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H.R. 13270

PART A—TESTIMONY TO BE RECEIVED TUESDAY, SEPTEMBER 16, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: Capital Gains; Restricted Stock; Lump-Sum Distributions Under Pension and Profit-Sharing Plans)

COMMITTEE ON FINANCE

UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

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STATEMENT OF ROBERT W. HAACK, PRESIDENT, NEW YORK STOCK EXCHANGE ON H.R. 13270, BEFORE THE SENATE FINANCE COMMITTEE SEPTEMBER 16, 1969

Summary

My name is Robert W. Haack. I am President of the New York Stock Exchange. With me today are Bernard J. Lasker, Chairman of the Board of Governors of the Exchange, and Donald L. Calvin, a Vice President of the Exchange.

My statement this morning is the summary of a comprehensive 18-page statement analyzing the impact of the capital gains tax provisions of the tax reform bill now before this Committee. Copies of the full statement, including my summary, have been submitted to the Committee.

In the ten minutes allotted to me this morning, I will summarize the principal points and conclusions of that statement.

* * * *

As passed by the House of Representatives, the specific capital gains tax provisions of the tax reform bill constitute a sharp increase in the capital gains tax. The Exchange believes that three major adverse results may be anticipated if these provisions are enacted in their present form:

First, risk-taking incentives and the supply of essential venture capital would be seriously curtailed.

Second, investments in modern plant and equipment and in new technologies would diminish.

And third, the mobility of capital assets -- which is crucial to maintaining a dynamic and fluid economy -- would be impeded.

To my knowledge, there is no controversy about the need for maintaining an adequate level of investment to promote long-run economic prosperity. Recognition of this need is implicit in a recent statement by Secretary David M. Kennedy, who pointed out that the bill passed by the House is (quote) "weighted in favor of consumption, to the potential detriment of the nation's productive investment." Secretary Kennedy concluded that the present version (and again I quote) "could impede economic growth in the years ahead by curtailing the incentive to make productive investments." (End of quote).

The Exchange's own analysis of the probable economic impact of the proposals under consideration suggests that their hasty enactment could cause irreparable harm to the nation's long-term capacity for growth.

Let us look briefly at each of the major proposed revisions in capital gains treatment:

The Holding Period

I don't think anyone would quarrel with the proposition that smooth functioning of capital markets is largely dependent upon liquidity -- that is, the ease with which investors can move in and out of investments.

The holding period required to distinguish between an investment transaction -- which qualifies for capital gains tax treatment -- and a non-investment transaction -- which does not -- automatically decreases the liquidity of the national investment pool.

In determining the most suitable length of the holding period, there is necessarily a trade-off between the opposing goals of making the necessary distinction between types of transactions and of stimulating market liquidity. To achieve one goal completely would be to sacrifice the other.

All available data indicate that the existing six-month holding period is more than ample to filter out the majority of non-investment transactions.

The proposal to extend the holding period to 12 months simplistically assumes that most investors will refrain from altering their investment behavior and that the net result will be a revenue gain. I submit that it is far more realistic to assume that investors will tend to follow their individual self-interest; that they will lock themselves into existing investments for the longer period in order to qualify for capital gains treatment. In that case, the net result could well be a revenue loss.

The logical tendency of an investor with a sizeable gain would be to speculate against the holding period if there were any reasonable chance of preserving enough of the gain to make waiting worthwhile. To the extent that this incentive would be operative, it would tend to lock large amounts of capital into current investment positions -- with an inevitable, and significant, loss in both capital mobility and market liquidity.

The House Ways and Means Committee Report suggests that upper-income taxpayers are the principal beneficiaries of the shorter holding period. But an examination of the available data refutes this. The most recent Treasury Department statistics show that only 4 percent of all long-term gains realized by taxpayers with incomes of $100,000 or more were from assets held between six and 12 months. By contrast, the ratios were 10 percent for those with incomes under $10,000 and 9 percent for those in the $10-50,000 bracket.

Stated somewhat differently, the top-income group accounted for only

17 percent of all gains realized between six and 12 months after purchase, while taxpayers with incomes under $10,000 accounted for 16 percent of all gains realized during the six-to-12 month period -- and those in the $10-50,000 bracket accounted for 50 percent.

Thus, it is clear that the major portion of the additional tax burden that would be imposed by lengthening the holding period would fall not on the wealthiest taxpayers -- but on those who can least afford to bear it.

The Alternative Rate

The most direct impact on the flow of risk capital would result from the proposed elimination of the alternative tax rate.

This is, pure and simple, an increase in the tax rate on long-term capital gains. And as such, it would lower the incentive for investors to put money at risk -- by reducing the after-tax rewards. Moreover, it would discourage the transfer of capital from matured investments to more venturesome opportunities by raising the tax cost of such transfers. Ultimately, the cost of capital would rise as entrepreneurs would be forced to compete for a portion of the smaller pool of available risk capital.

Relatively few individuals qualify for use of the alternative rate. However, it is this group that is the prime source of venture capital. These investors provide the cutting edge of economic growth. In effect, eliminating the alternative tax would penalize the group from which the largest proportionate share of the national investment pool is expected to be accumulated.

Common sense dictates that the lower the after-tax value of an existing investment, the more likely the investor is to hold onto it. This is, of course, another aspect of the "lock-in" phenomenon. The proposal to eliminate the alternative tax optimistically -- we might even say, naively -- minimizes the probable lock-in reaction of those who would be affected. The available data tabulated in the text of our statement clearly demonstrate that the higher the income, the greater the tendency to wait before realizing accrued capital gains. Elimination of the alternative tax would strongly accentuate this tendency.

Treatment of Capital Losses

Investment risk would also be affected marginally by the proposal to restrict the long-term capital loss deduction from ordinary income to 50 percent of the loss. It is no secret that investors weigh prospective gains or losses in terms of total dollars, and make their investment decisions accordingly.

The capital loss proposal assumes that many taxpayers can manage their investments so as to realize gains and losses in different years.

Not only is this assumption not valid, but the proposed change would most seriously affect lower-income taxpayers who are least able to time realizations to achieve a tax advantage, and who have the least prospect of offsetting accumulated losses against future gains.

In effect, a majority of taxpayers who may sustain investment losses -- which, in the lower and middle-income brackets can often amount to a sizeable portion of annual income -- would be subject to further penalties. The rationale for this seems to be that it is justifiable in the interests of restricting a relatively small number of higher-bracket individuals who, however, would still be in a position to use the loss provision to best advantage.

Contrary to the avowed intent of this measure's proponents, the disparity in loss treatment would continue to exist between taxpayers who can manage their investments so as to realize gains and losses in different years -- and the great majority who can not.

Conclusions

The bill under consideration contains several additional proposals which would tend to dampen investment incentives. Two of these are discussed briefly in the full statement we have submitted to the Committee. We plan to submit a more detailed analysis of these provisions for the record at a future date.

The proposals to lengthen the holding period, to eliminate the alternative tax, and to restrict capital loss deductions would -- if enacted -- have a serious adverse effect on investment incentives, capital mobility and stock market liquidity.

We agree with the Secretary of the Treasury that they carry the potential for impeding economic growth in the years ahead, and we respectfully urge this Committee to reject all three provisions.

For the future, we would urge that any new proposals to revise the existing capital gains tax structure be preceded -- or at the very least accompanied -- by a detailed study of all aspects of capital gains taxation. We would hope that such a study would provide more definitive data -- both on the effectiveness of the existing structure and on the probable impact of any proposed changes -- than were available to the House Ways and Means Committee when the present bill was drafted.

ANALYSIS OF ECONOMIC ASPECTS OF THE CAPITAL GAINS TAX PROVISIONS OF H.R. 13270

Any examination of the specific capital gains tax provisions of the tax reform bill must consider the broad economic consequences which may flow from enactment of the bill in its present form. As passed by the House, these provisions constitute an effective increase in the capital gains tax. The Exchange believes that three major adverse results may be anticipated if these provisions are enacted in their present form:

(1) Risk-taking incentives and the supply of essential venture funds would be seriously curtailed.

(2) Investments in modern plant and equipment and new technologies would diminish.

(3) The mobility of capital assets, which is crucial in maintaining a dynamic and fluid economy, would be impeded.

These effects, as discussed in greater detail below, would retard long-term economic growth and enterprise and would, ultimately, limit the rise in our nation's real standard of living. The New York Stock Exchange shares the view that policies which may inhibit the incentive to invest, to innovate, and to take risks should not be enacted in haste and without careful study. The mobility of capital assets is vital to the entire concept of private enterprise. Beyond these broader economic considerations, we believe that the House proposals on capital gains will fail in their avowed purpose of redistributing tax burdens in a more equitable fashion. Therefore, the current proposals should be made to bear a heavy burden of proof before they are accepted by the Congress.

Capital Gains and Risk

Congress has long acknowledged that there are distinct differences between ordinary income and gains realized on true capital assets, in that it is to the national economic advantage to encourage people to invest in productive enterprises. Accordingly, capital gains should be -- and, since 1921, have been -- subjected to a lower tax rate than ordinary income. Long-term investments play a crucial role in promoting economic growth. The House appears to have ignored the fact that the expectation of capital gains induces not only saving, but investing, and an optimum allocation of resources -- all of which are indispensable to a rising per capita income.

Capital must be encouraged to flow into new ventures if society is to benefit from new technological trends and discoveries. And the individual's willingness to assume unusual capital risks depends to a considerable extent upon the prospect he sees for suitable returns. Obviously, then, higher taxes on the gains from high-risk situations would discourage investors from assuming such risks. Accordingly, if the tax provisions

dealing with capital gains are altered to provide less favorable treatment, a reduced flow of equity capital to newer, more risky, business ventures and a diminution of aggregate investment will result.

Impact on the Level of Investment

There is no controversy about the need for an adequate level of investment to promote long-run economic prosperity. Government has available various fiscal and monetary tools by which it can attempt to influence aggregate investment. Since the acquisition of physical assets, such as plant and equipment, typically requires the issuance of securities of one type or another, tax policies towards buyers of securities directly affect the ease and cost of financing expansion. Realistic tax treatment of capital gains can effectively induce the saver-investor to offer funds in greater quantity and at lower cost to enterprises undertaking the expansion or modernization of their physical facilities. A number of industrial nations -- including Canada, West Germany and Japan -- have indicated their awareness of this by exempting capital gains from any form of taxation.

Administration officials have voiced concern on several occasions with regard to this bill's detrimental impact on the level of real economic investment. In a recent speech to the Tax Section of the American Bar Association, Assistant Secretary of the Treasury for Tax Policy Edwin S. Cohen stated that economic analysis indicated that the Bill "involves too great an allocation of benefits to consumption and not enough to investment in productive equipment and capacity." Secretary of the Treasury David M. Kennedy reiterated the view that the House bill was "weighted in favor of consumption, to the potential detriment of the nation's productive investment." He concluded that the House version "could impede economic growth in the years ahead by curtailing the incentive to make productive investments."

Capital Mobility

Increases in capital gains taxation will adversely affect both the level of investment and the allocation of investment funds.

Economists in general agree that the mobility of capital should be encouraged in order to achieve optimum allocation of economic resources. Tax measures which hamper investment liquidity and impair capital mobility are clearly undesirable. Increases in capital gains taxation offer a classic example of such measures. If funds are to be allocated among competing investment projects with maximum efficiency, it is essential for investors to have access to a liquid and orderly market when a sale is to be consummated. Liquidity in securities markets facilitates the purchase and sale of securities, and thereby frees capital to flow to whatever industries or companies offer the highest prospective returns. Individuals should not be deterred from making

desirable shifts in the composition of their assets as their needs and expectations change. Inevitably, higher capital gains taxes, by discouraging investors from switching to other alternatives, will interfere with the optimal allocation of resources, to the ultimate detriment of economic growth.

The Level of Savings and Inflation

It would, in any case, be difficult to imagine a more inopportune time for setting forth the proposed changes in capital gains taxation. The major economic issue confronting the American economy today is excessive demand and inadequate savings. Inflationary pressures are intense and, to some extent, are likely to remain with us into the 1970's. Tax policy at this time should encourage savings as a means of combatting the pressures of excessive demand. Instead, we find tax policy changes proposed which would increase the tax burden on capital gains. Studies indicate that individuals view capital gains in a different light than ordinary sources of income. Regarded as unusual and unpredictable receipts, capital gains are not typically consumed but are returned to the flow of savings. It follows that an increase in capital gains taxation may well stimulate consumption at the expense of savings, and decrease the over-all pool of funds available for investment. Such recommendations are inconsistent with other recent counter-inflationary policies, such as the income tax surcharge which represents a compulsory form of personal savings. To the extent that business capital investment is financed through savings rather than through the expansion of the money supply, price pressures are relieved and the task of the Federal Reserve is made easier.

Higher aggregate savings can also lessen inflationary pressures that arise from the "cost-push" side. Greater availability of aggregate savings serves to promote investment in more productive techniques.

By making the most efficient equipment available to employees, industry improves the productivity of the labor force. Larger gains in output per man-hour serve to narrow the gap between wage increases and improvements in productivity and thereby limit the inflationary push coming from the cost side. Thus, it seems clear that in the current economic environment, any tax policy which discourages savings compounds the problem of achieving non-inflationary economic growth.

The current economic climate underscores the importance of continuing existing capital gains tax policies without significant change. From the short-run point of view as well as the longer-run goals of our economy, it would be wise to refrain from altering the tax treatment of capital gains in a manner that would reduce savings, impair the mobility of capital, and seriously interfere with the flow of capital to newer, more dynamic, and more risky ventures. We believe that the recommendations made in the House bill have been conceived in haste and are based on inadequate data. Our

analysis of the economic impact of the proposals under consideration suggests that their hasty enactment can cause irreparable harm to the nation's long-term capacity for growth.

In the following pages, each of the major capital gains tax proposals is discussed in some detail, with reference to available data which we believe strongly accentuate the dangers inherent in proceeding at this time with the changes recommended by the House.

THE HOLDING PERIOD

Tax incentives for capital investment, however, are not the only determinant of capital market efficiency. Smooth functioning of a nation's capital markets is dependent upon liquidity -- the ability to move readily in and out of investments. The less liquid an investment, the less attractive it is to investors. Rates of return reflect, in part, the degree of liquidity. The strength of the NYSE -- and the U.S. securities markets in general -- stems from the large number of orders that continually flow to it. Any diminution in the flow tends to impair market quality.

The NYSE agrees with the assertion in the House Ways and Means Committee's Report that "The holding period is an arbitrary and imperfect procedure that may be inaccurate in some specific situations, but it provides an approach under which there are significantly fewer administrative and compliance difficulties than would arise under a less objective standard." In setting this admittedly imperfect cut-off point, two considerations should be paramount. First, the barrier must be raised high enough to separate ordinary business transactions and speculation from investment; and, second, it must not be raised so high as to seriously impair market liquidity. In other words, there is a trade-off between the two objectives. To achieve one completely is to sacrifice the other.

The current six-month holding period filters out the vast majority of transactions by those who earn their livelihood by buying and selling securities. It has the same effect with regard to investors who buy and sell securities with the objective of making short-term gains. The Ways and Means Committee estimates that the revenue gain from an extension of the holding period to 12 months will ultimately total $150 million annually. Underlying this estimate is the assumption that the proposed changes in the tax treatment of capital gains will have relatively little impact on investment behavior. It is realistic to assume, however, that investors would tend to significantly alter their pattern of realizations to conform to the lengthened holding period requirement. Some investors would be discouraged from purchasing equities altogether. It is, of course, impossible to determine precisely, in advance, the revenue effect of a changed holding pattern. It is clear, however, that, at best, postponement of realizations would tend to minimize the revenue gain associated with

a holding period extension and might very well lead to a revenue loss.

The problem is to weigh the uncertain promise of a small revenue gain against the economic disadvantages which would stem from a holding period extension.

Effectiveness of the Six-Month Holding Period

All available data indicate that the six-month holding period is more than ample to filter out the majority of "non-investment" transactions. Transactions data from the 1962 Internal Revenue study of capital gains, for example, demonstrate where long-term investment apparently is not the motivating factor, there is a strong tendency to go for quick gains.

Table I

GAINS TRANSACTIONS IN CORPORATE STOCK
BY LENGTH OF HOLDING PERIOD
1962

Holding Periods	Number of Transactions
Short term, total	1,124,449
Under 1 month	408,114
1 under 3 months	316,687
3 under 6 months	260,411
Not available	139,237
Long term, total	2,621,942
6 to 12 months	432,214
1 under 2 years	472,202
2 under 3 years	300,343
3 under 4 years	223,332
4 under 5 years	151,044
5 under 10 years	411,212
10 under 15 years	153,808
15 under 20 years	71,304
20 years and more	78,422
Not available	328,061
Total, all periods	3,746,391

Source: "Statistics of Income -- 1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns," U.S. Treasury Department, Table 12, p. 112 .

As can be seen from Table I, 2.6 times as many transactions occurred in stock held under six months than in stock held from six months to a year. Especially significant is the fact that the number of gain transactions that occurred in stock held under one month (408,000) was almost as great as the total for the entire six to twelve-month period (432,000). The number of gain transactions that occurred within three months of purchase is, in fact, so great -- approximately three-fourths of all short-term gain transactions -- as to suggest that six months may be a longer period than necessary to catch most non-investment transactions.

Corroboration of this view is apparent in the findings of studies of public transactions on the NYSE over the years. Results of the most recent studies are presented below.

Table II

VALUE OF SHARES SOLD BY INDIVIDUALS BY HOLDING PERIODS

	Holding Periods		
NYSE Public Transaction Studies	1 Month or Less	Over 1 to 6 Months	Over 6 Months
1960	17%*	22%*	61%*
1961	10	32	58
1963	24	29**	47***
1965	12	28	60
1966	23	23	54

* Percentages are based on total excluding "don't know" category.
**Over 1 to 3 months of holding accounted for 16% of total sales and over 3 months to 6 months accounted for 13%.
***Over 6 to 12 months of holding accounted for 18% of sales.

Source: New York Stock Exchange

As can be seen in the summary of the five studies in Table II, from two-fifths to over half of the value of sales occurred before the end of the six-month holding period, with disproportionately large dollar volume of sales taking place within the first month after purchase. A more detailed analysis of holding periods is available only for the 1963 study.

In that study, not only did most sales (53%) not qualify for long-term gains under the six-month test, but also the amount of sales within the first six months of holding were nearly three times greater than the amount in the six-to-12 month period.

There was a greater tendency to sell within three to six months after purchase than in six to twelve months. Putting the 1963 sales data on a monthly average basis, to allow for the difference in length of period, the ratio of all sales made in the three-to-six-month holding period (4.2%) was higher than the ratio for sales in the later period (3.0%).

In 1966, the American Stock Exchange undertook a similar study, the results of which confirm the findings of the 1963 NYSE study. As can be seen, 66% of the value of sales did not qualify for capital gains treatment, and only 13% of the sales total was attributable to holdings in the six-to-12 month category. Furthermore, the highest income group accounted for a disproportionately low share of sales in the six-to-12 month holding period.

Table III

VALUE OF SHARES SOLD BY HOLDING PERIODS
AMERICAN STOCK EXCHANGE
MAY 25, 1966

Income Class	Short Sales	Under 1 Month	1-3 Mos.	3-6 Mos.	6-12 Mos.	12+Mos.	Unknown
Under $10,000	5%	29%	23%	11%	15%	9%	8%
$10,000 - $25,000	9	25	15	13	13	18	8
$25,000 +	10	27	14	10	9	25	5
Unknown	-	24	12	27	13	12	12
Total	7%	28%	20%	11%	13%	14%	7%

The transactions data collected by the New York and American exchanges, do not specifically isolate the trading proclivities of short-term traders, who are the prime target of the holding period. We believe, however, that the typical short-term trader is interested in rapid turnover of funds with relatively small profits on each transaction, rather than with achieving long-term capital gains treatment.

Evidence on this point is provided by a study made in July 1961 among NYSE floor members who traded for their own account. There is little reason to doubt that the 1961 findings remain valid today. The study found that only 3% of both number and value of shares sold during a one-week period was held longer than six months. By contrast, 86% of the shares sold and 90% of their value were held one month or less.

The foregoing analysis of transactions strongly suggests that the six-month holding period is more than doing the job it was intended for. While it "may be inaccurate in some specific situations," it is clear that the six-month holding period excludes from long-term capital gains treatment the vast majority of transactions which are not consistent with the basic concept of what should and what should not qualify for preferential treatment.

Shortcomings of Ways and Means Committee Analysis

Underlying the NYSE analysis is the concept that the most accurate measure of the holding period's effectiveness is the number and value of transactions disqualified from capital gains treatment. The Ways and Means Committee's conclusion that the current holding period is not adequate for the job of distinguishing between investment and non-investment transactions stems from a limited perspective of the problem. Rather than measuring transactions directly, the Committee looked at capital gains realizations. Standing alone, gains realizations give little indication of trading patterns. One should also ask, how much trading do the gains represent?

For example, the Ways and Means Committee supports its contention that "...assets held between 6 months and 1 year tend to be speculative" by showing "that almost 90% of all capital gains on corporate stock in 1962 arose from sales occurring after 1 year of possession." But this offers no true indication of the efficacy of the six-month holding period. As indicated in the table on transactions above (Table I), taken from the same IRS study used in the Ways and Means Committee analysis, more capital gains transactions in stock (472,000) occurred between the first and second years of holding than in the 6 to 12-month period. By contrast, 1,124,000 transactions took place before the expiration of the holding period. If the six-month holding period did not adequately cope with the question of speculative and normal business transactions, we would expect the opposite results -- that is, a jump in gain transactions from the first to the second half of the year after purchase and a decline in the number of transactions in the second year after purchase.

The pattern of transactions provides a more reasonable basis for judging the holding period than the statistic that almost 90% of gain occurs from sales occurring after one year of possession. This compares growth over a single year with the total of gains which have accrued over many years. Obviously, in a growing economy with a secularly rising stock market, the dollar value of appreciated stocks held over a period of years will be substantial.

The Ways and Means Committee Report offers as evidence of the inadequacy of the current holding period, the "sharp increase in sales between the sixth and seventh months the stock was held." The fact is that there will always be a tendency for realizations to bulge at the expiration of a holding

period of any duration.

In appraising both the preceding and the Ways and Means Committee's discussion of trading patterns during the first year, it must be noted that 1962, the only year for which detailed IRS data on gains realizations are available, was undoubtedly an atypical year. A sharp market break in the spring of that year prompted early realizations of both profits and losses in order to preserve the former and minimize the latter. The high ratio of realized losses to gains emphasizes this point. In 1962, short-term losses reported to IRS ($768,000,000) were 2.2 times greater than short-term gains. Similarly, the value of losses realized after six to 12 months of holding ($804,000,000) was double the value of six-to-12-month gains.

The 1962 pattern of realizations emphasizes the need for preserving flexibility for the investor. No matter what his initial intentions, he is exposed to the fluctuations of the market after making his original purchase. An intended "long-term investment" may become a short-term gain, or even a loss as market conditions shift. The greater uncertainties of a longer holding period are bound to discourage investors. It would impede the mobility of capital and thereby lessen market liquidity. New ventures, particularly, would find financing more difficult as the longer holding period added to the basic risk associated with venture capital.

From the Treasury's point of view, a longer holding period, particularly in a year like 1962, would reduce revenue collections. This would occur because the investor is often well-advised to wait for the end of the holding period, even if substantial erosion in his gain takes place. With capital gains taxed at half the regular rate, the investor in the 50% tax bracket waiting for the holding period expiration could accept a one-third erosion in his gain and still come out with the same after-tax profit. At the top 70% marginal rate, the break-even point is a 60% erosion in profits, assuming a 25% alternative capital gains tax rate.

Table IV

EROSION IN GROSS GAIN AT WHICH
CAPITAL GAINS AND REGULAR TAX RATES
RESULT IN EQUIVALENT AFTER-TAX YIELDS

Marginal Tax Rate	Erosion Factor	Marginal Tax Rate	Erosion Factor
14%	8%	50%	33%
20%	11%	60%	47%*
30%	18%	70%	60%*
40%	25%		

*Assumes 25% alternative capital gains tax rate.

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Who Uses the 6-12 Month Holding Period?

The Ways and Means Committee report asserts that the inadequacy of the six-month holding period is demonstrated by the pattern of realizations in the first year of holding by the $100,000-and-over group. The report demonstrates that the top income group realizes a far greater portion of its first-year gain in the six-to-12 month period than in the 0-six month period. As shown in the preceding table (Table IV), that is to be expected, since higher income groups take a smaller risk (in after-tax profits) in delaying realizations than do lower income groups. This pattern would hold no matter what the holding period.

Furthermore, the Committee report does not point out that the higher income groups tend to hold assets longer than the lower income groups. In fact, when the data for all long-term realizations are examined -- rather than just those for the first year -- we find that in terms of total long-term capital gains, realizations in the six-to-12 month period are far more important for the lower income groups than the higher income groups.

For example, as indicated on Table VI, in 1962, only 4% of all realized long-term gains on returns with incomes of $100,000 or more were from assets held 6 to 12 months. By contrast, the respective ratios were 10% and 9% for those with incomes of under $10,000 and from $10,000 to under $50,000.

Put another way, the $100,000 and over group, while accounting for 33% of all reported long-term gains in 1962, accounted for only 17% of all gains realized in the six-to-12 month period; while taxpayers with incomes under $10,000 accounted for 16% of all gains realized in the six-to-12 month period -- and those in the $10-50,000 bracket accounted for 50% (Table V).

Similar results were obtained in the American Stock Exchange study. The AMEX study indicated that 74% of all sales in the six-to-12 month period were made by persons in the under-$10,000 group, compared with only 14% for the over $25,000 group. By contrast, their portion of sales of stock held longer than one year were 44% and 40%, respectively.

Table V
DISTRIBUTION OF CORPORATE STOCK CAPITAL GAINS
BY HOLDING PERIOD AND INCOME CLASS
1962

	Taxable Returns			
Holding Periods	Under $10,000	$10,000 Under $50,000	$50,000 Under $100,000	$100,000 and Over
6 to 12 months	16%	50%	16%	17%
1 under 2 years	16	50	17	18
2 under 3 years	15	47	16	22
3 under 4 years	14	47	16	22
4 under 5 years	15	45	17	23

(Table V - continued)

Holding Periods	Under $10,000	$10,000 Under $50,000	$ 50,000 Under $100,000	$100,000 and Over
5 under 10 years	13	39	16	32
10 under 15 years	7	39	16	39
15 under 20 years	5	31	16	48
20 years and over	8	21	12	59
Total, all periods	11%	40%	16%	33%

Source: "Statistics of Income -- 1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns," U.S. Treasury Department, Table 12, p. 112.

Available data give strong indication that lengthening the holding period would not exclude very many additional non-investment transactions from long-term capital gains treatment. Its principal effect would be to realign investment holding patterns, hinder market liquidity and capital mobility and increase the risk to venture capital.

ALTERNATIVE RATE

Among the proposed revisions in capital gains treatment, the most direct impact on the flow of risk capital would stem from elimination of the alternative tax rate. First, it would lower the incentive to put money at risk by reducing the after-tax reward. Second, it would discourage the movement of capital from mature, less risky investments to new and unproved but potentially rewarding opportunities by raising the tax cost of transferring investments. Ultimately, the cost of capital would rise as entrepreneurs vie for shares of the smaller pool of venture capital.

Relatively few individuals qualify for use of the alternative rate on long-term capital gains; however, it is this group that is the prime source of venture capital. These investors provide the cutting edge of economic growth.

In the landmark study, Effects of Taxation, Investments by Individuals, it was concluded that "...business must look mainly to a very small percentage of the population -- individuals with large incomes or substantial holdings of wealth or both -- to find any widespread willingness to assume the risks of business ownership, especially of unseasoned enterprises." The authors also found that there is "...very strong evidence for the validity of the major finding of this section, namely, that the investment decisions of the upper income and wealth groups are of overwhelming importance in governing the flow of equity capital from private

investors to business enterprise."*

While any blunting of investment incentives serves as an impediment to the generation and free flow of investment capital -- as the NYSE has pointed out many times -- its effects are magnified as the degree of risk increases. It is a fact of economic life that the relative handful of large savers are in the best position to supply risk capital. The problem is to maintain an investment environment which would stimulate the large savers to frequently turn over their matured investments and seek out new risk situations. The tax penalty for turning over an investment is clearly a major factor in the decision.

A dollar in an existing investment paying a reasonable return at minimum risk, often proves more attractive than 75¢ (after the alternative capital gains tax) in a high-risk investment that holds out the possibility of sizeable returns. The existing investment dollar looks even more attractive to top-bracket taxpayers when its after-tax value drops 13%, from 75¢ to 65¢. The lower the after-tax value of an existing investment, the more likely the investor is to hold on to it -- or "lock" himself in. This "lock-in" effect is generally acknowledged.

The 1965 capital gains study conducted for the NYSE by Louis Harris and Associates, Inc. was designed to measure investors' reactions to 20% and 50% reductions in tax rates. In examining the long-run implications of a 20% cut in the maximum capital gains tax rate, Harris estimated that Treasury revenues would rise by slightly more than one-quarter. If the maximum rate were halved, to 12-1/2%, estimated revenues would climb nearly three-quarters. The implications of these findings in the context of a tax rate increase are clearly disturbing.

This study of the lock-in effect of the capital gains tax suggests that an increase in the rate would have a substantial impact on capital mobility. As a consequence of the decline in gains realizations, the revenue increment would not rise in proportion to the increase in the effective capital gains tax rate.

Current Holding Patterns

Available data clearly demonstrate that the higher the income, the greater the tendency to wait before realizing accrued capital gains. This

* J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation, Investments by Individuals (Cambridge, Mass.: The Riverside Press, 1953), p. 27.

shows up in the following table.

Table VI

DISTRIBUTION OF REALIZED LONG-TERM CAPITAL GAINS ON CORPORATE STOCK BY HOLDING PERIODS AND INCOME SIZE CLASS 1962

	Taxable Returns			
Holding Period	Under $10,000	$10,000 Under $50,000	$ 50,000 Under $100,000	$100,000 and Over
6 to 12 months	10%	9%	7%	4%
1 under 2 years	13	12	10	5
2 under 3 years	11	10	9	5
3 under 4 years	9	9	8	6
4 under 5 years	8	7	7	4
5 under 10 years	28	25	25	24
10 under 15 years	8	14	15	17
15 under 20 years	4	7	9	13
20 years and over	9	7	10	22
	100%	100%	100%	100%

Source: "Statistics of Income -- 1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns," U.S. Treasury Department, Table 12, p. 112.

In the lowest (under $10,000) income group, 51% of total long-term capital gains were realized on assets held five years or less. While this ratio is only modestly higher than those for the $10,000-to-under $50,000 and $50,000-to-under $100,000 income groups, it is more than double the 24% ratio for the over $100,000 income group. By contrast, 22% of gains realizations by the top income group were accounted for by sales of holdings of 20 years or more, compared with only 7% to 10% for the three lower income groups.

We do not mean to imply that differences in the timing of realizations are all attributable to the lock-in effect. We do suggest, however, that securities markets (and other investors) would be better served if the holding pattern of the top income earners more closely resembled that of the less affluent groups (i.e., more frequent asset turnover). Elimination of the alternative tax on long-term capital gains would have the opposite effect. It would further widen the disparity in length of holding.

From the point of view of capital mobility, inclusion of capital gains in income averaging is not a substitute for the alternative tax. While the latter helps to ease the lock-in problem somewhat, income averaging would tend to aggravate it by providing an incentive to postpone the realization of gains so as to qualify for the advantages of averaging.

The blunting of tax incentives to the prime source of venture capital will mean more competition for the pool of available risk money. Returns to risk capital will have to rise if new ventures are to attract equity financing. In turn, desirable, but less promising, new ventures may fall by the wayside in the tougher competition for risk capital.

In an environment of strong competition for funds, it is especially imperative that incentives for risk capital be preserved. if the business sector is to make a maximum contribution to national economic growth and well-being. The proposal to eliminate the alternative tax -- which is essentially a technique for increasing the tax rate for the most substantial investors -- offers a virtually foolproof means of reducing such incentives.

TREATMENT OF CAPITAL LOSSES

Investment risk would also be affected marginally by the proposal to restrict the long-term capital loss deduction from ordinary income to 50% of the loss. Investors weigh prospective gains or losses in terms of total dollars and make their judgments accordingly.

The proposal is largely predicated on the assumption that many taxpayers are in a position to manage their investments in such a way as to realize gains and losses in different years. Not only is the assumption not valid, but the proposed change would have the greatest impact on the lower-income groups, which are in the least advantageous position to arrange the timing of realizations to qualify for beneficial tax treatment. In effect, the great bulk of taxpayers already hurt by investment losses -- often amounting to a sizeable portion of annual income -- would be further penalized in order to restrict a relatively small number of taxpayers who are in a position to use the loss provision to best advantage.

Not only does that rationale lead to inequities, but it still does not deal directly with the problem. Taxpayers in a position to properly time gain and loss realizations would still do so.

It should be emphasized that most capital losses (74% in 1962) result from stock sales. Stockholdings are subject to market fluctuations. For the most part, losses may be realized either because of the need for cash or to prevent possible erosion of the value of holdings. In either case, the sale cannot be postponed for very long. Similarly, for most investors, the possibility of erosion of the gain during the period when realization

is postponed generally outweighs the advantage of the minor tax saving attributable to proper timing.

From the individual's point of view, a loss is a loss no matter how it comes. A dollar lost through a decline in an investment hurts just as much financially as one lost through negligence or theft.

Impact of the Proposed Treatment of Losses

The limitation on deduction of loss hits hardest at the lower income groups. In point of fact, lower-income taxpayers with losses have far less of a possibility of offsetting losses against future gains or future income than do upper-income taxpayers. As a group, lower-income taxpayers sustain very high losses in relation to income.

Table VII

LONG-TERM CAPITAL LOSS CARRYOVER ON TAXABLE RETURNS SHOWING NET CAPITAL LOSS
1966

Adj. Gross Income Classes		Average Adj. Gross Income	Average Carryover	Average Carryover as % of Average Income
Under $3,000		1,432	3,589	254%
3,000 to under	4,000	3,491	2,974	85
4,000 to under	5,000	4,500	6,744	151
5,000 to under	6,000	5,005	13,628	248
6,000 to under	8,000	6,985	8,838	127
8,000 to under	10,000	8,941	4,308	48
10,000 to under	15,000	11,937	4,142	35
15,000 to under	20,000	16,976	5,428	32
20,000 to under	50,000	28,240	5,458	19
50,000 to under	100,000	65,847	7,183	11
100,000 to under	200,000	131,729	10,574	8
200,000 to under	500,000	280,453	16,202	6
500,000 to under	1,000,000	670,661	14,077	2
1,000,000 and over		2,161,328	15,125	1

Source: Adapted from "Statistics of Income -- 1966 Individual Income Tax Returns," U.S. Treasury Department, Table 19, p. 41.

For returns with under $8,000 of adjusted gross income, the average capital loss carryover generally runs well in excess of income. The ratio of loss carryover to income dwindles as income rises above $8,000, falling to only 1% for the top income earners.

That the tax burden of proposed capital loss limitations (including revised treatment of losses of married couples) will fall upon the lower and middle-income groups is corroborated by the Ways and Means Committee's revenue estimates. Of the $65 million of additional revenue attributable to the change in treatment of losses, 57% would be paid by the under $15,000 income group and 34% by the under $10,000 group.

In summary, net capital losses in practice have been virtually non-deductible. The proposed changes in treatment of losses will further penalize investors whose financial positions have already been impaired. They would hit hardest at individuals in the low and middle-income groups, who have the least prospect of offsetting accumulated losses against future gains.

OTHER PROVISIONS AFFECTING INVESTORS

In addition to the three proposed revisions in capital gains treatment already discussed, the Bill contains several other proposals which would tend to dampen investment incentives. The NYSE will submit a detailed statement on these to the Committee on Finance at a future date. Here, we will comment only briefly on two of these proposals.

Disallowance of Non-Business Deductions

Non-corporate taxpayers would be required to allocate non-business deductions -- such as interest, state and local taxes, charitable contributions, casualty losses and medical expenses -- between taxable income and tax preference items. The latter include one-half of long-term capital gains, presumably on the theory that one-half of long-term capital gains is being excluded from income.

In simplest terms, the proposal amounts to an increase in the effective rate of the capital gains tax. It does by indirection and through administrative complexity what could be more easily done by a simple increase in the tax rate, if that were thought desirable. The burden of the change in treatment of deductions would fall primarily on those individuals who are the major source of venture capital. Their response to the proposed change would be essentially the same as it would be to an increase in the alternative tax (discussed above).

In addition, the provision does not differentiate between capital gains realized in connection with a trade or business as contrasted with ordinary investments.

Furthermore, the rationale for the allocation of deductions between income included and excluded from taxable income does not, in actual practice, apply to the vast majority of realized capital gains. In the words of the report of the Committee on Ways and Means, "The bill essentially requires allocation of any itemized deduction where it is reasonable to assume that a portion of the pertinent expense is met out of nontaxable income." The fact is that most individuals who would be affected -- those with relatively large capital gains -- would tend to reinvest their realized funds rather than use them for living expenses

-- the assumption on which the proposal is based.

Overlooked completely by the proposal is its effect on the relationship between state income taxes and the Federal tax. Escalation of state tax rates at the upper end of the income scale is predicated on the theory that the taxpayer would recoup a large part of the additional tax through the state tax deduction. In addition, since many states tie their tax base to the Federal base, effective state income taxes in many instances would also rise. Combined, the two would have a substantial effect on total tax costs (state and Federal) of large investors which the report of the Ways and Means Committee evidently did not foresee.

Limitation on Deduction of Investment Interest

Limiting the interest deduction on loans used to finance investment property to $25,000 over and above investment income also penalizes those individuals who exhibit the greatest willingness to take investment risks. It seems anomalous to permit unlimited interest deductions for consumption purposes, while limiting interest deductions on funds put into productive investment. Furthermore, where does one draw the line between legitimate risk-taking through leveraging investments and tax considerations? Even where tax considerations are a factor, the end result is still an increase in investment.

This provision was apparently prompted by the widely-publicized 150 or so high-income returns for 1966 in which excess investment interest allegedly was used to insulate from taxation other types of income received by the taxpayers. The simple way of handling this situation would have been to include investment interest within the "limit on tax preferences" structure. Instead, the Bill offers an extremely complex provision which is shot-through with possibilities for inequities.

To the extent that interest must be offset against long-term capital gains, with an effective 50% disallowance, the real tax on such gains is substantially increased.

If the investment on which the interest is being paid results in a capital loss, both the loss and the interest in excess of the minimum are disallowed -- a disturbing new form of double tax jeopardy. When a taxpayer repays investment borrowings from non-investment income, he can deduct practically no capital losses and, under this Bill, only limited amounts of investment interest.

The argument that the $25,000 annual limitation means that only substantial investors are confronted with such a choice of alternatives hardly alters the intrinsic unfairness of the provision. It underscores, however, the fact that the impact of the Bill falls most heavily upon those investors who necessarily must be depended upon to supply a major share of risk capital.

CONCLUSION

The whole question of investment incentives, including capital gains taxation, is fraught with uncertainty. That incentives for investment are essential for sustained economic growth in a free enterprise economy is not in dispute. What constitutes a proper level of incentives is a question on which reasonable men can differ. The existing treatment of capital gains has been essentially unchanged for over a quarter of a century. Over that period, the U.S. has compiled an enviable record of economic growth.

In the years immediately ahead, the rate of generation of new capital must be stepped up if our economy is to meet the demands put upon it by an increasingly sophisticated and expensive industrial plant and a population demanding an attack on the backlog of social and environmental problems. In the face of these needs, the structure of incentives which has proved out over the years should not be casually or hastily dismantled.

Unfortunately, there is little hard current data on the capital gains tax and other incentives. Based on the fragmentary data that do exist, the NYSE believes that the various capital gains provisions are essentially doing the job for which they were designed.

Heavy reliance by proponents as well as opponents of capital gains tax revision has been put on a single study done in 1962 -- a year in which stock market performance, and probably gains realizations, was distinctly not typical.

As we have demonstrated, the existing data offer no persuasive rationale for altering the existing capital gains tax structure at this time; and, in fact, there is every indication that the provisions now in effect are accomplishing the job for which they were designed.

If, at some future time, it should be deemed desirable to alter the present tax treatment of capital gains, it would certainly seem necessary to base any proposals for far-reaching changes on a detailed study of capital gains. Such a study would aim to provide timely and definitive new data on all aspects of the capital gains tax provisions of the Internal Revenue Code.

Summary of the Statement of Donald T. Regan
President, Merrill Lynch, Pierce, Fenner & Smith, Inc.
Speaking on Behalf of the
Association of Stock Exchange Firms
to the
Senate Finance Committee
on the
Tax Reform Act of 1969
September 16, 1969

Capital is essential to economic growth. Consequently, adequate incentive to capital investment must be maintained to ensure that the nation's economic development keeps pace with the needs of an expanding population and its rising aspirations.

1. We recognize the need for tax reform, and we welcome any effort to reduce taxes.

2. The provisions to repeal the alternative tax, extend the holding period of capital assets, and reduce the deductibility of capital losses would all serve to discourage investment and thereby stunt economic growth. We oppose these provisions in H. R. 13270, although we approve of the Administration's proposal to revise the alternative tax.

3. We believe that the capital gains provisions of the House bill impair its balance. We agree with Secretary of the Treasury David M. Kennedy's view that the bill is "weighted in favor of consumption to the possible detriment of the nation's productive investment."

4. In drafting tax legislation, it is important not to erode the difference between capital and income. The higher the tax on capital the less investment money there is to start new businesses and to expand existing businesses.

5. Although a relatively few taxpayers use the alternative tax on long-term capital gains, their importance is disproportionate to their numbers, for they provide much of the risk capital for new business ventures. Repeal of the alternative tax would tend to influence such taxpayers to freeze their present investments, with the consequence that there will be less capital available for new enterprises.

6. The period of time that a security has been held is poor measure of whether it is a speculation or an investment. As Keith Funston, former President of the New York Stock Exchange, said:

> The holding period is merely an artificial, arbitrary, but administratively convenient and definite device to distinguish capital transactions from ordinary business transactions.

The present six-month holding period has been in the law since 1942. It is well understood by all taxpayers and is sufficiently long to distinguish capital transactions from ordinary business transactions.

7. We dispute the revenue estimates for the House provisions to repeal the alternative tax and to extend the holding period. These estimates are based on the assumption that investment would remain at the current level. Since we believe investment and the disposition of investments would decrease, we think there would be less -- not more -- tax revenue as a consequence.

8. An independent survey of a sample of Merrill Lynch's 1.5 million customers confirms our belief that investment would be reduced by the passage of the three capital gains provisions.

-- Three out of four investors opposed the capital gains provisions of H.R. 13270.

-- More than four out of five favored the present six-month holding period or a shorter period and only one in eight wanted a longer period.

-- Assuming passage of all three provisions, one in three said they would decrease their investments.

9. With inflation continuing and securities prices down, now is not the time to create further doubt about the future of the economy by enacting legislation that would diminish investment incentives.

STATEMENT OF DONALD T. REGAN
PRESIDENT, MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.
SPEAKING ON BEHALF OF THE
ASSOCIATION OF STOCK EXCHANGE FIRMS
TO THE
SENATE FINANCE COMMITTEE
ON THE
TAX REFORM ACT OF 1969
SEPTEMBER 16, 1969

Mr. Chairman and Members of the Committee:

I am honored to be here today and to have the opportunity to testify on behalf of the Association of Stock Exchange Firms. The Association represents 520 New York Stock Exchange member firms doing 85 percent of the securities business of the nation. These firms are concerned with the investments of more than 26 million Americans who own securities outright and 100 million more who own them indirectly through their participation in pension and profit-sharing trusts and other institutional investments.

As President of Merrill Lynch, Pierce, Fenner & Smith, I have responsibility for the management of 209 brokerage offices throughout the world. We hold 33 seats on 10 major U.S. and foreign securities exchanges and employ more than 3,760 securities brokers to serve 1.5 million customers.

Accompanying me are Henry W. Meers, Chairman of the Association of Stock Exchange Firms and a senior partner of White Weld & Company, Dr. Leon T. Kendall, its President, and James R. Rowen,

tax partner in the firm of Sherman & Sterling of New York, New York. These gentlemen will help me to try to answer any questions you might have concerning the securities industry's position on three provisions of H.R. 13270 dealing with capital gains.

While we recognise the need for tax reform, we oppose the provision to extend the holding period for capital assets. We also oppose the provision to repeal the alternative tax on long-term capital gains, although we are willing to accept the changes in this tax that the Treasury Department has proposed. The provision of the bill limiting the deductibility of capital losses also gives us pause. These are the only provisions of H.R. 13270 we are going to address ourselves to.

Economic Growth and Capital Formation

Although I am here to testify on proposed tax legislation, in the broad sense the subject before us is much larger. It is economic growth and the progress of the nation. Without a doubt the standards and guidelines this body brings forth on taxation will do more to affect the allocation of resources in the American economy than almost any other act of the 91st Congress. Tax policy has been and continues to be the chief means by which the people themselves, making their voices heard in a representative democracy, adjust the economic machinery to fit their evolving needs and aspirations.

The standard economic textbooks tell us that economic progress is the result of a skillfull blending of four basic factors -- natural resources, labor, capital, and management.

The importance of having all four elements is apparent when we consider the economic history of regions of the world that have an incomplete mix. Asia, for example, has an abundance of resources and labor, but it is short on capital and management. Consequently, a number of Asian nations are still primarily dependent upon agricultural economies.

Several Latin American countries are blessed with great natural resources, but their growing multitudes are reluctant to migrate to some of the promising but underdeveloped areas within their own boundaries. There is also a deficiency of capital and management in many of these lands.

At the other end of the scale is Switzerland, a storehouse for world capital but a place where natural resources are more scenic than economically productive.

In the United States, we have made particularly effective use of land, labor, capital and management, but as we look ahead it is equally clear that our economic machine is going to be called on to perform tasks of ever-growing immensity. We are within striking distance of an economy of one trillion dollars in terms of gross national product.

Our population is expected to grow by 100 million between now and the year 2000, and we cannot allow the economy to lag. No one would willingly distribute our economic output in diminishing portions among our growing population.

In the 1970s new families will be formed at the rate of about one million a year. This obviously means more housing, more jobs, more everything. Providing for these needs will require huge amounts of capital. At present, behind each job in manufacturing stands about $25,000 in capital, and the figure will certainly rise.

Our standard of living has doubled during the past 40 years, even allowing for inflation. To maintain this pace, heavy investment must be made in research and development. Technological advance enables our economy to surge ahead. We are currently spending $25 billion a year for R&D, and this total should rise rapidly in the next decade if we are to continue to grow.

Dr. C. Lowell Harriss, Professor of Economics at Columbia University, recently estimated that the 1.4 million annual increase in the labor force would require $28 billion in new capital investment each year just to provide acceptable jobs. To allow for rising expectations (a five percent annual increase in earnings of $8,000) an additional $40 billion in capital would be needed.

New housing for 1.1 million new families a year would cost

$16.5 billion, and this figure doesn't include the price of land, which is skyrocketing. Emphasis on apartments instead of single-family residences is also assumed in arriving at this estimate. Only modest upgrading of 60 million existing housing units would take another $18 billion. All this adds up to $102.5 billion in capital -- to be raised every year.

The public sector will also require massive infusions of capital for education, mass transit, health, urban development, and other vital social programs. According to the Tax Foundation, more than $250 billion in capital will be needed by state and local governments over the next decade. Furthermore, we are only beginning to make a systematic attack on air and water pollution. It is still too early to put a price tag on this ambitious undertaking, but already we know it will be costly to clean up our waterways and make the air over our cities fit to breathe.

A bumper crop of young adults, the children of the postwar baby boom, have already had a decisive impact on national politics, and gradually they will assert a strong influence in ordering our national priorities. These young men and women have grown up in an era of unprecedented prosperity, and we can be sure they will not settle for second best -- from government or in their private lives.

Most of these young adults enter the labor force with considerable talent and high aspirations, but with little accumulated capital --

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certainly not enough to supply their own needs.

Dr. Harriss perhaps summed up the problem most succinctly when he said, "If the coming years of rising expectations are to be dominated more by satisfaction than frustration, capital in large quantities must be available."

Managing The Economic Elements

We must never assume, however, that the nation's continued economic growth is foreordained. We have the knowledge, the manpower, and the capital-generating capability to move ahead. Will we be able to manage them well enough to achieve our goals?

Our economic system has worked because we have never lost sight of the great motivation that stems from a return on capital. We may be less single-minded about it as a driving force than we once were, but like Churchill in despairing of finding a suitable substitute for democracy, we have come to appreciate what only capital can do.

When we were a young nation, pushing our frontiers westward, we looked to the Old World for the capital to build our railroads and many of our industries. Long since faced with a need for capital that far exceeds all the European investments in 19th-century America, we now look principally to ourselves. At the same time, millions abroad look to us to help supply their own mounting capital needs.

Securities Industry and Capital Formation

Historically, the securities industry has played a vital role in capital formation, and this role will surely expand in the years ahead. Stock brokerage firms are a key link between potential investors with savings to put to work and the corporations and entrepreneurs that are seeking funds for growth.

Doing business through liquid central markets, such as the New York Stock Exchange, these firms provide financial services to large and small investors as well as to institutional and corporate clients. Their fundamental objective is to create and to select investments that have a good prospect of being profitable.

The rising demand for new capital will require an increase in the investment banking activity of Association member firms, an increase that is already underway. We regard ourselves as the catalysts in the creative process known as capitalism, bringing together investors' risk capital and those who can put it to good use.

This process used to involve relatively few people, but our capital requirements are now so large that only by tapping the enormous pool of capital provided by the great mass of American households can securities firms and other financial institutions assemble the necessary investment funds. Thus, millions of people participate in the growth and development of the economy.

But every investor does not participate the same way, of course. In our business, we stress the principle of "suitability" in advising our customers on investments. Simply stated, this means selecting the investments that are right for each individual. For the broad range of our own customers at Merrill Lynch we recommend long-term investments in high-grade securities and a balanced portfolio. We advise against riskier investments unless the customer has adequately provided for all his financial needs.

Those who are financially able to take risks typically divide their portfolios between investment-grade issues and more speculative securities. Such people are a principal source of risk capital used to underwrite new companies. These companies create new jobs, and sometimes whole new industries, adding strength and diversity to the economy.

The importance of risk capital can be seen in the following figures. In fiscal 1968, the Securities and Exchange Commission reported 2,906 filings for new issues of stocks, bonds, and investment company shares in accordance with the Securities Act of 1933. These new issues raised a total of $54 billion. In fiscal 1969, there were 4,706 new issues that raised $87 billion. In July and August of this year, despite a downturn in the market, there have been 703 new issues, up 17 percent over the corresponding period last year. Among the emerging industries benefiting from this flow of risk capital are

oceanography, pollution control, computer software, and real estate investment trusts.

Position on H.R. 13270

Let us now turn to H.R. 13270. We have read the House Ways and Means Committee report on the bill, and we understand what the committee intended in drafting the legislation. We recognize the need for tax reform and welcome the current effort to bring it about.

It is in keeping with the nation's commitment to meet its rising expectations that we come here to take exception to three specific provisions of the bill. They are:

1. Section 511 repealing the alternative tax on long-term capital gains,
2. Section 512 changing the treatment of capital losses of individuals,
3. Section 514 extending the holding period for long-term capital assets from six months to a year.

We are in agreement with the position of the Administration as stated by the United States Treasury Department on these sections. We believe that these changes would impair capital formation by placing a heavy burden on investment, thus diminishing the flow of private

capital into new and expanded businesses. We concur in Secretary of the Treasury David M. Kennedy's view that the bill is "weighted in favor of consumption to the possible detriment of the nation's productive investment," and Sections 511, 512 and 514 are prime examples of this weighting.

Former Secretary of the Treasury Henry H. Fowler said in a recent letter to this committee that is now part of the record, "A re-reading of the tax and economic message of the late President Kennedy in 1961-63 would raise serious doubts concerning the wisdom of tax proposals admittedly designed to diminish the premium and pace of risk investment. A primary thrust of these messages, confirmed as national policy in the Revenue Acts of 1962 and 1964, was the promotion of adequate private investment -- the freer and fuller flow of capital into productive effort."

The changes we are proposing are consistent with that philosophy of taxation. Again in the words of Secretary Fowler, "The nation does not need less capital and less private risk investment -- it needs more. It needs more private risk investment to provide more and better jobs which, in turn, increase total production and productivity, new products and services. It needs more private risk investment to provide opportunities for all our citizens and to increase the standard of living for all."

Sound tax legislation is based on a doctrine of fairness. Indeed, it is the necessity to correct inequities in existing tax laws that has led to the bill now before this committee. In trying to decide what is fair, however, it is important not to lose sight of the reasons behind the laws.

There is a contention that $1,000 in salary or wages and $1,000 in capital gains are the same and should be taxed the same. According to this theory, taxing capital gains at half the rate on income is inequitable. To be sure, H.R. 13270 is not a literal embodiment of this theory, but it clearly narrows the difference between capital and income.

It is important not to erode this difference, for the higher the tax on capital the less investment money there is to start new businesses and to expand existing businesses. The American worker enjoys the highest standard of living in the world because $25,000 has been invested in the tools he works with. This is not a chicken-and-egg argument. Capital investment must come first so that there are the means by which income may be earned, and to attract investment there must be incentive.

As our industrial economy becomes more service oriented, the need for capital investment will not diminish. On the contrary, it will increase. For example, in Merrill Lynch $30,000 in capital stands behind each of our 15,395 employees. Last year we created 2,680 new

jobs and increased our capital funds by $42 million. The securities industry as a whole added 23,000 jobs and $1 billion in capital during 1968.

Alternative Tax Rate

As a matter of principle, we do not believe the alternative tax should be eliminated.

The Ways and Means Committee in its report on H.R. 13270 noted that a relatively small group of individual taxpayers use the alternative tax. Data for 1966 show approximately 1.4 percent of the total number of taxpayers reporting net capital gains employed the alternative rate. Although a small percentage, it did represent 86,000 taxpayers. This group accounted for approximately 28 percent of all net capital gains reported in that year. Its importance was all out of proportion to its size.

Earlier in my testimony I noted in discussing the principle of suitability that it is in the interest of investors to tailor the type of risk securities an investor holds to his ability to bear risk. Furthermore, given the fact that most of the growing number of individuals joining the labor force enter without accumulated capital, we must provide adequate and certain incentives to those capable of providing that capital. The present 25-percent alternative tax rate on long-term capital gains is an appropriate inducement to individuals capable of accepting the largest risks.

The Treasury's recommendations for revising the alternative tax would accomplish the desired end without reducing investment incentives. The Treasury proposed that the alternative tax be limited in its use by any taxpayer to long-term capital gains that do not exceed the higher of the two following amounts:

1. $140,000 in the case of a married person and $85,000 in the case of a single person if their other tax preferences do not exceed $10,000, or
2. Four times the taxpayer's taxable income (other than long-term capital gains) if his other preferences do not exceed $10,000. (If his other preferences do exceed $10,000, the allowable amount would be four times his taxable income adjusted under the LTP and Allocation of Deduction rules, less the amount of those other preferences.)

To prevent an excessive tax burden resulting from an occasional realization of a large capital gain, the taxpayer would be permitted to carry over for five years the unused portion of his limit on the alternative tax computation for any taxable year. This will achieve a fair averaging result.

As Assistant Secretary of the Treasury Edwin S. Cohen testified, "The result of this rule will be to insure that a taxpayer who consistently realizes large capital gains in relation to his ordinary income will not be able to use the 25 percent ceiling tax to excess so as constantly to reduce his total effective tax rate."

Capital Losses

The Ways and Means Committee report views the treatment of long-term capital losses inconsistent with the treatment of long-term capital gains, and Section 512 would change this. The economic consequences of such a change give us pause. The provision would reduce the willingness of individuals to take risks and in all likelihood reduce funds available to those investors in the lower income brackets. The ability to take losses when investment returns are negative and to offset these losses against ordinary income seems to be particularly important to the small investor. As the New York Stock Exchange statement to this committee points out, a dollar lost through a poor investment hurts as much as one lost through theft or a natural disaster.

The Holding Period

A holding period of six months has been a part of our tax laws since Franklin Roosevelt's Administration. In fact, it was the Senate Finance Committee that in 1942 proposed the lowering of the holding period from 18 months to six months, and the proposal was enacted. In recommending the change, the committee noted that the tax revenue from capital gains and losses had been dropping steadily and said "the lowering of the holding period will have the effect of encouraging the

realisation of capital gains and thereby result in added revenue to the Treasury." This was, in fact, the case, as was pointed out in previous hearings on capital gains taxation.

We believe the effect of the enactment of Section 514 would be to discourage the investment of private risk capital in badly needed new ventures. With some of the incentive to invest removed, present capital investments would tend to remain frozen, and the growth of the economy would be stunted.

The Ways and Means Committee report concluded that the one-year holding period was an appropriate criterion for determining whether an equity purchase was a speculation or an investment. I do not agree. No time period, such as six months or 12 months, can serve to separate speculation from investment, but it can differentiate ordinary business transactions from capital transactions.

Keith Funston, former President of the New York Stock Exchange, gave what I consider to be the classic definition of the holding period. In testifying on the Revenue Act of 1964, he said:

> The holding period is merely an artificial, arbitrary, but administratively convenient and definitive device to distinguish capital transactions from ordinary business transactions.

The use of the concept of time alone to distinguish speculation from investment is an oversimplification of the reality of the market-

place. If it is the intent of Congress to separate speculation from investment in some way, then it must recognize that speculation is an intensely complex phenomenon that is tied to a great deal more than time. It is tied to the nature of consumer demand, the composition of an industry, invention and innovation, the age or maturity of an industry, even the psychology of the era.

For example, at one time railroad securities were blue chips, but many today must be considered speculations. Tobacco stocks have taken on new characteristics and have less of an investment character. Conversely, many of yesterday's speculations are today's blue chips. Polaroid in its early days was an unproven idea. Few at one point thought Xerox would become a top investment favorite. A speculative issue can achieve investment ranking in a short time, but it can also quickly lose this rank and whole industries can, too.

There is no way to put a time frame around such developments. Conditions within corporations are never static, and the interaction of consumer demand on corporations and industries is changing constantly. Finally, the economy itself is always in a state of flux.

To keep abreast of change, the securities industry employs thousands of security analysts and industry specialists to study practically every publicly held company that any investor might possibly be interested in. The cost of research at Merrill Lynch last year was

$4.7 million.

As you know, these men and women are continually reporting their findings to millions of investors, who rely heavily on this research in making up their minds about the purchase and sale of securities. Seasoned security analysts are the first to admit that the boundary separating speculation and investment is always shifting and never sharply delineated. It certainly isn't just the difference between six months and 12 months.

Revenue Estimates and Survey Results

The revenue estimates in the Ways and Means Committee report say that repeal of the alternative tax would yield $360 million in additional income to the Treasury, and extending the holding period would contribute $150 million more. We dispute both of these estimates, for they are based on the assumption that investors would continue to turn over their holdings at the present rate, that they would not change their investment habits. It is our belief that the enactment of these provisions would tend to freeze assets and discourage new investment, thereby bringing in less -- not more -- revenue.

Our belief is supported by the results of a recent survey of a cross-section of Merrill Lynch's 1.5 million customers regarding

H.R. 13270. The survey was conducted just before Labor Day weekend by Guideline Research Corporation of New York, New York, an independent organization specializing in marketing research. A total of 612 interviews were conducted in a dozen cities, New York, Los Angeles, Chicago, Boston, Cleveland, Washington, D.C., San Francisco, Dallas, Nashville, Grand Rapids, Dayton, and Kansas City, Kansas. Investors' names were randomly selected by Merrill Lynch account executives from their lists of clients in three income classes -- $10,000 to $20,000; $20,000 to $50,000; and $50,000 and over. The respondents had no prior knowledge of the impending interview, and the interviewers did not know the source of the names.

The results of the survey are presented in Exhibit A. In summary form, the study showed:

1. Investors accept the fact that net capital gains should be taxed, and this attitude prevails throughout all income brackets. Seventy-eight percent felt this way, although one out of five objected to any taxation of capital gains.

2. The investing public is quite aware of H.R. 13270, and 73 percent of the respondents opposed the passage of the capital gains provisions of the bill; 20 percent favored them. These attitudes varied little from one income bracket to the next.

3. Regarding the holding period, 68 percent favored six months

and 14 percent want a shorter period. Only one out of eight (12 percent) would agree to a longer period than six months. Significantly, respondents in all income brackets answered similarly on this count.

4. The projected investment behavior based on passage of the capital gains provisions of H.R. 13270 was tested regarding three provisions -- the holding period, the alternative rate and the change in the deductibility of capital losses. Assuming passage of all three provisions, 34 percent of the respondents said they would decrease their investments, six percent said they would increase them, and 54 percent said they would keep them about the same. The fact that more than a third indicated they would reduce their investments is considerable cause for concern. This response increased with income, with 39 percent of those in the top income bracket ($50,000 and over) indicating that they would decrease their investments.

As a pioneer in bringing the small investor into the securities market, and as a leader in investment banking as well, Merrill Lynch has built up a large list of customers who are representative of all income classes. Thus it is fair to assume that the response to the Guideline Research survey is indicative of how all investors feel about the capital gains provisions of the tax bill. If the results of this survey are a true gauge of what lies in store, the shortfall in revenue that the U.S. Treasury anticipates is an understatement.

Projecting the survey results across the broad spectrum of American investors, one sees that instead of enriching the Treasury by a total of $510 million, enactment of these two sections would undoubtedly produce less revenue than the Treasury now receives in capital gains taxes.

There is another revenue factor in the Ways and Means report that disturbs us. We cannot help but note that a bill designed to give tax relief to low- and middle-income Americans contains two provisions that increase the burden of capital gains taxes on taxpayers in all income classes. According to the revenue estimate for the extension of the holding period, taxpayers with adjusted gross income of less than $3,000, $5,000 to $10,000, or $10,000 to $20,000 would be paying a larger capital gains tax just as those in higher brackets would. Similarly, over 50 percent of the estimated revenue increase from the capital loss limitation would come from persons in the under-$15,000 category and two-thirds of the total would be generated by individuals with adjusted gross incomes of under $20,000. The effect of these provisions would be in marked contrast to other reforms in the bill, which are aimed at the high-income brackets.

Conclusion

In conclusion, our principal concern is that three sections of

the bill (Sections 511, 512 and 514) would tend to freeze capital assets and to reduce incentives to invest. As a result the liquidity of otherwise marketable securities would diminish, and this condition would be detrimental to economic growth. As Mr. Cohen testified, "Present capital investments would tend to be frozen and the economy as a whole would suffer."

Mr. Cohen's warning is well founded, gentlemen. Now is not the time to create further doubt about the future of the economy. The fallout from inflation is all around us, and the adjustment we have been patiently waiting for is still more of a promise than a reality.

In the meantime, paper losses in the value of securities have climbed to $125 billion since May, and that itself is quite a tax on capital. Bear markets feed on doubt and indecision. There is a large measure of both hanging over the securities markets today. Investors are seriously questioning whether shifting social and political tides can be channeled into the right course, or whether the legitimate cry for tax reform will lead to some uneconomic decisions. The final form this bill takes will be a key indicator that millions will be watching.

Thank you, Mr. Chairman.

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EXHIBIT A

A STUDY OF INVESTOR ATTITUDES TOWARD CAPITAL GAINS TAXATION AND H. R. 13270

RESEARCH METHODOLOGY

Six hundred and twelve telephone interviews were conducted among Merrill Lynch customers in twelve geographically dispersed cities through the country. The sample was segmented into three income groups of comparable size as follows: $10,000-19,999 (202), $20,000-49,999 (202), and $50,000 or over (208).

The investors' names were randomly selected by account executives from their lists of clients. Each city was responsible for a quota of names five times greater than the anticipated completion rate (200 per income group).

Neither the lists of names nor the envelopes in which they were sealed contained any Merrill Lynch identification. Further, in almost every case a local messenger service delivered the lists to the interviewing service. The messenger himself did not know the point of origin.

The respondent had no prior knowledge of the impending interview. If he inquired as to how he was selected, the interviewer, in truth, not knowing the source, replied:

"Guideline Research Corporation gave me a list which contained your name. I really don't know where they got the list."

Cities of varying size were included in the study. Larger cities were allocated a greater number of interviews than smaller cities. City size and availability of names in the required categories were the prime reasons for the disproportionate sampling.

The following table shows the number of completed interviews in each city by income segment.

City	# of Offices Sampled	Total Completed Interviews	Segments $50,000 or Over	$20,000-$49,999	$10,000-$19,999
1. New York	15	150	50	50	50
2. Los Angeles	6	112	40	36	36
3. Chicago	3	54	18	18	18
4. Boston	2	42	14	14	14
5. Cleveland	2	43	15	14	14
6. Washington, D.C.	2	42	14	14	14
7. San Francisco	2	43	15	14	14
8. Dallas	2	42	14	14	14
9. Nashville	1	21	7	7	7
10. Grand Rapids	1	21	7	7	7
11. Dayton	1	21	7	7	7
12. Kansas City, Kansas	1	21	7	7	7
		612	208	202	202

The Corporate Planning Department of Merrill Lynch was responsible for study design, questionnaire design and final analysis. Guideline Research Corporation, an independent research firm, was responsible for the interviewing and tabulations.

DETAILED RESULTS

1. Awareness of the Tax Reform Bill and of the Capital Gains Provisions

The Merrill Lynch customer considers himself very aware of the Tax Reform Bill and of its capital gains provisions. While knowledge of the bill's existence shows little appreciable difference among income groups, knowledge of the capital gains provisions increases with income.

	Total	$10,000-19,999	$20,000-49,999	$50,000 or Over
Aware of Tax Reform Bill	86%	85%	84%	89%
Aware of Capital Gains Provisions	65	58	66	72

2. Attitude Toward Capital Gains Taxation

Taxing capital gains seems to be accepted as a "necessary evil" and as such, something that must b lived with. To this end, almost eight out of 10 customers, regardless of their income, express the opinion that capital gains should be taxed.

	Total	$10,000-19,999	$20,000-49,999	$50,000 or Over
Should Be Taxed	79%	77%	77%	78%
Should Not Be Taxed	19	23	21	21
No opinion	2	--	2	2

3. Attitude Toward Passage of the Capital Gains Provisions of the Tax Reform Bill

While the theory of capital gains taxation is wholly subscribed to, passage of the three proposed capital gains provisions elicits precisely the opposite reaction. Seventy-three percent of the sample reject passage of the provisions while 20 percent are for passage.

	Total*	$10,000-19,999	$20,000-49,999	$50,000 or Over
For Passage	20%	22%	20%	16%
Against Passage	73	70	72	76

4. Overall Attitude Toward Length of Holding Period

The current six-month holding period meets with the approval of two-thirds of these Merrill Lynch customers. Among the remainder of the customers, there are as many who favor decreasing the holding period as there are those who want it increased. Income is not a factor here.

	Total	$10,000-19,999	$20,000-49,999	$50,000 or Over
Holding period should be:				
Increased	12%	12%	14%	11%
Decreased	14	15	13	15
Kept the Same	68	68	68	67

*Summary tables in the text of this report do not add to 100% because "no opinion" factor is not included.

5. Projected Investment Behavior Based on Passage of the Capital Gains Provisions

While reading through the following data, it should be kept in mind that in reaction to the possible passage of the provisions, over half the respondents state their investment behavior will remain unchanged. The exact number might not be the same, but this type of reaction can be assumed to occur in any similar situation short of something drastic. The proportion of investors who change in either direction is, therefore, smaller, but of at least equal significance:

a. Extension of the Six-Month Holding Period to One Year

If the provision to extend the six-month holding period to one year is passed, 21 percent of these ML customers claim they will decrease their investments in stocks during the next year. Planned increases are at a minimum (5%), while no change is foreseen by 65 percent.

Decreases in investments will occur more frequently among upper income investors ($50,000 or over -- 27%) than among upper middle income ($20,000-49,999 -- 20%) or middle income ($10,000-19,999 -- 17%) investors.

Extension of Holding Period	Total	$10,000-19,999	$20,000-49,999	$50,000 or Over
Increase investments	5%	6%	5%	4%
Decrease investments	21	17	20	27
Keep the same	65	67	67	62

b. Elimination of 25 Percent Maximum Rate

Elimination of the 25 percent maximum rate appears to have a more negative effect on the investor than the extension provision. In this respect, 30 percent of the ML investors claim that passage of this provision would cause them to decrease their investments next year, (8% said increase and 55%, keep the same).

Negative reaction varies directly with income ranging from a low of 20 percent among those earning $10,000-19,999 per year to a high of 38 percent among those with earnings $50,000 or more.

Elimination of 25% Maximum Rate	Total	$10,000-19,999	$20,000-49,999	$50,000 or Over
Increase investments	8%	10%	9%	4%
Decrease investments	30	20	31	38
Keep the same	55	61	54	51

There are a number of people who are not yet in the tax bracket that will be affected by this provision.

It is hypothesized that the reasons for their decreasing their investments in the next year if this provision is passed are:

(1) Elimination may be detrimental to large investors who, in turn, would reduce their investments. As a result, the breadth of the market would be narrowed;

(2) They are not yet generating incomes that would make this provision matter, but they anticipate the time when they would be;

(3) Undoubtedly, income does not completely reflect their tax positions; and

(4) A lack of knowledge.

c. Reduction of Deductible Capital Losses

Passage of the provisions that will reduce the amount of net long-term losses that can be deducted will have as much negative impact as the 25-percent elimination provision. However, the feelings are more universal and don't discriminate as greatly among income groups.

Thirty-two percent of the investors feel that passage of this provision will be cause to decrease their investments in the next year. Fifty-six percent say it will make no difference and 4-percent claim it will have a positive effect.

Reduction in Deductible Losses	Total	$10,000-19,999	$20,000-49,999	$50,000 or Over
Increase investments	4%	5%	5%	2%
Decrease investments	32	28	31	35
Keep the same	56	58	55	55

d. Passage of All Three

Among those who feel that passage of the capital gains provisions will affect their investment behavior next year, the feelings that evolve are decidedly more negative than positive. Further, as indicated earlier, the amount of income an investor has directly relates to his feelings about the provisions. Projected behavioral patterns of a negative nature are most pronounced among those with high incomes ($50,000 or over) and slowly decrease as income decreases.

Passage of all Three Provisions	Total	$10,000-19,999	$20,000-49,999	$50,000-or Over
Increase investments	6%	7%	7%	3%
Decrease investments	34	26	35	39
Keep about same	53	60	50	50

September 1969

Summary of Recommendations *

1. With respect to capital gains, we recommend that:

   a. A new system be created for the separate taxation of long-term capital gains of individuals, with more moderate rates of tax than at present.

   b. A credit against estate taxes of long-term gains of individuals be provided under the new system.

   c. A reasonable rule be enacted for allocation of interest deductions between income under the income tax system and long-term capital gains under the new system.

   d. Tax be eliminated on gains from sale of owner-occupied homes.

2. With respect to individual income tax rates, we recommend that:

   a. In H.R. 13270 rate reductions through the middle brackets be adjusted towards the goal of flattening the curve of graduation.

   b. The 50 percent maximum rate on earned income be enacted (Section 802 of H.R. 13270).

3. With respect to the corporation income tax, we recommend reduction in the top rate to 45 percent to take effect in the near future.

*of The Tax Council. From: FUNDAMENTAL REFORM CAPITAL GAINS AND INCOME TAX RATES, Statement of Roland M. Bixler in Behalf of The Tax Council before the Committee on Finance, United States Senate in the Hearings on H.R. 13270, Tuesday, September 16, 1969.

FUNDAMENTAL REFORM
CAPITAL GAINS AND INCOME TAX RATES

Statement of Roland M. Bixler
In Behalf of The Tax Council
before the
Committee on Finance, United States Senate
In the Hearings on H.R. 13270
Tuesday, September 16, 1969

My name is Roland M. Bixler. I am founder and President of J-B-T Instruments, Inc., a manufacturer of electrical instruments and electronic components located in New Haven, Connecticut.

I appear here on behalf of The Tax Council of which I am Chairman of the Board of Directors. The Council is a membership organization supported by business concerns, some large, some medium sized, and some small like my own. Broadly, the Council's purpose is to work towards a body of tax law in harmony with the economics of progress. We like to think of ourselves as a center for fresh and innovative thinking on tax issues of major importance to capital formation, economic growth and the creation of new and better jobs.

Consistent with its purpose, The Tax Council has developed two fundamental programs of tax reform, one in the capital gains area and the other on income tax rates.

The capital gains program implements a single idea, namely, that being transfers of capital the long-term capital gains of individuals do not belong in the income tax base.

Our program for reduction and reform of income tax rates also implements a single idea, namely, that taxpayers should have first but not irreversible claim to at least one-half of the increase in revenue which comes from economic growth.

We urge that H.R. 13270 be amende· to incorporate the Council program on capital gains, and to make modest change. consistent with the program on income tax rates. The major policy points which we propose for implementation in the pending legislation are summarized below:

Summary of Recommendations

1. With respect to capital gains, we recommend that:

   a. A new system be created for the separate taxation of long-term capital gains of individuals, with more moderate rates of tax than at present.

   b. A credit against estate taxes of long-term gains of individuals be provided under the new system.

   c. A reasonable rule be enacted for allocation of interest deductions between income under the income tax system and long-term capital gains under the new system.

   d. Tax be eliminated on gains from sale of owner-occupied homes.

2. With respect to individual income tax rates, we recommend that:

   a. In H.R. 13270 rate reductions through the middle brackets be adjusted towards the goal of flattening the curve of graduation.

   b. The 50 percent maximum rate on earned income be enacted (Section 802 of H.R. 13270).

3. With respect to the corporation income tax, we recommend reduction in the top rate to 45 percent to take effect in the near future.

Discussion and Complete Recommendations

A. Capital Gains

All capital gains have been taxed within the income tax system since its inception in 1913, but with special treatment (lower rates than on income) dating from 1922. For twenty-five years, the top rate (alternative tax) has been 25 percent. After studying capital gains for over a year, the Council last summer released a program for reform based on the belief that much of the controversy and unsettled atmosphere which pervades the field is due to its linkage with income taxation. H.R. 13270 confirms this belief by eliminating the alternative tax and by including gains in other provisions designed to increase the tax on high incomes.

Our original program contains seven major recommendations, as follows:

1. The new system. Creation of a new system for taxing long-term capital gains of individuals derived from transactions having all the characteristics of a transfer in capital assets. Rates of tax would be more moderate than at present, and there would be an appropriate form for reporting and paying this tax.

2. Holding period. Use of a holding-period test for separating gains to be taxed as transfers of capital under the new system, and ordinary income under the income tax system.

3. Long-term losses. That long-term losses of individuals on sale of assets under the new system be allowed only as an offset against long-term gains with unlimited carryover of excess losses.

4. Credit at death. Credit against estate taxes of the taxes paid on long-term gains by individuals. Under the new system, the taxed gains would be cumulatively recorded in a special box in each annual return filed during a

taxpayer's life. The total would be offset against any estate taxes otherwise payable at death.

5. Mixed transactions. No departure from present practice in taxing gains from mixed transactions, that is, the special treatment now accorded capital gains under the income tax system having characteristics partially related to transfer of capital assets and partially related to realization of income, including but not limited to those which are now generally known as "special statutory" gains.

6. Literary works, etc. That the works of creators of literary, music and artistic compositions be accorded the same tax treatment as the works of inventors, by creation of a new class of "special statutory" gains.

7. Sale of homes. That tax be eliminated on gains from sales of owner-occupied homes and of other properties not subject to loss offsets; moreover that short-term gains on sale of homes and other properties involved be relieved from tax unless loss offsets are provided.

Interest deductions. In addition to its original recommendations, the Council now recommends enactment of a reasonable rule for allocation of interest deductions between income under the income tax system and capital gains under the new system.

Major points in support of the separate system are:

- Enactment of the separate system would make clear that these long-term gains are really a part of capital and not of the income stream.
- Tax law would be cleansed of the taint so often associated with present treatment of gains by one branch of tax theory.
- It would no longer be possible to becloud the problem of tax burdens on high incomes by lumping together income and long-term gains.

- The economic implications of both the income tax, and the capital gain tax, could be more objectively observed, studied and evaluated.
- Revision in rates of tax on long-term capital gains would be related to factors peculiar to capital use and not to factors peculiar to receipt and use of income as at present.
- Because the tax would be a levy on the transfer of capital during life which would be transferred again at death, the case for offsetting the earlier tax against the later one would be evident. Thus, the problems of locked-in investments and fairness would be solved by minimizing instead of maximizing tax.
- The situation of gains with income characteristics receiving special treatment under the income tax system would be more clearly seen and appreciated.
- There would be less tax restraint on mobility and venturesome use of capital.

Suggested rate scales. The rate scales we suggest for long-term gains of individuals under the new system are set forth in Tables I and II for single and married taxpayers, respectively.

Table I

Suggested Rate Scale for Taxable

Long-Term Capital Gains of Individuals
(Single Returns)

Taxable Gains	Tax
Not over $5,000	4%
$ 5,000 - $10,000	$200 plus 7% of excess over $5,000
$10,000 - $15,000	$550 plus 10% of excess over $10,000
$15,000 - $20,000	$1,050 plus 13% of excess over $15,000
$20,000 - $30,000	$1,700 plus 16% of excess over $20,000
$30,000 - $40,000	$3,300 plus 19% of excess over $30,000
$40,000 and over	$5,200 plus 22% of excess over $40,000

Table II

Suggested Rate Scale for Taxable

Long-Term Capital Gains of Individuals
(Joint Returns)

Taxable Gains	Tax
Not over $10,000	4%
$10,000 - $20,000	$400 plus 7% of excess over $10,000
$20,000 - $30,000	$1,100 plus 10% of excess over $20,000
$30,000 - $40,000	$2,100 plus 13% of excess over $30,000
$40,000 - $60,000	$3,400 plus 16% of excess over $40,000
$60,000 - $80,000	$6,600 plus 19% of excess over $60,000
$80,000 and over	$10,400 plus 22% of excess over $80,000

In comparing these rates to those paid under the income tax system, the most important point to keep in mind is that they would be paid without regard to a taxpayer's income. This fact is of much less importance to people whose gains are taxed at the alternative rate of 25 percent at present than it is to those who have not yet built up substantial investment capital. Taxpayers whose gains are small in relation to income would benefit the most from breaking the link with income taxation. For example, a married taxpayer under the present system with a gain of $8,000 would pay an effective rate of 12.5 percent on the gains if his taxable income is $12,000 but 18 percent if it is $24,000. Under the proposed system, the same tax would be paid on any given amount of gains regardless of the amount of taxable income.

In addition to taxing small amounts of gains at up to the highest rates applying to capital gains, the present system taxes trivial amounts of gains if the taxpayer has taxable income. We suggest an exemption at $500 to avoid tax on trivial amounts of gains under the proposed system.

A reason sometimes given for advocating that all capital gains be taxed as income is that there are people who "live off their gains". Granting that there may be some such people, the fact is that taxing all gains as income would compound the discrimination against the working people who now pay tax on their gains "off the top of their income". The proposed system would end the present discrimination by bringing the tax on gains paid by those who earn income down to the same tax paid by those who do not work for a living.

It is of more than passing interest to recall in these proceedings that the program which the Kennedy-Johnson Administration submitted to Congress in 1963 would have substantially reduced the taxes on long-term gains.

Table III below shows the tax on $50,000 of long-term gains in relation to varying amounts of taxable income under four different tax methods.

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Table III

Comparison of Tax on Long-Term Gains of $50,000
According to Amount of Taxable Earned Income
(Married, Joint Returns)*

	Taxable Income	Tax on $50,000 of Long-Term Gains: Present System and Rates (1)	Proposals: Tax Council (2)	Proposals: 1963 Administration (3)	If Taxed in Full As Ordinary Income Under Present Rates (4)
1.	$ 0	$ 6,020	$4 840	$3,010	$17,060
2.	5,000	7,070	4,840	3,570	18,840
3.	10,000	8,100	4,840	4,200	20,480
4.	20,000	10,180	4,840	5,540	23,340
5.	30,000	11,770	4,840	6,680	25,660
6.	40,000	12,500	4,840	7,510	27,040

*The temporary surcharge is disregarded in all figures.

This table reveals a number of things, but especially illustrates how the Council program in taxing long-term gains would eliminate the discrimination against persons who earn income which exists under the present system and would have been continued under the 1963 proposals. If gains were taxed fully as income, the discrimination would be compounded. As shown by the table, a man earning $40,000 in income now pays about $6,000 more on $50,000 in gains than a man earning no income, but if gains were taxed at present income tax rates he would pay $10,000 more.

The next table relates tax-wise varying amounts of long-term gains to a stable amount of taxable income, $20,000.

Table IV

Comparative Tax on Gains of Married Taxpayers With $20,000 Taxable Income and Varying Amounts of Long-Term Gains *

			Tax on Gains Under		
			Present System	Proposals	
	Taxable Income	Long-Term Gains		Tax Council***	1963 Administration
			(1)	(2)	(3)
1.	$20,000**	$ 2,000	$ 320	$ 40	$ 192
2.	"	5,000	800	160	480
3.	"	10,000	1,640	360	960
4.	"	15,000	2,540	680	1,460
5.	"	20,000	3,500	1,030	2,000
6.	"	50,000	10,180	4,840	5,540
7.	"	100,000	23,340	15,580	13,280
8.	"	400,000	104,380	79,580	66,000
9.	"	1,000,000	250,000	212,580	190,600

*The temporary surcharge is disregarded in all figures
**Tax on income alone, joint return: $4,380
***Tax after two exemptions of $500

It will be noted that a middle-bracket income taxpayer with capital gains in the range of very modest up to something in excess of his taxable income would benefit the most under the Council program. This would be true as compared with the system now in effect as well as with the 1963 Administration program. At higher levels of taxable gains, benefits under the Council program would taper off percentage-wise but would still be quite significant as compared with the system now in effect. In the highest levels illustrated, however, the benefits under the 1963 Administration program would have been greater than the Council now proposes.

Unrealized Gains at Death. Under present law, gains not realized before death of a taxpayer are not taxed. This has led to a view held by a number of tax authorities that such gains should be taxed as part of the decedent's last income tax return, with remaining capital then being subject to estate taxation. Others have proposed that the unrealized gains be taxed twice within the estate tax system. Whichever way it might be done, the taxation of unrealized gains at death would mean a double simultaneous impost on a transfer of capital.

We cannot avoid, however, the fact that there is a problem of equity between the parties affected when gains are -- or are not -- realized before death. We also must recognize the effect on mobility of capital when gains are not realized in order to pass them untaxed to heirs. The question of policy is whether it is better to resolve such problems by increasing or decreasing the overall burden of taxes. Our view is that all possibilities for solution through decreasing taxes should be considered before contemplating an increase in taxes.

From this approach, there would be no reason to consider an increase in taxes to resolve the problems caused by unrealized gains at death. Even with long-term capital gains linked to the income tax system, it would be possible to work out an arrangement by which taxes on gains during life were cumulatively recorded and then credited against estate taxes at death. But the complete logic of the matter here, as with other aspects of taxing long-term gains, would be more evident if the link with income taxation were broken, and such gains taxed in the first instance under a separate system as transfers of capital.

Allocation of Deductions for Interest. When we prepared our capital gains program we had not contemplated any deductions against long-term gains of individuals except those now allowed as costs added to the basis for separate assets, plus the $500 exemption. This past winter we recognized that interest incurred in realizing capital gains is a cost which should be deductible against the gains and we amended the program accordingly. Specifically, in substitution for the provisions limiting the deduction of interest in Section 221 of H.R. 13270, we recommend for a taxpayer with long-term capital gains, and interest payments in excess of some figure such as $5,000 annually, the amount in excess of that figure be allocated as follows:

First, deduction under the income tax system up to the amounts of dividends, interest and 10 percent of other income included in adjusted gross income.

Second, deduction under the separate capital gains system up to the amount of otherwise taxable gains.

Third, deduction of any remainder under the income tax system.

B. Income Tax Rates

Basic program. This program would inaugurate regular, repetitive steps in reform and reduction of personal and corporate income tax rates when inflation has been contained. Its major elements are:

a. Pre-emption of at least one-half of the revenue growth, now estimated at $12 to $15 billion annually;

b. Substantial cuts in personal tax rates in all brackets with the greatest cuts through the middle brackets to flatten the curve of graduation;

c. Reduction of the top rate of corporate tax to 38 percent; and

d. Provision for temporary arresting of scheduled reductions by Congress if and when the public interest requires.

In preparing this program, we have been guided by five basic benchmarks as follows:

1. It is neither fair nor good economics to impose a sharply ascending scale of tax rates on the more ambitious, energetic and successful members of any given generation. This is the pattern of existing rates, and it is unfair because it is contrary to the accepted norm for compensation, namely, that whoever works longer, harder, and more effectively than the average deserves extra compensation. Graduation of rates penalizes those who are rewarded for extra effort by both private and public employers. The result is poor economics, we believe, because it arbitrarily reduces the amount of new capital in the most dynamic hands.

2. The greater the amount of capital available to any society, the greater will be its economic development and the higher its living standards. It is this factor more than any other which tends to be overlooked when tax policy is viewed from the short term. Taking a broader and longer view, whatever limits capital

limits economic growth and the creation of new and better jobs. Looking abroad, we always recognize the insatiable need for capital, but there is a tendency to overlook the application of this statement at home. It is not suggested here that tax policy should favor capital formation over current consumption, but there certainly is a case for getting much closer to neutrality as between the two than would be indicated by much of the economic literature of recent decades. This is the course which would lead to more growth with less inflation, to ever better jobs as well as more jobs, and especially to the best opportunities for those Americans who to the present have been counted among the disadvantaged.

3. The excessive rates and burden of taxes at the federal level inevitably create taxpayer resistance to state and local levies. It is evident that the fundamental corrective is moderation of both the rates and the burden at the federal level.

4. The same excessive tax rates, and the same excessive burden of taxation overall, inevitably would make it most difficult for the Federal government to meet a really major new national emergency. A significantly lower base of both rates and overall burden would put the national government in the position of being fiscally prepared to meet whatever emergencies may come hereafter.

5. In planning ahead, the government can maintain flexibility as regards that part of the revenue growth which is earmarked for tax reduction, but will lose flexibility as regards the part earmarked for spending. This is because a program of scheduled tax reductions may readily provide for arresting or even temporarily reversing any given reduction, but spending

programs do not lend themselves to this kind of procedure. It is true this procedure could exert a discipline on increased spending for domestic purposes by identifying the cost in terms of tax reduction dollars immediately foregone, but this would seem an attractive addition to budget-making procedures.

The reform of personal tax rates recommended by the Council is shown in Table V and illustrated in the chart which follows:

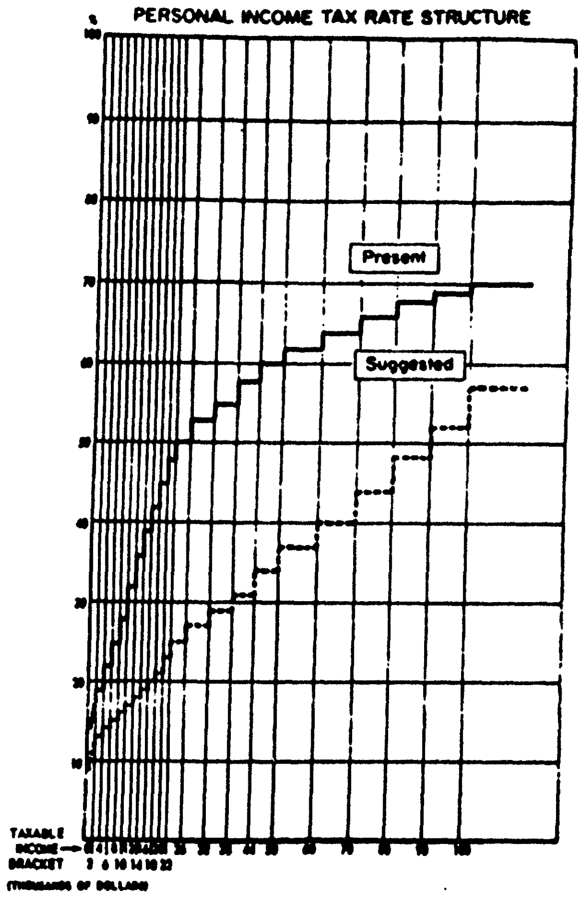
Table V

PERSONAL INCOME TAX RATE STRUCTURE
(disregarding temporary surcharge)

Taxable income bracket (single returns*)	Present	Suggested	Percent Rate Reduction
$ 0 - 0.5	14	9	36
0.5 - 1.0	15	10	33
1.0 - 1.5	16	11	31
1.5 - 2.0	17	12	29
2 - 4	19	13	32
4 - 6	22	14	36
6 - 8	25	15	40
8 - 10	28	16	43
10 - 12	32	17	47
12 - 14	36	18	50
14 - 16	39	19	51
16 - 18	42	20	52
18 - 20	45	21	53
20 - 22	48	23	52
22 - 26	50	25	50
26 - 32	53	27	49
32 - 38	55	29	47
38 - 44	58	31	47
44 - 50	60	34	43
50 - 60	62	37	40
60 - 70	64	40	38
70 - 80	66	44	33
80 - 90	68	48	29
90 - 100	69	52	25
100 and over	70	57	19

* brackets are double the given range for joint returns

Present and Suggested Rates
(disregarding temporary surcharge)



We estimate that effectuation of the personal rate cuts over a five-year period would result in tax reductions of something over $5 billion annually based on current income levels.

Adjustment in Middle Bracket Rates of H.R. 13270. Despite the benefits which would result therefrom, we realize it is too much to ask enactment of the Council's complete program at this time. However, we do urge the Committee on Finance to endorse the objective of flattening the curve of graduation through the middle brackets. As applied to the rate reductions in H.R. 13270, this principle would require adjustments in only a dozen brackets. These are shown in Table VI below:

Table VI

Personal Income Tax Rate Reform
(disregarding temporary surcharge)

Taxable Income Bracket (single returns*) (Thousands)	Present	H.R. 13270	Recommended Adjustments
$ 0 - 0.5	14	13	-
0.5 - 1.0	15	14	-
1.0 - 1.5	16	15	-
1.5 - 2.0	17	16	-
2 - 4	19	18	-
4 - 6	22	21	20
6 - 8	25	23	-
8 - 10	28	27	26
10 - 12	32	30	29
12 - 14	36	34	32
14 - 16	39	37	35
16 - 18	42	40	38
18 - 20	45	42	40
20 - 22	48	44	43
22 - 26	50	47	45
26 - 32	53	49	48
32 - 38	55	50	-
38 - 44	58	52	-
44 - 50	60	54	-
50 - 60	62	58	57
60 - 70	64	60	59
70 - 80	66	60	-
80 - 90	68	61	-
90 - 100	69	61	-
100 - 120	70	62	-
120 - 150	70	63	-
150 - 200	70	64	-
200 and over	70	65	-

*brackets are double the given range for joint returns

The reduction in rates with the adjustments we recommend would average about 10 percent through the middle brackets, or one-fifth of the full cuts contemplated in our complete program.

50% Maximum Rate on Earned Income. As a matter of principle, we believe that the top rate of tax on all income should be no higher than 50 percent. The maximum tax of 50 percent on earned income provided in Section 802 of the House bill is a long step in this direction. We agree with the Ways and Means Committee that this will diminish the pressures to avoid drawing down income as earnings. We also recognize that it would not be feasible in one step at this time to reduce the top rate on all income to this level. Accordingly, we endorse the provision as included in the House bill, and strongly recommend that it be retained in the final legislation.

C. Corporate Income Tax

As businessmen, we are acutely aware that the pace of business investment in the contemporary period is thought to be a major factor in the continued inflation. This spending, however, is the first line of defense against inflation over any period of time enabling as it does the production of more goods at lower unit costs. Such spending also is necessary to keep us competitive in international trade. It is noteworthy, moreover, that there is little or no evidence today that industry is building excess capacity, or putting new machinery in place which it cannot use effectively. The question then is what is industry doing wrong?

The answer is that too much current activity is being financed by borrowing and too little from savings out of current income. From this standpoint, the pending legislation is not going to help things. The drain of present taxes

on retained earnings of corporations is a primary cause of dependence on bank financing for expansion. It is a disturbing matter therefore that H.R. 13270 as passed by the House of Representatives would increase the overall tax burden on corporations by almost $5 billion.

As much as we want to get the current inflation under control, we don't want a new era of deflation with lagging growth and employment such as existed a decade ago. We are especially mindful that deflation would decrease the employment opportunities for marginal workers.

We therefore were most pleased to note the Administration's proposal for including in H.R. 13270 a one-percentage point cut in the corporate rate in 1971 and again in 1972. We do, however, recommend that the total cut be increased to three percentage points, or one and a half point in each year.

Conclusion

In conclusion, may I note that, if long-term capital gains of individuals were broken out of the income tax system, many aspects of capital gains taxation which have proven troublesome through the years would fall into a rational pattern. Overall, an unsettled and controversial field of tax policy -- a sort of breeding ground for reform proposals inimical to taxpayers -- would become one with a firm philosophic base consistent with the nature of capital and transactions in capital assets.

In the field of income tax rates, moreover, H.R. 13270 offers the opportunity to make a beginning towards full-scale reform over the years.

We appreciate the opportunity to present the thinking of The Tax Council in these hearings, and we hope our thoughts and suggestions prove helpful to you in your deliberations on improving the tax law.

WITNESS: David O. Ehlers, President
The Gibraltar Growth Fund, Inc.
Post Office Box 7171
Fort Lauderdale, Florida 33304

REFERENCE: Senate Finance Committee
Room 2227
New Senate Office Building

SUBJECT: Capital Gains Provisions,
H. R. #13,270

DATE: September 16, 1969

SUMMARY

1. Changes in the capital gains tax structure will create a further shortage of investment capital and contribute to inflation, higher interest rates, depressed securities markets and unemployment.

2. The Act as passed by the House fails to recognize the significant difference between capital and income.

3. The practical effect of the amendment will be to discourage needed capital investment at a time when such investment should be encouraged.

4. Domestic equity markets will become less attractive, inviting an outflow of investment monies to foreign markets.

5. To the extent that investable capital is eroded by the imposition of taxes, an inflationary expansion of credit results and this problem as it exists today will be aggravated by the present proposals.

6. The twelve month holding proposal will reduce to a dangerous extent liquidity in the securities markets and the long-term effect will be to reduce, not increase revenues to the Federal Government.

7. If additional revenues from taxation of capital are imperative, they should be raised through a kind of withholding tax on foreign investments. Wealthy foreigners deal extensively in our markets, taking advantage of our system yet making no tax contribution to its maintenance.

8. A healthy national economy demands more, not less capital investment. I propose a graduated capital gains structure, similar, but not identical to the present income tax structure. This progressive scale would reach a maximum rate at say, $300,000 per year and thereafter incremental gains would be taxed at a regressive rate.

STATEMENT

Mr. Chairman and Gentlemen of the Committee, my name is David O. Ehlers; I am engaged in the brokerage business in Fort Lauderdale, Florida, serving customers who invest very substantial sums in equity securities. I am also President of The Gibraltar Growth Fund, Inc., an open-end mutual fund with over 21,000 stockholders and investments in equity securities in excess of $75 million. I appreciate the opportunity to appear before you today as a concerned citizen to testify against adoption of capital gains amendments contained in the Tax Reform Act of 1969 passed by the House of Representatives last month.

Industrial, financial and governmental leaders have recognized and agreed for the past several years that a world-wide shortage of capital exists. The problem has not been corrected and all indications point to a worsening of the situation. This is true not only in the undeveloped nations of the world where it is so painfully obvious but in the industrialized countries as well, including our own United States, the most industrialized nation of all.

A clear indication of the shortage of capital in the United States is the present inflationary climate, including sharply rising interest rates, depressed securities markets, and increasing unemployment.

In the face of a serious shortage of capital and the accompanying

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alarming symptoms present in the economy today, the U. S. House of Representatives has included in the Tax Reform Act of 1969 amendments to the existing capital gains tax structure which can only have the effect of worsening the situation.

My purpose in appearing before you today is to make three basic points:

FIRST, that the capital gains amendments adopted by the House do not make allowances for the significant difference between capital and income;

SECOND, that the amendments will discourage needed capital investment at a time when such investment should be encouraged; and

THIRD, that as a result of the proposed legislation, our domestic equity markets will become less attractive and less liquid, thereby inviting domestic capital to consider domestic or foreign alternatives and foreign capital to cease its recent flow toward the U. S., thereby aggravating our already serious balance of payments problems.

There is a direct relation between capital and progress. A dramatic example of this relationship within the memory of many living in this country today is the depression of the 1930's. During that period investment capital disappeared. Our economy was stagnant. Savings were not being channeled into development of new industry or enterprises.

Since World War II, there has been generally a greater

recognition that a high rate of savings or investment is necessary to support a high rate of consumption; that the existence of one does not deny the other. Savings and consumption will both falter, of course, if there is not a steady expansion of credit and the supply of money. Credit and the money supply are expanded in our capitalist economy by savings being distributed through the nation's debt and equity markets. To the extent that investable capital is eroded by the imposition of taxes, an inflationary expansion of credit results.

The importance of capital investment to American industry can be suggested from Department of Commerce statistics published last month. During 1968 total expenditures for new plant and equipment were slightly more than $64 billion, while the total labor force on payrolls increased by about 2 million persons. This means that for each additional job created in 1968, industry had to spend about $31,000 in plant and equipment alone. Comparable figures for the more capital intensive manufacturing sector or our economy during the same period indicate an investment of about $79,000 for each new job. This high cost of creating new jobs emphasizes the large amount of capital necessary to sustain expansion of our industry and to employ our growing population.

The $64 billion needed to buy plant and equipment in 1968 came of course from a variety of sources, including bank loans and retained earnings as well as sale of securities. The Department of Commerce

reports that in 1968 American corporations raised approximately $16 billion of this amount from the sale of securities or 25% of the plant and equipment expendi*ures. The figures also show that on a percentage basis, total sales of equity securities (common and preferred stocks) about doubled in 1968 over 1967, while sales of debt securities (bonds) declined 20%. Because of a number of complex factors, industry appears to be relying more and more on equity financing and less on debt securities. It seems obvious that any policy that will negatively affect the sale of securities will jeopardize future plant and equipment expansion and the creation of new and better jobs for our increasing labor force.

It should be noted that the repeal of the investment credit contained in the Tax Reform Act will make less funds available internally to industry from profits. Thus, industry will become even more dependent on outside sources of capital. If outside sources are made less available, as I believe they will be because of the capital gains tax amendment, industry will have to curtail investment and will find whatever capital is available to be costly.

I heartily agree with a statement contained in THE WALL STREET JOURNAL's September 8th "Review and Outlook" column:

> "Thus Treasury Secretary Kennedy is quite right in telling the Senate Finance Committee that the House measure contains a bias against investment in favor of consumption. 'Such over-weighting, embodied in the proposed treatment of capital gains

as well as corporate tax increases, could impede economic growth in the years ahead by curtailing the incentive to make productive investments.'

"It is important, we think, to stress the long-term aspect here. If the economy is to maintain a much larger future population in conditions of reasonable well-being, a high degree of capital formation is absolutely essential. And intentionally or not, capital formation is one of the principal targets of the House bill."

Contrary to what apparently is assumed by many members of our national community, capital is not easy to create or to replace. It takes time, care and confidence to develop and nurture its increase. An increase in capital is very different from ordinary income earned from labor or sale of goods. True, it superficially looks the same. One may save by capital increase or save out of ordinary income. However, the increase in capital or gain "realized" when one asset is transferred for another really is not income at all. One "whole" has been exchanged for another "whole." When a person spends the increase in value he is really disposing of a part of his asset, not income. In short, there is nothing about a capital "gain" to distinguish it from the rest of the capital; the entire capital is equally as spendable or disposable.

This quality of capital gains distinguishes it from income. Since

the inception of federal taxation of capital gains this distinction has been recognized by Congress as one justification for extending different tax treatment in this area than imposed in the area of ordinary income. The amendments now enacted by the House largely ignore this important distinction, seeking to tax the increase in value of an asset as if it were ordinary income. Not only does the House disregard this basic difference between capital gains and income, but also it has, in an effort to reform the tax structure, chosen to ignore another basic reason for offering so-called "special treatment" for capital gains that has been recognized by past Congresses, namely the necessity of encouraging capital investment.

I firmly believe that the amendments enacted by the House, in particular the repeal of the alternative capital gains tax and the lengthening of the holding period, will result in investors curtailing investments so that expansion of the economy through creation of new or expanded facilities will be sharply reduced. The effect of repealing the alternative tax rate and increasing the holding period for capital gains on exchange of property will be most damaging to our equity markets and, in my opinion, the federal government is bound to <u>lose</u>, not increase, revenue as a result of the inevitable decline in the attractiveness of U. S. security investments. I am sure it is not the intention of this Congress to kill the goose that lays the golden egg.

The expansion of the holding period from six months to one year will lessen the attractiveness of an investment in the first instance, and

will further serve to postpone sale of securities that otherwise would be sold, reducing liquidity of the securities markets. The damage to be suffered inthe securities markets from loss of liquidity will be much greater than any revenue benefits that the House apparently feels will arise from denying long-term capital gains treatment to assets sold in the period seven to twelve months after acquisition.

Wealthy investors account for a major portion of the capital provided in our economy. The present alternative capital gains tax - a maximum of 25% on net long-term capital gains as opposed to the imposition of a regular tax on 50% of net long-term capital gains - does benefit the wealthier members of our community; but more important it is the encouraging factor that spurs the wealthy investor on to make his capital available. If the repeal of the alternative tax as provided in the Act is retained, there is no doubt that transactions will be curtailed and that the capital of the wealthy will be less readily available. Increasing the corporate maximum rate to 30% from 25% will have a similar adverse effect.

Other undesirable results can be expected from increasing taxes on capital gains. Possessors of large amounts of capital may be expected to shy away from common stocks, venture capital and other capital gains situations in favor of either taking capital abroad (perhaps even changing the domicile of the possessor) or deferring the realiz ation of capital gains. It seems apparent that at the very least possessors of capital will, upon consideration of the burdensome taxes imposed, begin to look elsewhere than

the organized domestic stock markets for investing their capital. I believe that investment funds in our free enterprise economy should be permitted to flow to the point where return is maximized, and should not be impeded by artificial tax considerations which will further aggravate capital shortages.

The Nation's already serious balance of payments problem may be worsened by passage of laws non-beneficial to holders of capital. In 1968, our balance of payments was greatly aided by an estimated $2.3 billion of U. S. securities purchased by foreigners. * After a number of years of decline, foreign confidence in U. S. common stocks is on the increase because of, for among other reasons, the substantial levels of foreign sales of American mutual funds. To the extent that our equity markets deteriorate in liquidity or attractiveness, foreign investors will look to other forms of and areas for investment. Thus, the significant inflow of foreign capital may well be expected to decline, thereby compounding the already unfortunate balance of payments problem.

CONCLUSION

I feel that the amendments to the existing capital gains tax structure adopted by the House in the Tax Reform Act ignore the difference between increase in value of capital and income, the need to encourage rather than discourage capital savings or investment, and the dangers to the economy and securities markets. While I have directed most of my remarks to the effect on securities markets of but two of many proposed amendments, it is my opinion that the amendments, as a whole, by increasing the tax burden

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* FORTUNE MAGAZINE, August, 1969

on holders of capital or reducing their freedom of action will have serious negative consequences for all capital markets in this country.

Therefore, I respectfully urge the rejection of the capital gains amendments contained in the Tax Reform Act of 1969, and suggest instead that consideration be given to setting up a separate structure for taxation of increase or "gain" of capital, apart from the income tax. This would give clear recognition to the distinction between capital increase and ordinary income, and would permit incentives needed to attract capital required to benefit the long range needs of our economy. Further, it would increase revenues to be collected by the Federal Government, not only through sums realized by a capital gains tax but also through the tax revenue from the general increase in business activity that would result.

This might best be accomplished by progressive tax on capital gains at a rate lower than that applicable to ordinary income. At some point, say $300,000 of capital gains for the year, incremental gains would be taxed at a declining rate. While the decline might appear to be somewhat novel, I believe that it would permit possessors of substantial capital freedom and flexibility not now possible to channel great amounts of capital to points where new capital might otherwise not be available, so that new industries and jobs could be created for our growing population.

A further innovation might include taxation at the source of foreign investors' capital gains. Capital gains of foreigners currently are not taxed. By placing their capital in our economy, foreign investors are, in essence,

utilizing the advantages of the most highly developed nation in the world without contributing to its support. In this respect, these foreign investors enjoy a free participation in the American economy not accorded our own citizens. In all fairness, foreign capital should be willing to bear a fair share of our tax on capital gains.

Thank you.

Testimony before the Committee on Finance
United States Senate
September 16, 1969

REFORMING CAPITAL GAINS: THE $100 BILLION MISUNDERSTANDING

By

Dr. Harley H. Hinrichs*

SUMMARY

1. Professional economists and students of public finance generally agree that the capital gains provisions of H.R. 13270 are an improvement over existing tax law. The Treasury proposals are not.

2. Further significant improvement can be made:

(a) Treating capital gains as ordinary income in the context of income averaging and lower top rates (to 50% or below) would be the most significant tax reform that the Senate could accomplish. This would:

--generate up to $8.5 billion in new revenues making other reductions and reforms possible.

--enormously simplify the tax code (and H.R. 13270).

--advance both equity and economic growth.

(b) Closing the $3 billion loophole of allowing $20 billion in capital gains annually to escape taxation by transfer at death would eliminate the present reward of a tax-free step-up in basis. This would:

--unlock capital now frozen in anticipation of the tax-free transfer at death. The financial community would serve its best interest by promoting such a reform. Furthermore, this reform combined with the House-passed 12-months holding period would increase capital mobility and improve the allocation of resources. Indeed the Treasury recommended it in 1963.

--greatly improve the equity of the tax system and at the same time generate up to $15 billion between 1970 and 1975. As a minimum start capital gains accrued after January 1, 1970, can be included; better yet, past gains (some $400 billion in gains outstanding held by some 4 million top wealth-holders) represent a potential federal revenue flow of nearly $100 billion which should not be allowed to escape over the next generation.

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*Associate Professor of Economics, U.S. Naval Academy, and Lecturer in Economics, University of Maryland Graduate School; member of the Editorial Advisory Board of the National Tax Journal, the official journal of the National Tax Association, and Consulting Editor of the Center for Political Research, publisher of the National Journal. The views expressed in this paper are those of the author and do not necessarily reflect the views of any of the above organizations. The author was a Fiscal Economist, Office of Tax Analysis, Office of the Secretary of the Treasury, and participated in preparation of the Revenue Acts of 1962 and 1964.

BASIC DATA SUMMARY FOR CONSTRUCTIVE REALIZATION OF CAPITAL GAINS AT DEATH

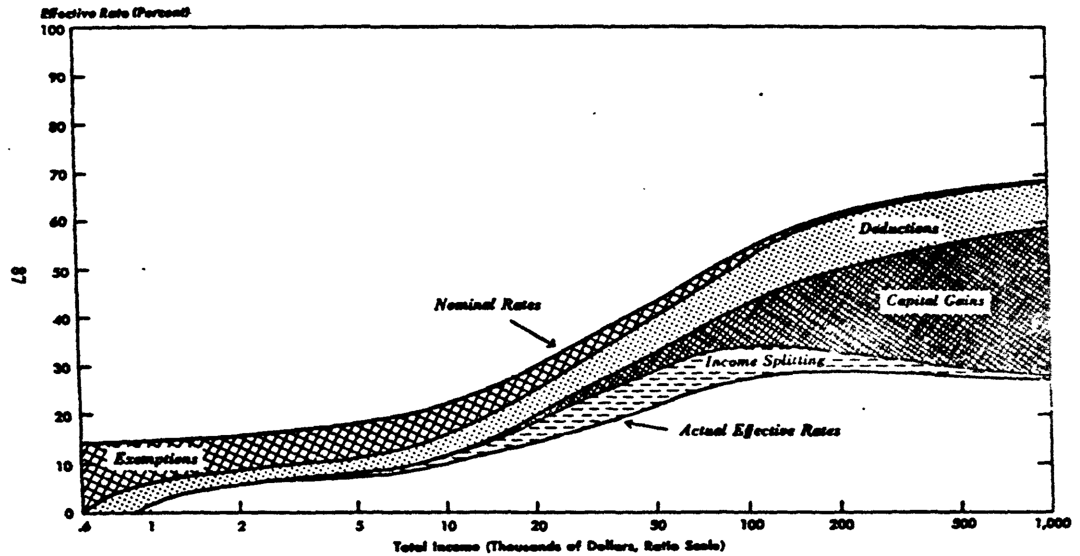
(billions of $)

Appreciable Assets	Individual Wealth			Decedents' Wealth			Decedents' Unrealized Capital Gain		
	Total	Top[1]	Other	Total	Top	Other	Total	Top	Other
1953									
Real Estate	$442.6	$ 70.1	$372.5	$9.757	$1.552	$8.205	$4.545	$0.853	$3.692
Stock 2/	127.2	105.7	21.5	3.487	2.983	.504	1.463	1.312	0.151
Non-Corp. Equity	187.4	20.0	167.4	4.498	0.480	4.018	1.397	0.192	1.205
Total	$757.2	$195.8	$561.4	$17.742	$5.015	$12.727	$7.405	$2.357	$5.048
1958									
Real Estate	$ 633.3	$114.0	$519.3	$13.934	$2.509	$11.425	$6.521	$1.380	$5.141
Stock	252.0	216.7	35.3	5.797	4.985	.812	2.437	2.193	.244
Non-Corp. Equity	243.8	31.7	212.1	5.850	.760	5.090	2.059	.304	1.755
Total	$1,129.1	$362.4	$766.7	$25.581	$8.254	$17.327	$11.017	$3.877	$7.140
1963									
Real Estate	$ 800	$160	$640	$17.600	$3.520	$14.080	$ 7.390	$1.760	$5.630
Stock	400	350	50	9.200	8.050	1.150	3.890	3.540	.350
Non-Corp. Equity	300	45	255	7.200	1.080	6.120	2.270	.430	1.840
Total	$1,500	$555	$945	$34.000	$12.650	$21.350	$13.550	$5.730	$7.820
1968									
Real Estate	$1,300	$250	$1.050	$28.600	$ 5.500	$23.100	$12.490	$2.750	$9.740
Stock	580	500	80	13.300	11.500	1.800	6.470	5.750	.720
Non-Corp. Equity	500	100	400	12.000	2.400	9.600	5.040	1.200	3.840
	$2,380	$850	$1.530	$53.900	$19.400	$34.500	$24.000	$9.700	$14.300

1/Gross Estate tax filers (assets over $60,000)
2/Stock held by individuals but excluding personal trust fund-held stock.

Source: Harley H. Hinrichs, Center for Political Research; estimates for 1953-63 originally prepared for the Office of Tax Analysis and these Hinrichs estimates are published with their methodology in Martin David, Alternative Approaches to Capital Gains Taxation, Brookings Institute, 1968, p. 100.

FIGURE 4-4. Erosion of Statutory Bracket Tax Rates Through Various Provisions of the Individual Income Tax, 1964 Act[a]



Source: Joseph A. Pechman, *Federal Tax Policy* (Brookings Institution, 1966), p. 66.

[a] Based on 1962 incomes, with rates applicable beginning Jan. 1, 1965.

Summary of Statement

I recommend to the Finance Committee that the capital gains tax law be amended to provide for realization of gain or loss upon a gratuitous transfer of property, inter vivos or at death, on a comprehensive basis.

The question whether this change in the income tax law should be made is one of legislative policy. The Constitution leaves the Congress free act in this matter. And the drafting difficulties that would be encountered in connection with this change in the law are not peculiarly difficult.

The national economic consequences of either leaving the capital gains tax law in this area as it is, or changing to realization at death as I recommend seem sufficiently minor so that the legislative decision need not be greatly influenced by this factor.

I think that the key factors are the weight to be attached to the burdens placed by the income tax law upon family interests in an adequate level of annual maintenance on the one hand, and family interests in the inheritance of property on the other. In these terms, I think that our present practice of forgiving the gains tax upon appreciated assets retained until death is inappropriate because it results in an unjustifiable subsidy to the interests of *some* families in the inheritance of property, as opposed to the interests of others in such inheritance, and because this subsidy to inheritance seems incongruous in the light of the burdens placed by our mass income tax upon family interests in annual maintenance.

A Recommendation that H.R. 13270 be Amended to Provide, Comprehensively, for the Realization of Capital Gain or Loss on Transfers of Capital Assets by Gift or at Death, and that Unrealized Gains in Respect of Property Held in Trust be Taxed Once in Each Generation--And a Comment Upon a Related Aspect of Federal Estate and Gift Tax Reform

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Let me first state the change in the gains tax law which I am supporting. At least since 1918, the federal income tax law has provided that assets owned by a decedent at his death should acquire a new cost basis for federal income tax purposes in the hands of the decedent's successors. The Section of the Internal Revenue Code of 1954 which so provides is Section 1014. This new cost basis is equal to the market value of the assets at the date of death (with limited exceptions which may be ignored for present purposes). The result of this new basis is to permanently eliminate the payment of gains taxes on any appreciation in the value of such assets during the period of the decedent's ownership. (*E.g.*, if A bought shares of X stock for $10,000 thirty years before his death, and still held them at his death when they were worth $50,000, the new basis would be $50,000, and no gains tax would be due if A's executor sold the shares in the course of administration of A's estate.) Of course,

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this new basis at death can wipe out deductions for unrealized capital losses too--if an asset declines in value between the date that a decedent acquires it and the date of his death. But since investors are more prone to retain their successful investments than their unsuccessful ones, the principal consequence of this new basis at death is the "forgiveness" of the gains tax on appreciation.

The change in the gains tax law that I am supporting would realize these gains at death, requiring payment of the gains tax in a decedent's final federal income tax return, which will be filed by his personal representative after his death. In the illustration above, A's representative would report A's $40,000 of appreciation in X stock in A's final income tax return, and pay a gains tax on this appreciation. This change in the law is commonly referred to as a change from "gains tax forgiveness at death" to "gains tax realization at death," and I will use this terminology here.

I also support the realization of unrealized gains in the event of an inter vivos gift of an appreciated asset, the gain to be taxed to the donor in the year of the gift. In the case of gifts made since 1920, the donor's cost basis has "carried over" to the donee. The Section of the Internal Revenue Code of 1954 which so provides is Section 1015. (Again, there are some refinements which may be ignored for present purposes.) This statutory solution is commonly referred to as a "carry-over basis rule," and I will use that term here.

It is true that the carry-over basis rule of Section 1015 does not immediately result in gains tax forgiveness, as does

the forgiveness at death rule of Section 1014. Indeed, if the donee immediately sells the property, any gains will immediately be taxed. But the donee may not sell. If an individual, he may retain the property until his own death and achieve forgiveness of the gains tax. If a trustee, he may retain the property throughout the term of the trust (which may be a century or more), and then distribute it (in a non-taxable transaction) to terminal beneficiaries.

Realization at death has been discussed academically for years, and was recently proposed to the Congress. The Kennedy Administration presented restrained proposals of this kind to the Ways and Means Committee of the House in 1963. The Committee failed to approve them. Why, then, do I revive the topic at this time?

In a few words, the reason is that I think realization at death may have been rejected by the Ways and Means Committee in 1963 because of errors of judgment made in developing and supporting the proposal, and that I have some arguments to offer in support of realization at death which the Finance Committee, and ultimately the Congress, may find to be persuasive.

The Kennedy Administration presented its realization at death proposals as part of a revision of capital gains taxation which included a lowering of gains tax rates, and advocated realization at death primarily on the ground that if an investor knew that he would have to pay gains taxes on his appreciated assets at death if not before, the "lock-in" effect of the gains tax would be reduced. That is, investors would be less likely to retain appreciated assets that, gains taxes aside, they would

prefer to sell in order to make more attractive alternative investments, if they knew that they would ultimately have to pay the gains tax anyway.

I am not a formally educated economist, but I have a basic understanding of public finance, and have worked to some extent with public finance economists. I have studied the economic aspects of realization at death in general, and the "lock-in" problem in particular, with some care. I was ultimately able to summarize the results of that work in about nine pages of a Law Review Article. My conclusions, in most pertinent part, are as follows:

> "This brief look at the economics of gains tax forgiveness and realization at death suggests that it does not matter much to the national economy which choice is made.
>
> "Apparently, the "lock-in" effect of conditioning the gains tax, inter vivos, upon a voluntary transfer would be somewhat reduced by realizing gains at death, though the national economic significance of the change seems slight."[1]

There is evidence that the Ways and Means Committee is not much impressed with the "lock-in" problem in the current proposals of the House Bill to somewhat increase capital gains tax rates and lengthen the required holding period.[2] But even if one _is_ impressed with the economic importance of keeping gains tax rates down in order to minimize "lock-in" effects, it does not follow that realizing gains at death would solve the "lock-in" problem. The central difficulty with gains tax realization at death as a "lock-in" remedy is that it is only helpful insofar as owners of appreciated assets decide whether to retain or sell them "in contemplation of death"--that is,

with an eye to the alternative of holding the assets until they die in order to avoid the gains tax. And it is not very easy to accept the idea that the national economy is heavily dependent upon the investment decisions of people (or those of the investment advisers of people) who expect to die soon enough so that holding appreciated assets until death appears as a prominent alternative to "selling now."

Having concluded myself that the Kennedy Administration's economic case for gains tax realization at death was not a very strong one, I have supposed that the Ways and Means Committee might have reached the same conclusion. And if they did, the Committee may also have thought that this realization at death proposal ought not to be enacted until a further case was made for it.

I have spent a substantial amount of time investigating the subject since the Kennedy Administration's proposal was advanced, and have emerged from that investigation with a further case that I find persuasive. This case of mine was published in the Minnesota Law Review in the Fall of 1967,[3] and I have brought along some reprints for such use (if any) as the Finance Committee Staff might wish to make of them.

Much of this Law Review discussion is concerned with essential technical matters which need not be reviewed here. Thus this discussion includes an investigation of the constitutionality of gains tax realization at death. (I am satisfied, for reasons elaborated there,[4] that the Finance Committee need not hesitate to support gains tax realization at death because of constitutional doubts.) And this discussion concludes with a

review of the technical drafting problems that would be encountered in giving legislative expression to gains tax realization at death. (I am satisfied, for reasons elaborated there,[5] that the Finance Committee need not hesitate to support gains tax realization at death because of drafting difficulties.)

What I want to discuss here are the basic reasons why I think that gains tax realization at death should become a part of our income tax law, immediately, and on a comprehensive basis. These reasons are not elaborate. They are as follows.

First, most gifts and transfers at death of appreciated assets are made to, or in trust for the benefit of, members of the transferor's family.[6] (Transfers to charity are not uncommon, particularly in disposing of large estates, but they raise distinguishable questions regarding the appropriate scope and character of subsidies to charitable giving, so I put them to one side for purposes of this discussion.)

When we forgive the gains tax at death by giving the deceased property owner's successors a basis for his appreciated assets equal to their market value at his death, the practical result, then, is very largely a subsidy to the transfer of wealth within the family. The result is a subsidy because forgiving the gains tax leaves more wealth in the hands of the family than would be the case if the gains tax had to be paid. This fact alone is not a reason for opposing gains tax forgiveness. I have developed at length in the Law Review discussion already referred to my reasons for believing that the interests of families in the financial security and opportunities of their successive generations are important social interests which are entitled to respect under our progressive income, gift and

death tax structure.[7] The objection to the subsidy afforded by gains tax forgiveness is that it is an irrationally distributed one. This is my next point.

Family interests are of fundamental importance in our society, for the obvious reason that the society is by and large composed of families. The family is our foundational social unit. Therefore it makes no sense to have a tax structure which contains subsidies to the financial security and opportunities of the members of <u>some</u> of the families in the society, to the relative detriment of the financial security and opportunities of the rest, unless those subsidies can be justified as achieving something of importance for the society that could not as readily be achieved without them.

Gains tax forgiveness at death cannot pass this test.

No significant national economic interests are served by forgiveness at death that could not be served, equally well, by offsetting changes in the tax law that do not involve comparable subsidies. (I do not say that gains tax forgiveness cannot be supported by economic arguments. As my late teacher Grover Grismore used to say of the Law of Contracts, "You can find authority for anything." Indeed, I know of an estate planner who is full of economic arguments in favor of forgiveness at death. I only say that, if the Finance Committee consults professional economists of good competence in this matter, they will support my conclusion.)

More specifically, gains tax forgiveness does not have peculiar value to the economy as a source of incentives to work,

save or invest.[8] And gains tax forgiveness does not have peculiar value to the economy as a subsidy to the formation of private capital.[9] And gains tax forgiveness is not required in order to avoid economically undesirable liquidation problems in administering the estates of decedents.[10] And gains tax forgiveness certainly does not contribute to eliminating the "lock-in" problem in an economically indispensable way. (It will be recalled that the Kennedy Administration advocated realization at death as a solution to the "lock-in" problem.)

And, turning from the interests of the economy as a whole to family interests, gains tax forgiveness is not a plausible subsidy to family interests in the inheritance of property.

Assuming that family interests in the inheritance of property are entitled to due consideration in designing the tax structure, gains tax forgiveness is not a plausible subsidy to family interests in inheritance. It is true that a fellow who gives his appreciated assets to the members of his family inter vivos, or retains them until his death and then transfers them to his spouse, or children, or other relatives, has demonstrated that he wanted the transferees to have the assets. But another who has found it necessary, or desirable, to sell his appreciated assets during his lifetime scarcely demonstrates, by selling them, that he is less interested than the first in the economic welfare of his spouse, or children, or other relatives. What he has demonstrated instead is that he thought it was a good idea to sell. Logically, this decision does not involve any rejection of the interests of one's family.

Also, in terms of the priority of family interests, it is hard to see why the family interest in inheritance should be subsidized to a greater degree than the family interest in current maintenance. There are more families in the society that have an immediate interest in an adequate level of annual maintenance than there are families that have an immediate interest in the inheritance of material amounts of property. Yet we have found it necessary to resort to mass taxation under the federal income tax, and hence to raise a great deal of revenue from families that have relatively modest incomes. If we are to continue to do this, it seems inevitable that we will not be able to exempt incomes that are reasonably required to fund an adequate level of current family maintenance. And if this last is so, it seems inevitable that gains tax forgiveness at death will remain vulnerable to the objection that family interests in the inheritance of property ought not to be subsidized in preference to family interests in an adequate level of current maintenance. The gains tax, after all, is levied at preferential rates, which are not notably progressive at the maximum--even under the House Bill, which would increase the maximum gains tax rate to one-half the maximum tax rate on ordinary income.

It is true that the inheritance of property is restrained by federal gift and death taxes which do not apply to family income that is devoted to maintenance expenditures, but it does not follow that these taxes are adequate substitutes for collecting the gains tax at death if not before. The basic reason is that federal estate and gift taxes apply in the same way to family wealth, whether or not it was accumulated with the aid

of the subsidy of gains tax forgiveness, and without regard to the extent to which its accumulation was otherwise impeded by the income tax. It does not seem practicable, therefore, to use these taxes to perform the function of gains tax realization at death.

Gains tax realization at death is not objectionable, either, on the ground that it would result in excessive taxation of the inheritance of property, because of our pre-existing federal estate and gift taxes. Any such exception necessarily assumes that family wealth which has been accumulated without the aid of gains tax forgiveness is now exposed to excessive taxation under the existing gift and estate tax laws. Instead, gains tax realization at death should be enacted, and federal gift and estate tax rates whould then be reviewed in the light of the fact that they will be imposed as a second, or subsequent, tax on family wealth that has already been reduced by the income tax.[11]

The foregoing will suffice as a terse statement of my general case for gains tax realization at death. I have also said that realization at death should be enacted on a comprehensive basis. Something should be said about this, though apart from one's view of the persuasiveness of the general case, the question of comprehensiveness is inevitably a matter of addressing particular questions, and many more of them are addressed in my Law Review discussion, already referred to, than can be addressed here. For present purposes, four, hopefully well-chosen, points may be made.

First, would it not make sense to have a reasonably substantial exemption, in order to avoid reducing "small estates" by

realization at death? I think not, in view of the very low level of exemption permitted under the income tax for incomes devoted to family maintenance. Exemptions on grounds of administrative convenience (e.g., in respect of personal belongings, and household furnishings, which, with the exception of a few categories of valuables, are likely to be worth less than their cost on the second-hand market) would, of course, be appropriate.

Secondly, since a surviving spouse in community property states is regarded as the owner of one-half of the spouses' community property, presumably one-half of unrealized community property gains ought not to be realized on the death of the first spouse to die. Therefore, in order to achieve equality of treatment for surviving spouses in non-community property states, ought there not to be an "equalizing" exception to realization at death for appreciated property passing to a surviving spouse? I think not, despite the availability of analogies to income-splitting between spouses, and to the federal estate tax marital deduction. Income splitting between spouses, unlike gains tax forgiveness, does not exempt income from taxation, and, unlike a carryover basis rule, does not permit indefinite future deferral of the income tax--income splitting between spouses only reduces the tax rate, and capital gains already benefit from a preferential rate. And an exemption of a deceased spouse's unrealized gains from realization at death, insofar as his appreciated assets were transferred to his surviving spouse (perhaps subject to a ceiling of one-half by analogy to the community property situation and the estate tax marital deduction) could result in the forgiveness, or indefinite deferral, of tax on a very large amount of gain. Again, in view of the low level of exemption permitted

for incomes devoted to family maintenance under the income tax, this does not seem sensible. So I think that, in this situation, the way to equalize treatment of surviving spouses in common law and community property states is to apply realization at death to both the deceased and the surviving spouse's share of unrealized community property gains. (I do not suggest that there is a strong case for such equalization; arguably, the co-tenancy of community property spouses should be recognized for realization at death purposes. After all, there are differences between the marital property rights conferred by community property statutes, and those generally prevailing in other states.)

Third, if gains tax realization at death is to be enacted comprehensively, does it not follow that life insurance gains should be taxed to the owner-insured of a life insurance policy, who "gains" the proceeds by his death? Analytically, this is a difficult question, which is treated at greater length in my Law Review discussion than seems appropriate here.[12] For present purposes, suffice it to say that, at least in the case of the proceeds of "pure" life insurance (i.e., proceeds in excess of policy reserves--policy reserves contain an element of accrued, but un-taxed, interest) purchased to insure the policy beneficiaries against the premature loss of the income-producing capacities of the insured, I think the answer is no. Statistically, the families of "bread-winners" are unlikely to be fully insured against the loss of future income through the premature "bread-winner" deaths. So the proceeds of insurance on such a decedent's life are unlikely to equal the provision which the insured would have made for the policy beneficiaries, had he lived out his productive expectancy. Arguably, as a

matter of social insurance, the surviving contemporaries of such under-insured decedents ought to make the latters' income tax contributions to the cost of government, leaving the life insurance proceeds for dependents.

To be sure, owners of appreciated assets may die prematurely too, but they will not in the average case, and asset appreciation is not normally created by the death of the owner of the asset. Conversely, "pure" life insurance gains are created by a death that is statistically premature.

Fourth, and finally, what should be done to insure that unrealized gains are realized, periodically, in the case of assets which appreciate in the hands of a multi-generation trustee? I think that such realization should be provided for in the course of enacting realization at death legislation. But the kind of case in which this problem arises is one involving enough factual detail to require a rather lengthy illustration, and since the same sort of illustration will be required in connection with my next, and final, topic, economy of words will be served by deferring this final point.

So much for the comprehensiveness of the realization at death remedy that I recommend. It remains to supplement the general case for realization at death, and the particulars just discussed, with some attention to an unmanageable topic that is broader than either, viz: assuming that a comprehensive realization at death remedy of the sort just described would improve the income tax structure, would it not be preferable, in terms of fairness, to postpone the adoption of this remedy, pending other reforms in the income, estate and gift tax law to eliminate more flagrant instances of subsidies to family interests in the inheritance of property?

I addressed this topic in a limited way in the Law Review discussion previously referred to,[13] suggesting that the adoption of realization at death ought not to be deferred on this final ground. I have not changed my mind. But since the publication of that discussion, I have about finished another (regarding the avoidance of gift and estate taxes by means of multi-generation transfers in trust) in the course of which I have given this topic further thought. Hence some of the comments which follow.

Again, only an illustrative discussion is possible here. For illustrative purposes, let us consider the relative priority of enacting gains tax realization at death, and of doing something equally comprehensive to eliminate the avoidance of gift and estate taxes by means of multi-generation trusts (which, under present law, can insulate family wealth from federal estate and gift taxation for a century or more). Let me illustrate this estate and gift tax problem (referred to in a current American Law Institute study[14] as "The Generation-Skipping Problem") with a hypothetical case, which, in its federal estate and gift tax aspects, seems quite realistic.

Case A

In 1932, anticipating the imminent permanent enactment of the federal gift tax, A, aged 55, transferred stock in several family corporations of the market value of $1,000,000 to "independent" trustees (who were nonetheless reliably interested in maintaining business connections with A and A's family). A's federal income tax basis for the stock was $100,000 (its value on March 1, 1913). The trustees were authorized to retain this

stack, and to participate in corporate reorganizations, and were directed to pay the trust income to A's daughter D, aged 30, for life, and then to her surviving daughter G, aged 5, for life, the principal to be distributed upon G's death to her then-surviving issue per stirpes, or if none then over to other issue of D.

Now, in 1969, the trustees hold stock in several additional corporations in which A's family is interested, but this stock was all acquired in the course of income tax free corporate reorganizations, so that all of the stock held by the trustees still has an aggregate basis of $100,000. Its market value, however, is now $10,000,000. A is deceased, having paid no gift or estate taxes in respect of the trust property, which was of the market value of $6,000,000 when A died in 1960. D is now aged 67. When she dies, no estate taxes will be payable in respect of the trust property. G is 42, and has four children, ranging in age from 20 to 10 years. When G dies and the trust property is distributed, no estate taxes will be payable in respect of the trust property. Thus the actuarial probabilities are that the first estate tax liability to which this trust property will be exposed will be in another 50 to 70 years, upon the successive deaths of G's children. Thus far, no gains taxes have been paid by the trustees in respect of the appreciation in the value of the trust property which has occurred since 1913. Conceivably, no gains taxes will be payable at all in respect of this appreciation, for the trustees might not make a taxable sale of this stock prior to the termination of the trust on G's death, the distribution itself would not be a taxable event, and

G's four children might retain their stock until their deaths, and if gains tax forgiveness is still in the income tax law in 50 to 70 years, their successors will get a new basis for the stock equal to its then market value.

This hypothetical case is surely atypical in its assumption of a trust principal that has never been exposed to an income tax, and in its assumed deferral of gains taxes for more than 50 years. Also, the emphasis placed upon the possibility of further deferral for another half-century or more is conjectural. These aspects of the case, do, however, highlight the final point regarding the need for a comprehensive realization at death remedy which was previously deferred--that there must be some provision for periodic realization of gain in the case of assets held in trust over several generations, if such trusts are assuredly to be prevented from postponing the realization of gains over very long periods of time.

Such a supplemental remedy would be necessary in cases, such as Case A, in which successive generations of trust beneficiaries did not have a sufficient interest in the trust property to cause that property to be included in their estates for federal estate tax purposes at death. And since the gains tax is not a notably progressive version of the income tax, it is hard to see why the opportunity for such prolonged deferral should be permitted to remain open--even though the retention of an appreciated asset in a trust for more than a generation may be more or less unusual.

Moreover, unless a currently enacted realization at death remedy were extended to multi-generation trusts such as this,

the current and future beneficiaries of such trusts would certainly enjoy a dramatic preference over the beneficiaries of much more modest contemporary and future accumulations of wealth, if realization at death were comprehensively applied to the latter. Opponents of realization at death in the case of smaller estates could certainly argue very forcefully that if the spouses and children of contemporary decedents of modest wealth should accept realization at death in order to achieve a tax structure that did not exalt family interests in the inheritance of property over family interests in adequate annual maintenance, later issue of past decedents of great wealth who have succeeded (to date) in avoiding our federal gift and estate taxes should join the parade!

So much for the question whether a supplementary realization at death remedy ought to be applied to such trusts. Let us turn, in conclusion, to the question whether there is a stronger case for devising and enacting a generation-skipping remedy to deal with prolonged federal estate and gift tax avoidance via such transfers as that involved in Case A, than for proceeding with gains tax realization at death.

In my earlier Law Review discussion,[15] I answered in the negative, essentially on the ground that a generation-skipping remedy was, in its application to <u>future</u> transfers, primarily a vehicle for collecting <u>second and subsequent</u> rounds of gratuitous transfer taxes, while gains tax realization at death was merely a vehicle for collecting an initial (and not very progressive) income tax. The underlying thought was simply that a less progressive tax is easier to justify than a more progressive tax because the appropriate degree of progression in a tax structure is an intrinsically vexed question.

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I should have added that the income tax should be the first tax imposed upon unrealized appreciation in order to apply estate or gift taxes to a base that has in all cases been reduced by an initial income tax (either an ordinary income tax on personal savings used to purchase an asset which does not appreciate, or a gains tax on realized gain if an asset which does not appreciate is purchased with the proceeds of sale of an appreciated asset previously held, or a gains tax realized upon a gift or transfer at death of an appreciated asset). And I should have emphasized the importance of this to achievement of a reasonably even-handed gift and death tax system.

Also, I should have qualified the argument I did make. The levy of another progressive tax upon an accumulation of family wealth once in each generation is not a repeated levy upon previously taxed wealth to the extent of unpredictable asset appreciation occurring during the intervening generation. As to that appreciation, it is an initial progressive death tax.

Also, there is a basic argument in favor of progressive gift and death taxes which qualifies my family-interest oriented arguments, and which merits attention. That argument rests on the assertion that we do not permit the accumulation of very large personal fortunes primarily out of regard for family interests in the inheritance of property, but out of regard for the advantage to our economy of having people who have great skill in making investment decisions in control of investable wealth. (This is not an economic argument to the effect that these economic advantages are in fact very substantial. The point is, merely, that our practices in this regard have been justified primarily upon economic grounds. I think this is true.

The next step in the argument is the assertion that, once the person whose economic skills accumulated the wealth is deceased, there is abruptly less economic reason to leave the wealth in a few hands. A good many economists of undoubted fidelity to the free market system, and of undoubted professional stature, accept this view. This is an economic argument, centering on incentives to accumulation.

If one accepts these economic views, there is a pretty strong case for relatively heavy progresaive gift and death taxation of very large accumulations of wealth (e.g., at maximum rates substantially in excess of 50 per cent).

And hence, if one accepts these economic views, there is a pretty strong case for exposing large accumulations of the past to substantially progressive gift and death taxation as soon as possible--particularly if they were initially accumulated without being exposed to such taxes as in Case A.

And there are a number of historical facts about the evolution of our progressive taxes on incomes, estates and gifts to suggest that there may be quite a few real cases which more or less involve the kind of estate and gift tax avoidance illustrated in Case A. Some of these are synopsized in the following extract from my Law Review discussion, previously referred to:

> To briefly review some familiar history, progressive taxation in this century began with the enactment of a progressive income tax which, by its basis rules and exemption of gratuitous receipts, treated past accumulations as sacrosanct. Several years later, an estate tax was added which permitted an accumulation of wealth, once exposed to the tax, to escape further death taxes for the period of perpetuities if the transferor chose to take

full advantage of his chance to make a multigeneration transfer in trust. Gains tax forgiveness at death accompanied the estate tax, allowing the transferor to defer further gains taxes on appreciation in the transferred property for the full term of the trust, and indeed, beyond it if no realization was required in the course of terminal distributions of principal.

A gift tax was not permanently added for another decade and a half, during which interval, a well-advised inter vivos transferor could achieve all of the multigeneration trust blessings above-mentioned, except gains tax forgiveness at death, without sustaining the initial burden of paying the estate tax.[16]

(It might not be amiss to add that no such philosophy as that just outlined is reflected in the American Law Institute's recently recommended "Additional Tax" solution to the "Generation-Skipping" problem.

On the contrary, the American Law Institute would not apply its Additional Tax to past generation-skipping transfers. There is a good reason on the facts for this position. The Additional Tax is a generation-skipping "remedy" that is vulnerable to astute pre-planning, and at the same time one that could penalize failure to pre-plan very severely. Consequently, were the Additional Tax to be commonly applied to past and future generation-skipping transfers, the past ones (necessarily designed without regard to it) would probably be much the more heavily burdened.

I do not mean to endorse the Additional Tax. Instead, for reasons that are elaborated in an article to be published in a few months, I think the Additional Tax a generation-skipping remedy better calculated to perpetuate the generation-skipping problem than to relieve it.)

To sum up, I am still of the opinion indicated at the outset--that the enactment of a comprehensive scheme for realizing gains

at death is a better first step to take in bringing the burdens of the income tax upon family interests in maintenance and inheritance into a more plausible relationship to one another than a program of reform involving the federal estate and gift taxes, which treats as irrelevant the inescapably relevant question whether these taxes are being imposed upon wealth that has been exposed to the income tax, and which ignores the fact that it is easier to justify rigor in the collection of a less progressive gains tax rather than a more progressive gift or death tax.

Nonetheless, I am more respectful of the case for relatively heavy progressive gift and death taxation of very large accumulations of wealth than I was a couple of years ago. And I suppose that the enactment of a comprehensive realization at death statute, which would yield gains tax revenues from many smaller estates, would tend to enhance the appeal of that case.

So perhaps acceptance of these realization at death arguments of mine would lead to more unfavorable adjustments in taxing the inheritance of property than I had thought earlier.

Even so, I urge the Finance Committee to weigh my arguments with care, because I think it of importance to the morale of the society that national policies which have a substantial effect upon important family interests be designed thoughtfully enough so that they are reasonably defensible.

The financial burdens placed upon families of modest income by the federal income tax are, I think, heavy enough to have a substantial effect upon family interests in adequate current maintenance. Unfortunately, I think that family interests in the inheritance of property now enjoy a relatively favored status,

and while I think these interests are of importance and entitled to respect under the income, gift and estate tax structure, it seems well to face the fact that they are relatively narrow interests when compared with those in adequate current maintenance. (It must not be forgotten that the opportunities afforded the children of families with modest incomes are affected in important ways by the level of maintenance that prevails.)

As a person who teaches law school courses which, in the main, are relevant to estate planning, I am constantly faced with the question whether the tax law in this area "makes sense." I have found law students to be an admirably pragmatic lot, but they are not oblivious to questions of reasonableness. It is very possible that, since I deal more with students than with practicing lawyers and the trust industry, I attach much more importance to this matter than the community at large.

Conversely, it is entirely plain that the practicing estate planning bar, and the trust and other related industries, have their own build-in biases in this area.

So the question boils down to one of informed, political judgment, which is why I have ventured to bring it to the Finance Committee of the United States Senate.

FOOTNOTES

1. Waterbury, A Case for Realizing Gains At Death In Terms of Family Interests, 52 Minn.L.Rev. 1, 55 (1967).

2. H.R. 13270, Sections 511, 514.

3. Waterbury, supra Note 1.

4. Id. at 6-15.

5. Id. at 56-64.

6. Id., Note 82, at 17-18.

7. Id., at 18-28.

8. Id., at 54-55.

9. Id., at 52-54.

10. Id., at 49-52.

11. For instance, the revenue yield of gains tax realization at death might be employed to fund reductions in the burden of federal estate taxes on small and medium-sized estates.

12. Waterbury, supra Note 1, at 38-42.

13. Id., at 42-47.

14. Federal Estate and Gift Taxation, Recommendations of the American Law Institute and Reporters' Studies (1969).

15. Waterbury, supra Note 1, at 44-47.

16. Id., at 45.

RESTRICTED STOCK PLANS

STATEMENT OF

JOHN SEATH
VICE PRESIDENT AND DIRECTOR OF TAXES
INTERNATIONAL TELEPHONE AND TELEGRAPH CORPORATION
BEFORE
THE SENATE FINANCE COMMITTEE
SEPTEMBER 16, 1969

SUMMARY

Mr. Chairman and Members of the Committee:

My name is John Seath. I am Vice President and Director of Taxes for International Telephone and Telegraph Corporation.

I am appreciative of this opportunity to present what I hope will be considered a constructive view of restricted stock plans. We urge that the tax treatment presently accorded to restricted stock plans under long-standing Treasury regulations be continued for plans which offer restricted stock to the employees of the issuing corporation or a subsidiary.

Numerous articles have been written over the last fifteen years about the scarcity of management talent in the United States today. Unfortunately, the articles are factual. In the statement we are submitting today we provide examples of how small closely-held corporations are able to offer to managers large blocs of these stock at very low prices. Shortly after the manager accepts the offer to purchase this stock at very low prices, these companies have gone public at much higher prices,

with a corresponding huge gain to the employee taxed at capital gain rates after six months holding.

This type of enticement is difficult, if not impossible, for us to combat. One of our weapons, in fact about our only weapon aside from the fascination of working for a corporation that is alive and moving forward constantly, is our restricted stock plan. This plan offers shares of the employing corporation to employees at half of the market value, but the employee may not keep any gain through market appreciation unless he remains with the corporation at least five years for 5% of the shares, and 25 years or retirement, if that is earlier, for the whole gain.

A plan such as this permits us to reward diligent employees and gives the employee a strong reason to remain with and to work for the success of the corporation. The point here is that this is not a gimmick plan; particularly not a tax gimmick plan. It is a plan to provide our management employees with a real financial interest in their company and a reward for their endeavors through market appreciation, if their endeavors are successful.

It is no answer that the needs of industry can be met through the use of qualified stock options. The changes in the Internal Revenue Code of 1964 have made these options not particularly attractive as an employee incentive in view of the decline of market prices, the higher rate of interest on borrowed funds, the fact that 100% of market price must be paid for the shares, and that the shares must be held a minimum of three years.

It has been said that the present treatment of restricted stock plans constitutes "an unwarranted and unintended benefit." It has been alleged that there are abuses under the law as presently written. It also has been argued that the change in the treatment of restricted stock plans proposed in the House Bill would correct an inequity.

As far as the so-called "unwarranted and unintended benefit" is concerned, perhaps it should be remembered that when Mr. Dillon was Secretary of the Treasury and testified before the Ways and Means Committee during consideration of the Revenue Act of 1964, he called the present regulations specifically and favorably to the attention of the Committee.

If there have been abuses which, as we understand it, means the granting of the right to purchase shares in a corporation other than the employing corporation or its parent, then we respectfully suggest that the way to correct the abuse is to limit restricted stock plans to shares of the employing corporation or its parent. It makes little sense to destroy a whole structure of management compensation for a few abuses, especially when the abuses may be corrected.

The present interpretation of the law has been in existence since 1959. Tax payers desiring to set up plans to provide an incentive to retain their management employees have been able to obtain rulings from the Internal Revenue Service that such plans were in accordance with the

Internal Revenue Code. Suddenly we are faced with a turnaround by the Treasury saying that for the last ten years it didn't understand the law, and even if it did understand it, it should be changed.

We feel strongly that this House provision has been hastily considered, in that it would not provide revenue for the Treasury. In fact, examination of the examples given in our written statement shows that the revenue would be even greater if the rate reduction on individuals is enacted as proposed.

The House Ways and Means Committee report, in commenting on the restricted stock provision, says: "The revenue impact of this provision is believed to be negligible in terms of any pickup in revenues from existing law. This is because restricted stock plans, for the most part, have the effect of transfering tax liability from the employees to the company." Also, the report prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance says that the revenue impact of restricted stock plans would be less than $2.5 million.

The Administration has proposed that the provisions of the House Bill dealing with the deferred compensation and lump sum distributions be deleted and left for further consideration. Also, we should like to suggest that any provision characterized as providing an unintended and unwarranted benefit which, after the proposed change, can only result in lower revenue to the Government, be sent back for further consideration.

Mr. Chairman, we have prepared for your review a more detailed statement which has been submitted to the Clark of the Committee. I wish again to thank you for the opportunity of presenting our views on this Bill.

RESTRICTED STOCK PLANS

STATEMENT OF

JOHN SEATH
VICE PRESIDENT AND DIRECTOR OF TAXES
INTERNATIONAL TELEPHONE AND TELEGRAPH CORPORATION
BEFORE
THE SENATE FINANCE COMMITTEE
SEPTEMBER 16, 1969

Mr. Chairman and Members of the Committee:

We would like to submit for your serious consideration our views with respect to the Tax Reform Bill of 1969, H.R. 13270, which is now pending before your committee. We urge that the tax treatment presently accorded to restricted stock plans under long-standing Treasury regulations be continued for plans which offer restricted stock to the employees of the issuing corporation or a subsidiary.

There has been a myriad of articles written on the subject of the scarcity of management talent in the United States today. ITT, like other companies, needs to retain the management it has in the face of talent "raiding" by other companies. Our problems are real. A national business magazine once referred to ITT as, in effect, a management training school, because our success as a company led other companies to lure management personnel with offers of remuneration we simply could not match. We need to retain our managers for our shareholders and our

employees -- and to do so we have to give our management an interest in ITT's business future.

It is difficult for professional managers, most of whom enter industry from modest backgrounds with their managerial capacities as their only capital, to translate the carrying of vast responsibilities into savings which compare to those amassed by their neighbors who, for example, may have invested in local enterprises such as an automobile distributorship, or similar enterprises. About the only way that a professional manager of a large company can do so is to be given an opportunity to earn an ownership interest in his employer's business. We believe that the restricted stock plan which our shareholders have authorized is an appropriate way to do this, since it makes acquisition of such an ownership interest financially practicable. It also provides the employee with an incentive to remain with our company because his future is then linked with ours. Also, it results in no revenue loss to the Treasury under existing rules, in contrast to the current proposals.

Our plan is not limited to high-level executives. It is open to virtually all of our employees in key management, which number in excess of 1100 in the U.S. Employees are offered the opportunity to purchase restricted stock at 1/2 of the current market price. They have all the customary rights of ownership of the stock, except that the stock is restricted so that under specific conditions all or part of the stock

must be re-sold to the corporation at its original purchase price if the employee-owner leaves before retirement, or 25 years of service. Restrictions requiring re-sale of the stock to the company gradually are removed over the employee's period of service. Specifically, 5% of any of the shares purchased become free of restriction after 5 years of service, and another 5% become free for each additional year of service until 15 years of service have been completed. The remaining 50% is generally not freed until the employee has 25 years of service after the purchase or reaches age 65, whichever happens first.

This plan is not a "gimmick" plan -- it is a carefully designed employee benefit plan that works. And we need it as an important incentive to retain our management.

We have had numerous cases where our managers have been approached by small, closely-held corporations and have left us because of the opportunities to make substantial long-term capital gains through stock ownership interest. We could not match the opportunities these smaller companies offered, often at bargain prices, because the stock is made available at low cost prior to a public offering at a much inflated price. Let me give you but three examples from our files:

Executive	Shares Offered	Offering Price Per Share	Market Price	Estimated Gain
	22,000	$ 18.00		
Mr. A	20,000	.20	$ 27.00	$734,000+
Mr. B	50,000	4.50	20.00	775,000+
Mr. C	42,700	13.63	39.25	1,300,000+

We have to compete against offers like these. It is idle to maintain, as the House Ways and Means Committee Report indicates on Page. 87, that employees can be given an adequate stake in their employer's business through "statutory stock options." To those who maintain that statutory stock options solve this problem, we refer you to an article by the distinguished New York Times business correspondent, Mr. John J. Abele, in the Business Section of the New York Times of Sunday, September 7, 1969. This article shows clearly that statutory stock options, especially in a period of declining stock prices, are not only of no value to employees but, even worse, encourage employees not to stay with but to leave their employer in order to obtain new statutory stock options at depressed market prices. (A copy of Mr. Abele's article is attached.)

Even if stock prices were to rise, statutory options would still not be attractive as long as interest rates remain at present levels, since the net cost (after receipt of dividends) of the borrowings necessary to exercise statutory options would be prohibitive. Further, the change in the treatment of interest cost contained in H.R. 13270, limiting deductibility to $25,000 plus investment income, if enacted, could further increase the effective cost of statutory stock options by not allowing a tax deduction for

interest paid on at least a portion of the borrowings. The Treasury Department's recommendation that interest on funds borrowed for the purchase of stocks be allowed as a deduction is one which we heartily endorse, but we believe that to be effective that type of interest must also be eliminated from "allocable deductions."

It should also be noted that the three year holding period required for capital gains to apply to the sale of stock received on the exercise of qualified options is far longer than the normal holding period. The fact that a qualified option is at 100% of market value, whereas restricted stock is at 50%, means larger borrowings and is an additional reason why qualified stock options are no longer attractive.

Thus, the restricted stock plan which ITT and many other corporations use is truly a long-range plan which serves desirable corporate ends. And it is not a tax gimmick, or, as Treasury testimony indicates, "an unwarranted and unintended benefit."

These plans are set up under rulings issued by the Treasury under long-established regulations. In fact, during the consideration by the Congress of the Revenue Act of 1964, Secretary Dillon called the Treasury regulations specifically and favorably to the attention of the Ways and Means Committee. See Hearings before the Committee on Ways and Means (88th Cong., 1st Session) on the President's 1963 Tax Message - Part 1, p. 466.'

Under existing law, an employee who receives stock subject to substantial restrictions realizes ordinary income at the time the restrictions

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lapse. The amount of such income is equal to the lesser of:

(i) the difference between the purchase price paid by the employee for the stock and the fair market value of the shares (determined without regard to restrictions) at the time of purchase; or

(ii) the difference between such purchase price and the fair market value of the shares at the time the restrictions lapse, whichever is the lesser.

However, under the Treasury proposal, contained in Section 321 of the House Bill, the employee will realize income when the restrictions lapse in an amount equal to the difference between the purchase price paid by the employee for the stock and the fair market value of the stock at the time the restrictions lapse. (In other words, the initial spread existing between the unrestricted fair market value of the stock at the time of transfer and the actual purchase price no longer limits the amount of ordinary income taxable to the employee when the restrictions lapse, even though such initial spread was the maximum compensation intended by the employer.)

It must first be recognized that the new rules make restricted stock plans generally unworkable because of the high tax impact on employees, a high-tax impact that the employee can probably only meet by selling his stock -- thus defeating the very purpose for which the plan was set up. Secondly, and equally important, it must be recognized that the new rules

do not have a significant effect on overall tax revenues; they do not serve to bring additional income tax revenues into the U. S. Treasury. To the extent that the new rules occasion more taxable income to the employee, the employer will be entitled at the same time to a larger deduction for the amount of compensation realized by the employee. Thus, considerations other than Government revenue must underlie the proposal.

Further, if the employee sells his stock after the restrictions lapse, the proposed regulations will result in a significant loss of tax revenues to the Treasury, as pointed out in the Ways and Means Committee report on the Tax Reform Bill.

For example, assume a married employee in the 45% bracket (taxable income about $36,000) purchases restricted stock at 100 with an unrestricted fair market value of 200. In four years, the restrictions lapse and the employee sells the stock for 300, its value at that time.

Present law:

Tax on income to employee:	Compensation $100 (200 - 100)@ 45% =	$45
	Capital gain $100 (300 - 200)@ 22.5% =	22.5
Total tax to employee		$67.5
Deduction to employer: Compensation $100 @ 48 =		48
Net tax paid to Treasury under present regulations		$19.5

Proposed amendment:

Tax on income to employee:	Compensation $200 (300-100)@ 45% =	$90
	Capital gain 0 (300-300) =	0
Total Tax to employee		$90
Deduction to employer: Compensation $200 @48% =		96
Net tax loss to Treasury under proposed regulations		$ (6)

(The above figures do not take into account the surtax which would increase the loss to the Treasury.)

Certainly, any tax proposal that can simultaneously cause responsible corporate employers to object and, at the same time, reduce Treasury revenues is one that deserves careful consideration.

We understand that the present Treasury regulations have been subject to abuse by a few taxpayers. We recommend and heartily support any changes in the law to correct the abuses -- such as a requirement that the restricted stock must be stock of the employer corporation, or a corporation that controls the employer corporation, or even a requirement denying restricted stock benefits to 5% or more shareholders of the employer corporation, or 5% or more shareholders of an affiliate of the employer corporation. However, to do away entirely with restricted stock plans simply because abuses have been found would be causing hardship to those who have not abused the law.

The ITT restricted stock plan was adopted by the management and shareholders to give its employees an incentive to remain with us on a career basis -- an incentive which is not effectively provided by other types of stock plans.

Thus, while we believe that abuses should be corrected, we urge that there is no reason for the enactment of a provision which will result in no increased revenues, but which will impede the efforts of large corporations to attract and retain its management. It is this management which corporations need to keep moving forward in order to continue the

activities which provide employment for thousands and which benefit the economy and the nation.

THE NEW YORK TIMES, SUNDAY, SEPTEMBER 7, 1969

ATTACHMENT

Bear Market Hurts Stock Options

By JOHN J. ABELE

Stock options, like stock prices, aren't what they used to be.

Options are a favorite device of many corporations to attract or retain executives. Theoretically, they are supposed to increase an executive's incentive by helping him to [illegible] in a stock interest in his company.

But the bear market in stock prices has put a decided crimp in the attractiveness of options granted in more bullish days.

As a result, many executives are [illegible] holding options that were supposed to be an important part of their compensation package but, at today's stock prices, are worthless.

To Pearl Meyer, the situation points up some basic weaknesses in option plans. The vanishing value of options, she contends, has caused considerable discontent in executive suites and reduced the incentive the options were supposed to build.

Mrs. Meyer is director of research for Handy Associates, Inc., a leading executive recruitment concern that also serves as a consultant on executive compensation programs to many large corporations.

"Stock options are not a sound, continuing method of executive compensation," Mrs. Meyer said in an interview last week. "Options are worthless in a declining stock market and the effect on executive morale can be devastating."

In Mrs. Meyer's view, options "concentrate the interest of an executive on the price of his stock, not the value. The whole thing depends on how the market is going. It's a game, a bet."

In a typical option arrangement, a company may grant an executive an option to buy a certain amount of stock at a price determined by the market value on the day the option is granted.

An executive earning $30,000 a year, for example, may be given an option to buy 1,000 shares of a stock selling at $30 a share. If the price of the stock later rises to $40 a share, the executive can net a tidy profit. But if the price of the stock goes down to $20 a share, his option is worthless.

Using the Dow-Jones in-

Continued on Page 36, Col. 5

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dustrial average as an analogy, Mrs. Meyer declared: "Suppose you received an option to buy shares of the Dow-Jones Average Company in February, 1966, at $1,000 a share. There wouldn't have been any time in the last three years when that option would have been of any value to you."

One result, Mrs. Meyer noted, is that many executives holding worthless options from their present employers are inclined to look for jobs elsewhere in the hopes of receiving option arrangements that will be more profitable for them.

A Time to Move

For executives in this category, she said, "the most sensible time to move is when the market is down."

Because the amount of shares involved in option plans is usually related to an executive's salary, executives who receive options when a stock is at a low level are able to receive more shares than executives with comparable salaries who received options when the stock was at a higher price.

In the case of a stock selling at $30 a share, a $30,000-a-year executive might receive an option for 1,000 shares. But if the price goes down to $20 a share, an executive at the same salary level would receive an option for 1,500 shares.

One result, Mrs. Meyer noted, is that some executives have to interview job candidates who will receive more attractive option arrangements than the interviewers themselves have.

Mrs. Meyer said that option arrangements could be equally troublesome when the stock market is rising. A strong market, she said, may result in some executives making such substantial paper profits on their option stock that the only way they can cash in on their profits is to leave the company and sell the stock.

Mrs. Meyer said there were a number of other methods of executive compensation that, in her opinion, serve the best interests of both the company and the executive.

One alternative to the standard qualified stock option plan, she said, is a nonqualified option plan, one that does not qualify for capital gains treatment because of some restriction. The terms of these plans are not as confining as regular plans, she said, and can be varied to meet particular situations.

Other possible alternatives, Mrs. Meyer said, include deferred compensation plans, stock bonus arrangements and profit-sharing plans.

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SUMMARY OF STATEMENT ON H.R. 13270
SUBMITTED BY JOHN A. CARDON AND JOHN H. SKILLING, JR.,
OF LEE, TOOMEY & KENT

I. DEFERRED COMPENSATION (§331)

The proposal for taxing deferred compensation should not be adopted.

(1) Deferred compensation is fully taxable at ordinary income rates and in no sense represents a tax loophole.

(2) Deferred compensation serves many corporate purposes: It attracts and holds employees; it provides supplemental retirement income; and, when awarded in the corporation's own stock, it creates additional employee incentive. Moreover, its use is not limited to a few highly paid executives, but is applicable to many employees at many levels.

(3) The proposal is unduly complex and presents a disproportionate compliance burden.

(4) Adoption of this proposal may well cause a loss of tax revenue, and most certainly will be inflationary by encouraging current cash payments of compensation rather than deferment.

(5) The proposed treatment of deferred compensation modifies radically the concepts of the cash method of accounting and the annual accounting period. Both of those concepts have been fundamental in our tax system. No adequate revenue purpose has been demonstrated for so drastic a departure from these basic concepts.

II. DISTRIBUTIONS FROM QUALIFIED PLANS (§515)

The proposed method of taxing lump sum distributions from qualified employee plans should be rejected.

(1) Such distributions represent the accumulation of employer contributions and increment thereon over a period of many years. The proposal to tax post-1969 employer contributions on a five-year "averaging" is neither realistic nor equitable.

(2) The proposal would substitute a complex set of rules for a very simple tax computation under existing law. Data needed to compute the tax liability under the proposal is not readily obtainable, nor is it always available to the taxpayer.

(3) The adverse effects of the proposal will be felt by all plan participants receiving lump sum distributions and not merely by those whose taxes on such distributions might be increased.

(4) The attempt to provide a five-year forward averaging will result in overpayment of taxes by some retired individuals who can least afford it and yet prevent them from recovering overpayments for a period of five years.

STATEMENT ON THE TAX REFORM ACT OF 1969
(H.R. 13270) BEFORE THE FINANCE
COMMITTEE OF THE UNITED STATES SENATE

Submitted By

John A. Cardon and
John M. Skilling, Jr.

This statement is submitted by John A. Cardon and John M. Skilling, Jr., in opposition to Sections 331 and 515 of H.R. 13270 dealing with the taxation of deferred compensation and the taxation of lump sum distributions from qualified pension, profit sharing and stock bonus plans.

The undersigned are members of the law firm of Lee, Toomey & Kent, 1200 18th Street, N. W., Washington, D. C. 20036, and have for a number of years specialized in Federal income tax and other legal aspects of qualified pension, profit sharing and stock bonus plans, as well as non-qualified plans of deferred compensation. Our clients have included both large and small corporations representing a cross-section of American industry.

In view of this experience, we desire to bring to the attention of the Committee certain aspects of the proposed changes in the Internal Revenue Code which would be affected by Sections 331 and 515 of the pending Bill.

Part I. DEFERRED COMPENSATION

Section 331 of H.R. 13270 adds a new §1354 to the Internal Revenue Code to deal with the taxation of deferred compensation. This new section provides for a minimum tax on deferred compensation payments in excess of $10,000 per year determined by "throwing back" such excess to each year in which it is deemed to have been earned (the period of employment or such lesser period as the Secretary shall determine). Alternatively, the taxpayer may compute the minimum tax by using the average increase in tax in the three highest of the last ten years and multiplying that by the number of years over which the deferred compensation is deemed earned. In any event, however, if the actual tax in the year of receipt is higher than the lower of the minimum tax computations, the higher tax will be due.

The objective of this provision is to tax an employee on deferred compensation payments at the time he receives them, but at the higher of (a) the tax he would have paid had he received the deferred compensation in the year it was earned, or (b) the tax he would pay on the deferred compensation in the year it is actually received. The alleged purpose of the proposed revision is to discourage taxpayers from taking advantage of the fact that they may

be in a lower tax bracket after they retire from full-time employment.

We are opposed to any changes in the taxation of deferred compensation, and specifically to Section 331 of the Bill, for the following reasons:

(1) Deferred Compensation Is In No Sense of the Word a "Tax Loophole"

Under present law every dollar of deferred compensation will be taxed to an employee at ordinary income rates, not as capital gain, and the employer will get no tax deduction until the time of payment. Actually, the principal benefit of deferred compensation to an employee is that it tends to level out his total earnings over a period of time more closely associated with his life rather than his years of employment. Thus it acts as an averaging device and any benefit arising from the difference in tax rates from year to year is incidental.

It is true that one of the attractive features of deferred compensation to an employee is the anticipation that he might be in a lower tax bracket when deferred compensation payments are ultimately made to him, but there is no guarantee that this will, in fact, be the case. There are numerous instances where just the opposite is true, either because the employee has other income or because he is a widower and thus subject to taxation at single

taxpayer rates, or because the tax rates have been increased (e.g., a year in which the surcharge is applicable). Moreover, even in those cases where the tax rates are lower in the year of receipt, the difference in rates is usually small and it has not been demonstrated that it represents a significant method of tax avoidance.

(2) Deferred Compensation Serves Many Corporate Purposes

Deferred compensation has been used for many years, wholly apart from tax consequences, as a method of attracting and retaining valuable employees, not only in the top echelons of management, but also in middle management. This is particularly true in the case of smaller companies who cannot afford the fixed annual cost of a pension plan or large current salaries. More often than not forfeiture provisions are included to further encourage employees to stay with an employer. Deferred compensation arrangements constitute one of the major tools of corporate management in acquiring and retaining capable employees.

Deferred compensation also provides a method whereby an employer can do something more in the way of retirement income for some of its employees. In many instances benefits provided by qualified pension and profit sharing plans are felt to be inadequate to do the job desired in middle and upper management ranks, and deferred compensation can serve to supplement such a retirement program.

Under many deferred compensation arrangements the ultimate payout is keyed to the value of the employer's stock. In such case there is an obvious incentive on the part of the employee to increase such value so that the amount he ultimately receives will be that much greater. Deferred compensation can thereby provide the employee with a direct and real stake in the business.

Deferred compensation plans are utilized by thousands of companies, large and small, representing a very large segment of the business community. We submit that these arrangements are not devices limited to a few highly paid employees who are in a financial position to demand them. On the contrary, many companies realize that orderly succession in executive ranks is vital to the success of any enterprise and therefore apply such plans broadly to technical and managerial personnel at many levels.

(3) Section 331 Introduces
Undue Complexity

A mere reading of the provisions of Section 331 of the Bill is enough to demonstrate that the computational process involved would be tremendously complicated. Assume, for example, that an employee had worked for a company for 25 years, and under a deferred compensation plan he is entitled to receive upon retirement $25,000 a year for 10 years. Ignoring for purposes of simplicity the exception for

amounts earned prior to 1970 and the $10,000 exclusion, the employee must make three computations:

(a) He computes his tax in the year of receipt by including $25,000 of deferred compensation as ordinary income.

(b) He "throws back" $1,000 to each of the 25 years in which he worked for the employer, computes the additional tax in each of those years (assuming the records are available), and totals the additional tax.

(c) He adds $1,000 to each of the three highest taxable years in his last 10 taxable years (again assuming the records are available), computes the additional tax thereon, averages it, and then multiplies by 25.

The higher tax resulting from either (a) or the lower of (b) or (c) is the tax due for the year of receipt. As if this were not enough, however, in the following year when the taxpayer receives another $25,000 payment he must go through the entire procedure again, but this time taking into account the amount of deferred compensation he received in the first year and including it in the throw back process.

While the computations required in the example cited are highly complex, they are far simpler than the computations

which would be required for many deferred compensation plans, where payments are made not in cash but in stock having fluctuating values and where other features, such as continued employment, non-competition, etc., add to the complexity of determining when an amount is earned and thus the calculations involved.

When it is recognized that the majority of the people affected by this provision are relatively unsophisticated taxpayers, this additional computational burden which must be complied with is simply intolerable. No revenue or tax equity reasons can be cited to justify this complex compliance problem.

(4) Potential Loss of Tax Revenue to the Treasury

The provisions of Section 331 of the Bill impose such a penalty on deferred compensation plans that it is quite likely such arrangements will be discontinued in the future. This, of course, means that current cash payments of salary will probably increase, particularly with lower rates on earned income. Moreover, the increased cash salaries would be included in the pension base for pension plan purposes, and thereby give rise to an increased current tax deduction for the employer.

The net result is likely to be a loss of revenue to the Treasury. Although it is impossible to estimate this potential revenue loss, it is clear that the shift in emphasis away from deferred compensation and into current compensation may not only cost the Treasury money, but most certainly will add an inflationary factor to the economy contrary to at least one of the major purposes of this Bill.

(5) Inconsistencies in the Bill

Section 802 of the Bill adds a provision which would limit the marginal tax rate on earned income to 50%. We believe this provision is a step forward in the taxation of earned income. It is anomalous, however, that while the Bill treats earned income favorably in Section 802, it turns around and deals harshly and unfairly with another form of earned income, i.e., deferred compensation, in Section 331. Thus the Bill increases taxes on deferred compensation while reducing taxes on other forms of earned income. There is no rationale for this inconsistent treatment.

(6) Departure from Traditional Concepts

The proposed treatment of deferred compensation modifies radically the concepts of the cash method of accounting and the annual accounting period. Both of these concepts have been fundamental in our tax system, and no adequate

revenue purpose has been demonstrated for so drastic a departure from them. The provisions of this Bill represent one more aberration from standard accounting and tax concepts and one more patch on the crazy quilt of the taxation of employee benefits.

In addition, it should be pointed out that the present rules have worked satisfactorily for quite a number of years. Through court decisions and administrative rulings the questions of whether an employee has income at the time he receives a promise to pay from his employer and whether such a promise (regardless of the financial condition of the employer) is equivalent to placing an amount in trust for an employee have been settled long ago, and there has been no indication from the Internal Revenue Service or the Treasury Department that these rules have been abused or that any change in them is required except possibly in the context of an overall revision relating to employee benefits.

CONCLUSION

It is submitted that there is in fact no real problem of tax avoidance in the area of deferred compensation, that deferred compensation serves a useful and valuable purpose wholly apart from the tax consequences, and that the suggested solution in this Bill is far worse, both in terms of compliance and in terms of concept, than the evil which it allegedly seeks to correct.

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Part II. DISTRIBUTIONS FROM QUALIFIED PENSION, PROFIT SHARING AND STOCK BONUS PLANS

Section 515 of the Bill would amend §§402(a)(2) and 403(a)(2) of the Code with respect to the taxation of lump sum distributions from qualified pension, profit sharing and stock bonus plans.

Under the present provisions of the Code, a lump sum distribution from a qualified plan or trust made on account of an employee's termination of service or death after termination of service is taxable as a long term capital gain to the extent it exceeds amounts which the employee contributed under the plan. The Bill would change this rule with respect to that portion of a lump sum distribution which represents the amounts contributed by the employer after December 31, 1969.

We strongly urge the Committee to reject the proposed change for the following reasons:

(1) The Existing Rule Is A Fair And Reasonable One

Distributions from qualified pension and profit sharing plans at retirement, death or other termination of employment represent contributions, earnings, and gains from investments accumulated over many years. Many employees work for the same employer for 30 years or more and a lump sum distribution

of his pension or profit sharing benefit at retirement represents employer contributions to the plan and investment experience thereon over a considerable period of time. It is obvious that a lump sum distribution cannot be taxed to the recipient as ordinary income all as of the year in which received without unduly reducing the amount available for the employee's retirement or for the protection of his beneficiary in the event of his death. Realizing this, Congress incorporated in the Revenue Act of 1942 provision for taxing lump sum distributions as long term capital gains, the net effect of which is to average out the tax impact and avoid depleting the employee's benefits.

This basic approach to the problem has been in the Code for some 27 years. It was amended in 1951 and 1952 to avoid taxing unrealized appreciation in employer securities included in a lump sum distribution and in 1954 it was extended to cover lump sum distributions on the death of an employee after his retirement and lump sum distributions from annuity plans. Thus, the legislative history of §§402(a) and 403(a)(2) has been to extend, rather than to restrict, the capital gain treatment of such payments.

The proposed change would tax the recipient on amounts representing employer contributions made after 1969 on the basis of a so-called five-year forward averaging. As

pointed out in more detail below, such treatment is not a true averaging method and is not a reasonable substitute for the existing rule. It is inequitable to tax the employee on a distribution on the basis of the five-year spread when, in fact, he may have been in the plan for as long as 30 years or more. We submit that the existing rule is far more equitable.

(2) The Present Rule Is A Simple One And Easy To Administer

Complexity in our tax laws is of growing concern, not only to the Government but to taxpayers throughout the country. The present provisions of the Code afford a method of taxing lump sum distributions which is easy to understand by taxpayers and is easily administered. Basically, the only computation which has to be made by the employee is the determination of what he contributed to the plan. The balance of a lump sum distribution is taxed to him as a long term capital gain. Thus, the employee need only divide the balance by two and include the resulting figure in his gross income and compute his tax in the normal manner. Having done this, his tax liability with respect to that distribution is a closed matter.

By contrast, the proposed rule would subject the individual to several complicated steps at the end of which his

tax liability would remain unsettled for several years. Specifically, the following steps would have to be taken:

Step 1: Compute the amount of the employer contributions made after 1969.

This computation is not as simple as it appears at first blush. In many pension plans, the employer's contributions are determined on the basis of aggregate costs reflecting the mortality, turnover, years of service and salary of the group of covered employees as a whole. The amount contributed for any one individual is not ordinarily determined. It can be determined but only upon rather elaborate actuarial assumptions. In no case could the average employee himself determine the figure. Under present law the employee can always determine his own contribution, which is the only portion of a lump sum distribution he need identify in computing his tax liability.

Even where employer contributions are allocated to the individual accounts of plan participants, the proposal will require the employer to maintain accounting records in such a way as to show the post-1969 contributions separately. The information will have to be supplied by the employer since the employee has no other way of obtaining it. Moreover, the employee will have to be given an explanation as to the significance of the information and the difference in tax

treatment between contributions made before and after January 1, 1970. The problem of communicating and explaining the information to the employee will impose a substantial burden on the employer.

<u>Step 2</u>: Compute the amount of forfeitures included in the distribution.

The Report of the Committee on Ways and Means (Part I, p. 155) states that for purposes of determining the post-1969 employer contributions forfeitures will be treated as contributions made by the employer. (Forfeitures are amounts relinquished by reason of an employee's termination of employment before he has acquired a fully vested right to a benefit.) Accordingly, another figure will have to be developed which is not always identifiable on an individual basis -- i.e., where the cost of benefits is figured on an aggregate basis. Even where forfeitures are allocated on an individual basis the rule will require an extra computation of an amount which the employee is not able to determine for himself.

A further question is raised as to whether or not certain amounts which were contributed to a plan prior to January 1, 1970, but reallocated upon forfeiture on or after such date will retain their status as pre-1970 contributions subject to the present rule. If so, it will be necessary to

further break down forfeitures between those attributable to employee contributions prior to 1970 and those attributable to employer contributions after 1969.

<u>Step 3</u>: Deduct the amount developed under Steps 1 and 2 from the total amount distributed.

<u>Step 4</u>: Determine the tax on the balance under the present rule applicable to long term capital gains.

<u>Step 5</u>: Determine the tax due on the employee's taxable income without the amount of post-1969 employer contributions.

<u>Step 6</u>: Determine the tax liability which would be due by including 20% of the amount of post-1969 employer contributions in the employee's taxable income for the year in which the distribution is made.

<u>Step 7</u>: Subtract the tax liability determined under Step 5 from the tax liability determined under Step 6 and multiply the result by 5. The product is the tentative tax liability of the employee which must be paid in the year the distribution is received.

<u>Step 8</u>: Five years later, recompute the tax liability which would have resulted from including 20% of the post-1969 employer contributions in the employee's taxable income for the taxable year in which the lump sum distribution was received and in each of the following four years.

In this connection, it should be noted that the averaging device in Step 8 is a different one from that contemplated in Steps 6 and 7. Thus, the employee must not only recompute his tax liability but he must do it on a different basis.

Step 9: If the amount determined in Step 8 exceeds the amount determined in Step 7, the employee is considered to have made an overpayment of his tax and may file a claim for refund.

It would appear that the distribution of the employee's interest in a lump sum amount in one year would also qualify for the income averaging rules proposed under Section 311 of the Bill and the employee could compute his tax liability thereunder. In order to take advantage of the averaging under Section 311, however, the employee would have to face yet another set of complex computations.

It is submitted that there is no necessity for providing for such a complicated method of taxing a distribution. The proposed rule would require every taxpayer who receives a lump sum distribution to compute his tax liability twice for each of the five years from his retirement or other termination of employment. This is particularly objectionable when considered in light of the fact that the rule is applicable to employees who have reached retirement age and who may not

be entirely able to cope with the necessary computations and record-keeping involved in the proposed rule.

(3) The Complexities Of The Proposed Rule Would Be Felt By All Employees Under Qualified Plans And Not Merely By Those Whose Tax Liabilities Would Be Increased

The Report of the Committee on Ways and Means (p. 154) indicates that the proposed rule is aimed at moderating the tax benefits to taxpayers with adjusted gross incomes in excess of $50,000. Whether or not this is a valid objective, the fact remains that all employees under qualified plans will have to follow the complex rules outlined above if the proposal is adopted. It has been estimated that some 25 to 30 million employees are currently covered by qualified pension and profit sharing plans and that this number will grow to approximately 40 million by the year 1980. Without attempting to estimate what percentage of employees receive lump sum distributions, it is obvious that a very substantial number of taxpayers will be required to follow the computations of the proposed rule. It is highly questionable whether the relatively small revenue gain anticipated from the proposed rule outweighs the disadvantages to millions of taxpayers who will be affected by it.

(4) The Proposed Rule Is Not A True Averaging Device

The purpose of an averaging rule is to spread an unusual item of income over a period of years to achieve a more realistic tax liability and avoid fluctuations in income. However, under the proposed rule the tax on a lump sum distribution is determined initially on the employee's situation in one year -- the year in which the distribution is made. Starting with income for that year, the employee must add 20% of the post-1969 employer contributions received as part of a lump sum distribution and recompute his tax liability and multiply it by five. If the employee happens to have unusual items of income such as termination of employment payments, his income for the year of distribution is apt to be inflated. Such a distortion of income is very likely to occur merely because of the fact that the employee receives a lump sum distribution in that year. The receipt of that payment alone will inflate his income.

Admittedly, the so-called five year forward averaging rule (Step 8 above) is a true averaging device but this is not applicable until five years after the distribution has been made. In the meantime, the employee has paid his tax based upon his circumstances in the year of distribution and has been deprived of the use of the overpayment during the

five-year period. This is particularly objectionable in view of the fact that the proposed rule is applicable to retired employees who are the relatively older taxpayers. It makes little sense to require an employee to overpay his tax at a time when he might need the money to provide for his retirement and the security of his beneficiaries. The crowning blow is the fact that he will have to file a claim for refund. This means engaging an attorney or other professional to prosecute the claim, thereby incurring an additional expense to recover what was rightfully his in the first place.

CONCLUSION

The proposed rule is far too complicated to be practical. The existing rule is a much simpler method of taxing a lump sum distribution, is far easier to administer and, on balance, provides a fair and reasonable system of taxation. The proposed rule should be rejected.

Respectfully submitted,

LEE, TOOMEY & KENT

By
John A. Cardon

John M. Skilling, Jr.

SUMMARY OF STATEMENT

STATEMENT TO THE COMMITTEE ON FINANCE, U. S. SENATE, ON SEPTEMBER 16, 1969, BY ARTHUR M. WOOD, PRESIDENT, SEARS, ROEBUCK AND CO., WITH RESPECT TO THE CHANGE WHICH WOULD BE MADE BY SECTION 515 OF H.R. 13270 IN TAXATION OF LUMP SUM DISTRIBUTIONS FROM PROFIT SHARING PLANS.

A. Change in Law Made by H.R. 13270

Section 515 of H.R. 13270 would change the taxation of employer contributions included in lump sum distributions from profit sharing plans. Sears, in its own interest as an employer, and in the interest of its employes, believes this change should not be enacted.

B. How Sears Profit Sharing Plan Works

The Sears Profit Sharing Plan was established in 1916. The employes contribute 5% of their compensation, up to $750 per year. Participation in the Plan is limited to $15,000 per year compensation. The Company contributes up to 11% of its profits to the Plan each year. The major portion of the Plan's assets is invested in Sears stock. The employe's interest in the Plan is fully vested after five years service, and most employes take the Sears stock credited to their account when they leave.

C. Review of Present Law and Proposed Change

Under present law, complete distributions because of separation from service are treated as long term capital gains. The tax on appreciation in any employer's stock included in such distributions is postponed until the stock is sold.

This present, well-established tax treatment would be changed by the House Bill. Under the House Bill all employer contributions made for years after 1969 which

are included in a complete distribution would be taxed as ordinary income in the year of the distribution under an averaging method. A later recomputation of tax would be permitted for the year of retirement and the four subsequent years on the assumption that 20% of such employer contributions were included in income in each of such years. If this resulted in a lesser tax than was paid under the averaging method in the year of retirement, the employe would be entitled to a refund.

In other respects, present law would continue. The balance of the taxable amount of the distribution would be taxed as long term capital gain, and tax on appreciation in employer stock would be postponed until the stock is sold.

D. Capital Gains Treatment Should be Retained in Its Present Form

An interest in a profit sharing plan is an investment at risk over a long period, and therefore, is entitled to capital gains treatment just as is any other investment. This is true of employer contributions as well as employe contributions and earnings. Capital gains treatment is fair, easy to understand, and workable, and is a desirable method for alleviating the effect of the "bunching" of income accumulated over many years of service and received by the employe in one year. The change made by the House Bill is complex and would be difficult for employes to understand and for the Internal Revenue Service to administer. It generally requires the retiring employe to overpay his tax in the year of retirement and to seek a refund five years later.

The final tax liability of the average employe does not, in the long run, appear to be significantly different under Section 515 of the House Bill than under present long term capital gains treatment, and therefore, capital gains treatment should be retained. If for some reason it is considered imperative that employer contributions be taxed as ordinary income, then an averaging device ought to be found which arrives at a final

and proper tax liability at the time of retirement, and which is reasonably easy for retiring employes to understand.

E. Tax on Unrealized Appreciation in Employer Securities Should be Deferred

Since its inception in 1916, Sears Profit Sharing Plan has been invested primarily in Sears stock. The employes are part owners of the Company, and thus have a real stake in its future. This results in an identity of interest between Sears and its employes. The loyalty and hard work of thousands of employes is largely responsible for Sears growth over the years. This growth has in turn benefited the employes, as Sears stock has increased in value almost sixty times since 1916. Employes generally take their Sears shares with them when they retire. Because of this the deferral of tax on unrealized appreciation in employer securities is of the utmost importance. The House Bill properly recognizes that such appreciation should not be taxed before it is realized through a sale. The retiring employe, when he leaves, does not receive cash but only receives direct legal title to stock which was already his. He should be treated just as anyone who purchases securities directly, and should not be taxed on the appreciation until he sells the stock. Taxing unrealized appreciation would work a hardship on him because he would have to borrow money or sell some of his stock to pay his tax.

STATEMENT TO THE COMMITTEE ON FINANCE, U. S. SENATE, ON SEPTEMBER 16, 1969, BY ARTHUR M. WOOD, PRESIDENT, SEARS, ROEBUCK AND CO., WITH RESPECT TO THE CHANGE WHICH WOULD BE MADE BY SECTION 515 OF H.R. 13270 IN TAXATION OF LUMP SUM DISTRIBUTIONS FROM PROFIT SHARING PLANS.

This statement is presented on behalf of Sears, Roebuck and Co. and its 200,000 profit sharing employes with respect to the change which would be made by Section 515 of the Tax Reform Act of 1969 in the taxation of distributions from profit sharing plans. The Act, as passed by the House of Representatives, would tax that part of a complete distribution from a profit sharing plan consisting of amounts contributed by the employer after 1969 as ordinary income, rather than long term capital gain as under present law.

This change should not be enacted. Long term capital gains treatment should be retained in its present form in recognition of the fact that an interest in a profit sharing plan is an investment at risk over a long period and is entitled to such treatment. Capital gains treatment is fair, workable, and easily understood, and is a good method for taxing "bunched" income. The change which would be made by the House Bill is extremely complex, and would be difficult for employes to understand, and for the Internal Revenue Service to administer. It would in most cases require employes to overpay their tax at the time of retirement, and then to seek a refund of the overpayment five years later.

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Before discussing the proposed tax change, I shall first describe the Sears Profit Sharing Plan.

Description of Sears Profit Sharing Plan

The Sears Profit Sharing Plan was established on July 1, 1916, more than fifty-three years ago. Its purposes were threefold -- to permit employes to share in the Company's profits, to encourage the habit of saving, and to allow employes to accumulate a sum sufficient to provide for their retirement. While the Plan has been amended many times over the years, these basic purposes have remained the same.

Under present rules all regular employes are eligible to join the Plan after one year's service with the Company. Although membership is voluntary, over 99% of those eligible to join do join. As a member of the Plan, the employe contributes 5% of his own tax-paid salary to the Plan each year, up to a maximum of $750 (5% of $15,000). This means that the employe participates in the Plan only on his first $15,000 of earnings. (Prior to the current year the maximum participation was $10,000 of annual earnings.) This limitation was adopted specifically to prevent the higher paid employes from participating unduly in the Plan.

The Company also makes contributions to the Plan each year, based on a sliding percentage of its net profit before taxes. The maximum percentage is 11% of pre-tax profits, and

it is expected that the Company will contribute this maximum amount during the current year. The Company contributions are allocated to the members under a formula which takes into account each employe's contributions, years of service, and age.

Since the inception of the Plan in 1916, its assets have been invested primarily in Sears stock. As of December 31, 1968, Sears stock constituted about 86% of the Plan's total assets, and other securities accounted for the remaining 14% of its assets.

Each employe has his own account in the Plan and receives an annual statement showing the details of his account, including how much he contributed during the year, his allocable share of Company contributions, and the earnings on the investments in his account. To the extent amounts credited to his account are invested in Sears stock, his statement shows the actual number of shares he owns. To the extent such amounts are invested in other securities, his statement shows their dollar value.

The employe's account in the Sears Plan becomes fully vested after he has been with the Company for five years. After an employe's account is vested, he can instruct the trustees of the Plan as to how to vote the Sears stock in his account at the shareholders' meetings. Also, he is then entitled to

take with him the full amount credited to his account if he leaves the Company for any reason. Sears shares credited to his account are generally distributed to him in kind rather than being converted into cash.

From this brief description, it can be seen that Sears employes are the true owners of their profit sharing investments throughout their working careers. They are not guaranteed any definite benefit on retirement, but assume the risk of gain or loss just like any other investor. Also, they are very definitely partners in Sears business. Since the Plan is largely invested in Sears stock - it now owns about 22% of the Company's outstanding stock - the employes themselves stand to gain significantly from any success which the Company may have. This gives Sears employes a real stake in the Company's future and in the American free enterprise system.

The actual dollar value of any particular employe's benefit from profit sharing obviously cannot be determined in advance since it will be dependent on his years of service, the increase or decrease in value of the investments in his account, and other factors. However, it is possible to show the benefits which Sears employes who have already retired have received. Using 1968 as an example, the Plan's records show that employes who retired in that year with twenty-five to thirty years service received, on the average, cash and Sears stock with a

combined value of $100,401. Employes with longer service would generally have received more. Those with shorter service would, on the average, have received less.

Present Law and Changes Made by House Bill

With this background on how the Sears Plan works, I should now like to discuss the tax treatment of profit sharing distributions. Under present law, which has been in effect for over twenty-five years, complete distributions from profit sharing plans are taxed as long term capital gains, if they are made in one taxable year as a result of the employe's separation from service with his employer. In addition, where the distribution includes securities of the employer corporation, these securities are valued at their original cost to the plan. Thus, the unrealized appreciation in such securities is not taxed until the employe later sells them.

The House Bill would change present law so as to tax as ordinary income, rather than as long term capital gain, that portion of a profit sharing distribution which is made up of employer contributions attributable to years after 1969. A special averaging device is included so as to minimize somewhat the effect of the "bunching" of income in the year of retirement. Under this averaging device, one-fifth of such employer contributions is added to the employe's other income and a tax is computed on it. This tax is then multiplied by five to arrive at the total tax on such employer contributions. In

addition, the House Bill provides for a recomputation of the tax for the taxable year of retirement and each of the four following taxable years. In making this recomputation the retired employe assumes that 20% of such employer contributions was includible in his income in the year of retirement, and the remaining 80% was includible ratably over the four years immediately following retirement. If this recomputation results in a lesser tax than was paid in the year of retirement (and it probably will), the employe is entitled to a refund.

Other than the change in the handling of company contributions, the future tax treatment of profit sharing distributions would be the same as under present law. That is, to the extent that a distribution is attributable to earnings of the plan over the years and to realized appreciation in the value of plan investments, the distribution would be treated as long term capital gain. Also, no change would be made in the tax treatment of the unrealized appreciation in employer's securities distributed in kind. Tax on such unrealized appreciation would continue to be deferred until it is realized through a sale of the stock.

There are other changes made by the House Bill which, although not specifically directed toward profit sharing,

could have an effect on the calculation of tax on profit sharing distributions. One of these is the removal of the 25% maximum tax rate on long term capital gains. Another is that Section 311 of the House Bill makes the general income averaging provisions of the Code (Sections 1301 through 1305) applicable to long term capital gains. Thus, under the House Bill a retiring employe would have two alternatives in computing the tax on his profit sharing distribution. One of these would be to use the special averaging device and the refund provisions described above. The other would be to use the general income averaging provisions of the Code.

Comments on Tax Treatment of Profit Sharing Distributions

Our purpose in presenting this statement is to point out the essential fairness of the present method of taxing profit sharing distributions. There are two fundamental principles which we feel are important -- first, profit sharing distributions are taxed as long term capital gains, and second, the tax on unrealized appreciation in employer securities is deferred until the employe sells the securities. These principles should be retained.

I. Reasons for Retaining Long Term Capital Gain Treatment In Its Present Form

A. Long Term Capital Gain Treatment of Employer Contributions is Correct

There are two major reasons why capital gains treatment is especially appropriate for lump sum distributions from a profit sharing plan. First, capital gains treatment was developed for and has been traditionally applied to situations where income accumulated over a number of years is "bunched" into one year. Lump sum distributions from profit sharing plans, which have been accumulated over many years of service and received by the employe in one taxable year, are an excellent example of the type of bunched income for which the capital gains method of taxation was developed.

Second, capital gains treatment should be applied to lump sum distributions from profit sharing plans because the individual employe's profit sharing account is an investment at risk throughout his working career. He is the true owner of his profit sharing investments, whether arising from his own contributions or from his employer's contributions. His interest in his profit sharing account is subject to the same risks that any investor in securities takes. If the investments turn out well, the employe enjoys the gain. On the

other hand, if the investments turn out badly, the employe suffers the full loss. Thus, the employe's profit sharing distribution should be entitled to capital gains treatment and it should not be fragmented so as to tax a part of it ·· ordinary income.

The fact that a portion of the employe's interest in his profit sharing account may originate from the employer's contribution, and thus may be attributable to the employe's own labor, does not make it any less a capital asset and should not require that this portion of his distribution be taxed as ordinary income. As an example of this, let us consider the individual entrepreneur who builds up the goodwill of his business through his own hard work over a long period of years. He is permitted to have capital gains treatment on the sale of this goodwill when he retires and sells his business even though it resulted from his personal labor. An employe's profit sharing account should be entitled to equivalent treatment.

B. Long Term Capital Gains Treatment Is a Better Averaging Device Than Is Provided Under the House Bill

The House Bill proceeds on the theory that the employer contributions included in a profit sharing distribution constitute compensation, and therefore, should be taxed as ordinary

income. It then recognizes the inequity of bunching this income into one taxable year, and adopts an averaging device and refund provisions to solve this problem. However, we submit that averaging is better accomplished, with less burden to the taxpayer, by applying the present long term capital gains treatment. It arrives at a fair result with a minimum of complexity and is superior to the averaging device contained in the House Bill.

The usual Sears employe begins working with the Company when he is just starting his career and is in the lower tax brackets. He then works his way up and probably earns his highest salary in the year of retirement. While long term capital gains treatment taxes only half of his distribution in the year of retirement, it does so at tax rates which begin at the employe's highest rate for that year and go upward from there. Thus, it results in a sizable tax and is generally a good averaging device for determining the tax on the employe's profit sharing distribution which was built up over an entire career, perhaps thirty or forty years or more.

Long term capital gains treatment arrives at a fair result even for the few employes who ultimately reach a high position in the Company. Such employes have generally started at the bottom of the ladder and worked their way up over a long period of years. For a good part of their career they

were generally in the lower tax brackets and it is not at all improper to tax them at rates lower than the bracket in which they find themselves at retirement. It should be noted also that the House Bill would eliminate the 25% maximum tax rate on long term capital gains, and if enacted, this in itself would raise the tax on employes in the higher tax brackets.

The averaging device provided by Section 515 of the House Bill is not satisfactory. Under this averaging device the employe computes the tax on one-fifth of the post-1969 employer contributions and then multiplies that result by five. One problem with this approach is that it assumes that the employer contributions were earned over a five year period even though they were generally earned over an entire career. A more serious problem, however, is that one-fifth of the post-1969 employer contributions is added on top of all other income in the year of retirement. This includes both the employe's salary and the capital gains portion of his profit sharing distribution. Thus, the year of retirement is generally his very highest income year and the employer contributions would be taxed at these high rates.

The House Bill makes a serious attempt at correcting this problem through the use of the refund provisions which treat 80% of the post-1969 employer contributions as taxable ratably over the four years subsequent to retirement. Our

rough calculations indicate that the average Sears retiree would be entitled to a significant tax refund five years after retirement, and that after he receives his refund his net tax liability would not be greatly different than under the present capital gains treatment. Thus, an important objection to the averaging provisions of the House Bill is that they deprive the employe of needed funds in the year of retirement and the four subsequent years.

The law should provide a reasonable opportunity for the employe to pay his correct tax in the first instance. Preferably this should occur in the year of his retirement, as is the case with long term capital gains treatment. However, if the theory is to be followed that only 20% of the employer contribution is to be taxable in the year of retirement, and the remaining 80% ratably over the four subsequent years, the employe should pay his tax each year on the pro rata amount taxable in such year. He should not pay tax on the entire amount of employer contribution in the year of retirement, and then be required to seek a refund at the end of five years.

C. The Change in the Treatment of Employer Contributions is Extremely Complex in its Application

Long term capital gains treatment also has the advantage of being easy to understand. It has been the law for over twenty-five years and people are familiar with it.

The treatment under the House Bill, on the other hand, is quite difficult to understand. It would require a number of complex calculations to determine the employe's tax for the year of retirement. First, a calculation would be made of the tax on the employe's income, including his salary and the capital gain portion of his profit sharing distribution, but entirely excluding the post-1969 employer contributions. Another calculation would be made of the tax on this same income plus one-fifth of the post-1969 employer contributions. The difference in these two tax figures would then be multiplied by five, to determine the total tax on the post-1969 employer contributions. This amount would then be added to the tax on the employe's other income to arrive at the total tax liability for the year of retirement.

Then, five years after retirement a recomputation would be made of the tax for the year of retirement and each of the succeeding four years. It would be based on the assumption that 20% of the post-1969 employer contributions is includible in the retired employe's income in each of these years. The total tax on the employer contributions computed on this basis for the five year period would then be compared with the tax the employe paid on the employer contributions in the year of retirement. If this total tax is less than that paid in the

year of retirement, the employe would be entitled to a refund of the difference.

To illustrate how this proposed change in the law would work, we have attached to this statement an exhibit showing the steps which an employe would have to take in complying with this new provision. This new provision would obviously be far more complex than merely including 50% of the gain in income at the time of distribution as is presently done in the case of long term capital gains.

D. The Refund Provisions of the House Bill Present Other Serious Practical Problems

There is another very practical problem which would arise from the new averaging device and the refund provisions. This is the fact that the elderly retiree may never remember to apply for a refund five years after retirement, and if he does remember he may well have lost or misplaced vital records from the intervening years.

As a matter of fact, the Internal Revenue Service would have a similar problem. In order to determine if an employe were really entitled to a refund, the Service would have to audit the employe's returns for the previous five years. Some of these may have been filed in other Internal Revenue Districts and may be difficult to locate. We believe that these refund provisions would cause serious administrative problems to the Service as well as to the employe.

In summary, we believe that long term capital gains treatment of profit sharing distributions is fair, has the advantage of being easy to understand, and is a good method of taxing "bunched" income. We recommend that such treatment be retained.

II. Unrealized Appreciation in Employer Securities Should Not be Taxed at the time of Distribution

Ever since its inception in 1916, the Sears Profit Sharing Plan has been invested primarily in Sears stock. The Rules of the Plan make specific provision for such investment, so that "depositors may, in the largest measure possible, share in the earnings of the Company".

Consequently, Sears employes are not only the true owners of their profit sharing accounts, but also the owners of a large portion of the Company for which they work. Through profit sharing, they own 22% of the Company, and this gives them a real stake in its future, and makes their interest and that of the Company, inseparable and indivisible. They are entrepreneurs just as much as any man who owns his own business.

Through the loyalty and devotion which their ownership in the Company has inspired, the Company has prospered and

grown. In 1916, when the Plan was started, Sears was a mail order house with sales of $137,000,000. At the end of 1968, Sears had 11 catalog order plants and 818 retail stores, and its sales for that year were over $8 billion. This great growth in our business could not have come about without the loyalty and hard work of thousands of employes.

Of course, this is a two way street. While the Company's growth has been due largely to the loyalty of its employes, the employes have benefitted greatly from that growth. Since 1916, the price of Sears stock has increased almost sixty times, and through their interest in the Plan, employes have shared in this increase.

Even when an employe retires from Sears, he retains his ties with the Company. Sears retirees generally take their Sears stock with them when they leave, and continue as shareholders during their retirement years.

At Sears, profit sharing and the principle of investing in Company stock are one and the same thing, and therefore, the deferral of tax on unrealized appreciation is of the utmost importance. The House Bill recognizes the fact that it would be inequitable to tax away such appreciation before it is realized through a sale of the stock. The retiring employe does not receive cash but only receives direct

legal title to the stock which was purchased for him previously and held for him throughout his employment. Individual purchasers of securities are not taxed on appreciation in securities which they own until that appreciation has been realized through a sale, and profit sharing plan members should not be treated differently.

To tax the employe on unrealized appreciation would work an undeserved hardship on him. Generally, he would not have the money to pay his tax, and would either have to borrow or liquidate a portion of his investment in his Company. Either of these courses would impair his retirement security substantially and would be undesirable.

The present tax treatment of employer securities is entirely proper and should be retained.

Conclusion

In conclusion, we believe that the House Bill properly recognizes that tax on unrealized appreciation in employer securities should be deferred. However, the change in the treatment of employer contributions provided in Section 515 of the House Bill should not be enacted. It is extremely complex and will be very difficult for retiring employes to

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understand. In addition, it will require them to overpay their tax in the first instance, and then obtain a refund without interest five years later.

The present long term capital gains treatment is proper because it recognizes the fact that an interest in a profit sharing plan is an investment at risk over a long period. It is fair, easy to understand, and provides a good averaging device for taxing profit sharing distributions. If, in spite of this fact, it is considered imperative to change the tax treatment of employer contributions, a better averaging device should be found than that provided in the House Bill. Such a device should be reasonably simple in its operation. It should provide for the employe's tax liability to be finally determined at the time of his retirement and should obviate the necessity for reliance upon refund procedures.

EXHIBIT TO STATEMENT TO THE COMMITTEE ON FINANCE, U. S. SENATE, ON SEPTEMBER 16, 1969, BY ARTHUR M. WOOD, PRESIDENT, SEARS, ROEBUCK AND CO., WITH RESPECT TO THE CHANGE WHICH WOULD BE MADE BY SECTION 515 OF H.R. 13270 IN TAXATION OF LUMP SUM DISTRIBUTIONS FROM PROFIT SHARING PLANS

Sample Computations of Tax Under Tax Reform Act of 1969 for Complete Distribution From Sears Profit Sharing Plan Because Of Separation from Service

A. Assumptions

It is assumed that an employe begins working for Sears on January 1, 1971, at a starting salary of $4,700 a year and retires at the end of 1995 after twenty-five years service at a final salary of $18,650 per year. It is further assumed that Company contributions to the Profit Sharing Plan are allocated to the employe's account each year in amounts approximately equal to those being allocated to employes currently, and that Sears stock appreciates at a rate of 6% a year and pays dividends of about 2% a year on its market value.

In the year of retirement, it is assumed that the employe has no income other than his salary and that the employe does not elect general income averaging on his distribution. In subsequent years, his dividend income on Sears stock and his other income is assumed to be $1,900 per year.

B. Taxable Value of Employe's Profit Sharing Distribution

Under these assumptions, the following analysis shows the taxable value of the employe's distribution at retirement.

Total Value of Account (Sears Stock)	$87,150
Less: Total of Employe's Annual Deposits	13,460
	$73,690
Less: Appreciation on Sears Stock	33,654
Taxable Value of Account	$40,036
Employer Contribution Included in Taxable Value - Ordinary Income	28,718
Balance of Taxable Value - Long Term Capital Gain	$11,318

C. Tax Computation Under Tax Reform Act of 1969

1. Tax in Year of Retirement

	Tax on Income Other Than Employer Contributions	Tax on Income Including 20% of Employer Contributions
Income		
Salary	$18,650	$18,650
Profit Sharing Distribution		
Company Contributions $28,718 20% Includible		5,744
Balance of Taxable Value $11,318 50% Includible	5,659	5,659
Gross Income	$24,309	$30,053
Less: 2 Exemptions and $2,000 Standard Deduction	3,200	3,200
Taxable Income	$21,109	$26,853
Tax on Above at Proposed Rates	$ 4,473	$ 6,310
Computation of Total Tax		
Tax on Income Excluding Employer Contributions	$	$ 4,473
Tax on Employer Contributions		
Tax on 20% of Employer Contributions ($6,310 - $4,473)	1,837 x 5	9,185
Total Tax in Year of Retirement		$13,658

2. Summary of Actual Tax Returns for Following Four Years

	Years After Retirement			
	1	2	3	4
Total Gross Income	$1,900	$1,900	$1,900	$1,900
Tax Liability (Low Income Allowance Applicable)	0	0	0	0

3. Recomputation of Tax for Following Four Years Including 20% of Employer Contributions in Income

	Years After Retirement			
	1	2	3	4
Gross Income per Returns Filed	$1,900	$1,900	$1,900	$1,900
20% of Company Contribution	5,744	5,744	5,744	5,744
Total Gross Income	$7,644	$7,644	$7,644	$7,644
Less: 2 Exemptions and 15% Standard Deduction	2,347	2,347	2,347	2,347
Taxable Income	$5,297	$5,297	$5,297	$5,297
Tax Liability	$ 813	$ 813	$ 813	$ 813

4. Computation of Refund Due

Tax Paid on Employer Contributions in Year of Retirement (See 1 Above)		$9,185
Tax Due if 20% of Employer Contributions Was Includible in Each of 5 Years		
Tax Due for Year of Retirement (See 1 Above)	$1,837	
Tax Due for Remaining 4 Years (See 3 Above - 4 x $813)	3,252	5,089
Net Refund Due at End of 5 Years		$4,096

Council of Profit Sharing Industries

29 N. WACKER DRIVE • CHICAGO, ILLINOIS 60606

FRANKLIN 2-3411 AREA CODE 312

Summary of the Principal Points Contained in the Statement of the Council of Profit Sharing Industries to the Senate Committee on Finance in Opposition to Those Portions of H. R. 13270 Which Would Change the Rules for Taxation of Lump Sum Distributions Under Qualified Profit Sharing Plans*

Purpose of Statement

The Council's statement opposes those portions of H. R. 13270 which would provide a special, revised method of taxation of a portion of lump sum distributions made under qualified profit sharing plans. (p. 1 of statement)

The Council is aware that other changes made by H. R. 13270 also would have an indirect effect on taxation of lump sum distributions, but does not direct its opposition to these changes. (pp. 2 and 3 of statement)

The proposed change would affect millions of employees, not just a handful of high income individuals. (pp. 3 and 4 of statement)

The reasons for the Council's opposition are:

I. The change of law is based on a misconception of what profit sharing is and what an employee's interest in profit sharing is.

II. The proposed change is not consistent with some of the underlying premises of H. R. 13270.

III. Modest estimated revenue gains will be offset by increased direct costs of administering the revised method and by indirect effects of the change which could result in an elimination of any revenue gain and might even produce a revenue loss. (p. 5 of statement)

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I. Misconceptions Regarding Profit Sharing

A. An employer's profit sharing contributions are not simply and solely "deferred compensation". (pp. 6-8 of statement)

B. An employee's interest in a qualified profit sharing plan is "risk capital". (p. 9 of statement)

* Presented by Raymond H. Giesecke, Chairman of the Board of Directors.

1. Reasons why employer contributions cannot be taxed at the time made. (pp. 9 and 10 of statement)

2. Reasons why employer contributions should not be taxed as ordinary income when distributed. (pp. 10-12 of statement)

II. Inconsistencies of the Proposed Method of Taxation With the Premises of H. R. 13270

Inconsistency with the objective of H. R. 13270 that special preferences should be eliminated in order to preserve confidence in the fairness of the self-assessment system of collection of income taxes. (pp. 13 and 14 of statement) H. R. 13270 also seeks to eliminate tax preferences in the Code which grant tax advantages to persons of substantial incomes and which were placed in the Code primarily to aid a limited segment of the economy. (pp. 21 and 22 of statement)

A. Fairness of the proposal and improvement of the tax system

1. Reasons why the proposed method of taxing parts of lump sum distributions as ordinary income is not fair.

(a) Would provide taxation on the basis of other income and highest tax rates in a single taxable year (p. 14 of statement)

(b) Requires in many cases overpayment of taxes initially and the recoupment of overpayment via a refund (pp. 14 and 15 of statement)

(c) Is unfair to younger employees as contrasted with older employees (p. 15 of statement)

2. The proposed change will not improve the tax system because of the complications which will be introduced by the special averaging method and the refund possibilities involved (pp. 15-19 of statement)

3. The bulk of the revenue gains envisioned will be paid by persons against whom the revised method of taxation is not directed. (pp. 19-21 of statement)

B. The present method of taxation is not an abuse which is availed of by only a handful of high income individuals comprising a limited segment of the economy. (pp. 21-24 of statement)

III. The Revenue Effects of the Proposed Method

A. Increased costs of administration must be balanced against estimated revenue gains. The complications introduced by the revised method inevitably will require the employment by the Treasury Department of many highly skilled individuals to administer those provisions. (p. 26 of statement)

B. Indirect revenue losses coupled with increased administrative costs could eliminate any revenue gain and might result in revenue loss for the following reasons:

1. Profit sharing is successful (pp. 27 and 28 of statement)

2. The government shares, through increased revenues, in such success (p. 29 of statement)

3. The proposal probably would discourage lump sum distributions with the result that the government would not collect revenues which it now collects when distribution is made in that form (pp. 30 and 31 of statement)

IV. Conclusion

A. H. R. 13270 recognizes much of what the Council contends regarding profit sharing. It also recognizes that employer contributions which are distributed as part of a lump sum payment are "bunched income". The special averaging provision which H. R. 13270 would add does not go far enough in recognizing this point. (pp. 31 and 32 of statement)

B. If any change is to be made it should adhere to the following general principles:

1. It should continue to recognize that a substantial part of an employee's interest in a profit sharing plan is risk capital and should be taxed as such.

2. Any averaging method which is substituted for the long term capital gain method of averaging taxes on bunched income should not be based upon the recipient's income and marginal rates in a single taxable year.

3. Any averaging method should contemplate payment of the taxes due on any distribution once and for all at the time the distribution is made. Refund possibilities should be avoided.

4. Any averaging method should be simple and should not involve the complications which the averaging method contemplated by H. R. 13270 would entail.

Council of Profit Sharing Industries

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Statement of the Council of Profit Sharing Industries to the Senate Committee on Finance in Opposition to Those Portions of H. R. 13270 Which Would Change the Rules for Taxation of Lump Sum Distributions Under Qualified Profit Sharing Plans

PURPOSE

This statement is submitted in opposition to those portions of H. R. 13270 which would change the method of taxation of lump sum distributions which are made under qualified profit sharing plans. Other changes contained in H. R. 13270 also would have an effect on the amount of taxes payable by employees who receive lump sum distributions. In brief, the three principal changes which would affect the taxability of lump sum distributions are:

1. Change of Method of Taxation Specifically Applicable to Lump Sum Distributions. The portion of any lump sum distribution which consists of employer contributions would be taxed as ordinary income. In the year of distribution, the amount of tax payable with respect to such ordinary income would be five times the amount of the increase in tax which is attributable to the addition of 20% of such ordinary income to other income.

Five years later, the employee would be entitled to recompute what the total taxes attributable to the ordinary income portion of his lump sum distribution would have been if 20% of the ordinary income portion of his lump sum distribution had been included in his taxable income in the year of distribution and each of the next four succeeding taxable years. If the ordinary income tax which he paid with respect to the lump sum distribution in the year of distribution was greater than he would have paid under the second test, he would be entitled to file a refund claim as though he had paid his "excessive" tax in the fourth taxable year following the year of distribution. This change would apply to that part of any lump sum distribution which consists of employer contributions made after the calendar year 1969. The balance of any lump sum distribution would continue to be taxed as a long term capital gain.

2. Change in General Income Averaging Provisions. Long term capital gains would be included in the definition of "averagable income" for purposes of general income tax averaging. Since portions of lump sum distributions will continue to be treated as long term capital gains, and the balance as ordinary income,

this change also would be applicable to lump sum distributions in their entirety.

3. Elimination of the Alternative Tax on Capital Gains. The alternative tax computation now provided for all net long term capital gains would be eliminated. This change would apply to that portion of any lump sum distribution which would continue to be taxed as a long term capital gain as is provided under existing law.

The latter two changes would apply to those portions of lump sum distributions treated as long term capital gains even if the first change were not made.

The Council urges no special treatment of lump sum distributions, either favorable or unfavorable, insofar as any changes generally applicable to capital gains are concerned. However, the first change would single out lump sum distributions and provide a special method of taxing portions of such distributions. Therefore, the main thrust of the Council's statement is directed at the portions of H. R. 13270 which would apply solely to lump sum distributions.

Contrary to any impression that may have been created to the effect that lump sum distributions are a means used by relatively few,

highly compensated employees to escape taxation, any proposal affecting lump sum distributions would have far reaching effects. It would not affect just a few highly compensated individuals. For instance, the Council conducted a survey in 1968 among its member companies regarding the use of lump sum distributions as a means of settlement of participants' interests in profit sharing plans. That survey showed that a majority of all distributions made under qualified profit sharing plans are made using this form of payment. Moreover, 90% of the lump sum distributions made involved distributions of less than $30,000.00. Nearly 70% of the distributions fell in the range of from $500.00 to $10,000.00. These results should be considered in light of the fact that there are now approximately 80,000 profit sharing plans in existence. Many of these plans have been established in recent years. For instance, the number of plans has approximately doubled every 4-5 years since 1946. In the year 1968 alone, according to Treasury Department statistics, there was a net addition of some 10,000 net profit sharing plans. In the period from 1964 through 1968 the net number of new profit sharing plans established was 36,119. Those plans covered a total of more than 1-1/2 million employees. In light of the foregoing, it is safe to say that the proposed change in method of taxation would be of far reaching effect and could eventually involve taxpayers numbering in the millions.

The Council opposes those portions of H.R. 13270 which would tax, as ordinary income, a portion of any lump sum distribution made under a profit sharing plan for the following reasons:

I. The Council believes that this change of law is based upon a misconception as to the nature of profit sharing and the nature of an employee's interest under a qualified profit sharing plan.

II. The Council believes that the results which the change in method of taxation would produce are inconsistent with some of the underlying premises of the Tax Reform Bill of 1969.

III. The Council believes that the added costs of administering the revised method of taxation together with other collateral effects which the changed method would produce should be balanced against any estimated revenue gains which would be produced by the change and that when all factors are taken into account, the relatively modest revenue gain now anticipated would be practically eliminated, or might even result in a net revenue loss.

I. Misconceptions Regarding Profit Sharing

The change in the method of taxation of lump sum distributions is based upon the proposition that an employer's contributions under a

qualified profit sharing plan are nothing more or less than "deferred compensation". The Council disagrees with this proposition. Perhaps the best way to demonstrate why the Council disagrees with this proposition would be to describe what profit sharing is and what the nature of an employee's interest in a qualified profit sharing plan is.

A. What is Profit Sharing?

Profit sharing is a means of enabling employees to share in the fruits of the companies for which they work. Without profit sharing, millions of employees who now have a stake in the company for which they work would not have such a stake. There are many reasons why they might not have such a stake. For example, inflation and taxes (both federal and local) make the accumulation of a "nest egg" for investment purposes difficult for the vast majority of employees. Moreover, many companies are not publicly owned and traded. Therefore, even if an employee is able to accumulate sufficient funds of his own in order to acquire an ownership interest in the company for which he works, he often is unable to do so for the simple reason that such ownership or part ownership is not for sale.

Through profit sharing an employee has an opportunity to share in one of the benefits of ownership -- a chance to share in the

same thing in which the investors in a business share -- the profits resulting from operations of the business.

The Council believes that its concept of profit sharing fairly describes what profit sharing is. Article II, Section 1 of the Constitution and By Laws of the Council states:

> "The Council defines its concept of profit sharing as any procedure under which an employer pays or makes available to regular employees subject to reasonable eligibility rules, in addition to prevailing rates of pay, special current or deferred sums based on the profits of the business."
>
> [Underscoring added]

Thus, profit sharing is something extra -- something over and above normal compensation. Profit sharing is not a substitute for paying going wages for average performance. It is an "extra" for doing better than average. True, employment is a requirement for participation in a qualified profit sharing plan. To that extent it can be said that an employer's contribution is in consideration of the employee's services. However, since it is something in addition to regular compensation, the Council believes that it is an oversimplification to simply characterize it as "deferred compensation". The objective of profit sharing is not simply to compensate employees. The Declaration of Principles contained in Article III of the Council's

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Constitution and By Laws set forth the Council's views as to the objectives of profit sharing.[1]

Coupled with the Council's concept of profit sharing as being something in addition to regular compensation, the Council's Declaration of Principles clearly indicates that something other than simply compensation to employees is sought as an objective in establishing a profit sharing plan.

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1 "DECLARATION OF PRINCIPLES

SECTION 1. The Council believes it to be highly important to develop an economy in which there is freedom of opportunity for each to achieve his maximum personal development. The Council holds that profit sharing offers a most significant means of bringing into being such an economy.

SECTION 2. The Council considers well-planned profit sharing to be an effective means of developing group co-operation and efficiency.

SECTION 3. The Council holds that widespread profit sharing will tend to stabilize the economy.

SECTION 4. The Council holds that the true spirit of partnership which sound profit sharing engenders is of paramount importance.

SECTION 5. The Council is dedicated to the purpose of extending soundly conceived and administered profit sharing in every practical way. At the same time it does not offer profit sharing as a panacea, nor does it minimize the importance of other means of fostering its broad objectives."

Article III, Constitution and By Laws of the Council of Profit Sharing Industries

B. What is the Nature of an Employee's Interest in a Qualified Profit Sharing Plan?

If an employer's contribution under a qualified profit sharing plan is nothing more or less than a compensating event, that compensating event occurs at the time the employer makes its contribution under the [illegible] Thereafter, whatever happens to the contribution also happens to [illegible]ployee. No guarantees are involved. The employer has no beneficial interest whatsoever in the contribution, once it has been made, and neither receives any benefit from, nor bears any burden of, the investment results which apply to the employer's contribution. On the contrary, the results of investment of the employer's contribution, whether good or bad, affect only the employee. Thus, once the contribution is made on behalf of an employee and is invested, it becomes risk capital. In this respect, it is no different than any other investment of risk capital and therefore should be treated no differently than any other risk capital.

Should the employer's contribution, therefore, be taxed to the employee at the time it is made on his behalf? There are at least two reasons why this should not be done. First, at the time the contribution is made it is not at all certain that the employee on whose behalf it is made will eventually receive it. Most plans provide for

graduated vesting of employees' interests, including the employer's contributions, over a period of years. Whatever an employee does not receive because of premature separation (for example, on account of resignation) is reallocated among all other participants in the plan. Second, and perhaps of equal importance, because of future investment results an employee may never receive an amount equal to the employer's contribution which is made on his behalf even though, at the time it is made, his interest in that contribution is fully vested and cannot be defeated by his subsequent termination of employment for any reason.

Since, for the reasons stated, it would be inequitable to exact a tax from the employee with respect to the employer's contribution at the time it is made, should it not be taxed as ordinary income when it is distributed? There are at least two reasons why this should not be done. First, throughout the time that the employer's contribution is held for the employee's benefit it is subject to risk. Second, when the employer's contributions are distributed in the form of a lump sum distribution they represent "bunched income" which may have been accumulated over an employee's working lifetime -- perhaps as much as 35 or 40 years. H. R. 13270's answer to this problem

would be a form of averaging. However, that averaging would be based on the employee's total ordinary income (including a part of the lump sum distribution) and his highest tax rates in a single taxable year. Unless those factors had remained constant throughout his working lifetime (a most unlikely possibility) this would result in more tax being paid by an employee than he would have paid had the contribution been taxed to him in each year when and as it was made. Clearly demonstrative of the fact that income, and hence marginal tax rates, do not remain the same is the fact that in the period from 1958 to 1967 the number of taxpayers with gross incomes in the $10,000.00 to $15,000.00 range quadrupled. The number went from about 2-1/2 million such taxpayers to more than 10 million such taxpayers. Those 10 million taxpayers alone comprised about 1/7th of all of the taxpayers reporting income on individual returns in 1967.[2]

It has been argued that deferral of taxes on contributions when they are made justifies the imposition of tax on an ordinary income basis when distributions are made. In essence, the tax deferral is a "tax subsidy" and therefore one should not complain if one's taxes, as eventually

2 Source: Preliminary Report, Statistics of Income - 1967, Individual Income Tax Returns, U. S. Government Printing Office, Publication No. 198, 1-69

determined, are higher than they might have been if taxes had been payable on employer contributions when and as they were made. This argument also ignores the fact that it is the employee who has borne the risk all along. That the employee would continue to bear all risks is borne out by H. R. 13270 itself. As drafted, H. R. 13270 would tax, as ordinary income, an amount equal to the employer's post-1969 contributions even though, through market conditions which could prevail in the future, those contributions would be in a loss position. For example, assume that as of December 31, 1969 an employee's account consists of $20,000.00, broken down as follows:

Actual Employer Contributions up to 12/31/69	$ 8,000.00
Reinvested Earnings and Appreciation	12,000.00
Total Value	$20,000.00

Suppose that after 1969 the employer's contributions total an additional $10,000.00. However, because of temporary market conditions at the time, when the employee retires and receives a lump sum distribution in 1979, he receives only $15,000.00. Under H. R. 13270, $10,000.00 out of the employee's total distribution of $15,000.00 would be taxed as ordinary income. All the risk of future market performance would have been borne by the employee.

In view of what profit sharing seeks to achieve and the nature of an employee's interest under a profit sharing plan, it is respectfully suggested that it is inaccurate to characterize any part of it simply as "deferred compensation".

II. Inconsistencies of the Proposed Method of Taxation With the Premises of H. R. 13270

For the taxable year 1967 over 71 million individual income tax returns were filed. Those returns were prepared and filed under a self-assessment system and produced a total of nearly $63 billion of revenue. That record attests to the willingness of American citizens to be taxed and to their willingness to voluntarily calculate and report their income and to pay the tax liabilities which result therefrom.

The Council agrees completely with the Ways and Means Committee's statement to the effect that:

> "Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and would make it far more

difficult to collect the necessary revenues. For this reason alone, the tax system should be improved."[3]

A. Is the Proposed Method of Taxing Lump Sum Distributions Fair?

Conceding, for purposes of argument, that employer contributions are nothing more than deferred compensation, what is "fair" in determining the tax which shall be paid on that deferred compensation on the basis of the employee's income and marginal tax rates in the year of distribution? Is it to be assumed that an individual employee's taxable income and his marginal tax rates will remain the same throughout his entire working lifetime? Only if the latter proves true can it be said that there is no element of unfairness in using his income and marginal rates in a single year, perhaps the year in which he reaches his highest peak of earnings, to determine the tax on employer contributions which may have been made on his behalf over his entire working lifetime.

A further element of "unfairness" in the changed method of taxation of lump sum distributions is the fact that an employee will be compelled to pay a tax in the year in which he receives his distribution and then will be compelled to wait five years to find out

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3 Report of the Committee on Ways and Means, House of Representatives, to Accompany H. R. 13270, page 9

whether or not he paid too much tax in the first instance. For employees whose income is drastically reduced following the payment, a refund probably will be payable following the fifth year. In the meantime, of course, the employee involved will have lost completely the use of the excessive tax which he paid in the first instance. In the interim, this money might be put to good use in meeting his retirement needs. The new method of taxation would not even allow him interest on the excessive tax which he paid in the first instance and which he must seek by a refund claim five years later.

Is the proposal fair to all employees? Looked at from the standpoint of an employee whose working life is behind him at this time, the proposal seems fair. It is to apply to future employer contributions only. However, looked at from the standpoint of the younger employee who is just joining a qualified plan, the proposal seems most unfair. The taxes which will be payable by him with respect to his employer's contributions may be substantially greater than those payable by his fellow employee who retires in the near future even though they have been treated exactly the same under the plan.

B. Will the Revised Method of Taxation Improve the Tax System?

Quite apart from any questions of fairness, the workability of our self-assessment system of tax collection clearly depends upon

the capacity of the self-assessor to determine his tax. In this respect, the revised method of taxation will result in incredible complications in determining the amount of tax finally payable with respect to a lump sum distribution. For example, assuming that an employee is going to seek to pay the least amount of tax in the year in which he receives his distribution:

1. For the year of distribution he would have to compute his tax on two alternative bases.

   (a) First, he would divide his lump sum distribution into the portion which will now be taxed as ordinary income (i.e., post-1969 employer contributions) and the portion which will continue to be taxed as a long term capital gain. With respect to the ordinary income portion, the new special averaging provision will apply. In essence, this new special averaging provision is the same averaging provision which was added to the Code with respect to self-employed individuals as a part of H. R. 10. This provision was added to the law in 1962. To date no form for calculating taxes payable under such special averaging has been published. In calculating the capital gains tax payable on the portion of

his lump sum distribution, if his capital gain exceeds $20,000.00 and if he itemizes his deductions, he will have to allocate his deductions between his "preference income" and his other income, as required by Section 302 of the Tax Reform Bill of 1969.

(b) Next, after calculating his taxes as indicated above, he also will have to calculate his taxes on the entire amount of his distribution using the general income averaging provisions of Sections 1301-1305 of the Code, as amended by the Reform Bill. Even after simplifications of general income averaging which H. R. 13270 would provide, the form for calculating taxes under general income tax averaging alone will consist of 22 separate lines.[4]

2. If he paid his tax in the year of distribution on the basis of the special provisions which will now apply to lump sum distributions rather than on the basis of general income averaging, then after five years he will have to recompute what the tax would have been if he had received the ordinary income portion of his lump sum

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4 Report of the Committee on Ways and Means, page 85

distribution ratably over the year of distribution and the next succeeding four taxable years. This alone will entail recomputation of the tax attributable to such ordinary income in each of four tax returns. Whatever complications already existed in preparing those four returns will be compounded by the addition of 20% of his special ordinary income to his other income in each of those years. If, after all of the foregoing, it develops that he paid too much income tax with respect to his special ordinary income at the time of distribution, he will then be entitled to file a claim for a refund.

Returning to the subject to "fairness", is it fair to require an average employee who receives a lump sum distribution to go through what has been described? Doubtless he will have to employ professional help to calculate his tax liabilities in the first instance, and then to recalculate them in the fifth year following his retirement in order to determine whether or not he is entitled to a refund. Moreover, if it develops that he is entitled to a refund, he no doubt will require assistance in preparing his refund claim. For a lower paid employee whose ultimate tax might actually be reduced below what his tax would be under existing law,

the cost of calculating his tax and filing a refund claim, it applicable, probably would exceed the amount of any savings which the net method might produce for him. Suppose that events prove that the employee is entitled to a refund of under $100.00, but that the costs of both determining the amount of that refund and collecting it will exceed $100.00. Will he bother to collect it? If he does not, will not the tax collecting agency have been unjustly enriched since, in fact, he paid more taxes than he should have paid? Is this fair?

C. Where do the Burdens Imposed by the Changed Method Fall?

One of the alleged bases of the proposed change in method of taxation is that, since employer contributions under qualified profit sharing plans consist simply of deferred compensation, qualified profit sharing plans are a means whereby highly compensated individuals escape ordinary income taxation on substantial amounts of their income. At the same time, one of the clear objectives of H.R. 13270 is to ease the tax burdens on middle and lower income bracket taxpayers. The Ways and Means Committee Report indicates that the more significant benefits under the existing method of taxation accrue to taxpayers with adjusted gross incomes in excess of $50,000.00.[5] At the same time,

5 Ways and Means Committee Report, page 154

of the estimated additional revenue of $70 million per year which would be produced by the proposed change in method of taxation, more than one-half will come from taxpayers whose adjusted gross incomes are less than $50,000.00.[6] In this connection, it is noteworthy that many lower and middle income bracket taxpayers may be in the "over $50,000.00 class" in the year in which they receive their lump sum distributions simply by virtue of the fact that the lump sum distribution is made to them.

On the basis of the latest available published information,[7] in 1962 54,484 individual returns were filed showing net long term capital gains arising from lump sum distributions under qualified plans of all types. Of that number, 53,364 returns, or 97.9% of the total, involved returns showing adjusted gross incomes of under $50,000.00. Moreover, 42,932 of those returns, or 81.3% of the total, involved returns showing adjusted gross incomes of less than $25,000.00. The returns showing adjusted gross incomes of less than $50,000.00 involved 81.3% of the

6 See Table 5, Ways and Means Committee Report, page 15

7 Source: "Statistics of Income, 1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns", table 8

total dollar amount of gains so reported. It seems clear that although the objective of H. R. 13270 is to eliminate alleged favorable tax treatment for persons whose adjusted gross incomes exceed $50,000.00, the major portion of the burden will fall upon persons whose adjusted gross incomes are lower than that figure.

Those who are fortunate enough to have adjusted gross incomes in excess of $50,000.00, exclusive of any long term capital gains resulting from lump sum distributions, no doubt will employ (and probably currently employ) professional assistance in preparing their income tax returns. However, those whose adjusted gross incomes are in the middle and lower brackets frequently do not employ professional assistance in preparing their income tax returns. To the extent that any complications introduced by the revised method of taxation require the employment of professional assistance, added burdens will be imposed upon persons against whom the revised method is not directed.

D. Is the Present Method of Taxation an Abuse?

One of the key objectives of H. R. 13270 is the elimination of tax preferences which enable a relatively few persons with high incomes to escape tax on a large proportion of their incomes. Thus:

"From time to time, since the enactment of the present income tax, over 50 years ago, various tax incentives or preferences have been added to the internal revenue laws. Increasingly, in recent years taxpayers with substantial incomes have found ways of gaining tax advantages from provisions placed in the code primarily to aid some limited segment of the economy."[8]

It is respectfully submitted that distributions from qualified profit sharing plans are not one of the alleged preferences which benefit a relatively few high income individuals. Earlier it was pointed out that qualified profit sharing plans cover millions of employees. These plans have been approved under a provision of the Internal Revenue Code which forbids discrimination in favor of highly compensated individuals, both in the matter of eligibility and the sharing of employer contributions. These provisions were added to the Code 27 years ago to insure that any tax provisions which apply to such plans would not be limited to a handful of individuals.

Moreover, the Code currently limits employer deductions for contributions made under qualified profit sharing plans to an average of 15% of participating pay of employees who are covered on a nondiscriminatory basis. Even if it be assumed that an employer's contributions on behalf of

8 Ways and Means Committee Report, page 1

a given employee amount to 15% of his pay in every single year of his employment (a most unlikely possibility) depending upon the employee's terminal pay the <u>total</u> of those contributions would amount to from 2-1/2 to 4-1/2 times the employee's annual terminal pay after 30 years of participation. Can the accumulation of such an amount as a "nest egg" to take care of an employee and his spouse for the balance of their lives after retirement, which may be as much as 15-25 years, be characterized as an abuse? In the vast majority of cases it is unlikely that the average employee will receive employer contributions of 15% of pay in each and every year that he participates in a profit sharing plan. For example, a survey by the Council indicates that in 1968 the average of the percentages of contributions related to participating compensation was 8.6% in the case of the companies responding to the survey. The results break down as follows:

Size of Company by Number of Employees	Employer Contribution to Deferred Profit Sharing Plan as a Percentage of Participants' Pay
Under 100 employees	10.6%
100 to 499 employees	8.8%
500 to 999 employees	7.5%
1000 to 5000 employees	8.8%
Over 5000 employees	7.3%
Average of the Percentages	8.6%

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That survey covered 445 plans embracing 1,423,640 employees. The Council has no reason to believe that the results produced are in any way atypical. Of course, if employer contributions on behalf of an employee over his entire working lifetime average less than 10% of his participating pay, the portion of his nest egg at retirement which is attributable to employer contributions will be even smaller. It might amount to less than twice his terminal pay. Whatever else he receives in addition to his employer's contribution will result from his having had his share of employer contributions and his own contributions (if he made any) at risk.

In view of the requirement that the benefits under a qualified profit sharing plan must be nondiscriminatory among employees and in view of the limits on the amounts which may be placed in a qualified plan for employees, can it be said that the method of taxation of lump sum distributions made under such plans gives rise to an abuse or a tax preference available to a limited segment of the economy?

III. The Revenue Effects of the Proposed Change of Method

At the outset it is estimated that the revised method of taxation will produce less than $2-1/2 million of additional revenue in the year 1970. In 1971, it is estimated that $5 million of additional revenue

would be produced, and by 1979 it is estimated that $50 million of additional revenue would be produced. It should be noted that in 1971 the estimated increased revenue arising from this single change will comprise only about 1/10 of 1% of the total revenue recoupment contemplated by H. R. 13270 and by 1979 will comprise only 7/10 of 1% of the total revenue recoupment.

While H. R. 13270 is intended to be a reform bill, practical considerations which may outweigh the modest revenue recoupment envisioned by the change which the bill would make in the method of taxation of lump sum distributions cannot be ignored. The increased burdens which would be cast upon the tax collecting agency must be balanced against any estimated revenue gains which otherwise might result from the changed method of taxation. Further, other reasonably predictable revenue reducing effects of the proposed change must also be added to the increased administrative costs. The Council believes that the combination of increased administrative costs plus any collateral revenue reducing results might well eliminate practically all of the estimated revenue gain and, in fact, might lead ultimately to a net revenue loss. In view of the great care otherwise exercised to see that the revenue cutting portions of the bill would be matched by revenue increases produced by the bill, this possibility should not be ignored.

A. Increased Costs of Administration Must be Balanced Against the Estimated Revenue Gain

The complications introduced by the revised method of taxation are almost certain to increase the costs of collection of taxes. The Council believes that the complications introduced by the revised method of taxation inevitably will require the employment of many additional, highly skilled personnel by the Treasury Department in order to administer the revised method of taxation. These additional personnel will be needed to review returns initially filed under the revised method, and thereafter to review all returns involved in determining whether a refund is due. The Council believes that experience would demonstrate that all of the direct costs which would be incurred by the federal government would significantly offset the estimated revenue gains envisioned by the bill.

B. The Indirect Revenue Losses, When Added to the Administrative Costs, Might Well Eliminate any Net Revenue Gain and Could Even Produce a Net Revenue Loss

In addition to the direct costs which must be balanced against the estimated revenue gain, the Council believes that there are at least two reasons why the changed method might eliminate most of the estimated revenue gains and might even produce a net revenue loss.

First, whatever the reason for the change, it would tend to discourage the spread of the principle of profit sharing among employers. To the extent that it does so, it will constitute a reversal of long standing Congressional policy. The Council believes that the federal government has long been a silent partner in profit sharing. Why? Because it has been shown that where profit sharing works successfully everybody, including the federal government, benefits.

A study covering 175 companies in a broad spectrum of industry is now complete and will be published next month. The study has been conducted under the auspices of Northwestern University. While the Council has supported the study, it was in no way in a position to control the results of the study. The purpose of the study has been to compare the performance of profit sharing companies with the performance of companies which do not have profit sharing plans. The industry groups covered were: chemicals, drugs, electronics, machinery & metal fabricators, oil-integrated domestic companies, publishing, retail department stores and mail order houses, retail food chains and tobacco (cigarettes). Ten measures of performance were used to compare the profit sharers and non-profit sharers in each industry. The indices were: operating income margin, net income margin, return on operating investments,

return on investments, return on common stock equity, earnings per employee, sales, earnings per share, dividends per share and market price per share. The study covered the years 1948 to 1966.

Among the results shown by this study was that the absolute level of performance by profit sharing companies was superior in over one-half of the cases studied and inferior in less than one quarter of the cases. Moreover, the trend of performance of the profit sharing companies was even more significant in that the margin of superior performance was even greater than when measured on absolute levels. The following is a quotation from the summary and conclusion of that study:

> "There are innumerable factors that bear on the operations of a particular business. They all, to a greater or lesser extent, affect its revenues, expenses or asset investment and hence its financial performance. Obviously it would be improper to conclude that the adoption of a profit-sharing plan leads directly to superior financial results. Nevertheless, the strong showing made by profit-sharing companies in this study would indicate that it is an important factor in the final result."

This study confirmed the results of more limited studies confined solely to the retail department store industry and retail food industry conducted under the auspices of the Profit Sharing Research Foundation, Evanston, Illinois, which covered the years 1952 to 1959 and was published in 1960.

Profit sharing works! Because it works, employees, shareholders and the federal government all benefit. To the extent that profit sharing companies are more profitable, employee security is enhanced. To the extent that profit sharing companies are more profitable, investors in those companies benefit through increased values in their investments. To the extent that profit sharing companies are more profitable, the federal government benefits through the increased taxes which result from those increased profits.

Finally, as pointed out earlier in its statement, the Council believes that employees' interests in profit sharing plans are truly risk capital. That capital provides jobs. People who have jobs pay taxes.

While it would be difficult, if not impossible, to measure, the Council believes that whatever Congress does which has a dampening effect on profit sharing also will have an indirect dampening effect on revenues. If the incentives of profit sharing are removed, companies which share profits probably will perform less efficiently. Profits and dividends, and hence income taxes, would be reduced as a result of reduced performance. To the extent that the invested capital furnished by profit sharing is reduced, fewer jobs would be provided. Fewer jobs

mean fewer taxpayers and lower revenue collections. Since there are some 80,000 profit sharing plans in existence today, it is not unreasonable to speculate that any dampening effects produced by the change in method of taxation could result, indirectly, in a reduction of revenues which, alone, exceeds the estimated revenue gains envisioned by H.R. 13270.

Second, estimated revenue gains of necessity must be based upon the assumption that employees will continue to receive lump sum distributions. However, if the taxes payable with respect to lump sum distributions become unduly burdensome, it is likely that this form of distribution will lose its appeal. For many employees, spreading of distributions over their lifetimes could result in either no income taxes being payable with respect to their benefits or lesser taxes being payable than would have been payable under the revised method of taxing lump sum distributions. Revenues derived from distribution of benefits to such individuals would be reduced below those which are derived under the existing method of taxation where lump sum distributions actually are made. Wealthy individuals having outside means will be in a better position to "let it ride" at retirement rather than to receive lump sum distributions than will average employees. Thus, the effect of the revised method of taxation may well be not to produce revenue, but simply to

compel employees to change the method of receipt of their benefits. Yet there will be many whose major assets consist of their profit sharing interest. These employees, for other compelling reasons, will continue to want to receive their benefits in a lump sum distribution. It is on such employees that the burden will fall. Others who are more fortunate will seek distribution in a form which will reduce the taxes payable by them below what might have been paid by them under the revised method of taxation.

IV. Conclusion

The Council commends the drafters of H. R. 13270 for what is clearly an effort to change the method of taxation of lump sum distributions with a minimum of dislocating and unsettling effects upon millions of employees. The prospective feature of H. R. 13270 bears witness to this. Moreover, in continuing to treat part of any lump sum distribution as a long term capital gain, H. R. 13270 recognizes, in part, what the Council sincerely contends and has long contended -- that at least a part of an employee's interest in a profit sharing plan is risk capital and should be treated as such. While H. R. 13270 would change part of a lump sum distribution from a capital gain to ordinary income, it also recognizes,

through a special averaging method, that lump sum distributions which represent employer contributions also constitute "bunched income". The bunched income concept, of course, is what underlies the entire concept of treatment of certain types of income as capital gains rather than ordinary income. However, the special averaging provision contained in H. R. 13270 which is designed to recognize the bunched income problem introduces extreme complications of administration as contrasted with the present, relatively simple method of taxation of bunched income received in the form of a lump sum distribution. For these reasons, the Council believes that the present method of taxation of such distributions should be retained.

It remains the duty of Congress, however, to make a final decision. Should that decision be to change the present method of taxation of lump sum distributions to some other averaging method, then for the reasons which have been given above, the Council offers the following principles which it believes should be kept uppermost in mind in formulating any alternative method of taxation:

1. Any change should recognize, as does H. R. 13270, that part of an employee's interest in a profit sharing plan is clearly risk capital and should be taxed as such.

2. Any averaging method which is to apply to the balance of a lump sum distribution which is not treated as a long term capital gain should not be based upon the recipient's income and marginal rates in a single taxable year.

3. Any averaging method which applies to part of a lump sum distribution should contemplate payment of the taxes due on the distributions once and for all at retirement. The possibility of refunds following calculation and payment of taxes should be avoided.

4. Any averaging method should be simple. It should not entail complications such as those which H. R. 13270 would entail.

Since the present method of taxing lump sum distributions meets all of the foregoing tests, it should not be lightly discarded.

AMERICAN PENSION CONFERENCE*

Statement Concerning Tax Reform Bill Proposals
Relating to Income Tax Treatment of Lump Sum
Payments from Pension and Other Qualified Plans

Summary of Principal Points

1. The Tax Reform Bill, as passed by the House of Representatives (H.R. 13270), proposes to tax benefits under qualified retirement plans accrued after December 31, 1969 attributable to amounts contributed by the employer as ordinary income under a five-year "forward" averaging formula (five times the increase in tax resulting from including 20% of the distribution in gross income). If the tax paid by the employee proves, at the end of the five-year period, to be more than the tax that he would have paid, for each year during such five-year period, on 20% of the distribution, the employee would be entitled to a refund.

2. The five-year carry-forward formula with the proposed procedure for refund claims would involve administrative complexities and heavy burdens on Government and taxpayers alike, with a special burden on retired employees who have not customarily retained tax consultants. Particularly if the 25% ceiling on the tax on capital gain is to be removed and taxes on earned income are to be reduced, as proposed in the Bill, the disparity between the rate of capital gains tax on lump sum payments and the rate of ordinary income tax on annuity payments in lieu of a lump sum will be sufficiently small in the preponderance of cases to warrant continuation of the present simple method of taxing the entire lump sum payment in excess of employee contributions at capital gains rates.

3. It is accordingly recommended, in the interests of a simple, fair method of solving the bunched-income problem upon receipt of a lump sum in one taxable year, that the present method of capital gains treatment be retained.

* Submitted by William F. Drake and V. Henry Rothschild, 2d.

September 8, 1969

AMERICAN PENSION CONFERENCE

Statement Concerning Tax Reform Bill Proposals Relating to Income Tax Treatment of Lump Sum Payments from Pension and Other Qualified Plans

Summary of Proposed Changes

Under present law, if an employee (other than a self-employed individual) receives his total accrued benefits from a qualified plan in a distribution within one taxable year on account of separation from service or death, the amount of the distribution in excess of employee contributions is taxed as a capital gain, rather than ordinary income. Section 515 of H.R. 13270 (the Bill) would limit this capital gains treatment to the amount of the total distribution in excess of employer contributions made during plan years beginning after 1969 Thus amounts attributable to employer contributions made during plan years beginning after 1969 would be treated as ordinary income, taxable at regular income tax rates.

The Bill provides for a special five-year "forward" averaging of the amounts to be treated as ordinary income, provided the employee participated in the plan for at least five years. Under this averaging method (which under present law applies to lump sum distributions to self-employed individuals), the employee would compute the increase in tax as a result of including 20% of the ordinary income amount of the distribution in his gross income for the taxable year of distribution, and then multiply the increase in tax by five to determine the amount of tax on the ordinary income portion.

The Bill further provides that an employee may recompute the tax paid on the ordinary income part of the distribution at the end of the five taxable years by including 20% of the ordinary income amount in gross income for each of the five years and determining if the tax he would have paid had he received the amount ratably over the five years is less than the tax he had actually paid under the five-year forward averaging rule. If the recomputed tax is less, the employee would be entitled to a refund. If the employee dies within the four-year period beginning on the last day of the taxable year of the distribution, the employee's estate would be entitled to a refund if the tax paid by the employee exceeded five times the average of the increase in tax which would result from the inclusion of 20% of the ordinary income portion in the gross income of the employee for each of the taxable years the decedent lived in the five-year period (excluding the year of his death).

The amount of the distribution treated as a capital gain would be eligible for averaging under the provisions of the Bill (§ 311) permitting capital gains to be included in income averaging. However, if the employee chooses the benefit of income averaging, the Bill provides that the five-year carry-forward averaging provision for the

ordinary income portion of the lump sum distribution would not be available to him.

Reasons Given for the Proposed Change

The House Ways and Means Committee gave the following reasons for the change in tax treatment of lump sum distributions:

1. The capital gains treatment of lump sum pension distributions was originally enacted in the Revenue Code of 1942 as a solution to the bunched-income problem of receiving an amount in one taxable year which has accrued over several years. Therefore, as a means of achieving an "averaging" effect for these amounts received in one year, Congress defined a lump sum distribution as a gain from a sale or exchange of a capital asset held for more than six months, subject to the more favorable capital gains tax rate.

2. The capital gains treatment allows employees to receive substantial amounts of what is in reality deferred compensation at a more favorable tax rate than other compensation for services rendered. The more significant benefits from capital gains treatment of substantial amounts go to those with adjusted gross income of over $50,000.

Conclusions of the American Pension Conference

1. The five-year carry-forward formula with the proposed procedure for refund claims would involve administrative complexities and heavy burdens on Government and taxpayers alike, with a special burden on retired employees who have not customarily retained tax consultants.

Rules and procedure would have to be developed for determining the portion of a lump sum distribution attributable to employer contributions for plan years beginning after 1969. The allocation of a distribution into portions representing employer contributions, forfeitures and investment earnings would add administrative burdens and costs to Government and employers. Such allocation would be particularly burdensome and expensive in the case of the typical aggregate funded pension plan in which individual determinations are rarely made or records kept of the amount of employer contributions (including forfeitures) or investment earnings which could be considered attributable to specific individuals. Ultimately the added administrative costs of preparing and maintaining such records would be reflected in the amount of the employees' benefits.

Computation of the amount of tax on the lump sum distribution would be extremely difficult for most employees, requiring the assistance of tax advisors. In most cases, employees would be over-paying the amount of tax ultimately due under the special refund limitation. The over-payment would be due to the fact that the employee's gross income for the taxable year of distribution would be increased by one-half of the portion of the distribution attributable to income and appreciation, putting him in a higher tax bracket than he would be in the years after distribution. Thus most

employees would be faced with the complex, burdensome task of making the refund computation five years later if they want to receive a refund of the overpayment.

2. We do not favor the substitution of the five-year carry-forward averaging rules with the procedure for refund claims as a substitute for capital gains treatment in alleviating the bunched-income problem of a lump sum distribution, for the following reasons:

(a) Particularly if the 25% ceiling on the tax on capital gains is to be removed and taxes on earned income are to be reduced, as proposed in the Bill, the disparity between the rate of capital gains tax on lump sum payments and the rate of ordinary income tax on annuity payments in lieu of a lump sum will be sufficiently small in the preponderance of cases to warrant the continuation of the present, simple method of taxing the entire lump sum payment in excess of employee contributions at capital gain rates.

(b) Capital gains treatment, under the proposed new capital gain rules of the Bill, provides a workable, equitable solution to the bunched-income problem caused by receipt of the entire amount attributable to employer contributions in one taxable year.

It is accordingly recommended, in the interests of a simple, fair method of solving the bunched-income problem upon receipt of a lump sum in one taxable year, that the present method of capital gains treatment be retained.

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COMPARISON UNDER H. R. 13270 OF CAPITAL GAINS TAX TREATMENT OF LUMP SUM DISTRIBUTION WITH TAX TREATMENT OF ANNUITY PAYMENTS

Submitted September 16, 1969 In Connection With Testimony Of V. Henry Rothschild 2nd On Lump Sum Payments From Qualified Retirement Plans

EXPLANATORY NOTES

The following tables show the difference in taxes payable under lump sum and annuity distributions of equal value, using tax rates proposed in H. R. 13270, as explained below. Taxes applicable to the lump sum distribution represent the present value of total taxes payable over a 15-year period. It is assumed that the total distribution is taxed as a capital gain in the year distributed and that the after-tax proceeds are reinvested to yield a 5% annual return taxable as ordinary income over the 15 years.

The taxes applicable to the annuity distribution represent the present value of total taxes payable over a 15-year period. The annuity payout is assumed to start at age 65, the normal retirement age, and the 15-year period represents the average life expectancy of a male aged 65 (Income Tax Regulations, Sec. 1.72-9, Table I). The annuity payments are based on a 5% annual interest rate.

Taxes shown assume a married taxpayer filing a joint return under the tax rates proposed in H. R. 13270 for taxable years after 1971, assuming that the 25% alternative capital gains rate is not applicable. Present value of the taxes reflects the application of a 5% compound discount factor to tax payments for the second through fifteenth years.

In Table 1 it is assumed that the employee has other income in each of the 15 years, beginning with the year distribution is made or the annuity commences but that the employee's deduction and exemptions equal such other income.

In Tables 2, 3 and 4 taxes are computed on two bases: the first assumes no other taxable income; the second assumes a specified amount of other taxable income each year.

Computations for these tables were prepared by Theresa B. Stuchiner with the assistance of George B. Buck Consulting Actuaries, Inc. Presentation of these tables was prepared by Towers, Perrin, Foster & Crosby, Inc.

TABLE 1 - $25,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value)	$ 3,660	$ 3,436
Taxes as Percent of Total Distribution	14.6%	13.7%

TABLE 2 - $100,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 21,848	$ 17,054
Taxes as Percent of Total Distribution	21.8%	17.1%

Taxes (Present Value) Assuming $5,000 Other Taxable Income	$ 23,422	$ 20,615
Taxes as Percent of Total Distribution	23.4%	20.6%

TABLE 3 - $200,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 53,704	$ 40,918
Taxes as Percent of Total Distribution	26.9%	20.5%

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming $10,000 Other Taxable Income	$ 57,436	$ 56,561
Taxes as Percent of Total Distribution	28.7%	28.3%

TABLE 4 - $500,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 167,555	$ 157,568
Taxes as Percent of Total Distribution	33.5%	31.5%
Taxes (Present Value) Assuming $20,000 Other Taxable Income	174,939	$ 215,966
Taxes as Percent of Total Distribution	35.0%	43.2%

PART B—ADDITIONAL STATEMENTS

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September 9, 1969

Honorable Russell B. Long
Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

Re: H.R. 13270 - Section 516(c) -
Omission of rules regarding
deductibility of certain
franchise acquisition costs

Dear Mr. Chairman:

The purpose of this statement is to direct the Committee's attention to a problem connected with section 516(c) of H.R. 13270, the new provision in the bill dealing with the sale of franchises and other intangible business assets. In short, the House bill has introduced specific statutory rules dealing with the tax treatment of the seller of such assets but is completely silent with respect to the treatment of the purchaser.

It is of great importance that the purchasers of these assets, the large majority of whom are small businessmen, know what tax effects attach to the payments they make for acquiring franchises, trademarks, trade names and similar intangible assets vital to the operation of their businesses. It would appear that in the development of the House bill the purchaser's problems were either simply overlooked or there was insufficient time to draft the necessary statutory language. Now, however, it seems most appropriate that the Senate complete the picture and provide rules for the deductibility of the payments made by the purchasers.

The analysis of the present law and the new problems which may arise by reason of the enactment of H.R. 13270, set forth below, is made to assist the

Committee in formulating a policy and developing a set of rules covering the purchase of intangibles. It should be kept in mind that the basic situation with which this statement is concerned is the tax treatment to be afforded to the annual, recurring payments made by the purchaser to the seller of a franchise, trademark, trade name or other similar business asset, which payment is measured by the year's use of the asset or by the annual income produced thereby, and is essential to the purchaser's continued ownership and utilization of the asset. In other words, this statement should not be confused with another basic proposition, i.e., the tax treatment to be afforded the payment of a lump sum for the acquisition of an intangible asset with an indeterminate useful life. That is an entirely different problem and it is completely unnecessary to deal with it in order to take care of the very common and important situation at which this statement is directed.

Thus, a significant item of tax reform can be effected by the Tax Reform Act of 1969 if the area of law under discussion is clarified* to permit the current deduction of franchise, trademark, trade name, etc., payments which are determined by reference to the income derived from, or the utilization of, the franchise or other intangible. As developed more fully below, this is not a novel concept; it has been applied by both the courts and the Internal Revenue Service in a sufficient number of analogous situations to have become known as the "flow of income" method of depreciation.

The significance of the tax reform recommended in this statement is heightened by the fact that franchising is a method of doing business whose importance is constantly increasing. Of even greater importance in the context of the current tax reform program, which has become so deeply concerned with providing more equality for the smaller taxpayer, is the fact that franchising is probably the single largest economic phenomenon whereby small businesses are being established and developed in the United States today. By removing the doubts surrounding the tax treatment of the cost of acquiring a franchise the proposal advanced herein will help to further stimulate the growth of franchise operations.

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* Significantly, the new rules regarding the taxation of transferors contained in section 516(c) of the bill have been characterized as being simply a clarification of the existing case law. H. Rep. No. 91-431 (Part 1), p. 164. This clarifying process should properly be extended to encompass transferees.

The Problem -- An Illustrative Case

Facts

Assume that Mr. and Mrs. John Public, a retired but still vigorous couple who have accumulated a sum of money by diligent saving, respond to an advertisement in a financial journal stating that "a food franchising business with good income potential is available for a modest capital investment." They are contacted by the franchisor who shows Mr. and Mrs. Public the standard franchise agreement (which, in fact, is essentially like many existing franchise arrangements) pursuant to which they would be granted the exclusive right to prepare and sell spareribs under the trade name "Super Ribs" in a defined geographical area. Mr. and Mrs. Public's rights would continue as long as they maintained a certain quality standard and made an annual payment of 25 cents per pound of spareribs sold.

Mr. and Mrs. Public sign the agreement and in 1968 they sell 100,000 pounds of spareribs at $1.00 per pound. They pay the franchisor $25,000 and incur additional costs and expenses of $63,000 in 1968. Accordingly, Mr. and Mrs. Public report $12,000 ($100,000 less total costs of operation, $88,000) on their 1968 return as income from the operation of the franchise business.

Mr. and Mrs. Public's 1968 return is audited and the revenue agent disallows the deduction taken for the $25,000 franchise payment on the ground that the franchise agreement granted Mr. and Mrs. Public "all substantial rights" to the trade name "Super Ribs" in the specified territory. The agent maintains that such rights represent a capital asset having an indeterminate useful life and that, accordingly, the franchise payment of $25,000 represents a non-deductible capital outlay.

The Decision in Dunn v. United States

In September 1968 the Court of Appeals for the Tenth Circuit in Dunn v. United States, 400 F.2d 679, affirming, 259 F. Supp. 828 (D.C. Okla. 1966), a case

involving payments of 28 cents per gallon of Dairy Queen mix used by a franchisee, upheld the Internal Revenue Service position. The gallonage payments were disallowed as a depreciation deduction with respect to the cost of the asset purchased thereby, viz., the franchise right to market under the Dairy Queen name, solely because the life of the franchise was of an unascertainable length (it could be ended by the franchisee by non-payment of the gallonage charges or by a voluntary surrender of the franchise, or by the franchisor upon violation of the terms of the agreement by the franchisee).

The Disastrous Economic Consequences of the Dunn Decision

Let us examine the intolerable economic situation into which Mr. and Mrs. Public have been placed by the Dunn decision. Now their taxable income for 1968 has been increased to $37,000. Twenty-five thousand dollars of this $37,000 ordinary income represents an "investment" in an asset which has little or no resale value.* The remaining $12,000 earned by Mr. and Mrs. Public from the operation of their franchise will probably be barely sufficient to cover the income tax due on this alleged $37,000 income.** If the audit occurs in 1972 the situation is even more drastic since Mr. and Mrs. Public would be faced with having three taxable years in issue with a substantial interest payment to boot. It is not unlikely that this tax situation will force Mr. and Mrs. Public to abandon their franchise--and another small business will have departed from the U. S. scene.

Dunn Rule Illogical and Bad Policy

Not only is the Dunn case intolerable from the viewpoint of small business economics, it is wrong as a matter of law.

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* It is difficult to imagine that anyone would be willing to pay the franchisee his cost basis for the franchise and, in addition, assume the burden of continuing the production payments to the original franchisor with no tax benefit in the form of a current deduction for any of the payments.

** The increase in state income taxes must also be taken into account.

Depreciation Deductions are Designed to Clearly Reflect Income

The Supreme Court has said that the "primary purpose of depreciation accounting [is] to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use of the asset to the period to which it contributes."* The Court of Appeals in the Dunn case failed to follow this dictate of the Supreme Court. Indeed, the conclusion in Dunn does violence to the integrity of periodic income statements by causing the deduction of the periodic production payments for franchise rights to be deferred in most cases until the termination of the franchise. The practical result of this is to deprive the taxpayer-franchisee of any deductions for the payments made to acquire the franchise because in the year of franchise termination there is apt to be little or no income against which the loss represented by the aggregated payments can be offset. Such a result can only be characterized as a patent distortion of income for tax purposes (as the Service itself expressly recognized in Rev. Rul. 67-136, discussed below).

Conversely, permitting a franchise payment based on production, use or sale to be deducted in the year of such production, use or sale results in the clear reflection of income which it is the function of section 167 to insure. This is so because there is a direct relationship between the income generated by the taxpayer's use of the asset during the period and the amount of the taxpayer's obligation to pay during that period arising under the franchise agreement. Furthermore, the right to continue such use is directly dependent upon such payment because the usual franchise agreement terminates, and the right reverts to the seller, in the event of a default in payment. Accordingly, the franchisee cannot acquire by such payments any residual rights in the asset. Moreover, the usual franchise agreement also precludes a transfer or assignment without the consent of the franchisor, even if there is no default in payment.

* Massey Motors v. United States, 364 U.S. at p. 104.

Dunn Decision Contrary to Cases

The taxpayer-franchisee's position that franchise acquisition costs geared to income generation are currently deductible is supported by court decisions as well as Internal Revenue Service rulings involving intangible assets, other than franchise rights, having indefinite or unascertainable useful lives. Thus, in cases involving unpatented inventions* and patent applications,** neither of which have a definitely measurable life, the Tax Court has held that if production payments "are to be regarded as part of the cost of the [asset] then it seems reasonable to allow a corresponding deduction for each year because the payments are measured by the profitable use of the [asset] in each year and will continue to be so measured during any year in which the payments are made."***

The case of Associated Patentees, Inc., 4 T.C. 979 (1945) is most helpful because of the force and clarity of its reasoning. The Associated Patentees case is all the more meaningful because it involves patents. The validity of the taxpayer's position is thus very dramatically illustrated since the court rejected the statutory lives of the patents as a basis for depreciation, for which the Government was contending, and held that the flow of income method of depreciation, for which the instant taxpayers are contending, should be used because it produced a deduction which resulted in a more clear reflection of annual income for tax purposes.

In Associated Patentees the taxpayer acquired patents of varying lives. The sellers were to receive as consideration 80 percent of taxpayer's annual income from any license agreements covering the patents which it negotiated. The taxpayer claimed a depreciation deduction in the amount of such royalties it paid to the sellers in the taxable year. The Commissioner disallowed the deduction contending that only a proportionate part of the

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* M. E. Cunningham Co., 10 TCM 276 (1951).

** Century Tank Manufacturing Co., 18 TCM 430 (1959).

*** M. E. Cunningham Co., 10 TCM at p. 278.

royalty payment should be allowed currently with the balance prorated over the remaining lives of the patents. In each succeeding year, the taxpayer would be allowed a deduction for a proportionate part of the payment in that year plus the amount allocated to such year from prior payments. Although the Commissioner used the definitely ascertainable life of the patent as the basis for his depreciation computation, his determination was rejected by the Tax Court with the following statement:

> It will readily be seen that although this method of computation will give to the petitioner aggregate theoretical deductions for depreciation equalling the total ultimate cost, its practical result will be an entirely inadequate allowance for depreciation at the beginning of the terms and excessive allowances for depreciation at the end. Actually, in the later years, the depreciation allowances would largely exceed income from the patents. Under such a method of computation the petitioner might not, in fact, recover its cost from income.

The court then went on to prescribe the method of depreciation for which taxpayer is contending in this request for legislative relief--the most rational method of depreciating an intangible asset with an indeterminate useful life being purchased by contingent payments because the deduction varies in direct relationship to the economic exploitation of the acquired asset. The court said:

> Petitioner's contention is that the cost payment made each year is subject to depreciation in its full amount because it is a cost pertaining to that year alone and measured by income over that period. It is argued that, with an allowance so made, at the close of the lives of the patents the petitioner will have recovered the amount of their cost prorated equitably over their lives.

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> Section 23 (1) provides for "a reasonable allowance" for depreciation. It provides no specific method for its computation. Respondent's regulations recognize the fact that there is no fixed rule, but that the cost should be apportioned over the useful life in such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The situation here is unusual. But we think that the method for computing depreciation for which petitioner argues gives it a reasonable, and not more than a reasonable, allowance, whereas the method urged by respondent might deny petitioner the recovery of its cost and would unquestionably result in a distortion of income.

It is respectfully submitted that the reasoning of Associated Patentees is unquestionably sound and applies to the instant situation with equal force.

Dunn Decision Also Contrary to IRS Rulings

It is significant to note that the Treasury Department has required taxpayers to use the "flow of income" method of depreciation in situations completely analogous to franchise acquisitions for the very reason that such a method assures a minimum distortion of income. In Rev. Rul. 60-358, 1960-2 C.B. 68, the Service ruled that the proper method for depreciating leased or rented television films, property with an unascertainable useful life, was by reference to the income generated by the films. In pertinent part the ruling states:

> . . . the usefulness of such assets in the taxpayer's trade or business is measurable over the income it produces and cannot be adequately measured by the passage of time alone. Therefore, in order to avoid distortion, depreciation must follow the "flow of income." (Emphasis added.)

In Rev. Rul. 67-136, 1967-1 C.B. 58, the Internal Revenue Service again approved the "flow of income" method of depreciation where inventions covered by patent applications were purchased for a continuing purchase price based upon income produced by the exploitation of the inventions:

> . . . by the terms of the contract in the instant case, the price of the assets is tied to the benefits the taxpayer derives from them; as the assets produce income their cost or basis increases and their period of usefulness to the taxpayer is proven. The use of the amounts which the taxpayer in this case is contractually obligated to pay on the price as the measure of the allowance for depreciation assures minimum distortion of income. The contrary would be the case if the taxpayer were required to delay recapturing his capital investment in the assets until their total price is established. (Emphasis added.)

In the light of the logical reasoning expressed in Rev. Rul. 67-136, how can the Service on one hand allow a deduction for annual payments where a patent application is involved and deny the deduction where a franchise is involved? In either case it is impossible to determine with any degree of certainty what the life of the asset will be. The uncertainty surrounding the life of a franchise right contingent upon exploitation has been outlined above. Similarly, it is impossible to determine with any degree of certainty when (if at all) a patent will issue after an application has been submitted to the Patent Office. Although the majority of applications are processed in three to four years, it is not unusual for an application to be pending as long as five or six years--and in some cases the period has exceeded ten years or more.

It is respectfully submitted that there is no difference in principle between the situations involved in the foregoing cases and rulings and that involved

where a franchise is purchased on a basis geared to the production of income.

IRS Error: Treating Lump Sum and Production-Based Acquisition Payments in a Like Manner

The error in the Internal Revenue Service position (unfortunately now embedded in the law by decisions of a District Court and a Circuit Court of Appeals) stems from a failure to distinguish, for purposes of income tax depreciation, the fundamental difference between a lump sum payment to purchase a franchise right and a purchase price consisting of periodic payments contingent upon the income derived from, or other indicia of exploitation of, the franchise. That this failure to distinguish between these two types of acquisition payments is not due to oversight or inadvertence, but is quite deliberate, is highlighted by the following language of the District Court:

> The great weight of authority appears to hold that intangible property with an unascertainable useful life is not subject to amortization or depreciation. This rule would clearly be applicable, if, for instance, the corporation herein paid a fixed sum at the start for the franchise. This payment would have to be capitalized and recovered when the business was ultimately sold. The fact that the parties here negotiated a different sale price, that is 28¢ per gallon forever, rather than a fixed figure, should make no difference in the legal conclusion which must be reached herein. (Emphasis added.)

It should be noted that neither the District nor the Circuit Court in Dunn ever explained why the foregoing cases and rulings did not require a "difference in the legal conclusion" where a production payment purchase price rather than a lump sum cost is being depreciated. In other words, the courts in Dunn failed to recognize that all the cases on which they relied involved acquisitions in which the purchase price was entirely or in substantial part paid

by a lump sum; simultaneously they ignored the authority of the cases and rulings dealing with non-lump sum purchases. As a result they misapplied the rule in the regulations to the effect that "An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation."*

When that regulatory rule is applied to a lump sum payment for an intangible asset having an unascertainable useful life, the result reached makes sense under section 167. In other words, since the total cost of the intangible asset extends for a number of years--a number which is not limited, i.e., unascertainable, there is no basis on which a deduction can be permitted which would assure that income would be clearly reflected. Certainly to permit the entire amount to be deducted in the year of expenditure would result in a distortion of income. Similarly, although the distortion would be less, there would be no rational basis for spreading the cost over a number of years. Accordingly, where a lump sum acquisition is involved, the regulations, and the courts, have reached a logical result in the light of the present statute.**

However, slavish adherence to the literal language of the regulations in the case of non-lump sum purchases contravenes the cases and Service rulings cited above and results in a manifest perversion of section 167.

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* Treasury Regulation § 1.167(a)-3.

** This is not to say that the Code is perfect in this respect. To defer deduction of the lump sum cost of a purchased intangible until it is abandoned often results, for the same reasons as discussed above with respect to periodic production payments, in the loss of the deduction. A reasonable compromise might be to permit an amortization of such cost over some arbitrary period such as 120 months. However, such legislative fiat is not required to solve the instant problem created by the IRS position and the Dunn cases. The solution of the instant problem lies simply in a Congressional reaffirmation of the correctness of the flow of income method of depreciation. Thus, the legislation sought does not require the adoption of a novel untested concept but is merely clarifying in nature, simply applying a rule which has been endorsed by both the courts and the Internal Revenue Service.

A False Issue--Parallel Treatment of Seller and Purchaser

The Dunn case and the second paragraph of item 10 in the tentative modification of the tax treatment of capital gains and losses set forth in the July 25, 1969 press release* of the Ways and Means Committee are some indication that the tax treatment received by the seller may affect the manner in which the purchaser is treated. Apparently it is felt by some that if the seller makes a sale at capital gains rates the purchaser should be precluded from depreciating the cost of acquiring the franchise or other intangible asset purchased. There is no basis in law, logic, or equity for such a position.

Apparently a cause for some of the thinking along this vein arises from analogizing the periodic purchase payments in question to rental or royalty payments. However, it is submitted that the character of the payment from the viewpoint of the franchisee is no different where the transaction is an installment sale, a lease or a royalty arrangement. If, under the new standards of section 516(c) of H.R. 13270, the transferor of a franchise has not retained any significant power, right or continuing interest with respect to the subject matter of the franchise (or if amounts are attributable to the transfer of all substantial rights to a patent, trademark or trade name) why should the transferee automatically be precluded from deducting the cost of acquring the franchise, patent, trademark or trade name? The question of deductibility does not hinge upon what happens to the transferor tax-wise. We must look to the nature of the item in the hands of the transferee and apply the pertinent rules of deductibility to him as a separate taxpayer.

Looking at the transaction from the viewpoint of the purchaser the threshold proposition is that there is no inherent prohibition in our tax laws against deducting the cost of assets used in the trade or business. Indeed,

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* This press release item also indicates that the problem of deductions by the purchaser was an inherent aspect of intangible asset transfers. Thus, it seems most appropriate that the Finance Committee complete the job by spelling out such deduction rules.

depreciation deductions are the classic example of such deductions. Certainly no one has suggested that depreciation deductions should be denied if the seller of the depreciable property realized capital gain on the sale rather than ordinary income. Moreover, no one would suggest that depreciation deductions should not be allowed simply because the capital gain sale was made on an installment basis. The same reasoning applies to the instant situation.*

Failure to Clarify Deduction Rules May Place Franchisees in Worse Position

One final observation may be worthwhile. If H.R. 13270 is not clarified along the lines suggested in this letter, franchisees and purchasers of other intangibles may be worse off after the bill's enactment than under existing law. The above-referred to item in the July 25 press release of the Ways and Means Committee may be regarded as lending support to the "parallel treatment" approach of the Dunn case. In other words, one might argue that the Dunn case doctrine, if not expressly codified, has at least received implicit Congressional approval. Thus, if the Dunn error is not rectified by statutory rules expressly permitting the deduction of contingent annual payments, the franchisee, invariably a small businessman who needs tax assistance rather than tax burdens, is saddled with a real penalty. If required to capitalize the annual payments he will get a deduction only when he abandons or disposes of the franchise. This will usually be a large capital loss which in most cases will be of little use to him. (The utility of capital losses will be further minimized when section 512 of the bill becomes effective.) The net result will be an extreme distortion of taxable income in the case of a class of taxpayers the law usually tries to help rather than hinder.

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* It is significant to note that in the above discussed cases and rulings permitting the purchaser current deductions under the principle of flow of income depreciation the tax treatment of the transferor played no part in determining whether the transferee should get such deductions.

Therefore, not only the correct application of depreciation principles, but policy considerations based on equity as well, require that contingent annual payments for franchises and other intangible assets be made deductible by express statutory provisions.

Conclusion and Suggested Solution

The IRS position on the deduction of franchise costs represents a fundamental departure from the logic of section 167. The significance of this erroneous position has been compounded by its endorsement by a circuit court of appeals. If taxpayers are required to resort to continued litigation of the issue, hoping for a conflict in the circuits, and eventual resolution of the problem by the Supreme Court, it is apparent as a practical matter that many small business taxpayers will be deprived of deductions to which they are rightfully entitled. Accordingly, it is appropriate that the problem be resolved by legislation--which can proceed with promptness and precision, particularly now that Congress has specially dealt with the seller's side of the transaction.

One possible legislative solution would be to add a new subsection to section 167 as follows:

"(k) A 'reasonable allowance' as used in subsection (a) in the case of a purchased intangible asset--

(1) having an unascertainable useful life, and

(2) the ownership of which is acquired by, and contingent upon, continuing purchase payments which are based upon a constant percentage of the income derived by the purchaser from the use, sale or other exploitation of such asset

shall be the amount of such purchase price paid or incurred in the taxable year."

Respectfully submitted,

BAKER & McKENZIE

By Michael Waris, Jr.

STATEMENT OF ARNO HERZBERG, CERTIFIED PUBLIC ACCOUNTANT[1]

1961 MORRIS AVENUE, UNION, N. J.

Sir: In response to your request for a statement on the capital gain provisions of H.R.13270 I submit the following comments.

Action on Capital Gain Provisions should be postponed

It is respectfully recommended to postpone action on the pertinent Sections 511 to 516 of the House Bill pending a thorough study of the entire capital gain structure. This study should solicit the views of authorities in this field, should extend to laws of foreign countries, and should examine the possibility to separate the capital gain taxation from income tax laws in general. The House Ways and Means Committee began such a study in 1959, but the discussions never lead to any meaningful action, simply because they were conducted in the framework of a general study of tax revision.

Other reasons that support a recommendation to postpone action on the House Bill, as far as capital gain provisions are concerned, are as follows:

1. The House bill was adopted in an emotional reaction to disclosures about tax inequities especially in the capital gain field,
2. The bill was adopted without consideration of the far-reaching economic effects of tax changes on national income, savings ~~and~~ investment,
3. The capital gain provisions of the bill are again patchwork, opening new inequities,
4. The bill does not show a new approach to capital gain taxation and does not change present shortcomings,
5. The bill does not consider the staggering problems of enforcement that are created on top of existing problems. The preparation of a tax return with income subject to provisions of the House bill will require more recordkeeping and will be more time consuming,
6. The House bill continues the unfortunate trend in recent legislation to perpetuate contradictions,
7. The bill shows inconsistencies in applying the capital gain concept.

[1] Author "Saving Taxes through Capital Gains" (Prentice-Hall).

Criticism of Bill (Sec. 511-516(c),461) - Recommendations

1. The proposed change in alternative capital gain tax for individuals and corporations overlooks the fact that even the present 25 per cent or 30 per cent maximum tax freezes existing investments and thereby reduces the funds that otherwise would go into new ventures. The fact remains that many authorities have recommended not a higher but a lower tax for true longterm capital gains. An increase was and is considered as very harmful by them.

   The reason given for the change in the bill, i.e. that it is not appropriate to allow high-income taxpayers to reduce their effective tax rate by means of the alternative capital gain tax, is at variance with all past thinking, which was influenced by the need for capital formation and unlocking investments.

2. Capital losses of individuals were allowed as a deduction but always with the thought that it is necessary to protect the revenue. This deduction has been changed so often that new reasons must be found to change the deduction again. As reason for the proposed change the example is given that taxpayers who are able to manage their investments to realize their gains and losses in different years are able to take advantage of the 50 per cent deduction for long-term capital gains in one year, and yet obtain a full deduction for long-term losses in another year. Although I have recommended such a tax saving device in my book on capital gains, I have failed to come across of any taxpayer who would be such a successful manager of his portfolio that he could take advantage of this device. It is not necessary to further complicate the Code. The $1,000 deduction against ordinary income is a bare minimum. It has lead to administrative difficulties because the loss to be carried forward indefinitely will have to be proven every year.

   It is therefore recommended not to adopt Sec.512 of the bill, but to restore the previous provision that the $1,000 deduction against ordinary income can be carried forward for five years. Another step would be to allow capital losses only against future capital gains, but then in full. This would eliminate, to a certain extent, the so called tax selling and would induce investors to hold their securities in a bear market.

3. Letters, memorandums, etc., especially in the form of collections, are typical assets. The bill, in its present form taxes gains from their sale as ordinary income, because they are similar to a literary or artistic composition which is created by the tax payer's personal efforts. No estimate of revenue gained is given. In fact, any additional revenue should be extremely small.

This is a typical case where the attempt is made to legislate details which again gives rise to doubts and controversies and makes the Code that much more complicated. Actually, there is no need for this provision. Any misuse could be dealt with on the administrative level. Since, most of the time, in such a case the question of valuation is involved, the Commissioner has ample opportunity to stop any misuse.

4. The bill proposes to extend the holding period that distinguishes long-term and short-term capital gain from six months to one year. In the list of the reasons given for such a change no mention is made of the so called locked-in problem which has been the object of many studies. These inquiries, in general, came to the conclusion that a lengthening of the holding period would impede the mobility of capital assets and compound the locked-in problem.

   A table giving figures of the year 1962 is used by the report on the bill to show the higher the adjusted gross income of the taxpayer, the more he is inclined to take long-term capital gains. It seems that these figures dating back to 1962 cannot tell the story of 1969. In the first place, they explain something which seems to be natural. Taxpayers in the lower brackets are inclined to invest in mutual funds. Their long-term capital gains from these sources do not show on a tax return with a specific holding period. Even in 1962 these gains make up 13.3 per cent of all long-term capital gains. Since then we have experienced the boom of the mutual fund industry and the number of security holders has increased to 26 million. Secondly, taxpayers in the higher brackets will always be in a position to hold investments longer or they will not change them at all. Legislators have always been presented with the effects of the holding period as far as gains are concerned. Their attention has never been drawn to the fact that a short holding period can have a very stabilizing effect in a bear market. The following table shows how much of his profit of $1,000 a taxpayer can lose in a declining market if he sells long-term instead of short-term. The higher the taxpayer's bracket, the more it pays if he waits to sell long-term instead of short-term. With a short, six months holding period such a taxpayer would not throw his stock on the market at the first sign of a decline. A 12 months holding period does not make it worthwhile to take a risk of a further decline. A long holding period would thus accelerate a decline and create a bear market much faster than a six months holding period. In a rising market a longer holding period would double or triple the required percentage of gain on any reinvestment to be made with the proceeds of sale after taxes. Up to this day, all authorities in the capital gain field have recommended a lower holding period than six months which would bring in more revenue and solve the locked-in problem.

Percentage Profit of $1,000 can shrink if sold long-term

(married, joint return)

Taxable Income Up To	Rate Including Surcharge	Left of $1,000 After Tax If Sold Short-term	Long-term	Percent Profit Can Drop If Sold Long-term
$ 10,000	24.2	$758	$879	13.8
20,000	30.8	692	846	18.2
30,000	42.9	571	786	31.5
40,000	49.5	505	753	32.9
50,000	55.0	450	725	37.9
100,000	66.0	340	725	53.1
			675*	49.6*
200,000	75.9	241	725	66.8
			675*	64.3*

* proposed 1971

5. The proposed provisions affecting pension and other plans add again to the complications that plague the Revenue Code. The revenue raised through these changes is negligible; there is no relation to this revenue and the cost of enforcement for the taxpayer and the government.

   Since distributions from profit or pension plans constitute deferred compensation, they should be treated as ordinary income. The provisions for averaging income will take care of any excessive increase in tax. In addition, plans will not be forced to liquidate investments if <u>as a consequence of such a treatment,</u> distributions would be spread over more than one year.

6. The proposed provisions for sales of life estates, casualty losses and franchises are of a technical nature and clarify certain situations.

7. The repeal of the investment credit leaves one problem unsolved that has been and is an urgent question for American industry. The necessity to modernize machinery will no longer receive recognition through tax legislation. This will effect especially the small manufacturer who is under constant pressure to raise working capital. Without much loss on revenue an extension of Section 1231 should be considered. This section was originally inserted in the Code to take care of the rise in prices of used machinery during the war. This problem is still

with us in an inflationery period. The incentive to buy new machinery and replace old one is being reduced by the fact that the sale of old machinery results in a tax which is higher than ever through the recapture provisions of the Code.

It is proposed to amend Section 1231 as follows:

> If assets of like or similar nature are acquired within one year of the sale of the old asset, the gain on the sale is figured as heretofore, but the gain is used to reduce the basis of the new asset. In case of a plant the one year period is to start one year before or after erection of the new one.

Such a provision would have these results:

1. Working capital for the purchase of a new asset would be freed,

2. Benefits are not dependent on profits like in the case of the investment credit,

3. Further complication of the tax structure, especially elaborate recordkeeping, is avoided,

4. The true meaning of the capital gain provision - to give recognition to the rise in the economic plateau of the country - is maintained,

5. The effect on the revenue through a decreased depreciation allowance would be negligible.

General Observations

There is a relationship between capital gains and inflation. The cost of living has increased by about 25 per cent during the last ten years. An increase in the value of any asset is therefore partly a product of inflation. The question arises whether a tax that is levied on such an increase is not harmful to capital formation or still has anything to do with increased income. The bill does not make any attempt to attack this problem.

The bill wants to lower income taxes in a period of inflation. So far economists have held the opposite to be true.

The bill wants to increase the standard deduction hitting the average homeowner in favor of the apartment dweller. So far any Tax Act has favored the homeowner.

Unfortunately, the spiritual climate in the country has undergone

radical changes since the last Revenue Act was passed. The air is polluted with negativism, extremism, hysteria, and demagoguery.

The question arises whether in such a climate a meaningful and durable Tax Reform Act can be enacted at all.

Respectfully submitted,

ARNO HERZBERG
Certified Public Accountant

STATEMENT OF HAROLD M. SHAPERO, ESQ.
ON THE EFFECTIVE DATE OF SECTION 511
OF H. R. 13270, THE TAX REFORM BILL OF
1969

My purpose in requesting appearance before the Committee was to seek a clarification of the language of Section 511 (c) so that it will unambiguously state that Section 511 eliminating long term capital gain alternative tax will not apply to transactions made pursuant to a binding contract of sale or disposition entered into on or before July 25, 1969 rather than the present ambiguous provision making it applicable to "sales or dispositions made after July 25, 1969". Since the Committee was unable to grant my request for appearance, this statement is being submitted instead as suggested by the staff.

I am an attorney-at-law, a member of the firm of Shapero, Shapero & Cohn, with offices at 2525 Cadillac Tower, Detroit, Michigan, 48226, WOodward 2-8164. I have actively practiced law for forty-eight years and have done considerable corporation, real estate and tax work during that period. This is the first time I ever requested an appearance or submitted a statement to a Congressional Committee. I am confining my remarks to the provision of Section 511 (c) of such Bill.

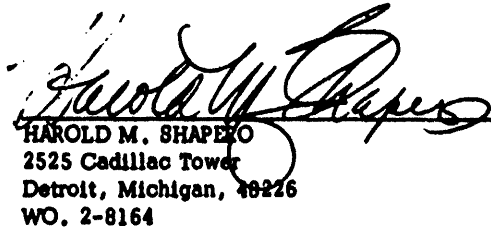
It seems apparent this effective date provision was intended to prevent large number of persons from entering into transactions after July 25, 1969, when the proposal to eliminate such alternative tax was first released by the House Ways and Means Committee to the public and thereby obtaining preferential alternative tax treatment. However, the language of the Bill is ambiguous and could possibly be held to apply to transactions made before July 25, 1969 but actually closed after that date, if a technical and narrow construction is given to the words "sale or disposition".

I have several clients in the category of taxpayers who entered into binding contracts of sale before July 25, 1969, but such sales were or will be closed after July 25, 1969. Since the transaction was bargained for and the obligation to sell became firm at the signing of the contract of sale, the change of position by the taxpayer occurred at that time and not later when the sale was actually closed. The act of closing does not substantially change the taxpayer's position from what it was before the closing, since the closing only is the act of performing what the taxpayer had already obligated himself to do. The decisive economic change occurred when the contract was entered into obligating the taxpayer to sell, and fixing the consideration to be received by the taxpayer as well as the terms of the sale.

I am sure that the House Ways and Means Committee intended that the provisions of Section 511 would not apply to a transaction entered into by a written contract binding on the taxpayer before July 25, 1969 notwithstanding that the actual closing took place after that date. In fact, I have been so advised by a member of that Committee. HOWEVER, unfortunately the language used may be ambiguous, and if not changed will undoubtedly lead to litigation under the claim that the words "sale and disposition" should include a sale closed by actual instruments of transfer after the critical date even if the taxpayer had irrevocably bound himself to the transaction before the critical date. To avoid this litigation and its attendant injustice if determined adversely to the taxpayer, the effective date provision should be modified so as to make its provisions inapplicable to transactions entered into under a written contract binding on taxpayer before July 25, 1969, irrespective of whether or not it was actually closed before such date.

Analagously, Section 703 of the Tax Reform Bill repealing the Section 38 Investment Credit, provides, in a new Section, being Section 703 (a), that the elimination of the Investment Credit shall not apply to property "acquired pursuant to a contract which was on April 18, 1969, and at all times thereafter binding on the taxpayer." The reasons for the effective date provisions of Section 703 to protect taxpayers who have in good faith bound themselves before the critical date from being thwarted in his reasonable tax expectations ex post facto, are exactly the same as such reasons for effective date contained in Section 511.

I strongly urge that Section 511 (c) of the House Bill be amended by inserting after the words "sales and other dispositions after July 25, 1969" the words "but not to sales made pursuant to written contracts binding on the taxpayer on such date."



HAROLD M. SHAPERO
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WO. 2-8164

Dated: September 9th, 1969.

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STATEMENT*

of the

INVESTMENT COMPANY INSTITUTE

ON THE TAX REFORM BILL OF 1969 (H.R. 13,270)

FILED WITH THE SENATE COMMITTEE ON FINANCE, SEPTEMBER 16, 1969

This statement is presented on behalf of the Investment Company Institute, 61 Broadway, New York, New York, and is directed to the changes proposed to be made by sections 511 and 514 of H.R. 13,270 in the federal capital gains tax structure.

We oppose removal of the 25% "ceiling" rate on "long-term" capital gains and extension of the holding period from 6 to 12 months. In this connection, we note that the Administration, speaking through Secretary of the Treasury Kennedy, strongly recommended on September 4, 1969 to the Senate Finance Committee the continuation of the 25% ceiling rate and retention of the 6 months holding period.

We take this position because in our view the effect of imposing such additional burdens on capital gains will be to discourage desirable investment in business, particularly new enterprises, to reduce rather than increase tax revenues, and, of particular importance to mutual funds and their over 5 million shareholders, to impair the depth and liquidity of the national securities markets and to interfere with the orderly carrying out by mutual funds of sound investment policies.

The Investment Company Institute is an association of 261 mutual funds

*Presented by John C. Bogle, Chairman of the Board.

(technically known as open-end investment companies) and their investment advisers and principal underwriters. Our member mutual funds have over 5 million shareholders, assets of over $45 billion and represent approximately 93% of the total assets of all U.S. mutual funds.

Mutual funds provide their shareholders with diversification of investment risk, skilled professional management and a variety of other services. Mutual funds thus make available to the investor of modest means the type of investment management and diversity that was once available only to the wealthy investor who could afford to hire a private investment counselor. Mutual fund assets are invested in a very wide selection of common stocks, preferred stocks, bonds and U.S. government debt obligations.

The mutual fund is a unique investment vehicle in that, in addition to continuously offering its shares to the public, it stands ready to redeem its own shares at any time at the then current net asset value per share. It therefore serves investors, small and large, as an excellent medium not only for the accumulation of an equity investment over a period of time but also for easy liquidation of such investments when investment goals have been realized. The amount invested in the average mutual fund account is $5,100.

As of June 30, 1969, the mutual fund members of the Investment Company Institute had in their shareholder accounts:

> 2,605,892 regular shareholder accounts where the dividends and capital gain distributions were being automatically reinvested in mutual fund shares. This is a favored form of systematic savings;

257,770 shareholder accounts which were "systematic withdrawal" accounts - providing for periodic payments (usually monthly) to the shareholder. These are a favored type of account for retired persons.

Over $2.3 billion dollars of long-term capital gain dividends were distributed to shareholders of mutual funds in 1968.

1. GENERAL

We believe that the provisions of Sections 511 and 514 of H.R. 13,270 which would eliminate the alternative capital gains tax rates and extend the holding period from 6 to 12 months, would be regressive in their effect. They would have a harmful effect on both mutual funds and their shareholders. The direct effects on mutual fund shareholders, while similar to the effects on the holders of any other security, are even sharper in impact.

Mutual funds are advised and managed by highly trained and skilled money managers who are in the business of determining on a continuous basis the investment merit of companies in whose securities they invest. An increase in the tax rates on portfolio changes resulting from prudent investment decisions is, in substance, the exaction of a penalty on the investment skill of the manager. Furthermore, the proposed increase in the holding period would have the unhealthy effect of deterring a fund manager from making a desirable portfolio change for an inordinate period of time. The tax impact of realizing a short-term rather than a long-term gain would be

a powerful factor in freezing an investment when sound investment discretion calls for disposing of it.

On the other hand, we have seen nothing that gives true economic support to these proposals. The justifications in the Ways and Means Committee Report for the proposed alternative tax rate changes and those in the "Summary of H.R. 13,270" prepared for the Finance Committee, do not rest on any statistical or economic base. They rely wholly on discussions of "equity" as between taxpayers and the need for deriving additional tax revenue from the "super rich" (Summary, p. 81) and "high income" taxpayers (Committee Report, p. 146).

We urge that these are superficial and far too limited considerations on which to erect a sound capital gains structure. The importance of capital transactions to the economic life of the country demands that capital gains tax rules reflect a proper balance between revenue yield to the government from a capital gains tax, and burdens on capital formation and mobility.

Tested by these criteria we do not believe that there is any justification for making the federal income tax on capital gains more burdensome than it already is.

II. INCREASE IN CAPITAL GAINS TAX BURDEN [illegible] REMOVING THE 25% [illegible]

A removal of the 25% ceiling on capital gains [illegible] increase the capital gains tax on many transactions.

The present capital gains tax structure is an [illegible] source of tax revenue to the government as shown by the figures on the following table:

"Net Capital Gains"
Included in Adjusted Gross Income
on Tax returns.

Year	Amount	Number of tax returns
1963	5,700,000,000	4,900,000
1964	7,900,000,000	5,300,000
1965	10,200,000,000	5,900,000
1966	9,950,000,000	6,000,000
1967	13,500,000,000	6,900,000

[These are the amounts included in adjusted gross income on income tax returns; tax collections on capital gains are not reported separately. From Commissioner's Annual Report and Statistics of Income.]

These figures clearly show the importance of capital gains revenues to the national economy, and warn that only a well documented statistical and economic case should provide the basis for tampering with the structure producing these revenue yields.

We do not believe that an economic case against the present capital gains tax structure can be made out on the basis of a relatively few taxpayers of very high income and high deductions.

The fact is, as Congress has recognized, that increased burdens on capital gains place in jeopardy the tax revenues from capital gains. People with savings available for investment will naturally be more reluctant to risk their savings in capital transactions

when the prospects for capital gains are diminished by an increased rate of tax or by an undue protraction of the period when their investment must remain at risk despite an adverse change in circumstances. To the extent that people refrain from sales of capital assets, whether it is a relatively richer person selling stock or a relatively poorer person selling his private home to move into an apartment, the determination of whether these sales will take place will be substantially affected by how much of the proceeds will be taken from the investor by federal and state taxation. With respect to those transactions which do not take place because of adverse effects of these proposals the federal government would be in a position of having given up 25% of something in return for 38-1/2% or 32-1/2% of nothing.

What seems to have been glossed over in the proposal for an increase from 25% to a 38-1/2% capital gains tax ceiling in the last five months of 1969, 35% in 1970, 33-3/4% in 1971 and 32-1/5% in 1972, is the burden of state income taxation which, as is widely known, is steadily increasing. Most states have income taxes; many are "federalized". In New York the rate on capital gains is 7% plus 1% more for those in New York City. The tax burden on a sale is not just the federal rate - it is the federal plus the state rate.

Investors will naturally shrink from "selling into" a high capital gains tax. This has been repeatedly recognized by the Congress. In 1942 the House Ways and Means Committee stated:

"It has been shown that too high a capital gains tax will result in loss of revenue to the Government. This is because the question of whether or not a gain will be realized is entirely within the discretion of the taxpayer." (underscoring supplied)

In fact, the validity of this reasoning has been publicly recognized by the House Ways and Means Committee and Senate Finance Committee in 1921, in 1938 and in 1942. Attached hereto as an Annex is a summary history of federal taxation of capital gains since 1913. The reports of the House Committee on Ways and Means and the Senate Committee on Finance over the years warn against regressive capital gains tax rules as an economic evil and as having a negative impact on tax revenues.

Thus, we urge this Committee to consider carefully the real danger that heavier tax burdens on capital gains will lower the revenue yield to the government and also slow down the growth and development of the American economy because of regressive effects on the nation's capital markets.

III. The Holding Period - 6 to 12 months

The proposal to increase the holding period from six to twelve months is in itself a dangerous change and can have a serious effect on the nation's securities markets.

We believe that the justifications supporting the proposal which are contained in the House Committee Report and the "Summary" (p. 85), are -

1. It is a step ". . . necessary to restore the original concept of the capital gains tax . . ."

2. "A person who holds an investment for little more than six months is primarily interested in obtaining speculative gains * * * which may be taxed at favorable rates."

* * * Further, a study made in 1962, of gains from corporate stock transactions revealed that almost 90% of all capital gains in that year arose from sales occurring after one year of possession. * * *"

As to restoring the "original concept of the capital gains tax", reference is made to the Annex hereto which shows that the "concept of the capital gains tax" cannot be considered separately from revenue collection and capital formation and mobility.

The speculator versus investor "finding" seems to be no more than an unstudied opinion on a dividing line that is bound to be obscure at best. Beginning with the Revenue Act of 1942 (see Annex) and for 27 years, the Congress has been satisfied with six months as the dividing line. This dividing line was first proposed by the Senate Committee on Finance (see Annex). Also, as shown in the Annex, in the course of development of the Revenue Act of 1950, the House Committee on Ways and Means, the House of Representatives and the Senate Committee on Finance all thought the holding period should be reduced from six months to three months.

In this connection, the Senate Committee on Finance in its Report on the Revenue Act of 1950 (Int. Rev. Rul. C.B. 1950-2, p. 523) stated:

"In the opinion of your committee the 6-month holding period requirement used in existing law is longer than necessary and there are good reasons for reducing the requirement to the minimum consistent with the fundamental policy of the Congress on the taxation of capital gains. A long holding period has a disturbing effect on prices in the markets for capital assets, which is most unfortunate. When prices rise, as has been the case in the security markets during the last year and notably in the commodity markets during recent weeks, sales which would otherwise have occurred do not take place until they can qualify the gains as long-term and obtain the resulting tax benefits. The consequence is that a check on the price movement which would otherwise appear is missing.

"In the opinion of your committee the reduction in the holding period from 6 months to 3 will not impair its effectiveness as a device for confining the more favorable tax treatment to the investor group."

The findings of the Finance Committee in 1950 are as valid in 1969 as they were in 1950. Since these findings support a reduction to three months they certainly support at least the maintenance of the present six months rule, and are inconsistent with the proposal for an extension of twelve months.

This brings us to a major point of concern on behalf of mutual fund companies and their shareholders. Extension of the holding period is bound to be seriously disruptive of the depth and liquidity of the securities markets of the country and will therefore tend to inhibit sound portfolio management.

In 1968, mutual funds purchased and sold for their portfolio over $38 billion of securities in the nation's securities markets. Mutual funds and their shareholders thus have a vital stake in the preservation of soundly functioning markets.

The concepts of depth and liquidity are critical to the efficient functioning of a securities market. * In this context liquidity means the ability of the market quickly to absorb or produce securities, while depth means the ability of the market to absorb or produce a reasonable amount of stock at prices reasonably related to previous transactions within a reasonable time.

* See Report of Special Study of Securities Markets of the Securities and Exchange Commission (1963), Part 2, pages 17-20, 828-829.

An efficient market will have "sufficient depth or liquidity to maximize the likelihood that both sides of a transaction will be available and to prevent disruptive price fluctuations in response to relatively small fluctuations in supply and demand . . . [T] he . . . effectiveness of the Exchange market depends upon maximizing the volume of transactions brought to it . . ." *

The depth and liquidity of the American securities markets are the envy of the world and have been a constructive force in the free enterprise system. There can be no doubt that extension of the 6 months holding period to 12 months will discourage many securities transactions and thus detract from depth and liquidity. No one can predict the actual extent to which this will occur. However, it must be recalled that the 6 month holding period has been law for 27 years - since 1942. The securities markets and investor of the country are "tuned"to it. This depth and liquidity should not be threatened by what clearly seems to be an undocumented case that 12 months is the proper period of time for defining a long-term capital gain.

Certain statistics, based entirely on corporate stock transactions during 1962, have been advanced, from which it might be inferred that the depth and liquidity of the markets would not suffer from increasing the holding period from 6 months to one year. Thus the House Report (p. 150) states that almost 90% of all capital gains on corporate stock in 1962 arose from sales occurring after 1 year of possession." In evaluating such statistics we think it most important

* Brief of the U.S. Department of Justice, Inquiry into proposals to modify the Commission Rate structure of the New York Stock Exchange, (April 1, 1968), pages 19, 26.

that 1962 saw the greatest market break since the great depression. In a break as deep and as serious as that which began in May 1962 a very significant part of the volume of selling comprised distress sales, forced sales and sales out of sheer panic.* To take the holding periods of sales which occurred in the year 1962 and insert them as a "norm" to prove a case for a 12 month holding period seems subject to serious question.

Not only would the ability of individuals and institutional investors to achieve fair prices in the securities markets be compromised by this proposal but a complicating adverse factor would be added to portfolio management. The requirements of the federal securities laws - primarily the Securities Act of 1933 and the Securities Exchange Act of 1934 - have produced large quantities of current and reliable information about the affairs of publicly traded enterprises which has never previously in the history of securities trading been readily available. No longer does the individual investor or the professional money manager have to wait from annual report to annual report to appraise the business success or failure of a particular company. Interim reports and reports of material changes are readily available and regularly disseminated as required by the securities laws and the rules of the major securities exchanges.

Today investors can withdraw capital from a faltering enterprise on the basis of current and timely information and reinvest it elsewhere as a result

* See Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 4, pages 812-859.

of continuing investment analysis and re-appraisal. The free enterprise system is strengthened by such capital mobility. The creation of an additional 6 month holding period to achieve capital gains treatment would involve an artificial roadblock against the free mobility of capital based on pure investment considerations.

Thus we believe that the 12 month holding period proposal contains the grave potential of serious disruption of the depth and liquidity of securities markets, would interfere with sound portfolio management by institutional and individual investors by holding out a tax advantage for freezing an investment, and is not based on any showing related to revenue needs or tax equity.

IV. INDIRECT TAX BURDENS ON CAPITAL GAINS

The same considerations thus far outlined in this statement as to the effect of a more burdensome capital gains tax on (a) capital gains tax revenues, and (b) capital formation and mobility, warrant the exclusion of long-term capital gains from those provisions of the Bill respecting limitation on tax preferences and allocation of deductions.

The deduction allocation proposal seems to be based on an assumption that the 50% of long-term capital gains is exempt income on the order of tax exempt interest on municipal bonds, or is a tax preference on the order of intangible drilling costs, etc. But the fact is that since 1942 long-term capital gains have always been regarded as 100% taxable income, with a ceiling of 25% on the tax.

Perhaps the biggest impact of the allocation of deduction provision would be in the area of reducing the deduction for state taxes. For example, a taxpayer in New York City in 1970 contemplating whether or not to make a sale resulting in long-term capital gain would, as to 100% of such gain, have a federal ceiling rate of 35% and a New York ceiling rate of 8% (7% state and 1% city) - a total of 43%. Actual rates imposed on the one-half of long-term gain used in the income computation on the tax return (if the taxpayer decides to "realize" the gain - he has the election not to sell) would be 70% federal and 16% New York, a total rate of 86% on 50% of his long-term gain.

This taxpayer is being told by the Bill that if he realizes that gain and pays a New York tax of 16% on 50% of the gain, the other 50% of the gain will be used to reduce his federal deduction for the New York tax he paid. In other words, the burden of the New York tax on his gain <u>will be increased</u> by using the 50% long-term gains that are left out of the federal tax calculation to deny him part of his federal deduction for this state taxation.

Faced with this dilemma, many taxpayers will <u>not</u> sell their securities or will delay sale for an extended period. The problems this creates are discussed in the earlier part of this statement.

V. CONCLUSION

For the foregoing reasons we respectfully urge that it is not in the public interest to place further burdens on capital gains and recommend that if consideration is to be given to changes in the federal capital gains structure such changes should be in the area of (a) reduction of the "ceiling" rate on long-term capital gains, and (b) reduction of the present six months holding period to three months.

THE INVESTMENT COMPANY INSTITUTE

By John C. Bogle, Chairman
Board of Governors

FOR THE SENATE COMMITTEE ON FINANCE

ANNEX

TO THE STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

ON H.R. 13,270

I. General

The provisions of the bill imposing higher tax burdens on capital gains - both directly and indirectly - and a longer holding period, run counter to the lessons of United States income tax history in experience with capital gains taxation.

This history teaches that high tax burdens and long holding periods on capital transactions:

(a) Reduce federal revenue from the taxation of capital gains.

(b) Handicap and reduce capital formation in the United States.

This history is a matter of public record, in some detail, in the reports of the House Committee on Ways and Means and the Senate Committee on Finance on major federal tax bills that have been reported by these Committees over the years.

II. Brief Chronology

A brief chronology of the federal capital gains tax structure (individuals) from 1913 to date is as follows:

1913 to 1921: no distinction between capital gains and ordinary income; such gains included in taxable income.

1922 to 1933: two year holding period to determine capital gain.

ceiling rate: 12 1/2%

1934 to 1938: capital gains taxed at regular rates, but taxable capital gain amount determined by a variety of holding periods:

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Holding period:	Taxable portion:
1 year	100%
1 to 2 years	80%
2 to 5 years	60%
5 to 10 years	50%
over 10 years	30%

1938 to 1942: ceiling rate of 30%, and taxable capital gain amount determined by holding periods:

Holding period:	Taxable portion:
18 months	100%
18 to 24 months	66 2/3%
over 24 months	50%

1942 to date: ceiling rate 25% - holding period 6 months.

Notes to foregoing:

1. Over this period there have been a number of variables in rules for the deduction of capital losses, including the portion deductible against ordinary income; also as to capital loss carry-overs.

2. In the development of the Revenue Act of 1950 both the House Committee on Ways and Means and the Senate Committee on Finance and the House of Representatives, approved reduction of the holding period from six months to three months. For reasons not explained in the conference report, this provision was dropped from the bill.

III. Proposals of H.R. 13,270

H.R. 13,270 proposes as direct changes in the capital gains tax structure:

(a) To lengthen the holding period from 6 months to 12 months.

(b) To eliminate the "alternative" capital gains tax rate for individuals - the 25% "ceiling," as of July 25, 1969.

Thus imposing these rate "ceilings" as to individuals:

Balance of 1969	38 1/2% (with surtax)
1970	35%
1971	33 3/4%
1972	32 1/2%

(c) To increase the corporate "alternative" capital gains tax rate to 30%.

(d) To reduce by 50% the amount of loss that can be deducted by individuals against "ordinary" income.

A number of other provisions of H.R. 13,270 put indirect and new burdens on persons realizing capital gains and losses. For example:

The provision containing the "Limitation on tax preferences" as to individuals. (Section 301)

The provision imposing rules for "allocation of deductions" as to individuals. (Section 302)

The provision imposing restrictions where an individual has investment interest deduction in excess of $25,000. (Section 221)

H.R. 13,270, by giving zero effect to the burden of state income taxes on capital gains, accepts another indirect burden - and the impact of this stems from (a) impact of state tax on top of federal, and (b) ignoring the severe effect of the deduction allocation rule in denying part of the impact of state income taxes on the taxpayer. Most states have income taxes; many states are federalized; state tax rates are high and the trend is for steady increase. In New York the rate is now up to 14% and those who live in New York City have another 2% burden.

IV. Revenue Act of 1921

It will be remembered that prior to the Revenue Act of 1921, capital gains were taxable as "ordinary" income. That Revenue Act provided for "favorable" capital gains treatment that lasted until 1934 (page references are to the reprint of this report in C.B. 1939-1):

Ways and Means Report No. 350, 67th Cong.:

(page 176) "Section 206: The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear

of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

Senate Committee on Finance, Report No. 275, 67th Cong.:

(page 189) "Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206 provides that only 40 per cent of the net gain derived from the sale or other disposition of capital assets shall be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 per cent. The maximum rate (normal and surtax) upon ordinary income after January 1, 1922, will be 40 per cent, and the maximum rate applicable to capital net gain will be 16 per cent. The House bill placed a similar limitation upon both capital gains and losses, but this limitation was not applicable to corporations nor to certain classes of taxpayers having net income less than $29,000. The Senate provision would permit a taxpayer to deduct the entire loss sustained in a capital transaction and is applicable to all classes of taxpayers. In Great Britain capital gain or loss is ignored or eliminated in computing the net income. Section 206 takes an intermediate position between the extreme views embodied, respectively, in the present American and British laws."

V. Revenue Act of 1934

This Revenue Act begins the period when the two tax writing committees fell into error - which they confessed later in 1938 and 1942 - and imposed a very burdensome capital gains tax structure (page references are to the reprint of these reports in C.B. 1939-1):

Ways and Means Report No. 1492, 73rd Cong.:

(page 561) "Our present system has the following defects:

"First. It produces an unstable revenue--large receipts in prosperous years, low receipts in depression years.

"Second. In many instances, the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value.

"Third. Taxpayers take their losses within the 2-year period and get full benefit therefrom, and delay taking gains until the 2-year period has expired, thereby reducing their taxes.

"Fourth. The relief afforded in the case of transactions of more than two years is inequitable. It gives relief only to the larger taxpayers with net incomes of over $16,000.

"Fifth. In some instances, normal business transactions are still prevented on account of the tax.

"Your Committee has examined the British system, which disregards these gains and losses for income-tax purposes. The stability of the British revenue over the last 11 years is in marked contrast to the instability of our own. In that period the maximum British revenue was only 35 per cent above the minimum, while in our own case the percentage of variation was 280 per cent.

"Your Committee, however, has been unable to reach the conclusion that we should adopt the British system. It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed. Your Committee recommends the following plan:

"First. To measure the gain or loss from the sale of property by an individual according to the length of time he has held the property, only the following percentages of the recognized gain or loss are taken into account for tax purposes:

"One hundred per cent if the capital asset has been held for not more than one year.

"Eighty per cent if the capital asset has been held for more than two years.

"Sixty per cent if the capital asset has been held for more than two years but not more than five years; and

"Forty per cent if the capital asset has been held for more than five years.

"Second. In the cases where the losses taken into account as above exceed the gains so taken into account, the excess losses are entirely disallowed.

"Third. In the case of corporations the graduated percentage reduction of gains and losses does not apply. However, capital losses sustained by corporations are allowed only to the extent of capital gains. Under the present law corporations are allowed to offset capital losses against ordinary income.

"Fourth. The plan outlined above is not made applicable, for obvious reasons, to stock in trade or property which is included in the taxpayer's inventory.

"It is believed that the adoption of this plan will result in much greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, and will yield substantially greater revenue. The method proposed is safe from a revenue standpoint, inasmuch as capital losses can not be used to reduce ordinary income, while gains are taxed in full or in part in proportion to the time for which the property has been held. The existing method which has been in force since 1921 can be defended only on the ground of expediency."

<u>Senate Finance Committee Report No. 558, 73rd Cong.:</u>

(pp. 594-596) Restates the Ways and Means Committee comment and adds a very significant statement. It is "significant" in the sense that it is shown by later events to be erroneous:

"<u>Substantially increased revenues are expected</u> from this new system of treatment of capital gains and losses. The changes

made are either to prevent tax avoidance or to bring about greater equity. No consequential amount of revenue is lost by these changes." [emphasis supplied]

VI. Revenue Act of 1938

These are the reports when both committees confess the 1934 error and begin the retreat to a more rational capital gains tax structure (page references are to the reprint of these reports in C.B. 1939-1):

Ways and Means Report No. 1860, 75th Cong.:

(page 32) "Considerable complaint has been made in respect to the present method of taxing the capital gains and losses of individuals. It is claimed that the present tax is so high, especially in the case of taxpayers subject to high surtax rates, that assets become frozen and few transactions take place. It is claimed that, if some relief were given, transactions would take place and the revenues be increased. Some fault has also been found with the percentage brackets governing the amount of gain or loss to be taken into account. * * * It has been claimed that these sharp reductions in the percentages of gain or loss taken into account encourage taxpayers to delay taking gains and, on the other hand, stimulate them to realize losses.

"It must be recognized that differences exist in the characteristics of ordinary income in comparison with the characteristics of income from capital gain. For example, no matter how high the rates, a taxpayer always benefits from an increase in salary. On the other hand, there is no tax on the appreciation in value of property unless such appreciation is realized through sale or exchange. Thus, it becomes optional with a taxpayer whether to pay a tax on capital gains, since he avoids the tax by refraining from making the sale. It is the opinion of the committee that too high taxes on capital gains prevent transactions and result in loss of revenue. On the other hand, the committee is also of the opinion that there is no justification for a lower tax on a speculator on the stock market than on an individual receiving a like income from salary or business.

"The committee has endeavored to revise the tax on capital gains so as to improve the system without loss of revenue;

in fact, it is hoped the revenue from this source may even be increased.

* * *

"The principal improvements which will be obtained from the adoption of the proposed system are believed to be as follows:

"(1) The sudden reduction permitted at certain annual periods in the percentage brackets under existing law has been eliminated.

"(2) The maximum rate of tax on a capital gain, where the asset has been held over 5 years, will be 16 per cent. This is because only 40 per cent of the gain is taken into account, and a maximum tax rate on this reduced amount of 40 per cent is provided for. The 40 per cent rate will also give limited relief in the case of property held for more than one year and for not more than five years. It is believed that this proposal will tend to stimulate business transactions.

"(3) Speculative transactions, in a practical way, are separated from investment transactions by the system of short-term capital gains and losses and long-term capital gains and losses.

"(4) The present minimum percentage bracket of 30 per cent is changed to 40 per cent, which should increase the revenue to some extent.

"It is the hope of the committee that the changes proposed, if adopted, <u>will be of benefit to the public interested in making long-term investments and will permit transactions to be made which are now prevented by the existing tax system.</u> The proposed system is explained in detail in the latter part of this report. (emphasis supplied)

<u>Senate Finance Committee Report No. 1567, 75th Cong.:</u>

(page 783) "While it may be recognized that the House provision is a considerable improvement over existing law, the committee believes that the plan proposed in the House bill is excessively complicated and will not permit of a free flow of capital into productive enterprises. <u>The Committee is convinced that at the present time transactions are prevented by the capital-gains tax and that the result has been a material hindrance to business and a considerable loss of revenue.</u>

"There is an essential difference between income derived from salaries, wages, interest, and rents and income derived from capital gains. It is always to the advantage of the taxpayer to receive the first class of income, no matter what the rate of tax as long as it is less than 100 per cent. On the other hand, the tax in respect of capital gains is optional--the taxpayer is not obliged to pay any tax unless he realizes a gain by the sale of the asset. There is no tax under existing law if a taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer his investment from a bond in one company to a bond in another company. Thus, an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments. The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises. This is most unfortunate, because it adversely affects the employment situation. (emphasis supplied)

* * *

"The committee believes that this treatment of capital gains and losses will stimulate transactions, facilitate the flow of capital into new enterprises, release frozen capital and increase the revenues of the Government." (emphasis supplied)

VII. Revenue Act of 1942

It was the Revenue Act of 1942 which established, basically, the present capital gains tax structure - erected around a 25% ceiling rate and six months holding period. It should be noted that when the Bill left the House side for the Senate it reduced the holding period to 15 months (not six) but established the ceiling rate of 25%. It established the present pattern of two forms of gains - "short term" and "long term." The present six months holding period resulted from Senate changes in the Revenue Act of 1942 (page references are to the reprint in C.B. 1942-2):

House Report No. 2333, 77th Cong.:

(pp. 396-399) "Your committee has given careful consideration to the taxation of capital gains and losses. It has been shown that too high a capital gains tax will result in a loss of revenue to the Government. This is because the question of whether or not a capital gain will be realized is entirely within the discretion of the taxpayer. If the rates are too high, taxpayers will

not dispose of their property. This will result in the Government losing not only income taxes but also stamp taxes on transfers of property. Too high a capital gains tax will also have the effect of discouraging taxpayers from investing in new or productive enterprises. Suppose an individual with a large net income desires, as a matter of investment, to place some of his money in an airplane factory. It might be a new factory in which he is interested or he might come to the rescue of an existing factory which is desperately in need of capital. The usual way in which this is accomplished is for him to buy securities in the corporation. In order to do this, he will be compelled to sell certain of his property in order to raise money to make the investment. If the capital gains tax is too high, it will prevent him from undertaking the enterprise. (emphasis supplied)

* * *

"One of the chief complaints against the 1934 system was that the sharp reduction in the percentage of gains or losses dependent upon the time of holding the capital asset had a tendency to delay the taking of gains and on the other hand stimulated the realization of losses. Statistics for 1934 indicate that of taxpayers with incomes of over $100,000, 70 per cent of their net capital gains were derived from transactions involving assets held over 10 years, whereas in the case of taxpayers with incomes not exceeding $25,000, only 25 per cent of their capital gains came from transactions in assets held over 10 years.

* * *

"However, your committee realizes that since the realization of a capital gain is solely a matter within the discretion of the taxpayer, a too high capital gain tax rate will lose rather than gain revenue for the Government. With a top normal tax and surtax rate of 88 per cent, it is not believed that a moderate increase in the capital gain rate will retard capital transactions." (emphasis supplied)

Senate Report No. 1631, 77th Cong.:

(pp. 544,545) The Finance Committee accepted the philosophy of the House Report and went further in the revision of the capital gains tax structure by reducing the holding period requirement to six months. It noted:

"Your committee has made the following changes in the capital gains and loss section:

"The House bill defined short-term capital gains or losses as those held for 15 months or less. Your committee has reduced the holding period to six months. Therefore, gains and losses from assets held over six months are treated as long-term gains or losses, and gains and losses from assets held for six months or less are treated as short-term gains or losses. The realization of a capital gain is entirely a matter within the discretion of the taxpayer. If the rates are too high, the Government will lose not only income taxes but also stamp taxes upon the transfer of property. The net receipts from capital gains and losses have been steadily declining as shown by the following table:

Estimated net revenue from tax treatment of capital gains and losses of individuals and taxable fiduciaries, 1926–1940.[1]

[In thousands.]

Calendar year.	Estimated net revenue from capital gains and losses.	Estimated tax liability on other income.	Total tax liability.
1926	$[illegible]	$[illegible]	$732,47[illegible]
1927	[illegible]	[illegible]	[illegible]
1928	[illegible]	[illegible]	1,104,234
1929	[illegible],971	[illegible]	1,[illegible]
1930	−13,[illegible]	491,940	478,715
1931	−[illegible]	[illegible],126	[illegible],137
1932	−[illegible],917	[illegible]	[illegible]
1933	[illegible]	367,[illegible]	374,138
1934	17,107	[illegible]	511,[illegible]
1935	[illegible]	[illegible]	[illegible]
1936	[illegible],041	1,[illegible]	1,314,017
1937	[illegible]	1,[illegible]	1,141,[illegible]
1938	[illegible]	712,[illegible]	[illegible]
1939	[illegible]	[illegible]	[illegible]
1940 [2]	12,[illegible]	1,[illegible],271	1,[illegible]

[1] The estimates are restricted to returns with net income, including, however, in 1930–1940 taxable deficit returns. Estimated net revenue from capital gains and losses is the difference between (a) total tax liability under the provisions of the particular Revenue Act applicable to each specified income year and (b) estimated tax liability on other income if capital gains and losses had been entirely excluded from the tax computation.

[2] Preliminary.

Source: Treasury Department, Division of Research and Statistics, Mar. 9, 1942.

"Your committee believes that the lowering of the holding period will have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury. It is believed that a holding period of six months will be a sufficient deterrent to the speculator as contrasted with the legitimate investor." (emphasis supplied)

VIII. Revenue Act of 1950

This Revenue Act is significant in that both of the Committees and the House approved a provision which would have reduced the holding period from six months to three months. For reasons not explained in the conference report (page 585, amendment No. 83), the change was not made and the holding period continued at six months (page references are to the reprint of these reports in C.B. 1950-2):

Ways and Means Report No. 2319, 81st Cong.:

(page 425) "Under existing law the more favorable treatment accorded capital gains is restricted to gains on capital assets held for more than 6 months. Section 209(e) of your committee's bill reduces this holding period from 6 months to 3. Essentially the distinction between long- and short-term gains and losses is intended to confine the more favorable tax treatment to the gains and losses realized by "investors" and the holding period requirement is the test by which the "investor" is distinguished from the "speculator," whose individual ventures in the markets for capital assets tend to be of comparatively short duration.

"In the opinion of your committee the 6-month holding period requirement used in existing law is longer than necessary, and there are very good reasons for reducing the requirement to the minimum consistent with the fundamental policy of the Congress on the taxation of capital gains. A long holding period has a disturbing effect on prices in the markets for capital assets, which is most unfortunate. When prices rise, as has been the case in the security markets during recent months, sales that would otherwise have occurred do not take place because the owners of the assets desire to hold them until they can qualify the gain as long-term and obtain the resulting tax benefits. The consequence is that a check on the price movement which would otherwise appear is missing. Your committee's action in reducing the holding period from 6 months to 3 will reduce this tendency, thus contributing to the stabilization of the security markets which is highly desirable, since it tends to encourage the flotation of new issues and improve the flow of venture capital so essential to the continued progress of our economy. (emphasis supplied)

"In the opinion of your committee the reduction in the holding period from 6 months to 3 will not impair the effectiveness of this test as a device for confining the more favorable tax treatment to the investor's group."

Senate Committee on Finance Report No. 2375, 81st Cong."

(page 523) "Under existing law the more favorable treatment accorded capital gains is restricted to gains on capital assets held for more than 6 months. Section 211(c) of your committee's bill reduces the period for determining long-term gains and losses from 6 months to 3. Essentially the distinction between long- and short-term gains and losses is intended to confine the more favorable tax treatment to the gains and losses realized by "investors." The holding period requirement is the test by which the "investor" is distinguished from the "speculator," whose individual ventures in the markets for capital assets tend to be of comparatively short duration.

"In the opinion of your committee the 6-month holding period requirement used in existing law is longer than necessary, and there are good reasons for reducing the requirement to the minimum consistent with the fundamental policy of the Congress on the taxation of capital gains. A long holding period has a disturbing effect on prices in the markets for capital assets, which is most unfortunate. When prices rise, as has been the case in the security markets during the last year and notably in the commodity markets during recent weeks, sales that would otherwise have occurred do not take place because the owners of the assets desire to hold them until they can qualify the gains as long-term and obtain the resulting tax benefits. The consequence is that a check on the price movement which would otherwise appear is missing.

"In the opinion of your committee the reduction in the holding period from 6 months to 3 will not impair its effectiveness as a device for confining the more favorable tax treatment to the investor group." (emphasis supplied)

IX. Other Revenue Acts

It should also be noted that since 1942 in the course of several very major Congressional reviews of the entire federal tax structure no changes were made in the two basic fundamentals of the capital gains tax structure - the 25% ceiling rate and the six months holding period. These included:

1. The Revenue Act of 1951 - proposal to increase capital gains tax rate.

2. The complete recasting of the Internal Revenue Code in 1954 - to create the Internal Revenue Code of 1954.

3. The Revenue Act of 1962.

4. The Revenue Act of 1964 - and its major tax rate changes.

As to the Revenue Act of 1951, there is more instructive history as to the importance of not increasing the rate of taxation of capital gains.

The Revenue Bill of 1951, as it left the House, proposed general income tax increases, including an increase in the alternative capital gains tax ceiling rate of 12 1/2 percent - to a little more than 28 percent. The Senate Finance Committee, with the later support of the Senate, refused to agree to the increase in the capital gains tax ceiling rate. The Senate Finance Committee stated in its report (I.R.B. 1951-2, page 463):

> "Although the House bill increases the alternative tax on capital gains to a little over 28 percent, your committee's bill retains the ceiling rate in this tax at 25 percent. Your committee recognizes that capital gains are different from ordinary income in that the time of realizing a capital gain, to a substantial degree, is subject to the control of the taxpayer. Therefore, in this case, particularly high tax rates tend to discourage the realization of gains. Congress has recognized this as far back as the Revenue Act of 1942 by placing an effective ceiling rate of 25 percent on capital gains income. Since that time, although individual income tax rates have been both substantially increased and decreased, this ceiling rate has remained the same. In view of this your committee does not believe that it is appropriate to consider a change in this ceiling rate at this time." [Emphasis supplied.]

The House-Senate conference on the Revenue Act of 1951 was one of the longest of tax bill conferences. Finally, to settle the dispute between the two Houses on the ceiling capital gains rate,

a compromise was reached of adding one percentage point, for one year, to the 25 percent ceiling rate.

X. The "Very High" Individual Income Tax Rate Brackets - 1942 to Date

It is especially to be emphasized that the 25% ceiling rate as to capital gains, and the 6 months holding period, have endured since 1942 - and that during these 27 years the individual income rate brackets have been very high indeed.

Income	1945*/	1950	1955	1963	1968
$ 10,000	38%	38%	38%	38%	32%
32,000	65%	65%	65%	65%	55%
100,000	89%	89%	89%	89%	70%
200,000	91%	91%	91%	91%	70%

*/ To these rates should be added the 3% "normal tax" in effect in this year.

ROBERT O. ROGERS
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TELEPHONE
833-4898

September 9, 1969

Senate Finance Committee
Washington, D. C.

Gentlemen:

The undersigned is representing a client who will suffer substantial economic detriment if Section 511 of H. R. 13270, relating to the repeal of alternative capital gains tax for individuals, is enacted without providing transitional rules to cover those situations where a course of business action was adopted in reliance on the availability of the alternative tax.

With the exception of certain situations that are not pertinent to this statement, our system of government gives an individual the right to choose between retaining property or making a sale or disposition thereof. In making this choice, most individuals are concerned with the net amount that will be realized after the payment of all taxes incurred as a result of such transaction and not with the gross amount they may receive. It is only the after tax dollar that can be utilized for further investment or whatever purposes a particular individual might find appropriate.

Throughout the history of the many various Revenue Acts, the taxpayers of this country have been able to rely on the basic structure of then existing tax laws in making their business choices. This is true because Congress has always made transitional rules available for those who entered a transaction in reliance on those laws. In addition to being true, it is fair. The federal income tax is an integral part of substantially all contracts and the failure to provide transitional rules would violate the spirit of our form of government which prohibits the passage of a law after the execution of a contract which retrospectively changes the legal consequences of such contract. Indeed, this is recognized many times in the bill that is presently pending which, among other things, provides transitional rules for the changes applicable to the treatment of capital losses.

Some might argue that the repeal of the alternative tax is nothing more than a rate change, and that all taxpayers assume the risk of a rate change in making any executory contract. Such an argument ignores

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the true nature and purpose of the alternative tax. The alternative tax is a limitation on the rate structure and not a part of it and was designed for the purpose of allowing "***transactions to go forward without fear of a prohibitive tax." (1920) H. Rept. 350, 67th Congress, 1st Session, pgs. 10, 11. With the exception of a short period covering taxable years beginning after December 31, 1933, and before December 31, 1937, this limitation on the rate structure has been in force since its adoption in the Revenue Act of 1921. It is believed that such a history induces reliance on its continuation for the purpose of determining whether to enter an executory contract for the sale of a capital asset.

The matter involving my client is a case in point. During the year 1952, he inherited an interest in a closely held business enterprise (approximately 32.25%) having a then value of $2.9x. Primarily as the result of his efforts in managing the company, this had grown by the year 1969 to a corporation having a value of approximately $70x, and he had become the owner of appr ximately 94% of the outstanding common stock. In the early part of the y r 1969, he was approached by a broker who advised him that he could sell substantially all of the assets owned by the corporation for such value.

Numerous computations were made, and on the basis of his understanding that the capital gains tax would not exceed 27.5% of his profit, including the applicable surtax, a decision was made to advise the broker that the corporation was willing to sell for the prices indicated. Following this decision, the company adopted a plan of complete liquidation under Section 337 of the Internal Revenue Code of 1954, and during the first week of July, 1969, actually closed transactions involving approximately 80% of its assets. Following these sales, the company, as a practical if not legal matter, was bound to complete the plan of liquidation. Unfortunately, because of the necessity of retaining assets to meet claims and to wind up the affairs of the corporation, it was not possible to distribute all of the assets prior to July 26, 1969. Presumably, under the House bill, distributions after that date would not be subject to the alternative tax even though this particular taxpayer was required to make distributions after such date without regard to the remaining tax consequences.

My client now finds himself in a situation where a law has been proposed which would retrospectively change the terms of his contract. Obviously, many other persons throughout the nation have signed executory contracts who will be similarly effected. It is submitted that such retrospective taxation is unfair to those persons who were induced to sign executory contracts

by the long standing tax policy of this nation to limit the tax on capital gain by means of the alternative tax. As was noted by the Ways and Means Committee when it reinstated the alternative tax in the Revenue Act of 1938, "***the question of whether or not a capital gain will be realized is entirely within the discretion of the taxpayer. If the rates are too high, taxpayers will not dispose of their property." If persons subject to executory contracts on July 25, 1969, had known of the possible repeal of the alternative tax, their discretion may well have been exercised differently.

Because of the foregoing, it is respectfully requested that this Committee give consideration to providing transitional rules for the repeal of the alternative tax, and that such rules should make the alternative tax available to those persons who executed binding contracts prior to July 25, 1969, or who are receiving a capital or liquidating distribution from a corporation under a plan adopted prior to such date. In this manner, those persons qualifying under the transitional rules will receive the full benefit of their bargain.

Respectfully submitted,

Robert O. Rogers

ROR:jmw

Restricted Stock - Summary of The Singer Company's Position

No abuse exists and therefore no "reform" is required in the tax treatment of restricted stock issued under plans such as Singer's which:

1. Limit the aggregate number of shares of the employer's stock which may be issued.

2. Have been approved by the shareholders of the company.

3. Contain a reasonable expiration date, such as five to ten years. (i.e., require further shareholder sanction for continuance.)

4. Contain restrictions on the sale, pledge, hypothecation, gift, or other transfer of the shares for a period of not less than two years, with provisions for forfeiture in the event of termination of employment.

5. Make eligible a broad class of participants - in an executive incentive plan, all officers and key employees based upon individual contribution; in a purchase plan, all employees having at least one year's service with the company.

In addition, if the Congress were disposed to apply to the tax treatment of restricted stock the same holding rules established in the stock option revisions for capital gains treatment, such would be regarded as consistent and reasonable.

The Singer Company Statement

On Restricted Stock Proposals

We are concerned that legislation designed to curb abuses in the use of "restricted stock" would unnecessarily (and presumably unintentionally) adversely affect broad-based non-abusive restricted stock plans such as those of The Singer Company. These plans are an Executive Incentive Compensation Plan and a Stock Purchase Plan.

Under the Executive Incentive Compensatibn Plan, bonus awards of restricted stock may be made annually to some 1200 supervisory and managerial personnel depending on the earnings of the Company and the beneficiary's contribution to the performance of the Company as determined by the Plan Committee. The stock awarded contains restrictions against its sale, pledge, or other disposition for periods of not less than two years. The Plan also provides for forfeitures in the event of termination of employment before the restrictions have lapsed. This Plan, which was adopted with the overwhelming support of the shareholders of The Singer Company, was designed to provide participating employees not only with incentive pay for past services but also, by awarding them restricted stock with forfeiture

provisions, to induce them to perform efficiently on a career basis with The Singer Company. Thus the use of restricted stock places the employee "at risk" and provides an inducement to continued employment and high performance not available under qualified stock option plans. An executive given an option has just that - a choice. The same man has a commitment under our restricted stock plan.

The Restricted Stock Purchase Plan allows approximately 60,000 eligible employees to purchase stock in The Singer Company at 80% of its current market value. Payment for the stock is made through payroll deductions which are limited to 10% of the employee's salary. Restrictions on the stock provide that if the employee terminates his employment within two years of the date of acquisition of the stock, the Company has the right to re-acquire the shares upon repayment of the original purchase price. To date, the Company has, in fact, exercised its right to repurchase such shares in each instance.

We respectfully submit that legislation which substantially undercuts the effectiveness of broadly-based incentive plans such as ours is contrary to the interest of employees and shareholders and serves no discernible public interest.

Noting that the Congress in 1964 in reforming the rules with respect to qualified stock options established a three-year holding period as a condition of providing capital gains treatment, if additional safeguards are required in the treatment of restricted shares it would appear to be consistent and equitable to make a like requirement applicable to shares upon lapse of restriction.

In addition, it is our understanding that the Treasury wishes to consider in further study the taxability of deferred compensation. Clearly, the use of restricted shares is a significant form of deferred compensation. We urge that the tax treatment to be accorded restricted stock be given the same study and consideration which the Treasury observes is required in the case of other forms of deferred compensation.

SOUTHERN NATURAL GAS COMPANY
POST OFFICE BOX 2563
BIRMINGHAM, ALABAMA 35202

September 10, 1969

Honorable Russell B. Long
Chairman
Committee on Finance
United States Senate
Washington, D. C. 20515

Re: Section I(10) (Restricted Stock) of Press Release Concerning Public Hearings on the Subject of Tax Reform

Dear Sir:

This written statement is submitted by Southern Natural Gas Company ("Southern") of Birmingham, Alabama, on the question of whether the present tax treatment of restricted stock plans should be modified.

I

STATEMENT OF SOUTHERN'S POSITION

We believe that there are many sound reasons, of significance to Southern and to other industries in the South and the nation, for the preservation of the tax consequences and benefits of restricted stock plans under which a company can permit its employees to purchase its stock subject to reasonable restrictions. Therefore, we support the present tax treatment afforded by existing Regulations to our restricted stock plan whereby only our own common stock is distributed to our employees. We oppose the modification of such tax treatment as proposed in H. R. 13270.

If, however, the Committee sees fit to adopt such proposals or any similar changes, we respectfully urge that such amendments should not apply to plans adopted, approved and put into effect prior to the date such amendments were originally proposed. We are opposed to a cut-off date of February 1, 1970, as proposed in H. R. 13270, and urge that the phase-out period for restricted stock plans permit all prior plans to continue for a reasonable phase-out period such as, in Southern's case, four more years.

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III

ANALYSIS OF SOUTHERN'S PLAN

A. Brief Description of Southern.

Southern is a publicly-held natural gas company engaged in the production and purchase of natural gas and in the operation of an interstate natural gas pipeline system throughout the Southeast.

B. Brief Description of Southern's Restricted Stock Plan.

Pursuant to, and in strict accordance with, existing Regulations 1.61-2(d)(5) and 1.421-6(d)(2) of the Treasury Department, Southern on May 1, 1968, by action of its stockholders, has adopted a restricted stock Plan under which certain employees of Southern have purchased, and employees designated from time to time during the next four years by the Board of Directors may purchase, Southern's stock subject to restrictions provided in the Plan.

Under Southern's Plan, the Company's Board of Directors may issue, to employees designated by the Board, the right to be exercised within 60 days after the date of grant, to purchase stock subject to restrictions which prevent the employee from selling, transferring or otherwise disposing of it and which under certain circumstances require the employee to resell the stock to Southern at the purchase price.

Such restrictions remain fully in effect for one year after the employee purchases the stock, and then gradually lapse over the ensuing eight years. Thus, in effect, Southern's Plan is not an "option" plan in the usual sense.

C. The Internal Revenue Service Issued a Private Ruling in Favor of Southern's Plan.

So that Southern's Board of Directors, stockholders, management and optionees would be completely secure in their understanding of the tax status of Southern's Plan, Southern's attorneys requested a ruling from the Internal Revenue Service concerning the tax consequences to Southern and its participating employees under its Plan.

On April 29, 1968, the Service issued a Private Ruling to Southern stating, in pertinent part, that:

> "After carefully considering the plan presented, we conclude that if the stock is transferred strictly in accordance with the provisions of the plan:
>
> "1. An employee will realize compensation at the time the restrictions on the shares lapse or the shares are disposed of by the employee in an arm's length transaction (whichever event occurs first), in an amount equal to the lesser of:
>
> "(i) The difference between the purchase price and the fair market value of the shares (determined without regard to the restrictions) at the time of purchase by the employee, or,
>
> "(ii) the difference between the purchase price and the fair

market value of the shares (determined without regard to the restrictions) at the time the restrictions lapse or, in the case of earlier disposition, the consideration received on disposition." (Emphasis added.)

On the basis of and in reliance on such Ruling, Southern put its Plan into effect and represented to its employees that such Plan would continue until 1973.

D. Southern's Plan Serves a Genuinely Useful Economic and Social Purpose.

Southern believes that its Plan, with tax consequences under present law as stated in the Ruling of the Internal Revenue Service, achieves certain very specific, and undeniably valuable and valid, objectives. First, it assists Southern in attracting and keeping qualified management-level people in our Company and in our geographical area. Second, it enables Southern's key personnel to acquire a substantial proprietary interest in our Company. This will motivate them to increase their efforts to cause earnings to grow - which will benefit not only our stockholders, but also our community and the entire Southeast. And, finally, a major feature of Southern's Plan compels a participant to retain his stock for at least nine years if he wants to realize its full benefit. This will

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result in maximum effort for our Company and community for a significant period of time.

IV

THE COMMITTEE SHOULD FIND THAT CHANGES IN THE PRESENT TAX TREATMENT OF RESTRICTED STOCK PLANS ARE NOT JUSTIFIED

A. Under Existing Law, the Amount of Tax Involved is Clearly Related to the Taxable Event.

In analyzing the tax consequences which should result from the issuance of restricted stock to employees, there are two elements to be considered:

1. The occurrence of a taxable event - that is, receipt by the employee of an item of property constituting intended compensation to him; and

2. The occurrence of events which permit the valuation for tax purposes of that compensation.

Upon the sale or distribution to an employee of restricted stock, he has received property intended as compensation. However, because of the restrictions, which in Southern's case include a requirement of continued employment which would constitute "a substantial risk of forfeiture," it is not possible to determine the fair value of such property to the employee and the amount of the intended compensation. Such determination must await the lapse of the restrictions, or at least the lapse of substantial restrictions such as

the requirement of continued employment. When this occurs, under present law, the amount of compensation is determined and tax is imposed, but the amount of such compensation and tax is related back to the occurrence of the taxable event - that is, the receipt by the employee of the restricted stock. On the other hand, Section 321 of H. R. 13270 would determine the amount of compensation and tax solely on the basis of the value of the stock at the time when no substantial restrictions remain. In the case of a plan such as Southern's, where substantial restrictions amounting to a risk of forfeiture continue with respect to some stock for as much as nine years, we submit that the result achieved by existing Regulation Section 1.421-6(d)(2), and by the Private Ruling issued to Southern, is reasonable and proper, and is a more equitable treatment than that proposed by H. R. 13270.

The inequity of the House proposal is apparent when it is applied to a plan such as Southern's which requires the employee to make a substantial cash investment in the restricted stock at the time it is issued to him. If the stock has appreciated in value on the subsequent date when it is no longer subject to a substantial risk of forfeiture, then under the House proposal the entire difference between its fair market

value at such time and the amount invested by the employee will be treated as compensation and taxed as ordinary income. A portion of this appreciation, however, would represent an increase in value of the cash investment by the employee. As such, it clearly is not compensation and is entitled to be taxed as capital gain.

B. Comparison of Restricted Stock Plans to Non-Exempt Trusts is Misleading.

The Report of the House Committee on Ways and Means (Rept. 91-413, Part 1, p. 86) and the Staff Summary of H. R. 13270 (Committee Print, p. 51) undertake to justify the House proposal by comparing the issuance of stock to a non-exempt employees' trust and the issuance of restricted stock to an employee. The result stated when stock is issued to a non-exempt trust - that is, receipt by the employee of taxable compensation at the time of the transfer - occurs only if the interest of the employee is non-forfeitable at the time the contribution is made - that is, if there is no contingency which may cause the employee to lose his rights in the contribution (Internal Revenue Code Section 402(b); Regulations Section 1.402 (b)-1(a)(2)(i)). The House Report states that if stock is transferred to a non-exempt employees' trust and the employee will receive the stock at the end of five years if he is alive at that time, then the employee would be

taxed on the value of the stock at the time of transfer. This statement is apparently based on the provision in Regulations Section 1.402(b)-1(a)(2)(iii) that the mere fact that an employee may not live to the retirement date does not make his beneficial interest in contributions by the employer forfeitable. In its context, however, this statement in the Regulations has reference to a plan for pension or annuity payments, the duration and aggregate amount of which would be related to the life of the employee. It is questionable whether this provision would apply to the transfer of stock to a trust for delivery to an employee at the end of five years if he is alive at that time. Such a condition would appear to make the interest of the employee in such stock forfeitable under the statutory language of Internal Revenue Code Section 402(b).

The House Report also states that an employee with restricted stock can vote it and receive the dividends, while an employee-beneficiary of a non-exempt trust does not have these benefits. This is misleading, since in the latter situation the trustee of the trust would presumably be entitled to these benefits on behalf of the employee as beneficiary, so that he has them indirectly.

If the present treatment of restricted stock and non-exempt employees' trusts is to be compared, it is interesting to note that Regulations Section 1.402(b)-1 (a)(1) provides that if the employee's interest in a contribution to a non-exempt trust is forfeitable at the time the contribution is made, the amount of such contribution is not required to be included in the income of the employee at the later time when his interest becomes non-forfeitable. This contrasts with the treatment under present law of restricted stock plans like that of Southern, whereby the employee recognizes no income at the time the restricted stock is purchased, since it is "forfeitable" at that time, but is required to recognize income and pay tax at the later time when the restrictions lapse and his interest becomes non-forfeitable.

In any event, the transfer of stock to a non-exempt trust under the conditions stated in the House Report would be unusual. Likewise, the issuance of stock to an employee subject only to the restriction that it cannot be sold for five years differs substantially from a plan such as Southern's that contains a number of restrictions, including the requirement of continued employment. We submit that this example contained in the House Report is of questionable value and certainly does not justify the drastic change from present law that H. R. 13270 proposes.

C. Modification of Present Tax Treatment Will Not Result in Increased Tax Revenues to the Government.

We believe it is especially noteworthy that there has been no suggestion that the existing Regulations are resulting in any significant revenue loss to the Treasury Department or, conversely, that any new law will result in any significant increase in revenues. For example, your Committee's Print entitled "Summary of H. R. 13270, The Tax Reform Act of 1969," explaining arguments for the proposed amendments in H. R. 13270 does not contain the slightest hint along these lines (p. 52). In fact, one argument against H. R. 13270 is that "there is no real benefit accruing from making a change" since little revenue is involved (p. 52).

Actually, any change in the existing statutes or Regulations may have an adverse effect on the revenue. For example, if a corporate employer in the 48% tax bracket were to transfer 1,000 shares of its common stock, subject to restrictions which imposed a substantial risk of forfeiture, to an employee having taxable income of $20,000 (exclusive of the stock plan) at a time when the stock is worth $10 per share and - after the restrictions lapse five years hence - the employee were to sell the stock at its then value of $40 per share, the result on pre-surtax revenue to the Government would be:

1. Under existing law -

Employee would pay additional taxes of $9,040.

	Taxable Income	Individual's Tax	Additional Tax
Year Risk of Forfeiture Terminates:			
Excluding Stock	20,000	4,380	-
Including Stock	30,000	7,880	3,500
Year of Sale	35,000	9,920	5,540
			9,040

Corporation's tax reduction would be $4,800 (48% of $10,000).

Net revenue to the Government - a $4,240 gain.
($9,040 minus $4,800)

2. Under a change compelling employee's tax to be based on market value when the risk of forfeiture terminates -

Employee would pay additional taxes of $17,920.

	Taxable Income	Individual's Tax	Additional Tax
Year Risk of Forfeiture Terminates:			
Excluding Stock	20,000	4,380	-
Including Stock	60,000	22,300	17,920
Year of Sale (Sale price and tax basis are same)	20,000	4,380	-
			17,920

Corporation's tax reduction would be $19,200 (48% of $40,000).

Net revenue to the Government - a $1,280 loss.
($19,200 minus $17,920)

Thus, a change in the law based on the assumptions set forth above would result in a loss of net revenue to the Government of $5,520 ($4,240 - the net revenue gain

to the Government as shown above - plus $1,280 - net revenue loss to the Government as shown above). And if the employee's taxable income before the stock plan were $200,000 or more, the difference in loss of net revenue to the Government would be less pronounced but would still amount to $900.

We recognize that the tax consequences of any participation by an employee in a given restricted stock plan will vary according to the circumstances of such employee's financial situation and the facts surrounding the purchase and sale of the restricted stock. We have used 32% and 70% tax bracket examples in this written statement in order to better illustrate for you and the members of the Committee the fact that mathematical results will flow from any modification of the present tax treatment of restricted stock plans and the further fact that such mathematical results almost always have an adverse effect upon the Government's revenues. Therefore, we submit that the suggested change or modification in the present tax treatment of restricted stock plans is solely for the sake of change (See Committee Print, _supra_, p. 52).

D. Southern's Employees Should Not Be Penalized or Punished for Any Abuses Resulting From the Plans of Others.

Southern's employees should not be penalized or punished for abuses - if abuses there be - by other

companies which have adopted peculiar or undesirable plans or plans whereby property other than the employer's own common stock is distributed. We suggest that your Committee leave unchanged those portions of the tax laws which permit tax benefits to restricted stock plans whereby a company sells merely its own common stock subject to reasonable restrictions which adhere to all present applicable laws. Adoption of this suggestion will permit control of abuses without interfering with plans, such as ours, to which no taint of abuse attaches.

V

SOUTHERN SUPPORTS THE PRESENT TAX TREATMENT OF ITS PLAN AND OPPOSES MODIFICATION OF SUCH TAX TREATMENT

A. Present Tax Treatment <u>Should be Continued.</u>

As the Committee knows (Committee Print, pp. 51-52), present law does not contain any specific rules governing the tax treatment of restricted stock plans. However, Treasury Regulation Section 1.421-6(d) presently provides that our employees will incur no tax until the year in which restrictions lapse on the stock purchased. At such time the employee is deemed to receive compensation, taxable as ordinary income, in an amount equal to the difference between the purchase price of such stock and the lesser of the market

value of the stock (i) when originally transferred to him or (ii) when the restrictions lapse.

The plain facts are that the present tax consequences of restricted stock plans arise from well-considered attitudes of the Treasury Department after lengthy consideration of judicial pronouncements and there has been no public hue and cry for a change. Indeed, the need for such a change cannot be substantiated in law or fact and we respectfully submit that the public interest completely warrants and justifies the continuation of the existing tax treatment of restricted stock plans.

As we have pointed out elsewhere herein, stock option or stock trust plans simply do not provide any real "interest" in an employer's business and abuses and loopholes - if any there be - may be corrected and closed without doing irreparable damage to a proven benefit to personnel and community. We urge you and the Committee to reject the arguments advanced as being in favor of the change in the tax consequences of restricted stock plans as set forth in H. R. 13270.

B. The Effects of Changes as Proposed in H. R. 13270 are Undesirable.

The proposed amendments contained in H. R. 13270 will have the effect of changing existing Regulations

Sections 1.61-2(d)(5) and 1.421-6(d)(2) and thereby affect the tax treatment of restricted stock plans. Your Committee's Print sets forth seven arguments against adoption of the instant portions of H. R. 13270. These reasons - which we seek to emphasize by our endorsement - show that the change may:

> "(1) ...discourage employees' stock ownership of their employers' business.
>
> "(2) ...immediately tax the receipt of property which, in many instances, cannot be sold or otherwise disposed of by the taxpayer to pay the tax.
>
> "(3) ...tax capital appreciation of the property as ordinary income."

And that:

> "(4) Restricted stock plans are not, in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business.
>
> "(5) It is necessary to have these preferred stock plans so as to obtain and retain key employees.
>
> "(6) These tax incentives increase the economic productivity of business; hence, the benefits to everyone concerned are increased.
>
> "(7) Little revenue appears to be involved; hence, there is no real benefit accruing from making a change."

At the same time, adoption of the amendments of H. R. 13270 will punish all restricted stock plans - with or without abuses - regardless of the total benefits

and merits of plans which have no abuses and which have been sanctioned by private rulings of the Internal Revenue Service. And, as Argument (7), supra, succinctly notes, adoption of such amendments will not produce significant additional revenue, if any at all.

Therefore, for all of the reasons contained herein, we are opposed to the amendments of H. R. 13270 and we urge that such proposed legislation be rejected, in toto, by the Committee. After all, if "no real benefit" will accrue from the proposed changes, there is no real reason for change. And, we respectfully submit, a "reform" measure which produces no benefit is a futile, empty gesture.

VI

ADOPTION OF ANY MODIFICATIONS SHOULD NOT BE MADE RETROACTIVE

Even if it is assumed, arguendo, that existing law should be amended, such amendments should not be applied to plans - such as Southern's Plan - put into effect prior to the date that such amendments were originally proposed.

It is unfair and inequitable to penalize anyone by a change in long-standing and well-considered basic rules. Hence, we believe that even if certain changes in the law are adopted, such changes should not be applied to any restricted stock plan adopted prior to the

date such changes were proposed, where such plan was adopted in reliance upon judicial decisions, announced administrative policy, private and published rulings (and, in the case of Southern's Plan, an express private ruling). The benefits of a plan so promulgated should not be terminated when, as here, the problem of retroactivity can easily be avoided without prejudice to anyone.

We submit that the Committee, if it sees fit for some reason to recommend changes in the tax treatment of restricted stock plans, should allow our Plan, which was adopted on May 1, 1968, to retain all of the tax consequences set out in the Service's Private Ruling for the remaining four years of the Plan. Any other result would penalize Southern's employees because Southern's Plan calls for short-term purchase rights rather than options running the life of the plan.

And finally, we note that H. R. 13270 proposes a cut-off date of February 1, 1970, on purchases of restricted stock made pursuant to a plan adopted and approved prior to July 1, 1969 (Section 321, amending Section 85(f) of the Code). We urge your Committee to recognize the arbitrary and unreasonable character of such a cut-off date. The tax consequences of a plan which received express approval of the Internal

Revenue Service should be permitted to continue for a reasonable phase-out period - in our case, until 1973, since only four more years are involved in the total plan. We note that reasonable phase-out periods are provided for in other Sections of H. R. 13270. For example, Section 201 provides a five-year phase-out period relating to unlimited charitable contributions deductions and Section 401, relating to multiple corporations, provides a phase-out period of seven years for multiple surtax exemptions, accumulated earning exemption and small business deduction limitation. A similar seven-year phase-out period, in Section 401, is effective for treating the amount taxable on dividends received from affiliated corporations. And Section 442, relating to bad debt deduction of mutual savings banks based on percentage of income, provides a phase-out period of ten years beginning in 1969. These, as well as other examples contained in H. R. 13270, indicate very clearly a legislative intent to provide relief to those who have adopted courses of action in reliance upon prior legislative or administrative rules and regulations. Fairness dictates, we submit, that comparable relief be afforded to companies which have adopted plans and employees who have accepted or continued employment,

in good faith, in reliance upon existing law. Although the suggested cut-off date of February 1, 1970, indicates the desire to afford some relief such date fails to permit plans - such as Southern's Plan - to continue for a reasonable phase-out period, in our case only an additional four years.

VII

CONCLUSION

We support the present treatment afforded by existing law to restricted stock plans - such as our Plan - whereby the company merely sells its own common stock subject to reasonable restrictions. We oppose the modification of such tax treatment, principally because such modification is not necessary. It is also our position that any amendments to existing law should not be applicable to plans - such as our Plan - which were adopted before any changes were proposed.

At the same time, we want to make it crystal clear that we do not condone tax evasion or tax loopholes, nor do we deny our nation's acknowledged need for funds. Thus, it is important to note, without unduly repeating what we point out elsewhere herein, that the existing tax treatment of restricted stock plans is consistent with existing law, permits the

amount of tax to be related to the taxable event and produces maximum revenue under the circumstances.

In sum, we believe that the Committee will ultimately conclude that the present tax treatment is fair and adequate, that modifications are unnecessary and that changes need not be made merely for the sake of change.

We very much appreciate the opportunity afforded by your Committee to submit this written statement. In addition, we respectfully invite your attention to our written and oral statements appearing in Tax Reform, 1969, Hearings Before The Committee On Ways And Means, House of Representatives, Ninety-First Congress, First Session, Part 7, pages 2631-2642.

If we can be of further assistance to you, to the Committee or to its counsel, please let us know.

Respectfully submitted,

SOUTHERN NATURAL GAS COMPANY

Lewis Carroll
P. O. Box 2563
Birmingham, Alabama 35202

Harry C. Howard
King & Spalding
Trust Company of Georgia Building
Atlanta, Georgia 30303

cc: Honorable Tom Vail

33-758 O - 69 -- No. 5 -- 21

GEUDER, PAESCHKE & FREY CO.
324 North 15th Street
Milwaukee, Wisconsin 53201

September 10, 1969

STATEMENT TO SENATE FINANCE COMMITTEE IN LIEU OF A PERSONAL APPEARANCE

TOPIC: CAPITAL GAINS AND LOSSES

The law regarding distribution from qualified pension plans should not be changed. Specifically, capital gain treatment for lump sum payments upon permanent separation of employees from a company with a plan providing for lump sum distribution of benefits should remain.

1. Workers covered by pension plans are the backbone of the United States economy. They have worked hard for many years, and paid proportionately the highest taxes of any group. This tax money supported the senators while in office and paid their pensions when they retired. These taxpayers also supported relief recipients, other underprivileged people, and provided old age assistance for people who had not saved any money.

2. It is grossly unfair after a lifetime of hard work to arbitrarily reduce their life savings by taxing the company contribution at ordinary rates. Due to an annual inflation of 2% a year, which is certainly a minimal figure, in 30 years the company contribution would have declined to 40% or less of its value when contributed.

3. The feature of forwarded income averaging is too complicated to explain to pension plan participants, and even more complicated to calculate. When a person has retired, he does not wish to spend a great deal of money hiring a tax attorney to claim refunds over the following 5 years in order to recoup the excess taxes paid upon retirement.

4. While it is recognized that the government needs tax money to provide for the welfare of those who are unable to work, it should not penalize those people who are willing to sacrifice all their lives in order to provide for their own old age.

5. It is to the economy's benefit for corporations to contribute to such pension plans, as such funds become a source of capital which is invested and is used to provide jobs for the ever increasing numbers of people entering the work force. Nothing should be done to discourage this practice.

6. It is hoped that you will take these factors in consideration during your deliberations, and eliminate this confiscatory provision in House Bill HR 13270.

Sincerely,

GEUDER, PAESCHKE & FREY CO.

Bonner Hoffmann

Bonner Hoffmann, Secretary

BH:MK

STATEMENT SUBMITTED TO

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

TAX REFORM HEARINGS

by

INDEPENDENT RADIONIC WORKERS OF AMERICA

Chicago, Illinois
September 11, 1969

TOPIC: CAPITAL GAINS AND LOSSES

SUMMARY OF PRINCIPAL POINTS

I. House Report No. 91-413 (Part 1, 91st Congress, 1st Session, pp. 9-10) clearly shows that the general purpose of the Tax Reform Act of 1969, H.R. 13270 is to:

(A) Eliminate loopholes whereby a small minority of high income individuals escape tax on a large proportion of their income.

(B) Provide for payment of substantially the same tax by those with substantially the same incomes and to insure that the graduated income tax structure is working fairly as between different income levels.

II. House Report No. 91-413 (Part 1, 91st Congress, 1st Session, p. 154) states that the general reason for the tax revision on limitation on capital gains treatment effected by Sec. 151, H.R. 13270 on distributions from employee pension and profit sharing trusts is to correct the present capital gains tax treatment of qualified lump-sum distributions to highly compensated employees (which constitute deferred compensation) by taxing

employer contributions after December 31, 1969 as ordinary income.

III. Neither the general purposes of tax reform, nor the specific purpose of Sec. 515 are applicable to distributions from employee pension and profit sharing retirement trusts to hourly paid production and maintenance workers because:

(A) Limitation of capital gains treatment to distribution from employees' pension and profit sharing trusts to such employees do not constitute "substantial amounts of deferred compensation" which Sec. 515 taxes at ordinary income tax rates.

(B) Such distributions to such employees constitute their principal, and in most cases, only asset for retirement purposes (in addition to Social Security Retirement Benefits).

(C) Sec. 515 imposes an additional tax burden on those least able to afford it.

(D) Sec. 515 is inequitable in that it penalizes the little man (hourly paid employee) to get at the big fellow (highly paid corporate executive).

IV. Independent Radionic Workers of America recommends to the Committee on Finance, United States Senate, that the above inequities inherent in Sec. 515, H.R. 13270, can be cured by restricting the limitation on capital gains tax treatment to distribution from employee profit sharing and pension trusts.

(A) To employees whose compensation for services to an employer, computed on an annual basis, exceeds $25,000 annually or

(B) Whose lump-sum distribution from qualified employee pension and profit sharing trusts exceeds $100,000.

STATEMENT SUBMITTED TO

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

TAX REFORM HEARINGS

by

INDEPENDENT RADIONIC WORKERS OF AMERICA

Chicago, Illinois
September 11, 1969

TOPIC: CAPITAL GAINS AND LOSSES

TO: Senator Russell B. Long, Chairman
Senator Clinton T. Anderson
Senator Albert Gore
Senator Herman Talmadge
Senator Eugene McCarthy
Senator Vance Hartke
Senator J. William Fulbright
Senator Abraham A. Ribicoff
Senator Fred R. Harris
Senator Harry F. Byrd, Jr.
Senator John J. Williams
Senator Wallace F. Bennett
Senator Carl T. Curtis
Senator Jack R. Miller
Senator Len B. Jordan
Senator Paul J. Fannin

The Description of Submittor of Statement

This statement in opposition to the enactment into law of Sec. 515 -- Total Distributions From Qualified Pension, etc., Plans, H.R. 13270 (p.290, ll. 7-24 inclusive, p. 291, ll. 1-5 inclusive) is submitted by Independent Radionic Workers of America, Ronald T. Berg, President, 5812 West Grand

Avenue, Chicago, Illinois, 60639 (I.R.W.A.). The I.R.W.A. is an independent local union affiliated with the National Federation of Independent Unions, 910 17th Street, N.W., Washington, D.C. The I.R.W.A. is the certified bargaining representative of approximately 10,000 production and maintenance employees employed by Zenith Radio Corporation in Chicago, Illinois.

Reason Statement Submitted

On April 28, 1950, Zenith Radio Corporation (Zenith), Chicago, Illinois, established the Zenith Profit Sharing Retirement Plan (the Plan) for the benefit of its employees. All the members of I.R.W.A. who qualify under the terms of the Plan have been and are beneficiaries. In the intervening 19 years the Plan has provided the means by which I.R.W.A. members (1) have been able to retire from lifelong service of producing for the American economy with self-sufficient dignity not possible on Social Security benefits alone; (2) have received lump-sum benefits (having qualified by length of service) even though they did not continue in Zenith's employ until retirement; and (3) have left lump-sum benefits to designated beneficiary(ies) when death terminated Zenith employment.

The distribution payments to member-retirees or members whose employment is terminated for any other reason constitutes, in the vast majority of cases, the principal asset to support retirement or of a deceased member's estate. As the maximum considered compensation under the Plan presently is $11,500.00, its major percentage impact and benefit accrues to I.R.W.A. member-employees as compared with non-bargaining unit employees who are generally higher paid in supervisory and executive categories. While the treatment of all employees is the same, the group of employees to whom this Plan means the most, particularly in retirement, are the hourly rated

I.R.W.A. member-employees.

The foregoing comment is stressed to emphasize that the Zenith Plan is not a "favorable tax shelter" for deferred compensation of high-paid corporate employees designed for the purpose of avoidance of an equitable share of the tax burden. On the contrary, the Plan provides the economic substance by which senior citizens who have labored as blue-collar workers all of their working lives can retire or look forward to retirement at a decent level of living without burdening national and state welfare funds. They are thus enabled to live the evening of their lives in self-respect as free and independent American citizens. It is submitted, therefore, that any revision of the Federal Income Tax law which imposes an increased burden on the amount distributed to such member-employees is not in the best interest and welfare of all of the citizens of the United States of America.

The Issue

The specific issue presented by this Statement to this honorable Committee, in consideration of H.R. 13270, is whether the Committee should recommend passage of Sec. 515 of H.R. 13270 as it is now written. That section provides that part of the distribution from a plan such as Zenith's, beginning with the plan years commencing after December 31, 1969, which consists of what has accrued to the benefit of an employee during any plan year beginning before January 1, 1970, plus any part of the benefits accrued after December 31, 1969, which does not consist of an employer's contribution for the benefit of an employee shall receive the favorable long-term capital gain tax treatment provided for by Sec. 402 (a)(2) of the Internal Revenue

Code. The effect of Sec. 515 is to subject to income tax rates an employer's (such as Zenith's) contribution to each employee's account made for each plan year beginning after December 31, 1969. This places additional ordinary income tax burden under the five-year forwarding income averaging formula on retired employees, beneficiaries of deceased employees and employees whose employment is terminated for other reasons. In the latter case, the income would be added to earned income, thus raising the effective rate in most cases on earned taxable income.

Analysis of the Reasons for Revision Effected by Sec. 515, H.R. 13270

On the surface it appears that the revision effected in Sec. 515 is based on the equitable theory of closing a loop hole for avoidance of income tax on deferred compensation. The general principle is not opposed. However, Sec. 515, H.R. 13270 employs a shotgun approach that shoots down the little sparrows and the economic fat geese with one blast.

Examination of House Report No. 91-413 (Part 1, 91st Congress, 1st Session) makes it crystal clear that Sec. 515 was aimed at subjecting large amounts of deferred compensation paid by corporations to their highly paid corporate executives, by means of contributions to profit sharing or pension trusts, to ordinary income taxation treatment. Sec. 515 seeks to remove the favorable long-term capital gain treatment from such company contributions in plan years beginning after December 31, 1969. That this is the primary motivation for the revision accomplished by Sec. 515 clearly appears from the Report of the Committee on Ways and Means, House of Representatives. That Report states (House Report No. 91-413, Part 1, 91st Congress, 1st Session, p. 154):

"The capital gains treatment afforded lump-sum distributions from qualified pension plans allows employees to receive substantial amounts of what is in reality deferred compensation at a more favorable tax rate than other compensation received for services rendered. Moreover, it appears that the more significant benefits accrue to taxpayers with adjusted gross incomes in excess of $50,000.

"The manner in which the present treatment of qualified lump-sum pension distributions enable highly compensated employees to convert substantial amounts of deferred compensation from its regular ordinary income treatment to capital gains may be illustrated by the following example: Assume the case of a corporate executive who has an average taxable income of $100,000.00 for the 4 years prior to the distribution; receives a $500,000.00(net of any employee contribution) lump-sum pension distribution in January, 1970, after retiring in December, 1969. . . . ." (emphasis supplied)

Then follows a detailed explanation of the income tax effect of the revision written in Sec. 515 compared to the existing law. This is the sole example cited by the Committee on Ways and Means of the House of Representatives illustrating the general reasons for the revision incorporated in Sec. 515. The Report then continues (supra, p.155):

"Your Committee therefore considers it appropriate to restrict the extent to which lump-sum pension distributions receive the more favorable capital gain treatment, as compared to pension income received over a period of years of retirement. Moreover, it is also desirable to tighten the tax treatment of the amounts of distribution represented by employer contributions made to purchase employer securities for the plan, as those amounts are presently accorded capital gains treatment when the securities are distributed. The cost of the employer contributions in the stock would properly be considered as deferred compensation subject to ordinary income treatment when eventually received by the employee."

The Report of the Committee on Ways and Means, leaves no doubt that Sec. 515 was aimed at the specific category of highly paid corporate employees who received large amounts of deferred compensation as corporate contributions to tax exempt employees' trusts and the favorable long term capital gains treatment on payment of distributions from such trusts.

The result, however, on I.R.W.A. members, for example, will be that a long-time member of I.R.W.A. employed for 35 years at Zenith, whose hourly rate of pay may never exceed $3.00 an hour will be caught by the tax revision aimed at the corporation president who earns $200,000 a year and who has profit sharing or pension trust contributions made to his account of $50,000 a year. The $500,000 lump-sum pension distribution assumed in the example cited in the Report of the Committee on Ways and Means supporting the reason for the change effected by Sec. 515 compares overwhelmingly with the $20,000 - $25,000 that might be received by the $3.00 per hour member-employee on his retirement, yet the tax treatment is identical. Not only is this inequality, but on a percentage relationship between the two employees it is confiscatory with respect to the little man. Additionally, as has been pointed out above, the little man's sole asset for retirement in all but a very few cases is his Zenith Profit Sharing distribution. This cannot be believed to be so in the case of the $200,000 per year corporate president who, it can fairly be assumed, would have income-producing investments and/or insurance annuities purchased during his high income earning years. Indeed, the Report of the Committee on Ways and Means in its example as quoted above assumes taxable income of $35,000 annually in addition to the lump-sum pension distribution.

Sec. 515 does not distinguish between those who are "getting away with murder" and those "who will be murdered." Under Sec. 515, as now written the I.R.W.A. member-employee will pay ordinary income tax on all of Zenith's contributions to his account after December 31, 1969. It will be paid him in lump-sum in the year of his retirement or termination of employment for other reason, albeit this income will be averaged on the five-year "forward" averaging method.

It is submitted that this tax treatment of the comparatively lower income group, which includes all members of I.R.W.A., is not consistent with the stated reasons for tax reform as written by H.R. 13270. Your attention is directed to House Report No. 91-413, Part 1, supra, p. 9, where the Committee on Ways and Means states:

> "The fact that present law permits a small minority of high-income individuals to escape tax on a large proportion of their income has seriously undermined the feeling of taxpayers that others are paying their fair share of the tax burden. It is essential that reform be obtained not only as a matter of justice but as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of the taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved.
>
> "Tax reform is necessary both to be sure that those with substantially the same incomes are paying substantially the same tax and also to make sure that the graduated income tax structure is working fairly as between different income levels. Present law, because of various tax preferences, permits a minority of high-income taxpayers to escape payment of tax on a very large proportion of their economic income by arranging to receive various kinds of tax-free income and by taking advantage of a combination of special tax deductions. As a result, many high-income individuals pay tax lower effective rates than those with relatively modest incomes." (emphasis supplied)

It is submitted that the same treatment by Sec. 515 of the highly paid corporate president and the comparatively low-paid production and maintenance employee is utterly inconsistent with the above-stated reasons for tax law revision. The I.R.W.A., therefore, submits that the Committee on Finance of the United States Senate very carefully review Sec. 515 with specific emphasis on its contention that Sec. 515, as it now stands, is not equitable. Neither the purpose for the specific revision

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incorporated in Sec. 515, nor the general reasons for tax reform are achieved by levying an additional income tax on those who can least afford to pay it. In fact, Sec. 515 subverts that purpose and those reasons. Accordingly, I.R.W.A. makes the following recommendation to the Committee on Finance of the United States Senate.

I.R.W.A. Recommendation as to Amendment of Sec. 515 as Proposed by H.R. 13270

I.R.W.A. respectfully recommends to the Committee on Finance of the United States Senate that Sec. 515 be amended by restricting the limitation on capital gains treatment (H.R. 13270, 91st Congress, 1st Session, p. 290, lines 14-24 incl., p. 291, lines 1-2 incl.) of distributions paid after December 31, 1969 to employees whose compensation for services to an employer computed on an annual basis exceeds $25,000 per annum or to distributions paid after December 31, 1969 which exceed $100,000 in total.

This amendment to Sec. 515 would accomplish the specific purpose, compatible with the general reasons for tax reform, expressed by the Committee on Ways and Means in House Report No. 91-413, supra. At the same time, it obviates the objection herein stated that is is not equity to penalize the little man in order to get at the big fellow. This recommendation, if adopted, would further the social and moral welfare of the nation by encouraging the vast majority of American workers to largely provide for a self-sufficient retirement through their own efforts in cooperation with their employer. There can be no question that it would enhance taxpayer morale on the part of millions of employee-participants in existing pension and profit sharing trusts.

Respectfully submitted,

INDEPENDENT RADIONIC WORKERS OF AMERICA

By: [signature]
Ronald T. Berg, President

Counsel:

Jacob N. Gross
33 North LaSalle Street
Chicago, Illinois 60602
Area Code 312 346-0936

September 11, 1969

STATEMENT

submitted to the
SENATE FINANCE COMMITTEE

on behalf of
FIDUCIARY TRUST COMPANY OF NEW YORK

by

WALTER S. ROTHSCHILD
Cleary, Gottlieb, Steen & Hamilton
52 Wall Street, New York, N.Y.

Mr. Chairman and Members of the Committee:

On behalf of Fiduciary Trust Company of New York, we would like to call to the attention of the Committee the unfair and, perhaps, unintended effect of Sec. 515 of H.R. 13270, relating to the tax on lump sum distributions from qualified plans.

Under Bill Sec. 515, the portion of a lump sum distribution under a qualified pension or profit sharing plan equivalent to post-1969 employer contributions is taxed as ordinary income. This treatment parallels that proposed for deferred compensation under Bill Sec. 331. We do not endorse nor do we attack the decision to amend the law in this manner. We are concerned, however, at what we believe is the unfair effect of the operation of Bill Sec. 515 in combination with the repeal of the alternate capital gains tax (Bill Sec. 511), and the allocation of deductions to tax preference income (Bill Sec. 302).

Our client, the Fiduciary Trust Company of New York, is interested in the lump sum distribution provisions of the proposed Bill both as an employer and as a trustee of numerous pension and profit sharing trusts. Its experience has proven that many employees would prefer to have a total distribution at retirement rather than an annuity or fixed income for life. The lump sum gives the retired employee the flexibility to enjoy his retirement through the purchase of a retirement residence, or otherwise in a manner suited to his personal circumstances. It also permits him to use his investment judgment in preventing his retirement resources from being eroded by inflation. Fiduciary Trust has two qualified plans for its employees, both of which authorize lump sum payouts. Fiduciary would like to see its employees and others taxed fairly on these distributions.

Under present law, a lump sum distribution made to an employee of his entire interest in a qualified plan as a result of his separation from the service (referred to here as a retirement distribution) is treated as a long-term capital gain. Section 515 provides for the treatment of that portion of a retirement distribution under a qualified pension plan equivalent to employer contributions subsequent to December 31, 1969 as ordinary income to the recipient. The remaining amounts of the retirement distribution would continue to be treated as a long-term capital gain. Section 511 repeals the alternate capital gain rate (the 25% maximum), so that 50% of all long-term capital gains is always includible in the taxpayer's ordinary income. The side-effect of the repeal of the alternate capital

gains tax is that the receipt of capital gains will always affect the rate of tax on incremental amounts of ordinary income. This side-effect creates an undesirable result when applied to the income averaging provisions under Sec. 515.

Our principal objection to Bill Sec. 515 is with the operation of the five year forward averaging provision. It computes the tax in the year the retirement distribution is received by adding to the tax otherwise payable on all other income an amount equal to five times the additional tax produced by including in income one-fifth of the ordinary income portion of the retirement distribution.

The difficulty with the changes proposed by H.R. 13270 arises from the fact that in the same year the taxpayer receives the ordinary income portion of the retirement distribution, he also receives a large amount of capital gain in the lump sum distribution. Because H.R. 13270 calls for the repeal of the provision allowing a separate computation of the tax on capital gains, the ordinary income upon which the income averaging tax is calculated is received on top of the 50% of the capital gain added to adjusted gross income. Due to the progressive rates, the rate of tax applicable to the deferred compensation being received in a lump sum distribution remains abnormally high.

It is interesting to observe that the result is different in the case of lump sum distributions from plans covering self-employed persons, after which the forward averaging provision is patterned. These distributions are all ordinary

income, so that the entire distribution is subject to averaging. In that case the result is fair since the ordinary income is not taxed on top of a non-recurring capital gain attributable to the same distribution.

The refund provision provided by Sec. 515 of H.R. 13270 does alleviate some of the distortion created by the operation of the forward averaging method. Because the forward averaging method has the technical defect referred to above, the refund, or look-back method, will be the method under which virtually all recipients of retirement distributions eventually will be taxed. This fact in itself demonstrates that the forward averaging provision is technically faulty.

The refund method itself has several undesirable aspects. A taxpayer who dies in the second, third or fourth years after the year of the lump sum distribution suffers the inequities of the high tax in the first year but never receives the full five year benefits of the look-back.

The look-back provision has another defect. Under Bill Sec. 302, the capital gain portion of the retirement distribution will constitute a substantial tax preference under proposed new IRC Sec. 277. As a result, a portion of the taxpayer's personal deductions are allocated to the non-taxed half of the capital gain. Moreover, Bill Sec. 302 appears to provide that under the five year look-back provision the tax preference income in the year the retirement distribution is received is recalculated, with only 20% of the ordinary income portion of the retirement distribution being taken into account. This increases the amount of disallowed deductions unjustifiably.

This application of the disallowance of tax preferences to retirement distributions is unfair. The Committee's Report on Sec. 302 justifies the disallowance of deductions on the grounds that the personal expenses giving rise to the deductions (interest, state and local taxes, etc.) are paid from the tax preferred income. This is unlikely to be true in the case of a retiree receiving a retirement distribution. Moreover, in most cases, tax preferred income is recurring in nature. A retirement distribution is not.

Finally, it is undesirable to burden the taxpayers and the Internal Revenue Service with large numbers of avoidable refund claims, as would be the case under Bill Sec. 515, and it is unfair to require virtually all recipients of retirement distributions to make interest free loans to the government.

The effect of Bill Sec. 515 and Bill Sec. 302 is to subject the recipient of a distributed distribution to excessive tax. Moreover, there is no indication in the Committee Reports under either Section that consideration has been given to the precise way in which a modestly situated recipient of such a distribution would be affected. We, therefore, suggest an alternative treatment, as follows:

1. Exclude both the capital gains and ordinary income portions of the retirement distribution from the effect of Sec. 302 (relating to tax allocation of deductions in tax preference income);*

2. In calculating the tax on the forward averaging method, the capital gain portion of the distribution should be ignored; and

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* We also believe such distributions should be excluded from Bill Sec. 301, but this is beyond the scope of this statement which is limited to Sec. 515 and other Sections which directly affect Sec. 515.

3. Eliminate the look-back refund.

Our first recommendation is the exclusion of both the capital gain and ordinary income portions of the distribution from the effect of Sec. 302. A retirement distribution is by nature non-recurring and because it involves a bunching of income, does not really result in an unduly low tax burden on the recipient even with respect to its capital gain component. Therefore, to subject the distribution to additional tax through allocation of deductions is inequitable.

Our second suggestion is that the tax on the ordinary income portion of the retirement distribution be computed without regard to the portion of the retirement distribution capital gain. Thus 20% of the ordinary income would be taxed on the same basis as can be expected to be the taxpayer's normal retirement level, with the tax attributable to this 20% then multiplied by 5 to produce the five year forward averaging. In making this computation, all other income and capital gains received in the year of the retirement distribution would be taken into account. The non-recurring capital gain would then be taxed on top of this 20%, and would not distort the amount of tax on the ordinary income. Under this method, the incremental tax on which the averaging is based normally would be the approximate amount of tax payable if the distribution were received over five years.

The tax on the amount averaged will still be calculated on top of the other ordinary income that the taxpayer receives in the year of distribution, so that the separate computation will not unduly help the taxpayers with large

outside incomes. The income averaging provision will aid the mass of taxpayers who must rely upon a lump sum distribution to meet their needs during retirement years.

Finally, the rationalization of the forward averaging computation would permit the administratively undesirable refund provision to be dropped or, if retained, to be available principally to serve as an equitable relief for those whose incomes drop severely in subsequent years, rather than being the principal eventual basis for tax as now is the case.

Our proposals are not intended to benefit high paid taxpayers. The Committee should consider that substantial retirement distributions may be made under qualified plans to modestly compensated taxpayers. For example, a taxpayer with average career income of $15,000 who benefits from an employer contribution of 15% of compensation for 30 years would receive ordinary income of $67,500 as part of a retirement distribution. The capital gain portion of the distribution could be in excess of $100,000 (assuming level income, 6% average annual return, no benefit from forfeitures of other employees and no contributions by the employee himself). Thus, middle income taxpayers can benefit from retirement distributions with large ordinary income components, and, therefore, be subject to excessive tax under Sec. 515 as now drafted.

Secondly, the Committee should consider that the lump sum distribution may be mandatory rather than elected by the retiree. Many plans provide automatic lump sum distributions to simplify administration, and for other reasons. Even where taxpayers have a choice in the form of distribution, moderate

income taxpayers may request a lump sum without realizing the adverse tax it may have compared to an annuity. Thus, the annuity alternative may be denied to many taxpayers or they may unwisely fail to elect it. They should not be penalized, as they would be, under Bill Sec. 515 as now drafted.

We appreciate the opportunity to assist the Committee in providing a fair and equitable method of taxing retirement distributions.

Walter S. Rothschild

Statement of Eastman Kodak Company*
with regard to
Proposed Change in Tax Treatment of
Total Distributions from Qualified
Pension and Profit-sharing Plans.

Eastman Kodak Company maintains for its employees a qualified profit-sharing plan under which the company makes all contributions to the plan for the benefit of its employees. It is known as the Eastman Kodak Employees' Savings and Investment Plan, and was established in 1960. Company payments to the profit-sharing plan are made in the year following the year for which they are accrued on the company's books. As of June 1, 1969, 23,722 employees of Eastman Kodak Company were active participants in the Savings and Investment Plan which had a total market value in excess of $158 million.

When the employee retires, payments under the plan may be made either in a lump sum or at the request of employees may be made in installments. From the inception of our plan in 1960 through May 31, 1969, 5,847 employees or their beneficiaries had received lump-sum distributions totaling $31,792,000--an average of only $5,437 per employee. 684 employees had elected to receive installment settlements.

The proposed change in the method of taxing lump-sum distributions from profit-sharing plans would affect all of the thousands of Kodak employees now or hereafter participating in our plan. The change in the method of taxing lump-sum distributions is, therefore, of serious concern to us.

* Submitted by R. L. McKnight, Manager, Tax Department.

The present method of taxing lump-sum distributions was enacted in 1942 as an equitable means of taxing the receipt of a relatively large amount in one taxable year which had accrued for the benefit of an employee over a long period of time. The method is simple and has the result of imposing a fair tax upon an amount which has become to the employee a capital accumulation in the true sense of the word. This distribution enables the employee to use funds, which, although accumulated for him, have not been available to him, for any necessary purpose at the time when he retires. The plan is an important element in assisting our people in retirement. Participation therein should not be discouraged by increased taxation. Every sociologist in the country would applaud efforts such as the Kodak plan to make elderly retirees self-sufficient.

The proposed method would require a tax on an amount equal to the employer contribution in the fund on an averaging basis after the employee retires and is vastly complicated. It will impose an additional tax on the millions of employees throughout the country who will be affected. The averaging method will surely result in many failures to claim refund with attendant tax windfalls to the Internal Revenue Service at the expense of the tax unwary.

Furthermore, the provisions will be difficult to explain so that the average employee will understand their effect on the method of taxing lump-sum distributions under the profit-sharing plan. In effect employers will have to describe two plans from now on--before and after January 1, 1970.

It would be unfortunate if, as a result of the proposed change in tax treatment of distributions under profit-sharing and pension plans, there is a reduction in the numbers of employees covered by such plans. The social benefits of having large numbers of employees participate in such plans and in having available additional funds for use after retirement we believe warrant continuing the present provisions of taxing lump-sum distributions entirely as capital gain.

We emphasize that under the revised capital gains provisions contained in the Tax Reform Bill the maximum tax on these distributions will be increased from 25% to 32 1/2%--a substantial increase in tax particularly on employees whose tax rates are in the maximum brackets.

We also suggest that in lieu of the complicated averaging provisions the Committee consider continuing to tax these distributions as capital gains but at rates no less than 20%, up to the maximum of 32 1/2%. It would be preferable, however, if the present capital gains provisions were continued, having in mind the proposed increases in capital gains tax rates.

We also note that under the bill amounts subject to ordinary income tax when received in a lump-sum distribution will not be entitled to the maximum rate on earned income provided by Section 802 of the bill and Section 1348 of the Code. We recommend that if a part of the lump-sum distributions from profit-sharing

plans is to be taxed as ordinary income that the 50% tax limit on earned income be made applicable to such distributions. Specifically we believe that the exception for distributions to which Section 72(n), Section 401(a)(2) or Section 403(a)(2) applies should be deleted from Section 1348(b)(1).

Thank you for your consideration of our suggestions.

EASTMAN KODAK COMPANY