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TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED FRIDAY, SEPTEMBER 12, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: Tax-Exempt Organizations; Multiple Corporations)

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

SEPTEMBER 10, 1969

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STATEMENT OF MORTIMER M. CAPLIN
ON BEHALF OF THE NATIONAL TAX EQUALITY ASSOCIATION

Hearings of Senate Finance Committee
on Tax-Exempt Organizations, September 12, 1969

UNFAIR BUSINESS COMPETITION BY TAX-FREE ORGANIZATIONS

SUMMARY

With marked frequency, tax-exempt organizations are becoming involved in competitive commercial enterprises. Private foundations, churches, trade associations, fraternal beneficiary societies, cooperatives, and other tax-free organizations own such businesses as plastics manufacturing plants, department stores, girdle factories, foundries, and dairies. Their acquisition of such businesses received strong impetus from a 1965 Supreme Court decision approving a form of arrangement which permits exempt organizations to pay substantially higher prices for businesses than taxable purchasers can afford.

The fundamental problem presented by the business activities of tax-free organizations is that of unfair competition. Tax-exemption of business profits permits the exempt organization to wage competition with a major and often decisive advantage over other businesses. Though Congress recognized this problem in 1950, and attempted to deal with it by means of the unrelated business income tax, major defects in existing

law have left exempt organizations largely free to engage in tax-sheltered commercial endeavors.

The House bill deals with most of the problems which have arisen in this area. In some cases the House actions are effective and sufficient. In others, they require strengthening. In certain instances the House bill does not address the problems at all, and additional legislation is desirable.

Specifically, I recommend:

1) Approval of the House action to extend the unrelated business income tax to churches, social welfare organizations, fraternal beneficiary societies and other classes of organizations exempt under the general exemption provision.

2) Approval of the portion of the House bill which imposes tax on exempt organization debt-financed acquisitions of income-producing property.

3) Extension, to cooperatives and their owner-patrons, of the fundamental two-tier system of taxation now applicable to other corporations and their shareholders. A bill recently introduced by Senator Ribicoff provides the proper approach to taxation of cooperative income. However, if the Committee should decide against that approach, it should adopt the July 25, 1969, decision of the House Ways and Means Committee on the point, requiring cooperatives to distribute currently 50% of their earnings in cash -- rather than the presently required

20% -- and requiring the remaining 50% to be paid to owner-patrons within five years.

4) Approval of the portion of the House bill which requires private foundations, over a reasonable period of time, to reduce their holdings in any unrelated business below 20% of the equity of the business.

5) Approval of the portion of the House bill which deals with exempt organization advertising income and similar problems. To insure that the fundamental policy decision to tax such income is not defeated by accounting readjustments, special reporting techniques, and like devices, I recommend that the Treasury Department be granted authority to prescribe legislative regulations for the determination of allowable deductions under the unrelated business income tax.

6) Restriction of the exclusions provided by the present unrelated income tax for such classes of income as rent from real property, royalties, and interest. Further, serious consideration should be given to eliminating the rental exclusion altogether.

7) That the Congress direct the Treasury Department (a) to review the competitive problems presented by tax-free businesses which would be considered "related" to exempt functions under existing law, and (b) to make legislative proposals for correction of any competitive inequalities which are found to exist.

8) Approval of the portion of the House bill which makes it clear that costs of servicing non-profit organization membership, or conducting other non-profit activities, may not, for tax purposes, be deducted from other income of the organization.

STATEMENT
OF
MORTIMER M. CAPLIN
ON BEHALF OF
THE NATIONAL TAX EQUALITY ASSOCIATION

Hearings of Senate Finance Committee
on Tax-Exempt Organizations

September 12, 1969

UNFAIR BUSINESS COMPETITION BY TAX-FREE ORGANIZATIONS

Mr. Chairman and Members of the Committee:

My name is Mortimer M. Caplin. I am a member of the Washington law firm of Caplin & Drysdale. I am appearing today on behalf of the National Tax Equality Association.

The Problem

The National Tax Equality Association represents approximately 6,000 taxpaying businesses and businessmen. The problem which concerns those businessmen -- and the problem on which I would like to focus the Committee's attention today -- is that of unfair business competition by tax-free organizations. With marked frequency and plain inequity, (1) the tax-exempt are entering the market-place; (2) the tax exemption is being stretched to shelter the earnings of ordinary commercial enterprises, operated in straightforward competition with taxable businesses; and (3) the general taxpayer is being

asked to subsidize the commercial encroachments of those to whom Congress has granted the unique privilege of tax exemption.

Though the problem of business involvement exists among private foundations, it is not, I am sorry to say, confined to that class of tax-exempt organizations. A broad range of tax-exempt and tax-favored organizations has undertaken vigorous, large-scale business activities. The multi-million dollar industrial enterprise operating tax-free as a "cooperative," the university-owned department store (euphemistically labelled a "bookstore"), the church-owned girdle factory, and the trade association advertising business are not flights of fancy. They are facts. And, for the taxpaying businessmen of our country who must compete with them, they are very unpleasant facts.

Illustrations of Tax-Exempt Businesses

Let us take a moment to survey some of these facts.

A private foundation whose tax exemption was upheld by the Tax Court this year had acquired twenty-four separate businesses during the nine-year period covered by the Tax Court decision.*/ Included were a plastics manufacturing business, three sand, gravel, and concrete businesses, a foundry, three dairies, a hotel, a printing establishment, and businesses manufacturing windows, oil burners, rubber treads, and locks. All were operated under arrangements

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*/ University Hills Foundation v. Commissioner, 51 T.C. No. 54 (1969).

designed to provide a complete tax shelter for the profits produced by the businesses.

At the time of the 1965 Treasury Department Report on Private Foundations, one foundation described in the Report held controlling interests in 26 separate corporations, 18 of which operated going businesses. One of the businesses is a large and highly competitive metropolitan newspaper, with assets valued most recently at $35,000,000 and gross receipts of more than $17,000,000 for 1962. Another of the corporations operates the largest radio broadcasting station in the state. A third, sold to a national concern at the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20,000,000 at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in a single city, these properties present an economic empire of substantial power and influence.

A number of churches have entered into active and aggressive commercial endeavors. One, for example, has become a wholesale distributor of popular phonograph records. Another has acquired at least seven sportswear and clothing manufacturing businesses. A third manufactures mobile homes and operates a drilling business. Others conduct real estate development businesses, provide petroleum storage facilities, and carry on a broad variety of manufacturing enterprises.

Over 700 trade associations and other exempt organizations operate active and successful commercial advertising businesses in conjunction with periodicals which they publish. One trade association, for example, earns more than $10 million each year from its advertising businesses. Another has annual advertising income of more than $6 million. Reports published in the press in recent years have estimated the advertising revenues of tax-exempt organizations to be considerably in excess of $100 million a year.

Fraternal beneficiary societies, exempt under section 501(c)(8) of the Internal Revenue Code, carry on a very large volume of insurance business. On January 1, 1964, they had approximately $13.8 billion of insurance in force. Beyond their insurance operations, they conduct a number of other businesses -- including bowling alleys, driving ranges, restaurants, and hotels.

Cooperatives afford another -- and extreme -- illustration of the intrusion of tax-free organizations into the market-place. Though only a limited class of cooperatives is technically classified as "tax-exempt," the present tax rules available to other cooperatives accord them the practical effect of exemption. Where a cooperative makes paper allocations of its earnings to its patrons, and meets certain other requirements, the cooperative corporation -- unlike other business corporations -- need pay no federal income tax whatever. It can achieve that result

despite the fact that it has earnings of several million dollars and retains up to 80 percent of those earnings for expansion and other business purposes.

The tax advantage of cooperatives evolved at an early stage in the development of our federal income tax laws, during a period when cooperatives consisted of small groups of farmers, forming simple associations for marketing farm produce or purchasing farm supplies. The cooperatives of today bear little resemblance to their predecessors of 50 years ago. No longer are they limited to group marketing of farm produce and group purchasing of farm supplies. No longer do they consist primarily of small groups of farmers operating at the local level. Consumers have organized cooperatives, and so have strictly business organizations. With accelerating rapidity, cooperatives have moved into the fields of processing, manufacturing, and wholesale and retail distribution of non-agricultural commodities. Upon a major scale, they produce fertilizer; refine oil; manufacture paint and agricultural chemicals; process citrus fruits; produce dairy goods; sell at wholesale such products as hardware, lumber, drugs, and groceries; and operate consumer retail stores.

One cooperative reported assets valued at $246,599,000 in 1967 and had sales totaling over $500,000,000 for that year. Another had 1967 sales of more than $350,000,000. A third reported sales of $246,508,000. Five cooperatives appear in Fortune's latest list of the 500 largest business operations in the United States.

Capitalizing upon their ability to generate tax-free earnings, cooperatives have become permanent, large-scale institutions, separate from, and in large measure independent of, their patron-owners. Many have developed complex corporate structures, closely resembling the parent-subsidiary organizational pattern of large corporations in the private business field. They have even joined the acquisition trend which has become so evident in the private business sector in recent years, taking over a considerable number of non-cooperative corporations in tax-free exchanges. The competition which they are capable of generating is aggressive and formidable.

Recent Impetus for Exempt Organization Involvement in Business

Though exempt organizations have been involved in competitive business activities for many years, their acquisition of businesses received strong impetus from a 1965 Supreme Court decision. In the case of Commissioner v. Clay B. Brown, 380 U.S. 563 (1965), the Supreme Court accorded capital gains treatment to persons who transferred a lumber and sawmill business to an exempt organization under an arrangement meticulously designed both to avoid tax on the business profits and to permit the organization to acquire the business entirely without investment of its own funds. Because of the tax immunity of the business profits, arrangements of this sort enable exempt

organizations to pay higher prices for businesses than taxable purchasers can afford. An exempt organization can, in effect, pay to the seller the portion of the business profits which a taxpaying purchaser would have to pay to the government in taxes. The result is a clear and substantial incentive to sell businesses to exempt organizations.

The advantages of such sales have been thoroughly advertised by exempt organizations. A solicitation letter circulated on behalf of a church quite frankly explains that "the church has made and will continue to make acquisitions of companies by paying to the sellers a more attractive selling price than a commercial buyer will pay . . ." (The emphasis is that of the original.) An advertisement appearing in the Wall Street Journal states that a "TAX EXEMPT INSTITUTION SEEKS CLOSELY HELD COMPANIES," explaining "Negotiations conducted on generous pretax earnings basis." Another Wall Street Journal advertisement specifies that a "Highly respected charitable fund . . . will purchase private or closely held companies with minimum pretax profit of $250,000," taking care to point out that the "financial and other benefits [are] very rewarding."

With the incentive provided by the Supreme Court approval of capital gains treatment for sellers in such situations, and the compelling stimulant added by advertising of this kind, it is scarcely surprising to find that the acquisition of commercial businesses by tax exempt organizations is proceeding apace.

The Nature of the Problem

The tax immunity of exempt organization businesses produces substantial losses of federal revenues. Even more serious, however, is the fundamental problem of unfair competition. The businesses with which the exempt organization competes must pay taxes on their earnings. The exempt organization, on the other hand, can make a variety of effective uses of the additional funds which it derives from its exemption. It may cut its prices below those which are economically feasible for its competitors. It may reinvest its tax savings in capital improvement and expansion programs. It may utilize its tax subsidies -- which, of course, are underwritten by other taxpayers, including precisely those businesses with which the exempt organization competes -- to provide higher salaries and other benefits to attract capable personnel away from its competitors. It is, in sum, permitted to wage business competition with a major and often decisive advantage over other businesses.

Previous Congressional Action

The problem is hardly a new one to this Committee or the Congress. Over 25 years ago, the Ways and Means Committee stated straightforwardly that the problem should be analyzed "with a view to closing existing loopholes and requiring the payment of tax and the protection of legitimate companies against this

unfair competitive situation." Again, in 1950, in applying the unrelated business income tax to certain exempt organizations, both the Finance Committee and the Ways and Means Committee stated that the problem at which the new tax was aimed was "primarily that of unfair competition." Again and again the legislative history of the 1950 statute demonstrates deep Congressional concern about unfair competition by tax-free organizations and clear Congressional consciousness of the seriousness of exempt organization expansion through commercial acquisitions.

Nothing makes the fundamental intent of the 1950 unrelated business income tax clearer than the minor and carefully limited character of the activities which Congress specifically meant to exclude. The Committee Reports provide the following examples of businesses which were not made subject to the new tax: sales of donated second-hand clothing by a shop operated by an orphanage; sales of articles manufactured by handicapped persons as a part of their rehabilitation; a laundry operated by a college primarily for the convenience of its students; the operation of a sandwich stand at an annual county fair; and occasional fund-raising dances.

The major, multi-million dollar, aggressively conducted business enterprises which tax-free organizations have today managed to bring under the shelter of their tax immunity afford

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a startling contrast to the minor business activities which Congress specifically intended to remain untaxed. The difference, indeed, could hardly be more extreme. What are the causes of that difference? And what can be done about them?

The Sources of the Difficulty; the House Solutions; and My Recommendations

The sources of today's broadscale tax-exempt commercialism are of several different classes. The House tax reform bill contains provisions designed to deal with most of them. In some cases the House solutions are excellent; in others, analysis discloses them to be insufficient. Last week, the Treasury Department witnesses made their own recommendations to you.

To sort out the separate problems and to explain what I think should be done about them, I would like briefly to describe the source of each, analyze the relevant House provision and Treasury recommendation, and outline my own proposal.

1. Extension of Unrelated Business Income Tax.

In its present form, the unrelated business income tax applies only to certain classes of exempt organizations. Designed to place the businesses of exempt organizations upon the same tax basis as their taxable competitors, the unrelated business income tax was made applicable only to those categories

of exempt organizations which the Congress in 1950 found to be significantly involved in business. As a consequence, the tax does not apply at all to many types of organizations, including churches, so-called "social welfare" organizations, fraternal beneficiary societies, and others; and a considerable number of these organizations have taken advantage of their immunity to embark upon major commercial acquisitions.

The House approach to this problem is both simple and sufficient. With a single, limited exception, section 121 of the bill would extend the unrelated business income tax to all classes of organizations which are exempt under the general exemption provision.*/ The National Council of Churches, the United States Catholic Conference, and similar organizations have endorsed this approach, and the Treasury witnesses last week concurred. On this point, I think that the House and the Treasury Department are quite right; and I recommend that you adopt the House solution without qualification.

2. Debt-Financed Acquisitions.

The incentive which present law establishes for the transfer of businesses to exempt organizations in debt-financed transactions of the kind involved in the *Clay Brown* case is

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*/ Only certain governmental instrumentalities would remain excluded from the tax.

both compelling and unjustifiable. It is, in the main, traceable to the tax immunity of earnings used to discharge indebtedness assumed by the exempt organization in acquiring the business.

Section 121 of the House bill strikes directly at the source of the problem: it imposes tax on the earnings of the acquired property to the extent of the indebtedness incurred in acquiring it. Since 1966, when the Ways and Means Committee originally held hearings on the Clay Brown problem, the Treasury Department has strongly supported the solution now incorporated in the House bill. Here again, it is my view that the House and the Treasury Department are entirely correct; and I urge you to approve this part of the House bill.

3. Taxation of Cooperatives.

Present law contains no satisfactory provision for the taxation of profits earned by cooperative corporations. For many years cooperatives and their owner-patrons were able to deal with each other and with the general public without, in many circumstances, the inconvenience of paying tax at all -- either at the cooperative level or at the owner-patron level. In 1962 Congress acted to curtail this extreme abuse. The measure which was adopted, however, aimed only at securing a single tax from the cooperative and its owner-patrons. Where

a cooperative makes paper allocations of its earnings to owner-patrons, and pays them 20% of the earnings in cash, the responsibility for tax shifts entirely to the owner-patrons; and the cooperative remains able to engage in broad-scale business competition, earn large sums of income, and retain the major part of those earnings without paying tax.

The proper solution is to extend, to cooperative corporations and their owner-patrons, the fundamental two-tier system of taxation now applicable to other corporations and their shareholders. An extensive legal study which my firm completed this spring, and which has subsequently been published, demonstrates that cooperatives are corporations; that their owner-patrons are shareholders; that cooperatives' activities are properly viewed as earning income for purposes of basic income tax principles; and that the cooperative-patron relationship has no special legal features which justify failure to tax that income to the cooperative. Cooperatives should be made fully taxable on the income which they earn, and where those earnings are subsequently distributed to owner-patrons, they should be taxed to the owners -- just as other corporate dividends are now. Senator Ribicoff has recently introduced a bill (S.2646) which incorporates precisely that approach. In my view, the Ribicoff bill should form the basis for this Committee's resolution of the cooperative problem.

Placing cooperatives on the same footing as other corporate business enterprises, Senator Ribicoff's bill allows cooperatives all of the tax advantages available to other corporations. Thus, for example, where cooperatives are able to qualify for the special treatment provided by Subchapter S for small business corporations, they would receive that treatment. Indeed, in an important particular, the Senator's bill allows the cooperative/patron relationship more liberal treatment than that now accorded other corporation/shareholder relationships: it grants patrons a $300 dividend exclusion, rather than the $100 exclusion which existing law provides for other shareholders.

Unfortunately, the House did not deal with the problem as effectively as Senator Ribicoff has. Though it began with important strides in the right direction, the House ended with a quite inadequate solution. The Ways and Means Committee Tentative Decisions of July 25 would have required cooperatives to distribute 50% of their earnings in cash -- rather than the presently required 20% -- to shift tax to their owner-patrons, and would have required the remaining 50% to be paid to owner-patrons within five years. Although these rules would not produce additional tax at the cooperative level, they would establish important limitations on the competitive advantages of cooperatives: for they would restrict the ability of cooperatives to retain up to 80% of their untaxed earnings for expansion, capital improvements, and similar competitive uses.

The final House action, however, substantially loosens the 50% requirement, and extends the five-year rule to 15 years. Awed by "administrative problems," the Treasury Department last week recommended that this Committee make the inadequate House solution even more inadequate. Treasury proposed that the 50% rule be scrapped altogether and the 20% rule of existing law be substituted. The Treasury approach would leave cooperatives with the same formidable advantages they now have over their taxpaying competitors -- and would thereby leave a major and entirely unjustifiable gap in the considerable progress being made by other portions of the tax reform bill on the problem of competitive equality for businesses.

The Ribicoff bill has important advantages over both the House and the Treasury approaches. The relationship of cooperatives to their owner-patrons is, in all fundamental respects, identical to that of corporations and shareholders; and the Ribicoff bill reflects that identity by according essentially the same tax treatment to both situations. In doing so, it prescribes a fair and effective solution to the severe competitive abuses which have arisen in this field. Furthermore, while the House and Treasury proposals would have no revenue effect at all, the Ribicoff bill would produce an estimated annual revenue yield of $200,000,000. Consequently, I strongly recommend that you adopt the approach of the Ribicoff bill. If, however,

you decide against that approach, I recommend that you adopt the original decision of the Ways and Means Committee on this matter. Anything short of that simply will not relieve the severe competitive inequities which now exist in this area.

4. Divestiture of Foundation Business Holdings.

The involvement of private foundations in business gives rise to a number of special and serious problems even where the business income is subject to tax. The Report on Private Foundations which the Treasury Department made to this Committee in 1965 provides an accurate catalog of those problems. Upon the grounds elaborated in that Report, the Treasury Department recommended that private foundations be required, over a reasonable period of time, to reduce their holdings in any unrelated business to below 20%. With relatively minor modifications, the House bill adopts that requirement.*/ I recommend that you approve it.

In passing, I would like to point out that, once the business and other specific foundation abuses at which the House bill aims are dealt with directly, it makes very little

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*/ The bill would accomplish this result by adding a new section 4943 to the Internal Revenue Code. Its fundamental divestiture rule is an important improvement upon the existing rules under which foundations operate, and should be enacted; but the Committee will have to give careful attention to transition problems arising under it. The Committee may, for example, wish to consider an exception to the general disposition requirement for foundations whose governing instruments provided for retention of specified business interests as of the time the Treasury proposal originally became public.

sense to impose a general tax upon the investment income of private foundations. The Congress should do everything within its power to make certain that foundation income and assets are applied to the educational, charitable, and other purposes for which exemption has been granted foundations, but once having done that, it seems to me an error of serious magnitude to divert foundation resources from exempt purposes by means of a tax on investment income. On the other hand, having spent several years attempting to cope with the administrative problems which some private foundations produce for the Internal Revenue Service, I would agree with last week's recommendation by the Treasury Department that a supervisory fee be imposed upon foundations and devoted to Service administrative operations in the foundation field.

5. Advertising Income.

In 1967 the Treasury Department adopted regulations under the unrelated business income tax which, among other things, specified that that tax applies to the profits which exempt organizations earn from commercial advertising published in their periodicals. This position of the regulations has, of course, been strongly opposed by those exempt organizations which have advertising income. After careful study of the regulations, however, I am convinced that the taxation of advertising

income represents an entirely valid interpretation of existing law; and last year the Senate overwhelmingly rejected an amendment which would have reversed the regulations on this point.

The Ways and Means Committee reviewed the problem this year and concluded that the judgment of the Senate and the Treasury Department was sound. To bring the controversy to an end, the House bill (in section 121(c)) specifically incorporates the position taken by the regulations. Because the taxation of advertising income is in direct accord with the fundamental policy of the unrelated business income tax -- placing a highly competitive set of exempt organization business activities upon the same tax footing as their taxpaying competitors -- I urge you to approve the action of the House.

In one respect, however, additional legislation is desirable. In recent articles, tax advisors of exempt organizations have indicated that they will attempt to defeat the effect of the tax on advertising income by accounting adjustments, special reporting techniques, and other devices. The problems here are intricate, and the scope for maneuvering uncertain. To insure that the fundamental policy decision to tax advertising income is not defeated by such maneuvering, I recommend that you grant the Treasury Department authority to prescribe legislative regulations (like those governing corporations which report their

income on consolidated returns) for the determination of allowable deductions under the unrelated business income tax.

6. Technical Correction of Unrelated Business Income Tax.

A peripheral exception embodied in the original unrelated business income tax has proved to be a loophole of major dimensions. In its desire to permit exempt organizations to receive "passive" income free of tax, Congress incorporated exemptions for rent, royalties, and certain other forms of income in the 1950 statute. Tax planners have made full and repeated use of these exceptions to avoid the impact of the unrelated business income tax altogether.

A common method of achieving that result has been for an exempt organization which owns business assets to transfer an operating interest in the assets to a subsidiary in exchange for a payment -- generally rent or royalty -- which is deductible by the operating entity but qualified for one of the exemptions from the unrelated business income tax in the hands of the exempt organization. In that way, tax is avoided both at the operating company level and at the exempt organization level. The courts have repeatedly approved arrangements of this kind.*/

*/ See, for example, U.S. v. Robert A. Welch Foundation, 334 F.2d 774 (5th Cir. 1964); University Hills Foundation v. Commissioner, 51 T.C. No. 54 (1969).

The House bill (section 121(b)) attempts to deal with this problem, but its solution is limited to situations in which the exempt organization owns 80% or more of the stock of the operating entity. So restricted, the House measure would fail to apply to a number of variations of this basic avoidance device -- including those involved in several litigated cases.

I recommend that:

--The unrelated business income tax exclusions for rent, royalties, and interest be made unavailable for any class of income which is deductible by the payor and which is paid to the exempt organization by an entity in which the exempt organization, its creditors, or related persons have a significant interest;

--These exclusions also be made unavailable for any rent, royalty, or interest whose amount is determined by the amount of income -- gross or net -- realized by the payor; and

--Because experience demonstrates that the exclusion for real property rent creates a substantial competitive disadvantage for the taxable owners of real property, careful consideration be given to eliminating the rental exclusion from the statute altogether.

7. Taxation of Related Businesses.

The 1950 unrelated business income statute does not tax profits of businesses which are "substantially related" to the exempt functions of the organization conducting them. Some highly competitive business activities can meet this test, and are therefore not taxed. For example, a large book or map publishing business might well be considered to have substantial relationship to the exempt purposes of certain kinds of educational organizations. The business would, therefore, escape taxation even though it constitutes a severe and direct competitive treatment to commercial publishing enterprises. Similarly, it seems clear that, if the present form of the unrelated business income tax were extended to fraternal beneficiary societies, the insurance businesses conducted by such societies would be considered related to their exempt purposes and therefore nontaxable. A number of other large and competitive -- but "related" -- businesses exist. The House bill does not address this problem.

No systematic study of the nature and dimensions of the problem has been conducted for many years. To develop the necessary background for measures bringing competitive equality to those fields in which taxpaying businessmen compete with exempt businesses "related" to exempt purposes, I recommend that this Committee and the Congress direct the Treasury Department

to conduct a detailed review of such businesses and submit legislative proposals for the correction of any competitive inequalities which are found to exist.

8. Clarification of Deduction Rules.

Some courts have adopted a rule for the allowance of deductions to non-exempt, non-profit organizations which accords such organizations the full practical effect of tax exemption. These courts have permitted such organizations to deduct the expenses of their non-profit activities -- generally, the furnishing of services to their membership -- from the net income which the organizations realize from unrelated sources.*/ Under this rule, for example, a non-profit water company would be permitted to offset the full cost of providing water services to its members against the income produced by its investment properties. It could, therefore, avoid tax upon the investment income entirely. Though other courts have rejected this rule, the law on the point is far from settled at the present time; and, where the more liberal rule obtains, a non-profit organization which, for one reason or another, fails to satisfy the technical requirements of tax exemption may nonetheless secure the real advantages of exemption for its business operations.

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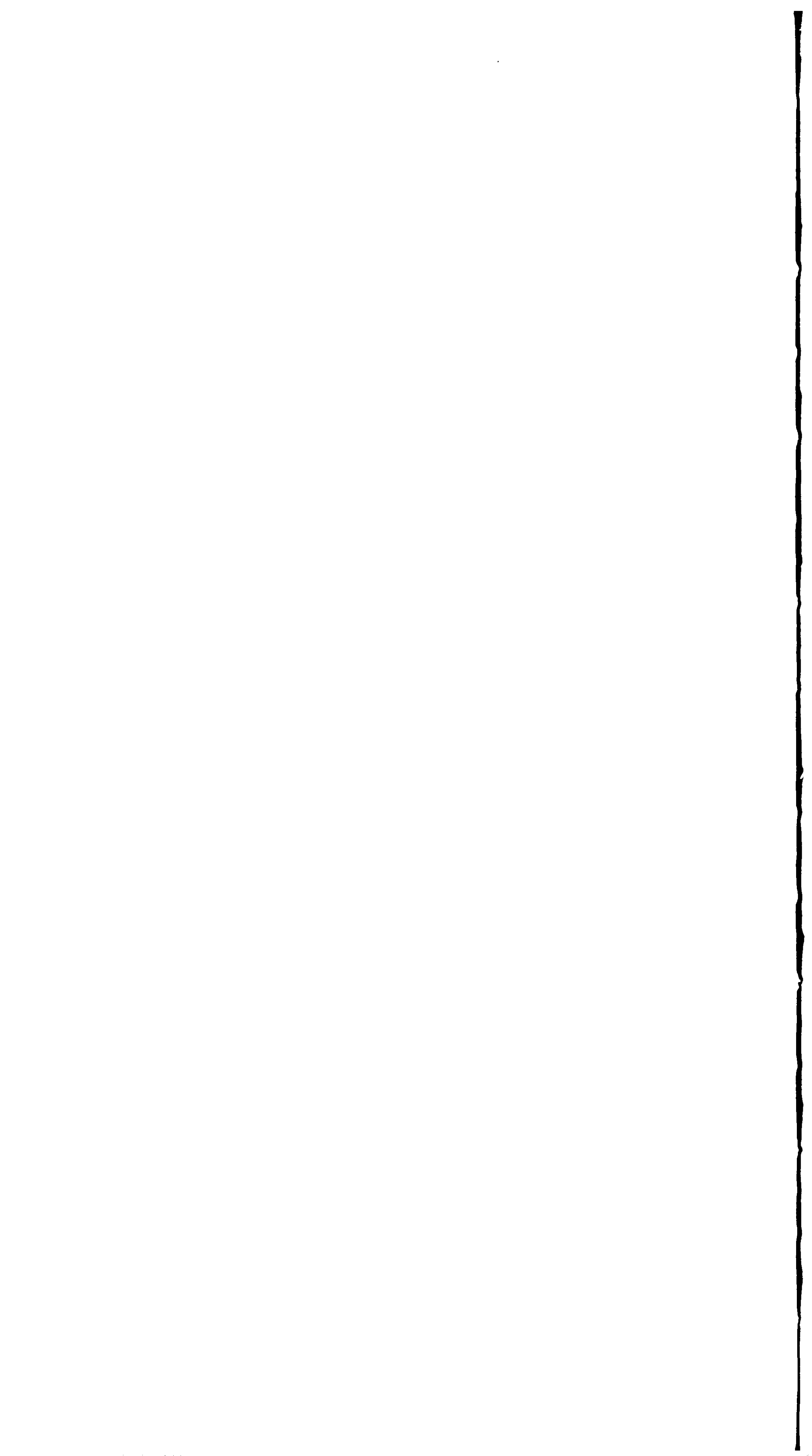
*/ Anaheim Union Water Co. v. Commissioner, 321 F.2d 253 (9th Cir. 1963); Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949 (D.C. Calif. 1968, appeal to 9th Cir. pending).

Adding a new section 278 to the Internal Revenue Code, the House bill deals directly and effectively with this problem. The Treasury Department has approved the House solution. I recommend that the Finance Committee incorporate such a provision in its final legislation here.

Conclusion.

The problems presented by the business involvement of tax-free organizations are severe -- and rapidly growing more severe. They constitute a major source of inequity in our present tax system. Congress has recognized the seriousness of the issue before; but the steps which have been taken to deal with it have proved insufficient to cope with the ingenuity of tax planners and the increasing willingness of tax-free organizations to enter the market-place.

I strongly recommend that this Committee take prompt and effective action to resolve these problems.



September 12, 1969

Oral Summary

Of

Prepared Statement

Very Rev. Homer R. Jolley, S.J.
President, Loyola University, New Orleans

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

Mr. Chairman and Members of the Committee:

My name is Father Homer R. Jolley, S.J., and I appear here today as President of Loyola University of New Orleans. I fully intend to comply with the Chairman's request for a brief summary of our position and ask only that my written statement be included in its entirety in the Committee Record.

H.R. 13270, the Tax Reform Act of 1969 contains many tax changes affecting Loyola and other churches, charitable, religious and educational institutions. Although we believe that the effects of some of these changes will be to diminish charitable contributions, my purpose in appearing today is to point out our reasons for objecting to Section 121 which extends the unrelated business income tax to churches. First, we do not oppose legislative efforts aimed at curing abuses in the tax exempt

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organization area. We hold no brief for the Clay-Brown type transactions. We do, however, object to extending the unrelated business income tax to churches. In my judgment, there are ways to prevent abuses and permit legitimate church activities to continue.

Loyola, founded in 1849, has a student body of nearly 5,000 students. Its commitment to broadcasting began in 1909 as part of the University's Physics Department. On March 31, 1922, radio station WWL beamed the first radio program broadcast in New Orleans. In 1957, WWL began television operations.

Loyola is a private university. Its revenues are realized from tuition fees, gifts, a small security endowment and from the operation of its broadcasting facilities. Even with these sources of financial assistance, Loyola's five year financial projections indicate that without additional sources of revenue, the University will operate at a deficit in all five years which would be increased substantially if it were not for the anticipated revenue to be derived from WWL.

Prior to the 1950 Revenue Act, religious, charitable and educational organizations were exempt from Federal tax. In 1950, Congress, taxed certain unrelated

business activities of exempt organizations but it specifically exempted churches. Again this year, Congress is concerned with what it considers to be abuses in the unrelated activities of churches. The House dealt with these abuses in two ways. It enacted specific provisions designed to halt the Clay-Brown type transactions and extended the unrelated business income tax to churches. Recognizing the economic hardship of immediate extension, the House provided churches with a six-year period within which to restructure their activities. We believe that Congress could both eliminate the abuses and retain the exempt status of churches under certain conditions.

The principal reasons for extending the unrelated business tax to churches are that vis-a-vis their taxpaying competitors, churches (because of tax exemption) can "charge lower prices and . . . expand their business operations out of earnings undiminished by taxation." WWL has always operated on a strictly competitive basis. Its employees belong to the same union as employees of other stations. Advertising rates charged by WWL and other stations in the New Orleans area are comparable. WWL has never engaged in any unfair competitive practices, and we support all efforts to stop such activity.

Another reason for extending the tax is that churches can expand their business operations out of earnings undiminished by taxation. The enactment of the Clay-Brown provisions will curb debt financed business expansions. While others may have expanded their unrelated activities through the use of non-tax retained earnings, WWL has expended more, not less of its earnings than corporations in general. For the last five years, or any previous period selected, WWL has expended more than 82% (often more than 90%) of its earnings for the benefit of its religious and educational purposes. In this connection, recent Treasury Department studies revealed that in 1965, the effective tax rate was 44.4% for most manufacturing enterprises, except the petroleum and lumber industries. Another Treasury publication indicated that all manufacturing companies distributed to stockholders approximately 46% of after-tax income (30% of pre-tax income) or, approximately 74% of taxable income was accounted for either in Federal taxes or in distributions to shareholders. These figures show that, on the average, manufacturing corporations retain nearly one-fourth of pre-tax profits. This figure should be compared with the one-sixth retained by WWL.

Loyola recognizes that the potential for unfair competition does exist if churches neither pay taxes nor expend their earnings for the benefit of the public. We support all efforts to establish equality of operation and to secure this result, we recommend, as an alternative to across the board extension of the unrelated business income tax to churches, that churches be required to expend a minimum of their earnings on an annual basis.

Briefly, Loyola supports legislative efforts which would (i) remove all non-tax advantages enjoyed by the churches in the conduct of unrelated activities, and (ii) require churches to expend at least 80% of the sum of (a) their unrelated business taxable income for the taxable year, and (b) their gross revenues for the taxable year derived from any source (exclusive of gifts, grants, bequests and extraordinary items), other than any unrelated trade or business income. It is Loyola's position that a church should be required to expend such amounts in the exercise or performance of its religious, charitable or educational purposes. We believe that this minimum expenditure approach combined with the inability to borrow imposed by the Clay-Brown provisions will remove any competitive edge which churches may enjoy, and, at the

same time, it permits churches to continue their positive contributions to the communities they serve - contributions which, in our view, are far more significant than the potential revenue impact of extending across the board the section 511 tax to churches. Churches which do not expend at least 80% of total revenues should be taxed as a commercial entity on their unrelated trade or business income. If this approach is not deemed desirable by the Committee, we would hope that methods other than the provisions of the House Bill which would eliminate abuses will be explored. Examples of these methods include:

(1) Churches could be allowed an unlimited deduction for earnings distributed to or permanently set aside for the benefit of certain qualified operations or organizations such as schools, hospitals, and charities which derive their support from the general public.

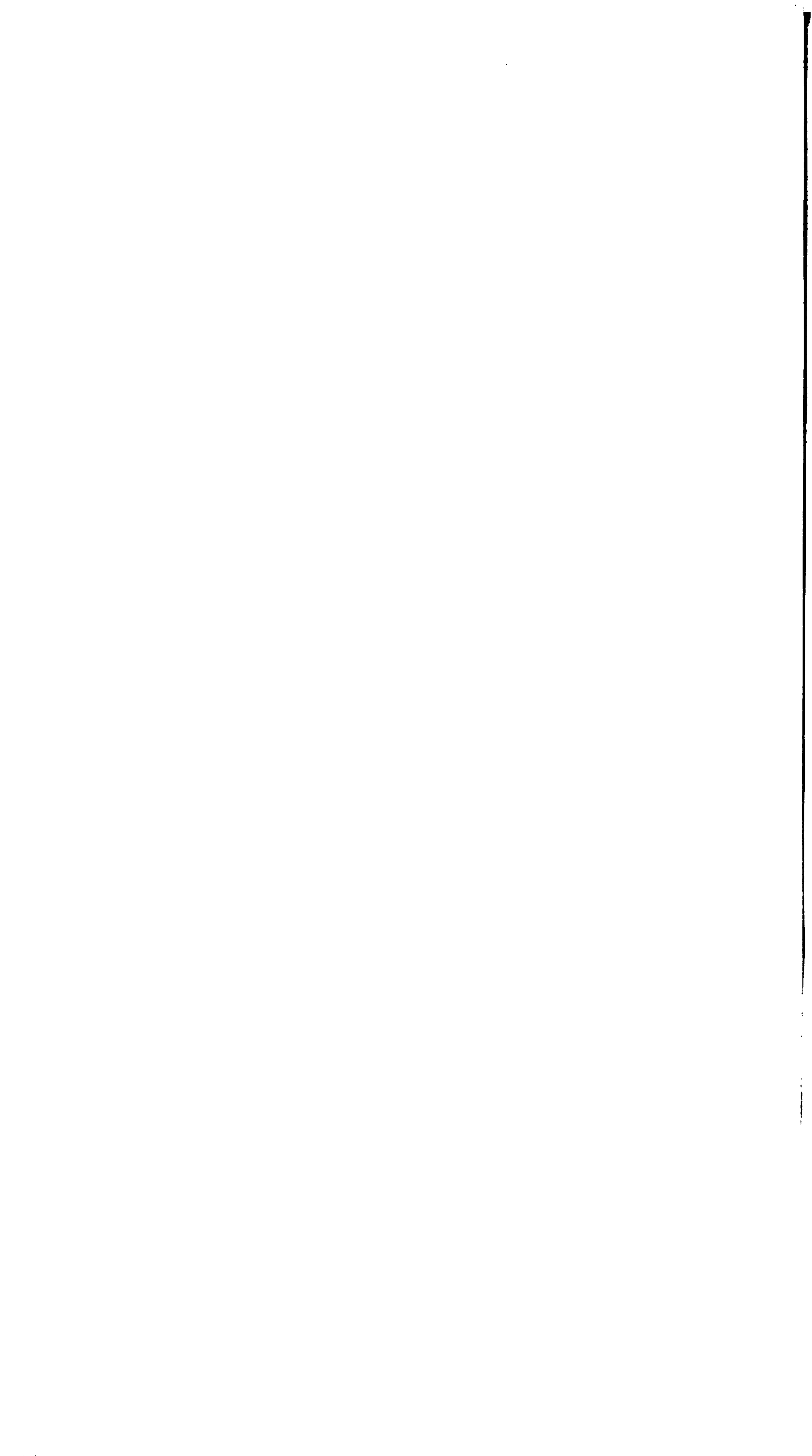
The benefit of this approach is that the church would be required annually to distribute or permanently set aside a portion of its earnings or pay income taxes on its failure to do so. This approach would also prevent churches which conduct business activities from expanding such businesses through retained earnings undiminished by income taxes.

(2) A phase-in period of 10 years could be provided. Churches which have relied on prior Congressional action for nearly 50 years should not now be

prejudiced by the far reaching changes contained in the House Bill. Many churches, including Loyola, have expanded their church facilities by incurring substantial long term indebtedness which in major part is financed by revenues from their unrelated activities. In the event that it is deemed necessary to extend the unrelated business income tax to these activities, we would hope that Congress would allow churches with existing business activities a 10 year - 10% per year - phase-in period following the effective date of this provision in the House Bill. Such a phase-in would provide churches with existing business activities a reasonable time within which to retire shorter term obligations and make adequate provisions for previously incurred long term indebtedness secured in part by the expected revenues from their business activities.

We would like to reiterate our belief that income earned by competitively conducted church businesses should continue to be tax exempt if the earnings are annually used for publicly supported religious, educational or charitable activities.

I thank the Committee members for their time and attention to my statement, and I will attempt to answer any questions you may have at this time.



September 12, 1969

STATEMENT FOR THE RECORD

VERY REV. HOMER R. JOLLEY, S.J.
LOYOLA UNIVERSITY, NEW ORLEANS, LOUISIANA

COMMITTEE ON FINANCE, UNITED STATES SENATE
WASHINGTON, D.C.

Re: Extension of the Unrelated Business Income Tax to Churches

INTRODUCTION:

This statement is made on behalf of Loyola University of New Orleans for the purpose of presenting its views on the extension of the unrelated business income tax to churches. Loyola wants to make its position perfectly clear at the outset: We do not oppose legislative efforts to stop the Clay-Brown type transactions. We do, however, have serious reservations concerning the extension of the unrelated business income tax to churches. In this connection, we feel there are ways of curing the abuses to which extension of the Section 511 taxes is aimed which permit churches to continue their traditional religious, educational and charitable activities.

BRIEF HISTORY OF LOYOLA UNIVERSITY OF NEW ORLEANS:

In 1849, members of the Society of Jesus founded Immaculate Conception College in downtown New Orleans. Thereafter, in 1904, Loyola College and Academy moved to

its present site in uptown New Orleans. In 1912, the State of Louisiana granted Loyola a University charter. Subsequent colleges established were Pharmacy in 1913; Law and Dentistry in 1914; Music in 1932; and Business Administration in 1947.

Presently, Loyola's student body, representing 43 states and 27 countries, consists of nearly 5,000 students, of which slightly more than 20 percent are not members of the Catholic faith. From its earliest days, Loyola has been active in the New Orleans community and committed to providing educational opportunity for all citizens in the South. Loyola has, since 1924, conducted an evening division for students employed during the day and present enrollment now exceeds 2,000 students. The Institute of Human Relations of Loyola University was founded in 1947 and evidences a long-standing commitment to the promotion of human and civil rights and to the education of the underemployed and the unemployed. The Institute has conducted four federally funded manpower training programs for the disadvantaged. Since 1935, the Inter-American Center, a division of the Institute, has directed 28 leadership training seminars, supported by the Agency for International Development. These six-week sessions have provided training for

over 800 nationals from Central and Latin American countries. During the past three years, more than 150 students have participated in the University's Upward Bound Program. A college program for police officers and cadets was inaugurated in 1964 and more than 300 are now enrolled studying for degrees in Police Science. Projects ranging from studies in the Strontium-90 content in teeth to the desalinization of water are under way at the Loyola Health Research Center.

Loyola's long commitment to broadcasting began in 1909 with a spark-gap transmitter as part of the Physics Department. At that time, radio licenses were granted to most of the higher educational institutions in Louisiana as well as other civic groups. The only requirement for preserving the license was that it be renewed every 90 days. Most of these licensees grew disenchanted with early radio and allowed their licenses to lapse. Loyola, recognizing the use to which radio could be put as an educational tool, renewed its license on a regular basis. Although much of its equipment was rudimentary by present standards, Loyola immediately placed its radio facilities, teaching aids and equipment at the service of the Government during World War I.

On March 31, 1922, radio station WWL beamed the first radio program ever broadcast in the City of New Orleans, and probably the entire Gulf Coast. Today, it is

one of the few 50,000-watt clear-channel stations in the nation and is heard throughout the Mississippi Valley as well as other parts of the country. It was not, however, until December, 1929, that WWL broadcast its first commercial program. In 1957, Loyola branched into television, with WWL/TV. Both WWL and WWL/TV are still part of Loyola University and, aside from providing much needed financial assistance to Loyola, these facilities provide valuable technical assistance to the Department of Communications and furnish a media by which Loyola can better serve the New Orleans community.

Loyola was a pioneer in the use of television to offer education courses for credit. A typical lecture series might dwell on "Science of Optics" (Physics) or "Marketing Techniques" (Business Administration) or "The Philosophy of Existentialism" (Philosophy). In 1965, Loyola instituted a full-time Department of Communications offering degrees in several fields of broadcasting. For some years prior to this, Loyola students were able to receive credits in a variety of broadcast courses using its broadcasting facilities as the primary classroom. Presently, courses are offered in all phases of broadcasting, including production, writing, announcing and even marketing. Beginning in 1962, Loyola through its broadcasting facilities presented a series of

programs designed to teach functional illiterates how to read and write. Presented in cooperation with the Greater New Orleans Council of Jewish Women, the program "Project Learn" was aimed at the area's Negro minority. Public affairs programming is varied and reaches a majority of homes in the broad WWL broadcast range. Community service has become a hallmark of WWL broadcasting, as is evidenced by the fact that WWL has, within the last five years, received more national awards for programs and services than all other stations in New Orleans combined.

INCREASED DEMAND FOR EDUCATIONAL FACILITIES:

In the past 10 years, Loyola's enrollment has increased more than 50 percent. In order to meet this increase, Loyola--like all other educational institutions--has substantially increased the size of its faculty, faculty salaries, and physical plant. Increased enrollment over the next five years is projected at nearly 20 percent. In the last five years, close to $14 million in capital improvements have been made. Indeed, within the last few months, Loyola dedicated a $6.7 million science complex in order to keep abreast of the widening vistas of science. With ever-increasing operating costs, the tuition fees continue to

rise and the University is required to appropriate more scholarship aid to assist more deserving students. None of Loyola's past accomplishments or future goals could have been--or will be--possible without the direct financial assistance Loyola receives from WWL.

Loyola is a private university engaged in public service. University revenues are realized from tuition fees, alumni gifts, matching gifts of corporations, friends, and foundations, a small security endowment, and the revenues derived from the operation of its broadcasting facilities. Even with these sources of financial assistance, Loyola, like most private universities, must operate on a marginal budget. Our five-year projections indicate that without additional sources of revenue, the University will operate at a deficit for all five years. This deficit will be increased substantially without the anticipated revenue that would be derived from WWL.

While others may have expanded their unrelated businesses through the use of competitive practices gained as a result of tax exemption, WWL has always operated on a strictly competitive basis--on a par with other broadcast operations in its market. Its employees, both engineering and talent, belong to the same unions as the employees of

other stations. Accordingly, the same union contracts are generally involved. While some business operations perhaps lend themselves more easily to utilizing a competitive edge, the broadcasting industry is strictly regulated by the Federal Communications Commission. New Orleans is a highly competitive local and national television market, with each of the network-affiliate stations and the independents competing for the same advertising dollars. Since television rates are primarily based on audience ratings compiled by the American Research Bureau and the A. C. Neilson Co., individual stations formulate rate cards to reflect audience flow during the broadcast day. WWL, with its CBS affiliation, maintains advertising rates comparable to the other stations in the area. For example, minute announcements during the 12 noon to 4:30 p.m. period for each of the stations are:

Station	Cost per Minute
WDSU/TV	\$120 - \$170
WWL/TV	\$110 - \$200
WVUE/TV	\$ 40 - \$ 65
W[illegible]CM/TV	\$ 15 - \$ 32

The advertising costs during the so-called prime time hours (7 to 10 p.m.) for each of the various stations are as follows:

Station	Cost per Minute
WDSU/TV	$1,550
WWL/TV	$1,550
WVUE/TV	$1,100
WWOM/TV	$ 300

HOW WWL EARNINGS ARE USED:

Since WWL began commercial operations in 1929, Loyola's educational facilities have been the sole beneficiary of these earnings. For example, in the past five years, WWL has expended 82 percent of its earnings for the benefit of Loyola's educational facilities. Without this source of income, Loyola could neither afford to meet the ever increasing demand for higher education programs in the South nor continue to maintain our present level of competence in academic quality. Even with WWL, Loyola has and will continue to have difficulty competing with the public universities and colleges that receive State aid.

The Tax Reform Studies and Proposals of the United States Treasury Department, published on February 5,

1969, state that in 1965 the effective tax rate*/ was 29.3 percent for the lumber industry; 30.9 percent for the paper industry; and 44.4 percent for all manufacturing enterprises, except the petroleum and lumber industries. Another U. S. Treasury publication (Publication No. 159(8-38)) entitled Preliminary Report, Statistics of Income - 1966, Corporation Income Tax Returns, indicates that this effective tax rate for the various industries has not changed significantly. Moreover, this same publication indicates that all manufacturing companies distributed to stockholders approximately 4[illegible] percent of after-tax income (30 percent of pretax income), or, approximately 74 percent of taxable income was accounted for either in federal taxes or in distributions to shareholders. These figures show that, on the average, manufacturing corporations retained slightly more than 25 percent of pretax profits. This figure should be compared with the 18 percent retained by WWL. The Treasury Department does not break down radio and TV stations as a separate industry and, accordingly, no comparison on this particular industry can be made.

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*/ The effective tax rate is the actual tax, both domestic and foreign, as a percent of taxable income.

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WAYS TO CURE ABUSES AND PERMIT CHURCH ACTIVITIES TO CONTINUE:

Prior to the Revenue Act of 1950, religious, charitable and educational organizations were exempt from Federal income taxation. In the Revenue Act of 1950, Congress, concerned with certain business activities of exempt organizations, enacted the unrelated business income tax. In taking this step, Congress specifically exempted churches or a convention or association of churches. The primary basis for this exemption was the recognition of the vital role churches play in this nation and the feeling was that churches should continue to provide religious, charitable and educational services free from the burden of Federal income taxation. Earlier this year, the House of Representatives, concerned with what it considered to be abuses in the unrelated activities of certain organizations, including churches, chose to attack these abuses in two ways. The first was to enact certain provisions designed to halt the Clay-Brown type transactions. We agree that the Clay-Brown situations constituted a clear abuse; indeed, such transactions exploited the tax-exempt status conferred on non-profit organizations under existing law, and we applaud the House action in this regard. The second action taken by the House (Section 121 of H.R. 13270) was

to extend the unrelated business income tax to certain tax-exempt organizations, including churches. Recognizing the economic hardship that such extension would cause, the House Bill provides churches with a six-year period within which to re-structure their activities. We believe that there is a middle ground available to Congress which will both curb the abuses to which the House Bill is aimed and, at the same time, retain the traditional tax-exempt status of churches.

The principal reasons advanced by the Treasury Department for extension of the unrelated business income tax to churches are that vis-a-vis their taxpaying competitors, churches (because of tax exemption) can "charge lower prices and . . . expand their business operations out of earnings undiminished by taxation." As evidenced by the advertising rates charged by WWL, it is apparent that WWL does not "charge lower prices" for its broadcasting services. WWL recognizes that tax exemption creates that potential advantage, but we can say unequivocally that WWL has not been guilty of any unfair competitive practices, and that we support all efforts to stop such activity. If, indeed, a church did use this potential advantage and did charge lower prices, it is difficult for us to understand how the imposition of the unrelated business income tax would materially change this situation. Rather, unfair

competitive practices should be met head-on and not through the taxing statute.

The other reason advanced by the Treasury Department is that churches can expand their business operations out of earnings undiminished by taxation. The enactment of the Clay-Brown provisions will curb debt financed business expansions. Moreover, as the above figures indicate, WWL has expended more, not less, of its earnings than corporations in general. For the last five years, or any previous period selected, WWL has expended more than 80% (often more than 90%) of its earnings for the benefit of its religious and educational purposes. As a consequence, WWL has less funds available for expansion than do taxpaying corporations.

Loyola recognizes that the potential for unfair competition does exist if churches neither pay taxes nor expend their earnings for the benefit of the public. We support all efforts to establish equality of operation, and to secure this result we recommend, as an alternative to across the board extension of the unrelated business income tax to churches, that churches be required to expend a minimum of their earnings on an annual basis.

Loyola supports legislative efforts which would (i) remove all non-tax advantages enjoyed by churches in the conduct of unrelated activities, and (ii) require churches to expend at least 80% of the sum of (a) their unrelated business taxable income for the taxable year and (b) their gross revenues for the taxable year derived from any source (exclusive of gifts, grants, bequests, and extraordinary items) other than any unrelated trade or business income. It is Loyola's position that a church should be required to expend such amounts in the exercise or performance of its religious, charitable or educational purposes. We believe that this minimum expenditure approach combined with the inability to borrow imposed by the Clay-Brown provisions will remove any competitive edge which churches may enjoy, and, at the same time, permit churches to continue making positive contributions to the communities they serve -- contributions which, in our view, are far more significant than the potential revenue impact of extending across the board the Section 511 tax to churches. Churches which do not expend at least 80% of their total revenues should be taxed as commercial entities on their unrelated trade or business income. We have attached a draft bill which embodies these proposals and would hope that the Committee will give it serious consideration.

If this approach is not deemed desirable by the Committee, we would hope that methods other than the provisions of the House Bill which would eliminate abuses will be explored. Examples of these methods include:

(1) Churches could be allowed an unlimited deduction for earnings distributed to or permanently set aside for the benefit of certain qualified operations or organizations such as schools, hospitals, and charities which derive their support from the general public.

The benefit of this approach is that the church would be required annually to distribute or permanently set aside a portion of its earnings or pay income taxes on its failure to do so. This approach would also prevent churches which conduct business activities from expanding such businesses through retained earnings undiminished by income taxes.

(2) A phase-in period of 10 years could be provided. Churches which have relied on prior Congressional action for nearly 50 years should not now be prejudiced by the far reaching changes contained in the House Bill. Many churches, including Loyola, have expanded their church facilities by incurring substantial long term indebtedness which in major part is financed by revenues

from their unrelated activities. In the event that it is deemed necessary to extend the unrelated business income tax to these activities, we would hope that Congress would allow churches with existing business activities a 10 year - 10% per year - phase-in period following the effective date of this provision in the House Bill. Such a phase-in would provide churches with existing business activities a reasonable time within which to retire shorter term obligations and make adequate provisions for previously incurred long term indebtedness secured in part by the expected revenues from their business activities.

SUMMARY:

In summary, Loyola believes strongly that churches have an obligation to the community they serve, as well as to the nation, to benefit the general public. While the primary obligation runs from the church to its members, its obligation to serve the community extends to the public. Among the ways the public benefits from church activities are the operation of schools, hospitals, day-care centers, etc. To continue such activities, large amounts of money are necessary. Because of its deep commitment to higher education and its need to secure funds to operate a

university, Loyola operates WWL. As was noted above, Loyola's entry into the broadcasting field was not inspired by economics, but rather, as an educational tool to serve the New Orleans area. As New Orleans grew, so did Loyola and WWL; and, while not originally conceived as a revenue producer, WWL -- there is little doubt on this point -- has in large measure made possible Loyola's recent expansion of its university facilities, through the funds which it provided. Moreover, Loyola's ability to expand and improve its existing educational facilities is heavily dependent on the revenue produced by WWL.

In recognition of the obligation which churches owe to the communities they serve, we have suggested two alternatives to outright extension of the unrelated business income tax to churches. Loyola supports legislative efforts which would (i) remove all non-tax advantages enjoyed by churches in the conduct of unrelated businesses, and (ii) require churches to expend on an annual basis a minimum amount of both unrelated business income and other gross revenues for the benefit of educational facilities, religious and other charitable purposes for which they were formed. We believe that such an approach would remove any competitive edge which churches may enjoy and, at the same time, make a positive contribution to the local communities they

serve. In our view, such a contribution is far more significant than the potential revenue impact of extending the Section 511 tax across the board to churches. Churches which do not meet this minimum expenditure requirement should be taxed on their commercial activities.

Loyola and all its representatives stand ready to assist the Committee, in attempts to reach a satisfactory conclusion in this area. We feel that the minimum expenditure requirement discussed above is equitable under the circumstances and should be adopted.

Testimony of

AMERICAN BUSINESS PRESS

(Also on behalf of other publishing associations and individual publishers)

H.R. 13270, September 12, 1969

COMMITTEE ON FINANCE, U.S. SENATE

WITNESSES: Robert E. McKenna, President, Chilton Company, Philadelphia
Robert A. Saltzstein, Wyatt & Saltzstein, General Counsel

SUMMARY OF PRINCIPAL POINTS

(1) Advertising is a business unrelated to any tax exempt purpose, and where it produces a profit, it ought to pay a normal income tax on that profit.

(2) IRS, acting under authority delegated to it by Congress, properly applied the unrelated business tax to tax exempt advertising profits; the Ways and Means Committee codified this IRS regulation into H.R. 13270 as Section 278(c), page 93.

(3) Testimony includes examples of formerly tax exempt advertising activities.

(4) Members of organizations pay dues to receive membership services for which they take tax deductions. Dues should not be subsidized through use of an additional tax exemption on advertising profits of a tax exempt organization. Accordingly, each separate publication of a tax exempt organization should be accounted for separately, so as to prevent tax avoidance.

(5) Some tax exempt organizations may seek to use accounting devices to avoid payment of the tax. In addition to continuing unfair competition, this could deprive the government of perhaps $25,000,000 in tax revenue.

(6) The performance of good works is not a reason for exempting advertising profits of tax exempt organizations. This would simply be a form of government subsidy. Moreover, in 1969, taxpayers, the tax paying press included, also perform worthwhile public services for which they ask no tax exemption.

MR. CHAIRMAN: MEMBERS OF THE COMMITTEE:

My name is Robert E. McKenna. I am President of the Chilton Company in Philadelphia and Chairman of the Washington Legal Committee of the American Business Press, which numbers among its membership over 400 specialized business publications published coast to coast.

On my right is Mr. Paul Conrad, General Counsel of the National Newspaper Association which includes in its membership 7,000 newspapers in all 50 states. Known from 1885 until 1966 as the National Editorial Association, the organization is generally thought of as representing the nation's community press, although some of the nation's largest metropolitan daily newspapers are members also.

On my left is Robert Saltzstein, Wyatt and Saltzstein, General Counsel of the American Business Press.

I am authorized to say that Fairchild Publications, New York; C. V. Mosby Medical Publications, St. Louis; Holiday Magazine, New York; the Atlantic, Boston; Investment Dealers Digest, New York; Safety Journal, Anderson, S.C., Second Class Mail Publications, an association of publications mailed at second class rates including such publications as Public Utilities Fortnightly, and Yachting, and Associated Construction Publications, published in 14 different states, have associated themselves with the testimony of the National Newspaper Association and the American Business Press in order to conserve the time of this Committee. They all support the principles we are privileged to put before you today.

The National Newspaper Association, the American Business Press and the other associations and publications I have just mentioned, have consolidated their testimony because they see eye to eye on the principle that advertising is a business, that profits earned

on advertising should not take the place of professional society or trade association dues or membership charges, and that where advertising makes a profit, it should pay an income tax on that profit.

The Ways and Means Committee, by including Section 278(c)beginning at line 22 on page 93 of the bill before you and headed "advertising, etc., activities" legislatively supported the loophole closing IRS had achieved when the service issues its regulation applying the unrelated business tax to advertising profits of tax exempt publications. It is our hope that this Committee will make certain that Section 278(c) is administered so as to prevent tax avoidance through the use of accounting devices which could dissipate possibly $25,000,000 in tax collections.

In July, 1967, before issuing its regulation and after much public discussion about its intention to do so, IRS held an extensive hearing at which it heard those who oppose the tax, and those who favor the tax. On February 24 and 25 of this year, the Ways and Means Committee included advertising profits of tax-exempt organizations as part of its tax reform hearings.

At the IRS hearing and at the Ways and Means Committee hearings, the following arguments were made against the tax:

(1) IRS had no authority to issue the regulation and this constituted "administrative regulation" and "usurpation of the powers of Congress".

(2) The profits earned on advertising in tax exempt publications are devoted to good works, so they should be untaxed,

even though the same advertisement which runs in a tax exempt publication may also run in a tax paying publication.

(3) Since the editorial portion of an association publication is for the appropriate purpose of communicating with members, advertising cannot be separated out for tax purposes even though the exempt communication function is exploited by the running of advertising.

(4) Advertising is somehow related to a tax exempt purpose.

Prior to issuance of the regulation, all of these arguments had been repeatedly made for several years at tax symposiums and in tax literature, but none of these hypotheses or written comments took into account the very critical statement appearing in both the House and Senate Committee reports at the time the unrelated business tax was passed in 1950. That statement follows:

> "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition."

After hearing all these arguments, IRS went ahead and issued its regulation. Then the opponents of the regulation, again lead by the American Medical Association, the United States Chamber of Commerce, the American Society of Association Executives, the Society of National Association Publications, the American Chemical Society (and based on a statement filed in the House Committee report by the National Geographic Society as well) or appeared or filed statements before the Ways and Means Committee and, in general, repeated the same arguments they had made to IRS, and before that to the Treasury,to slow down issuance of the regulation. Once again the argument was made that IRS did not have the authority

to issue the regulation.

To the statement that IRS had no authority to issue the regulation, the tax paying press illustrated both before the IRS hearing and the Ways and Means hearing that IRS did have such authority. There is ample evidence in the legislative history of 1950 when the Unrelated Business Tax was passed, that IRS was granted discretion to apply the tax to situations which would come up in the future. For example, in the 1950 hearings, Chairman Knutson read a list of business activities carried on by tax exempt organizations, and publishing is mentioned five times. Moreover, in the floor debate in the House, Congressman Lynch was asked where the tax would apply and where it would not, and he replied:

> "It is not possible to define in the bill exactly every case that is going to be covered. We have drawn it so that there is a certain amount of discretion for the determination of questions of fact as to whether or not a certain matter comes within the purview of the bill."

Thus, in applying the tax, IRS was properly exercising the discretion Congress had delegated to it.

Page 1179, in Volume 3 of the House Ways and Means Committee hearings this year, contains a brief prepared by Wyatt and Saltzstein setting forth the legislative history behind the unrelated business tax.

The arguments in support of the IRS regulation and its codification in the bill before you, are that when an advertisement appears in two publications, one of which pays a tax and the other does not, this is unfair competition. Secondly, unless this loophole remains plugged, some 700 trade associations and professional

societies will continue to take a tax-free handout from the government, which is precisely what tax exempt profits really are. A little later Mr. Conrad will show you some examples of this in the newspaper field.

I would like to show an illustration which was presented earlier to the IRS hearing and also to the Ways and Means Committee. In this display are all the identical advertisements which appeared in Chemical and Engineering News, published by the American Chemical Society during the first six months of 1967, and the same advertisements which appeared in Chemical Week, published by taxpaying McGraw-Hill during the same time. The situation is no different today.

Now the reason why an advertisement appears in the tax exempt chemical publication is to sell chemicals, which certainly is not a tax exempt purpose. If the profit earned on that advertisement is tax exempt, then the profits of the tax paying publisher should be tax exempt and tax paying publishers, of course, do not ask for tax exemption.

Here is a copy of Hardware Retailer, published by the National Retail Hardware Association, and here is a copy of Hardware Age, published by my company, Chilton. No one needs a crying towel for the Hardware Association which has agreed to pay a tax on its profits, and the last thing they need is a tax sanctuary, but it is not hard to imagine that if this Committee does not back up IRS and the House codification, the hardware dealers aren't going to pay a tax either.

The National Geographic Society competes directly with Holiday

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Magazine, the Atlantic Monthly, and others. Here are some advertisements run recently by the National Geographic in Advertising Age for the purpose of selling advertising to advertisers. Note the headlines on these advertisements:

> "The Bridge to 6,000,000 high income households."
>
> "National Geographic -- the Bridge to 6,360,000 upscaled households."

Why should the National Georgaphic be tax exempt when from a publishing standpoint it operates in exactly the same manner as Holiday, except that the 6,360,000 recipients who read the National Geographic are called "members" rather than "subscribers".

The tax paying publishers for whom we speak share what we believe to be the view point of the taxpaying public in general. We don't object to paying taxes as long as everybody pays theirs, and this is equally true in the publishing business.

The American Medical Association is also a large publishing house. In 1967, it had a gross income from all sources of $31,677,215 against expenses of $28,346,984. Of that $31,677,215 gross income, 42.8% was from advertising whereas dues represented only 36.5%. The AMA also received in 1967 $1,538,139 for use of its mailing lists for other medical publications and for direct mail advertising to doctors. The following table, taken from figures published in the AMA News, show growth and net worth of the AMA as follows:

1965	-	$14,307,334
1966	-	15,681,397
1967	-	19,011,610

When the General Counsel of the AMA appeared before the Ways and Means Committee, Congressman Burke asked the following question:

> "Have you a financial statement ready to present to this Committee containing the operating expenses, the revenues, and how any excess revenues over operating expenses are expended?"

To which Mr. Hirsh replied:

> "No, I do not have any financial statements with me, Congressman. They are in the process of preparation. These regulations have made it necessary for the American Medical Association to review and revise its entire accounting procedures and this is now being done." (emphasis supplied)

Mr. Hirsh also testified:

> "Present indications are that after paying all of the costs of publication -- editorial cost, paper cost, overhead, et cetera -- that the profit, or so-called profit, if any will be nominal. I do not have these figures now because they are in the process of being determined by our accountants. I will be glad to furnish them to the Committee when they are available if the Committee so desires." (emphasis supplied)

The record then includes a letter dated April 15, 1969, from Dr. E. B. Howard, Executive Vice President of the AMA, which includes the following pertinent paragraph:

> "With respect to a request for a financial statement indicating revenues from, and operating expenses of, the Association's publications and the use of any excess over operating expenses, we sincerely regret that this information is not available. As Mr. Hirsch indicated, the promulgation by the Internal Revenue Service of the expanded unrelated business tax regulations has required the Association to completely review and revise its accounting procedures. This was and is being done. However, the problems of this revision are so complex that the Association has requested a 60-day extension for filing its return for 1968." (emphasis supplied)

If, because of accounting revisions, nominal or no tax results for the AMA, this would be very much in line with a statement submitted at the IRS hearing in July by the Attorney for the U.S. Chamber of Commerce. Page 59 of that statement contains the following comment:

> "Normally, in the case of a proposed new tax measure, the effect of the tax on the revenues would be another important consideration. But even the proponents of the advertising tax concede that gross advertising receipts of all tax-exempt publications are only some $100,000,000 annually. It is probable that at least 50% of this would be offset by deductions under any realistic and fair tax statute. Thus, net receipts probably would be less than $25,000,000, a nominal figure in terms of overall revenues. As tax-exempt organizations stepped up their expenditures to improve their publications to make them more competitive, <u>and realigned their publishing activities, perhaps by the judicious combination of profitable and unprofitable activities in taxable subsidiary corporations, tax revenues might well dwindle to the vanishing point</u>." (emphasis supplied)

For the United States Chamber of Commerce to take this position is, to us, incredible. The business press and the newspapers of this country are no less advocates of free enterprise than the Chamber. When the unrelated business tax was passed in 1950, the leading advocate in support of the tax was the Chamber. Its witness then told the Senate Finance Committee:

> "It is our policy that we are opposed to Government favoritism in any form, and we urge that no enterprise be favored over any other, and that each enterprise, whether it is cooperative, individual, or corporation, should stand on its own feet, with protection from unfair competition, and free from either tax exemption or other public subsidy."

It is all the more astounding that even at this late date, the Chamber, in its Congressional Action Bulletin, dated August 19, 1969, in talking about the bill now before you, takes the following two opposite positions in urging its local members to write you or to visit with you. Among other things, the Chamber is asking its members to:

> "Urge passage of the Clay-Brown provision and the extension of the unrelated business income to debt-financed income."

and

> "Oppose the section which taxes advertising income as unrelated business income even though the publication is related to the exempt purpose of the organization."

How the Chamber can support the Unrelated Business Tax except when the Chamber itself has to pay a tax, is something we find disappointing to say the least.

An August 19 press release of the Chamber quotes its President as stating:

> "We in Chambers of Commerce are going to have to exercise a little self-discipline ourselves. We are in a poor position to yawp about the destruction of the currency as long as we reward best those public servants who have been most willing to loot the Treasury.
>
> "If we want to save the dollar we're going to have to stretch out our gimmies. We are going to have to be willing to wait another six months for the new bridge and maybe a year for the new hospital wing. And we're going to have to get the word to Washington...."

Wouldn't one think that with this philosophy, the Chamber could well pay a tax to support the government when it makes a profit on Nation's Business, which it publishes?

In the Senate last year, two votes were taken on this issue:

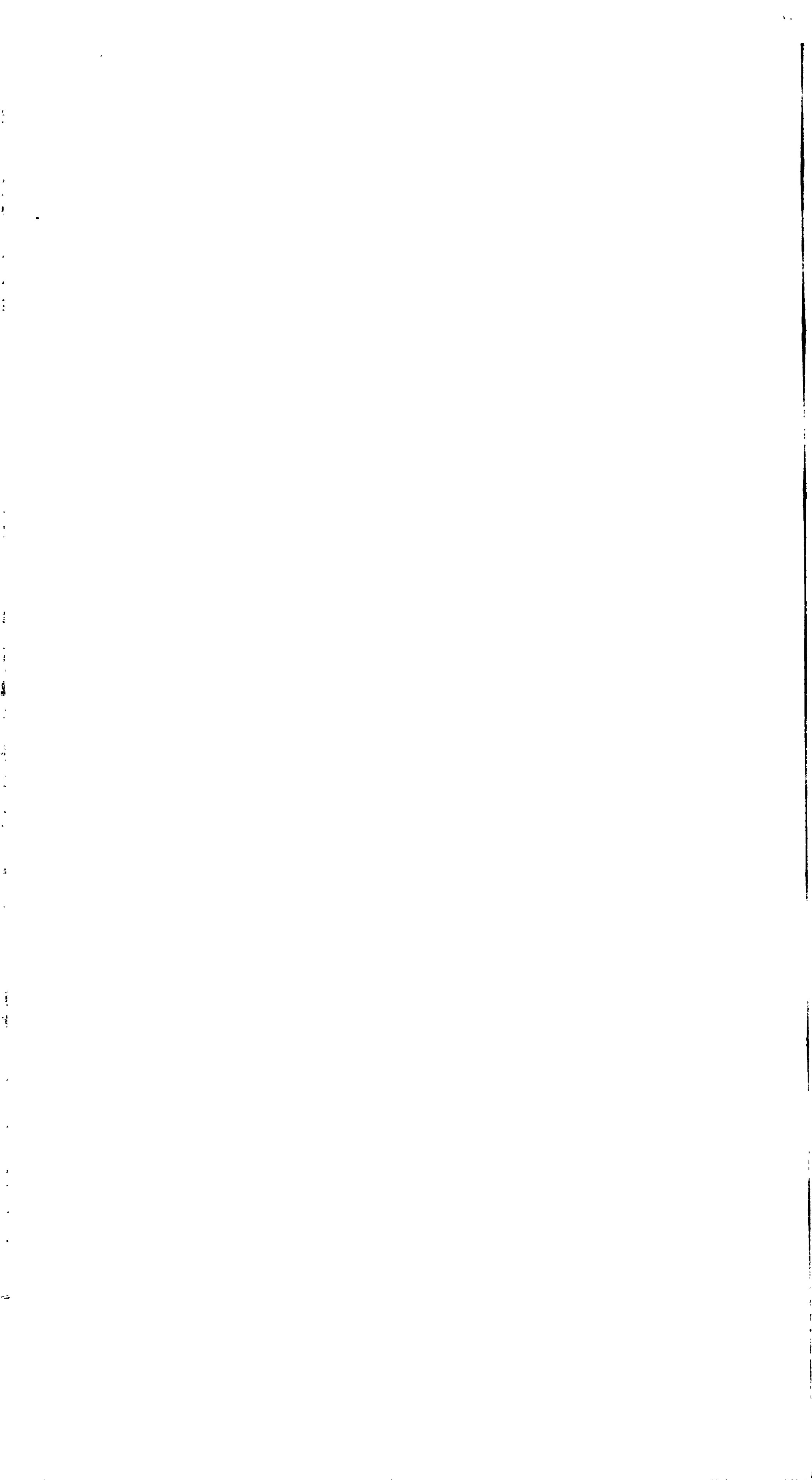
The first, March 27, carried as a floor amendment to the Excise Tax extension bill, and had it not been deleted in conference, it would have nullified the IRS regulation in its entirety. The second vote came on September 20,* and in the floor debate at the time, Senator Anderson, who with Senators Fulbright, Metcalf and Morton had offered an amendment to a Committee proviso postponing the effective date of the provision, made the following exemplary statement which succinctly and clearly explains that situation:

> "MR. ANDERSON. Mr. President, when the excise tax bill was before the Senate on March 27, an amendment nullifying the IRS regulation which would apply the unrelated business tax to advertising profits of tax-exempt organizations was introduced. IRS issued its regulation after lengthy study and exhaustive hearings. Without any hearing before either the Ways and Means Committee or the Senate Finance Committee, and without complete information, after very brief debate, the Senate passed this amendment. In the conference on the excise tax bill this provision was deleted, and I think wisely.
>
> "When the matter was before the Senate on March 27, I think we all must admit we knew very little about it. We did not know, for example, that we were opening up a loophole that could cost the general taxpayers $25,000,000 a year, and this at a time when we are raising taxes for everyone else.
>
> "Now the committee's amendment is another attempt to nullify the IRS regulation, albeit if only for a year.
>
> "Mr. President,I hope that the Senate will agree to this action to strike out the committee's amendment. I limit myself to these remarks at this time. I believe my amendment to be a most important one which should be adopted by the Senate."(S-11184)

When the Conference Committee deleted the March 27 proviso, the Ways and Means Committee stated that it would hold hearings. It did so shortly after the new Congress convened and the result of that hearing is that the IRS regulation was codified by Section 278(c) of the bill before you.

* In the September 20th Senate vote, the IRS position was sustained.

The difficulty now is that unless the tax is so administered as to prevent the use of accounting devices to nullify it, unfair competition will continue and the tax revenue achievable will be frittered away. Mr.Conrad will discuss this. Mr. Conrad:



STATEMENT

Of The

NATIONAL NEWSPAPER ASSOCIATION

Before The

COMMITTEE ON FINANCE

UNITED STATES SENATE

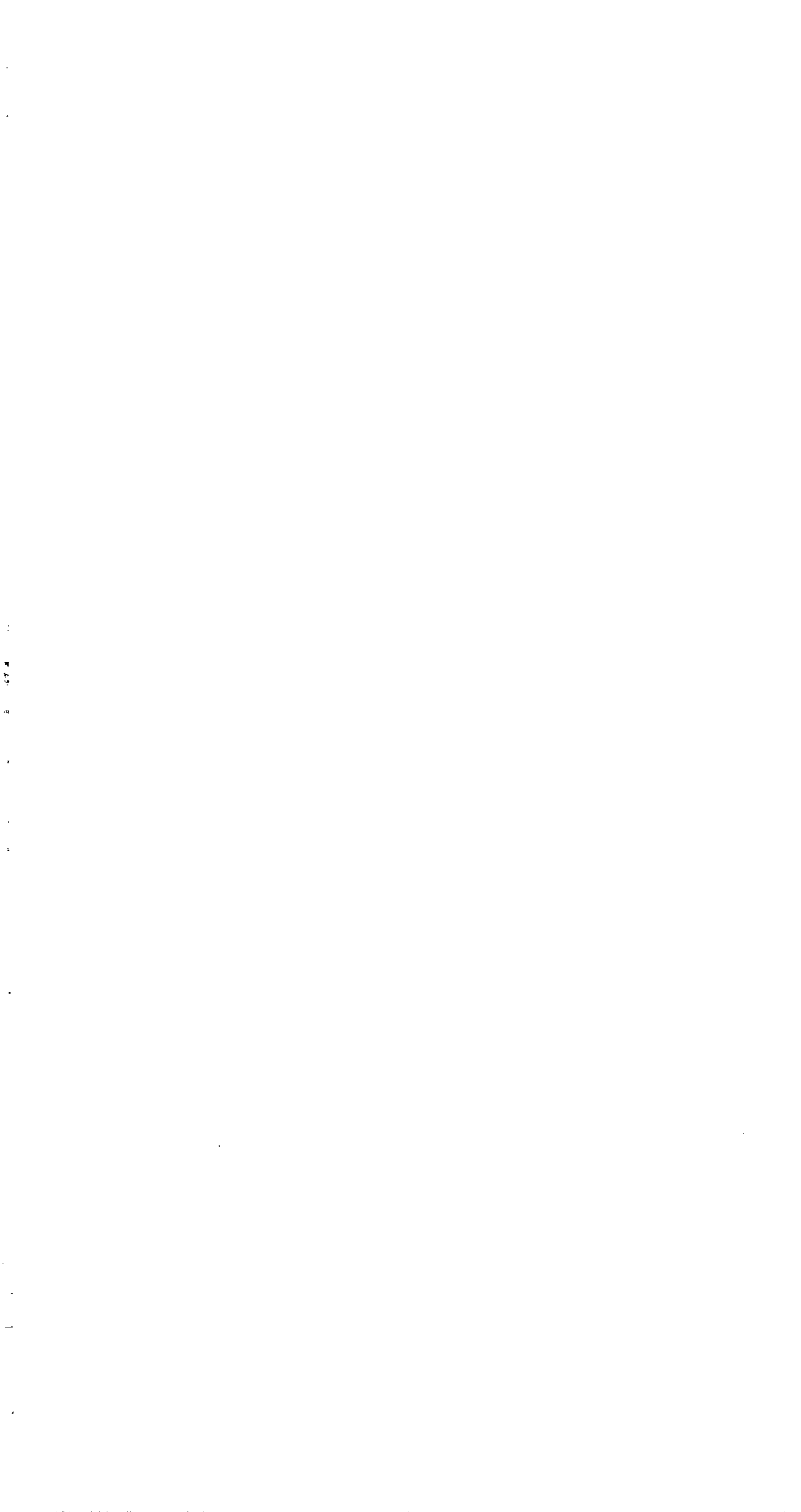
On

H. R. 13270

September 12, 1969

A Summary:

1. The Unrelated Business Income tax is intended to eliminate unfair competition when tax-exempt organizations engage in business enterprises.
2. The sale of advertising is a business enterprise unrelated to the purpose of tax-exempt organizations.
3. This sale of advertising is directly competitive with the sale of advertising by newspapers and other taxpaying media.
4. Congress should support the Internal Revenue Service in its application of the Unrelated Business Income tax to advertising.
5. Congress should not, through statute or committee report, undermine this application by giving the affected organizations the opportunity to mix profits of one publication with losses of other publications.



The Unrelated Business Income tax imposed by Congress in 1950 was intended to end the unfair competitive advantage of businesses conducted by tax-exempt organizations. With the exception of the business of advertising, this has been accomplished. In 1967 the Internal Revenue Service adopted regulations which made it clear that the sale of advertising by a tax-exempt organization did give rise to constitute Unrelated Business Income which would hereafter be subjected to tax.

The National Newspaper Association submits the following information in support of the IRS regulation, to the specific point that non-profit, tax-exempt organizations are selling advertising in direct competition to the nation's newspapers. Since newspapers rely heavily on advertising for revenue, permitting tax-exempt competitors to profit from the sale of advertising without subjecting those profits to income tax would permit the unfair competition the UBI tax was adopted to end.

Advertising in the February, 1969, National Geographic included Ford Motor Company's Lincoln-Mercury and Ford Divisions; General Motors' Cadillac, Pontiac and Chevrolet Divisions; International Harvester; Quantas and BOAC; Johnson Outboard Motors; Aetna Insurance; and Kellogg's Cereals.

The Journal of the American Medical Association in recent issues has carried advertising of Bufferin; Bayer Aspirin; Haley's M.O.; Phillips Milk of Magnesia; Ivory Soap; and Zeiss Ikon Cameras.

Nation's Business of February, 1969, included advertisements of all Chrysler Corporation automobiles; Lark Cigarettes; Chevrolet; Cadillac; GMC Trucks; Evinrude; New York Life; and Aetna Life and Casualty.

All of these products and services would be appropriately advertised in a newspaper, or any other medium of consumer advertising.

A little noticed product of the past decade or two is the city chamber of commerce publication. These magazines, usually printed on fine paper and in full color, have become common across the U.S. They qualify at the city level as publications of tax-exempt business leagues, in the manner of Nation's Business, the publication of the U.S. Chamber of Commerce on the national scene. The following examples of consumer advertising have been gleaned from a review of recent city chamber of commerce magazine issues.

The Baltimore Chamber of Commerce publication, Baltimore Magazine, in its January issue carried advertising for three banks; a number of restaurants; liquor distilleries; a Chevrolet agency; several realtors; a Ford dealer; a Volkswagen dealer; a dry cleaners; a deodorant; a jeweler; an exterminator; Esso; Baltimore Gas & Electric; Blue Cross-Blue Shield; the Chesapeake and Potomac Telephone Company; the C&O and B&O Railroads; and a nursing convalescent home.

A recent issue of the Birmingham (Alabama) Chamber's magazine carried advertising of life insurance companies; airlines; Pepsi-Cola; hotels; bars and night clubs; furniture; clothing; book stores; jewelry and watches; organ and piano sales.

The Louisville (Kentucky) Area Chamber of Commerce magazine includes many of these types of advertising plus Viceroy Cigaretts and Kentucky Fried Chicken.

The Chicagoland Voice of Business and Industry in its December issue, which came in two parts and totaled 146 pages, included many of these types of advertising plus Bell & Howell products; the Burlington Railroad; All-State Insurance; and Montgomery Ward.

The Duluthian, a publication of the Duluth Chamber of Commerce adds to the list beer; retail liquor store; and a Chinese restaurant.

Dayton, U.S.A., the Dayton Area Chamber's publication, contributes tire advertising; Omega watches; the Book of Knowledge; Trans World Airlines; an anti-perspirant; and a women's fashion shop.

Nor are all of these publications in metropolitan areas. The Fayetteville Chamber of Commerce magazine, while a modest four pages, carries more than half of its total space in advertising.

The Mid-Monmouth Panorama Magazine, published by the Mid-Monmouth - Greater Freehold Chamber of Commerce in central New Jersey, serves the communities of Freehold, Colt's Neck, Englishtown, Howell, Manalapan, Marlboro and Millstone. In addition to some of the advertising mentioned above add a lawn and garden shop; a sporting goods store; United Van Lines; a music and dance studio; a florist; a poultry farm; a beauty salon; a supermarket; and a painter and paperhanger.

In short, there exist today localized publications of tax-exempt organizations which are selling local advertising in direct competition with local media.

The potential is virtually unlimited, if advertising is laid open to tax-exempt usage by the non-profits. The advent of shopping centers has seen also the development of shopping center-oriented boards of trade. Some of them are already producing their own advertising publications. Surely they should not be allowed to escape taxation if these publications show a net profit, for they are in direct competition with taxpaying media.

Farm groups, civic associations, unions, lodges, fraternal groups - the list of potential exploiters of advertising is long. Many now publish periodicals of one type or another, and sell advertising. So long as their tax-exempt status does not preclude such activity, we have no quarrel. But surely no one could argue that, in addition to other inherent advantages these publications enjoy, their profits should escape ordinary federal tax.

In the course of studying the extent to which tax-exempt organizations compete with NNA member newspapers for advertising sales, this Association uncovered at least two publications which are community newspapers in the full sense, yet avoid federal income tax as non-profit organizations.

The first is the Dover (Massachusetts) Reporter, registered with the state as a

non-profit bulletin "formed to promote the civic and social welfare of the Town of Dover". It has been declared tax-exempt as a 501 (c) (3) organization. Started as a twice-a-month mimeographed bulletin, it now is published weekly as an offset tabloid and in every appearance is a weekly newspaper. It employs a manager and staff, pays salaries, and competes directly with the taxpaying newspapers of that area.

At Greenbelt, Maryland, the Greenbelt News-Review is produced by the Greenbelt Cooperative Publishing Association, Inc., a non-profit organization. It too pays no federal income taxes.

The point is that non-profit newspapers can and do exist; can and do compete against taxpaying newspaper publishers. If Congress were to reverse the Internal Revenue Service in its application of the Unrelated Business Income tax to these organizations, it is quite conceivable that local boards of trade, shopping center merchant groups, or even the local Kiwanis or Lions club could launch a newspaper. The publisher would draw a salary appropriate for a publication that makes tax-free profits, and could pay liberal salaries to this staff. The profits remaining could be used to expand the publication. Token contributions could be turned over to the tax-exempt organization in payment for the tax umbrella. Everybody benefits except the government and competing, taxpaying media.

At a time when Congress is trying to close loopholes and insure that all are paying their fair share; at a time when indivuduals and corporations are being asked to pay a surtax on top of already substantial federal income taxes - we urge this Committee to ratify the action of the Treasury Department in applying the Unrelated Business Income tax to the sale of advertising. We know of no sound reason why our field - advertising - should be singled out as the one exception to the 1950 rule that tax-exempt organizations, when they elect to go into business for profit, must compete on an equal footing with taxpaying business competitors.

STATEMENT OF NATIONAL FRATERNAL CONGRESS OF AMERICA ON H. R. 13270 (The Tax Reform Act of 1969) ON THE EXTENTION OF THE UNRELATED BUSINESS INCOME TAX (INCLUDING DEBT FINANCED INCOME) AND THE EXTENTION OF FILING REQUIREMENTS FOR INFORMATION RETURNS TO FRATERNAL BENEFICIARY SOCIETIES.

September 12, 1969

I. SUMMARY OF STATEMENT

A. If the unrelated business income tax is extended in its present form to all exempt organizations, regardless of classification, the National Fraternal Congress would have no substantial objection.

B. If the unrelated debt financed tax is extended to all exempt organizations, regardless of classification, the National Fraternal Congress would have no substantial objection.

C. The National Fraternal Congress objects to the discriminatory treatment of fraternal beneficiary society investment income where various classes of membership organizations (including other large benefit organizations) will not be subject to tax on such investment earnings.

D. The National Fraternal Congress has no substantial objection to the requirement that all exempt organizations file public information returns so long as some provision is made in the statute for an automatic exception for very small organizations, such as local lodges with less than $5,000 in gross receipts and assets.

II. INFORMATION ON NATIONAL FRATERNAL CONGRESS OF AMERICA

In 1886, the National Fraternal Congress was formed by representatives of 16 fraternal benefit societies. Its object was declared to be "the uniting permanently of all legitimate fraternal benefit societies for purposes of mutual information, benefit and protection."

Today the National Fraternal Congress of America is composed of 101 fraternal benefit societies. The societies which compose the National Fraternal Congress of America have an extremely large percentage both of the total membership of the Fraternal Benefit System and of the entire fraternal insurance in force. This reveals the magnitude and influence of the societies which make up this association.

Not only does NFC look after the interests of its members but it also serves as a liaison between the Fraternal Benefit System, all of the various states, the Federal government and the general public.

Originally, fraternal benefit societies were organized along four different lines: (1) by religion; (2) by nationality; (3) by labor groups; and (4) in general, making no distinctions among the foregoing.

They write life insurance on a legal reserve basis, the same as commercial life insurance companies, and they are required to meet the same tests of solvency as their commercial counterparts. Fraternal benefit societies feature the open [assessable] contract, which gives them an added measure of safety.

In summary, fraternal benefit societies feature balanced programs of insurance and fraternal benefits. Their fraternal benefits are unique; among others, they include social opportunities to those who might otherwise not have them, many and varied charitable activities, and the promotion of religious beliefs and civic welfare. It is this combination of insurance and fraternal benefits that has contributed the most to the continued tradition of service to this country by these societies.

III. OPPOSITION TO PROPOSED IRC §512(a)(3) LIMITING EXEMPTION OF FRATERNAL SOCIETIES TO "EXEMPT FUNCTION INCOME"

The basic goal of Congress in dealing with exempt organization reforms should be to treat equivalent organizations on an equal basis and to treat equivalent incomes on an equal basis. Equality and fairness in the revenue structure is a fundamental tenet of our American self-assessment system. Where substantially all other classes of tax exempt self-insurance organizations would enjoy complete investment income exemption, and fraternals would not, there would be unequal treatment of equivalent organizations. Where substantially all organizations, now or later covered by the unrelated tax, would enjoy complete exemption of their dividend, interest, royalty and rent income and fraternals would not, there would be unequal treatment of equivalent income. In brief, the proposed unequal and discriminatory treatment of fraternal organizations should not be countenanced.

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The Internal Revenue Code of 1954 (§501(c)(8)) provides for the exemption of fraternal beneficiary societies, operating under the lodge system, providing for the payment of life, sick, accident, or other benefits to their members or dependents. In specific terms, the provisions of §501(c) grant tax exemption to certain insurance organizations such as local benevolent life insurance associations, voluntary employee beneficiary associations (government and nongovernment), mutual insurance associations (other than life and marine), etc. See IRC §§501(c)(12), 501(c)(9) and (10) and 501(c)(15). In general terms, some health and life or related benefit organizations have been granted federal income tax exemption as charitable (Teachers Insurance and Annuity Association), as social welfare (The Blue Cross-Blue Shield Plans) and as labor organizations (Rev. Rul. 62-17, Cum. Bull. 1962-1, 87), depending upon the nature or class of membership and the type of benefits provided.

The exemption for fraternal organizations, in one form or another, has been part of our Nation's revenue laws since the first income tax act was enacted in 1894. 1/ In more recent times, Congress recognized that fraternal organizations did not become involved in business or other commercial undertakings which would warrant a change in their status. In 1943, Congress sought to ascertain information on business activities and required charities, cooperatives, labor unions and other classes of exempt organizations to file

annual information returns. [2] Fraternal beneficiary societies were relieved from this filing requirement. [3] Several years later, when major abuses of the exemption privilege were uncovered in Congressional hearings, [4] leading to the enactment of the unrelated business income tax, [5] Congress chose not to subject fraternals (or their lodges) to this tax. In the 19 years since enactment of the unrelated tax, there has been no evidence indicating fraternal involvement in unrelated business enterprises or debt financed transactions which would warrant a change in their status. For a period covering almost 75 years, Congress has seen fit to champion the growth of the fraternal and benevolent concepts of beneficary societies by approving continued exempt status for their premium and investment income.

In an abrupt departure from this position, the Treasury Department in 1969 suggested a tax of all investment earnings of fraternal organizations where the underlying property was not "permanently committed" to the insurance or benefit function. The Treasury Department assumed that a portion of the investment income of fraternal organizations was regularly used to pay for social activities. [6] By suggesting a limitation upon tax exemption which would exempt only premium income and earnings from assets "permanently committed" to the insurance function, the Treasury supposed that it would be preventing the use of untaxed, nonmember income for personal

(member recreation) purposes. The manifest defect of the proposal was in equating investment income from assets not permanently committed to the insurance function with income used to support social or recreational activities of members of local lodges. The Treasury failed to ascertain that, as a general rule, investment income of the parent organization is not used for recreational purposes to benefit local lodge members, and any income which does flow to local lodges is used for charitable, benevolent or like activities. In fact, there are many fraternal organizations whose lodges have no social facilities or purely social activities but which engage primarily in church related, benevolent activities. §121 of H. R. 13270 passed by the House adopted a modified version of the Treasury proposal.

The National Fraternal Congress has no substantial objection to the extension of the unrelated business income tax in its present form across the board even though there is no apparent justification for applying it to fraternal beneficiary societies. Likewise, in the case of the taxation of unrelated debt financed income, we have no substantial objection to this provision since all exempt organizations are being treated in equal fashion. Where we do object is not in extension of the unrelated business income tax in its present form, but to the extension of the tax in discriminatory fashion where applied to fraternal beneficiary societies.

Under §121 of the House bill, four classes of exempt organizations are grouped together and all their income, except exempt function income, is treated as unrelated business income; income is treated as exempt if derived directly from members in the insurance function (e. g., premiums) or if derived from investments and permanently committed to charitable purposes or for providing for benefits. Unrelated income, debt financed income, income from controlled corporations, etc. regardless of its commitment would be taxable to a fraternal beneficiary society. Discrimination arises in the following contexts:

1. <u>Membership Organizations Now Subject to Unrelated Tax Are Exempt On Their Investment Income.</u> Under present law (§§512(b)(1)-(5)), technical or professional societies, labor organizations (including

unions), business leagues, though taxed on their unrelated income, are not taxed on any investment income such as dividends, interest, royalties, annuities, or other passive income which they receive (except the taxable proportion of business lease income, §514(a)). They may use this investment income to provide "purely personal facilities" for their members without any adverse tax implications.

2. Membership Organizations Proposed For Coverage Would Be Exempt On Their Investment Income. If the provisions of the unrelated business tax are extended to all mutual or membership organizations, regardless of classification, e.g., to social welfare organizations, civic leagues, farmers cooperatives, cemeteries, credit unions, employee beneficiary societies, only two classes of mutual organizations, other than fraternals, viz., social clubs and employee beneficiary societies would be subject to tax on their investment income. All other classes of membership organizations would enjoy the use of their investment income free from any tax whatsoever, regardless of member services provided by such income.

3. Substantially All Other Tax Exempt Self-Insurance Organizations Under the Proposal, Except Fraternal Beneficiary Societies, Will Be Exempt From Tax On Their Investment Income. Under present

law, there are a variety of exempt organizations which provide benefits or perform insurance functions respecting the payment of life, sick, accident, or other benefits, similar to that performed by fraternal organizations operating under the lodge system. In large measure, regardless of the exemption classification, the investment income of these other exempt insurers, as described below, will not have their investment income disturbed if the unrelated business tax is extended to them.

A. §501(c)(3) Organizations. The largest plan for life insurance and retirement benefits for college professors and related employees, the Teachers Insurance and Annuity Association, is exempt as a charitable organization. A. R. R. 218, Cum. Bull. No. 3, 238 (1920). No part of its investment income is taxable (see §§512(b)(1)-(5)), although the organization is now subject to the unrelated tax. Its investment income can be used for any membership purpose, consistent with its charter and exemption classification, without any limitation under the proposed bill.

B. §501(c)(4) Organizations. The largest health insurance system in the United States, Blue Cross-Blue Shield, is exempt from tax (private ruling to Group Hospitalization Association of America dated November, 1947). Even if the unrelated tax is extended to §501(c)(4) social welfare organizations, the entire investment income of this entity, and all similar entities providing insurance benefits (Cf.

Rev. Rul. 55-495, Cum. Bull. 1955-2, 259) will be free from tax without regard to any other membership use. 7/

C. §501(c)(5) Organizations. Labor organizations exempt under this section are permitted to provide their members with death, sick and accident benefits (Rev. Rul. 62-17, Cum. Bull. 1962-1, 87), and no part of the investment income of these organizations would be reached.

D. §501(c)(11) Organizations. Teachers retirement fund associations which pay retirement and death benefits and whose earnings must include investment income, will not have any part of such investment income taxed.

E. §501(c)(12) Organizations. Local benevolent life insurance associations will not have any part of their investment income taxed. To maintain exempt status, this class of exempt insurer must have less than 15% of its income from sources other than members.

F. §501(c)(15) Organizations. Mutual insurance associations (providing other than life and marine insurance) exempt under this section will not have any part of their investment income taxed. To maintain exempt status, the total income (excluding capital gain) of such associations must not exceed $150,000 per year.

4. Voluntary Employee Beneficiary Associations Do Not Rely On Investment Income, Are Not Self-Insurers, and Members Don't Pay

For Their Own Benefits. In the case of the 4330 voluntary employee beneficiary associations exempt under §501(c)(9) [8] and the 467 voluntary government employee beneficiary associations exempt under §501-(c)(10), [9] there is some parallel to the insurance functions of a fraternal beneficiary society. Even though classed with fraternals, the potential affect upon them is likely to be minimal as compared to the treatment of fraternals. These membership organizations provide benefits including life, accident and sick benefits but primarily through the use of a commercial insurance company rather than being self-insurers. [10] The great body of these organizations are supported not by employee-members themselves (which is the case with fraternal insurance), but through the contributions by the employers of such employees in union negotiated plans as part of overall wage and fringe benefit packages provided employees. Since a major portion of §501(c)(9) and (10) organizations are not self-insurers, investment income arises only from investments of excess contributions from employers and is of significantly less consequence to them than to an organization which must invest premiums to assure payment of the contracted benefits. Because a substantial portion of these organizations are funded either completely or primarily by nonmembers (employers) the cost of maintaining the benefit schedule if any tax is applied to investment income would not be borne by the members. On the other

hand, since members of fraternals pay for their own insurance, any reduction in benefits or services because of the application of tax would be borne entirely by fraternal members. Only fraternal organizations (among the §512(a)(3) grouping) must rely on investment income for providing and maintaining the purposes and functions constituting the basis of its exemption.

5. Social Clubs Will Be Able To Avoid Investment Tax On All But 15% Of Their Investment Income. Social clubs and fraternals are supposedly on a par with respect to the taxation of their investment income. However, social clubs need only shift their portfolio, if any, into dividend producing properties to enjoy an 85% exclusion of such income pursuant to §243. Because of reserve and solvency regulations imposed by the states, no more than 5% to 10% of the investments of fraternal beneficiary societies may be invested in dividend producing securities but rather must be in fixed income, interest bearing obligations.

Secondly, the aspect of taxation of social club investment income is almost illusory since such organizations generally do not have such income. In testimony before the Ways and Means Committee, representatives of social clubs indicated that investment income is "minor" and of very little consequence in the overall scheme of application of the unrelated business tax to such clubs. [11/] This is obviously not the

case for fraternal beneficiary societies.

To summarize and conclude: Of the hundreds of thousands of tax exempt mutual or membership organizations providing services or facilities to members (whether insurance, economic, social or the like) no class of exempt organization is more likely to be adversely affected by the enactment of §512(a)(3) than fraternal beneficiary societies.

We cannot understand why the unsupported allegation of social services to members represents the principal basis for the change in tax status of investment income when many other services rendered by membership organizations (like labor unions) may be of far more direct importance to the participating member. Furthermore, we fail to see the distinction which permits the largest (indeed larger than any commercial insurer) health insurance plan to be tax exempt on its investment income along with a great variety of member-centered insurance organizations exempt under classifications other than §§501(c)(8), (9) and (10). Today, insurance issued by fraternal benefit societies represents only 1.8% of the insurance in force in the United States, and this percentage has been in steady decline since 1900.[12/] Because of limitations on the types of insurance which can be issued, and the limitations as to the fact that purchasers (local lodge members) must meet membership tests and participate in local

lodge functions to be eligible to purchase a benefit contract, fraternal beneficiary societies are not an anti-competitive force in the insurance industry today. We do not believe that Congress really wants legislation of this type which is so unjustified and discriminatory.

IV. SUGGESTED TECHNICAL (NONSUBSTANTIVE) CHANGES

If it is the will of the Senate to make special provisions with respect to fraternal beneficiary societies in the manner proposed by the House, we suggest certain technical changes which would be helpful when and as problems of interpretation arise.

The National Fraternal Congress understands that the rationale of the proposal seeks to eliminate the exemption for investment earnings used to defray the costs of providing "social recreations." [13/] On the other hand, there is no intention to tax "investment income associated with fraternal insurance." [14/] The language used by the draftsmen, while generally consistent with this purpose, is not sufficiently precise to provide definitive answers to several questions posed by normal fraternal operations. In discussions with representatives of the executive and legislative staffs, the points covered below were raised and the reply was that the present language is broad enough to provide answers satisfactory to fraternals. While we believe that favorable interpretations may be made under the provision as now written, we would prefer to rely on a more precise statute.

The National Fraternal Congress foresees difficulties with the Internal Revenue Service on the interpretation of the present language of the H. R. 13270 (§121(b)) on matters relating to (1) premium income and benefit payments, (2) treatment of surplus, and (3) use of term "permanently" in the statute.

1. Premium Income and Benefits. Initially, there is the ambiguity in scope of proposed §512(a)(3)(B), first sentence, lines 9-17, p. 88 of the bill. As we read the first sentence, this seems to include, as "exempt function income" within the phrase "charge or similar account" all premiums paid by an insurance member with respect to his benefit certificate. We believe that the term "services" used in that first sentence includes the insurance or benefit function. Neither the bill nor the general or supplemental reports explicitly makes this point. The sentence seems to cover, in addition to social clubs dues, etc., dues or charges paid to the local lodge of the fraternal by a member for the goods or facilities which are offered in connection with any recreational, fraternal, or benevolent function of the lodge. We believe it would clarify the status of premium income under the first sentence of proposed §512(a)(3)(B) to insert the terms "premiums" and "benefits" therein. 15/ The first sentence then, as clarified, would also cover an assessment which

might have to be made upon all insurance members of a society where the legal or related insurance reserves and surplus were not adequate to cover outstanding or new contracts for insurance and an assessment was required to bring reserves or surplus up to a specified amount.

2. Treatment of Surplus. Next, there are several ambiguities in the scope of proposed §512(a)(3)(B) second sentence, lines 17-24, p. 88 and lines 1-11, p. 89 of the bill.

As for the second sentence of §512(a)(3)(B), it includes all other related income not from a member source, earned by either the parent organization or the local lodge, such as investment income. We do not include, of course, any income earned from an unrelated business (such as advertising, debt financed income, or income from controlled corporations) in this classification of exempt function income. Thus, for the national organization holding the benefit contracts, it includes the traditional passive income generally excluded from tax under present law.[16/]

Where such investment income is expended or set aside ["permanently committed"] for either (i) charitable purposes ['§170(c)(4)

purposes"] or (ii) for providing for benefits (or policy dividends) then such investment income is not taxed. However, there is concern over investment earned by the fraternal which, after provision for reserves and policy dividends, is accumulated at the close of the year in a surplus account called, "Unassigned Funds." The term "Unassigned Funds" is the name prescribed by the National Association of Insurance Commissioners in their uniform accounting form required of fraternals when submitting annual statements of financial condition to the state insurance departments.

As you know, regulation of fraternal benefit societies by insurance departments differs from state to state. The degree of control or supervision varies and some states are more strict than others in prescribing limitations on operations. A number of jurisdictions prescribe with great detail the reserve factors, fraternal fund and surplus requirements. Since many of our member societies do business in the jurisdictions with strict regulations, such jurisdictions' regulations have the effect of protecting the policyholders of other states whose laws are less strict.

Some states require a separation of insurance funds and fraternal funds. They prescribe the limits allowed for fraternal disbursements. Some states provide that a fraternal beneficiary society must have "Unassigned Funds" representing the excess of 105% of liabilities

(legal life and related reserves) over the amount of such reserves before insurance funds may be used for charitable, educational or fraternal purposes. Thus, the "Unassigned Funds" must be more than five percent of liabilities before disbursements may be made from this surplus for other than insurance purposes.

The "Unassigned Funds" account of fraternals represents a solvency account which is available in the event of extraordinary losses (claims) or severe market depressions. It may be used in the event of an extraordinary claim for cash surrender values, may hold dividends or benefits retained by the society, and may be used for charitable purposes. It provides a cushion in excess of the legal life and other reserves held for benefit purposes. If "Unassigned Funds" become too large, some states may require a fraternal to return to the policyholders a portion of the excess so that this cushion is not too inflated. On the other hand, if there is no surplus, the state regulatory agency can order the provisions of such surplus (through assessments), bar new contracts and/or revoke a license to do business. By addition of the term "or securing" to §512(a)(3)(B)(ii), it would indicate that surplus, i.e., "Unassigned Funds," which secures the payment of benefits is proper and appropriate and investment earnings so committed are not taxable unless diverted.

3. Use of Term Permanently. In the context of my discussion on "Unassigned Funds", the term "permanently" added to the term "committed" could cause administrators at a later date to differ with the scope of the term intended by the Committee on Ways and Means.

According to the dictionary, 17/ the term "permanently" means "continuing or enduring without fundamental or marked change." This definition is contradicted by the last sentence in §512(a)(3)(B) (p. 89, lines 6-11) when it provides:

> If during the taxable year, an amount which is attributable to income so permanently committed is used for a purpose other than that described in clause (i) or (ii), such amount shall be included under subparagraph (A), in unrelated business taxable income for the taxable year.

It doesn't make sense how amounts permanently committed can be diverted. The purpose of the last sentence is to tax investment income which was not set aside for benefits (or policy dividends) or charity but expended for "social recreations" or like "purely personal facilities for the membership" of fraternal societies. Since that language will tax any untoward diversion, the term "permanently" is superfluous and rather confusing. The fact that "permanently" didn't mean "permanently" was pointed out in the debates on the Tax Reform Act prior to passage by the House.

As Congressman Byrnes pointed out during the House debates

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on the Tax Reform Act [18/] the term "permanently committed" in §512(a)(3)(B) does not require a commitment pursuant to state law or benefit contract. What is required is that the governing board of the fraternal beneficiary society takes steps to assure that accumulated earnings in the "Unassigned Funds" surplus account be used exclusively for charitable or insurance purposes. This would be done by a corporate resolution to effect such commitment.

As Chairman Mills pointed out, [19/] the "permanently committed" test does not turn on some legally binding contract which absolutely requires such but rather on the commitment made by the organization as to the proper (charitable or insurance) disposition intended for such funds. If this is the case, the use of the term "permanently" is almost contradictory and implies an unintended obligation which needed clarification during the floor debates.

We believe that deletion of the term "permanently" would clarify the fact that investment earnings added to such "Unassigned Funds" need not be committed by state law or contract to the insurance or charitable functions to qualify as "exempt function income." Thus, §512(a)(3)(B) as altered by our changes would more clearly reflect the intention of Congress. Our version as altered appears as an appendix to this statement.

V. COMMENTS UPON REQUIREMENT THAT FRATERNAL BENEFICIARY SOCIETIES FILE PUBLIC INFORMATION RETURNS

Under §101(d) of the House bill, all exempt organizations shall be required to file annual information returns with the Internal Revenue Service. By amendment to §6104 [20/] such returns will be made available for public inspection. This provision presents no substantial problems for fraternals because under state law, fraternals are required to file extremely detailed statements of financial condition. In addition, these statements in some states are made public. When the insurance departments of the various statutes conduct their triennial examination of the books and records of fraternal beneficiary societies, the operations, investments and related activities of the national organization are scrutinized in great detail. We could not foresee any examination by the Internal Revenue Service which would approximate the examinations of the state insurance departments. While we do not believe it is necessary for fraternals to file information returns because of the detailed returns filed with the states which regulate their insurance activities (which are available to any Internal Revenue agent at any time) the nondiscriminatory aspect of this provision deserves our support. Fraternal organizations are being treated

like all other exempt organizations. No particular class of exempt organizations are particularly favored over any other class. All classes of organizations will file information returns and all such returns will be made public.

We are concerned, however, that an undue burden would be placed on very small organizations (regardless of class) which maintain themselves through the services of volunteers. If these volunteers would be required to analyze and prepare the complicated information returns of nonprofit organizations, few people would be willing to offer their services. In addition, if the volunteer overlooks the filing, he may under certain circumstances, be liable for a personal penalty for his failure to file a return. While this personal penalty may be appropriate for larger organizations, it could be very mischievous as to smaller ones operating with volunteer assistance. We suggest, therefore, that the proposed §6033 be amended to exclude from the annual filing requirement organizations which have less than $5,000 in gross income and $5,000 in assets in any year. 21/ Such a provision would not be administratively harmful since the potential abuse of exempt status in such small organizations is almost nil. Also, the Revenue Service would not be deluged with hundreds of thousands

of meaningless returns serving no audit or revenue function. Finally, it would not place an undue burden on small organizations operating with volunteer help and would not discourage individuals from associating themselves in the administration of these small organizations. It makes a great deal of sense for the Internal Revenue Service to obtain returns which enables them to carry on their audit and enforcement procedures more ably and efficiently; we do not believe a statutory excusion for very small organizations would in any way adversely affect these functions and indeed could well save the taxpayers thousands of dollars which would have to be spent to process, collate and perfect such returns. We believe our proposition is a salutory one and urge its adoption.

VI. CONCLUSION

The National Fraternal Congress of America wishes to emphasize that it has no substantial objection to the extension of the unrelated business income tax in its present form to fraternal beneficiary societies since all other exempt organizations will be subject to this tax. The equivalent treatment of all other exempt organizations as to the taxation of unrelated debt financed income is supportable for the same reason. However, we strongly object to the discrimination inherent in proposed IRC §512(a)(3) of the House bill. There is no justification for singling out fraternal beneficiary societies (and §501(c)(7), (9) and (10) groups) for special treatment of "diverted" passive income where all other tax exempt membership organizations can do as they please with such income under the exclusions granted by §§512(b)(1), (2), (3) and (5). Proposed §512(a)(3) does not treat equivalent organizations on an equal basis; it does not treat equivalent income on an equal basis. We urge the Senate to reject this provision.

Respectfully submitted,

The National Fraternal Congress
of America
35 East Wacker Drive
Chicago, Illinois. 69601

Of Counsel:
William J. Lehrfeld
Arent, Fox, Kintner, Plotkin & Kahn
1000 Federal Bar Building
Washington, D. C. 20006
(347-8500)

VII. FOOTNOTES

1. Public Law 227, 53rd Cong., 2d Sess. (August 27, 1894).

2. §117, Revenue Act of 1943, Public Law 235, 78th Cong., 2d Sess. (Feb. 25, 1944); §54(f), Internal Revenue Code of 1939.

3. Ibid.

4. Hearings on Revenue Revisions, 1947-1948, Before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess., pp. 3395-3553. Hearings before the Committee on Ways and Means, House of Representatives, 81st Cong., 2d Sess., at pp. 18-19, 114-117, 165-171, 494-595, 781-813, 2530, 2531, 2612-2615, 2630, 2633, 2635, 2743 (1950).

5. §301(a) Revenue Act of 1950, Public Law 814, 81st Cong., 2d Sess. (Sept. 23, 1950) adding §§421-424 to Internal Revenue Code of 1939.

6. Tax Reform Studies and Proposals, U.S. Treasury Department (February 5, 1969), Part 3, pp. 317-319. Also, Tax Reform Proposals, etc. of the Treasury Department (April 22, 1969), p. 40, pp. 162-169. The statement was made, in the February 5 report, (p. 317) as to the justification of the tax on investments: "To the extent income is available to provide recreational or social facilities, tax free dollars are being used for purely personal facilities for the membership.

7. It should be pointed out that in a 1945 study of exempt organization information returns by the Joint Committee staff and representatives of the Treasury Department (Tax Exempt Organizations, Preliminary Report to The Joint Committee on Internal Revenue Taxation, December 15, 1945), there were 18 hospitalization or health plans exempt under §101(8) (1939 Code, now §501(c)(4), 1954 Code) with gross receipts of more than $1 million, the largest having receipts of over $11 million. See pp. 20-21.

8. Announcement 1969-22, I.R.B. 1969-18, 26.

9. Ibid.

10. Rev. Rul. 65-81, C.B. 1965-1, 225.

11. Statement of Jack P. Janetatos, on behalf of National Club Association, Tax Reform, 1969, Hearings Before Committee on Ways and Means, House of Representatives, 91st Cong., 1st Sess. on the subject of Tax Reform, p. 988 at 991.

12. For 1967, all life insurance in force amounts to 1.040 trillion dollars with fraternal insurance approximately 18 billion. Life Insurance Fact Book, 1968 (a publication of the Institute of Life Insurance).

13. Tax Reform Proposals (April 22, 1969) supra. at p. 40.

14. Ibid.

15. We should point out that under proposed IRC §278 (bill p. 92, lines 3-16) relating to denial of certain deductions incurred by certain membership organizations (including nonexempt social clubs), the draftsmen have used the phrase "services, insurance, goods or other items of value." This may be contrasted with the phrase "goods, facilities or services" used in proposed §512(a)-(3)(B). To be consistent, some reference in §512(a)(3)(B) should be made to premiums and benefits to bring these phrases of similar import into balance.

16. IRC §512(b)(1), (2), (3) and (5) (dealing with exclusions in computing the unrelated business income tax of amounts derived from dividends, interest, rents, royalties, and capital gains, as modified by §512(b)(4)).

17. Webster's Seventh New Collegiate Dictionary, Merriam-Webster Co., 1967.

18. Cong. Rec. August 7, 1969 at pp. H7086-H7087.

19. Ibid.

20. H.R. 13270, §101(j)(36).

21. This suggestion coincides with that made by the Tax Section of the American Bar Association during their recent annual meeting in Texas. We recommend for your information the background information on exempt organization information returns found in "The Tax Lawyer" (Bulletin of the Section of Taxation) Summer, 1969, Vol. 22, No. 4, pp. 1019-1030.

VIII. §121(b), H. R. 13270, ADDING §512(a)(3)(B) (DEFINING EXEMPT FUNCTION INCOME

9 "(B) EXEMPT FUNCTION INCOME.—For pur-
10 poses of subparagraph (A), the term 'exempt
11 function income' means the gross income from dues,
12 fees, charges, or similar amounts paid by members
13 of the organization as consideration for providing
14 such members or their guests goods, facilities, or
15 services in furtherance of the purposes constituting
16 the basis for the exemption of the organization to
17 which such income is paid. In the case of an organi-
18 zation described in section 501 (c) (8), (9), or
19 (10), the term 'exempt function income' also in-
20 cludes all income (other than an amount equal to
21 the gross income derived from any unrelated trade
22 or business regularly carried on by such organiza-
23 tion computed as if the organization were subject to
24 paragraph (1)), which is permanently committed—

1 "(i) for a purpose specified in section
2 170(c)(4), or
3 "(ii) to providing for the payment of life,
4 sick, accident, or other benefits under section
5 501(c)(8)(B), (9), or (10).
6 If during the taxable year, an amount which is
7 attributable to income so permanently committed
8 is used for a purpose other than that described in
9 clause (i) or (ii), such amount shall be included,
10 under subparagraph (A), in unrelated business tax-
11 able income for the taxable year.
12 "(C) APPLICABILITY TO CERTAIN CORPORA-
13 TIONS DESCRIBED IN SECTION 501(c)(2).—In the
14 case of a corporation described in section 501(c)
15 (2), the income of which is payable to an organiza-
16 tion described in section 501(c) (7), (8), (9), or
17 (10), the rules of subparagraphs (A) and (B)
18 shall apply as if such corporation were the organiza-
19 tion to which the income were payable, and in com-
20 puting exempt function income amounts paid by
21 the organization to which such corporation's income
22 is payable as well as by members of such organiza-
23 tion shall be taken into account."

IX. PROP. IRC §512(a)(3)(B), WITH CLARIFYING AMENDMENTS PROPOSED BY NATIONAL FRATERNAL CONGRESS

"(B) Exempt Function Income. For purposes of subparagraph (A), the term 'exempt function income' means the gross income from dues, fees, charges, premiums, or similar amounts paid by members of the organization as consideration for providing such members or their guests goods, facilities, benefits, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. In the case of an organization described in section 501(c)(8), (9), or (10), the term 'exempt function income' also includes all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is [~~permanently~~] committed -

(i) for a purpose specified in section 170(c)(4); or

(ii) to providing for, or securing, the payment of life, sick, accident, or other benefits under section 501(c)(8)(B), (9), or (10).

If during the taxable year, an amount which is attributable to income so [~~permanently~~] committed is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

X. STATEMENTS OF REPRESENTATIVE JOHN BYRNES AND REPRESENTATIVE WILBUR MILLS, AUGUST 7, 1969

. . . .

Mr. BYRNES of Wisconsin. Mr. Chairman, I yield myself 1 minute.

Mr. Chairman, I have taken this time while the chairman of the committee is available to call his attention to an inquiry that was made of me and the advice that I gave the individual. I want to see whether the chairman concurs that the advice I gave this individual was correct. This relates to the area, Mr. Chairman, of unrelated business income and its relationship particularly to fraternal societies, orders, and associations. You will notice on page 88 of the bill that we provide that "exempt function income" includes funds which are permanently committed to certain general purposes. These purposes are set forth at lines 1 through 5 on page 89.

The question arises with respect to what is "permanently committed." I have advised these people that if action is taken by the governing body of the organization to insure that the funds are to be used for such purposes that they will be considered permanently committed. In other words, it does not necessary have to be permanently committed under some State law or contract. It seems to me that that is a correct interpretation because we do say further on that in the event the funds are used for other than these purposes——

The CHAIRMAN. The time of the gentleman from Wisconsin has expired.

Mr. BYRNES of Wisconsin. Mr. Chairman, I yield myself 2 additional minutes.

The CHAIRMAN. The gentleman from Wisconsin is recognized for 2 additional minutes.

Mr. BYRNES of Wisconsin. As I was saying, it seems to me that that is a correct interpretation because we do say further on that in the event the funds are used for other than these purposes then they shall become taxable.

The reason this question arises, Mr. Chairman, is because some of these associations do have funds that are generated and accumulated and added to surplus under rather general terms such as "unassigned funds," and yet those funds are dedicated and used exclusively for either the basic charitable and benevolent purposes of the organization or for insurance purposes, but the law does not require them necessarily to maintain such funds.

Mr. MILLS. Mr. Chairman, I would say to the gentleman from Wisconsin I agree completely with his interpretation. Let me add this. Neither does the expression "which is permanently committed" mean that there is a legal binding contract involved.

Mr. BYRNES of Wisconsin. It is intended that some action has been taken by the organization itself which makes it clear that these funds are accumulated for these general purposes.

Mr. MILLS. I agree with the gentleman entirely.

Mr. BYRNES of Wisconsin. Mr. Chairman, I thank the gentleman

TAXATION OF ALL INVESTMENT INCOME AND INCOME DERIVED FROM NON-MEMBER FUND RAISING ACTIVITIES OF FRATERNAL BENEFICIARY SOCIETIES

Written Statement Presented to the Senate Committee on Finance by Edwin K. Steers, General Counsel on behalf of The Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America

I. SUMMARY OF STATEMENT

A. Background data concerning The Imperial Council, A.A.O.N.M.S. and its philanthropy, Shriners Hospitals for Crippled Children.

B. Effect of imposing a tax on all investment income and income obtained from fund-raising activities of The Imperial Council, A.A.O.N.M.S. (and other fraternal organizations) would result in drastic curtailment of their future charitable and philanthropic endeavors. The revenue advantages to the government appear to be nominal.

C. Extension of the present Unrelated Business Income Tax should be similarly applicable to all classes of organizations exempt under Section 501 of the Internal Revenue Code.

D. No historical legislative precedent for attempting to treat exempt fraternal beneficiary societies in the same categorical manner as exempt social clubs.

E. All investment income and income derived from non-member admissions to fund-raising events of fraternal beneficiary societies should not be subject to tax.

1. Taxing all investment income of fraternal beneficiary societies (not permanently committed to charity or for insurance benefits) is directly contrary to existing provisions of the Unrelated Business Income Tax.

2. Taxing the income of all intermittent fund-raising activities of fraternal beneficiary societies (not permanently committed to charity or for insurance benefits) is contrary to the Amended Regulations covering the Unrelated Business Income Tax.

F. Summary of the position of The Imperial Council, A.A.O.N.M.S. and amendment requested to Tax Reform Act of 1969 (H.R. 13270).

II. STATEMENT

My name is Edwin K. Steers. I am General Counsel for The Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America, commonly referred to as The Imperial Council, A.A.O.N.M.S., a non-profit and tax-exempt fraternal organization described in Section 501 (c) (8) of the Internal Revenue Code.

Our principle offices are located at 323 North Michigan Avenue, Chicago, Illinois, 60601, and this written statement is made on behalf of the Shriners of North America, of which there were 863,065 (see Attachment #1) at the close of 1968, the vast majority of whom are Americans.

A. BACKGROUND DATA CONCERNING THE IMPERIAL COUNCIL, A.A.O.N.M.S.

Since December 18, 1935, The Imperial Council A.A.O.N.M.S. and the 170 Shrine Temples, Chartered by The Imperial Council, have been granted a group tax-exempt status by the Internal Revenue Service.

The objects and purposes of The Imperial Council, A.A.O.N.M.S. are as set forth in Article III of its Articles of Incorporation (see Attachment #2); these purposes reflect such attitudes as Faith in God, man's relationship with his brother and philanthropy.

The Shrine has long been characterized for the color and pageantry of its parades, its marching uniformed units, its bands and its clowns. It has been equally characterized for its fund-raising activities (circuses and sporting events) which individual Shrine Temples sponsor to raise funds for what many persons have aptly described to be the "World's Greatest Philanthropy",-- SHRINERS HOSPITALS FOR CRIPPLED CHILDREN. Mention the word "Shriner" and you immediately get two responses from people -- one being "parade", because our Shrine Nobility still believes in old-fashioned patriotism and merriment, and the other is "crippled children's hospital", the soul of the Shrine, where men of faith are stirred to help improve the lives of countless number of mankind.

Everywhere our Shrine Units parade, they attempt to call attention to our charitable endeavors. Our annual circuses and sporting events are known throughout this great land as a means by which monies are raised to continue this support of our philanthropy. These monies also substantially assist our Shrine Temples in defraying the expenses of bringing many crippled and burned children

along with their parents, to our twenty-two (22) hospitals for treatment since the Charter of our charitable corporation does not permit such expenditure of funds. In addition, the monies raised from our fraternal activities are utilized to help provide parade uniforms and equipment for members, and to assist many other local worthwhile community projects.

We proudly believe that it has been vividly demonstrated over the years that The Imperial Council, A.A.O.N.M.S., or the "Shrine", as it is more commonly known, is a body of men with a dedicated charitable purpose; a purpose for which Shriners freely donate of their time, energy, and money.

Our first Shriners Hospital was constructed in 1922 and eighteen (18) more have followed. These hospitals have cured or materially helped more than 140,000 children; in doing so, we have trained thousands of medical students. It is interesting to observe that there are approximately 4,200 certified orthopedists in the nation of which about one-fourth were Shrine-trained! Another interesting fact is that each year we provide treatment to more than 6,000 children in our nineteen (19) orthopedic hospitals without any charge to parents or guardians. The average cost per patient to our charity approximates $2,200.00.

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Some years ago, the military leaders of this nation interested the Shrine in what they felt was one of the greatest, unmet needs -- having specific hospital facilities available in the United States for the care and treatment of badly burned children. By 1962, it was determined that there was an urgent need for 4,000 beds for this purpose, and there were only two (2) hospitals in the world which were then dedicated to burns completely, one located in Europe and the other in this country operated by the United States Army.

The Shrine fraternal organization immediately commenced positive steps to help alleviate this crisis. At a cost in excess of ten million ($10,000,000.00) dollars, the Shrine has constructed in recent years three (3) Burns Institutes, at Boston, Massachusetts; Cincinnati, Ohio; and Galveston, Texas which are dedicated solely to the purpose of saving severely burned children's lives and in performing reconstructive surgery on these patients, again at no charge to the parent or guardian. At present, the average cost to the Shrine for treating a burned patient approximates $16,000.00 which sum includes all reconstructive surgery involved.

In addition, the Shrine has committed itself to spending

very substantial sums of money at its Burns Institutes in research areas in finding better ways of patient care, and in learning better methods for treating the side-effects resulting from severe thermal injury. Teaching of the medical profession has likewise been vastly aided by the Shrine in the treatment of burns through its entering into Affiliation Agreements with near-by university teaching hospitals.

The operating expenses of Shriners Hospitals for Crippled Children are estimated for the calendar year 1969 to amount to in excess of twenty-two million ($22,000,000.00) dollars. The Imperial Council, A.A.O.N.M.S. which has made all this possible in treating children wholly free of charge whose parents do not have the means for payment, has aided its philanthropy by sponsoring many activities, which the present Internal Revenue Code Regulations permit fraternal organizations to do, to help meet these prodigious operating expenses. Just by way of illustration, thirty-one (31) Shrine charity football games were held during 1968, sponsored by Shrine Temples throughout the United States, which raised approximately $1,370,000.00 in net receipts for the support of our hospitals. Funds to assist our hospitals have also been raised by such local sponsored Shrine Temple activites as circuses, horse shows and charity balls.

B. EFFECT OF IMPOSING A TAX ON CERTAIN INCOME OF THE IMPERIAL COUNCIL, A.A.O.N.M.S. AND OTHER FRATERNAL ORGANIZATIONS WOULD RESULT IN DRASTIC CURTAILMENT OF THEIR FUTURE CHARITABLE AND PHILANTHROPIC ENDEAVORS.

The worthly fraternal activities sponsored by the Shrine in the interest of public welfare, as related in the preceding paragraphs, would be greatly imperiled if The Imperial Council, A.A.O.N.M.S., and other charitable-minded fraternal organizations conducting fund-raising activities, were to be singled out among other exempt organizations and henceforth taxed at corporation rates on all future income they derive from non-member admissions to their fund-raising activities and on their investment income other than the income which is permanently committed for charitable purposes or for insurance benefits for members or dependents. In effect, what the House Tax Reform Act proposes is to tax all income of the Shrine and other fraternal organizations which do not fall within the category of membership income, income from exempt function facilities or income that has been permanently committed by our Shrine Temples to charity or membership insurance benefits.

There is no question but that a tax placed on income from investments and fund-raising activities would result in a drastic reduction in available support which our Shrine Fraternal Order could give its philanthropy, Shriners Hospitals for Crippled Children. Certainly the revenue advantages of this form of taxation to the

government must be considered nominal and it would do nothing toward correcting any inequities or abuses in our current tax system.

C. EXTENSION OF THE PRESENT UNRELATED BUSINESS INCOME TAX SHOULD BE APPLICABLE TO ALL CLASSES OF ORGANIZATIONS EXEMPT UNDER SECTION 501 OF THE INTERNAL REVENUE CODE.

The Unrelated Business Income Tax under current law is not applicable to such tax-exempt organizations as churches, social welfare organizations, social clubs and fraternal beneficiary societies. The Imperial Council, A.A.O.N.M.S. acknowledges that these exempt organizations could conceivably obtain a competitive advantage over private tax-paying businesses, if the organizations were able to generate income from a trade or business regularly carried on, which was not substantially related to its purposes or functions. It is for this reason that The Imperial Council, A.A.O.N.M.S. supports Congressional legislative action which would encompass fraternal organizations, along with these other referred to exempt organizations, under the existing provisions of the Unrelated Business Income Tax.

It should be recalled that legislative history at the time of enactment of the Unrelated Business Income Tax in 1950, clearly indicated that Congress decided that the income from substantially "unrelated businesses" should be taxable, but that it should not subject to tax the income derived from unrelated activities which do not constitute a "business regularly carried on", or to tax any income derived from related businesses to

the exempt organization's purposes.

D. NO HISTORICAL LEGISLATIVE PRECEDENT FOR ATTEMPTING TO TREAT EXEMPT FRATERNAL BENEFICIARY SOCIETIES IN THE SAME CATEGORICAL MANNER AS EXEMPT SOCIAL CLUBS.

It is respectfully submitted that a fundamental error occurred when the Treasury Department proposed to Congress to treat fraternal organizations in the "same boat" as social clubs. There has never heretofore been shown any attempt by Congress to consider fraternal organizations in a similar manner to exempt social clubs for tax purposes. Actually, the organizational structure and purposes of these two exempt organizations are quite dissimilar from each other, with the exception that both are a "membership" form of organization. For that matter, churches, too, are a membership organization. It can be readily observed that no effort or attempt was made in this Tax Reform Act to tax most other exempt organizations on any non-member annual admission income which they might generate from fair booths, bazaars, dances or such other fund-raising events. Why the distinction as to fraternal organizations?

The purpose behind the Unrelated Business Income Tax was to eliminate any unfair competitive advantages which exempt organizations might have if they chose to engage in competitive business activities. What competitive advantages exist which need to be curbed, that prompts the House of Representatives to pass a tax bill with little opportunity for discussion whereby all investment

income and income received from fund-raising events of fraternal organizations (not permanently committed to charity) should be taxed? There are none. We maintain these income sources to fraternal organizations are not now nor have they ever been a matter of unfair competition with private tax-paying businesses. We are also not aware of any complaint even being lodged by tax-paying businesses objecting to any fund-raising activities of the Shrine. In fact, these activities of the Shrine are clearly furthering the public interest and welfare and consistent with the purposes of Congress in granting organizations such as The Imperial Council A.A.O.N.M.S. exemption from tax.

The provisions and requirements for exemption by social clubs under the Internal Revenue Code are that they must be "organized and operated exclusively for pleasure, recreation and other non-profitable purposes..." and this exemption for social clubs extends to social and recreational clubs which are supported "solely" by membership fees, dues and assessments.

Contrast this wording in the Internal Revenue Code as to social clubs with that pertaining to fraternal beneficiary societies which are more than mere social and recreational clubs. The Regulations governing fraternal organizations state that they must be operated in furtherance of their fraternal purposes. In the case of the Shrine, we are operated in accordance with

Masonic principals and purposes, which includes Faith in God, philanthropy and brotherhood among our basic attitudes.

The Regulations as to fraternal organizations, unlike social clubs, further provide that the "carrying on of activities which raise revenue from members and their guests will not deprive the society of its exemption." Congress clearly then has always manifested a willingness to recognize fund-raising activities of fraternal organizations as long as these organizations according to the Regulations do "not engage in business activities of a kind carried on for profit."

Numerous Revenue Rulings have been promulgated in the past few years by the Treasury Department dealing with exempt social clubs and under what conditions and to what extent a social club may make its social and recreational facilities available to the general public. In none of these Revenue Rulings, was there any indication by the Treasury Department that these rulings were to bè also made applicable to fraternal beneficiary societies. Merely because social clubs and fraternal organizations are both membership organizations, does not mean their purposes, activities and operations are at all similar. If that were true, there would be no need for two separate tax exemption categories under Section 501(c) of the Code.

We can appreciate the reasons for the Treasury Department's recommendation to the House Committee on Ways and Means to tax the income of a social club should it permit its bar, restaurant, social, or other recreational facilities to be utilized in any substantial degree by non-members; this very likely could result in an unfair competitive advantage to the exempt social club over private tax-paying businesses within the community offering similar services to the general public. However, there is no competitive advantage to be concerned with in taxing the investment income of fraternal organizations or the income they receive from non-member admissions to annual fund-raising events, which actually go to support their fraternal activities and in many ways their charitable endeavors.

While we have noted that some social clubs have apparently taken the position in statements filed with the House Committee on Ways and Means that a tax being placed on their investment income would represent to them only a minor problem since this has for a number of years been the subject of a Revenue Ruling pertaining only to them (Revenue Ruling 66-149), this is certainly not true as to fraternal beneficiary societies. Such a tax on all investment income of The Imperial Council A.A.O.N.M.S. which is not permanently committed directly for charitable purposes or for insurance benefits for members, could have a drastic effect on its future fraternal operations and activities. Such income by Shrine Temples is used

for uniforms and equipment and travel expenses in allowing Shrine Units to participate at parades and sporting events so as to help call attention to its philanthropy and in aid of obtaining gifts and bequests to it. This income is also needed by Temples to accumulate sufficient assets for future building and renovating needs. At times increased property taxes have forced our Shrine Temples into selling its building and relocating on less valuable land sites. If a capital gains tax were imposed in such circumstances, it would create difficulties in the financing of new facilities which certainly cannot be the intent of Congress.

E. ALL INVESTMENT INCOME AND INCOME DERIVED FROM NON MEMBER ADMISSIONS TO FUND-RAISING EVENTS OF FRATERNAL BENEFICIARY SOCIETIES SHOULD NOT BE SUBJECT TO TAX.

1. TAXING ALL INVESTMENT INCOME OF FRATERNAL BENEFICIARY SOCIETIES (NOT PERMANENTLY COMMITTED TO CHARITY OR FOR INSURANCE BENEFITS) IS DIRECTLY CONTRARY TO EXISTING PROVISIONS OF THE UNRELATED BUSINESS INCOME TAX.

Under the present provisions of the Unrelated Business Income Tax, income from rents, royalties, interest, dividends and annuities, as well as gains from the sales or other disposition of capital assets are exempt from tax. If the Tax Reform Act (H.R. 13270) was enacted into law, these current exceptions to the Unrelated Business Income Tax which continue for most all exempt organizations, would hereafter be made inapplicable to exempt fraternal organizations.

The provisions of Section 121 (b (1) of the Tax Reform Act of 1969 are highly discriminatory in their attempt to tax fraternal beneficiary societies on all their investment income while not proposing any similar tax treatment for other exempt organizations under Section 501 of the Internal Revenue Code. As heretofore expressed, the primary impetus and purpose for the Unrelated Business Income Tax enacted in 1950 was to eliminate a source of unfair competition and the taxation of all investment income of fraternal organizations has no bearing whatsoever on this purpose. It can also be judged that this source of revenue to the government would be nominal in amount. Surely it must be hoped that it is more the intent of Congress to eliminate existing inequities in our tax structure among exempt organizations and not create further disparity among them.

2. TAXING THE INCOME OF ALL INTERMITTENT FUND-RAISING ACTIVITIES OF FRATERNAL BENEFICIARY SOCIETIES (NOT PERMANENTLY COMMITTED TO CHARITY OR FOR INSURANCE BENEFITS) IS CONTRARY TO THE AMENDED REGULATIONS COVERING THE UNRELATED BUSINESS INCOME TAX.

The present Amended Regulations promulgated in December, 1967, (1.513-1(c)(2)(iii)) provide that:

> "...income producing or fund-raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted

on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund-raising event for charity would not be income from trade or business regularly carried on."

Under this present Amended Regulation, it is clearly recognized that these annual or intermittent fund-raising activities are not to be considered a "business regularly carried on." Also, it is equally clear that no form of unfair competition would be eliminated if Congress were to enact legislation taxing all the income from such non-member admissions to its annual fund-raising activities sponsored by fraternal organizations. Actually, public welfare would be far better sustained if all fraternal organizations were permitted to continue conducting these fund-raising activities unhampered which both by direct and indirect means aids charitable and philanthropic purposes which might otherwise of necessity become federally financed and controlled.

F. SUMMARY OF THE POSITION OF THE IMPERIAL COUNCIL, A.A.O.N.M.S. AND AMENDMENT REQUEST TO TAX REFORM ACT OF 1969 (H.R. 13270)

In summary, The Imperial Council, A.A.O.N.M.S. supports extending the Unrelated Business Income Tax as presently constituted to fraternal beneficiary societies. The Shrine is desirous of seeing inequities corrected in our present tax structure. However, at the same time, we feel that fraternal organizations such as The Imperial

Council, A.A.O.N.M.S., should be treated with the same degree of fairness and in exactly the same manner with the same present exemptions, additions, and limitations referred to under Section 512 (b) of the Internal Revenue Code that are now accorded other exempt organizations under the Unrelated Business Income tax sections of the Code.

We therefore strongly deprecate and take exception to fraternal beneficiary societies being summarily categorized in a manner similar to social clubs without any justifiable basis and having all their investment income (including interest, dividends, rents, and capital gains from the sale of property) and all their income from annual or intermittent fund-raising activities, henceforth taxable at corporation rates, if not permanently committed strictly for charitable purposes or for insurance benefits for members.

It is therefore respectfully requested that the Committee on Finance give earnest consideration and action toward amending the Tax Reform Act of 1969 (H.R. 13270) by removing any and all references to Section 501(c)(8) organizations from the discriminatory provisions of Section 121(b)(1) of the Tax Reform Act. It is this section of House Bill 13270 which adds Section 512(a)(3) to the Internal

Revenue Code and creates Special Taxable Rules Applicable to fraternal organizations exempt under Section 501(c)(8).

Respectfully submitted,

Edwin K. Steers
General Counsel

(Attachment #1)

THE IMPERIAL COUNCIL OF THE ANCIENT
ARABIC ORDER OF THE NOBLES OF THE
MYSTIC SHRINE FOR NORTH AMERICA

Shrine Temple	Membership
AAD TEMPLE 201 East First Street Duluth, Minnesota	3,404
AAHMES TEMPLE 3291 School Street Oakland, California	8,741
ABBA TEMPLE 1056 Government Street Mobile, Alabama	2,160
ABDALLAH TEMPLE 914 Huron Building Kansas City, Kansas	2,967
ABOU BEN ADHEM TEMPLE 601 St. Louis Street Springfield, Missouri	3,859
ABOU SAAD TEMPLE P. O. Box 3668 Panama Canal Zone	2,036
ABU BEKR TEMPLE 515 6th Street Sioux City, Iowa	3,809
ACCA TEMPLE 1712 Bellevue Avenue P. O. Box 9217 Richmond, Virginia	4,687
AFIFI TEMPLE 47 St. Helens Avenue Tacoma, Washington	4,062
AHMED TEMPLE 128 W. Washington Street P. O. Box 519 Marquette, Michigan	1,339

Shrine Temple	Membership
AINAD TEMPLE 609 St. Louis Avenue East St. Louis, Illinois	7,766
AKDAR TEMPLE 20 East 21st Street Tulsa, Oklahoma	3,152
ALADDIN TEMPLE 34 North 4th Street Columbus, Ohio	13,539
AL AZHAR TEMPLE 506 17th Avenue S.W. Calgary, Alberta	2,356
AL BAHR TEMPLE 1895 Camino del Rio San Diego, California	4,258
AL BEDOO TEMPLE 1125 Broadwater Avenue Billings, Montana	2,869
ALCAZAR TEMPLE 1021 Madison Avenue Montgomery, Alabama	2,456
AL CHYMIA TEMPLE 1257 Poplar Avenue Memphis, Tennessee	5,094
ALEE TEMPLE Skidaway Road and Eisenberg Drive Savannah, Georgia	2,658
ALEPPO TEMPLE 569 Boylston Street Boston, Massachusetts	15,603

Shrine Temple	Membership
ALGERIA TEMPLE 15 North Jackson Helena, Montana	2,730
ALHAMBRA TEMPLE 2 Market Street Chattanooga, Tennessee	2,382
ALI GHAN TEMPLE Route 2, Baltimore Pike P. O. Box 1416 Cumberland, Maryland	1,990
AL KADER TEMPLE 1119 S.W. Park Avenue Portland, Oregon	7,056
AL KALY TEMPLE 101 N. Union Avenue Pueblo, Colorado	1,870
AL KORAN TEMPLE 3411 Euclid Avenue Cleveland, Ohio	11,035
AL MALAIKAH TEMPLE 665 West Jefferson Boulevard Los Angeles, California	27,725
ALMAS TEMPLE 1315 K Street N.W. Washington, D.C.	5,107
AL MENAH TEMPLE 100 Seventh Avenue, North Nashville, Tennessee	5,309
ALOHA TEMPLE 438 First Hawaiian Bank Building Honolulu, Hawaii	3,235

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Shrine Temple	Membership
AL SIHAH TEMPLE 745 Poplar Street Macon, Georgia	3,517
ALZAFAR TEMPLE 503 Fourth Street San Antonio, Texas	6,116
ANAH TEMPLE 39 Columbia Street Bangor, Maine	2,762
ANEZEH TEMPLE Lucerna 84-101 Mexico 6, D.F., Mexico	577
ANSAR TEMPLE 630 South Sixth Street Springfield, Illinois	6,294
ANTIOCH TEMPLE 107 E. First Street Dayton, Ohio	7,906
ARAB TEMPLE 1305 Kansas Avenue Topeka, Kansas	1,927
ARABA TEMPLE 2010 Hanson Street Fort Myers, Florida	1,543
ARABIA TEMPLE 1322 Prairie Street Houston, Texas	8,304
ARARAT TEMPLE 300 West 11th Street Kansas City, Missouri	7,723

Shrine Temple	Membership
BAGDAD TEMPLE 314 West Park Street Butte, Montana	1,386
BAHIA TEMPLE 60 West Gore Orlando, Florida	4,337
BALLUT ABYAD TEMPLE 625 Central Avenue N.W. Albuquerque, New Mexico	4,982
BEDOUIN TEMPLE 201 South Sixth Muskogee, Oklahoma	1,644
BEKTASH TEMPLE 17 Warren Street Concord, New Hampshire	3,166
BEN ALI TEMPLE Room 7, Hotel Senator Sacramento, California	8,939
BEN HUR TEMPLE 207 West 18th Street Austin, Texas	2,304
BENI KEDEM TEMPLE 100 Quarrier Street Charleston, West Virginia	7,501
BOUMI TEMPLE 4900 North Charles Street Baltimore, Maryland	7,669
CAIRO TEMPLE P. O. Box 774 Rutland, Vermont	1,051

Shrine Temple	Membership
CALAM TEMPLE 855 Main Street Lewiston, Idaho	1,152
CRESCENT TEMPLE North Clinton Avenue & Wall Street Trenton, New Jersey	11,154
CYPRUS TEMPLE 74 Chapel Street Albany, New York	2,835
DAMASCUS TEMPLE 875 East Main Street Rochester, New York	3,376
EGYPT TEMPLE 5050 Memorial Highway Tampa, Florida	5,617
EL BEKAL TEMPLE 801 Elm Avenue Long Beach, California	4,339
ELF KHURAFEH TEMPLE 211 N. Washington Saginaw, Michigan	4,683
EL HASA TEMPLE 15th and Central Avenue Ashland, Kentucky	1,660
EL JEBEL TEMPLE 1614 Welton Street Suite 307 Denver, Colorado	9,025
EL KAHIR TEMPLE 125 5th Street, S.E. Cedar Rapids, Iowa	4,450

Shrine Temple	Membership
EL KALAH TEMPLE 650 East South Temple Salt Lake City, Utah	2,508
EL KARUBAH TEMPLE South Lakeshore Drive P. O. Box 1824 Shreveport, Louisiana	5,008
EL KATIF TEMPLE W. 1108 Riverside Avenue Spokane, Washington	4,153
EL KORAH TEMPLE 1118 Idaho Street Boise, Idaho	2,675
EL MAIDA TEMPLE 6331 Alabama El Paso, Texas	3,045
EL MINA TEMPLE 2328 Broadway Galveston, Texas	2,409
EL RIAD TEMPLE 520 South First Avenue Sioux Falls, South Dakota	2,425
EL ZAGAL TEMPLE 1429 No. 3rd Street Fargo, North Dakota	2,301
EL ZARIBAH TEMPLE 15th Avenue at Washington Street Phoenix, Arizona	4,352
GIZEH TEMPLE 940 Richards Street Vancouver, B.C.	3,178

Shrine Temple	Membership
HADI TEMPLE 6 Walnut Street Evansville, Indiana	4,135
HADJI TEMPLE P. O. Box 2234 Pensacola, Florida	1,736
HAMASA TEMPLE 2320 8th Street Meridian, Mississippi	3,603
HASAN TEMPLE Palmyra Road at 11th Avenue Albany, Georgia	2,828
HEJAZ TEMPLE 101 East Coffee Street Greenville, South Carolina	6,412
HELLA TEMPLE Harwood & Young Streets Dallas, Texas	13,725
HILLAH TEMPLE 51 Winburn Way Ashland, Oregon	2,781
INDIA TEMPLE 225 N.W. 4th Street Oklahoma City, Oklahoma	5,250
IREM TEMPLE 52 North Franklin Street Wilkes-Barre, Pennsylvania	8,589
ISIS TEMPLE 336 South Santa Fe Salina, Kansas	4,390

Shrine Temple	Membership
ISLAM TEMPLE 650 Geary Street San Francisco, California	8,855
ISMAILIA TEMPLE 1600 Southwestern Boulevard Buffalo, New .York	4,699
JAFFA TEMPLE Broad Avenue and 22nd Street Altoona, Pennsylvania	6,974
JERUSALEM TEMPLE 1137 St. Charles Avenue New Orleans, Louisiana	5,619
KAABA TEMPLE 115 West Seventh Street Davenport, Iowa	4,763
KALIF TEMPLE 145 West Loucks Sheridan, Wyoming	1,653
KALURAH TEMPLE 117 Murray Street Binghamton, New York	1,562
KAREM TEMPLE 208 North 7th Waco,Texas	3,018
KARNAK TEMPLE 2295 St. Mark Street Montreal, Quebec	1,297
KAZIM TEMPLE 628 Campbell Avenue, S.W. Roanoke, Virginia	3,800

Shrine Temple	Membership
KEM TEMPLE 423 Bruce Avenue Grand Forks, North Dakota	2,138
KENA TEMPLE 101 N. Columbus Street Alexandria, Virginia	2,313
KERAK TEMPLE 40 West First Street Reno, Nevada	3,167
KERBELA TEMPLE 315 Mimosa Avenue Knoxville, Tennessee	4,618
KHARTUM TEMPLE 529 Wellington Crescent Winnipeg, Manitoba	2,545
KHEDIVE TEMPLE 243 West Freemason Street Norfolk, Virginia	5,347
KHIVA TEMPLE 305 East Fifth P. O. Box 328 Amarillo, Texas	4,108
KISMET TEMPLE 155 Lakeville Road New Hyde Park, New York	4,593
KORA TEMPLE 11 Sabattus Street Lewiston, Maine	4,265
KOREIN TEMPLE Fifth and Pine Streets Rawlings, Wyoming	2,014

Shrine Temple	Membership
KOSAIR TEMPLE 812 South 2nd Street Louisville, Kentucky	4,490
LU LU TEMPLE 313 South Broad Street Philadelphia, Pennsylvania	8,507
LUXOR TEMPLE 92 Germain Street St. John, N.B.	911
MAHI TEMPLE 1480 N.W. North River Drive Miami, Florida	7,326
MASKAT TEMPLE 1100 Lamar Street Wichita Falls, Texas	2,249
MECCA TEMPLE 71 West 23rd Street New York, New York	4,374
MEDIA TEMPLE 240 Washington Street Watertown, New York	1,076
MEDINAH TEMPLE 600 North Wabash Avenue Chicago, Illinois	20,967
MELHA TEMPLE 133 Longhill Street Springfield, Massachusetts	3,605
MIDIAN TEMPLE 115 North Topeka Wichita, Kansas	8,169

Shrine Temple	Membership
MIRZA TEMPLE 110½ West 5th Street Pittsburg, Kansas	2,396
MIZPAH TEMPLE 407 West Berry Street Fort Wayne, Indiana	5,555
MOCHA TEMPLE 468 Colborne Street London, Ontario	3,199
MOHAMMED TEMPLE 207 N.E. Monroe Street Peoria, Illinois	8,339
MOILA TEMPLE 701 No. Noyes Boulevard St. Joseph, Missouri	4,445
MOOLAH TEMPLE 3821 Lindell Boulevard St. Louis, Missouri	10,527
MOROCCO TEMPLE P. O. Box 1078 Newnan and Monroe Jacksonville, Florida	7,682
MOSLAH TEMPLE 1100 Henderson Street P. O. Box 1320 Fort Worth, Texas	8,230
MOSLEM TEMPLE 434 Temple Avenue Detroit, Michigan	16,324
MOUNT SINAI TEMPLE 16 State Street Montpelier, Vermont	1,561

Shrine Temple	Membership
MURAT TEMPLE 510 N. New Jersey Street Indianapolis, Indiana	16,493
NAJA TEMPLE P. O. Box 463 Deadwood, South Dakota	1,147
NEMESIS TEMPLE 900 Market Street Parkersburg, West Virginia	1,917
NILE TEMPLE 229 Third Avenue North Seattle, Washington	10,861
NUR TEMPLE P. O. Box 3030 Wilmington, Delaware	2,254
OASIS TEMPLE 321 East Tryon Street Charlotte, North Carolina	9,298
OLEIKA TEMPLE 326 Southland Drive Lexington, Kentucky	2,666
OMAR TEMPLE 40-44 East Battery Charleston, South Carolina	4,654
ORAK TEMPLE 45 Muenich Court Hammond, Indiana	4,173
ORIENTAL TEMPLE P. O. Box 124 Troy, New York	1,881

Shrine Temple	Membership
OSIRIS TEMPLE Monument Place Elm Grove Wheeling, West Virginia	3,410
OSMAN TEMPLE 130 N. Smith Avenue St. Paul, Minnesota	4,445
PALESTINE TEMPLE One Rhodes Place Cranston, Rhode Island	2,515
PHILAE TEMPLE 5835 College Street Halifax, N.S.	1,116
PYRAMID TEMPLE 1035 State Street Bridgeport, Connecticut	2,677
RAJAH TEMPLE 136 North 6th Street Reading, Pennsylvania	7,527
RAMESES TEMPLE 1395 Lake Shore Boulevard W. Toronto, Ontario	4,701
RIZPAH TEMPLE U. S. 41 North P. O. Box 327 Madisonville, Kentucky	1,644
SABBAR TEMPLE 450 S. Tucson Boulevard Tucson, Arizona	1,686
SAHARA TEMPLE 308 West 2nd Street Pine Bluff, Arkansas	2,452

Shrine Temple	Membership
SALAAM TEMPLE 369 East Mt. Pleasant Avenue Livingston, New Jersey	7,476
SALADIN TEMPLE 233 Fulton Street, East Grand Rapids, Michigan	5,281
SCIMITAR TEMPLE 2100 Main P. O. Box 5005 Little Rock, Arkansas	4,134
SESOSTRIS TEMPLE 332 South 15th Street Lincoln, Nebraska	3,316
SHARON TEMPLE 219 North Broadway Tyler, Texas	2,846
SPHINX TEMPLE 410 Asylum Street P. O. Box 207 Hartford, Connecticut	4,474
SUDAN TEMPLE 403 East Front Street P. O. Drawer 490 New Bern, North Carolina	8,747
SUEZ TEMPLE 333 West Avenue C San Angelo, Texas	2,206
SYRIA TEMPLE 4423 Bigelow Boulevard Pittsburgh, Pennsylvania	25,797
SYRIAN TEMPLE 217 William Howard Taft Rd. Cincinnati, Ohio	7,950

Shrine Temple	Membership
TADMOR TEMPLE 578 East Market Street Akron, Ohio	5,596
TANGIER TEMPLE 405 Farnam Building Omaha, Nebraska	5,298
TEBALA TEMPLE 327 North Main Street Rockford, Illinois	4,783
TEHAMA TEMPLE 411 North Hastings Hastings, Nebraska	2,601
TEHRAN TEMPLE 5666 East Gettysburg Avenue Fresno, California	2,760
TIGRIS TEMPLE Hotel Syracuse Syracuse, New York	1,544
TRIPOLI TEMPLE 3000 West Wisconsin Avenue Milwaukee, Wisconsin	8,889
WAHABI TEMPLE 1130 West Capitol Street Jackson, Mississippi	5,417
WA-WA TEMPLE 2065 Hamilton Street Regina, Saskatchewan	2,003
YAARAB TEMPLE 400 Ponce De Leon Avenue, N.E. Atlanta, Georgia	9,511

Shrine Temple		Membership
YELDUZ TEMPLE 503 South Main Street Aberdeen, South Dakota		1,628
ZA-GA-ZIG TEMPLE 1006 Grand Avenue Des Moines, Iowa		7,157
ZAMORA TEMPLE 531 North 19th Street Birmingham, Alabama		8,104
ZEMBO TEMPLE 3rd & Division Streets Harrisburg, Pennsylvania		9,937
ZEM ZEM TEMPLE 124 East 8th Street Erie, Pennsylvania		4,902
ZENOBIA TEMPLE 1507-11 Madison Avenue Toledo, Ohio		4,916
ZIYARA TEMPLE 251 Genesee Street Utica, New York		2,211
ZOR TEMPLE 301 Wisconsin Avenue Madison, Wisconsin		5,816
ZORAH TEMPLE 420 North 7th Street Terre Haute, Indiana		2,091
ZUHRAH TEMPLE 2540 Park Avenue Minneapolis, Minnesota		12,181
	Total	863,065

EXCERPT FROM
ARTICLES OF INCORPORATION
of
THE IMPERIAL COUNCIL OF THE
ANCIENT ARABIC ORDER OF THE NOBLES
OF THE MYSTIC SHRINE FOR NORTH AMERICAN, AN IOWA CORPORATION

ARTICLE III

The objects and purposes of this Corporation and business to be transacted by it are:

1. Said Corporation shall be the irrevocable common agent, representative and supreme authority in all matters appertaining to the government of the system of fraternal lodges or temples known in the aggregate as the Ancient Arabic Order of the Nobles of the Mystic Shrine, which lodges and temples are located in each of the States of the United States, District of Columbia, the Dominion of Canada, the Canal Zone, the Hawaiian Islands, the Philippine Islands and the Republic of Mexico, and as such shall have supreme complete original jurisdiction and essential powers necessary to such control and government.

(a) To enact and enforce laws, statutes, and regulations for the government of itself and subordinate Temples and members of the Order known in the aggregate as the Ancient Arabic Order of the Nobles of the Mystic Shrine, and to alter, amend and repeal the same at pleasure.

(b) To issue edicts relating to the government and control of the several Temples and the members thereof, and to alter, amend and repeal the same.

(c) To constitute new Temples by granting dispensations and charters under seal, and for good cause to suspend, annul and revoke the same at pleasure.

(d) To create, establish and preserve a uniform mode of work and lectures, and to publish and issue the rituals containing such authorized work and lectures.

(e) To assess and collect from the several Temples under its jurisdiction such sums of money as may be deemed necessary to be appropriated for the benefit of the corporation and its members and benevolences.

(f) To hear and determine all questions of dispute between Temples and between members in Temples.

(g) To hear and decide all appeals from the decisions of subordinate Temples.

(h) To demand and receive such fees and charges for granting dispensations, charters, certificates and diplomas as may be by it determined to be proper and reasonable.

(i) To require and collect from all Temples and all members of Temples such sums of money for Shriners' Hospitals for Crippled Children and other charitable purposes as may from time to time be provided for and required by law.

(j) To hear and decide all charges and complaints against any officer of the Imperial Council, or of any subordinate Temple, and to inflict such punishment as may seem just and proper.

ATTACHMENT NO. (2)

(k) To prescribe and define the duties and powers of the several officers of the Imperial Council and the members (representatives) and the powers and duties of the several officers of subordinate Temples.

(l) To exercise such power and control, and to perform all such acts, as may seem proper and necessary to carry out the full purpose and intent of this Corporation.

2. To maintain, control, conduct and superintend any and all charities, benevolences, and hospitals now established, maintained and controlled by the Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America, or which may be by it hereafter established.

3. To purchase, or otherwise acquire, to have, hold, lease, mortgage, or otherwise create liens on, to sell, convey, exchange, transfer, assign or let on lease, or in any other manner whatsoever to acquire and dispose of, real and personal property necessary or convenient in carrying out any of the purposes of this corporation, without restriction as to place, state or country. To erect thereon, to construct, maintain, and operate, hospitals or other eleemosynary institutions for the treatment of curable crippled children, free of charge, and other purposes, under such regulations and such restrictions as may from time to time be adopted by the Imperial Council, and to purchase, or erect, construct, maintain and operate, such hospitals, or other institutions, in any state of the United States, the District of Columbia, the Hawaiian Islands, the Canal Zone, and the Dominion of Canada and the Republic of Mexico.

4. To create and maintain a charitable and educational fund, a representative fund, a library fund, an Imperial Council fund, a fund for the purchase, erection, operation and maintenance of Shriners' Hospitals for Crippled Children, and other benevolences, and any other fund or trust necessary or convenient in carrying out any of the purposes, benevolences or charities now established, or which may be hereafter authorized by the Imperial Council.

5. To accept and receive gifts, devises, bequests, donations, annuities and endowments, of real or personal property, and to use, hold and enjoy the same, both as to principal and income, and invest and reinvest the same, or any part thereof, for the furtherance of any of the objects,

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interests or purposes of the corporation as hereinbefore stated, or such as may hereafter be authorized.

6. To have the exclusive right to and use of the name "The Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America," together with the emblems, costumes, regalia, characteristic insignia, and jewels of said Order, heretofore or hereafter adopted by said Imperial Council.

And with power to use and exercise all the powers, rights and privileges incidental to fraternal and benevolent corporations organized for purposes other than pecuniary profit, and which are usually exercised by the supreme or governing bodies of fraternal or benevolent organizations operating as the representatives of a system of fraternal lodges.

And it is intended that the powers specified and clauses contained in the foregoing paragraphs shall in no wise limit or restrict, by reference to or inference from, the terms of any other clause of this or any other paragraph in these Articles, but the powers specified in each of the several clauses of this paragraph shall be regarded as independent powers and purposes.

In furtherance of the purposes and objects above expressed, to acquire by purchase, lease, bequest or otherwise, and to own, hold and use for such purposes real estate and personal property situate in the State of Iowa and also in all of the States of the United States, the District of Columbia, the Hawaiian Islands, the Canal Zone, the Dominion of Canada and the Republic of Mexico, and to erect, construct and build any building or buildings for the use and benefit of said corporation and to equip, maintain, rent, lease, sublease, mortgage, transfer or otherwise dispose of its property so to be used for the purposes aforesaid.

SUMMARY
AMERICAN AUTOMOBILE ASSOCIATION
SENATE FINANCE COMMITTEE
TAX REFORM ACT OF 1969
SEPTEMBER 12, 1969

The American Automobile Association on behalf of its 227 affiliated clubs and 12,000,000 members is appearing to voice its objections to Section 121 of House passed H.R. 13270, the Tax Reform Act of 1969. We specifically refer to that portion of Section 121 which relates to limitations on deductions of certain non-exempt organizations and would add a new Section 278 to the Internal Revenue Code.

We are a tax-paying service organization and though this provision appears to be directed to social clubs and other taxable organizations whose members have direct control over dues structure, as presently written, it will apply to the AAA and have catastrophic effects on our finances.

Organizations which compete with the AAA, but have a non-member stockholder interest, appear to be excluded from application of Section 278 while we are not. This would put us at a serious competitive disadvantage and subject us to severe tax discrimination.

AAA and its affiliated clubs are unique organizations in the motoring and travel field whose activities benefit far more than just our members. For a few examples of AAA activities which benefit the general public and are in the public interest, attention is called to pages 4 through 11 of the attached statement. If Section 278 is enacted into law in its present form, AAA and its clubs would be forced to curtail, if not eliminate, many public service oriented activities such as outlined.

Other objections to Section 278 are:

(1) Discriminatory -- AAA competitors (insurance and oil companies with subsidiary motor clubs) apparently will be permitted to deduct membership operation losses while AAA would not. (See pages 11 and 12 of statement.)

(2) Membership Service Costs -- Impossible to Predict Accurately -- No deduction would be permitted for cost of servicing members in excess of income derived from members. If a net operating loss results in any year, the loss would be disallowed forever. When winters with heavy snow and severe cold or other unusual weather conditions occur, the cost to AAA in carrying out its services may substantially exceed dues income for that year.

It is impossible to predict membership costs accurately, primarily because of weather conditions. If we guess incorrectly as to severity of the weather or members' demands for other services, we bear the entire loss. If we guess correctly, income taxes will take away more than half our net income. (See pages 12 and 13 of statement.)

(3) Investment Income -- Dues Paid in Advance -- Membership dues are paid annually in advance. These funds are invested at the best possible return. Under Section 278, income from these invested dues would be subject to tax without any offset even though this income results from the fact that dues are paid in advance of the receipt of services.

This is discriminatory since taxable newspapers and magazines receive subscription income in advance and may invest such funds. Yet these publications are not required to be taxed on their investment income separately from the remainder of their operations. (See page 14 of statement.)

(4) Advertising & Other Income Used to Reduce Publication Costs -- AAA publishes and provides its members with tour books and other publications which

describe and give ratings to hotels, motels, restaurants and similar facilities which have met AAA standards.

Hotels, motels, restaurants, etc., advertise in the tour books and through "Official Appointments" publicize the fact that they are AAA inspected and approved.

Under Section 278, AAA would be required to pay taxes on such advertising and related income without reduction for the cost of the publication which contains the advertising, because it is non-member income.

A newspaper can apply its advertising revenue to its production cost without penalty, so as to reduce the price to its subscribers. AAA would be penalized in a similar transaction. Once again, a clear case of discrimination. (See pages 14, 15 & 16 of statement.)

(5) Cost Allocation, Members & Non-members -- Impractical -- AAA and its clubs cannot provide certain services to its members unless it provides the same services to the general public. For example, International Driving Permits are issued by AAA under rules of the United Nations Convention on Road Traffic which prohibits their issuance to members only. Similar rules are enforced by the Air Traffic Conference, the International Air Transport Association and various steamship companies covering the sale of airline and steamship tickets.

Under Section 278, AAA would be required to segregate dealings with members from non-members and to compute taxes separately from non-member transactions. It would be difficult and expensive, if not impossible, to develop a cost accounting system that would make a reasonable allocation of cost between members and non-members. (See pages 16 and 17 of statement.)

(6) Section 278 -- Scope Too Broad -- The effort to close loopholes in unrelated business income of tax-exempt organizations while at the same time trying to prevent them from escaping by adopting a non-exempt status is understandable.

However, the all encompassing scope of Section 278, we believe, is too broad for the apparent purpose for which it was designed. Only banking and insurance institutions are specifically excluded.

AAA advertising and other income is clearly related to the stated purpose of our organization. Unlike social or other organizations in which the membership may have direct control over the dues structure, our dues are not based upon the whims of the membership but are determined by competitive conditions and costs in the marketplace.

While Section 278 strives to eliminate specific abuses, because of the scope of the language, it would also penalize organizations such as the AAA, which are not guilty of these abuses (See pages 17 & 18 of statement.)

Recommendation -- AAA strongly recommends that the Committee carefully consider the full implications of this Section. If the Committee still feels that Section 278 (a) is required as presently worded, then we would urge that 278 (b) be amended so that Section (a) would not apply to non-abusers, such as the American Automobile Association.

STATEMENT BY
GEORGE F. KACHLEIN, JR.
EXECUTIVE VICE-PRESIDENT
AMERICAN AUTOMOBILE ASSOCIATION
BEFORE
SENATE FINANCE COMMITTEE
ON
TAX REFORM ACT OF 1969 (H. R. 13270)
SEPTEMBER 12, 1969

The American Automobile Association and its 227 affiliated clubs representing 12,000,000 members, appreciate this opportunity to voice their objection to Section 121 of House passed H. R. 13270, the Tax Reform Act of 1969.

Section 121 which relates to limitations on deductions of certain non-exempt membership organizations would add a new Section 278 to the Internal Revenue Code as follows:

> "SEC. 278. DEDUCTIONS INCURRED BY CERTAIN MEMBERSHIP ORGANIZATIONS IN TRANSACTIONS WITH MEMBERS.
>
> "(a) General Rule. -- In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year in furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members. (underlining ours)
>
> "(b) Exceptions. -- Subsection (a) shall not apply to any organization which for the taxable year is subject to taxation under subchapter H or L."

The above exceptions in paragraph (b) relate solely to banks and insurance companies.

The House Ways and Means Committee Report #91-413 contains the following explanation of the above quoted portion of Section 121 of the bill:

> "Present law. -- Certain non-exempt corporations organized to provide services to members on a non-profit basis realize investment income, or income from pro-

viding services to non-members, which is used to defray all or part of the cost of providing services to members. The courts have upheld this treatment in certain cases, although the effect is to render the investment income non-taxable, and therefore to permit untaxed dollars to be used by the organization to provide services for its members.

* * *

Explanation of provisions. -- Your committee's bill adds a new provision (sec. 278) which provides that in the case of a social club or other membership organization operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions in furnishing services, insurance, goods, and other items of value to members are allowable only to the extent of income from members or transactions with members. This provision does not apply to organizations that are taxable as banking institutions or insurance companies under the code.

. . . New section 278 applies in the case of a social club, cooperative, or other membership organization which is not exempt from taxation and which is operated primarily to furnish services or goods to members. New section 278 provides that the deductions for the taxable year in furnishing services, insurance, goods, or other items of value to members (or shareholders) of such organizations are to be allowed only to the extent of income derived during such year from members or transactions with members. Therefore, in such a case, income from sources other than members may not be reduced, in determining taxable income, by losses arising from dealings with members."

Our tax counsel which is the Washington law firm of Ivins, Phillips and Barker advises that the above quoted provision of the House passed bill would appear to be applicable to the AAA and its affiliated clubs as membership organizations operated primarily to furnish services to members. They further advise that deductions would be allowable only to the extent income was received from members or transactions with members. This would mean, they point out, that any excess of deductions over income would not be allowable for net operating loss purposes. Also, any excess of deductions over income with respect to members or transactions with members could not be

offset against income generated from transactions with non-members.

This provision of the bill, if enacted into law in its present form, would have a devastating effect on the AAA and its affiliated clubs.

AAA Organization Structure

The AAA is a tax-paying service organization subject to both Federal and State taxation. It was organized in March 1902 and in 1910 was incorporated as a non-profit corporation under the laws of the State of Connecticut relating to corporations without capital stock.

The AAA consists of 227 tax-paying affiliated autonomous clubs and 11 divisions with 841 offices serving 12,000,000 members throughout the United States and Canada.

AAA Serves Public Interest -- Benefits Non-members

Since its formation over 67 years ago, the AAA has devoted its energies and activities to serving its members with such services as emergency road service, towing service, maps, touring and travel services, etc. However, many of its other activities are of direct benefit to the motoring and general public.

The AAA By-Laws provide in part:

ARTICLE II

Objects and Purposes

"SECTION 3. (Objects and Purposes) The objects and purposes of this corporation are:

(a) To aid in the establishment and maintenance of a uniform and stable system of laws relating to the regulation and use of automobiles and motor vehicles, and the rights and privileges of the owners and users thereof.

(b) To promote the construction, maintenance, improvement and supervision of highways that are safe, convenient and accessible to motor vehicles.

(c) To educate the users of motor vehicles and the public at large in the principles of traffic safety.

(d) To collect and distribute information as to all matters or things of whatsoever character concerning motor vehicles, or of interest to the users thereof.

(e) To conduct and participate in exhibitions, contests and safety activities and to offer and grant awards, in connection with the interests of the users of motor vehicles.

(f) To organize, and grant affiliation to other corporations, associations and organizations with objects and purposes similar to those of this corporation.

(g) To engage in any activity permitted by law intended to further and protect the interests of the users of motor vehicles.

(h) To promote understanding among people in the United States and Canada and abroad and to that end to promote, arrange, and provide for travel of all kinds by land, sea and air; and to take all steps reasonable or necessary to carry out the foregoing.

(i) To do any and all acts or things incidental, necessary or convenient to the accomplishment of these objects and purposes.

SECTION 4. (Use of Funds) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the Members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors."

Members of the AAA corporation referred to in Section 4 of the By-Laws quoted above consist of the 227 affiliated clubs and the 11 divisions. These affiliated clubs have similar provisions in their By-Laws.

AAA Public Interest Activities -- A Few Examples

Highways -- Down through the years, AAA and its affiliated clubs throughout the country have supported and promoted improved highways. The organization was a leader in the campaign which resulted in the first Federal-aid highway program in 1916. It was one of the first to seek public support for the limited-access highway concept worked out by the U.S. Bureau of Public Roads prior to World War II. Jointly, AAA and its clubs staged an intensive educational campaign to build widespread enthusiasm for the expanded Federal highway program, with emphasis on the Interstate system, which was adopted in 1956. In the states, AAA clubs have worked for better highways, supporting motorist tax increases when that seemed necessary.

In recent years, AAA has given increasing attention to urban transportation problems, producing a variety of materials on advantages of urban freeways, explaining the space-saving possibilities of joint development of highways and other urban facilities. It has worked diligently for provision of adequate off-street parking spaces, both as a convenience to the motorist and as a measure necessary for downtown health.

AAA and its clubs were early advocates of roadside protection and gave hearty support to Federal legislation for roadside beautification. They approve of the expenditure of motorist tax money for roadside rest and information areas, scenic look-outs and similar amenities within the highway right-of-way.

Safety Programs for Drivers -- Over 25,000 high school driver education teachers have attended intensive short courses conducted by AAA Educational Consultants since our teacher preparation program began in 1936.

Since 1936, AAA clubs have assisted high schools in obtaining some 250,000 free-loan cars from dealers for high school driver education programs. AAA has pioneered in the production of driver education text materials with AAA's Sportsmanlike Driving textbook currently being the most widely used text in the field.

AAA Driver Education Television Series is being used in closed circuit TV school programs as well as on public service programs on regular TV channels for the general public.

AAA sponsors a nationwide holiday highway safety program "Bring 'Em Back Alive." This year, 5.5 million free pieces of promotional literature were distributed during Memorial, Fourth of July, and Labor Day Holidays. A network of public service radio and TV holiday news reports are also used in conjunction with the BEBA program.

Pedestrian Safety Programs -- Each year, AAA clubs distribute free to schools over 25 million pieces of safety education posters, lesson guides for teachers, and safety stories for children.

Each year, AAA clubs conduct a nationwide "School's Open-Drive Carefully" campaign to alert motorists to look out for children at school opening time.

Each year, AAA sponsors a National Pedestrian Safety Inventory Program with some 2,000 cities in U. S. and Canada submitting detailed reports on their pedestrian safety programs. Since AAA started this program in 1939, pedestrian deaths have been reduced by 45% while all other traffic deaths have increased nearly 75% -- this is the most remarkable improvement made in highway safety to date.

AAA clubs furnish free literature and equipment to some 900,000 School Safety Patrol Boys and Girls serving in 40,000 schools across the nation who are helping to protect the lives of 20 million children as they walk to and from school.

Annually, an estimated 100,000 traffic safety posters are drawn by youngsters from grades 1-12 for AAA's National School Traffic Safety Poster Contest. Some $10,000 in U. S. Savings Bonds are distributed to student Poster Contest Winners.

Traffic Engineering -- In cooperation with the Institute of Traffic Engineers, AAA recently sponsored 13 regional Workshops on Urban Arterial Traffic Improvements which were attended by city officials and lay persons working for traffic improvement. ($35,000 was contributed by AAA to help underwrite this project.)

AAA clubs conduct local traffic surveys and traffic forums to help officials develop effective traffic improvement programs.

AAA in the interest of uniformity of Traffic Control Devices, signs, signals, markings, actively participates in keeping current the National Manual on "Uniform Traffic Control Devices" which serves as a guide to states and localities.

Federal Safety Standards -- AAA Support -- AAA actively promotes the National Highway Safety Program Standards developed as a result of the 1966 Highway Safety Act. AAA is a financial contributor and active participant in the "STATES" program -- a Public Support program designed to get states to implement the National Highway Safety Standards.

AAA worked with the National Highway Safety Bureau in the development of the National Standards and Manuals on pedestrian safety, driver education, codes and laws, etc.

National Parks -- Recreation Areas -- In recent years AAA has appeared before Congressional committees and enthusiastically supported the creation of several new national parks and seashore recreational areas.

The AAA was the first non-government issuer of the Golden Eagle Passport. AAA affiliated clubs during 1968 sold for the U.S. Government more than 30,000 passports, at no handling cost, thus facilitating use of national parks and recreational areas by the general public.

International Driving Permits -- The AAA has been authorized by the U.S. State Department to issue International Driving Permits as provided for in the United Nations Convention on Road Traffic (Geneva, 1949). Among the criteria established for such authorization is that the licenser has to be a non-profit organization and must be officially affiliated with automobile clubs in all foreign countries.

In 1968 AAA issued 238,766 International Driver's Licenses. Such licenses entitle U.S. motorists to drive in foreign countries and also permit foreigners to drive in the U. S.

International Motoring -- Uniform Laws -- For many years, AAA has promoted uniformity in national laws and regulations applicable to international traffic. AAA representatives participated with U. S. Government officials when the United Nations promulgated the "1949 Convention on Road Traffic" at a conference in Geneva, Switzerland. This United Nations Convention (treaty) has greatly facilitated international motoring. The 1949 convention was ratified by 80 nations in all parts of the world including the United States, which ratified it in 1950. AAA was a member of the official U. S. delegation to the United Nations Conference held in Vienna, Austria in November 1968, which revised the Convention on Road Traffic. This revised and expanded "Convention on Road Traffic" is currently before the United Nations and will soon be distributed to the member nations including the United States for ratification.

Uniform Traffic Laws -- AAA and its affiliated clubs have since their inception promoted uniform traffic laws throughout the United States. Representatives of the AAA and its affiliated clubs actively participate in the activities of the National Committee on Uniform Traffic Laws and Ordinances. The National Committee published in 1926 the "Uniform Vehicle Code" which has been used, and the 1968 amended version is currently being used, by the 50 states as a guide in achieving uniform traffic laws. The draftsman for the Uniform Vehicle Code in the mid 1920's was the then General Counsel of the Automobile Club of Southern California. The General Counsel of the Chicago Motor Club played a prominent role in drafting the chapter of the Code dealing with Financial Responsibility. Currently, the Director of the Legal Department of AAA is chairman of the Rules of the Road Subcommittee of the National Committee.

AAA contributes annually $4,000 to the National Committee on Uniform Traffic Laws and Ordinances.

Digest of Motor Laws -- AAA publishes annually a "Digest of Motor Laws" of the 50 states and Canadian Provinces. The 36th edition was published in January 1969. Affiliated clubs distribute the Digest as a public service to municipal traffic court judges, state highway patrol and local traffic enforcement officials as an aid in their enforcement activities.

Auto Thefts -- In 1968 AAA representatives testified before Congressional committees in support of legislation subsequently enacted into law which prohibits the mailing of motor vehicle master keys. The AAA and its affiliated clubs actively participate in a public information campaign by the distribution of considerable pamphlets and material aimed at alerting motorists to the importance of removing keys from unattended vehicles and locking their cars. In 1968, 776,000 cars were stolen. Auto thefts are one of the country's most serious crime problems.

Speed Traps -- AAA with the full cooperation of its affiliated clubs investigates traffic arrest complaints and speed trap areas (traffic enforcement for monetary rather than for safety purposes). Where traffic arrest complaints involve highway design problems, such matters are brought to the attention of appropriate state and local Highway Departments as are complaints involving confusing signing, traffic signs, signals and markings. From time to time, AAA publishes a list of speed trap areas and "strict enforcement" areas where frequent traffic arrests are made. These lists are given wide public distribution, thus alerting the motoring public of such situations. Affiliated clubs throughout the years have promoted state laws to eliminate the "fee system" -- arresting officer and traffic judge or justice of the peace is compensated on the basis of the number of traffic arrests and convictions rather than on a salary. (About 25 states still have the "fee system.")

Gambling Traps -- AAA and its affiliated clubs process and investigate complaints from out-of-state motorists who have been victimized by gyp artists when they stop for food, pecans or just to rest. What happens is, the proprietor entices the traveler into rolling dice for a free meal, free alligator bag or some other item. Individual victims are normally taken for several hundred dollars before they depart -- all in a matter of minutes. AAA with the cooperation of its affiliated clubs have been successful in having appropriate police authority eliminate several such gambling traps.

Traffic Court Reform -- For many years AAA and its affiliated clubs have worked to improve traffic courts throughout the country. Just recently, the Automobile Club of New York was successful in their support of a new approach. With the assistance of the five Borough District Attorneys of New York City, Mayor Lindsay, Governor Rockefeller, New York City Bar Association and the New York State Legislature, a law was enacted which will remove minor traffic law violation cases from the criminal courts of New York City to Administrative Hearing Officers of the State Motor Vehicle Department.

In addition to relieving the crushing backlog of criminal cases of the criminal courts of New York City, this new traffic court procedure should be most beneficial to the motoring public. If it proves successful, no doubt other AAA clubs throughout the country will follow the New York lead.

Protection of the Motorist as Consumer -- Through materials supplied to free-lance writers and magazine editors, and through annually-distributed pamphlets, the AAA and its affiliated clubs help motorists to operate their cars with a maximum of economy and a minimum of difficulty. They are given figures on how much it costs to operate a car, how to figure vacation costs, state laws affecting car operation, special winter car-care, and so on.

Special recent efforts in this direction include a special report to the Federal Trade Commission on purchasers' complaints about new car warranties and a warning about gyp practices of some filling stations in selling unneeded car parts.

In light of the foregoing comments, we believe that the AAA and its affiliated clubs, is a unique organization in the motoring and travel field whose activities benefit far more than just its members. Thus, one may well wonder why this provision is a problem to the AAA as it appears to be directed at social clubs and other taxable organizations whose members have direct control over the dues structure.

As presently written, however, this section will apply to the AAA and, if passed, it will have catastrophic effects on our finances and will place us at a severe competitive disadvantage.

Our additional objections to this proposed Section 278 are as follows:

SECTION 278 IS DISCRIMINATORY

The AAA and its affiliates are not exempt from income tax. We have no objection to paying our fair share of corporate income taxes and make no claim for special treatment. We do, however, object to tax discrimination and we believe that Section 278 of this Bill is unfair to our organization

Members of the AAA are, in reality, persons who pay an annual fee, called dues, for the right to certain services such as emergency road service, personal accident insurance coverage, bail bond service, etc., as they may be needed. In this light, we see no essential difference between the AAA and mutual insurance companies. Yet insurance companies are specificially exempted from Section 278.

Furthermore, although the statutory language of Section 278 appears to make no distinction between corporations with stockholders and those without stockholders, page 49 of part I of the Ways and Means Committee report refers to corporations

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organized to provide services to members on a non-profit basis. This would appear to exclude corporations with non-member stockholders. Moreover, membership organizations (the words used in Section 278) are defined elsewhere in the code and this definition excludes corporations with stockholders. The AAA has no stockholders, but it is in competition with motor clubs operated by corporations which do have stockholders -- and we mean stockholders other than the members.

These organizations, many of which are owned and operated by giant, well-financed corporations with access to the securities market for capital, compete directly with the AAA. Like the AAA, they have members and their purpose is to provide services to their members similar to those provided by the AAA to its members.

If organizations engaged in competition with the AAA, but which have a non-member stockholder interest, are to be excluded from application of Section 278 while the AAA is subjected to this provision, it is obvious that our ability to compete would be severely restricted. Our competitors may well be perfectly willing to render membership services at a loss simply as a "loss leader" because of other business (such as automobile insurance, gasoline, oil and other product sales) that can be obtained profitably from persons desiring these membership services.

If the AAA's competitors are permitted to deduct their membership operation losses while we are not, the unfairness of the proposed Section 278 is obvious.

ACCURATE PREDICTION OF MEMBERSHIP SERVICE COSTS IS IMPOSSIBLE

Members pay dues to the AAA and its affiliated clubs for one year in advance. It is not practical to collect dues monthly or less than annually because of the small amounts involved. The dues charged are intended to be sufficient to cover the costs

of providing services to the membership as a whole. In setting the annual dues, however, the Association and its affiliates have to deal with many variables which cannot always be predicted accurately. For example, one of the principal services provided to members is emergency road service. The demand for this service increases sharply in periods of bad weather, particularly in severe winters. If a particularly bad winter should occur, the cost to a club in carrying out its services often substantially exceeds the dues income for that year.

Under the provisions of Section 278 of this Bill, no deduction is to be permitted for the costs of serving members in excess of the income derived from the members. If a net operating loss results in any year, the loss would be disallowed forever. Under this Bill, the AAA and its affiliated clubs would be penalized the most in situations where, by reason of adverse weather conditions or other unforeseeable conditions, they have provided their services when they were needed the most. The AAA cannot predict motoring service demands and weather conditions a year in advance -- yet we must set our dues this far ahead. We fail to see the justification for not allowing our organization a deduction for such costs simply because they may exceed dues in a given year.

If we guess incorrectly as to severity.of the weather or the demand for other services by our membership, we bear the entire loss. If we guess correctly, income taxes will take away more than half our net income.

To illustrate that the question is not theoretical, we might point out that the AAA itself incurred a net operating loss in 1968 due in part to higher than expected emergency road service costs. If Section 278 were the law, this loss would have been disallowed forever.

INVESTMENT INCOME -- DUES PAID IN ADVANCE

In 1960, Congress recognizing the problem faced by the AAA and similar organizations, enacted Section 456 so that an organization such as the AAA, which was obligated to render services beyond the close of a taxable year, would not be required to prepay its tax before it had performed the services for which the member had paid his dues. Thus, at the end of any taxable year, the AAA and its affiliates are obligated to render services after the close of this taxable year to their members with respect to dues previously paid.

These dues, having been collected in advance, are in the possession of the AAA and its clubs. Good business judgment requires that these funds, which are held for the benefit of the member until expiration of his membership, be invested at the best possible return. Under proposed Section 278, any income resulting from these invested funds is subject to tax without any offset even though this income results from the fact that dues are paid in advance of the receipt of services by the member.

Here is another instance of discrimination as taxable newspapers and magazines have received subscription income in advance and may invest these funds. Yet these publications are not required to be taxed on their investment income separately from the remainder of their operations.

ADVERTISING AND OTHER INCOME USED TO REDUCE PUBLICATION COSTS.

In carrying out its corporate purposes, as explained earlier, the AAA publishes maps, tour books, and other similar material which is provided to its individual members. The tour books and other publications describe and give ratings to hotels, motels, restaurants and similar facilities which have met AAA standards.

The hotels, motels, restaurants, etc., are interested in attracting AAA members to use their facilities and therefore advertise in the tour books which are distributed to members.

Additionally, the hotels, motels, restaurants, etc., wish to advertise to the general public that they have AAA approval. A charge is made by the AAA for this privilege and establishments paying this charge are designated by the AAA as an "Official Appointment". The amounts paid by advertisers and official appointments are used to pay part of the publication costs of the tour books and to reimburse the AAA for the costs incurred in making inspections, assigning ratings, etc.

Thus, we have, in effect, a single integrated transaction much like the receipt of advertising revenue by a newspaper which is used to lower the cost of the publication to its subscribers. The hotels, motels, etc., pay for the privilege of publicizing their approved status to the membership. The members are interested in obtaining information regarding the facilities, their rates, their ratings, etc.

Under Section 278 of this Bill, this single integrated transaction may have to be divided into two parts; a transaction with members in providing them with tour books, maps, etc., and secondly, a transaction with non-members (hotels, motels, restaurants, etc.) in charging them for the advertising and for the "Official Appointments" by which they publicize their status to the members.

The AAA could be required by the Bill to pay taxes on the advertising and related revenue by which the hotels identify themsleves to the membership without reduction of that revenue for the cost of the very publication which contains the advertising.

Yet a newspaper can apply its advertising revenue to its production cost without

penalty in order to reduce the ultimate price to its subscriber. But the AAA would be penalized in a similar transaction.

Affiliated AAA clubs publish more than 136 periodicals for their members. Advertising revenue, which is obtained from non-member advertisers would be treated under this Bill as a separate taxable activity. Once again, a clear case of discrimination.

ALLOCATION OF COSTS BETWEEN MEMBERS AND NON-MEMBERS IS IMPRACTICAL

AAA and its clubs provide some services to non-members as mentioned earlier. AAA and its affiliated clubs could not provide certain services to its members unless it were willing to provide the same services to the general public. For example, the AAA is one of the few organizations permitted to issue international driving permits. The rules prescribed by the United Nations Convention on Road Traffic, covering such permits, provide that their issuance may not be limited to members but must be available to anyone.

Similar regulations are enforced by the Air Traffic Conference and the International Air Transport Association as well as the various steamship organizations. Thus, clubs cannot sell airline tickets, steamship tickets, and other forms of transportation to members only. But under the provisions of Section 278, we would be required to segregate dealings with members from non-members and compute taxes separately for non-member transactions. It would be difficult and expensive, if not impossible, to develop a cost accounting system that would make a reasonable allocation of costs between non-members and members. Even if such a system were developed, the costs of operation would place an additional financial strain on the clubs and the system would be a source of continual argument between the Internal Revenue Service and the individual clubs.

We understand that the Revenue Service has had difficulty in applying costing principles in the regulations issued pursuant to Section 482 (allocation of income and deductions among taxpayers). Our accountants advise that there would be similar if not greater difficulties in the allocation of costs between member and non-member activities.

In addition, unless similar rules would be applied to competitors of AAA clubs, Congress would be favoring some taxpayers over others. We refer specifically to oil companies which operate motor clubs.

The AAA and its affiliates spend considerable sums of money each year on public service activities as those outlined earlier in this statement.

Expenditures of this type are basic to the very nature of our organization. If we were a different type of organization, we might have used these monies to reduce members' costs or to provide additional services to them. But our objectives are much broader. There is no measurable financial gain from such public service activities. They benefit the public, including our members. Does Section 278 require us to allocate these costs in some fashion between members and non-members?

SECTION 278 IS TOO BROAD IN SCOPE

We appreciate the effort to close the loopholes in unrelated business income of tax-exempt organizations while at the same time trying to prevent them from escaping by adopting a non-exempt status.

In our case, our investment and other income is clearly related to the stated purpose of our organization. Unlike social or other organizations in which the membership has direct control, our dues structure is not based upon the whims of the membership but is determined by competitive conditions and costs in the marketplace.

Therefore it is vitally necessary for the AAA, to develop supplementary income because sharply increasing its dues would price it out of business. In effect, what

this provision of the bill would do would be to force us to curtail our many public service oriented activities in order to remain competitive.

The all-encompassing scope of Section 278 is, we submit, too broad for the apparent purpose for which it was designed. This is demonstrated by the fact that only banking and insurance institutions were specifically excluded.

RECOMMENDATION

As previously explained, it appears that proposed Section 278 was aimed at certain specific abuses, actual or anticipated, by some organizations. However, its language is such that it also penalizes organizations, such as the AAA, which are not guilty of these abuses.

We therefore strongly recommend that the Committee carefully consider the full implications of this section. After a full and complete study, if the Committee still agrees that Section 278 (a) is required as presently worded, then we would urge that Section 278 (b) be amended so that Section (a) would not apply to non-abusers such as the American Automobile Association.

STATEMENT OF J. P. JANETATOS
REPRESENTING
THE NATIONAL CLUB ASSOCIATION
AND
THE CLUB MANAGERS ASSOCIATION OF AMERICA
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON H.R. 13270

September 12, 1969

SUMMARY OF PRINCIPAL POINTS

1. Charitable and civic activity now carried on by clubs should be permitted to continue.

2. The term "directly connected" in defining deductible expenses must be clarified.

3. The definition of "exempt function income" is needlessly complex and erroneously restrictive.

4. The concept of the "guest" of a member should be clarified.

5. Gains from the sale or exchange of property should not be taxed.

6. Small amounts of investment income arising from capital improvement funds should not be taxed.

STATEMENT OF J. P. JANETATOS

REPRESENTING

THE NATIONAL CLUB ASSOCIATION

AND

THE CLUB MANAGERS ASSOCIATION OF AMERICA

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON H.R. 13270

September 12, 1969

Mr. Chairman and members of the Committee:

INTRODUCTION

I am Jack P. Janetatos of the law firm of Baker & McKenzie of Washington, D. C. I am appearing on behalf of the National Club Association and the Club Managers Association of America. With me today is Mr. Kenneth Emerson, Executive Director of the National Club Association; E. Guenter Skole, Manager of the Cosmos Club and chairman of the Governmental Affairs Committee of the Club Managers Association of America; and my partner, Walter A. Slowinski of Baker & McKenzie.

The National Club Association is a trade association comprising more than seven hundred of the private, bona fide social clubs in the nation, including country clubs, athletic clubs and town clubs. The Club Managers Association of America is an association of nearly two thousand professional managers of bona fide social clubs in every state and nearly every metropolitan area of the United States.

We are here today as spokesmen for the clubs, their managers, and most importantly, for the several million members of these clubs. Our purpose is to give you our views on H.R. 13270, the Tax Reform Act of 1969, as it pertains to social clubs exempt from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954.

THEORY OF EXEMPTION

Congress included the predecessor of the present section 501(c)(7) in the Revenue Act of 1916. It was explained at that time that social clubs were being exempted from the income tax because the Treasury Department had found that securing tax returns from social clubs was "a source of expense and annoyance and has resulted in the collection of either no tax or an amount which is practically negligible."

Clearly, the drafters of the Bill before us today understand the nature of the social club tax exemption. As stated in the Ways and Means Committee Report (H.Rep. No. 91-413 (Part 1) 43): "the tax exemption for social clubs . . .

is designed to allow individuals to join together to provide recreational or social facilities on a mutual basis, without tax consequences." This is and always has been the theory of exemption and the basic operating principle of these clubs.

PROBLEMS UNDER PRESENT LAW

The Report on this Bill, after describing the theory of exemption, goes on to state that "the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership." This is not a new statement--it is but a concise reiteration of the most significant problem faced by the Internal Revenue Service in administering the social club exemption for many years. The subject of non-member business in social clubs has been taken up in numerous court cases and Revenue Rulings spanning a long period of time. The chief problem has been to determine what constitutes non-member business and how much of it is permissable.

At the outset it must be made clear that the exemption contemplates that clubs raise their operating funds not only from fees, dues and assessments paid by members. In many cases the principal operating income of a club is derived from the operation of food and beverage facilities. No violence is done to the exemption where the food and beverage sales are made to

members. This is not the operation of a bar and restaurant business. It is no more than a convenient method of dividing the cost of operation of the club among the members in accordance with the quantity of services, goods and facilities consumed and used by each member. To the extent of uniform charges to all members, they bear the cost equally. To the extent of individual charges made to each member for consumables and use of facilities, essential fairness in cost allocation is achieved.

Consistent with the theory described, clubs are permitted to allow use of facilities not only by members but also by the guests of the members. Most of our clubs permit members to entertain guests at the club in a manner similar to the way the member would entertain a guest in his own home. This is the simplest case of non-member use of club facilities and is certainly permissable under present law. Further, the Bill would not seek to impose a tax in this situation and this is proper.

But beyond this member and guest of member situation, there are categories of non-member use of social club facilities which are impossible to avoid and which provide a definite benefit to the communities involved. Many of our clubs permit non-members to use the club facilities in ways that further exempt purposes and do not amount to doing business with the

public. The Red Cross, hospitals and similar organizations use social club facilities for fund raising drives. Schools use country club golf courses for their golf teams. Civic organizations use club rooms for meetings for governmental, educational and community functions. To tax this use will be to deny these civic and charitable benefits to our communities with small benefit to the revenue and a senseless waste of a useful and beneficial asset.

The necessity for this type of activity is and has long been apparent . The Internal Revenue Service has, however, recognized that abuses may occur, and has adopted a guideline. Revenue Procedure 64-36 stated that when non-member receipts were less than five percent of total gross receipts, a club would not be considered as having an intent to do business. When non-member receipts exceeded that amount, the IRS would take a closer look at a club's operation, examine each function to see if it did indeed qualify with the standards of exemption. When the guideline was exceeded the IRS had no choice but to revoke the exemption of the offending club and collect taxes from it just as if it were an ordinary business corporation.

EFFECT OF THE NEW LAW

The new Bill seeks to eliminate at least this last problem. The IRS will now be permitted to tax this unrelated business and leave the exempt operations undisturbed. This new

procedure will enable the IRS to police the activities of clubs and to levy an appropriate tax on the now-exempt activity only when it is found that operations are improper. It avoids the necessity for revocation of exemption. The new law, we believe, will effectively abrogate the five percent guideline set up by the IRS and permit clubs to engage in business with the general public so long as the principal purpose of the club remains social and recreational. We urge that this Committee explain this change in its Report to avoid needless complexity and expensive litigation.

Our industry feels that the imposition of this tax on activities which are motivated by charitable and civic intent would be harmful. We would urge that this Committee preserve the present availability of club facilities for these purposes by giving legislative authority to the present five-percent rule which has worked well over the past five years. The tax would then be levied on the true unrelated business activity of those clubs which actually do business with the public.

The Tax Reform Act, in extending the tax on unrelated business income to social clubs, begins by imposing the tax on gross income. Then the Bill permits to be subtracted from gross income those deductions "directly connected" with the earning of the income less "exempt function income." The important words here are "directly connected." More care must be taken to see that the term is clarified. Clearly the cost of goods sold and direct labor are directly connected. But beyond this it would appear that the Bill leaves it to the IRS and the courts to interpret the meaning of the words. This interpretation is necessary and should be made now by this Committee, for both the obligation and the opportunity are here.

It is our understanding that the intention of the Bill is to tax profits made by a club, earned from sources other than members and their guests. There is no intention to tax anything other than the net profits--it is a tax, not a penalty. This being so, we urge this Committee to insure that all deductions are allocated and permitted to be set off against this gross income. By this we include all items of overhead, administrative expenses, depreciation and capital charges which helped to produce the income being taxed.

After the directly connected expenses are deducted from gross income, the taxpaying club then deducts its "exempt function income." This is defined as "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid."

This definition, as it stands, incorporates numerous existing problems and unresolved issues. Some of these are:

What are dues, fees, and charges;

What amounts are paid by members;

Who are guests;

What is the basis for exemption; and

What activities are in furtherance of this basis.

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We see no necessity for so complex a definition. We would propose dropping the words "dues, fees, charges, or similar," as not essential or helpful to the definition. Exempt function income would then include "gross income from amounts paid by members . . . ." To retain these words invites an attempt to exclude items of income as being something other than of the categories described or similar to those categories. It is felt that the intent of this Bill is more accurately expressed by the simpler language urged here.

The definition further incorporates another issue which is to determine what activities are in furtherance of the exempt purposes. We feel that this again is needless complication. If the organization qualifies for exemption, then all receipts from members should be part of the exemption.

As an example, some clubs maintain rooms where members may reside, either temporarily or as permanent residents. There are cases now pending, we understand, where the IRS contends that this is not in furtherance of the exempt purposes of the club. That this activity is exempt seems to us beyond question, but as in many areas, what is clear to taxpayers and even this Committee when drafting legislation can become very unclear when the administrators take the opportunity to put their inventiveness to bear on the statute. Perhaps it is worth noting that social clubs have been providing lodging to their members continuously since long before 1909 when the tax on corporations began.

We propose then that the words "in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid" be eliminated. This simplifies the definition, does not detract from any beneficial aspects of the section, and avoids harmful and needless confusion and litigation.

Our Association, many of our clubs, and the Internal Revenue Service have worked hard over the past ten years in an attempt to define the term "guest." We must admit that we have had small success; we have been unable to agree upon a satisfactory definition to be applied even in relatively common situations. As an example, it is clear that when the father of the bride holds his daughter's wedding receiption at his club, all of the funds are from a member. But when the function is held at the club of the father of the groom and the bride's father pays the bill or reimburses the groom's father, the nature of the funds is not clear. It appears that, under present law, this is treated as a member function. Under the Bill as it is written an opposite result may be possible. Yet another issue occurs when the member pays the bill for use of the club and is later reimbursed by his guest or by his employer. What does the bill mean by "paid by members"? Can the club be expected to look behind every payment made to it? We think not in

most situations. In some situations, however, the answer is clear. If a member, the sales manager of a company, holds a party for 300 customers, the club now inquires whether he is being reimbursed and if so the receipts are considered outside income for purposes of the five percent rule.

Numerous other questions have arisen and will continue to arise. The wording of the Bill gives new significance to these questions and indeed serves to further confuse an already complex issue.

Unlike the treatment given to other exempt organizations, the new Bill allows very few of the modifications allowed generally by section 512(b) of the Code. The Bill will permit clubs to deduct only the net operating loss, charitable contributions, and the $1000 specific deduction. This will have the effect of taxing all dividends; interest, rents, royalties, and gain from the sale of property.

We feel that the authors of this Bill have given little thought to the effect of this tax and less thought to the reasons for it. It may well be that clubs should not have their operations supported by the proceeds from investments. This is forbidden under present law. Investment income in any significant amount will cause loss of exempt status.

None of our clubs are speculators or traders in real estate or investors in the stock market. Any capital gains which occur are the result of adverse occurrences in a club's history and investment income is usually a further result.

Gains from the sale of property by clubs sometimes occur when governments take property from clubs for public purposes by right of eminent domain. Perhaps a highway is to be built through the golf course. Another reason for sale is that property taxes may make continued holding of land economically impossible. As the cities expand to surround clubs, adjacent intensive land use causes large increases in property tax assessments. Only a few of our more progressive taxing authorities have provided relief in this situation. Where no legal relief is available, the club must sell its old land and facilities and move on to a location farther away from the intensively developed areas.

Should a tax be imposed upon the proceeds of such a sale, many of our clubs would be unable to reinstitute operations and would have to liquidate. With the cost of acquisition of rural land so high, and the costs of construction so great, the expenses of moving and rebuilding equal the proceeds of sale. Such a tax as is here proposed will in the long run prove

destructive to an honorable and worthwhile segment of our nation's recreational activities. It does not seem that the purpose of the income tax should be to destroy.

But if this tax must be, then it must be tempered with fairness. In this event, exemption from the tax must be provided where the funds are used within a relatively short time, perhaps five years, for the reacquisition of new facilities.

Further, many of our clubs have been in the same location for a hundred years or more. When computing their basis they should not go back to 1913. When the tax on gain was instituted, that year of imposition was used to measure basis. If a tax on gain should be imposed on a new class of property owners, their basis should be measured just as in the other cases--from the time of the imposition of the tax.

Once the proceeds from such a sale are in hand, there is a time lag before the money can be paid out for new facilities. This may be a period of from three to five years. The funds cannot be allowed to sit idle and are usually invested in government securities or bank accounts. The interest yield on these funds barely keeps pace with inflation and perhaps the pace of inflation even causes the worth of funds to decrease. A tax on this income compounds an already bad situation. An exemption from this tax should be provided for funds held for use in rebuilding the club.

CONCLUSION

We are then, not wholly opposed to the Tax Reform Act and its aims. Much good can come from this Bill and our industry is willing to pay its just share of taxes. We do not shirk this duty. What we ask is a statute that does not force our clubs into needless and expensive litigation and administrative proceedings. We ask clarity and sensible precision of legislative language. We hope that our comments today will contribute to this end.

STATEMENT OF
DENVEL D. ADAMS
NATIONAL ADJUTANT
DISABLED AMERICAN VETERANS
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON
H.R. 13270
SEPTEMBER 12, 1969

SUMMARY OF PRINCIPAL POINTS

1. The Disabled American Veterans, a non-profit corporation chartered by Act of Congress and accountable to Congress, devotes the major part of its efforts to free assistance to veterans and their dependents, members and non-members alike.

2. The DAV approves enactment of provisions taxing unrelated debt-financed income, curtailing self-dealing, and requiring full public disclosure of activities of tax exempt organizations.

3. Although the DAV does not oppose enactment of provisions extending the unrelated business income tax to all exempt organizations, it believes strongly that in enacting any such extension, Congress should make clear its intent that the DAV's traditional methods of fund-raising should not be taxed. The tax on unrelated business income should be confined to commercial transactions in competition with taxpaying business. Any tax imposed on the funds of the DAV would cause a great reduction in service to disabled veterans at a time when these services are most needed by the wounded and disabled returning from Viet Nam.

STATEMENT OF
DENVEL D. ADAMS
NATIONAL ADJUTANT
DISABLED AMERICAN VETERANS
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON
H.R. 13270
SEPTEMBER 12, 1969

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The Disabled American Veterans appreciates this opportunity to express its views on the important subject of tax reform.

The Disabled American Veterans is a non-profit corporation chartered by Act of Congress (P.L. 72-186) on June 17, 1932. Eligibility for membership is restricted to those who have been wounded, injured or otherwise disabled while serving in the Armed Forces of the United States during time of national emergency.

The DAV was chartered by Congress to uphold and maintain the Constitution and the laws of the United States; to realize the true American ideals and aims for which its membership fought; and to aid and assist disabled veterans, their widows, orphans and dependents. It cooperates with the United States Veterans' Administration and all other public and private agencies devoted to advancing the interests and working for the betterment of all disabled veterans, DAV members and nonmembers alike.

Empowered by statute to establish state and local units, the Disabled American Veterans has approximately 1900 local chapters throughout all 50 states. As of June 30, 1969, 282,045 active members were on its rolls.

The DAV devotes the major portion of its efforts to providing free representation and assistance to hundreds of thousands of disabled veterans and their dependents in the complicated task of establishing legal entitlement to veterans' benefits. In this work, our National Service Program employs 140 full-time National Service Officers.

In the fiscal year ending on June 30, 1969; DAV National Service Officers, who are stationed in all of the 64 Veterans' Administration Regional Offices, represented 220,358 claimants, made 108,507 appearances before Veterans' Administration Rating Boards, and assisted in securing $186,434,275.94 in monetary benefits for veterans and their dependents.

The advantages of the National Service Program--which costs the DAV in excess of $2,000,000 per year to provide--are offered free of charge to all veterans and their dependents, without regard to membership in the organization. The DAV, a non-profit organization, must depend upon charitable contributions received from the general public to finance its service activities.

TAX REFORM

In view of the importance which this nation has long attached to private philanthropy, the Congress has made special tax provisions for charitable, religious and social welfare organizations. Since circumstances may change, it is entirely appropriate that these provisions be re-examined from time to time to make certain that they promote the values for which enacted and do not permit abuse or undeserved advantage.

During the course of these hearings, a broad range of proposals for tax reform, both those contained in H.R. 13270 and others, will be considered. The DAV wishes to make known its views on some of these.

UNRELATED DEBT-FINANCED INCOME

The DAV supports the enactment of legislation that would tax the unrelated debt-financed income of all tax-exempt organizations.

Through the loophole revealed by the Clay Brown case, tax-exempt organizations have been enabled to compete unfairly for the acquisition of commercially competitive businesses. Enactment of Section 121(d) of H.R. 13270 would effectively prevent a tax-exempt organization from trading on its exemption. It would place such organizations in the same position as other would-be purchasers.

SELF-DEALING

Section 101(b) of the Tax Reform Bill strengthens the Government's hand in combating self-dealing. The DAV supports this provision. Further, the Committee is invited to note that Article XVII - Section 17.0, of our National By-Laws states:

> Para. 1: "This corporation is not organized for profit. It shall issue no stock. No part of its net earnings shall inure to the benefit of any individual. No member shall have any pecuniary interest in any of the income, earnings, assets or property of this corporation, nor shall any part thereof be withdrawn or distributed to any of its members."
>
> Para. 2: "Upon final dissolution or liquidation of this corporation, and after the discharge or satisfaction of all outstanding obligations and liabilities, the remaining assets shall be

distributed to such charitable corporation as a court of competent jurisdiction determines to have purposes closest to those of this corporation."

FULL PUBLIC DISCLOSURE

The DAV approves the new provisions dealing with disclosure and publicity, although the affairs of the Disabled American Veterans could hardly become more public than now is the case.

In accordance with P.L. 88-504, the accounts of the DAV--as one of the few non-profit organizations established under Federal law--are audited annually by independent certified public accountants and these audit reports are submitted to Congress. Each report contains a full statement of income and expenses for the year.

Additionally, on December 18, 1967, the DAV's Congressional Charter was amended by P.L. 90-208, which provides:

> (b)(1) "That said corporation shall as soon as practicable after the close of each of its fiscal years make and transmit to the Comptroller General a report of its proceedings for the preceding fiscal year, including a full, complete and itemized report of receipts and expenditures of whatever kind, which report shall be duly audited by the Comptroller General."

In its report (No. 898) on the bill, H.R. 2152, the Senate Judiciary Committee said, in part:

> ...."Of all the various congressionally chartered organizations engaged in veterans' service activities, only the Disabled American Veterans and the American National Red Cross have nationwide service programs financed and paid for by the national organizations. The Disabled American Veterans specific orientation is toward the disabled veterans and its service program is devoted exclusively to the welfare of disabled veterans. To carry out its purpose the Disabled American Veterans operates on a national

rather than a State or departmental level having full-time nationally paid professional representatives stationed in every Veterans' Administration regional office to provide free service to the veterans of every state. This service is provided without regard to membership or affiliation."

Moreover, by resolution adopted at the beginning of each Congress, the House Committee on Veterans' Affairs is authorized to determine whether additional supervision of the fund-raising activities of veterans' organizations chartered by Congress is necessary or desirable.

UNRELATED BUSINESS INCOME TAX

The activities of the DAV are not competitive with private enterprises. Therefore, it has no income which should be considered unrelated to the purpose for which it was Congressionally chartered. The DAV thus does not oppose enactment of Section 121(a) of H.R. 13270.

Extension of the tax on unrelated business income without clarification of its scope, however, might encourage the Internal Revenue Service to interpret the term "unrelated business income" very broadly. This could happen in spite of the statement of the Assistant Secretary of the Treasury in explaining this extension to this Committee; "The business income of churches and other exempt organizations from commercial transactions in direct competition with taxpaying business would no longer be tax exempt."

Such a broad interpretation might encompass a major portion of the funds used to operate the DAV, though they are contributions obtained by traditional fund-raising rather than revenue of a commercial business.

The DAV urges this Committee to make it quite clear that any extension of the unrelated business income provisions is intended only to impose the tax upon the commercial activities of those who until now have been beyond its reach. As the House Report (H.R. Rep. no. 91-413 (Part 1) 91st Cong., 1st Sess. 47) on this provision notes, "There is inequity in taxing certain exempt organizations on their 'unrelated business income' and not taxing others." However, the extension should not be interpreted by the Internal Revenue Service as a license to attack every source of funds for an exempt organization.

The Committee is undoubtedly aware that the primary objective of the adoption of the unrelated business income tax in 1950 was to eliminate unfair competition by placing the commercial activities of tax-exempt organizations upon the same tax basis as the taxpaying business exterprises with which they compete. The activities intended to be taxable were regular competitive businesses operated by exempt organizations, such as a macaroni factory, a tire factory and the sale of spark plugs and ceramics.

The proposed extension simply would ensure that income from such commercial activities would be taxed in the hands of all exempt organizations. The House Report on this bill notes the various full-scale businesses that have been engaged in by organizations until now not subject to the tax on unrelated business income: bookstores, hotels, factories, radio and TV stations, record companies, groceries, bakeries, cleaners, etc.

The DAV conducts no activities such as these. It has long relied, however, upon mailing idento-tags (a small tag bearing the recipient's automobile license plate number) to individuals as a method of seeking contributions. The commercial value of the tag is negligible and it is not marketed by private enterprise. The recipient is told that he may keep the tag whether or not he contributes and, in fact, many recipients do not contribute. The tag simply is a way to gain the attention of the potential contributor in much the same way as paper flowers sold on street corners and Salvation Army musical groups.

The DAV also sends out other mailings describing its work, requesting donations for it, and suggesting that various books, usually with patriotic themes, will be sent upon receipt of a contribution in a certain amount. The amount of the contribution is far in excess of the commercial value, if any, of the particular book. The response of the contributor arises not from a commercial judgment of the value to him of the book, but from his charitable impulses. His decision upon contributing is that the goals of the DAV, which has succeeded in bringing itself and its purposes to his attention, are ones which he desires to support. Such a solicitation technique is not a commercial business transaction where the motive of the individual in parting with money is the receipt of a quid pro quo in material goods.

Like so-called "passive" investments--rents, royalties, capital gains and dividends--which will continue to be nontaxed sources of revenue if not subject to the tax on debt-financed income, such methods of soliciting contributions present no

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competitive threat of significance to taxable enterprises. An individual seeking to obtain a particular article will rely upon commercial sources where the cost to him will approximate the value of the item obtained. If, instead, he makes a contribution as a result of the mailing of an idento-tag to him or if he makes a contribution in the amount requested to receive a particular book, such contribution, above the commercial value, if any, of the token or item to him, must be based upon charitable motivation.

If the Internal Revenue Service were to attack successfully these traditional fund-raising techniques, it would be disastrous to the DAV. A drastic curtailment of DAV's national service activities would occur and at a time when they are vitally needed by the wounded and disabled veterans returning in ever-increasing numbers from the battlefields of Viet Nam.

Unlike profit-making corporations, the DAV has no prices that can be increased to offset the assessment of income tax. It has no consumer, only a prospective contributor whose benevolence enables the DAV to provide vitally-needed assistance for disabled veterans, their widows and their orphans.

The United States Congress has provided much in the way of rehabilitation benefits for this nation's veterans. None of these benefits are given automatically, however. In every case, a claim must be filed and proved. It is thus as necessary for the disabled veteran to have expert representation in the development and presentation of his claim as it is for any citizen to have a lawyer represent him in an action in court. National Service

Officers of the DAV, as "Attorneys in Fact", represent their claimants before the Veterans' Administration Rating Boards in a manner similar to that of an attorney presenting a case for his client.

It should be pointed out in this connection that, because of the $10.00 limitation on legal fees imposed by Section 3404(c) of Title 38, United States Code, it is virtually impossible for a veteran to retain an attorney to represent him in a claim for veterans' benefits.

Imposing of tax on DAV's funds would greatly diminish its ability to assist America's veterans in the preparation, presentation and prosecution of claims under laws administered by the Veterans' Administration.

If the Government undertook the financial burden of replacing our services, the taxpayers would have to bear a greatly increased cost; but if the Government did not do so, the disabled veterans of the United States would suffer greatly. An extension of the unrelated business income tax to the charitable solicitation programs of the DAV would therefore not be in the public interest.

We urgently request this distinguished Committee to make certain that any extension of the unrelated business income tax does not apply to the Disabled American Veterans' traditional sources of revenue.

STATEMENT ON BEHALF OF THE
VOLUME FOOTWEAR RETAILERS OF AMERICA
AND OF THE
COMMITTEE OF CONSUMER FINANCE COMPANIES
BEFORE THE
SENATE FINANCE COMMITTEE
RELATING TO THE MULTIPLE SURTAX
EXEMPTION PROVISIONS CONTAINED
IN H.R. 13270
THE TAX REFORM ACT OF 1969
SEPTEMBER 12, 1969

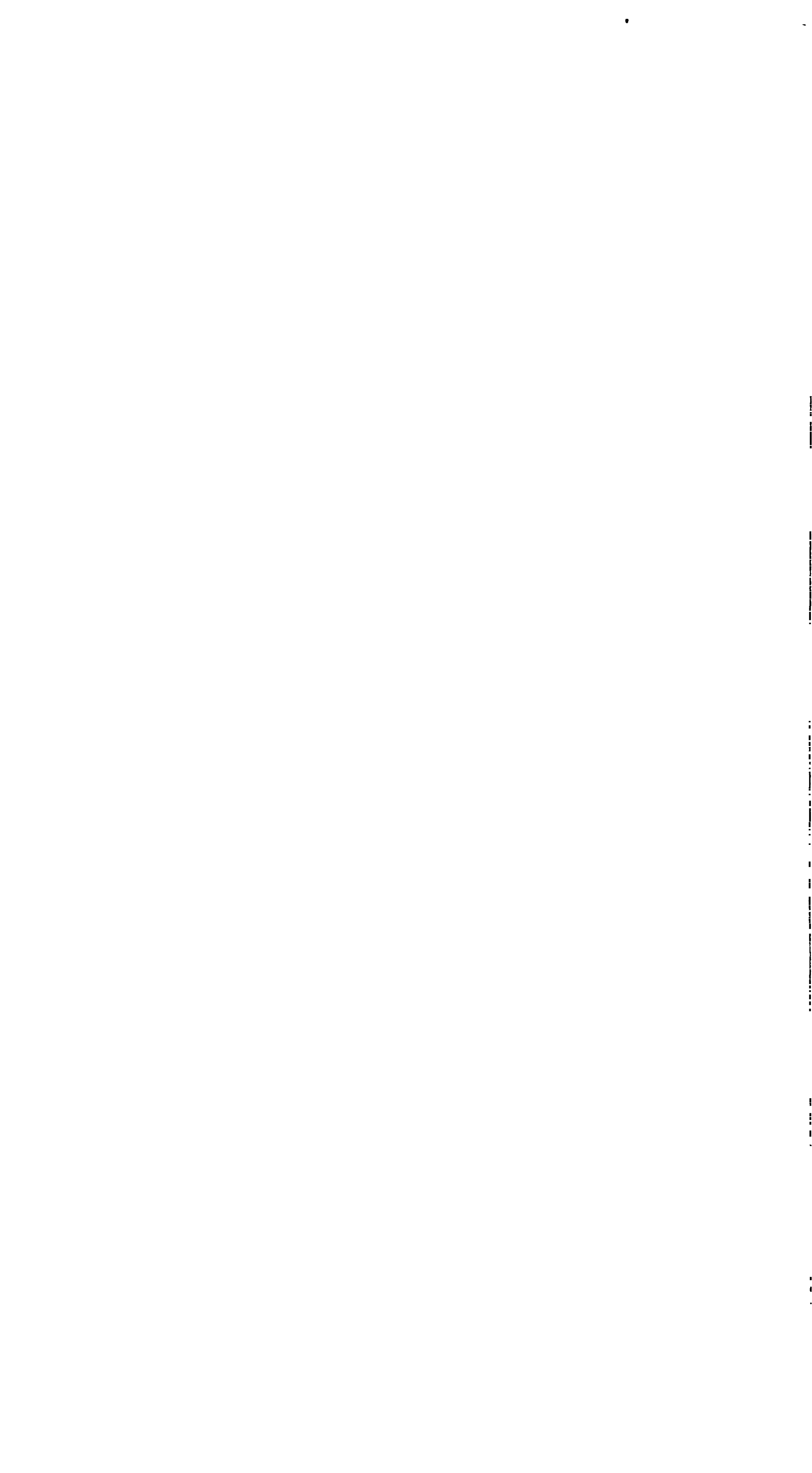
SUMMARY OF PRINCIPLE POINTS

The Volume Footwear Retailers of America and the Committee of Consumer Finance Companies oppose the provisions of H.R. 13270 which would repeal the privilege of claiming multiple surtax exemptions and urge that if the result of H.R. 13270 is to be accepted, that it be modified in the following respects:

(1) The effective date be changed from the taxable year 1969 to the taxable year 1970.

(2) That the phase-out period be increased from 8 to 10 years.

(3) That during the phase-out period, a 100% dividends received credit be allowed, and that members of an affiliated group claiming the benefits of the phase-out be permitted the same benefits with respect to intercorporate losses as are accorded to members of an affiliated group who file a consolidated return.



STATEMENT ON BEHALF OF THE
VOLUME FOOTWEAR RETAILERS OF AMERICA
AND OF THE
COMMITTEE OF CONSUMER FINANCE COMPANIES
BEFORE THE
SENATE FINANCE COMMITTEE
RELATING TO THE MULTIPLE SURTAX
EXEMPTION PROVISIONS CONTAINED
IN H.R. 13270
THE TAX REFORM ACT OF 1969
SEPTEMBER 12, 1969

My name is James W. Riddell of the law firm of Dawson, Quinn, Riddell, Taylor & Davis, 723 Washington Building, Washington, D.C. I appear as tax counsel for the Volume Footwear Retailers of America and the Committee of Consumer Finance Companies to state the opposition of these groups to the multiple surtax exemption provisions contained in H.R. 13270, the Tax Reform Act of 1969.

Under existing law, every member of an affiliated group of corporations which was formed for purposes of expanding a growing business is permitted to file a separate tax return and claim a surtax exemption. This privilege is accorded at the price of an additional six percentage points of corporate tax. Under the provisions of H.R. 13270, this privilege would be withdrawn over a period of eight years.

Under existing law, members of an affiliated group which files a consolidated return are entitled to only one surtax exemption, but they are permitted, without penalty, to claim the losses of unprofitable corporations within the affiliated group against the earnings of profitable corporations within the group. Additionally, they are permitted a 100% credit for intercorporate dividends received. H.R. 13270 would permit an increasing intercorporate dividends received credit and, in addition, would provide a limited ability whereby intercorporate losses could be claimed against intercorporate profits.

My clients oppose the repeal of the privilege of claiming a multiple surtax exemption. We do not believe that the result put forth in H.R. 13270 can be supported in fact and we believe that the increase in tax which will result therefrom can only be reflected in increased prices for goods and services. The legislative history of the policy of permitting multiple surtax exemptions is as follows:

LEGISLATIVE HISTORY

The Revenue Act of 1950

This legislative policy was first enunciated in the Revenue Act of 1950 when the surtax exemption was first allowed by the law. As you will recall, up to that time the corporate rate structure provided for graduated rates which resulted in a notch problem. The notch rate or 53% bracket rate applied to the income of corporations between $25,000 and $50,000 and was objected to on the grounds that corporations normally having incomes somewhat over $25,000 had little incentive to increase their earnings since 53¢ out of each additional dollar earned until they reached the $50,000 income tax level was taken by the Federal Government in taxes, leaving only 47¢ for the other needs of the corporation. On the other hand, corporations with incomes over $50,000 had a much greater incentive to expand their earnings since the rate schedule took only 38¢ out of each additional dollar in their case, leaving 62¢ for the other purposes of the corporation. The Congress decided to eliminate

this 53% marginal or notch rate and the device chosen for this purpose was the allowance of a surtax exemption on the first $25,000 of taxable income earned by a corporation.

House Report No. 2319, accompanying H.R. 8920, which became the Revenue Act of 1950, specifically states that the exemption would be available to all corporations. The Report provides as follows:

> "The bill eliminates the notch rate by providing a flat $25,000 surtax exemption which would be available to all corporations. This will provide tax advantages to small businesses without introducing a system which is readily adaptable to a drastic graduation of rates.
>
> "The particular exemption plan in your committee's bill provides only a single exemption which it is believed best expresses the idea of a flat tax rate modified by a concession for small businesses. It is also believed that this single exemption plan has a number of advantages over a multiple exemption system. First, the single-exemption system is much simpler and could be presented on the tax form in a way which would make it easier for the taxpayer to compute its tax. It should also be pointed out that the single-exemption system would make it possible to consolidate the normal tax and surtax computation. While this might also be possible in the case of a multiple-exemption plan or a graduated rate plan, difficult problems would, in any case, be presented under such plans in the handling of such items as partially tax-exempt interest and the special tax treatment accorded Western Hemisphere trade corporations and dividends paid by public utilities on certain preferred stock."

The Revenue Act of 1951

The policy of allowing the surtax exemption to all corporations was reviewed by the Congress again in connection with the Revenue Act of 1951. At that time a provision was added to the House bill which would have eliminated the multiple surtax exemption in the case of corporations which were members of an affiliated group. The policy embraced in the provision and the terms of the provision itself were very close to that which we today find in the current recommendations. This provision was added to the House bill without hearings and passed the House. However, it was the subject of strenuous objection before the Senate Finance Committee when its terms became known.

The Senate, acting on the recommendation of the Senate Finance Committee, eliminated the provision of the bill. The reasons for this action are stated in Senate Report No. 781, which accompanied H.R. 4473, the bill which became the Revenue Act of 1951, as follows:

> "Your committee realizes that there may be some opportunities for tax avoidance under present law through the use of multiple corporations, although it should be pointed out that sections 45 and 129 of the code now afford the Government protection in cases where the principal purpose of the formation of multiple corporations can be shown to be the avoidance of taxes.

"However, the House bill is so broad in its attack on this problem that, if enacted, it could result in substantial injury to many businesses whose present corporate organization has not been motivated by tax avoidance.

"Many businesses were organized in the form of multiple corporations long before the present surtax exemption and minimum excess profits tax credit were introduced. A business may be required to incorporate separately in each State in which it carries on its activities. Furthermore, State laws sometimes prohibit the chartering of a corporation for more than one business purpose. A related corporation frequently will be formed for the purpose of limiting liability with respect to the development of a new and risky enterprise. All of these are traditional and legitimate purposes for the creation of new and separate corporations, yet the House bill would strike at these bona fide corporate entities in the same manner as it would treat cases of true tax avoidance.

"Corporations defined as 'related' under the House bill may, in fact, be carrying on entirely unrelated types of business with few or no transactions between the members of the related groups. In such cases, failure to extend the full surtax exemption and the full excess profits tax credit to each corporation could affect seriously its competitive position with respect to other corporations of similar size carrying on the same type of business.

"The provisions of the House bill would apply to corporations without regard to when they were formed. This would work a particular hardship on those related corporations which were organized in the past for legitimate business reasons. It should be noted that the denial of the full surtax exemption and the full minimum excess profits tax credit can result in a very substantial increase in tax liabilities, especially in the case of small

"corporations. On the other hand, to limit a provision such as that of the House bill to corporations created in the future would give rise to numerous competitive discriminations between new and old corporations.

"For these reasons, your committee had eliminated entirely this provision of the House bill. Any future study undertaken to develop methods of limiting avoidance in this area should emphasize the importance of correcting the true cases of avoidance without working a hardship on legitimate business organizations."

The House concurred in this action of the Senate and offered an amendment, Section 15(c) of the Internal Revenue Code of 1939, which was designed to prevent the artificial split up of existing businesses for the purpose of obtaining additional corporate surtax and excess profit tax exemptions.

As a result of the conference on H.R. 4473, it was agreed that the one case which should be prevented as an abuse was the case of a split-up of an existing business and for that reason, Section 15(c) of the Internal Revenue Code of 1939 was enacted. The Conference Report on the Revenue Act of 1951 is silent as to the reasons for enacting Section 15 (c) and contains only an explanation of the terms of the amendment. However, the summary of the provisions of the Revenue Act of 1951, as published by the Staff of the Joint

Committee on Internal Revenue Taxation, at pages 21 and 22, contained a discussion, the final paragraph of which explained the scope of the section in the following language:

> "This provision of the bill does not prohibit or discourage expansion of an existing business accompanied by the formation of new corporations, as distinguished from the mere split-up of an existing business nor does it prevent an individual or a group of individuals who may own the stock of a corporation from forming additional corporations to engage in a similar or a different business. A corporation wishing to expand its activities may use a part of its funds, whether or not those funds represent accumulated earnings, to form the capital of a new corporation in exchange for those funds. Or an individual who owns all the stock of a corporation may use any cash or property he owns to form a new corporation. In such cases the new corporation will be allowed the full surtax exemption and the minimum excess profits credit."

The regulations issued by the Internal Revenue Service under Section 15(c) reflect the same policy stated by the summary of the Joint Committee on Internal Revenue Taxation. Section 1551(d) provides as follows:

> "(d) Nature of Transfer. A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 368 is within the scope of section 1551 except that section 1551 does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation

"of a new corporation is not a transfer within the scope of section 1551 irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property."

The scope of the regulations issued under Section 15(c) and the differences between the regulations as proposed and as finally issued are put forth in a letter from Mr. Edwin L. Kahn, then Director, Technical Planning Division of the Internal Revenue Service, to Mr. Wilbur H. Friedman, attached hereto as Exhibit A. The letter states, in part:

"Under the regulations as finally issued, section 15(c) will not be applicable to a transfer of cash from one corporation to a newly formed corporation where the new corporation is formed in connection with the expansion, as distinguished from the mere split-up, of an existing business. This will be so even though the new corporation uses the cash which was obtained from the transferor corporation to buy inventory, fixtures, or similar property from the transferor corporation. The test under the regulations is not the nature of the property purchased from the transferor corporation but whether the formation of the new corporation is in connection with the expansion of a business or the mere split-up of an existing business."

<u>The Revenue Act of 1964</u>

The Congress was again presented by the Treasury Department with an opportunity to clearly change the legislative policy and direction of Section 1551 on Wednesday,

February 6, 1963. The Honorable Douglas Dillon, then Secretary of the Treasury, appeared before the Committee on Ways and Means of the House of Representatives and proposed the following with respect to multiple surtax exemptions:

> "The proposed reduction in the corporate normal tax rate from 30 to 22 percent would not be feasible in the absence of appropriate changes in related parts of the tax structure.
>
> "Under existing law, multi-corporate groups, whether formed for good business reasons or not, are in position to derive multiple tax benefits from the $25,000 surtax exemption. They can obtain a substantial reduction in their effective tax rate as compared with enterprises having equal income but organized as a single corporate entity. Consequently, the reduced tax rate designed to assist small business would confer unintended benefits on medium-sized and large businesses operating through a series of separately incorporated units.
>
> "The fact that there are valid business reasons for many of these multiple corporate structures does not justify treating each corporate unit in the group as if it were an independently controlled small business. Under existing law, in the case of these multiple corporate structures an incentive for small business is converted into a large bonus for middle and big business. The present rules do more than misdirect the tax benefits intended for small businesses; in some situations, they even provide an incentive for uneconomic corporate arrangements and deliberate abuse through proliferation of corporate units.

"The President has, therefore, recommended that provisions be adopted to limit related corporations subject to 80 percent common ownership and control to a single surtax exemption. Related corporations for this purpose would include 80-percent-owned corporations which are subsidiaries of the same corporate parent (parent-subsidiary type) or which are owned by the same five or fewer individuals (brother-sister type). Also included would be corporations which are 80 percent owned by five or fewer corporations (commonly controlled subsidiaries).

"In order to prevent any abrupt financial impact from the proposed limitation of the surtax exemption, the denial of multiple surtax benefits should be made effective gradually over a 5-year transition period beginning with 1963.

"Enactment of this proposal will add $120 million annually to tax receipts."

It should be noted that the Treasury's recommendation was brought forth notwithstanding an admission that there are valid business reasons for maintaining multiple corporate structures. Reams of supporting material were supplied by the Treasury Department, setting forth in detail the tax savings inherent in the multiple corporate structure. Thus the Congress was fully informed as to the facts surrounding the existence of and the inherent tax savings available to multiple corporate structures which file separate corporate tax returns and claim surtax exemptions with respect to corporate subsidiaries.

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It is well known that the Congress did not adopt the Treasury Department's proposals in the Revenue Act of 1964. Instead, the Congress took the pains to enact Part II of Subchapter B of Chapter 6 of the Internal Revenue Code of 1954. Subchapter B, which takes up approximately ten pages of the Internal Revenue Code and which is just a little bit shorter than the original income tax statute enacted in 1913, provides elaborate machinery for electing the use of multiple corporations. The subchapter does provide, however, that affiliated corporate groups who utilize a multiple corporate structure and elect multiple surtax exemptions must pay a 6% penalty for the privilege of doing so. The action of Congress with respect to multiple surtax exemptions is explained in House Report No. 749, 88th Congress, 1st Session, at page 117:

> "*** The method of taxing controlled corporations contained in the bill will, in your committee's opinion, when coupled with the repeal of the 2 percent additional tax on consolidated returns, encourage some controlled groups to file consolidated returns, while leaving groups which do not choose to file consolidated returns in approximately the same relative position they are in under present law.
>
> "While your committee recognizes the advantages of use of multiple corporations, your committee believes, as it has in the past, that, where corporations owned and controlled by the same

"interests engage in different businesses in the same area or conduct the same type of business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions. However, your committee does not intend to encourage the formation of these multiple corporations and therefore proposes to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of sections 269, 1551 or 482 if the multiple corporation form of organization is adopted to avoid taxes."

As a part of its legislative proposals with respect to multiple surtax exemptions, having failed in its attempt to do away with them altogether, the Treasury Department proposed that the exception for cash transfers be repealed. On June 12, 1963, the Committee on Ways and Means considered and tentatively adopted an amendment to Section 1551. The press release issued by the Committee on June 12, 1963, explained the tentatively-adopted amendment in the following language:

"The Committee also tentatively adopted an amendment to section 1551 of the Internal Revenue Code of 1954 to provide that there will be a disallowance of a surtax exemption in certain cases where a corporation transfers property in the form of money to another controlled corporation (as well as, under present law, where it transfers property

"other than money in such a case). Under the committee's decision, the provision would also be expanded to make it applicable to transfers by individuals (present law applies only to corporations)."

Immediately, memoranda were filed with the Treasury Department and with the Committee on Ways and Means, which pointed out that the effect of such an amendment would be to effectively grandfather the right to surtax exemptions in view of the history of the Treasury Department's endeavors to do away with multiple surtax exemptions and the existing requirement that taxpayers must establish by clear preponderance of the evidence that the securing of a surtax exemption was not a major purpose of a transfer. It was also pointed out in these memoranda that the proposed amendment would successfully preclude the expansion of growing businesses.

The Committee's tentative decision was subsequently rejected and insofar as we can determine was never reduced to a legislative draft. Substituted therefor was the amendment which added the word "indirectly" to Section 1551. This amendment was explained in House Report No. 749 at pages 210 through 213. Nothing in this Committee Report, or in the Committee Report of the Senate Finance Committee, reveals an intent to change the legislative policy under Section 1551

from one against split-ups to one against expansion. However, Example No. 1 [1/] on page 211 of the House Report was so ambiguous that it was thought that the report required explanation. For that reason, the floor statements of Chairman Mills of the Committee on Ways and Means and Senator Long of the Committee on Finance contained the following language in explanation:

> "*** Under existing law, if a corporation transfers property other than money directly to a corporation which it controls and the transferee corporation was created for the purpose of acquiring this property, or was not actively engaged in business at the time of this acquisition, the Secretary of the Treasury or his delegate may disallow the $25,000 surtax exemption or the $100,000 accumulative earnings credit, unless the transferee corporation establishes by the clear preponderance of the evidence that the securing of the exemption or credit was not a major purpose for the transfer.
>
> "Thus, present law applies only to direct transfers of property other than money. The bill amends the section to include indirect transfers of property other than money. Cases have been presented to the conferees where a

1/ "Example (1).-- On June 15, 1963, corporation X organizes corporation Y (a wholly-owned subsidiary) and transfers cash to such corporation which it then uses to purchase stock in trade from corporation X. The exception for transfers of money does not apply to the transfer by corporation X to corporation Y. X has made an indirect transfer of property (other than money) within the meaning of subsection (a) (2) of Section 1551."

"newly-organized subsidiary -- created by expanding, rather than merely changing the location of the business -- in the ordinary course of its business purchases merchandise from a centralized warehouse maintained by the parent corporation. In such a case, it is not intended that any surtax exemption or accumulated earnings credit be disallowed under the amendment where a major purpose of the separate incorporation was not the securing of an additional surtax exemption." (Congressional Record, February 25, 1964, Congressman Mills, pages 3428-29; Senator Long, page 3401.)

In view of the floor statements of Senator Long of the Senate Finance Committee and Chairman Mills of the Ways and Means Committee, negotiations with officials of the Treasury Department looking toward regulations under the amended Section 1551 were immediately undertaken. These negotiations resulted in the recently adopted regulations under Section 1551 which were initially proposed in the Federal Register of July 19, 1966. The regulations were adopted as proposed. They are shown for convenience as proposed rather than as they were adopted so that the changes can more clearly be shown. These regulations provide as follows:

"1. Nature of transfers to which section 1551 applies.

"Section 1.1551-1(d) should be amended to read as follows (omitted material is bracketed;

"added material is underlined):

"(d) Nature of Transfer. A *direct* or indirect transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 368 is within the scope of section 1551 except that section 1551 does not apply to a transfer of money only. [For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 1551 irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.] *For example, if a transferor corporation transfers property to its shareholders or a subsidiary, the transfer of that property by the shareholders or the subsidiary to a transferee corporation is a transfer of property by the transferor corporation to which section 1551 applies. A purchase of property by a transferee corporation from a transferor corporation or five or fewer individuals controlling the transferee corporation is a transfer within the scope of section 1551, whether or not the purchase follows a transfer of cash from the controlling corporation or individuals.*"

"2. 'Major Purpose.' Section 1.1551-1(e) should be amended to read as follows (added material is underlined):

"(e) Purpose of Transfer. In determining, for the purpose of section 1551, whether the securing of the exemption from surtax or the accumulated earnings credit constituted 'a major purpose' of the transfer, all circumstances relevant to the transfer shall be considered. *'A major purpose' will not be inferred from the mere purchase of inventory by a subsidiary from a centralized warehouse maintained*

"by its parent or by another subsidiary of the parent. For disallowance of the surtax exemption and accumulated earnings credit under section 1551, it is not necessary that the obtaining of either such credit or exemption or both have been the 'sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the accumulated earnings credit may constitute 'a major purpose' of the transfer notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 368. The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not 'a major purpose' of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer."

TWIN LEGISLATIVE POLICIES

Thus it can be said that it has been the policy of the Congress to encourage legitimate and normal expansion of growing businesses by the allowance of a surtax exemption to every corporation within a controlled group which is established for sound business purposes. It has also been the firm legislative policy of Congress to deny the surtax exemption and all other deductions or exclusions to corporations

which are formed for the purpose of tax avoidance without sound business purposes. This is evidenced by the terms of Section 269 of the Internal Revenue Code which deals with business acquisitions made to evade or avoid income taxes, and Section 1551 of the Code which deals specifically with the problem here under consideration by disallowing a surtax exemption and accumulated earnings tax credit in the case of corporations which are created for the purpose of acquiring property, unless it can be established by the transferee corporation by the clear preponderance of the evidence that the securing of a surtax exemption or accumulated earnings tax credit was not a major purpose for the transfer of the property.

The legislative history and intent set forth above have been summarized and reinforced in the floor statement of Chairman Wilbur D. Mills of the Committee on Ways and Means before the House on August 6, 1969. While we submit that these legislative policies of permitting the legitimate expansion of business while denying the fruits of tax avoidance have worked well and that no meaningful reasons have been advanced for changing them, nevertheless, we urge

this Committee, if it is to accept the results put forth in the House bill, to change the results in the following ways:

(1) That the effective date be changed so that the provision becomes applicable with respect to taxable years beginning after December 31, 1969. That is to say, that the phase-out period begin in 1970 rather than in 1969. In this connection, we point out that this provision of the bill is the only one which would have industry-wide impact for 1969.

(2) We urge that the phase-out period be increased from 8 years to 10 years.

(3) In view of the fact that the bill continues the six percent penalty during the phase-out period, corporations claiming the benefits of the phase-out be permitted a 100% dividends received credit and the same benefits with respect to intercorporate losses as are today permitted to those affiliated corporations which file consolidated returns.

NATIONAL RETAIL MERCHANTS ASSOCIATION

SUMMARY OF STATEMENT IN OPPOSITION TO PROPOSED ELIMINATION OF MULTIPLE SURTAX EXEMPTIONS

1. Present law already imposes a 6% penalty tax on component members of affiliated groups of corporations as compared with individually owned corporations. The latter can also avoid all corporate income taxes by electing to be taxed under the provisions of Subchapter S.

2. It is wrong to equate economically a national retail organization comprised of many small stores with a giant industrial enterprise. The appropriate economic comparison is with competitive locally owned stores.

3. The House Bill would result in the closing of marginal stores and discourage the opening of new stores with resulting loss of jobs, reduced services, and higher prices to consumers through diminished competition. The effects would be most severe in the smaller communities of the nation.

4. The Treasury estimate of additional revenue seems wholly unrealistic and neglects entirely the resulting economic dislocations in the retail sector of the economy.

NATIONAL RETAIL MERCHANTS ASSOCIATION

STATEMENT IN OPPOSITION TO PROPOSED ELIMINATION OF MULTIPLE SURTAX EXEMPTIONS

My name is Walter Pozen and I am the Washington resident partner of the law firm of Stroock & Stroock & Lavan, New York City. I am appearing on behalf of the National Retail Merchants Association in opposition to the proposed elimination of corporate multiple surtax exemptions.

Prior to the Revenue Act of 1950, there was a system of progressive income tax rates applied to corporations with a "notch tax rate" of 53% applicable to taxable incomes between $25,000. and $50,000. This rate was confiscatory in the sense that it destroyed the incentive for small corporations to increase their taxable incomes above the $25,000. level. It had no effect on large corporations which paid 38% on taxable incomes in excess of $50,000.

In the Revenue Act of 1950, Congress recognized this inequity and eliminated the so-called "notch tax rate," by instituting a normal tax and a surtax. A normal tax of 25% was levied on all taxable income and a surtax of 20% applied to taxable income in excess of $25,000; thus the concept of a surtax exemption was created. Congress reviewed this concept almost annually, and except for the incorporation of sections to prevent abuses, made no significant change in the surtax exemptions until the Revenue Act of 1964.

In the Revenue Act of 1964, Congress after careful study reduced the normal tax rate on corporations from 30% to 22%, and correspondingly

increased the surtax rate from 22% to 28% and later to 26%, with transition rates for fiscal year taxpayers. At this time, an additional tax of 6% was imposed on the first $25,000. of taxable income for component members of affiliated groups of corporations. However, this additional tax of 6% was imposed only if the groups elected surtax exemptions for each of their component members. The penalty tax of 2% on the filing of consolidated tax returns by affiliated groups was at the same time eliminated. These changes permitted groups of corporations to elect the method most advantageous to their economic status within reasonable limits.

Unfortunately, slogans and catch-words have replaced reasoned arguments in some of the proposals now made to close "tax loopholes." Some proposed changes are being promoted as panaceas for the excessive burdens of the present high tax rates. The effect of pending proposals to eliminate multiple surtax exemptions, if they become law, will in our judgment create a chaotic condition with potentially very serious consequences in the retailing sector of our economy.

Since World War II, there has been a complete metamorphosis in the retailing industry, almost a "retailing revolution." Prior to that time, the trend towards consolidation and the growth of large urban department store complexes had accelerated. However, the shift in population from the urban metropolises to the suburbs required the opening of a large number of stores in suburban areas. The lack of parking

facilities and other inconveniences that customers had to suffer to purchase necessities made this shift to smaller suburban stores essential. In addition, great demand for improved retail services was found to exist in a large number of small communities throughout the entire country outside of great metropolitan areas. Local stores were organized in order to combine mass purchasing power with the individual service and attention to consumers demands, which the situation required. This process stimulated competition and lowered the cost of living through reduced prices to consumers.

To accomplish this desired result, stores were incorporated separately. These separate corporations were created in order to limit the liability of their parent, to encourage relative autonomy of operation and to avoid state tax problems.

When small stores are established from time to time, the problems of administration often increase geometrically. Uniformity of merchandise, advertising, personnel policies among all the stores is impossible because of the diverse sectional differences. Local concepts and personnel must determine policy. Autonomy in operation is essential. The fact is that most national retail enterprises really operate a large number of small local businesses. The appropriate economic comparison should be with other small locally owned retail stores. It is wrong to compare a national retail operation, with a large number of small stores, with a giant industrial enterprise. If the latter were operated through a very large number of separate

corporations, some tax adjustment would probably be justified. It is clearly not justified under the circumstances prevailing in the case of retail stores.

The present law is not objectionable since it places component corporations of a group at an acceptable 6% tax disadvantage as compared to individually owned stores. (See Exhibit A for comparison of tax treatment under present and proposed laws.) Probably the fairness of the present statute is demonstrated by the fact that there have been virtually no complaints from small independent retailers. It should also be pointed out that many small retailers pay no corporate taxes at all by electing to be treated as Subchapter S corporations under Sections 1371-78 of the Internal Revenue Code. This election is prohibited to affiliated groups.

The elimination of the multiple surtax exemptions would cause small marginal stores to be closed. The return on capital invested, and the business risks resulting from mistakes in location, unsuitable merchandise or personnel would appear to be overwhelming considerations if the expected small net profit were substantially reduced by increased income taxes. Business risks are assumed only if the possibility of reward under the most favorable conditions are substantial enough to justify them. In retailing, the prevailing tendency has been for large volume, small profit margins and comparatively low net profits. This has been characteristic regardless of the size of the store. The elimination of the multiple surtax exemptions would have a catastrophic

effect on many small stores which cannot absorb additional taxes of great magnitude and still remain profitable to operate. Innumerable local communities would suffer from a decline in services, availability and suitability of merchandise, a decrease in competition and a loss of jobs.

The Treasury estimates that the elimination of the multiple surtax exemptions would, at the end of the phase-out period, result in $235 million of additional tax revenue. This estimate seems to us wholly unrealistic. It is not even clear what offsetting tax factors the Treasury has used for purposes of this estimate. What does seem clear, however, is that the Treasury is relying on data four or five years old which may bear no meaningful relationship to present conditions.

Furthermore, no account has been taken of the revenue loss (both corporate and individual) resulting from the closing of marginal stores and from stores which never open as a result of the adverse tax changes in the House Bill. It is even possible that the Treasury would actually lose revenue as a result of the economic dislocations caused in the retail sector of the economy by this Bill.

Moreover, how does one measure the over-all economic effects of legislation which would so radically change the ground rules for the taxation of retail organizations? How much will the cost of living rise as a result of diminished competition? How many jobs will be

lost or never created? How much will the American consumer be inconvenienced in shopping for the necessities of life if these provisions are allowed to become law?

We urge the Committee to reject the multiple surtax provisions of the House Bill. No change so disruptive of the national retail economy should be made in the absence of a thorough economic study of its effects not only on Federal revenues but of the interest of the American consumer.

EXHIBIT A

UNDER PRESENT LAW

	Component Unit	Independent Unit
Assumed Taxable Net Income	25,000	25,000
Corporate Income Tax:		
Normal Tax at 22%	5,500	5,500
6% Penalty for Filing Separate Corporate Returns	1,500	-
Total Tax	7,000	5,500

UNDER PROPOSED LAW
AFTER PHASE-OUT PERIOD

	Component Unit	Independent Unit
Assumed Taxable Net Income	25,000	25,000
Corporate Income Tax:		
Normal Tax at 22%	5,500	5,500
26% Additional Tax	6,500	-
Total Tax	12,000	5,500

SUMMARY

	Component Unit	Independent Unit
Under Proposed Law	12,000	5,500
Under Present Law	7,000	5,500
Increase Under Proposed Law	5,000	0

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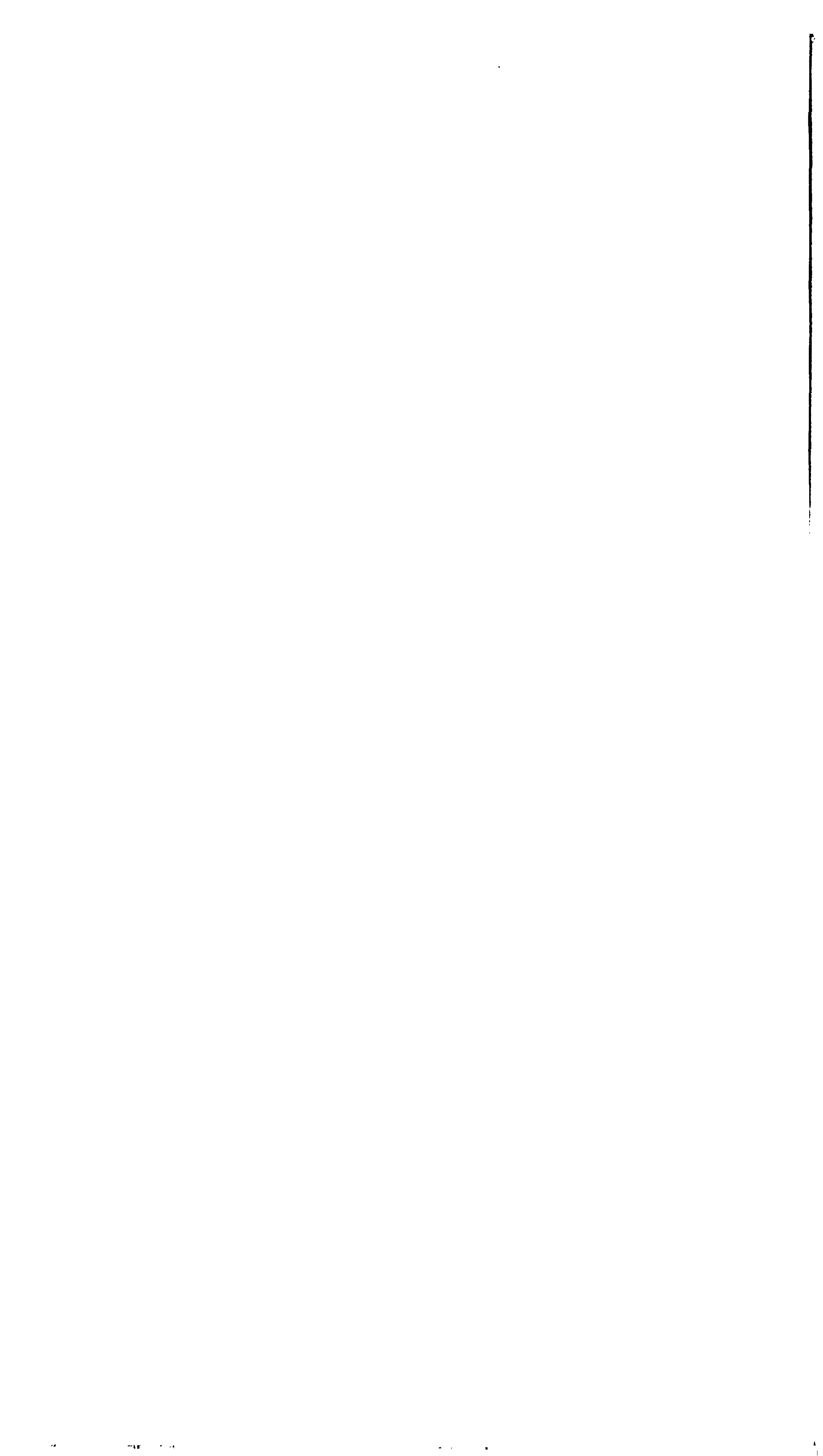
STATEMENT PRESENTED TO
SENATE COMMITTEE ON FINANCE
SEPTEMBER 2, 1969

REGARDING
TAX REFORM BILL OF 1969, H.R. 13270
SECTION 401
PERTAINING TO MULTIPLE CORPORATIONS

Presented by
MR. BENJAMIN BOTWINICK, C.P.A.
PARTNER, BENJAMIN BOTWINICK & CO.



SUMMARY OF PRINCIPAL POINTS

A) Sound business practices, such as limited liability, dictate the organization method a businessman employs; taxes are only one of many important factors.

B) The principle of having the first $25,000 of taxable income of each corporation taxable at a lower rate than all income in excess of $25,000 does not create a loophole and does not require "reform". It has been recognized in every tax law as far back as you can go.

C) Sections 269 and 1551 of the present Internal Revenue Code have powerful provisions that effectively prevent the use of sham or shell corporations, or the transfer of property to new corporations, not having good business purposes, to obtain the tax benefit of having a lower tax on the first $25,000 of taxable income.

D) Section 482 of the present Internal Revenue Code provides that where two or more corporations are owned or controlled directly or indirectly by the same interest, the Secretary of the Treasury or his delegate may allocate deductions, credits, or allowances between or among these corporations, if he determines that this is necessary to prevent evasion of taxes or clearly to reflect the income of the corporations.

E) As recently as 1964, Sections 1561-1563 of the Internal Revenue Code went into effect, imposing a penalty tax of 6% of income, in addition to the normal tax of 22%, for the privilege of using multiple corporation surtax exemptions. The reasons that the Senate Finance Committee gave in its explanation of the 1964 bill are just as valid today. The 6% penalty, coupled with many other tax and operating cost obstacles inherent in multiple corporation operation, was deemed by the Senate Finance Committee to be a sufficient deterrent to undue use by medium and large corporations.

F) Those small businessmen who for valid business purposes use multiple corporations, and who operate them at arms length (as necessitated by Sections 269 and 482), lose the opportunity of applying net losses of one company against the profits of another, thus taxes are paid on a higher amount than the consolidated net income.

G) The sole reason given in the report of the House Committee on Ways and Means for the enactment of Section 401 of the tax reform of 1969 (Page 98 of the report) clearly states their intention was to continue to help small business but restrict large organizations. However the impact of Section 401 will be mainly against small business and only hurt big business in a very limited number of cases. It is not necessary to destroy a time honored and proven equitable provision of law essential to the existance and growth of small business to accomplish what the Ways and Means Committee intended to accomplish.

H) Section 401 should be eliminated from the bill in entirety and in lieu thereof there should be adopted simple provisions that will effectively prohibit only big corporations from utilizing undue multiple surtax exemptions. One possibility would be a requirement limiting multiple corporation surtax exemptions to a maximum of $500,000 of pre-tax income (or perhaps an even lower amount).

STATEMENT

A) USE OF MULTIPLE CORPORATIONS

Sound business practices dictate the organization methods a businessman employs; taxes are only one of many important factors. Yet under Section 401, the government arbitrarily would heap severe tax penalties on companies which were not even considering taxes in establishing allied corporations. Among the sound business reasons for separate units are incorporation of branches so that local managers may have stock ownership incentive for participation in profits; limited liability for tort actions, long-term lease requirements, hazardous business condition; estate planning considerations; alleviation of labor problems; etc.

Many small businessmen are engaged in a few different businesses that are totally unrelated. In small towns particularly, a businessman might own in different corporations a retail store, a gas station, a real estate venture, a transportation business. Consider what Section 401 does to such businessmen.

There are many additional costs of doing business involved in the use of multiple corporations, such as costs of keeping separate sets of books, bank accounts, State, City and Federal filing requirements, separate payroll records and returns, etc.

Small business finds it next to impossible to obtain public financing. Small business is at the bottom of the pile when it comes to getting bank loans (especially during a period of tight credit, as at present). The modest tax benefit that the present law permits, helps the small businessman to retain some seed money in his business. There is no sound or equitable reason to curtail this.

B) THE PRESENT LAW DOES NOT CREATE A LOOPHOLE

The principle of having the first $25,000 of taxable income of each corporation taxable at a lower rate than all income in excess of $25,000, does not create a loophole and does not need "reform". It has been recognized in every tax law as far back as you can go. Under existing inflationary conditions, a good case could be presented to substantially increase this $25,000 but, obviously, the fiscal problems of the government would prevail. The Senate Finance Committee report on the Revenue Bill of 1964, in commenting on this subject states (Page 148): "This tax structure was intended to encourage small businesses which operate in corporate form."

C) SECTIONS 269 and 1551 PREVENT ABUSE

The Senate Finance Committee report on the Revenue Bill of 1964, in its comments on this subject (Page 149) states: "As a result, the Internal Revenue Code contains several provisions designed to prevent taxpayers from using the multiple form of corporate organization, to avoid taxes. For example, present law provides (Sec. 269) that where an individual or corporation acquires control of a corporation and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, this deduction, credit, or allowance is not to be allowed. Also, elsewhere (Sec. 1551) present law provides that if a corporation transfer part or all of its property (other than money) to another corporation created to acquire the property, or not actively engaged in business at the time of the transfer, and if there is common control of the two corporations, then the transferee corporation is not to be allowed the $25,000

surtax exemption or the $100,000 accumulated earnings credit unless it establishes by the clear preponderance of the evidence that the securing of the exemption or credit is not a major purpose of the transfer."

D) SECTION 482 ASSURES "ARMS LENGTH" INTERCOMPANY TRANSACTIONS

The Senate Finance Committee report on the Revenue Bill of 1964 further states (Page 149): "In addition, present law (Sec. 482) provides that where two or more corporations are owned or controlled directly or indirectly by the same interest, the Secretary of the Treasury or his delegate may allocate deductions, credits, or allowances between or among these corporations, if he determines that this is necessary to prevent evasion of taxes or clearly to reflect the income of the corporations."

E) 6% PENALTY TAX, ENACTED IN 1964, NEGATES NECESSITY FOR SEC. 401

As recently as 1964, Sections 1561-1563 of the Internal Revenue Code went into effect, imposing a penalty tax of 6% of income, in addition to the normal tax of 22%, for the privilege of using multiple corporation surtax exemptions. The reasons that the Senate Finance Committee gave in its explanation of the 1964 bill are just as valid today (Pages 149 and 150):

"While the House and your Committee recognize the advantages of use of multiple corporations, it is believed, as it has been in the past that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions.

However, the House and your Committee do not intend to encourage the formation of these multiple corporations and, therefore, propose to apply higher tax rates to corporations which are members of an affiliated group of corporations. Of course, nothing in this bill is intended as changing the application of Sections 269, 1551 or 482 if the multiple corporation form of organization is adopted to avoid taxes." ----------(under Sec. 1562) "Corporations in the group may elect to pay a penalty tax and file a multiple surtax exemption return. Under this election, each member of the group (subject to the tax avoidance provision) may claim a separate $25,000 surtax exemption, but each must also agree to pay an additional tax of 6% on the first $25,000 of its taxable income. With generally applicable rates of 22% on the first $25,000 of taxable income and 50% or 48% on income over $25,000, this means a total tax for such companies of 28% on the first $25,000 of income and 50% in 1964 and 48% in 1965 and subsequent years on income over $25,000.

F) NET LOSS OF ONE CORPORATION CANNOT BE APPLIED AGAINST THE PROFITS OF ANOTHER

Those small businessmen who for valid business purposes use multiple corporations, and who operate them at arms length (as necessitated by Sections 269 and 482) lose the opportunity of applying net losses of one company against the profits of another. Thus taxes are paid on a higher amount than the consolidated net income, as shown in the following example:

Corp.	Net Income or (Loss)	22% + 6% Income Tax
A	$ 25,000	$ 7,000
B	20,000	5,600
C	20,000	5,600
D	(25,000)	-----
Totals	$ 40,000	$ 18,200

Of course the loss of D corporation could be carried back or forward against profits of D corporation, if any. There is also a tax on 15% on intercorporate dividends, which is not incurred where a group of affiliated companies files a consolidated return.

G) SOLE REASONS GIVEN BY WAYS AND MEANS COMMITTEE TO JUSTIFY SECTION 401.

The following is the sole reason given in the report of the House Committee on Ways and Means for the enactment of Section 401 of the Tax Reform Bill of 1969 (Page 98 of the report):

"General reasons for change. -- Although the surtax exemption, and the other tax provisions discussed above, were designed to help small businesses, large organizations have been able to obtain substantial benefits from the exemption by dividing the organization's income among a number of related corporations. Your Committee does not believe that large organizations which operate through multiple corporations should be allowed to receive the substantial and unintended tax benefits resulting from the multiple use of the surtax exemption and the other provisions of present law."

The above reason disregards the fact that the impact of Section 401 will be mainly against small business and will only affect big business in a very limited number of cases. It is not necessary to destroy a time honored and proven equitable provision of law essential to the existence and growth of small business to accomplish what the Ways and Means Committee intended to accomplish. If the 6% penalty tax enacted in 1964 is deemed to be an insufficient deterrent, then additional deterrents can be enacted. You do not destroy an

entire house when an additional storm door will suffice.

H) CONCLUSION - SECTION 401 SHOULD BE ELIMINATED

Section 401 should be eliminated from the bill in entirety and in lieu thereof there should be adopted, if found necessary, simple provisions that will effectively prohibit only big corporations from utilizing undue multiple surtax exemptions. One possibility would be a requirement limiting multiple corporation surtax exemptions for any group of affiliated corporations to a maximum of $500,000 of pre-tax income (or perhaps an even lower amount). However, small business believes that the findings of the Senate Finance Committee in 1964 are as relevant today as they were in 1964, and that the law should remain essentially as it is.

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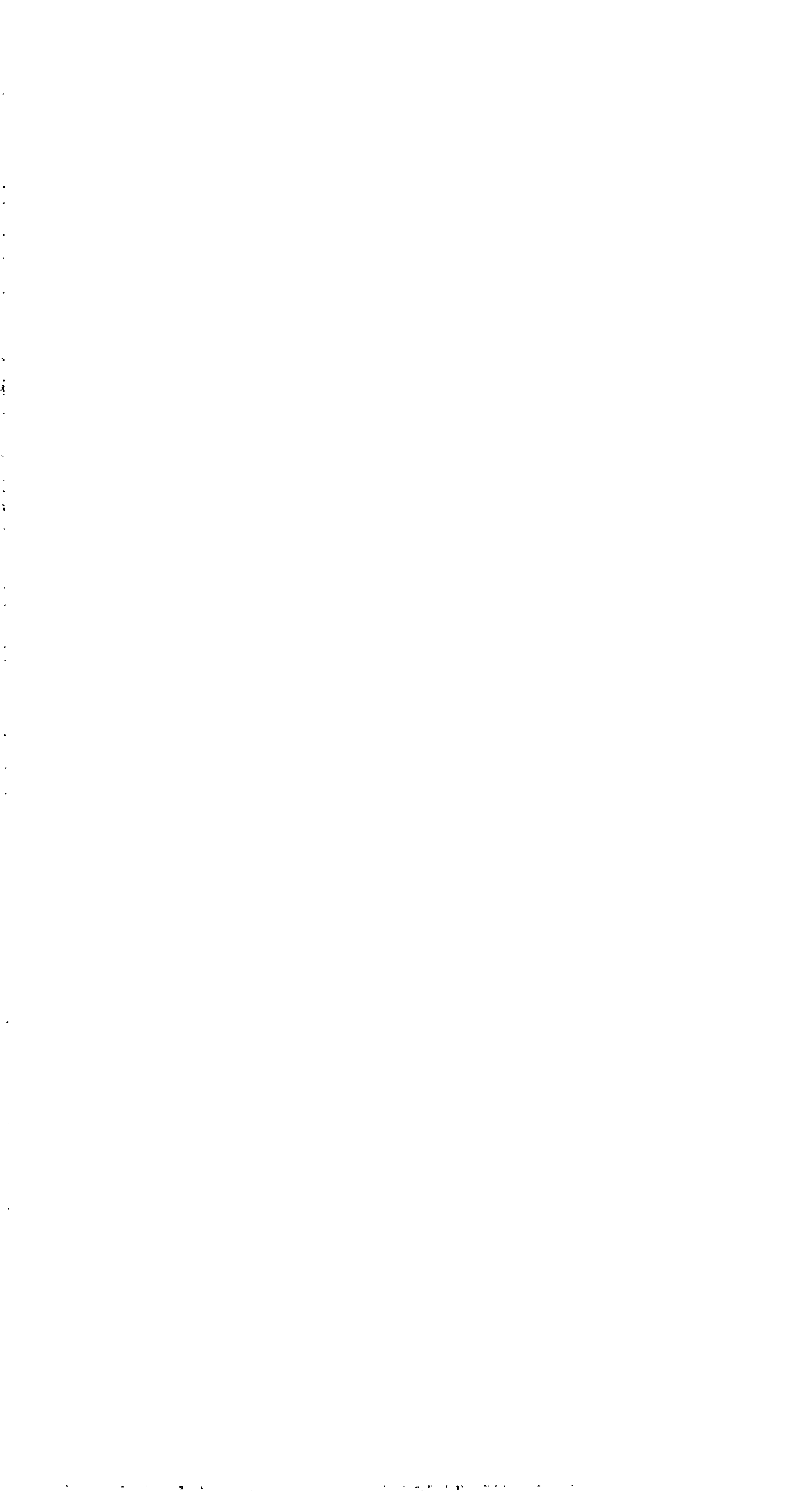


STATEMENT
on
PROPOSAL TO DENY SURTAX EXEMPTION
TO MULTIPLE CORPORATIONS
before the
SENATE FINANCE COMMITTEE
for
REPRESENTATIVES OF LP-GAS INDUSTRY
and
NATIONAL SMALL BUSINESS ASSOCIATION
by
ROBERT E. THOMAS

September 12, 1969

Summary

1. The surtax exemption was enacted 19 years ago to aid small businesses whether they operate in single or in multiple corporate form. The LP-Gas business is such a business because there is no such thing in the competitive scale in which we operate as a large LP-Gas company. The same principles apply to many other small businesses.

2. Affiliated multiple corporations were in existence long before enactment of the surtax exemption and continue to be formed for many non-tax reasons, such as the limitation of liability, operation of employee benefit plans at the local level, simplification of state taxation, etc.

3. Multi-plant companies in the LP-Gas and other industries are already paying under existing law an effective tax rate of 33% compared with 22% for competing local businesses, a tax penalty of .50%.

4. Far from resulting in tax equity, the House proposal would increase further the discriminatory and anti-competitive effects of the present tax structure.

5. Affiliated multiple corporations are not taking advantage of some unintended tax preference or "loophole" when they use multiple surtax exemptions; there are already three sections of the Internal Revenue Code giving the Commissioner of Internal Revenue power to prevent abuse of multiple surtax exemptions.

6. Denial of the surtax exemption to multiple corporations would deal a devastating blow to the cause of small business by affecting a reduction of up to 33% in the market price of small family-owned businesses.

33-758 O-69—No. 3——16

STATEMENT
on
PROPOSAL TO DENY SURTAX EXEMPTION
TO MULTIPLE CORPORATIONS
Before the
SENATE FINANCE COMMITTEE
for
REPRESENTATIVES OF LP-GAS INDUSTRY
and
NATIONAL SMALL BUSINESS ASSOCIATION
by
ROBERT E. THOMAS

September 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco, Inc., a producer, transporter and marketer of LP-Gas. I appear today on behalf of representatives of the LP-Gas Industry as well as the National Small Business Association in opposition to the proposal in the House-passed bill that the corporate surtax exemption be denied to multiple corporations under common control.

Throughout the recent months of tax reform activity, the surtax exemption, as it applies to multiple corporations, has been the subject of a great deal of misunderstanding. Many misconceptions have arisen concerning the reasons why businesses operate in multi-corporate form. Similarly, the proposal by the House to deny the exemption to multiple corporations has also been misunderstood. Analyses of the proposal have concentrated on its mechanics, with little attention being given to the effect it would have on the businesses to which it would apply.

My purpose today is to attempt to dispel what we feel are the primary misconceptions regarding the surtax exemption and the House proposal, and in doing so to indicate why we feel the exemption should not be denied to a corporation merely because it is a member of a multiple corporate group. I will show that contrary to prevailing misconceptions --

(1) the surtax exemption was enacted to aid small businesses whether they operated in single or in multiple corporate form;

(2) affiliated multiple corporations were in existence long before enactment of the surtax exemption and continue to be formed for many non-tax reasons;

(3) rather than resulting in tax equity, the House proposal would be discriminatory and anti-competitive in effect; and

(4) affiliated multiple corporations are not taking advantage of some unintended tax preference or "loophole" when they use multiple surtax exemptions; there are already provisions in the tax code enabling the Commissioner of Internal Revenue to prevent abuses by use of several surtax exemptions.

Perhaps the most common misconception regarding the surtax exemption, as it applies to affiliated corporations, is that it is an unintended tax preference or "loophole." Many proponents of the House proposal readily acknowledge that the exemption is not a "loophole." However, the implication still remains that affiliated corporations were never intended to benefit by the surtax exemption. This implication is patently untrue.

When the exemption was enacted in 1950, the House committee report (House Report No. 2319) accompanying H.R. 8920, which became the Revenue Act of 1950, expressly provided that the exemption would be available to all corporations. Certainly Congress was aware at that time of the existence of businesses operating through affiliated multiple corporations. Congressional intention in this regard is made even clearer by the fact that proposals similar to the one contained in the House bill have been considered and rejected by Congress on several occasions in the past 19 years.

The fact that the purpose of the surtax exemption has been greatly misunderstood is pointed up by the statement in the committee report accompanying the present House bill that the exemption was "adopted to benefit small corporations." This statement is simply not supported by the legislative history of the surtax exemption. In

explaining the purpose of the surtax exemption, the House committee report in 1950 stated as follows:

> The bill eliminates the notch rate by providing a flat $25,000 surtax exemption which would be available to all corporations. This will provide tax advantages to small businesses without introducing a system which is readily adaptable to a drastic graduation of rates.

The report says nothing about benefiting only small corporations. To the contrary, the excerpt quoted above says that the exemption was to be available to all corporations, and that it should serve to provide tax advantages to "small businesses" (without a complicated structure of tax rates). There is, we believe, a very significant difference between saying that the exemption was adopted to aid small corporations and in saying that it was adopted to aid small businesses. Although the surtax exemption is a benefit to small corporations, it is also a benefit to small businesses which for legitimate non-tax reasons operate in multiple corporate form. The LP-Gas business is such a business because from the standpoint of economic competition there is no such thing as a large LP-Gas company.

The rapid growth of the LP-Gas industry in the past 20 years is testimony to the fact that the surtax exemption has worked in the way intended by Congress. Today the LP-Gas marketing industry is carried on by an estimated

4,000 individual or family-owned outlets and about 10 multi-plant LP-Gas marketing companies. The multi-plant LP-Gas marketers operate through small local corporations, because of the nature of the LP-Gas marketing business. To enact a limitation on the surtax exemption such as now proposed by the House would impose severe tax burdens on businesses which have grown in reliance on the availability of the exemption. The severe hardships resulting from the loss of the surtax exemption would stifle further expansion and could even destroy much of the expansion that has occurred previously.

Another misconception about the surtax exemption is the contention that it is the principal reason for businesses operating through multiple corporations. This contention ignores the fact that affiliated multiple corporations existed as businesses long before the exemption and continue to be established for many non-tax reasons. A few of these reasons are as follows:

(1) Limitation of Liability. This has long been recognized as a legitimate reason for separate incorporation. In fact, in the LP-Gas industry, it is virtually a necessity for a company operating in more than one locality to separately incorporate each of its branches in order to limit its liability in event of a disaster. Otherwise,

insurance expense would probably be prohibitive even if obtainable.

(2) Incentive to Local Employees. Granting employees profit-sharing in local corporations encourages efficient local management.

(3) State Law. A business may be required to incorporate separately in each State in which it carries on its activities. In addition, some states prohibit chartering of a corporation for more than one business purpose.

(4) State Taxation. Many businesses which operate in more than one State separately incorporate in each State in order to make sure that the tax laws of each State will be applied only to the income of the company from operations within the State. Separate incorporation in each State also relieves the business from the administrative burden which would otherwise arise from the application of allocation formulas.

All of these are traditional and legitimate purposes for the creation of new and separate corporations, yet the House bill would strike at bona fide corporate entities in the same manner as it would treat cases of true tax avoidance.

Another misconception regarding the surtax exemption is the allegation that its availability to affiliated multiple corporations results in a tax inequity which discriminates against their competitors. In the vast majority of industries where some of the businesses are separately incorporated, there is no inequity in the present system. In fact, any discrimination which does exist is against the affiliated group rather than in its favor, and the House proposal would greatly increase this discrimination.

In the LP-Gas industry, for example, multi-plant marketers operate at the local level through separate corporations under common ownership. These affiliated corporations compete at the local level with unaffiliated LP-Gas plants -- individually or family-owned. Although not linked in any formal sense, these unaffiliated LP-Gas plants or corporations are in a real sense an "economic group" with which an affiliated multiple group must compete. Under present law the unaffiliated corporations pay a tax of only 22% on their first $25,000 of taxable income. On the other hand, the affiliated corporations, due to a 6% penalty tax enacted in 1964, pay a tax of 28% on their first $25,000. And on top of that, the parent of the affiliated multiple group pays a tax of 48% on 15% of the earnings transferred upstairs, thus raising the effective tax to 33%, a penalty of 50% over the individual or family-owned corporation.

Under the House proposal, this disparity would be increased so that after eight years, the unaffiliated corporations would (assuming no rate changes) be paying 22% while the affiliated corporations would be paying 48%. Thus, in each locality in which a multi-unit business operated, its primary competition would be paying taxes at less than half its own rate. The advantage to the unaffiliated corporation under the proposal is clear. Yet, the economic factors for both affiliated and unaffiliated corporations, at least in the LP-Gas industry, are substantially the same. Competitively, there is no such thing as a large retail LP-Gas company because the economics of distribution limit a marketing outlet to a small geographic area. In addition, affiliated corporations have no price advantage in the cost of purchased gas because of regulation by the Federal Trade Commission, or, in the level of operating expenses, due to local economic factors. Under these circumstances, the House proposal would imperil the very existence of multiple LP-Gas marketers. This would leave local LP-Gas operations solely to unaffiliated corporations, which in many areas of the country would mean that only one LP-Gas company would be serving the needs of the community. Such an absence of competition could only result in higher prices and a decrease in the quality of service to the community.

Finally, I would like to put to rest the misconception that the House proposal is necessary to end the practice of some businesses of using multiple separate corporations simply to take advantage of more than one surtax exemption. The Internal Revenue Code already contains three sections which were designed to deal with this problem. Sections 269, 482 and 1551 enable the Commissioner of Internal Revenue to end true cases of tax avoidance without harming the business practices of legitimate businesses. If these sections need to be supplemented, provisions with similar approaches should be enacted.

The House proposal takes just the opposite tack. It would end the surtax exemption for all affiliated multiple corporations, regardless of their legitimacy, the purposes for which they were established, or the effect of the denial of the exemptions on their operations. This arbitrary approach, which would remove all discretion from the Commissioner of Internal Revenue, should not, we feel, be adopted.

The most disastrous effect of the House proposal, which had no discussion or consideration by the House, is the impact on the market price of the stock or assets of small family-owned businesses. (In the LP-Gas business alone there are over 4,000 small family-owned businesses.)

Obviously if the sale of the business to a corporation or to an individual who owned a substantial interest in another corporation would eliminate the business' surtax exemption, the market price for the business would be reduced substantially. The attached exhibit entitled "Loss of Value of Typical Small LP-Gas Business" shows two examples of the reduction in value upon sale ranging from $78,000 to $97,500, with the percentage of reduction being 33%. Such reduction in the market value of the business would be especially harmful in circumstances such as sale by an owner wishing to retire or sale by the estate of the principal shareholder. For this reason, we would advocate that if the Congress should be finally persuaded to eliminate the surtax exemption for affiliated multiple corporations that it not do so in circumstances where a small business had been acquired and continued in operation. To be workable and equitable, provision would have to be made for some form of "grandfather" rights to present multiple corporate businesses built up by acquisition of small businesses and for permitting such minor changes upon acquisition as name, state of incorporation and capital structure.

Such a provision could be constructive and at the very least, would not be destructive of the present value of thousands of small family-owned businesses. At

the same time such a provision would deny the use of multiple surtax exemptions to large companies setting up new operating units to take advantage of the surtax exemption.

LOSS OF VALUE OF TYPICAL SMALL LP GAS BUSINESS
UPON SALE TO MAJOR LP GAS COMPANY
(Assuming elimination of multiple surtax exemptions)

	INDIVIDUAL OR FAMILY OWNED	MEMBER OF MULTIPLE CORPORATE GROUP	LOSS IN VALUE TO INDIVIDUAL OR FAMILY ON SALE
INCOME BEFORE TAX	$ 25,000	$ 25,000	
FEDERAL INCOME TAX	5,500 (22% Rate)	12,000 (48% Rate)	
INCOME AFTER TAX	$ 19,500	$ 13,000	
VALUE OF BUSINESS UPON SALE			
12 X earnings	$234,000	$156,000	$ 78,000 (33%)
15 X earnings	$292,500	$195,000	$ 97,500 (33%)

STATEMENT
on
TOTAL DISTRIBUTIONS FROM
QUALIFIED PROFIT SHARING PLANS
DEALT WITH IN SEC. 515 of H. R. 13270
before the
SENATE FINANCE COMMITTEE
for
MAPCO INC.
by
ROBERT E. THOMAS

September 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco Inc., a relatively new company but one which has been listed on the New York Stock Exchange since 1966.

Mr. Chairman, Mapco appreciates this opportunity to express the concern of its almost 1300 employees regarding the proposed change in tax treatment of lump sum distributions from a qualified profit sharing plan under Sec. 515 of H. R. 13270.

Summary of Position

1) Mapco is one of the relatively few larger American companies maintaining a profit sharing plan for its 1294 employees in addition to a pension plan.

2) Mapco's profit sharing plan makes lump sum distributions to employees upon retirement which are an important factor in employee planning for retirement.

3) Only 15 of Mapco's 1294 employees are officers in a higher tax bracket. The average base salary of the other 1279 employees is $6300 yearly. Present capital gains treatment for lump sum distributions would be accorded 85 Mapco employees in low tax brackets for each officer in high tax brackets.

4) The House Ways and Means Committee appears to believe that the benefits of capital gains tax treatment of lump sums paid from profit sharing plans are derived only by high salaried corporate executives and in addition fails to recognize that low salaried fellow employees of such executives receive proportionately large lump sums at retirement.

5) Other provisions of H. R. 13270 already propose eliminating the small benefit to a high bracket taxpayer of the maximum tax of 25% on capital gains.

6) If enacted Section 515 will diminish for Mapco employees and employees everywhere a tremendous incentive to provide for their own future. The cost of this so-called reform will be borne by tens of thousands of small taxpayers across the country and the Congress will be responsible for giving an added cost-push to wage levels and inflation in the years ahead.

7) On behalf of its almost 1300 employees Mapco appeals to the Senate Finance Committee to delete Section 515 from H. R. 13270.

Total Distributions From Qualified Profit Sharing Plans

Mapco is an oil, gas and gas liquids producer, operator of a 3400-mile LPG and anhydrous ammonia pipeline system serving the upper Middle West and a marketer of propane and liquid plant foods in 10 states.

Mapco employs about 1300 employees and is one of the relatively few larger American companies maintaining a profit sharing plan, in addition to a pension plan, for its employees. Retirement benefits from these plans have become important factors in the planning of each individual Mapco employee for his retirement.

While Mapco's pension plan provides for monthly payments after retirement, Mapco's profit sharing plan provides for a lump sum distribution to the employee upon retirement and it is this lump sum profit sharing distribution with which I am concerned today.

To get the matter in proper perspective, it is important to note that out of 1294 employees, only 15 are Mapco officers receiving more than $20,000 yearly and 1279 are employees receiving compensation of $20,000 yearly or less. The average base salary of this group of 1279 employees amounts to $6,300 yearly.

The Report of the House Ways and Means Committee on Section 515 of H. R. 13270 makes much of the supposed tax benefits currently derived by corporate executives with an average taxable income of $100,000 a year receiving a $500,000 lump sum distribution upon retirement. The Report fails to point out that if such an executive existed, fellow employees in the same company with much smaller taxable income would have similarly received at retirement sums equalling 5 times their average taxable income as well.

The Ways and Means Committee overlooks completely the fact that the present law extends the benefit of capital gains treatment of lump sum distribution from profit sharing plans to many, many people at modest income levels, reducing the rate of tax on the distribution by 50% from their normal tax bracket. Capital gains treatment would be accorded 85 Mapco employees in lower tax brackets for every company officer in higher tax brackets.

H. R. 13270 already proposes to eliminate for the high bracket taxpayer the maximum limit of 25% of capital gains and substitutes therefor a tax rate on capital gains of one-half the individual taxpayer's tax bracket. This by itself will produce additional revenue to the Treasury and if any inequity has been deemed to exist would appear to eliminate it.

Total Distributions From Qualified Profit Sharing Plans (Continued)

The Treasury Department's own figures set forth on page 152 of the Ways and Means Committee Report on H. R. 13270 shows that out of total long term capital gains in 1962 of approximately $380,000,000, less than 20% or $70,000,000 were realized by taxpayers with $100,000 or more of gross income and $136,000 or 35% of the total were realized by taxpayers with gross income of $50,000 a year or more. My point is this -- the realization of capital gains with its beneficial tax treatment is becoming more and more prevalent at lower income levels than ever before. Even the low bracket taxpayer of $10,000 a year or less realized about 20% of all capital gains in 1962.

The provisions of Section 515 will have the impact of diminishing for Mapco employees the tremendous incentive of providing for their own future security by being more efficient and loyal employees during their working life and all of this is to be accomplished in the name of reform designed to close a so-called loophole for a very few very high bracket taxpayers.

The cost of this reform will be substantial for the 99% of Mapco employees who are not high bracket taxpayers and who benefit substantially by the capital gains tax treatment of lump sum distributions from Mapco's profit sharing plan. When this is multiplied by the thousands of employees across the country at similar income levels, the Congress should realize that first, Congress is hurting in a major way many tens of thousands of small taxpayers in the name of reform directed at literally a handful of high bracket taxpayers and secondly, Congress is giving an added cost-push to wage levels and inflation in the years ahead.

In behalf of its 1294 employees, Mapco appeals to the Senate Finance Committee to delete Sec. 515 from H.R. 13270, thus retaining the present tax treatment for lump sum distributions from qualified profit sharing plans.

33-758 O-69—No. 3——17

STATEMENT
on
MINERAL PRODUCTION PAYMENTS
DEALT WITH IN SEC. 501(b) of H.R. 13270
before the
SENATE FINANCE COMMITTEE
for
MAPCO INC.
by
ROBERT E. THOMAS

September 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco Inc., a relatively new company but one which has been listed on the New York Stock Exchange since 1966.

Mr. Chairman, Mapco appreciates this opportunity to express its concern about the proposed tax treatment of one form of mineral production payments, namely, the carved out production payments provided for in Sec. 501(b) of H.R. 13270.

Summary of Position

1) Mapco's oil and gas production subsidiary has legitimately accumulated operating losses pursuant to provisions of the Internal Revenue Code.

2) Summarily taking away Mapco's ability to carve out a production payment for the purpose of covering accumulated losses is exceedingly unfair and a breach of good faith on the part of the United States Government because:

   a) Mapco's losses have been built up and carried forward under legitimate provisions of law; and

   b) Mapco has not chosen to subject itself and its roughly 50% partner -- the United States Government -- to the tremendous expense of annually carving out production payments to cover each year's operating loss.

3) Mapco therefore appeals to the Senate Finance Committee to appropriately amend Section 501(b) of H.R. 13270 to provide a suitable grace period during which companies such as Mapco might get their tax books in order.

4) Section 501(b) of H.R. 13270 is also directly contrary to a recent tax court case affirmed by the 6th Circuit U.S. Court of Appeals, known as the Hagen Advertising Case. This raises the question as to whether the manufacturer of advertising signs is to be treated one way for tax purposes and the oil business to be singled out for treatment in a directly opposite way on similar accounting and legal facts.

Carved Out Production Payments

Mapco is an oil, gas and gas liquids producer, operator of a 3400-mile LPG and anhydrous ammonia pipeline system serving the upper Middle West, and a marketer of propane and liquid plant foods in 10 states. Mapco's production operations are carried on by a subsidiary, Mapco Production Company, which was first organized in 1963.

For the past five years Mapco Production Company has accumulated operating losses pursuant to provisions of the loss carry-forward sections of the Internal Revenue Code based upon the belief and the practice under current law that a production payment could be carved out in late 1969 or early 1970 for the purpose of covering accumulated losses.

It appears to Mapco that summarily taking away of its ability to carve out a production payment for this purpose is exceedingly unfair and a breach of good faith on the part of the United States Government because Mapco's losses in its production company have been built up and carried forward under appropriate provisions of existing law. Because Mapco did not choose to subject itself and its roughly 50% partner -- the United States Government -- to the expense of carving out a production payment to cover each year's operating loss, it is about to be penalized for not so doing.

If carved out production payments are to be outlawed, it would seem only fair that they be outlawed with respect to future operations and not with respect to past losses accumulated under legitimate carry-forward provisions of the Internal Revenue Code.

Therefore Mapco appeals to the Senate Finance Committee at the very least to amend Section 501(b) of H. R. 13270 to give production companies with accumulated loss carry-forwards a grace period in which to get their tax books in order.

It should also be pointed out that Section 501(b) of H. R. 13270 is directly contrary to a recent Tax Court case affirmed by the 6th Circuit U. S. Court of Appeals, known as the Hagen Advertising Case, in which the Treasury Department initiated a claim against a taxpayer directly contrary to the tax treatment now being proposed to be adopted by the Ways and Means Committee for the petroleum industry. The legal and accounting circumstances of the Hagen Case are remarkably similar to carved out production payments used in the petroleum industry. Therefore I wish to raise with the Committee the question as to whether the manufacture of advertising signs is to be treated one way for tax purposes and the oil business treated in a directly opposite way on similar accounting and legal facts.

STATEMENT
on
PLANT FACILITY DEFINITION
CONTAINED IN SEC. 703 of H. R. 13270
before the
SENATE FINANCE COMMITTEE
for
MAPCO INC.
by
ROBERT E. THOMAS

September 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco Inc., a relatively new company but one which has been listed on the New York Stock Exchange since 1966.

Mr. Chairman, Mapco appreciates this opportunity to express its concern about the "plant facility definition" contained in Sec. 703 of H. R. 13270.

Summary of Position

1) Mapco is concerned about the language "located on a single site" contained in the proposed new Section 49 (b) (3) (B) (ii) of the Internal Revenue Code as set forth in Section 703 of H. R. 13270.

2) The House Ways and Means Committee's Report on H. R. 13270 enumerates specified examples of a plant facility meeting the single site rule at the bottom of page 187, one of which is "a railroad by-pass route."

3) Mapco is expending approximately $28,000,000 for expansion of its pipeline system, the construction of which commenced prior to April 19, 1969 and on which the investment credit will amount to about $2,000,000.

4) A narrow interpretation of the language "a single site" could only lead to unnecessary litigation not contemplated by Congress.

5) Mapco appeals to the Committee to include in its report upon this legislation language to the effect that "a pipeline route or right-of-way" meets the single site requirement as does "a railroad by-pass route."

Plant Facility Definition

Section 703 of H. R. 13270 amends the Internal Revenue Code by adding a new Section 49 dealing with Termination of Credit. It is Section 49 (b) (3) (B) (ii) defining a plant facility with which Mapco is concerned. Specifically we are concerned that sub-section (ii) states one of three requirements for meeting the plant facility definition to be "located on a single site."

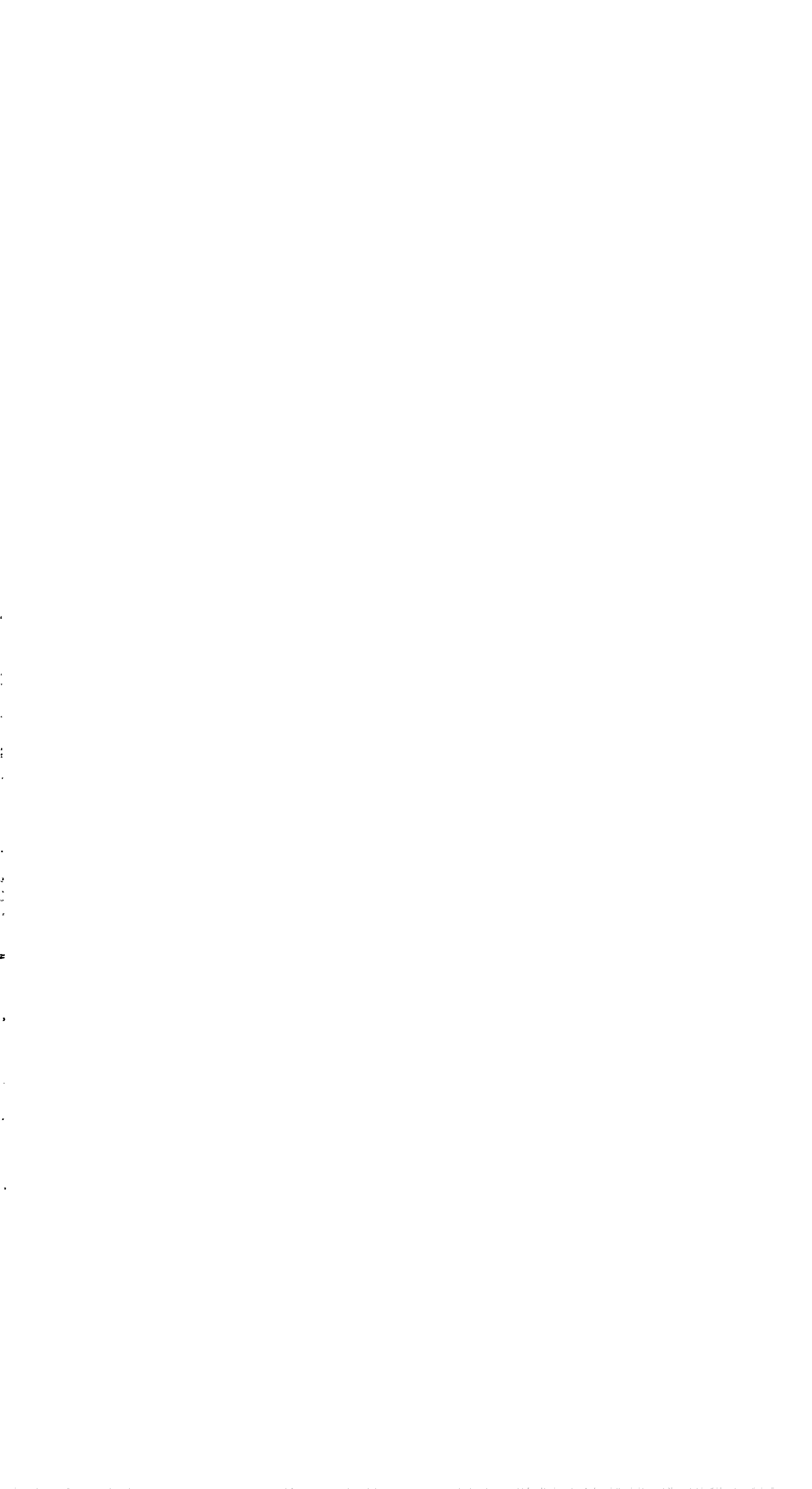
Plant Facility Definition (Continued)

Mapco among other business activities owns and operates a 3400-mile LPG and anhydrous ammonia pipeline system extending from southeastern New Mexico and West Texas to the upper Middle West. Prior to April 19, 1969 we had commenced construction of 600 miles of additional pipeline looping our present system.

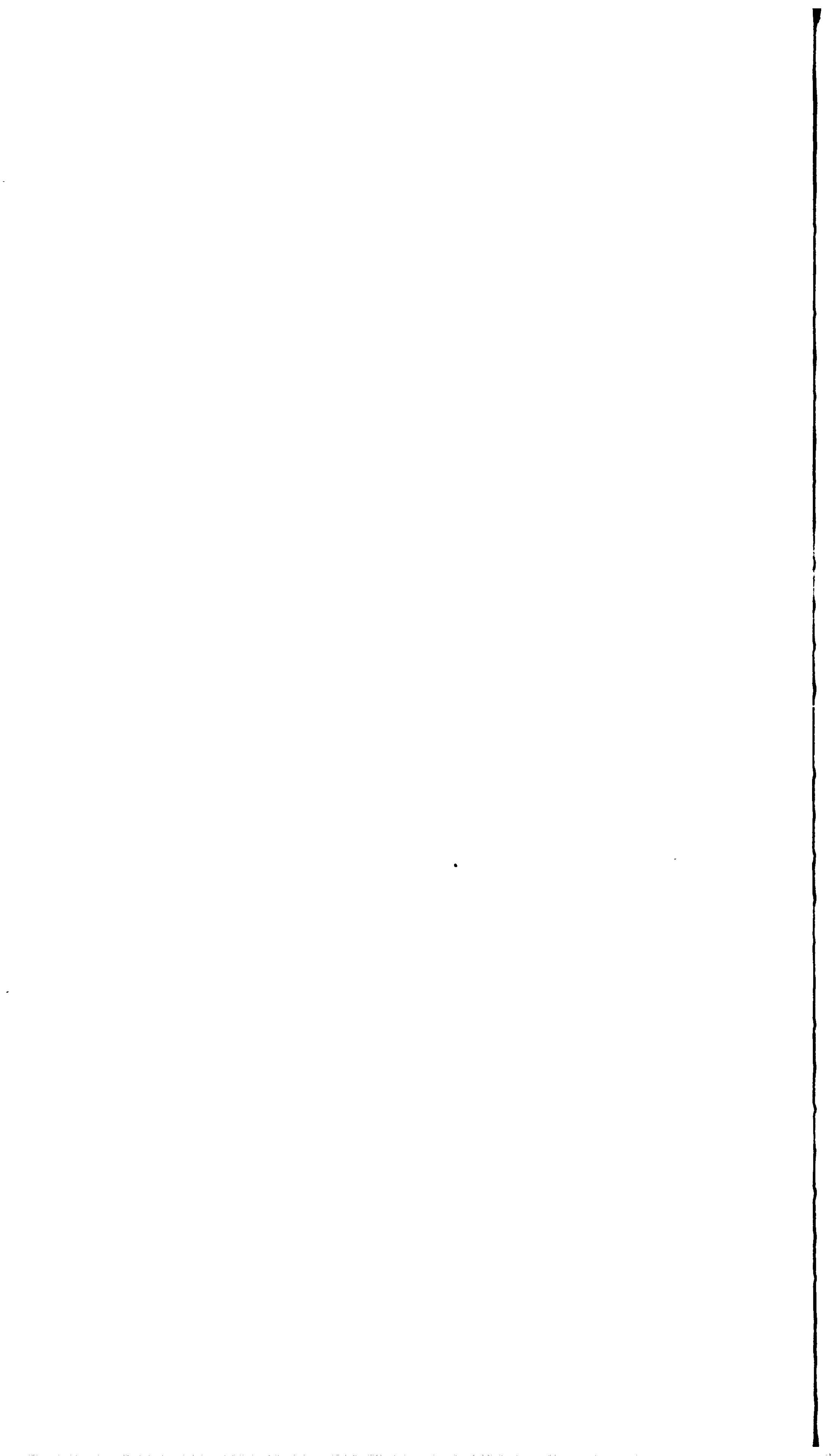
It is clear from other provisions of the bill that this pipeline expansion is entitled to an investment credit. My concern is the possible narrow interpretation of the phrase "a single site" because the single site of our pipeline expansion stretches out over a right-of-way 600 miles long and is made up of hundreds of easements from property owners owning the land in fee. Such a narrow interpretation could lead to unnecessary dispute and litigation which, while I am confident we would win, only points to the desirability of Congress making its intent clear right now.

The Report of the House Ways and Means Committee on H. R. 13270 enumerates certain examples of a plant facility under this rule in the bottom two lines of page 187. One of the examples set forth is "a railroad by-pass route." Such a railroad route would be directly comparable to the right-of-way of a pipeline system such as Mapco's but I would be a lot happier if the report of the Senate Finance Committee on this legislation could expand the list of examples to include the words "a pipeline route."

The Committee will perhaps understand my concern better when it is realized that Mapco is expending approximately $28,000,000 for this pipeline expansion, the construction of which was commenced prior to April 19, 1969. The investment credit of 7% on $28,000,000 is approximately $2,000,000 of hard cash which, incidentally, has been counted upon to help pay for the expansion. For this reason I would appeal to the Committee to include in its report upon this legislation language to the effect that "a pipeline route or right-of-way" meets the single site requirement in the plant facility definition.



PART B—ADDITIONAL STATEMENTS



SUMMARY OF STATEMENT

by

MICHAEL WARIS, JR.* and PETER L. BRIGER**

BEFORE THE SENATE FINANCE COMMITTEE

REGARDING PROPOSAL TO ELIMINATE

MULTIPLE SURTAX EXEMPTIONS

I. Finance Committee Previously Rejected Identical Proposal.

After very thorough study Congress in 1951 (spearheaded by the Senate Finance Committee) and 1964 rejected virtually the identical proposal presently being advanced by the Treasury to eliminate multiple surtax exemptions. Many taxpayers are required by the very nature of their businesses to operate through multiple corporations. Many businesses have been developed on reliance of the existing rules--particularly in view of past Congressional actions. The law presently contains sufficient measures to eliminate tax abuse and avoidance through multiple corporations. None of the basic facts has changed since Congress last considered the issue. Has Congress been wrong all these years? There is no real justification for changing the law now--and it would be inequitable to do so.

II. Other Code Provisions Being Disregarded.

The Treasury's basic premise in calling for the termination of the multiple surtax exemption (namely, that from an economic standpoint an affiliated group of corporations electing the exemption is a single business unit) is erroneous and misleading. It disregards and is in direct conflict with a number of key provisions of the Internal Revenue Code requiring that related or controlled business entities must be treated as though they were separate and wholly unrelated businesses dealing at arm's length. Moreover, net losses of one member of a group cannot be used to offset the profits of other members. Dividends (which may include intercompany loans) are subject to an effective tax

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* Baker & McKenzie, Washington, D. C.

** Baker & McKenzie, New York, New York

rate of 7.9 percent. The net effect of the Treasury's position is to deprive that class of taxpayers required by their business to use multiple corporations of the only significant tax benefit available to them, while leaving them saddled with numerous detriments due to their need to use separate corporations.

III. Consolidated Return Regulations Will be Rendered Unconstitutional

Elimination of the multiple surtax exemption could render the consolidated return provisions unconstitutional to that class of taxpayers required by the nature of their business to operate through a number of corporations. The reason is that such taxpayers will not be left with any real choice of whether or not to file consolidated returns. As was clearly recognized by the Senate in 1928, because of the legislative function delegated by Congress to the Treasury in this area, the existence of a meaningful election on the part of taxpayers as whether or not to become subject to the consolidated return provisions is essential to assure their constitutionality. The Treasury's regulations in this area depart substantially in a number of respects from the basic tax rules provided by Congress in the Internal Revenue Code and in several situations provide treatment for affiliated groups that is substantially more adverse than is the treatment under the Internal Revenue Code for unitary corporate taxpayers operating through branches or divisions.

IV. Equity Requires More Liberal Transitional Rules--Solution to Constitutional Problem Suggested

If the multiple surtax exemption is eliminated, a more liberal transitional phase-out period should be permitted to minimize the disruptive financial impact upon those taxpayers which relied upon Congress' prior action in this area. Reorganization expenses incurred by taxpayers in simplifying their corporate structures should be allowed as deductions during this period. The phase-out period should not be commenced until the question concerning the constitutionality of the consolidated return regulations is resolved. This could be accomplished promptly if Congress were to delegate to the Treasury the function of initially drafting the regulations but were to retain for itself the responsibility of actually promulgating the final provisions. It is submitted that a phase-out of the multiple surtax exemption proportionately over 20 years, 5 percent per year, would be an appropriate transitional period.

Statement Before

Senate Finance Committee

regarding

Proposed Elimination of Multiple

Corporate Surtax Exemptions

by Michael Waris, Jr. and Peter L. Briger of

Baker & McKenzie

I. Surtax Exemptions Have Repeatedly Gained Congressional Approval After Careful Study--The Same Treatment Is Presently Warranted

For almost two decades--indeed since the outset of the present system of subjecting corporations to a normal tax and a surtax, the tax statutes of the United States have respected the separate existence of each corporate entity formed and operated for good business reasons. Conversely, corporations formed merely to gain tax advantages have been denied such separate identity for surtax exemption purposes. Now, in the name of tax reform, the House of Representatives has endorsed a Treasury proposal which would jettison this fundamental precept.

More is at stake in this move than the immediate issue of corporate surtax exemptions. Involved here is the far-reaching process of ignoring for an immediate revenue objective a basic legal concept which provides a rational framework on which business affairs can be planned, organized and operated, i.e., the full integrity of the separate existence of each viable corporate entity.

The consequences of taking these extreme steps should be carefully weighed before they are adopted. Aside from the immediate inequities which are discussed below, the disadvantages to the tax structure as a whole should be taken into account. Each time an arbitrary tax rule ignoring legal and factual realities is adopted, experience has shown that other arbitrary rules inevitably follow in order to make the artificial creation function. The result is an ever more complex, unwieldy and unworkable Internal Revenue Code.

It is most important to keep in mind that on two prior occasions the Congress has considered this very same issue of eliminating multiple surtax exemptions--once in 1951 and again in 1964. Each time--after thorough study--and based on exactly the same facts and considerations as exist today-- Congress refused to accept the same across-the-board abandonment of the separate entity concept which the Treasury for the third time is urging upon it.

Also of great significance is the fact that in the past the Senate has played the leading role in preserving the integrity of the corporate entity--in 1951 reversing the action of the House. Thus, there is a striking revisitation of history in the present posture of this issue--with the Senate again being called upon to preserve a long-standing logical ar-

rangement. Accordingly, to put the matter into clear perspective it will be helpful to examine in more detail the reasons for the prior Congressional action to see whether Congress erred on those two prior occasions--or whether the error lies on the part of those who would effect a change at this time.

A. Congressional Action in 1951

In 1951, without any hearings on the issue, the House of Representatives passed a provision essentially similar to the one in the present House bill eliminating multiple surtax exemptions. The reasons given for the House action have a familiar ring, the report of the Ways and Means Committee stating that to give each member of a group of related corporations a separate surtax exemption "confers an unwarranted tax advantage on business carried out by means of a series of corporations, rather than a single corporation, and sets up an incentive for the artificial splitting up of corporations. This effect of the existing law is difficult to reconcile with the fact that the surtax exemption . . . [was] intended to confer tax advantages on small business."*

The 1951 report of the Ways and Means Committee goes on to sound an urgent note also having a very familiar

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* H. R. Rep. No. 586, 88th Cong., 1st Sess., 1951-2 C.B. 374.

ring currently (so much so that it is difficult to believe that almost twenty years have intervened):

> While these amendments to the surtax exemption . . . would be desirable in any event, they are particularly necessary at the present time. The substantial revenue loss under existing law is difficult to reconcile with the current budgetary stringency, and this revenue loss might be increased by the deliberate splitting up of corporations for the purpose of realizing the unusual tax advantages which present law permits in a period of high corporate tax rates.*

Extensive hearings were conducted by the Senate Finance Committee in 1951 and a large number of witnesses testified with regard to the House provision. As a result the House action was rejected. The reasoning of the Senate Finance Committee is clear and concise. It is as convincing and valid today as it was in 1951.

The Finance Committee's basic reason for rejecting the House proposal was that the amendment was so "broad in its attack that, if enacted, it could result in substantial injury to many businesses whose present corporate structure has not been motivated by tax avoidance."** After pointing out a number of reasons commonly dictating the use of separate and multiple incorporations as a means of doing business the

* Ibid.

** S. Rep. No. 781, 82d Cong., 1st Sess., 1951-2 C.B. 506, 507.

Committee stated:

> All of these are traditional and legitimate purposes for the creation of new and separate corporations, yet the House bill would strike these bona fide corporate entities in the same manner as it would treat cases of true tax avoidance. (Emphasis added.)

The Finance Committee also noted that, although opportunities for tax avoidance might exist through the use of multiple corporations, the predecessors of sections 482 and 269 afforded the Treasury adequate protection in cases where tax avoidance was the principal purpose of utilizing multiple corporations. The Committee concluded that any further study undertaken to develop methods of limiting avoidance in this area "should emphasize the importance of correcting the true cases of avoidance without working a hardship on legitimate business organizations."

In Conference, the House concurred in the action taken by the Senate and offered as an amendment the predecessor of section 1551 of the Code, which is designed to prevent the artificial split-up of existing businesses for the purpose of obtaining additional corporate surtax and excess profit exemptions. This provision was enacted into law as part of the Revenue Act of 1951 and has remained an effective barrier against the artificial creation of multiple surtax exemptions.

B. Congressional Action 1963 and 1964

Early in 1963 the Treasury Department again proposed the elimination of multiple surtax exemptions for precisely the same reasons as in 1951. In addition the Treasury submitted to the Congress voluminous materials describing in detail the tax savings inherent in the multiple corporate structure. Thus, the Congress was fully informed as to the applicable arguments and the extent of tax savings available to multiple corporate structures by reason of surtax exemptions.

However, as it had done in 1951, the Congress again refused to adopt the Treasury's proposals to eliminate multiple surtax exemptions. Again its reasoning was precise and forceful. The House Ways and Means Committee, now fully in accord with the 1951 thinking of the Senate Finance Committee, stated:

> While your committee recognizes the advantages of use of multiple corporations, your committee believes, as it has in the past, that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type of business in different geographical locales, there are legitimate business reasons for use of separate corporations and, therefore, the separate corporations should generally be recognized as separate taxpayers, retaining the benefit of use of multiple surtax exemptions.*

* H.R. Rep. No. 749, 88th Cong., 1st Sess., 1964-1 (Part 2) C.B. 242.

From the foregoing, it is apparent that in very recent years Congress has carefully studied and analyzed the desirability of permitting each member of an affiliated group of corporations to file a separate return and claim a separate surtax exemption. On the basis of its repeated and exhaustive consideration of the matter, Congress has twice determined not to eliminate the right to elect multiple surtax exemptions. It has concluded that the proper route to follow in order to avoid abuse of the exemption is carefully to police the area, utilizing the several statutory provisions already available.

The basic facts and conditions relating to utilization of multiple surtax exemptions and the filing of separate returns have not changed to any sigificant degree since 1964. The Treasury's own statistics do not show that there has been any material increase in the number of affiliated groups of companies electing to claim multiple surtax exemptions. Under all the circumstances, there would appear to be no bona fide reason for Congress to change the ground rules in this area.

One observation regarding the inequity involved in changing the law under such circumstances seems warranted. As was clearly recognized by both the Treasury and Congress,

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there are certain groups of taxpayers, particularly those in the retail apparel business, the restaurant and quick food service business, and the consumer finance or small loan business, who are forced by the very nature of their businesses to utilize multiple corporate forms of organization. While no taxpayer or group of taxpayers has a vested right in any of the provisions of the Internal Revenue Code, these groups or classes of taxpayers have relied, and it is submitted they acted reasonably in doing so, upon the above-described action of Congress in planning their corporate affairs and in arranging their structure for conducting business. It therefore is extremely inequitable for Congress at this time to reverse the position that it has taken in both 1951 and 1964, particularly since none of the underlying facts or considerations have changed in any material degree.

II. Treasury's Case Is Based on Erroneous Premise: Its Position That An Affiliated Group of Corporations Is a Single Business Enterprise Is in Direct Conflict With A Number of Code Provisions Treating Each Member of the Group As a Separate Entity

The basic premise underlying the Treasury's contention that the election of multiple surtax exemptions by an affiliated group of corporations is a tax loophole is that such group of corporations is, for tax purposes, conceptually nothing more than a single business entity*. While superficially this argument seems to be valid from an economic standpoint, it disregards and is in direct conflict with a number of key provisions of the Internal Revenue Code.

In recent years one of the provisions of the Code most actively administered by the Treasury Department has been section 482. The heart of that provision is the principle that all related or controlled business entities, in their inter-company dealings, must be treated or regarded for Federal income tax purposes as though they were separate and wholly-unrelated businesses dealing at arm's length.

* See footnote 7 at page 243 of the Tax Reform Studies and Proposals of the U.S. Treasury Department issued as a joint publication of the Committee on Ways and Means and the Senate Finance Committee dated February 5, 1969.

The net operating loss is another item which causes the Treasury to have double vision rather than the singleness of view it manifests where the multiple surtax exemption is involved. Thus, if one member of an affiliated group which elects the multiple surtax exemption incurs a net operating loss, such loss cannot be used to offset the profits of any other member of the group. Each company is required to stand on its own and is treated as a separate business.

Similarly, if one member of an affiliated group electing multiple surtax exemptions lends money to another member of the group,the Treasury is quite likely to maintain that the intercompany loan is a constructive dividend to the common parent of the group. Fifteen percent of the dividend deemed to have been received in such situations is subject to corporate taxation.*

* Indeed, the predecessor of section 243(a)(1) (which makes some portion of intercorporate dividends subject to full rates of tax) was enacted by Congress specifically to prevent the use of multiple corporations to avoid taxes. Thus, in 1935, Congress reduced to 85 percent the 100 percent intercorporate dividend received deduction, which was designed to eliminate double or multiple taxation of the same income at the corporate level. The deduction was reduced from 100 to 85 percent to prevent the possibility of evasion of taxes under then existing law (which instead of using a surtax exemption, taxed corporations on a graduated basis). It was believed that one possible means of evading the effective graduated tax rate was through the division of existing businesses among numerous subsidiaries or affiliates. H. Rept. No. 1681, 74th Cong., 1st Sess 1939-1 C.B. (Part 2) 643, 647; S. Rept. No. 1240, 74th Cong., 1st Sess. 1939-1 C.B. (Part 2) 651, 654. This is another clear example of the fact that existing law already contains specifically enacted deterrents to the splitting up of businesses among multiple entities and provides certain carefully considered adverse tax consequences in connection therewith.

As a result of the various adverse tax consequences which accrue to affiliated or controlled groups of corporations electing multiple surtax exemptions when they do not treat each other as if they were separate business entities dealing on an arm's length basis, the Treasury undoubtedly derives a substantial amount of revenue that it would not otherwise receive if the affiliated group could operate as a single corporation or filed a consolidated return. It would be significant to learn from the Treasury the total amount of income tax deficiencies arising in 1968 by reason of constructive dividends. The Treasury has estimated that approximately $235,000,000 of tax revenues was lost in 1968 as a result of the multiple surtax exemption. This statement is misleading. To be truly meaningful this figure should be reduced to reflect the tax collected on intercorporate dividends, the inability of one member of an affiliated group to utilize the net operating losses of other members, and the taxes currently paid on profits generated upon intercompany transactions. Quite possibly there may be no loss of tax revenues due to the use of multiple corporations, but, in fact, a net gain in tax collections.

The net effect of the Treasury's position is to deprive related corporations of one of the few significant tax benefits now available to them as separate entities while leaving them saddled with numerous tax detriments flowing from their separate incorporation. The Senate should reject this conceptually inequitable approach.

III. Effect of Elimination of Multiple Surtax Election Will Be to Force Taxpayers Requiring Multiple Corporate Structure as a Matter of Economic Necessity to File Consolidated Returns.

If Congress decides to eliminate the multiple surtax election, the direct and necessary consequence of such action will be to force the majority of those taxpayers whose businesses require them to operate in multiple corporate form to file consolidated returns under sections 1501 through 1504 and the underlying Treasury Regulations. In other words, such taxpayers will not be left with any realistic choice of whether or not to elect to file consolidated returns. The elimination of the multiple surtax exemption (and the other ancillary benefits resulting from separate corporate status) will necessarily and effectively determine their course of action. Probably in the majority of cases, the nature of their businesses prevents them from operating through branches or divisions of a single corporation. They are required to utilize a number of corporations through which to conduct their business activities. It seems unrealistic and unfair for the tax laws to provide that, as regards all of the adverse consequences (such as intercompany sales and the utilization of net operating losses), such entities must operate as separate taxpayers engaging in separate businesses, while as regards the surtax exemption to provide that such entities will be regarded as a single business enterprise. In essence

that class of taxpayers, required by the nature of their business to utilize a number of corporations, will have the worst of all possible worlds. Consequently, most taxpayers falling into this class will be compelled to file consolidated returns*

If Congress eliminates the multiple surtax exemption, a serious question will arise concerning the constitutionality of the consolidated return provisions as applied to taxpayers whose business requires them to operate in multiple corporate structure. This question was clearly recognized by the Senate in 1928 when it specifically reviewed the legislative history of the consolidated return provisions and authorized the Treasury to prescribe regulations, legislative in character, concerning the filing of consolidated returns.

Initially, when Congress in 1918 authorized provisions for consolidated returns, it did so by conferring upon the Treasury explicit authority to require that such returns be filed on a mandatory basis. Consolidated returns were regarded by the Treasury as a means of preventing the avoidance or distortion of income as a result of intercompany transactions between affiliated or related taxpayers.

The House, in 1928, after considering the desirability of consolidated returns, eliminated or struck the authorization conferred upon the Treasury in this respect. The Senate

* This result is clearly recognized by the House bill which includes a provision that losses sustained by a member of a controlled group of corporations prior to the filing of consolidated returns can, contrary to existing law, be taken as a deduction against the income of other members of the group in the same proportion as the additional surtax exemptions of the group. This particular provision is, in fact, an additional factor eliminating any effective or meaningful choice on the part of taxpayers with multiple groups as to whether to file a consolidated return.

Finance Committee, however, reinstated the consolidated return provisions. It noted that provisions for the filing of consolidated returns should be continued because the principle of taxing as a business unit what in reality is a business unit, is sound, equitable and convenient both to the taxpayer and the Government. However, it pointed out, that a number of difficult and complicated problems had arisen in the administration of these provisions and that it was impracticable to attempt by legislation to prescribe the various detailed and complex rules necessary. The Senate Finance Committee indicated that it:

> "...found it necessary to delegate power to the Commissioner to prescribe regulations legislative in character covering [the filing of consolidated returns]. The standard prescribed by the section keeps the delegation from being a delegation of pure legislative power, and is well within the rules established by the Supreme Court. (See Hampton, Jr. & Co. v. United States, decided by the Supreme Court on April 9, 1928, and the cases there cited.) Furthermore, the section requires that all the corporations joining in the filing of consolidated returns must consent to the regulations prescribed prior to the date on which the return is filed." S. Rept. No. 960, 70th Cong., 1st Sess., C.B. 1939-1 (Part 2) 409, 419.

This additional safeguard of requiring an election by the corporate members of an affiliated group constituted clear recognition by Congress that, in dealing with the problems of consolidated returns, the Treasury might find it necessary to adopt new concepts and approaches to cope with the myriad

problems involving intercompany dealings. Congress was most certainly aware that such concepts might not always coincide with the tax rules enacted by Congress governing unitary corporate taxpayers. It also was obviously aware of such decisions as St. Louis Independent Parking Co. v. Houston, 215 Fed. 553 (8th Cir., 1914) and McKenny v. Farnsworth, 121 Me. 450, 118 Atl. 237 (1922), which prohibit the delegation of legislative authority to promulgate regulations which are inconsistent with existing legislative enactments. It is not surprising then that when the Senate reviewed the feasibility of permitting the filing of consolidated returns under a statute whereunder the Treasury was delegated the task of issuing legislative regulations, the Senate found it necessary to give taxpayers a real and meaningful choice as to whether they would elect to file pursuant to such regulations. See S. Rept. No. 960, 70th Cong., 1st Sess., C.B. 1939-1 (Part 2) 409, 419.

Thus, another fundamental determination involved in the proposal to eliminate the multiple surtax exemption is whether the consolidated return regulations are to be made mandatory with respect to that group or class of taxpayers whose businesses are such that, for all practical purposes, they are required to operate through a number of corporations. In the consideration of this issue, it is important to keep

in mind that the Treasury has extremely broad discretion in the drafting and interpretation of regulations under the consolidated return provisions. The Treasury has recently exercised this discretion in 1965 and 1966 by almost completely revising the consolidated return regulations. In so doing, it has in a number of areas provided totally different rules for taxpayers electing to use the consolidated return provisions than those which Congress has enacted as part of the Internal Revenue Code. The so-called "excess-loss" provisions completely alter the Code rules concerning basis in assets and introduce the concept of "negative basis" which the courts upon numerous occasions have held did not exist under the Internal Revenue laws enacted by Congress. See: Crane v. Commissioner, 331 U.S. 1 (1947); Jack L. Easson, 33 T.C. 963 (1960) modified 294 F. 2d 653 (9th Cir., 1961). Moreover, section 704(d) of the Code reflects the studied position of Congress to reject the concept of "negative basis" in matters of Federal income taxation.

It should be further noted that the "excess-loss" provisions of the new consolidated return regulations under certain circumstances provide for materially different and adverse tax consequences for corporations filing consolidated returns than would occur in the same circumstances for a cor-

poration operating its business activities through various branches. For example, it is possible that under Treas. Reg. § 1.1502-19 a consolidated taxpaying group would, in effect, lose the utilization of an insolvent subsidiary member's net operating loss. Such a result would occur through the creation by use of the net operating loss of an excess loss account and the consequent taking of this excess loss account into income as per the regulation. In similiar circumstances, a corporation that was able to operate through various branches would be able to utilize the net operating loss of one of its branches.

The mandatory imposition of the consolidated return regulations is further objectionable in that these regulations impose upon that class of taxpayers which require multiple corporations as a necessary means of conducting business an extremely complex and burdensome set of provisions under which to operate. The present regulations have been described by a number of consolidated return authorities as inordinately obtuse and of uncertain meaning in a number of areas of application. See Cuddihy, Planning for Consolidated Returns Under The New Regulations, Prentice Hall Tax Ideas, No. 25,007.

In addition, the elimination of any practical alternative or choice to the utilization of consolidated returns would impose upon taxpayers whose businesses require

multiple corporations a variety of uncharted, and highly problematical relationships with minority shareholders. Accordingly, such taxpayers will be held to a higher standard of dealing with minority shareholders than would otherwise be encountered. See Western Pacific R.R. Corp. v. Western Pacific R.R. Corp., 197 F.2d 994 (9th Cir. 1952) reversed on other grounds, 345 U.S. 247 (1953); Johnson, Minority Stockholders in Affiliated and Related Corporations, 23 NYU Inst. on Fed. Tax. 321 (1965).

In addition to the uncertainties surrounding their application, the recently adopted consolidated return regulations appear to be contrary to statements of Congressional intent or understanding as to the manner in which the consolidated return provisions would operate. For example, the new treatment of intercompany transactions providing for a "suspense account or deferred gain" concept appears to be inconsistent with Congressional intention and long established administrative practice. See H. Rep. 704, 73d Cong., 2d Sess., pp. 16, 17 (1934) where the Ways and Means Committee noted:

> . . . there is no profit recognized for tax purposes on intercompany transactions, and profits on a product of the consolidated group, passing through the hands of the different members of the group, are not taxed until the product is disposed of by two persons outside the group.

See also H. Rep. 2333, 72d Cong., 2d Sess., p. 135 (1942).

The Treasury's adoption of this system of "suspense account or deferred gains" will create in connection with the administration of consolidated returns interminable examinations of intercompany dealings from a standpoint of section 482 and the Treasury's regulations thereunder. This is indeed anomalous since a basic reason which motivated the Congress to retain the consolidated return provisions was to obviate the necessity of detailed administrative policing of intercompany transactions. The Treasury over the years had maintained that the use of consolidated returns would simplify the administration of intercompany transactions.

IV. If Multiple Surtax Exemptions Are Nevertheless Repealed, More Equitable Transitional Rules Should Be Provided

If Congress concludes, despite the prior legislative history and the soundness of the considerations militating against so doing, to eliminate multiple surtax exemptions, it then appears incumbent upon Congress to take several corollary steps to minimize the disruptive financial impact of this fundamental change in the tax structure and to avoid forcing a significant class of taxpayers to file consolidated returns under legislative regulations promulgated by the Treasury (which would in any event be subject to substantial question from a constitutional standpoint). The first step would be to provide for a more gradual transition mechanism than is contained in the House bill or in the original Johnson administration proposal. In essence, it is suggested that the reduction in surtax benefits be made at five percent a year over a 20 year period rather than at the 12-1/2 percent per year reduction proposed in the House bill. The basis of this request for a more gradual transition lies in equitable considerations and the need for carefully studying the various ramifications, some of them known, such as providing a proper legal framework for the drafting and administration of the consolidated return regulations, and the fact that many of the ramifications for changing this rule will undoubtedly be unanticipated.

Moreover, this transition or phase-out period for multiple surtax exemptions should not commence until the basic constitutional problem regarding the consolidated return regulations, discussed above, is satisfactorily resolved.

One way for Congress to resolve the constitutional issue promptly would be to institute a new procedure whereby the problem of excessive delegation of legislative authority to the Treasury Department would be eliminated. This could be done by simply expanding the familiar phrase "Under regulations prescribed by the Secretary or his delegate" to read "Under regulations prescribed by the Secretary or his delegate and approved by the Joint Committee on Internal Revenue Taxation or its delegate." In other words, the initial drafting of the consolidated return regulations would be delegated to the Treasury Department, thus obtaining the full benefit of Treasury thinking and expertise in this complicated area. The retention of the review authority of these regulations by the Congress would insure that these important substantive regulations were fully responsive to Congressional intent. It is submitted that this procedure would not only cure the constitutional question under discussion but would have the salutary effect of minimizing controversies as to the legality of the numerous complex provisions contained in those regulations and should also tend to enhance the coordination of thinking between Congressional and Treasury tax people, a factor with which Chairman Mills and

Congressman Byrnes of the House Ways and Means Committee have recently stated needs further development. See the colliquy between Messrs. Mills and Byrnes and former Commissioner of Internal Revenue Sheldon S. Cohen at the Ways and Means Committee hearings on tax reform, March 28, 1969, Part 12, pp. 4215-4223.

Another step which should be taken if Congress determines to eliminate multiple surtax exemptions is that liberal transitional rules should be enacted to provide assistance and incentives to multiple corporate structures in the reorganization of their businesses (to the extent they are able to do so--and possibly they may do so to the detriment of their business operations) to achieve simpler corporate structures. The purpose in doing so would be to eliminate the necessity of satisfying the intricate and complex provisions of the Code governing intercompany transactions between related entities. One thing that could be provided for in this respect is to permit taxpayers to deduct during a transitional period the expenses incurred in simplifying and modifying their corporate structures as a result of Congress' action to eliminate

the multiple surtax exemption. Normally, the expenses incurred in connection with corporate reorganizations are treated for Federal income tax purposes as capital expenditures.

Much is heard today about the negative effects of certain existing tax rules upon taxpayer morale. Indeed, this is probably the single most important theme which has emerged during the current tax reform program. However, it appears that relatively little concern has been given to the morale of the taxpayers comprising the business sector of the community. The destructive effect on business morale of eliminating the tax benefits flowing from multiple surtax exemptions is a case in point. It takes years of effort and the risk of much capital to develop a going business. Obviously one of the factors taken into account in formulating and developing the structure of a business is the system of taxation to which it is subject. As above discussed, a number of businesses in this country which compete on a local level in small units have found it necessary to conduct their operations through separate corporate entities in each geographical location in which they function. These corporations have been organized, prices structured, profits planned, etc., taking into account the tax effects of multiple surtax exemptions. The loss of this tax benefit will have a significant economic effect on these businesses.

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Clearly no one has a vested interest in an unchanging tax statute. Changing times and varying national needs make it inevitable that our tax structure must correspondingly change. Nevertheless, there are times and circumstances when it is reasonable for taxpayers to rely upon the existing provisions of the Internal Revenue Code and the prior actions of Congress with respect to specific provisions of the Code. In some circumstances, it is proper for taxpayers reasonably to expect that these rules will not be changed in the relatively near future. The instant proposal to eliminate the multiple surtax exemption is a dramatic illustration of such a situation. To repeat, not only once before, but on two separate prior occasions--with a substantial number of years intervening between them--Congress reviewed the multiple surtax exemption and found it acceptable. In view of this history and in view of the fact that nothing new in the way of business considerations or national interests has arisen, if the affected taxpayers have no right to expect that the present Congress will act as had its predecessors on two occasions, it seems that at the very least they are entitled, as a matter of equity, that the change be made in such a manner as to permit them to alter their corporate structures with a minimum of financial strain. If more liberal transition mechanisms which we have suggested

are adopted, the loss from the repeal of the multiple surtax exemption will be nonetheless real to these taxpayers--it will just be more gradual.

A brief reference to the variety of transitional proposals which have heretofore been advanced is enlightening. Under the House bill, the amount of each additional surtax exemption (over one for the group) would be reduced at the rate of 12-1/2 percent a year. Thus, after eight years (really seven given the effective date of the proposal) each affiliated group of corporations would have only one surtax exemption. The Treasury Department's transitional rule as proposed in April 1969 was more strict. It would have immediately limited the maximum number of surtax exemptions available to an affiliated group of corporations to 100 and each year thereafter reduced the number fifty percent so that after five years the group would have only one surtax exemption. The Treasury Department under the Johnson administration had still another version of the transitional mechanism--its proposal being spread over an 8-year period--starting with a maximum of 500 surtax exemptions per group, reducing the number to 250 the second year, 100 the third year and thereafter by 50 percent until the eighth year when only one exemption would be available to the group.

This review of the various transitional rules already advanced indicates that there is no one perfect or logical formula. In the final analysis the purpose of such a phase-out mechanism is to do equity. It is submitted that under all the circumstances an even and gradual reduction--five percent a year for 20 years--would not be unduly considerate of those taxpayers who would be deprived of multiple surtax exemption benefits. (This, of course, assumes that the phase-out will not begin until the question concerning the constitutionality of the consolidated return provisions is resolved)

The return to Congress of the authority to issue the consolidated return regulations is also necessary to eliminate problems concerning the constitutionality of the consolidated return regulations. The enactment of a transitional rule permitting the deductibility of reorganization expenses incurred in providing a simpler corporate structure is also necessary to provide basic equity to taxpayers that wish to simplify their corporate structures to avoid the burdensome provisions imposed upon taxpayers with multiple corporate structures.

NATIONAL ASSOCIATION OF EVANGELICALS
Office of Public Affairs / 1405 G St. NW
Washington, D C 20005 / 202-628-7911

TAX REFORM TESTIMONY ON H.R. 13270

PRESENTED BY MR. FLOYD ROBERTSON, ASSISTANT GENERAL DIRECTOR, NATIONAL ASSOCIATION OF EVANGELICALS TO THE COMMITTEE ON FINANCE, U.S. SENATE DATE OF SEPTEMBER 5, 1969

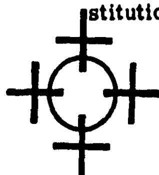
The following testimony is given on behalf of the 34,000 churches which compose our constituency.

I. UNRELATED BUSINESS INCOME TAX

The Association has adopted the position that income from any business not directly related to and a necessary part of the function of a tax exempt organization should be taxed on the same basis as any other business income. To do otherwise not only results in the loss of taxes which are due the government but creates unfair competition and other inequities between tax exempt organizations and the rest of the business world.

II. ADVERTISING INCOME

Our Association has not adopted an official position on whether advertising income should be characterized as unrelated business in the case of magazines and other periodicals published by exempt organizations. In the past the government has properly recognized the value of eleemosynary institutions and encouraged their support.



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COMMISSIONS: Chaplaincy, Evangelical Action, Evangelical Churchmen, Evangelical Home Missions, Evangelism and Spiritual Life, Higher Education, Radio and TV, Social Concern, Stewardship, Theology, Women's Fellowship, World Relief
AFFILIATES: Evangelical Foreign Missions Association, National Association of Christian Schools, National Religious Broadcasters, National Sunday School Association

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Churches have been included in this category. The publishing of magazines is usually a very important and essential part of the functioning of such institutions.

It is hoped that no changes will be made that will reflect any less interest on the part of the government in the existence and expansion of these fine charitable organizations. If it is found that the advertising income on the part of some has become a *de facto* unrelated business we would interpose no objection to having such income taxed. However, we strongly recommend that such advertising income as relates to the business of the organization continue to be tax exempt. It should be noted that most church publications are heavily subsidized and do not realize an overall profit from their advertising.

III. STANDARD DEDUCTION

It appears to us that an increase in the standard deduction from the present 10 percent of adjusted gross income would be in order. We also recommend that those using the standard deduction be allowed to claim as a deductible item contributions to churches and other charitable institutions.

IV. TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

1. THE 3% LIMITATION. The proposal to take charitable contributions out of the area of the standard deductions and treat them as a separate

deductible item with its own 3% minimum amount above which deductions would be allowable will have very serious implications. This can only be interpreted as a change in government policy and have the effect of discouraging the support of eleemosynary institutions. It would appear that this will eliminate at least 90% of the contributions to such organizations as a tax deductible item and is apt to have a detrimental effect on the voluntary support they receive. Inevitably this will require additional taxes for welfare purposes which may be far more than the additional revenue received as a result of the change. So it would appear that such a move would not only be detrimental to the public interest but economically unwise.

According to the Yearbook of American Churches the per capita giving of church members runs from less than $5.00 to about $265.00 per year. Currently published figures show that the medium income for an average family is around $9,000.00 per year. It is obvious from these figures that only a small fraction of contributions to the churches would be in excess of the 3% limitation. Even so, we do not believe that such a change would seriously affect the giving to churches. The tax deduction incentive for church giving is minimal particularly for those who give in excess of 3% of their income.

So our concern expressed above is for the charitable organizations other than the churches but more importantly it is disturbing to suppose

that the government would take any action to discourage the support of the outstanding work so many of them are doing. While the churches do not need nor do they incur the favors of the government we believe as a matter of equity and justice they should always be placed in the same category as other eleemosynary institutions as far as treatment given by the government.

2. APPRECIATION OF CONTRIBUTIONS ABOVE COSTS. A person may now buy an item for $5.00 and later contribute that item to the Red Cross with an appreciated value of $10.00. He pays no taxes on the increase in value but receives credit for a $10.00 contribution. Looking only at the personal benefit it would appear that he has received an undue tax advantage. On the other hand the objective of allowing the tax deduction is to encourage the support of such organizations as the Red Cross which has received the full value of the contribution claimed. For this reason we believe that this type of contribution should be allowed when it is made to long established organizations which do not invite abuse of the privilege.

- END -

STATEMENT OF THE NEW ENGLAND JOURNAL OF MEDICINE BEFORE THE SENATE FINANCE COMMITTEE IN SUPPORT OF SECTION 121(c) OF THE TAX REFORM BILL OF 1969 (H.R. 13270), WITH MODIFICATIONS

The New England Journal of Medicine, which is published by the Massachusetts Medical Society, is one of the world's leading medical journals. For many years the Society subsidized the Journal, spending hundreds of thousands of dollars as a contribution to the dissemination of scientific knowledge. Over 90% of the circulation of the Journal is to subscribers who are not members of the Society.

In recent years the Journal has been profitable, mainly because of the need of the drug industry for advertising media. The Tax Reform Bill of 1969, as passed by the House of Representatives, is designed to tax those profits.

The Journal carries advertising (although it carefully selects ads and imposes extremely high standards of acceptability) in order to make money. Because of the large advertising revenue the Journal as a whole makes a profit, which is eventually used for the charitable and educational purposes of the Society. This is not merely passive income from investments; it is active income derived from the entry of the Journal into the marketplace of commercial advertising.

In light of this, it is the position of the Journal that broad considerations of social policy indicate that the profits of the Journal from advertising should be subject to federal income tax. The need for equitable sharing of the tax burden requires that all who enter into an active enterprise for the purpose of making money should contribute to the support of the essential programs which the federal

government has begun to implement. While it can rightly be argued that private charitable and educational uses contribute equally to the welfare of our society, and indeed may provide flexibility and imagination necessary to development of our social resources, thus justifying the exemption from tax of the Society's income, on balance we believe that the exemption should be limited to passive income.

We disagree emphatically with one of the arguments of the proponents of this section, that of "unfair competition." Our tax exemption gives no competitive advantage over nonexempt publishers. For one thing, we are not in competition in any real sense, because an enterprise which as a whole exists for the purpose of making profits cannot be and is not trusted to maintain the disinterested objectivity necessary to the selection and publication of learned scientific work. Sooner or later the judgment will be clouded and concessions will be made to the expedient and the profitable. For another, the tax exemption has no effect on our pretax profits as compared to those of any other publisher; it is merely that our after-tax dollars, devoted to charitable purposes, are greater than the after-tax dollars, devoted to selfish purposes, of profit-oriented businesses. There is nothing "unfair" about this.

Nevertheless, by receiving a share of the available advertising dollars we may be diverting money which would otherwise be subject to tax, and thereby depleting the available federal revenues. Although we believe that we can and do make good use of these funds for valuable purposes, we also believe that to the extent we derive revenue from active participation in the marketplace, we should share these

revenues with the federal government and that the tax exemption should be eliminated.

We offer to the committee a substitute draft of section 121(c), which we believe is preferable as a matter of form since the present version is ambiguous and lacks precision. Our substitute also contains the following substantive changes:

1. The words "be deemed to include" are inserted to make it clear that ordinarily the term "trade or business" does not include an activity or element not capable of independent existence. The Society has engaged in extensive litigation with the Internal Revenue Service on this matter, and continues to resist the application of the regulations promulgated December 12, 1967. There are now two taxable years involved. If the Congress is to legislate on this subject, it seems to us unfair to leave those two years in dispute when the dispute will have no continuing importance.

Our opposition to the Internal Revenue Service has not been on grounds of tax policy. As stated above, we favor taxation of this income. We have done battle with the Internal Revenue Service and the Treasury, resisting their attempts to distort the meaning of the present statute by revoking their own long-standing construction of its meaning, because in this matter the executive branch has attempted to engage in legislation, rather than its proper function of interpretation. Only the Congress has power to change the law. The Senate, which in other areas is effectively resisting executive usurpation, should be equally vigilant here.

2. The requirement that a profit-motivated element be substantial, alone or in combination with other such elements, and the definition of

substantial as being more than 10% of gross receipts, are intended to establish a *de minimus* rule. This will be helpful to some of our small brothers who may carry classified ads of the "doctor wanted" and "doctor available" sort, the revenue from which is insignificant in terms of dollar amount, while the necessity of calculating the tax would impose heavy administrative burdens.

3. The exclusion of "a necessary subsidiary procedure" from the "trade or business" definition is essential to cure an ambiguity in the present version. Under the present version the sending of bills for subscriptions to an educational magazine which carries no advertising would, literally, constitute an "activity which is carried on for the production of income." Since it is not intended that the subscription revenue be subject to tax (and there are similar examples in other areas) the bill requires the clarification supplied in our proposed substitute.

4. The proposed substitute provides that the tax is not to exceed what the tax would be if the whole publication were a taxable entity. For example, the advertising revenues may exceed costs allocable to the advertising element by $200,000; while the costs allocable to the educational element (the scientific articles themselves) may exceed subscription revenue by $100,000. Thus the overall profit would be only $100,000, and this is what a fully taxable publication with similar figures would pay. Since there could be no advertising without the educational matter, the net costs of the educational element are an ordinary and necessary expense of producing advertising revenue.

The Report of the House Ways and Means Committee (General Explanation of section 121(c)) indicates that this "net" result was intended, but

the bill as drafted completely fails to provide for it.

5. The bill in its present form leaves a significant loophole. It would be possible for an exempt organization which now publishes a related magazine to sell the physical equipment outright to a commercial entity, and to grant the right to use the exempt organization's name, membership lists, etc., in return for a royalty. The royalty might be a large proportion of the net profits of the enterprise, but would constitute a business deduction to the commercial entity and yet would be nontaxable income to the exempt organization under section 512(b)(2) of the Code.

The second paragraph of section 121(c) contained in the substitute is designed to prevent tax avoidance by this method.

Annexed to this statement is a copy of the proposed substitute for section 121(c). Also annexed are two sentences which we suggest might be included in the committee report to explain the purposes of certain of the substantive provisions of the proposed substitute.

In summary, we believe that section 121(c) as passed by the House of Representatives is defective in form and to some extent in substance, and should not be enacted as it stands. However, we agree with the general purpose of the bill, and support enactment of our proposed substitute for section 121(c).

Portion of Committee Report on Sec. 121(c) of H.R. 13270 Proposed by Massachusetts Medical Society

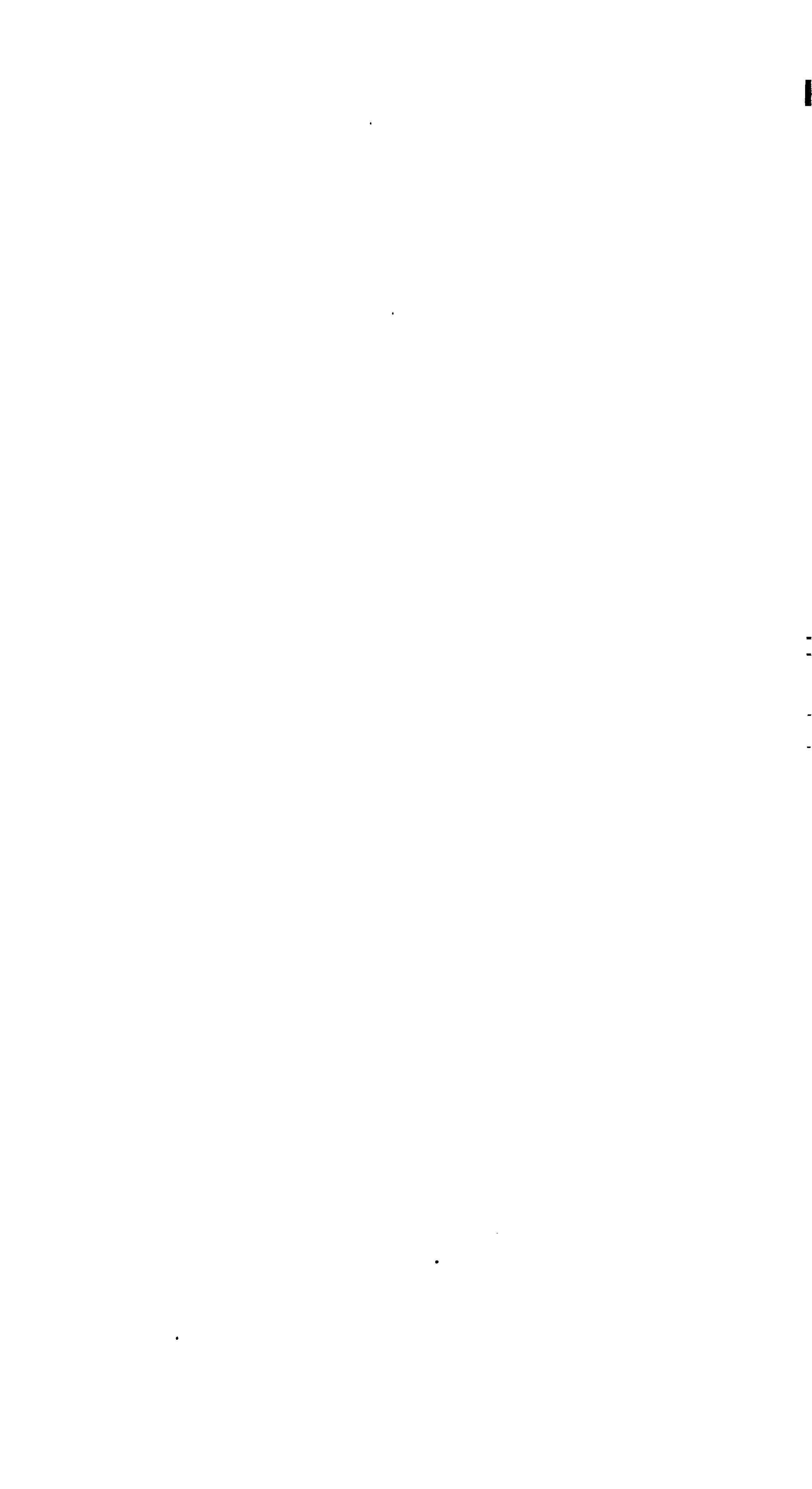
The requirement that the element be substantial will usually eliminate from the category of an unrelated trade or business such activities as the carrying of a few classified ads in trade or professional journals or the infrequent filling of prescriptions for outsiders by a hospital pharmacy. The requirement that the element not be merely a necessary subsidiary procedure in carrying on the trade or business as a whole will make it clear that an activity such as the sending of bills for services which are directly related to the exempt function, for example bills for normal hospital charges or for the subscription price of professional journals, does not constitute a separate trade or business.

Substitute Draft of Sec. 121(c) of H.R. 13270
Proposed by Massachusetts Medical Society

Bill Sec. 121(c)

(c) ACTIVITIES INCLUDED AS UNRELATED TRADE OR BUSINESS.--Section 513 (relating to unrelated trade or business) is amended by striking out subsection (c) and inserting in lieu thereof the following new subsection:

> (c) ADVERTISING, ETC., ACTIVITIES.--For purposes of this section, the term 'trade or business' shall, with respect to any taxable year beginning after December 31, 1969, be deemed to include any element of an integral trade or business if such element exists for the principal purpose of producing income from the sale of goods or the performance of services, provided such element is substantial in relation to the integral trade or business, and is not merely a necessary subsidiary procedure in the carrying on of the integral trade or business as a whole. For purposes of the preceding sentence an element shall be considered substantial if it (or in the case of an integral trade or business containing more than one element described in the preceding sentence, the combination of all such elements) produces more than 10% of the gross receipts of the integral trade or business. The combined unrelated business taxable income of all elements of an integral trade or business, which elements are trades or businesses solely by reason of this subsection, shall be deemed not to exceed what would be the unrelated business taxable income of such integral trade or business if such integral trade or business were an unrelated trade or business, giving effect to any net operating loss deductions.
>
> If an organization described in section 511(a)(2) receives royalties or other payments for the use of its name, membership lists, mailing lists or similar property, in a trade or business which if owned by it would be or would contain elements which would be, an unrelated trade or business, such royalties or other payments shall for purposes of section 512(b)(2) be treated as payments which are not royalties.



BERLIN, ROISMAN AND KESSLER
1910 N STREET, NORTHWEST
WASHINGTON, D. C. 20036

EDWARD BERLIN
ANTHONY Z. ROISMAN
GLADYS KESSLER

AREA CODE 202
PHONE 833-8794

ANALYSES OF FOUNDATION PROVISIONS OF TAX REFORM BILL OF 1969 (H.R. 13270)

By

Anthony Z. Roisman

It can no longer be doubted that there is a need for federal tax reforms. Preferential treatment such as allowing mineral depletion allowances unrelated to the costs of production and permitting some very wealthy taxpayers to completely avoid taxes must be abolished. Loop-holes allowing sophisticated tax lawyers to draw up business schemes using accelerated depreciation or combinations of interest deductions and other expenses to turn out-of-pocket losses into tax savings must be closed. Outmoded and archaic tax provisions dealing with tax exempt organizations and capital gains provisions which have no relation to present day problems and goals must be amended.

The proposed Tax Reform Bill of 1969 (H.R. 13270) attempts to meet some of these problems, ignores others and in some cases creates new and far worse problems than it was intended to solve. In at least one case, the reforms relative to tax exempt organizations, the bill displays a wanton disregard for the public interest, and for the tax exempt organizations and for any semblance of fair and equitable taxation. Instead the bill is an obvious vendetta motivated by a few isolated examples of gross abuses by tax exempt organizations but might just as well have been motivated by the belief that tax exempt organizations, particularly those engaged in charitable, educational and social welfare work and now exempt under Section 50(C)(3), are going too far and being too successful in obtaining their tax exempt objectives.

An adequate analysis of the more than 135 pages of the bill which deal with tax exempt organizations and charitable contributions is impossible in the few weeks in which the public has had an opportunity to view the bill. However, even a cursory analysis of the proposed provisions clearly indicates that this is one of the most complex and vindictive pieces of tax legislation ever proposed. Under existing law a taxpayer found guilty of civil tax fraud pays a penalty equal to 50% of the tax due. Under the proposed bill a private foundation which innocently makes a grant for an activity which IRS later determines is an

attempt to influence legislation must pay a tax equal to 100% of the amount of the grant. (New Section 4945) 1/ Such obvious discrimination against private foundations is wholly unjustified.

In the next few pages I shall indicate other areas in H.R. 13270 dealing with tax exempt organizations which are equally discriminatory. There are also many other provisions which are too vague to provide any proper statutory standard or are so worded as to create results which were obviously never intended and I shall also indicate some of these provisions.

My purpose is to establish beyond any reasonable doubt that the so-called reform provisions relating to tax exempt organizations are so ill-conceived and so poorly drafted that no amount of cutting, pasting or patching could possibly produce an intelligent legislative proposal; that in the face of a genuine desire on the part of most tax exempt (Section 501(C)(3)) organizations to have honest reform which will abolish the abuses of present law, including those abuses which unduly limit tax exempt activities, now is the time to undertake a really new look at tax exempt organizations; and finally that the Senate Finance Committee should remove the tax exempt provisions from H.R. 13270 and should immediately schedule separate hearings on that subject setting a specific time in the future when concrete proposals shall be submitted and when a study of these proposals shall begin.

The bludgeon of the reform provisions fall on the head of a newly defined entity -- the "private foundation". The underlying premise of this brutal attack is that any organization which does not rely upon year by year contributions from a large segment of the populace does not really deserve to be tax exempt. Reliance upon large contributions from a few public spirited individuals has frequently been the backbone of charitable and social welfare activity. Even our elected officials usually must rely upon a few heavy contributors or their own wealth for their campaigns.

The mere fact that a charitable organization is supported by a relatively few contributors is no basis to automatically subject the organization to the burdens of the proposed bill. We have a National Gallery of Art in Washington due in large measure to the philanthrophy of one family. Colleges, civic buildings,

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1/ Unless otherwise specified new section numbers refer to the section numbers which will exist if the tax reform legislation is passed. Other section references are to present provisions of the 1954 code.

public parks, student aid programs and thousands of other socially useful projects are the results of one-family or one-man philanthropy. It is merely lazy legislating which results in proposals like H.R. 13270 that punish the good with the bad. If abuses flow from some narrowly supported organizations then the legislature should have the ingenuity to draft legislation which will cure the disease, not kill the patient. As a result of the broad and irresponsible sweep of new section 509, defining private foundations, many legitimate and worthwhile activities will be curtailed or even worse eliminated.

New Section 506

The first limitation imposed on the "private foundation" is a 7-1/2% tax on net investment income. (New Section 506) I have no objection to fairly taxing the tax exempts to pay the cost of administration of the tax law, but why only "private foundations" and why at a 7-1/2% rate. A simple fee to be paid upon application for tax exempt status, by all tax exempt organizations, could be imposed, graduated according to the size of the organization. If additional funds are needed an additional fee, clearly limited to the costs of operation could be imposed annually. (See for instance the fee schedules for the salary and expenses of referees in bankruptcy 11 U.S.C. 68(c)(2)).

What is really disturbing about Section 506 is the method of computing the net investment income. First in subsection (b)(4)(A) the market value of investments as of December 31, 1969, is automatically set as the minimum fair market value. In today's depressed security market this virtually eliminates any possible net capital losses. Certainly ease of administrative computation cannot be the excuse for the artificial cutoff because in New Section 507, the foundation is required to trace back to 1913 to determine the aggregate tax benefit accuring to it and contributors to the organization -- a far more complex computation. A fair law would at least permit the foundation to use the donors basis (if it can be established) or the December 31, 1969 figure whichever is higher.

In subsection (b)(4)(B) the law creates one of many counter productive results. If capital gains are added to net investment income only where the assets are held for production of income, foundations will be encouraged to avoid the safe blue chip securities and bonds which have income and buy instead the non-dividend paying common stocks which produce only capital gain, which will not be taxed. This policy clearly conflicts with the policy in New Sections 4942(e) and 4944 which encourage to some extent holding assets which produce safe and steady rates of return.

New Section 507

New Section 507 is one of those provisions which is so ludicrous that merely reading it vividly displays its most blatant defects. The whole idea of tracing the aggregate tax benefit back to 1913 for taxpayers long since dead whose tax returns, if not destroyed, are private documents which can probably never be obtained, is absurd. Yet the section requires that the tax imposed be the lower of the aggregate tax benefit or the total net assets. Only IRS can be sure of having access to the foundations' contributors tax returns. How can the IRS determination be challenged by the foundation?

Another one of the counter-productive effects of the new law is the use of a tax measured by net assets. For that foundation which intentionally desires to terminate its private foundation status the tax can effectively be avoided by heavy expenditures financed by loans (to get net assets to zero) before taking the acts which culminate in the termination. For the foundation which inadvertently has its private foundation status terminated it may be caught with massive net assets. A law which encourages intentionally well-planned violations is hardly desirable.

In subsection (b)(1)(B) of New Section 507 is further evidence of unjustifiable discrimination. Aggregate tax benefit is measured by the tax benefits which the 501 (c)(3) private foundation has obtained since 1913. However, these tax benefits, i.e. tax exemption, are available and would have been available to every tax exempt organization even those permitted to lobby or engage in other activities prohibited to the 501(c)(3) organizations. Given the massive burden already imposed by New Section 507, an additional penalty requiring forfeiture of benefits which any tax exempt organization could obtain would appear to be another case of legislative over-kill.

Subsection (b)(2) is an example of the muddled language and sloppy drafting which pervades the bill. It is impossible to determine on the face of the statute whether a "substantial contributor" refers to human beings only or also to corporations and other non-personal entities. Reference to the "spouse" of the contributor implies a human donor. But in New Section 4946 (a)(1)(c), the phrase "substantial contributor" (defined by New Section 4946(a)(2) as being the definition in New Section 507(b)(2)) clearly refers to the corporation, partnership or unincorporated enterprise which is a substantial contributor to the foundation." Even if this obvious confusion were clarified New Section 507(b)(2) leaves much to be desired. It is unclear if the grants from other

foundations are to be used in determining under subparagraph (B) who contributed the greatest amount to the foundation. In addition, in the case of little "private foundations" receiving small contributions, a single donor of $100 may suddenly find himself thrust in the spotlight as the "substantial contributor" and therefore as a "disqualified person". (See New Section 4946(a)(1)(A)). This status immediately throws his entire financial holdings and activities under the scrutiny of the IRS by virtue of the self-dealing provisions in New Section 4941 which are triggered by the presence of a "disqualified person". A wholly innocent purchase of goods or services from this $100 donor or sale of goods to him will automatically result in a self-dealing tax regardless of the motives of the parties involved or the fairness of the transaction, and could produce a tax as high as 200% of the amount involved in the transaction, under New Section 4941(b)(1).

The real evil is not even the case in which any foundation is caught but the dilemna in which the small "private foundation" finds itself. Unable to grasp the intricacies of this legislative thicket, too poor to hire tax counsel, the small and private foundation will certainly go under. The result -- fewer small foundations, more big foundations, precisely the opposite result which tax reformers have been seeking. Unfortunately, this is not the only area in which pressure against the existence of small foundations is created in the proposed law.

New Section 507(c) is an excellent example of how to draft a statute to create the maximum confusion and litigation. One can hardly imagine a date less susceptible to precise identification than the date on which "action is taken by the private foundation which culminates in its ceasing to be a section 501 (c)(3) organization". Is the date to be when appropriate board resolutions are passed, when funds are collected, when funds are expended, when the first newspaper ad appears, when the first voter is registered, when the research leading to the prohibited activity is begun, or what? Subsection (d) has the same defect. Both subsections require determination of a precise date but neither has any sound basis for accurately determining that date.

New Section 507(e) is hardly a taxpayer benefit. What good does it do a private foundation to have the unpaid portion of an assessment abated 5 years after the assessment became due and payable? Is the section intended to reward the foundation which can avoid payment of the tax for 5 years? Does subparagraph (2) of subsection (e) suggest that an organization could be treated as meeting the requirements of New Section 170(b)(1)(B)for years before the enactment of the new section? Given the technical requirements of New Section 170(b)(1)(B) any organization which has met these requirements did so by the sheerest coincidence.

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A far more disturbing aspect of subsection (e) is that the Secretary is given the discretion to determine whether the unpaid assessment will be abated. Certainly in the case where a "private foundation" terminates its status by qualifying under New Section 170(b)(1)(B) (i.e. by becoming a publicly-supported foundation) there is no reason at all to allow the Secretary to exercise discretion in abatement of the assessment. The bill is based upon the belief that private foundations should be encouraged to become publicly supported. Even the risk of a tax equal to the total net assets of the foundation would deter the foundation. Yet, under New Section 508(e) if the foundation meets the requirements of New Section 507(e), is a good boy for 5 years, its status as a private foundation automatically "shall be terminated". If there is any doubt that the Secretary's discretionary refusal to abate the assessment is virtually irreversible, that doubt should be dispelled by the decision in Transport Manufacturing and Equipment Co. of Delaware v. Trainor, et al, 382 F.2d 793 (C.A.8th, 1967).

New Section 507(f) places another nail in the coffin of the small independent foundation. In subsection (1)(B) the charitable contribution is denied to any substantial contributor to a terminated private foundation starting in the year in which the first act which culminates in termination occurs. Maybe the big foundation can give their contributors adequate assurances. The little foundations will clearly founder, each contributor(in light of New Section 507(b)(2)(B)), rather than attempting to keep his contribution at least $.01 below that of the largest contributor will merely avoid the contribution.

New Section 508

The theory of subsection(b) which penalizes foundations for not making their existence known to IRS is sound. The execution is questionable. As written, subsection(b) could apply to organizations which are described in Section 501(c)(3), but which have not sought, nor have its contributors sought, any of the tax benefits of Section 501(c)(3) organizations. What justification is there for imposing a presumption on such organizations? Furthermore, the subsection is apparently aimed at requiring disclosures of the existence of organizations. If the foundation makes its existence known and does not, through inadvertence or ignorance, claim it is not a private foundation, why should the presumption apply against it? A fairly-drafted provision would have eliminated these defects.

The open-ended exemption granted by subsection(c)(3) is only as effective as one's faith in the IRS. Congress could and

should give a better set of guidelines. One possible standard would be to set a minimum standard based on total assets and yearly income and provide no coverage of these new provisions at all for organizations below the minimum. Adequate protection to prevent abuses caused by the fragmentation of large foundations can be easily built into the statute.

The harshness of the penalty imposed upon a private foundation, which terminates its status makes it all the more necessary that termination be found to occur only in the most serious cases, yet in subsection (e)(1), a single willful and flagrant act of self-dealing, of excess business holdings, of engaging in taxable expenditures, of investing in a manner which jeopardizes charitable purposes, or of a failure to distribute income, will result in imposing the full termination tax. These various actions are not equally bad and imposition of a single harsh penalty for all prohibited actions is unjustified. While willful and flagrant acts should not be condoned, nonetheless a single such act should not result in total destruction of the foundation (a result which a tax consisting of the total net assets of the foundation will produce). This is particularly true since the taxes imposed under New Chapter 42 are based on such imprecise standards that no organization will ever know whether it is conforming with the law or not.

The consequences of subsection (f) is that unless the foundation which has fought 5 long years to terminate its private foundation status to become a public foundation and which has had the good fortune to have the termination tax abated, remembers to notify the Secretary that it is not a private foundation then it will automatically be presumed (New Section 508(b)) to be a private foundation and its troubles will start all over again.

New Section 509

Much can be said and will be said during the hearings about the overly-broad definition of a private foundation. In addition, the section has some drafting problems. In subsection (a)(3), there is much confusion. Is an organization qualified which meets the requirements of subparagraph (A) or must it also, as does a subparagraph (B) organization have to meet the requirements of subparagraph (C). Subparagraph (A) is so broad that it may be interpreted to allow large public foundations to protect what would otherwise be private foundations by allowing the latter to operate for the benefit of it. If this is intended it will greatly lighten the burden of the reforms. This should be made far clearer in the legislation in order to avoid any confusion.

Subsection (b) imposes the status of "private foundation" on all existing organizations based upon their past conduct, even though the past conduct may have been perfectly legal and without any adverse tax consequence when engaged in. This seems to be unduly harsh, inasmuch as the private foundation status apparently cannot be terminated any sooner than 1974 since not until then will any organization meet the continuous operating standards of New Section 507(e).

New Section 4941

This is one of the most difficult sections to justify in terms of sound tax policy. Under existing law (Section 503(c)), self-dealing results in loss of tax exemption and is directed at activities which are not arms length dealings. The absolute prohibition on any dealing between foundations and disqualified persons is far more severe than similar provisions dealing with dealings between related parties such as husband and wife or related corporation.

. On subsection (a)(1), the tax imposed is not merely 5% of the amount involved because that 5% is imposed for each year during the taxable period -- the period from when the act of self-dealing occurred until it is corrected or a deficiency notice is mailed. Furthermore, the person liable for the tax is any disqualified person "who participates in the act of self-dealing". This is an extremely vague standard and is open to much conjecture and confusion.

Subsection (b)(1), imposes a 200% tax on the disqualified person if the act of self-dealing is not corrected within the correction period. Not even a willful refusal to correct is required as a condition of this tax being imposed. Under subsection (e)(3), the correction requires at requires at least placing the foundation in the position in which it would be if the disqualified person were dealing under the highest fiduciary standard. This minimum standard of correction is totally unworkable. In any given case it will be necessary to re-examine all relevant financial and economic data to determine what the highest fiduciary standards would require. With a 200% tax riding on the outcome, there can hardly be any room for error yet the standard is too vague to ensure any accuracy in the corrective actions taken.

In subsection (b)(2) a 50% tax is imposed on the foundation manager who refuses to agree to the correction regardless of whether the correction is legally required or not and leaves the foundation manager no independent judgment in the matter. Since the "foundation manager" includes directors and

trustees (New Section 4946(b) it is possible that he will be faced with the dilemma of either allowing the correction and violating his fiduciary obligation to the foundation or refusing the correction and paying the tax. Normally, at the time corrective action is to be taken no one will know whether the action meets the vague standards of New Section 4941(e)(3).

A frequent practice among foundations is to sell products or services to contributors who are then able to have something for their contribution. Conversely a foundation will frequently obtain a contribution by being allowed to make a bargain purchase. Surely a way can be found to deal with the abuses of self-dealing without automatically cutting off these commonly used fund raising devices as is done in subsection (d)(1). Even the exceptions in (d)(2)(B), (C) and (D) do not permit the freedom of action which is required or desirable.

In subsection (d)(2)(F) there is no provision for corporate adjustments required by law, such as bankruptcy reorganizations, in which the foundation did not receive fair market value. Surely any transaction approved by a court in an adversary proceeding should be protection enough to avoid undesirable self-dealing.

In subsection (e)(2) the "amount involved" for purposes of computing the tax in subsection (a)(1) is keyed to the highest fair market value of the properties involved in an act of self-dealing. Where the act involved is a bargain sale of goods by a disqualified person to a foundation (an act which itself seems free of any abuse) the disqualified is subjected to the penalty tax based upon a value which he did not even receive in the transaction. It would be fairer to measure the amount involved by the fair market value of the property received by the person who is being subjected to the tax.

More of the inequities created by the unworkable standard for correction in subsection (e)(3) appear in subsection (e)(2)(B) where the 200% penalty tax is based upon the highest fair market value, during the correction period, of the property involved in the transaction. This merely creates another arguing point and will surely create more litigation as the IRS and the taxpayer attempt to find the highest fair market value and to determine whether or not a correction has been made. Isn't a 200% tax penalty enough? Doesn't this additional burden merely further increase the incredibly difficult task of administration of this law?

New Section 4942

Taxes on undistributed income are not unique in Revenue Code. Sections 531-537 impose such a tax on accumulated business income. What is unique in Section 4942 is the imposition of the 15% tax and the further imposition of a special 100% penalty tax under subsection (b). Inasmuch as the 15% tax is due every year in which the amounts remain undistributed there is no good reason to treat a charitable or educational organization with more severity than a private for profit business.

Subsection (e) will have an indirect deterrent effect on investment policies of foundations which the bill should encourage. Many securities, such as government and municipal bonds, do not produce a 5% rate of return and are generally lower than the commercial rate of return. By in effect forcing the foundation to obtain an investment return at the commercial rate, subsection (e) is driving the foundation to the higher risk and less socially desirable investment. In addition subsection (e)(2) values the assets for purposes of the computing the rate of return on the basis of current market value rather than value at the time of acquisition. This really makes the rate of return required higher than 5% because by using current market values, it will be necessary to include unrealized capital gains. This means the return of 5% on a stock worth $100 will be inadequate when the stock's market value reaches $120. In a market of appreciating asset values a foundation might either have to actively trade and realize its capital accretions, or seek investments returning 10% or 12% on the purchase price to keep the return above 5% on the increasing but unrealized fair market values of its investments. One must wonder if the sound tax policy really requires the burdensome impact and administrative paperwork which subsection (e)(2) will entail.

On subsection (f) the foundation is limited in the deductions which it may claim. Taxes paid under New Sections other than New Section 506 are not allowed as deductions. Also the provisions of subsection (f)(1)(B)(i) raise some interesting problems. May the foundation, like a corporation subject to tax under Section 11, be permitted to deduct its lobbying expenses directly related to its incoming-producing activities under Section 162(e) of the 1954 Code? If the expense is allowable, as it clearly seems to be and should be if the foundation is to be fairly treated, will that

lobbying activity be prohibited activity under New Section 4945(b) (1)? There is also something which offends one's sense of fair play in subsection (f)(2)(B) which compels the foundation to include net short term gains but not to deduct new short term losses. Compare this with Section 1231 of the 1954 Code which allows where the average profit making businessman is allowed to treat certain gains as capital gains but if they are losses, they are ordinary losses. It hardly pays to be interested in educational and charitable pursuits. You can get better tax treatment as a profit making amoral businessman.

Subsection (g)(2) allows "set asides" in certain limited cases. However, a set aside to be treated as a qualifying distribution must first be approved by the Secretary or his delegate. Given the usual backlog in IRS administration, this requirement of an advance ruling and the concomitant lack of precise statutory standards may unduly interfere with the prompt commitment of funds for worthwhile projects. There is no adequate standard to guide the Secretary in setting the necessary terms and conditions for the use of set asides although the use of such multi-year projects is a common and important practice of most foundations and should be subjected to some more specific and easily followed standards.

No one would deny that the new tax reform measures are extremely complex. It may be many months or years before meaningful Treasury Regulations are promulgated. Note the 16 year delay in developing comprehensive regulations under Sections 511-513 relating to the unrelated business income tax. In the meantime many foundations will be reluctant to take action which will subject them to the severe penalties of the law. As a result many foundations will greatly curtail their giving, a result which in itself raises grave doubts as to the wisdom of the immediate effective date of this law. However, under subsection (h), this cautionary attitude might result in endless years of excess taxes. Subsection (h) clearly indicates that distributions made in subsequent years will be treated as paid out of the earlier year's undistributed income. A foundation which is now distributing all income and curtails giving for a year or two in order to get better guidelines for action will, unless it unloads massive grants in one year, never get out from under the results of its earlier caution, a caution dictated by a desire to act in conformity with the law. A period of grace, perhaps one year after final regulations are promulgated by IRS, should be given with respect to every section of the new

bill to avoid these disastrous cross pressures on the foundations. This is particularly necessary where the permissible course of action cannot be determined until the final Treasury Regulations have been published. See, for instance, New Sections 4942(b)(2), 4941(e)(4)(B), 508(c)(3).

The statute should clarify whether the election under subsection (h)(2) will give rise to refunds for prior years. It is also unclear what periods of statute of limitations apply to the various transactions and computation dates created by the new provision. These are relevant both for purposes of the right to seek refunds and for purposes of legally permissible time for assessment of taxes. It is hoped that the bill does not intend, in the absence of fraud (for which a six year statute of limitations applies) or failure to file a return (for which no statute of limitations applies), that the foundations will be subjected to more burdensome statute of limitations than the average business corporation or other taxpayer.

Subsection (i) fails to clearly indicate when and how it operates. Does subparagraph (1) require that in each of the five years there be an excess of distributions or only that the total distributed for the five years exceed the total required to be distributed. The latter interpretation would appear to be fairer and would allow a carryover of any excess not used in the sixth and subsequent taxable years to amounts not distributed in those years. The subsection does not indicate whether in making the compilation for the five year period it is permissible to consider years before the enactment of these new provisions.

The newly created entity -- operating foundation -- is inadequately defined in subsection (j)(3). What is the status of a foundation whose exempt purpose is to fund worthwhile educational activities which deal with consumer education? Is the direct active conduct of the foundation the giving of grants? In what manner must its assets be devoted directly to such activities? Even if the foundation engaged in research itself would its assets be directly devoted to the activities if they produced income for it or would the assets have to consist of books, libraries, desks, etc? Would the asset be directly devoted if it were used to fund an annuity program to attract high quality scholars to the educational organization?

Even greater problems exist under subsection (j)(3)(B)(ii). Under subsection (g)(1)(A)(ii), distributions to foundations which are not operating foundations are not qualified distributions. Thus, a foundation needs to know in advance if its recipient is or is not an operating foundation. Since five or more foundations must be distributing to a foundation for it to qualify under subsection (j)(3)(B)(ii), any potential operating foundation will be forced into a very difficult task of obtaining funding commitments from any single foundation. The belief that this task can be done presupposes a far more precise method of operation than foundations can or should obtain. Many foundations can only afford one or two funding meetings a year. If a potential grantee is not clearly qualified when the meeting occurs, it will likely be passed over, regardless of the merit of its project. These substantial problems of operation must be weighed against the questionable virtue (as discussed earlier) of requiring diversified support for foundations.

(more)

New Section 4943

Subsection (a)(2)(B) contains another of those unnecessarily harsh and difficult to administer provisions. What good reason is there for judging excess holdings on the basis of the highest holdings during the year. A new corporation which issues 1% of its stock to a foundation but does so for convenience only one day before the remaining 99% of the stock is issued will subject the foundation to the excess holding provision. In addition the IRS investigation is required to check every day of the year both as to foundation holdings and as to the total stock or other interests held in the business. The benefits, if any, to be gained by this provision certainly do not outweigh the considerable difficulties which it creates. An end of year determination of holdings would appear to be more than adequate.

I assume that the principal abuse which this section is intended to reach is the control of businesses by foundation. Other sections deal with the wisdom of the investment (New Section 4944) or the danger of self-dealing (New Section 4941). Why then is it not permissible under this section to own any percentage of non-voting stock or other securities (including bonds and other evidences of indebtedness). Clearly subsection (c)(2)(A) does not allow such holdings but the reasons for such exclusions remain a mystery.

Under subsection (d)(1) a foundation will have to examine the holdings of all disqualified persons and the holdings of all the entities in which such disqualified persons have holdings to be sure that no violations exist. This is so because the percentage of holdings allowed includes, in effect, the holdings of disqualified persons. (New Section 4943 (c)(2)(A)(ii). This kind of intricate tracing of stock ownership, which ownership can shift from day to day is a monstrous burden upon the foundation. A minor stockholder in a corporation which owns a very large percentage of stock of a corporation in which the foundation owns stock may be the inadvertent cause of a completely innocent violation of the statute. The situation is not dangerous and should not be covered by the proposed section, which is true elsewhere in the bill, sweeps broader than necessary.

Subsection (d)(4) creates a wholly new concept in the tax exempt law - "functionally related business." Inasmuch as Sections 511-513 of the 1954 code already contain a similar concept ("related business") it would be far wiser to use that definition or to modify that definition to also refer to "functionally related business."

New Section 4944

It is difficult to imagine a less precise standard for the imposition of such a massive tax (100%) than that provided in subsection (a). How any foundation can accurately judge whether its investments will "jeopardize" the carrying out of its exempt purposes is beyond comprehension. One immediate problem is whether actions taken with regard to investments which subject the foundation to new taxes, such as excess holdings, net investment income, etc., would be investments which jeopardize the carrying out of its function by reducing available funds. The need for such a provision at all is also puzzling. State law governs the conduct of foundations and a suit would lie by the attorney general on behalf of the public against a foundation's managers for improper conduct endangering its exempt purposes. It is anamolous that this section which is apparently intended to protect the exempt objectives of the foundation should do so by subjecting it to a massive tax which could in some cases completely destroy the foundation.

New Section 4945

While many may sympathize with the objectives of this section, although I am not one, it is difficult to imagine much legitimate support for the imposition of a 100% tax on any expenditure which no matter how innocently entered into turns out to be a prohibited expenditure. This is clearly carrying the concept of taxation as a penalty beyond the point of reasonableness. Even willful tax evasion does not result in such a penalty. The kinds of activities being condemned are, in some cases, those which most businessmen may engage in and obtain tax deductions (see, for instance, Sections 1.162-14 and 1.162-20 of the Treasury Regulations of the 1954 code) or at least those which private individuals only pay normal taxes, up to a 70% maximum, upon. For what reasons are the foundations placed in a less favorable position than the average taxpayer?

Under subsection (b)(4) grants to private foundations are prohibited unless there is expenditure responsibility. Those responsibilities are set out in subsection (f) and are so burdensome as to be totally useless. In particular the requirement in subsection (f)(2) that reports be verified seems incredible. It is obviously necessary to hire auditors and even private detectives to verify the report. The expenses incurred in providing this verification coupled with the substantial risks of a 100% tax will virtually abolish all small grants and will drive small private foundations out of the tax exempt area. This will produce the very over-emphasis on big foundations which the law was intended to cure.

Earlier I talked about the problem of foundations holding grants until clear guidelines are published thus increasing undistributed income and the tax thereon (see New Section 4942). Under subsection (e) of this section individual grants can only be made pursuant to a procedure approved in advance by the Secretary. With organizations across the country seeking approval of procedures immediately upon enactment of this bill there will be an inevitable delay in approval and thus through no fault of their own private foundations which emphasize individual grants will be subjected to an undistributed income tax.

New Section 4946

The most troublesome part of this section is subsection (b) defining foundation managers as officer, director, or trustee of a foundation. Many foundations have an honorary board of well known men and women who agree with the basic principles of the organization, but do not participate in day-to-day operations of the foundation or even set overall policy. These honorary board members may well be designated trustee or directors but will certainly not lend their names to any foundation where they may be treated as a foundation manager. Nonetheless they are valuable additions to the foundation, lending their prestige and stamp of approval to the foundation objectives but unable because of the press of other matters to devote significant time to the foundation activities. Their participation even on an honorary basis should not be discouraged.

Conclusion

There are, of course, many other provisions of the Tax Reform bill relating to foundations and charitable contributions which are equally objectionable, but which time does not permit me to explore at this time. Based upon the present analysis, it is clear that the presently proposed legislation is unacceptable. Even if the objectives sought to be obtained are accepted, the proposed law goes much too far and in a much too careless manner to be enacted as Federal tax legislation. There is much work to be done if truly imaginative and desirable reforms for foundations are to be forthcoming. No consideration was given to problems created by the availability of tax deductible lobbying activities on behalf of business interests (Section 162(e) of the 1954 Code) without some similar advantage for the pro-consumer, pro-conservationist, pro-public interest lobbying. No consideration was given to expanding the definition of a charitable organization to include all social welfare activities such as conservation and consumer interests. These and many other "liberalizing" reforms must be considered in conjunction with any new strictures on foundation activities. The 501(c)(3) tax exempt organizations for the most part serve an invaluable function in our society by providing non-partisan education, partisan representation of social values which would otherwise not be represented because they are not always important to and are even sometimes opposed by the business community and its economic interests, and the doing of good works. Any diminution of these

socially desirable activities should be carefully studied before any action is taken. The foundation provisions of H.R.13270 have not had and will not have adequate consideration in the present political climate which appears to demand immediate tax reform legislation on areas other than the foundations. It would be a grave mistake to let this pressure for other tax reforms result in hasty and regrettable legislation respecting foundations.