corporation subject to the divestiture provisions of the Bank Holding Company Act is given its choice of alternative routes—to remain a bank holding company and divest its prohibited nonbanking property, or to dispose of its interest in banking property and, as a result, cease to be a bank holding company. Republic has decided to remain a bank holding company. Accordingly, it must divest itself of any "prohibited property," that is, nonbank property, by a specified statutory deadline.

H.R. 11997 provides two alternative methods of tax relief for Republic's divestitures of nonbank property. First, the bill (like the 1974

draft), provides a spinoff option under which a bank holding company may distribute its nonbanking assets to its own shareholders (or, in some cases, security holders) without an inclusion in income or a recognition of gain by these stock (or security) holders, but with appropriate basis adjustments. This "spinoff" approach is generally the same as that adopted with respect to divestitures under the original bank holding company legislation enacted in 1956 and 1966.

Second, the bill permits a bank holding company to sell its nonbanking property in a taxable sale or exchange and to pay the income tax incurred at the corporate level in installments over at least a 10-year period. While Republic supports the retention of both of these methods of tax relief, it is imperative that the Finance Committee modify the bill in order to recognize the particular problems faced by certain bank holding companies in making their required divestitures.

THE NEED FOR REVISION OF H.R. 11997

During the Ways and Means Committee hearing of January 27, 1976, Republic and several other bank holding companies urged the committee to include H.R. 11997, a third alternative method of tax relief—the "rollover" method. In 1974, the Ways and Means Committee did include a rollover provision in its draft bill. Under the 1974 provision, a bank holding company would not have been required to recognize immediately a capital gain on the sale of divested property if it reinvested the proceeds of that sale in qualified replacement property. The tax would be deferred until the date on which the replacement property was sold.

The rationale supporting the rollover method of tax relief is that there is no reason to impose harsh tax consequences on a bank holding company, so long as it complies with the divestiture requirements of the Bank Holding Company Act and reinvests in qualified replacement (permissible) assets. As noted in the testimony of Mr. William Goldstein, Deputy Assistant Secretary of the Treasury for Tax Policy, "Ideally, a carefully drafted rollover proposal would maintain a bank holding company in essentially the same tax position after the required divestiture as it was in prior thereto." (Hearings on bank holding company divestitures before the Committee on Ways and Means, 94th Cong., 2d sess., at 6 (1976). Rollover treatment simply provides for tax deferral, not tax avoidance; it defers the tax impact until a subsequent voluntary sale of the replacement property. The rollover concept is common in the Internal Revenue Code, for example, section 1033 on involuntary conversions and section 1071 on FCC forced divestitures.

Despite the compelling logic of the rollover method, it is not included in H.R. 11997.

In his testimony before the Ways and Means Committee, Deputy Assistant Treasury Secretary Goldstein stated that the rollover provisions contained in the 1974 draft legislation involved "a number of intractable problems in the Code which, if attempted to be resolved, would give rise to extreme complexity in the Code, or which, if left unresolved, might often result in tax treatment which is either far too generous or not generous enough." However, Secretary Goldstein

stated that the Treasury Department would not characterize the rollover concept as unacceptable, but believed that it was unnecessary because of the installment method.

On analysis the reasons for not including the rollover concept seem inadequate. While unnecessary complexity certainly should be avoided, avoiding complexity, without more, is not a reason for inequitable treatment. As discussed below, we believe that rollover treatment can be provided without undue complexity. Moreover, the rollover concept is necessary to provide sufficient flexibility and fair treatment to those affected by the 1970 amendments to the Bank Holding Company Act.

The spinoff and installment methods, although useful in many situations, are not sufficient because they do not provide the fairest method of tax relief.

On balance, the rollover method is the fairest kind of tax relief when Congress forces a sale of particular property, and the proceeds from such sale are reinvested in qualified replacement property. The installment method provides limited relief in forced divestitures, but the rollover method is fairer since taxation is postponed until the taxpayer effects a voluntary disposition of the replacement property. The imposition of a tax because of a forced sale of property would be in the nature of a levy on the ownership of capital, which is contrary to our system of taxing income generated by voluntary actions of taxpayers. Rollover treatment is fair; it permits disposition and reinvestment without loss of capital.

Second, Republic believes that a rollover provision can be drafted which will not be too complex and which will be equitable both to the Treasury and to bank holding companies. Admittedly the 1974 draft legislation "rollover" provision was exceedingly complicated (as well as being really inequitable to the taxpayer). It is believed that the concern of the Treasury Department and the Ways and Means Committee, which led to the complicated rollover provisions in the 1974 draft legislation can be evidenced by the following example: Suppose that a bank holding company sells prohibited assets with a low basis, for example, $100,000, for their then fair market value of, for example, $1 million. It then reinvests the $1 million in stock of a corporation owning assets which constitute qualified replacement property which assets have a value of the same $1 million but have a much higher basis than $100,000, for example, $1 million.

This higher asset basis possibly would furnish higher deductions, such as depreciation, in the bank holding company's future consolidated returns than would have been available had the prohibited property been retained with its lower $100,000 basis—the stock of the acquired corporation would have the $100,000 carryover basis under the rollover concept—not the assets of the assigned corporation. It was apparently believed that this possibility would encourage bank holding companies to look for corporations to buy which would fit this example, so as to obtain the advantage of higher asset bases without having to pay a corresponding capital gain tax. To avoid this possible "abuse," the 1974 draft legislation contained the so-called double basis reduction.

Under the double basis reduction concept, if a bank holding company had made a qualifying reinvestment in stock of a corporation, the basis

of both the stock and of the corporation's underlying assets had to be reduced by the amount of the deferred gain; the priority of basis reduction in the various types of corporate assets was complicated and really more than unfair to the bank holding company. This double basis reduction feature was widely regarded as too complex to administer and grossly unfair to the taxpayer.

A rollover provision which would be fair to the holding companies, relatively simple to administer, and not open to the above abuse can, however, be designed. Such a provision would work as follows:

A qualified bank holding company or one of its subsidiaries would sell assets and/or stock of a corporation which constituted prohibited property and reinvest in the stock of another corporation as qualified replacement property.[3] The basis of the assets and/or stock sold would be transferred to the stock of the corporation purchased, and there would be no adjustment to the basis of the assets of the corporation purchased. However, if the corporation purchased held assets with a basis which exceeded the basis in the assets sold (or as the case may be, the basis in assets held by the corporation whose stock was sold) then the holding company would recognize gain on such excess and pay the tax thereon under the installment method provided in H.R. 11997. The basis of the stock in the replacement corporation would be equal to the basis in the assets or stock sold, increased by the amount of the recognized gain. If the assets held by the purchased corporation had the same or a lower basis, then no gain or loss would be recognized.

This provision would place the holding company in no better position than it was in prior to the forced divestiture. The holding company would pay a tax as if it realized gain to the extent it obtained the benefit of any increase in asset basis. However, the problems associated with "double basis reduction" are eliminated; the difficult accounting problems associated with the priority in which the acquired corporation's assets bases are reduced is completely eliminated, and deferred gain would no longer be subject to double taxation—once when the acquired corporation's assets are sold and again when the stock of the corporation is sold. Moreover, the possibility that all or a substantial portion of the deferred gain will be converted from capital gains into ordinary income is eliminated because, unlike double basis reduction, the basis of assets of the acquired corporation will no longer be reduced.

In short, this proposal triggers the same kind of recognition that is provided by the code in all cases where assets with a low basis are sold and the proceeds are reinvested in new assets. Furthermore, the proposal is much simpler than the double basis adjustments contained in the 1974 draft bill.

Assuming that your committee determines, as we urge, to adopt a fair "rollover method" as well as the "installment method," then we would further emphasize that it should provide that to the extent sales proceeds are not reinvested in qualified replacement property, tax would be due with respect to such noninvested proceeds (just as section 1033 of the code presently provides with respect to the gain from involuntary conversions) and could be paid on the installment method as already provided in H.R. 11997. This would be simple and fair—allow rollover to the extent of qualified reinvestment, and installment payment to the extent of any gain. The period within which reinvest-

[3] Although the possible "abuse" does not exist if assets rather than stock of a corporation are purchased as replacement property, the provision must permit stock of a corporation owning qualified replacement property to be purchased (as well as assets) since as a practical matter replacement property consisting of banking type assets can only readily be purchased in the form of stock of banking corporations.

ment would be allowed should start with the date by which final divestiture is required by the Federal Reserve Board and extend for at least 3 years thereafter, so as to give a reasonable time to find proper replacement property. The provision should apply to totals only (not on an asset-by-asset basis, which would be complicated accounting wise) so that the total proceeds from assets sold before the final divestiture date would be compared with the total reinvestments within the subsequent 3-year period. This would be simple and easy to administer. The election for rollover treatment and the effect of a subsequent failure to rollover within the specified time limit could also be handled in the same fashion as involuntary conversions are now treated under section 1033. (*See* Regs. 1.1033(a)-2.)

Finally stock would be allowed as qualified replacement property only if acquired by purchase from a third party. Purchase of newly issued stock or treasury stock (where the cash went directly into a corporation) would not be allowed as qualified replacement property so as to avoid the double basis adjustment problems (compare section 362(c) of the code) previously referred to.

The combination of the rollover and installment methods of relief would be fair to both taxpayer and government, would offer no opportunity for abuse, and would avoid undesired complexities. And we wish to emphasize again that even if the addition of the simplified rollover method is slightly more complex than its complete absence, this is hardly justification for its non-use. If fairness justifies use of the rollover method, it should be adopted.

In this connection, it is important to note that bank holding companies are now placed at a substantial disadvantage in negotiating with prospective buyers who are aware of the pressure the companies are under to dispose of their prohibited property under the statutory time limits. For example, Republic's original statutory deadline for divestiture was May 9, 1976. Fortunately, we have been able to obtain a 1-year extension of our deadline. However, as Congress said in 1970:

> [U]nder these circumstances, it will be a buyer's market and the sellers may not be able to get fair market value for the assets they are divesting, particularly if they are all required to divest simultaneously within a relatively short period of time. [S. Rep. No. 91-1084, 91st Cong. 2d sess. (1970)].

It seems only fair then that Congress should, to the extent possible, provide the maximum flexibility to a bank holding company in connection with divestitures which are to be made in such a short remaining period of time.

One other modification to H.R. 11997 is also necessary. Republic is a successor bank holding company which was created in 1974 through a triangular statutory merger. H.R. 11997 extends the full measure of tax relief to Republic and any other similarly situated successor bank holding companies whose creation did not constitute a change in ownership of prohibited assets. However, in order to obtain approval from the Federal Reserve Board of its application to become a bank holding company, Republic had to commit itself to divestiture of certain of its bank properties. Tax relief should be made available for these divestitures as well, since the same adverse tax consequences will otherwise follow divestiture regardless of the nature of the property divested. While the 1974 draft bill made tax relief for sales of banking or nonbanking assets mutually exclusive, as does H.R. 11997, we believe this

limitation should be eliminated in any situation where approval of the creation of a bank holding company was conditioned upon divestiture of bank properties and where the Federal Reserve Board certifies that the disposition is necessary or appropriate to effectuate the policies of the Bank Holding Company Act.

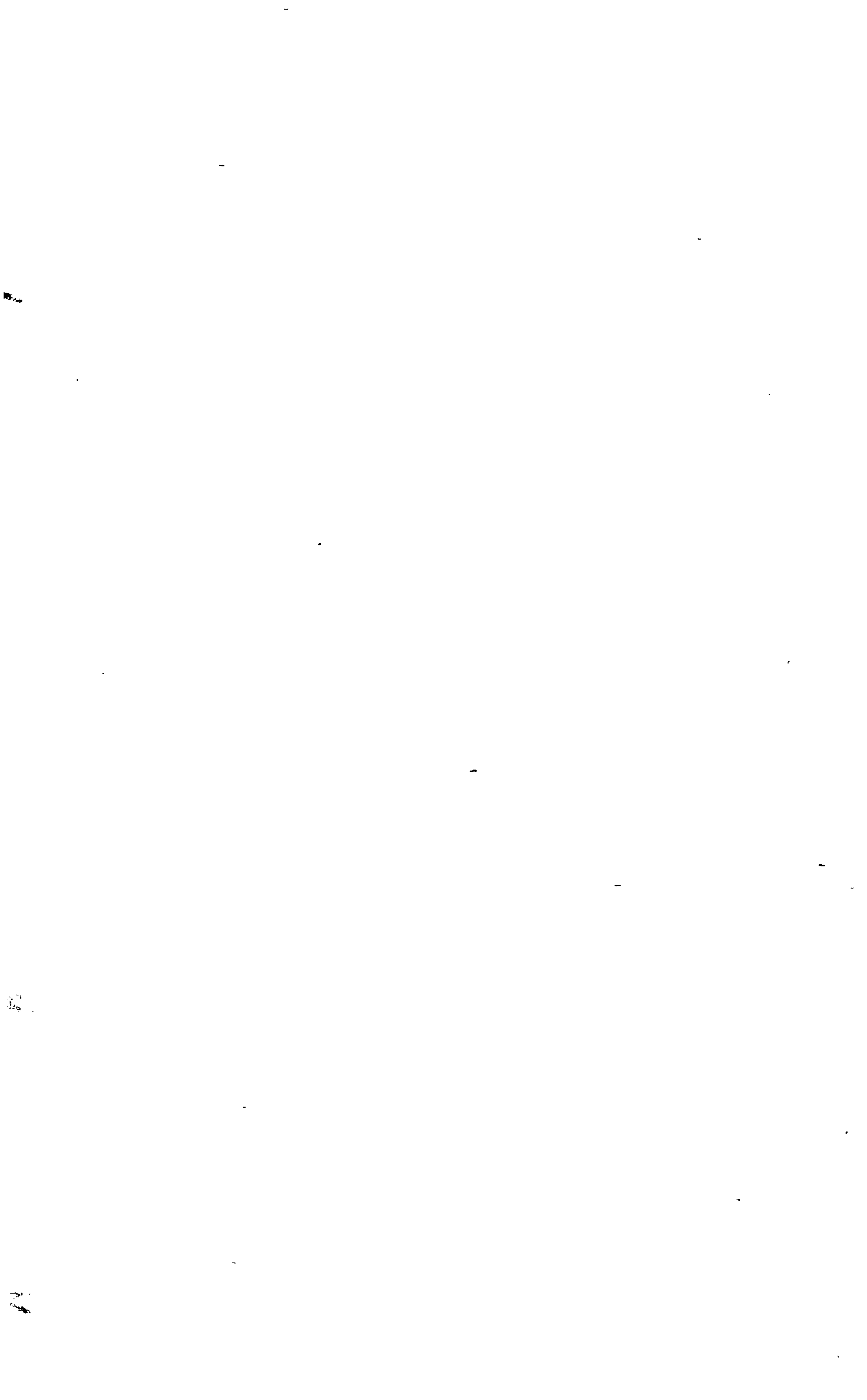
There are also some necessary minor technical modifications which counsel for Republic of Texas Corp. will discuss with the staff.

CONCLUSION

The Republic of Texas Corp. strongly supports the passage of H.R. 11997 with the modifications discussed above. It is hoped that Congress will act now to fulfill its 1970 commitment to provide tax relief legislation to bank holding companies affected by the passage of the 1970 amendments to the Bank Holding Company Act.

Sincerely,

JAMES D. BERRY, *President.*



Mortgage Interest Tax Credit

VETERANS OF FOREIGN WARS,
Washington, D.C.

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

MY DEAR MR. CHAIRMAN: The Veterans of Foreign Wars of the United States is deeply concerned with the inability of the average Vietnam era veteran to purchase a home due to both the high cost of the property and current interest rates. Therefore, one of my priority legislative goals for this Second Session of the 94th Congress is to seek improvement of the current housing program.

Relative to the foregoing, your colleague, the Honorable Thomas J. McIntyre of New Hampshire, has introduced S. 2772 identified as the "Uniform Tax Treatment of Financial Institutions Act." We have been advised this legislation would reduce mortgage interest rates by the Federal National Mortgage Association if included as much as one-half of one percent, thus reducing somewhat the burden of home ownership by veterans.

In reviewing this legislation, I find on Page 24 under the heading "Credit Disallowed" that the Federal National Mortgage Association is specifically excluded from enjoying the tax credit afforded other lending institutions. Such exclusion would quite obviously place the Federal National Mortgage Association in a disadvantaged position both in borrowing money and competing on the open market in so far as interest rates on loans are concerned. We believe such an unfavorable market position would be a disservice to veterans, since the Federal National Mortgage Association's purchases are comprised of nearly 50 percent of Veterans Administration guaranteed home loans, the actual figures being 48.7 percent for the calendar year 1974 and 47.9 percent the first three-quarters of calendar year 1975.

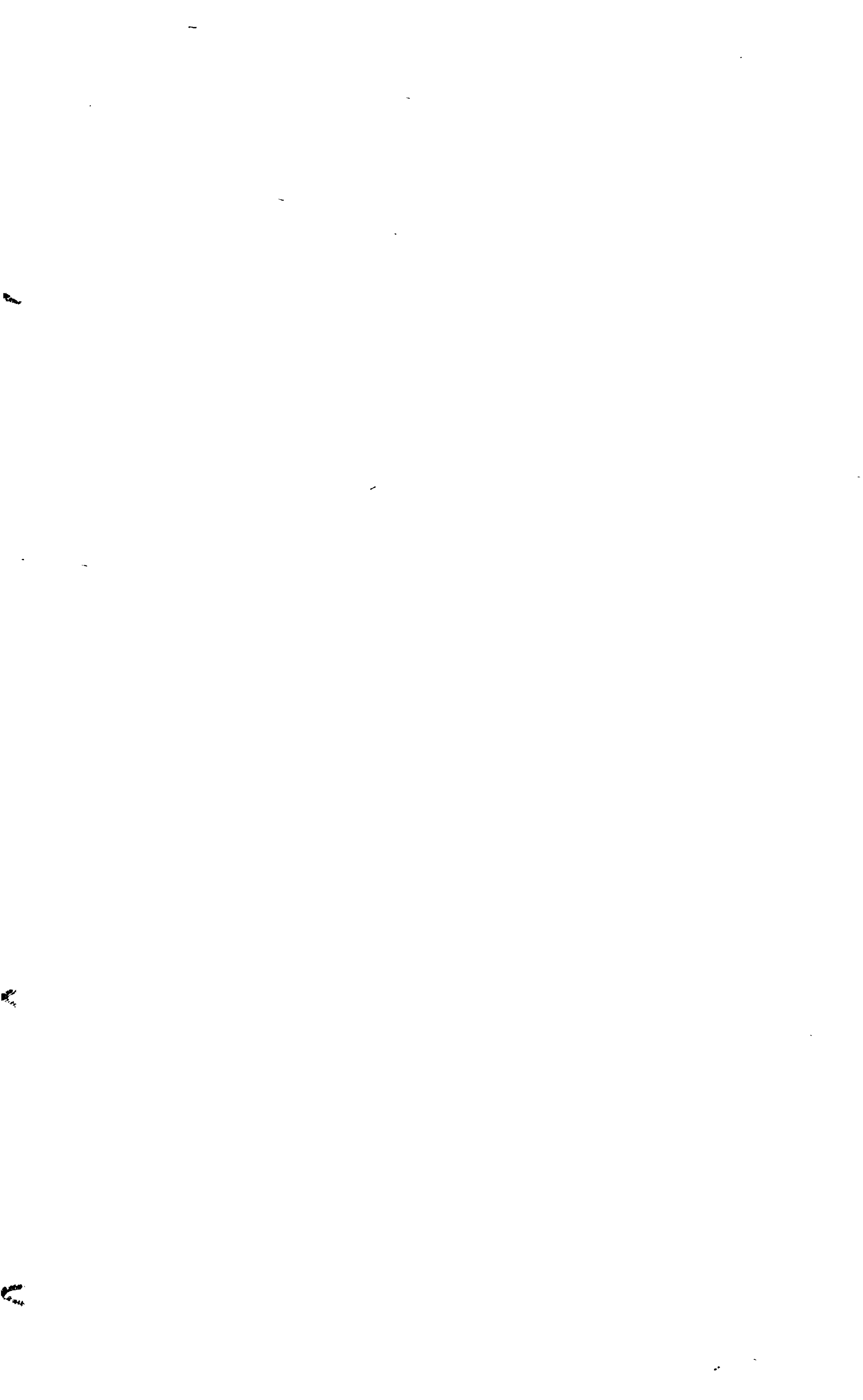
In view of the foregoing I would urge amendment to S. 2772 by, on Page 24 beginning with Line 22, striking out all language through Line 4 on Page 25, and substituting therefor the following: Under Subsection (a) "shall be denied to a taxpayer that is formed or availed of primarily for the purpose of obtaining such credit"; and on Page 25 strike Line 7 and insert in lieu thereof "this paragraph." Such amendment would permit the Federal National Mortgage Association to avail itself of the mortgage interest tax credit in the same manner and to the same extent as any other taxpayer.

The sole interest of the Veterans of Foreign Wars in this legislation, Mr. Chairman, is to make housing available at the very best rate from all sources for the veterans of this Nation who have contributed so much in the service of their country.

With best wishes and kind personal regards, I am

Sincerely,

THOMAS C. "PETE" WALKER,
Commander-in-Chief.



Value-Added Tax

Statement of Richard W. Lindholm, Professor of Finance, University of Oregon

This is a statement of an academic economist who feels the domestic and foreign climate for U.S. introduction of the value-added tax (VAT) has been right since 1960 and that a great opportunity was missed when VAT was not actively supported by the U.S. Treasury in 1965 when the European community's direction became apparent.

TAX SPECIALIST HANGUP

The VAT in both the U.S. and the United Kingdom has suffered from academic and government tax specialist pro-income tax bias. In April, 1971 the United Kingdom finally broke through the prejudices of its tax specialists. The quicker the United States does the same the sounder the world and U.S. economies will be.

In the words of Professor Kaldor, famed British economist and author of the best selling tax book, The Expenditure Tax, "British economists have been completely mesmerized in their efforts to define income" and "much too little has been done on the usefulness of income, however defined, to measure ability to pay taxes." Kaldor, a member of the Labour party's inner advisory group, is a longtime critic of the ability of the income tax to reach the right individuals or the correct element of society if economic growth or tax justice is to be maximized.

MAIN ARGUMENTS FOR VAT FOR U.S.

The first step to be taken to develop an intellectual position as to whether VAT is good or bad for the U.S. is to admit tax collecting at high progressive rates does not create the income redistribution sought. The next step is to accept the position that government is going to reduce poverty and equalize people opportunities through spending wisely—if it is going to do it at all.

The base of VAT can be as broad as GNP, and therefore large revenues can be raised with low rates applied to sales less purchases from VAT paying suppliers. Like the corporate income tax VAT is collected from business enterprises, but because the base is all value-added, and not just profits, the revenues provided are much more stable and quantities collected can be changed by billions of dollars with a small change of rates.

The world of the future should be one where capital and goods are transferred between nations with a minimum of special restrictions and payments. The use of VAT, because of its economic neutrality and the usefulness of its provision of international insulation from the variable impacts of public sector spending, is very helpful in reducing the need for international economic controls. VAT's usefulness in reducing international trade and investment restrictions is being demonstrated

in the steady widening of the areas of economic cooperation between the nations of Western Europe.

COVERAGE AND RATE

The European experience teaches that only one rate should be used. If one product or service is to be subject to a heavier or a lighter VAT burden, the goal is better accomplished by differences in the percentage applied to the price in arriving at the base. The administrative characteristics of VAT are such that complete exemption is only possible through tax refund or "zero rate."

In France VAT spread from an original tax on manufacturing to a tax including a large portion of private sector GNP in its base. The built-in expansion characteristic of VAT is now recognized, and all VAT legislation, except in Italy, extend down through the retail level. Even Italy, however, has replaced local retail taxes with a national tax.

Although a very excellent study sponsored by the American Retail Federation demonstrated a VAT can be administered without difficulty alongside state and local retail sales taxes, the European practice of eliminating these local taxes must be the preferred route because it has been proven in Europe that it is the best. A national VAT of 10 percent with half of the collections distributed to the states if they repeal all state and local sales and gross receipts taxes would accomplish three very important goals of wise U.S. national fiscal policy at this juncture.

1. The American VAT rate would become comparable with the European rates while avoiding at least 40 percent of the upward pressure on prices of a national 10 percent VAT.
2. The growing and very serious inefficiencies and difficulties arising out of the diverse and ever expanding state and local sales taxes would be eliminated.
3. Revenues available for state and local government use would be a 200 to 400 percent greater than under existing general sales and receipts taxes and a neutral base, retail sales, for revenue sharing is provided ready-made.

SOCIAL SECURITY AND MEDICARE FINANCING

The degree to which general revenues will be used to supplement payroll taxes and to meet the costs of minimum income maintenance and to cover social and medical services is still very uncertain. Suggestions ranging from a negative income tax with very high starting positive taxpayer rates to the continuation of the current procedures are heard.

Data are not available, but general finance information from Western Europe show that VAT is indirectly very important in meeting social welfare costs. For example, the substantial VAT revenues have permitted reduction of P-A-Y-E rates, making possible higher payroll taxes without increasing total wage withholding.

In America, the tradition of exempting welfare, health and accident, and social security benefits from the individual income tax is very strong. This situation which is causing increasingly larger departures from perceived tax justice can be righted by a tax related to expenditures. A tax such as VAT is likely to be correctly interpreted as a payment for the necessary costs of government services.

On the other hand, the income tax with its close identification with ability-to-pay is largely unable to project this attitude.

DECREASING UNEMPLOYMENT

The failure of the United States to introduce a major VAT when the European development got under way in 1965 has worked to increase American unemployment in three major ways.

First, it stimulated the export of American savings. This in turn prevented the multiplier effect of the investment of these savings at home. Estimates of the relative economic stimulation of an American dollar of saving invested abroad and one invested at home conclude the domestically invested dollar is two to three times more effective in expanding U.S. employment and income.

Second, American exports carry the full U.S. tax burden and in addition have to bear importer country border taxes. The border tax rate of an importing VAT using nation is the full VAT rate of 15 percent or so applied to a base consisting of cost plus transportation, plus insurance and plus import duties. On the other hand, exports from a VAT using nation receive a refund of the full VAT upon exportation and are not liable for a border tax upon entering the United States.

Third, foreign producing units of American companies financed with American savings provide sources of supply for export. These exports benefit from VAT refunds. This gives them a competitive advantage over similar goods of the company that are manufactured in America in meeting the import needs of third countries.

THE HIDDEN TAX PARADOX

A double standard exists in taxation. The amount of corporate income tax and the amount of property tax and social security contributions included as a part of the price paid for a pair of shoes is unknown. These taxes are all hidden in the price. In fact they are so well hidden that a buyer is generally unaware his shoes cost more because these taxes have been paid. This type of hidden tax is accepted.

On the other hand, an excise tax or a sales tax must be an "add on." The product must be sold at a price plus tax. This difference in treatment of taxes is largely an American paradox and does not exist in Western Europe or Australia, for example. In the United States a transaction tax is unfair and underhanded when it is "hidden" in the price while to "hide" other taxes is accepted normal practice.

This situation, as demonstrated by the federal air ticket tax which was first hidden completely and was later changed to be only partially hidden, is not easily changed. The existence of this situation has retarded the U.S. development of transaction based taxes. VAT at the retail level in the United States should be included in price just as it is in Europe and just as other taxes are included in price in the United States.

VAT A SIMPLE TAX

The use of a VAT along the lines set down in the above paragraphs does not require an elaborate administrative machinery. One of VAT's great advantages is the simplicity of the concept.

Illustration 2

Value Added Tax
DECLARATION

Taxable Period

Kroner (rounded)	Specification
	Tax payable
	Tax deductible
	Tax liable

Signature

Space reserved

LETTER

Official
Paid
194

To
Tax Service
Postbox 297

Copenhagen V

Percentage Depletion

STATEMENT SUBMITTED ON BEHALF OF ALADDIN PETROLEUM CORP., HERBST OIL CO., DENNY KLEPPER OIL CO., KOCOLENE OIL CORP., MARTIN OIL SERVICE, NAVAJO REFINING CO., AND POWER TEST CORP.

Submitted by William C. Lane, Jr., Batzell, Nunn and Bode

PROBLEM

The exclusion of retailers from the benefits of percentage depletion under I.R.C. § 613A(d)(2).

Section 613A of the Internal Revenue Code, which was adopted as part of the Tax Reduction Act of 1975, grants independent crude producers a percentage depletion allowance on the first 2,000 barrels per day of production. However, the provisions of that section exclude independent gasoline retailers which have crude production. Exclusion of these independent gasoline retailers from the benefits of percentage depletion not only results in an exceptional economic hardship to them, but is at variance with the intent of Congress to preserve percentage depletion for the independent, non-integrated producer.

BACKGROUND

Amendments offered on the Senate floor to H.R. 2611 sought to retain the percentage depletion allowance for small independent producers, while denying such benefits to major oil companies. The bills introduced to accomplish this result proposed to exclude specified production levels from the provision of H.R. 2611, unless the producer also met some independent test of "integration."

Senate bills drafted in the early phase of this effort would have denied depletion benefits to producers which refine crude petroleum in recognition of the fact that all major oil companies refine crude. It was subsequently recognized, however, that a few independent refiners with crude production would be denied the benefits of the percentage depletion allowance.

Accordingly, the final drafts of bills actually offered in amendment of H.R. 2611, such as that offered by Senators Hollings and Bentsen, were worded to deny percentage depletion to refiners whose runs to stills were in excess of 50,000 barrels per day and to all retailers of petroleum product. This latter provision was added in recognition of the fact that all major oil companies sell petroleum products.

Conversations with the staffs of Senators Bentsen, Hart, Church, and Hollings reveal that it was not generally recognized at the time this final language was adopted that some independent gasoline retailers have crude production. Indeed, conversations with the staffs of each member of the Senate Finance Committee reveal that it was not the intention of those members supporting the Hollings

amendment to H.R. 2611 to deny independent gasoline retailers with crude oil production the percentage depletion allowance

It is clear that the intent of Congress in enacting the present section 613A was to withdraw the benefits of percentage depletion from integrated oil companies. No other rationale can be advanced for the retailer and refiner exclusions of that provision. Indeed, a "Fact Sheet" on the Hollings amendment, which contained the present subsection (d)(2), said that amendment would provide: "No exemption for integrated producers. . . ." (Congressional Record, March 18, 1975, p. 4236.) Yet a producer with service stations and some totally unrelated crude production can hardly be deemed to be integrated. Nevertheless, under section 613A and the proposed IRS regulations implementing that section, such a producer would lose the benefits of percentage depletion.

SUGGESTED TECHNICAL AMENDMENT

In order to rectify this problem, we would propose a technical amendment to section 613A(d)(2) which would provide percentage depletion to those independent retailers of petroleum products which neither refine crude oil nor sell petroleum products obtained through crude processing agreements. Suggested draft language of such an amendment to the first paragraph of that section is underlined below:

"613(d)(2) *CERTAIN* RETAILERS EXCLUDED—Subsection (c) shall not apply in the case of any taxpayer *who, directly or through a crude processing agreement, refines oil or natural gas;* and who, directly or through a related person, sells oil or natural gas, or any product derived from oil or natural gas—* * * ."

COMMENT

The proposed technical amendment would:

(a) Deny percentage depletion to integrated oil companies as intended by Congress;

(b) Retain percentage depletion for truly independent firms as intended by Congress, including those independent retailers whose retailing and producing activities are carried on in complete disjunction one from another.

Such a result would be in keeping with the Congressional policy of encouraging new entry into the oil industry in order to promote competition, and to provide maximum incentives for the discovery of new oil resources. It would accomplish these objectives at only a minimal revenue loss to the Treasury, since the number of companies affected by the proposed change would be very small. Finally, the suggested technical amendment would end the inequitable discrimination against independent retailers presently created by section 613A.

Material Supplied by the American Petroleum Institute

The following information was submitted in response to the following question of Chairman Long (vol. 2, pg. 798):

Can you people get us some kind of study to indicate what the effect has been on employment, somewhat in line with the economic model Dr. Ture set up for the real estate people? He endeavored to demonstrate in his judgment how many jobs would be lost, how much the gross national product of the United States would be reduced, and how much revenue would be lost if we passed the House recommended package with regard to real estate.

Now, admittedly those estimates are imprecise, but when you try to work out an estimate, you find oftentimes that you are not arguing about the figures, you are just arguing about where you ought to put them, whether you ought to put them in one column or whether they should be put in another column. Usually the majority of people tend to arrive at the right conclusion if they have all the facts set before them.

In estimating the effects of the proposed changes in tax provisions affecting the oil industry, it is appropriate to consider these effects in the light of other recent legislative actions which have had a substantial effect upon the oil industry.

Estimates indicate that oil industry net income in 1976 will be reduced by approximately $1.8 billion as a result of the loss of percentage depletion, and about $6.5 billion as a result of price controls. Over the longer term, it is estimated that the loss of percentage depletion will reduce oil industry net income by some $21–22 billion over the 1975–1985 decade. Over the 40 months of price controls, which began in February, 1976, it is estimated that the oil industry's net income will be reduced by $25 billion. It is estimated that H.R. 10612, which would virtually eliminate the option to currently deduct intangible drilling costs (IDC) for individuals, will reduce funds available for exploration by an estimated three-quarters of a billion dollars over the period 1976–1981.

This loss of internally generated cash flow, combined with the resulting decline in the ability of the affected petroleum companies to attract external capital, can only result in a decrease in both the ability and incentive of the oil industry to make the capital expenditures required for increased domestic energy development. This decrease in capital expenditures will in turn have important direct and indirect effects upon economic activity in the U.S. economy. This will mean lower GNP, higher unemployment, lower personal income, and most likely lower federal government tax revenues.

A recent study [1] has estimated the effects of recent and planned legislative action on general economic activity in the U.S. economy. This study analyzed the economic effects of the reduction in percentage depletion, the price rollback and continued controls of domestic oil prices, and two proposed oil and gas tax provisions of H.R. 10612. The two tax provisions analyzed were the limitation on artificial losses and the increase in the minimum tax.

The results of this study are presented in Tables 1–3. In all cases, it can be seen that the effects of these tax and price changes lead to large decreases of oil and gas production and much lower additions to oil and gas reserves. As long as one assumes that imports are available to replace lost domestic energy production, and assumes that U.S. exports will rise to equal the increased imports, then the reduction in economic activity is definitely significant, but not too severe. However, it is far from certain that either one of these assumptions will always hold. Although one must assume that the U.S. will not impose an arbitrary import control program upon itself, the increased dependence of the U.S. economy upon imports increases the vulnerability of the U.S. to another embargo. As can be seen in Case I of Table 1 and Case (a) of Tables 2 and 3, the economic effects of such a development are devastating.

[1] Norman B. Ture, Inc., "Economic and Revenue Effects of Reductions in Depletion Allowances, H.R. 10512's Oil and Gas Provisions, and the Price Rollback for New Oil," Washington, D.C., May 5, 1976.

As severe as these effects are in all cases, the API believes that the study cited above has actually understated all cases. This is because the study assumes that the minimum loss in GNP resulting from the new tax and price provisions is the lost domestic energy production from new energy developments. In reality, these new provisions will also affect energy production from fields already developed. In addition, these provisions are likely to lead to lower investments in physical assets needed for exploration and development of new fields. This effect on GNP and other economic variables also is not considered by the study.

The API believes that the lack of consideration of these additional factors in no way invalidates the study cited, nor does it change any of the essential conclusions. The only change is that the effects of the tax and price proposals upon economic activity will be even more detrimental in all cases than is shown in Tables 1–3.

TABLE 1.—EFFECTS OF REDUCTION IN DEPLETION ALLOWANCES AND H.R. 10612

	Reduction in depletion	H.R. 10612
Price and import controls: [1]		
1. Oil reserves (millions of barrels)	−6,980	−670
2. Gas reserves (billions of cubic feet)	−50,430	−4,680
3. Oil production (millions of barrels)	−250	−20
4. Gas production (billions of cubic feet)	−1,660	−150
5. GNP (billions of 1975 dollars)	−44.9	−3.8
6. Employment (thousands)	−1,450	−120
7. Federal revenues (billions of 1975 dollars)	−11.6	−1.2
Controlled prices, uncontrolled imports: [1]		
1. Oil reserves (millions of barrels)	−6,980	−670
2. Gas reserves (billions of cubic feet)	−50,430	−4,680
3. Oil production (millions of barrels)	−250	−20
4. Gas production (billions of cubic feet)	−1,660	−150
5. GNP (billions of 1975 dollars)[2]	−2.7 to −10.5	−0.2 to −0.9
6. Employment (thousands)[2]	−90 to −340	−10 to −30
7. Federal revenues (billions of 1975 dollars)[2]	+1.7 to −0.7	−.03 to −0.2
Uncontrolled prices, controlled imports: [1]		
1. Oil reserves (millions of barrels)	−2,870	−260
2. Gas reserves (billions of cubic feet)	−20,080	−1,730
3. Oil production (millions of barrels)	−90	−10
4. Gas production (billions of cubic feet)	−580	−50
5. GNP (billions of 1975 dollars)	−15.9	−1.6
6. Employment (thousands)	−510	−50
7. Federal revenues (billions of 1975 dollars)	−2.4	−0.5

[1] Assumes prices or imports would not have been allowed to exceed actual 1975 levels.
[2] Smaller loss assumes rise in exports offsets rise in imports; larger loss assumes no change in exports.

TABLE 2.—EFFECTS OF PRICE ROLLBACKS FOR NEW OIL

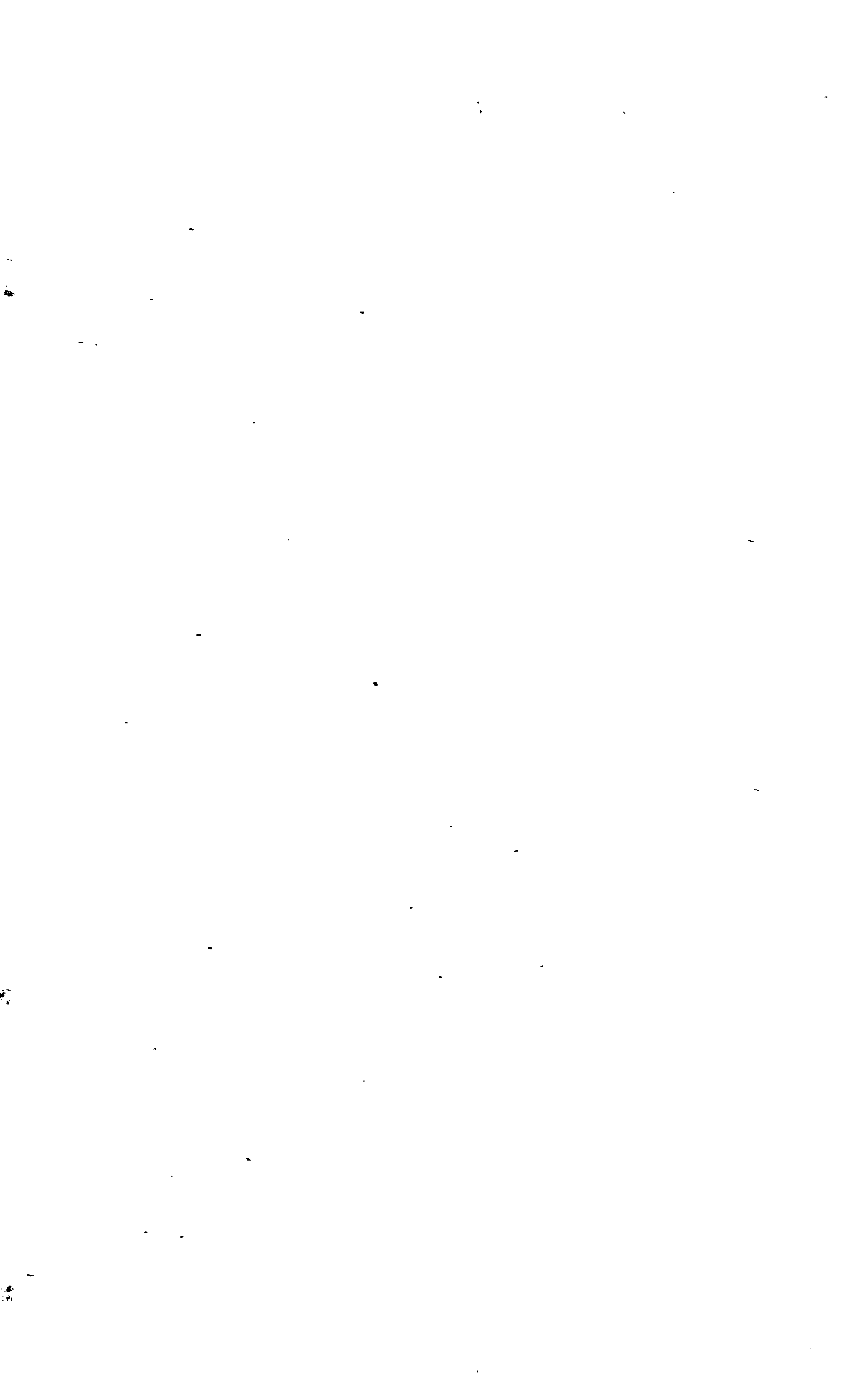
	1976	1977	1978	1979
Oil reserves (millions of barrels)	−5,240	−7,650	−10,540	−6,010
Oil production (millions of barrels)	−210	−290	−370	−180
GNP (billions of 1974 dollars):				
(a) With import controls	−17.1	−23.6	−30.1	−14.6
(b) Without import controls [1]	−2.5 to −5.5	−3.6 to −8.1	−4.9 to −11.2	−3.1 to −6.5
Employment (thousands):				
(a) With import controls	−550	−760	−970	−470
(b) Without import controls [1]	−80 to −180	−120 to −260	−160 to −360	−100 to −210
Federal revenues (billions of 1975 dollars):				
(a) With import controls	−5.3	−7.3	−9.3	−4.5
(b) Without import controls [1]	−0.8 to −1.7	−1.1 to −2.5	−1.6 to −3.5	−1.0 to 2.0

[1] Smaller loss assumes rise in exports offsets rise in imports; larger loss assumes no change in exports.

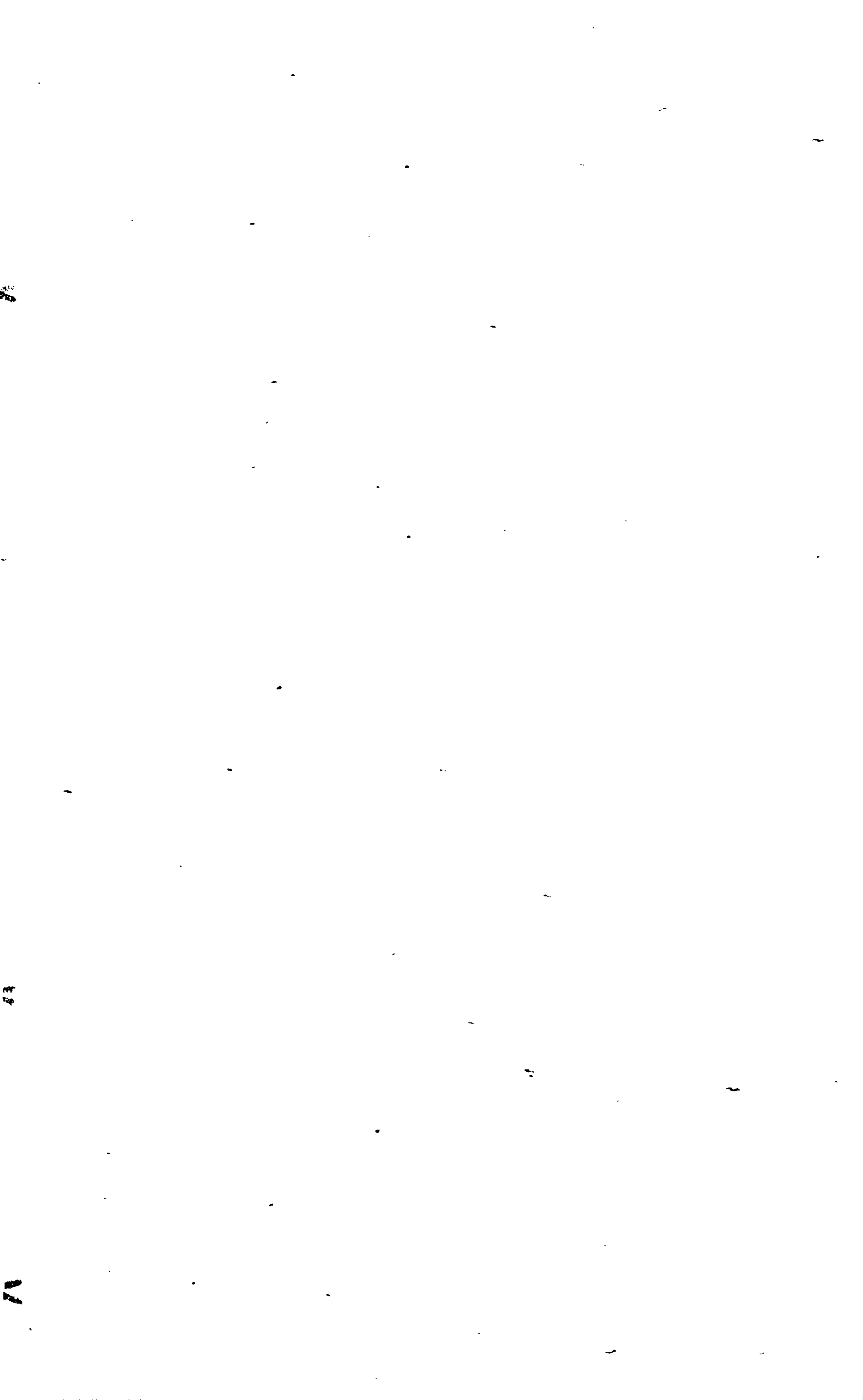
TABLE 3

Combined effects of reduction in depletion allowance, H.R. 10612, and price rollback for new oil, 1976

Item	Effect
1. Oil reserves (millions of barrels)	−10,980
2. Gas reserves (billions of cubic feet)	−53,030
3. Oil production (millions of barrels)	−430
4. Gas production (billions of cubic feet)	−1,790
5. GNP (billions of 1975 dollars):	
a. With import controls	−61.4
b. Without import controls	−5.1 to −15.8
6. Employment (thousands):	
a. With import controls	−1,980
b. Without import controls	−150 to −510
7. Federal revenues (billions of 1975 dollars):	
a. With import controls	−16.5
b. Without import controls	+1.0 to −2.4



Retirement Income Credit



STATEMENT OF SENATOR HIRAM L. FONG

PROPOSAL

The purpose of this statement is to propose adoption of Amendment No. 1578 to H.R. 10612. The Tax Reform Act.

I strongly endorse improvements in the Retirement Income Tax Credit provisions of the Internal Revenue Code as approved by the House in H.R. 10612 as a step in the right direction.

H.R. 10612 as now drawn, however, falls short of the fully equitable treatment of retirement income which I believe should characterize our income tax law. I therefore urge the Committee on Finance to act favorably on my amendment No. 1578 to H.R. 10612. Under my amendment the Retirement Income Tax Credit would be changed so that retirement income from sources other than social security will have full and permanent tax-parity with tax-free social security benefits.

SUMMARY OF AMENDMENT PROVISIONS AND EFFECT

Amendment provisions

The amendment would provide that each year the Secretary of Health, Education and Welfare shall determine the maximum social security retirement benefit payable at age 65 for the year. The amount so certified shall be used during that tax year to determine the taxpayer's Section 37 initial amount, as follows:

A. One hundred percent of the amount certified by the Secretary in the case of a single individual;

B. One hundred percent of the amount certified by the Secretary in the case of a joint return where only one spouse is eligible for the credit;

C. One hundred fifty percent of the amount certified by the Secretary in the case of a joint return where both spouses are eligible for the credit, and

D. Seventy five percent of the amount certified by the Secretary in the case of a married individual filing a separate return.

The amendment would make no change in the language of H.R. 10612 with regard to the Reduction as provided in paragraph 3 or in the Adjusted Gross Income Limitation in subsection (c). Nor would it affect other changes in the Retirement Income Tax Credit which are proposed in H.R. 10612.

Section 37 credit amount for 1976

According to the Department of Health, Education and Welfare, the Section 37 initial amount for calendar year 1976, based on the

maximum social security retirement benefit payable at age 65, as proposed in my amendment, would be:

A. $4,368 in the case of a single individual;

B. $4,368 in the case of a joint return where ony one spouse is eligible for the credit;

C. $6,552 in the case of a joint return where both spouses are eligible for the credit, and

D. $3,276 in the case of a married individual filing a separate return.

Beneficiaries of amendment

The primary beneficiaries of my amendment, as is the case under existing law, would be those retirees who have little or no opportunity to participate in the social security system during their working years. In addition to Federal retirees, it would help many State and local government retirees and non-profit association retirees who are not covered by social security. Other persons who would benefit would be those who have some social security, but less than the maximum, and who have saved for their later years through other retirement programs.

Cost

Staff of the Joint Committee on Internal Revenue Taxation have advised that precise cost estimates are difficult because fully compatible data are not available respectively on individual social security benefit levels, income tax liabilities, and the relationships between retirement income derived from social security and other retirement programs.

First year costs under this amendment have, however, been estimated to range from $600 million to $700 million more than the present law. In comparison, raising the taxpayer's Section 37 initial amount to the levels in H.R. 10612, as passed by the House, would cost from $250 to $300 million. These costs are exclusive of those which would be incurred through other H.R. 10612 changes in determining the tax credit.

RATIONALE FOR MY PROPOSAL

My amendment to the Tax Reform Act, H.R. 10612, would implement improvements first proposed by me in S. 2402, which I introduced September 24, 1975 and which is cosponsored by Senators Bill Brock, James L. Buckley and J. Bennett Johnston.

The rationale for this proposal is the simple but very important one of equitable tax treatment of different groups of retirees. Its adoption would extend to retirees of Federal, State and local employment systems, and to others covered under retirement systems with small or no social security benfits, the same tax break enjoyed by persons receiving the maximum payable social security retirement benefits. The latter is, of course, now totally exempt from Federal income taxes.

Under H.R. 10612, as passed by the House of Representatives, the maximum amount subject to the Retirement Income Tax Credit would be raised from $1,524 for an individual and $2,286 for a couple to $2,500 and $3,750, respectively. This increase in the base income subject to the credit is the same as proposed early in 1973. Subsequent review

and economic changes which have taken place since then have convinced me, however, that what appeared to be an adequate Retirement Income Tax Credit adjustment in 1973 is not enough in 1976. It will be even less adequate in 1977 or years to follow.

My amendment would apply the credit to the same income level as the maximum social security retirement benefit as certified each year by the Secretary of Health, Education, and Welfare.

Its immediate effect would be to raise the income subject to the retirement income tax credit to approximately $4,368 for an individual and $6,552 for a couple. The amount would be adjusted in the future as social security maximum retirement benefits increase so that the originally intended parity would be maintained on a constant basis.

I am strongly persuaded that such a permanent—and automatic—updating of the retirement income tax credit provision of the law is necessary because of the poor record we have had in the 14 years since the credit was last updated. Our failure to make changes has often worked a severe hardship on the many persons whose retirement income includes no social security payments, or whose social security benefits have been so low as to be of minor importance to them.

The people who would benefit from an updated tax credit include Federal retirees, who numbered 989,786, and Federal survivor annuitants, who numbered 382,347, as of June 30, 1975. But it would also help many State and local government retirees and non-profit association retirees who are not covered by social security. The latter groups include teachers, police officers, firefighters, some clergymen, and a number of other public servants.

A tabulation of the number of Federal employee annuitants and survivor annuitants by monthly rates of annuity, as of June 30, 1975, is shown in attachment "A" at the end of this statement.

Figures on the number of non-federal retirees who are not covered by social security are almost impossible to obtain. Some idea of the magnitude of this group is indicated, however, by a partial list of State and local public employee systems in 19 States under which employees receive no social security coverage. See attachment "B" at the end of this statement.

At a recent hearing of the Senate Special Committee on Aging in Chicago. for example. it was reported that there are now over 35,000 teacher retirees in Illinois who do not, as such, have social security. Since their retirement income has no adjustment for cost of living, an updated retirement income credit can be doubly important to them.

With possible continuation of high inflation rates, the annual automatic adjustment in the income subject to the retirement tax credit becomes most important. Failure to include such a mechanism in any change in the law invites the prospect of inequities in the future comparable to those which now exist because of our failure to act during the past dozen years.

As a matter of fact, updating of the retirement income tax credit to any specific dollar amount—even if appropriate when introduced—is almost certain to be out of date by the time it is enacted and takes effect.

In previous sessions of Congress, I have introduced a number of bills to update the retirement income credit—as have other Members. In

each case I have tried to bring the tax credit fully into line with the tax-free status of social security retirement benefits. This is also the purpose of my Amendment No. 1578, but with a significant difference. By permanently tying the tax credit to the maximum social security benefit as certified each year by the Secretary of Health. Education, and Welfare, it would also assure that parity is maintained in the future.

EXHIBIT A—FONG STATEMENT RE AMENDMENT NO. 1578 TO H.R. 10612

NUMBER OF EMPLOYEE ANNUITANTS AND SURVIVOR ANNUITANTS ON THE RETIREMENT ROLL AS OF JUNE 30, 1975, BY MONTHLY RATES OF ANNUITY

Monthly rates of annuity	Employee annuitants	Survivor annuitants
Under $25	119	730
$25 to $40	4,400	11,406
$50 to $74	18,290	20,745
$75 to $99	16,025	20,931
$100 to $124	31,219	93,110
$125 to $149	19,423	37,857
$150 to $174	19,924	19,851
$175 to $199	23,474	21,911
Subtotal, under $200	132,874	226,541
$200 to $249	52,109	47,155
$250 to $299	63,591	32,899
$300 to $349	73,388	23,746
$350 to $399	83,823	17,260
$400 to $449	72,832	10,456
$450 to $499	68,926	7,228
Subtotal, under $500	547,548	364,285
$500 to $599	128,130	8,328
$600 to $699	91,225	4,233
$700 to $799	62,423	2,532
$800 to $899	47,306	1,278
$900 to $999	29,011	732
Subtotal, under $1,000	900,634	381,308
$1,000 to $1,249	44,234	756
$1,250 to $1,499	23,003	157
$1,500 to $1,749	11,766	36
$1,750 to $1,999	5,949	4
$2,000 to $2,249	2,663	5
$2,250 to $2,499	992	
Subtotal, under $2,500	989,245	382,346
$2,500 and over	541	
Grand total	989,786	382,347

[Exhibit "B"—Fong Statement re Amendment No. 1578 to H.R. 10612]

STATE AND LOCAL PUBLIC EMPLOYEE RETIREMENT SYSTEMS NOT SUPPLEMENTED BY SOCIAL SECURITY

A partial list of state and local public employee retirement systems under which employees receive no social security coverage follows.

This list was derived from the following publications: "Summary of Member System Plan Provisions", 1974, published by National Conference on Public Employment Retirement Systems; and "Teacher Retirement Systems (1975)", published by the National Education Association.

Alaska

Teacher's Retirement System of Alaska.

California

City Employee's Retirement System of the city of Los Angeles; Fire and Police Pension System of the city of Los Angeles; and State Teacher's Retirement System, State of California.

Colorado

Denver Public School Employee's Pension and Benefit Association; Retired Fireman's Association of Denver, Colo.; and The Public Employees' Retirement Association of Colorado.

Connecticut

Connecticut Teacher's Retirement System.

Illinois

Municipal Employees' Annuity and Benefit Fund of Chicago, Ill.; Public School Teachers' Pension and Retirement Fund of Chicago; Teachers Retirement System of the State of Illinois; and The Retirement Board of the Policemen's Annuity and Benefit Fund of the city of Chicago.

Kentucky

Louisville Firefighters Pension Fund; and Teachers Retirement System of the State of Kentucky (social security coverage only for teachers in State colleges and universities).

Louisiana

The Louisiana State Employees' Retirement System.

Maine

Maine State Retirement System.

Massachusetts

The Massachusetts Retirement Plan.

Michigan

City of Warren, Mich., Police and Fire Retirement Commission; and Fire and/or Police Department Pension and Retirement Act of Michigan.

Minnesota

Duluth Police Pension Association; Minneapolis Fire Department Relief Association; Minneapolis Municipal Employees Retirement Board; Minneapolis Teachers' Retirement Fund Association; St. Paul Fire Department Relief Association; St. Paul Teachers' Retirement Fund; and The Duluth Fireman's Relief Association.

Missouri

Police Retirement System of the Kansas City, Mo., Police Department.

Nevada

Public Employee's Retirement System of the State of Nevada.

New Jersey

The Employee's Retirement System of the city of Newark, N.J.

Ohio

The Police and Firemen's Disability and Pension Fund of Ohio; The Public Employees Retirement System of Ohio; The Retirement System of the city of Cincinnati; The School Employees Retirement System of Ohio; and The State Teachers' Retirement System of Ohio.

Oregon

Fire and Police Disability and Retirement Fund of Portland, Oreg.

Rhode Island

Employees' Retirement System of the State of Rhode Island (social security coverage for teachers in State schools of higher education, and some cities and towns which elected social security coverage).

Washington

Washington Law Enforcement Officers' and Fire Fighters' Retirement System.

Wisconsin

The Policemen's Annuity and Benefit Fund of Milwaukee.

94TH CONGRESS
2D SESSION

H. R. 10612

IN THE SENATE OF THE UNITED STATES

APRIL 8, 1976

Referred to the Committee on Finance and ordered to be printed

AMENDMENT

Intended to be proposed by Mr. FONG to H.R. 10612, an Act to reform the tax laws of the United States, viz: On page 102, beginning with line 2, strike out all through the matter between lines 3 and 4 on page 110, and insert in lieu thereof the following:

1 (a) CHANGE IN LIMITATION ON RETIREMENT IN-
2 COME.—Section 37 (relating to retirement income credit)
3 is amended by redesignating subsection (j) as subsection (k)
4 and inserting after subsection (i) the following new sub-
5 section:
6 "(j) CERTIFICATION OF AMOUNTS.—Before July 1 of
7 each calendar year, the Secretary of Health, Education, and
8 Welfare shall certify to the Secretary or his delegate—

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1 "(1) the maximum amount of the old-age insurance
2 benefits which could be paid for the months in such
3 calendar year under title II of the Social Security Act
4 to any individual who attained age 65 in, and first be-
5 came entitled to benefits for, the first month of such
6 calendar year; and

7 "(2) the maximum amount of the earnings (as de-
8 fined by section 203 (f) (5) of the Social Security Act)
9 which may be received in such calendar year by any
10 individual who is entitled to old-age insurance benefits
11 under title II of such Act and who has not attained age
12 72 without a reduction in such benefits for any month of
13 such calendar year.".

14 (b) CONFORMING AMENDMENTS.—

15 (1) Subsection (d) of such section 37 is amended
16 by striking out "$1,524" and inserting in lieu thereof
17 "the amount certified under subsection (j) (1) with
18 respect to the calendar year in which the taxable year
19 begins".

20 (2) Subsection (d) (2) (B) of such section 37 is
21 amended to read as follows:

22 "(B) if such individual has attained age 62
23 before the close of the taxable year, 50 percent of
24 the amount of the earned income received by such
25 individual in the taxable year in excess of the amount

1 certified under subsection (j) (2) with respect to the
2 calendar year in which the taxable year begins.".
3 (3) Subsection (i) (2) (B) of such section 37 is
4 amended by striking out "$2,286" and inserting in lieu
5 thereof "150 percent of the amount certified under sub-
6 section (j) (1) with respect to the calendar year in
7 which the taxable year begins".
8 (c) EFFECTIVE DATE.—The amendments made by
9 this section shall apply to taxable years beginning after
10 December 31, 1975.